

products; coal mining; chemicals; trucking; and electric power generation. Coastal is a Federal and Indian lands lessee, and, therefore, has an interest in the Proposed Rule.

II. COASTAL'S POSITION

A. In Regard to the Underlying Political and Business Environment

1. The royalty value of crude oil and condensate (**oil**) produced from Federal and Indian lands, onshore or offshore, is the market value of that oil at or near the lease.
2. The lessee has an express duty to place that oil in marketable condition at no cost to the Federal or Indian lessor. For the sake of argument, there may be an implied duty to market that oil at the lease, but there is no duty, express or implied, to market that oil downstream of the lease at no cost to the lessor. (This issue is currently the subject of litigation in the Federal Courts in IPAA v. Armstrong, et al. and API v. Babbitt, et al.)
3. Except for a few unique areas, there is a viable and competitive lease oil market which accurately reflects the market value of that oil at the lease.
4. The posted price for oil at the lease, by itself, may not always accurately reflect the market value of the subject oil. For example, depending upon competition, demand, quality and quantity available, and other market conditions, the oil purchaser may sometimes pay a bonus to the lessee or deem the gravity of the oil higher than it actual is (or, in a few unique areas, where there is no competition, the posted price may be too low). But posted prices, together with bonuses and other consideration, generally do accurately reflect the market value of oil at the lease.
5. If a wide-spread royalty under-payment problem actually exists due to the above described situation (as opposed to the mere possibility of cheating),
 - a. there is little or no evidence in the record to support it, except for a very few highly publicized cases in California (a unique oil marketing area) involving a few major producers who transported their oil to their own refineries, and
 - b. there is little or no evidence in the record to support the allegation that a sweeping rule change, such as the Proposed Rule, is required to deal with it.

6. Assuming, arguendo, that such a problem actually exists, this situation is already addressed in the present regulations, and, therefore, the present regulations do not need to be changed. For example:
 - a. “[royalty] [v]alue may not be less than the gross proceeds accruing to the lessee, including the additional consideration.” (30 CFR Part 206.102 (b)(1)(ii)), and
 - b. “The value of oil . . . not sold pursuant to an arm’s-length contract shall be the reasonable value determined in accordance with the first applicable of the following . . .” (30 CFR Part 206.102 (c))
 - c. “The Secretary, or his/her authorized representative, shall initiate and conduct audits relating to the scope, nature and extent of compliance by lessees . . .” (30 CFR Part 217.50.).

The above-quoted regulations (i) require lessees to include any additional compensation in the calculation of oil value for royalty purposes, (ii) provide for the determination of a reasonable value in the event of a non-arm’s length sale at the lease or the absence of competition at the lease, and (iii) grant the MMS full authority to enforce the regulations through the audit process. If any change at all is justified, it should be limited to California, which is admittedly a unique oil marketing area and which has the only documented cases of substantial non-compliance.

7. The MMS royalty audit process, carried out by MMS and State auditors, although sometimes burdensome and time consuming, is generally effective in ensuring compliance with the regulations and in discovering instances of non-compliance.
8. The vast majority of lessees who sell their oil at the lease to a third-party are honest, and they properly report and pay royalty in accordance with the regulations and based upon the full value of oil at the lease.
9. The vast majority of lessees who sell their oil at the lease to an affiliate (who in turn markets its own and others’ oil downstream of the lease in the “mid-stream market”) are also honest, and they also report and pay royalties in accordance with the regulations and based upon the full market value of the oil at the lease, as determined by the benchmarks in the regulations and their own independent knowledge of the regional lease oil market.

10. The MMS has little or no real world experience in the oil business, as shown by the Proposed Rule and its earlier drafts, and, without substantial evidence, assumes that every lessee is basically dishonest and that there is a giant conspiracy to defraud the Federal government. The MMS would be well served to initiate a meaningful Royalty In-Kind (RIK) program (where the government takes its royalty share of production in-kind rather than in-value) so that it could learn something first-hand about the oil business, and in particular, the risks and costs associated with the downstream marketing of oil, before it proposes changes to the existing valuation rules.

B. In Regard to the Proposed Rule

1. Coastal wishes to express its recognition of the fact that the MMS has modified the proposed rules in response to some of the comments. The Proposed Rule is a big improvement over the rule originally proposed in 1997, however, for the reasons stated herein and in Coastal's earlier comments, as well as the reasons stated in the comments submitted in this matter by Industry trade organizations, other lessees, and independent oil purchasers, Coastal remains opposed to the Proposed Rule.
2. The MMS refused, and continues to refuse, to meet with Industry to negotiate a new oil valuation rule that makes practical sense in light of current business practices and the evidence. Coastal has been available, and remains available, for such meetings, but only if the MMS is also ready to engage in meaningful negotiations.
3. For lessees, like Coastal, who have affiliates in the oil marketing, supply, and trading businesses, the current Proposed Rule, like the original proposed rule, continues to value oil at a point far downstream of the lease with no compensation to the lessee for the risks and costs associated with such mid-stream businesses (except direct transportation expenses as determined and allowed by the MMS). This is a prime example of either (i) the inexperience and lack of practical knowledge of the MMS, or (ii) the knowledgeable and intentional attempt to unlawfully increase royalty collections.
4. Any new royalty valuation rule should continue to value oil at the lease, preferably through a series of benchmarks similar to the present regulations, as previously proposed by Coastal and Industry trade organizations.
5. In order for such a benchmark valuation system to work efficiently, the MMS and the lessee should know on a current basis the market value of oil at the lease. There are at least two different methods that would accomplish this objective:

- a. The MMS, as part of its re-engineering plan, is now in the process of implementing programs to conduct royalty audits (i) on a field-wide or basin-wide basis, rather than on a company-by-company basis, and (ii) on a current basis rather than a backward basis. As a result, the MMS will shortly have current price data for each field or basin. With this database, an efficient and workable benchmark valuation system will become practical in the very near future, and the cumbersome and burdensome tracing and net-back valuation methodology for sales to affiliates, as set forth in the Proposed Rule, will become totally unnecessary.
 - b. In the alternative, for each major field or basin the MMS could (i) take a portion of its royalty share of oil in-kind and sell it at the lease, or (ii) it could permit the lessee to sell a portion of its oil to a third-party at the lease. In either event, the result could be the market value of the remainder of the oil not sold at the lease. Again, a cumbersome and burdensome tracing and net-back system is unnecessary.
6. Coastal continues to believe that the best long-term solution to the whole oil and gas valuation problem is RIK, thus eliminating almost entirely the necessity of royalty audits and its correspondingly large auditing staff. Coastal is available to the MMS to discuss and negotiate the details of a workable RIK program.
7. Coastal is an active member of the American Petroleum Institute (**API**) and the Independent Petroleum Association of America (**IPAA**), and has joined with other members of the API and the IPAA in drafting extensive written comments on the original rule, the supplemental rule, and the present Proposed Rule (collectively the **proposed rules**) on behalf of their respective members. In addition, Coastal actively participated in the public meetings held by the MMS on the proposed rules, and drafted and filed its own separate written comments on the proposed rules. Coastal hereby endorses and incorporates herein by reference the written and oral comments previously submitted in this matter by itself, the API, and the IPAA.
8. Coastal also hereby endorses, adopts, and incorporates herein by reference, the written comments submitted by the API in this matter during this latest extended comment period.

III. CONCLUSION

1. The Proposed Rule should be withdrawn.
 - a. There was no showing on the record that the present regulations are no longer workable, and, therefore, there is no justification for the radical changes set forth in the Proposed Rule. Rather than simplifying the valuation process, and thus reducing the audit burden, the Proposed Rule makes the whole oil valuation process more complex, more costly, and more burdensome, thus increasing the audit burden. Without justification or express authority, the Proposed Rule moves the valuation point for many lessees far downstream of the lease. Coastal would prefer to leave the current regulations and benchmarks in place (although it is not opposed to removing references to "posted prices" from the current regulations).
 - b. In light of the MMS' proposed intent to conduct future royalty audits on a current basis and on a field-by-field/basin-by-basin basis, there now may be no need for changing the current regulations.
2. In the alternative, Coastal requests the MMS to postpone the Proposed Rule indefinitely.
3. In either event, the MMS should promptly commence meaningful discussions with Industry to consider a negotiated rule.
4. If it is mutually determined that a new rule is necessary, MMS and Industry should work together to negotiate and draft a new workable oil valuation rule bases upon value at the lease, and propose it as a new Proposed Rule, or in the alternative, in the form of a Revised Notice of Proposed Rulemaking.

Minerals Management Service
Mr. David S. Guzy
April 26, 1999
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RESPECTFULLY SUBMITTED this 26th day of April 1999.

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