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Ms. Lucy Querques Denett
Associate Director, Minerals Management Service
United States Department of the Interior
1849 C Street, NW
Washington, DC 20240

Dear Ms. Querques Denett

Comments on Minerals Management Service Crude Oil Valuation Rulemaking, 64 FR 12267 (March 12, 1999)

Conoco Inc. (hereinafter "Conoco") respectfully submits the following comments in the referenced matter. As a preliminary matter, Conoco was an active participant in the preparation of the joint comments being concurrently filed by the industry coalition consisting of the American Petroleum Institute, Independent Producers Association of America, Domestic Petroleum Council, and the United States Oil & Gas Association. Conoco wholeheartedly endorses and supports those comments. Conoco Inc. has also submitted comments on the various iterations of the proposed oil valuation rulemaking since the original proposed rules were first noticed in the Federal Register on January 24, 1997. Instead of restating our previous comments we hereby incorporate them herewith by reference.

However, because of Conoco's great success with identifying lease market value using a "tendering" program, and our belief that it is superior in establishing the real value of crude oil at the lease, we wish to again provide pertinent comments regarding our "tendering" program that we refer to as a "Competitive Bid Program". The following comments address Conoco's very successful "tendering" program.

Introduction: Conoco is an integrated oil and gas company with operations in over 40 countries worldwide. Domestically, Conoco produces approximately 50,000 barrels of equity crude oil per day. Conoco operates four crude oil refineries in the United States, which are capable of refining approximately 516,000 barrels of crude oil per day. As a result, Conoco's need for crude oil exceeds its production by a significant margin. Of the crude oil produced daily by Conoco, approximately 4,000 barrels per day are federal royalty. Of this amount the MMS has elected to receive royalty in kind of approximately 2,000 barrels per day. Thus, Conoco's valuation methodology applies to only 2,000 barrels per day of federal royalty crude oil. What the MMS may not know is that Conoco uses its Competitive Bid Program to value well over 50,000 barrels of oil per day over and above the Federal Oil being valued. Conoco Inc. uses its lease crude oil valuation method to value essentially all of its owned and controlled lease crude oil because it captures the *true* value of crude oil at the lease by allowing the lease market to define what are or are not important value factors at each lease or nearest field area.

Competitive Bid Program: Conoco has been successfully conducting a so-called "tendering" program for over two years to establish a fair market value at or near the lease. The design of Conoco's program was based on economic principals and advice provided to Conoco Inc. by Harvard Professor Dr. Joseph P. Kalt, a well-known and highly respected energy economist who has studied this issue. Conoco's program is designed to determine the *true* market value of crude oil at the lease, or as close as possible to the lease. Conoco tenders (offers for sale) essentially up to one hundred percent (100%) of its total domestic crude oil production for sale under the program. Bids are sent to numerous qualifying non-affiliated bidders (often 20-25 bidders). The numbers of actual bids received depends on a number of factors including the location, quality and local demand of the production. Conoco (and Dr. Kalt) firmly believe that such a vibrant bid process generates the best indication of the *true* market value by interested buyers. Conoco uses the weighted average of the highest bid prices received to calculate the value of federal and state royalty lawfully due. Typically, bidders are required to bid on a minimum volume of 10% of the total volume offered but may bid for up to 100% of the offered volume. A bid price level is neither suggested nor imposed, and no other impediments to a free market are imposed. Conoco reviews bids from all bidders. Conoco reserves the right to reject any and all bids if, in our judgement, they do not reflect market value at the lease. To date, Conoco has historically sold between 20-50% of the production offered out for bid to the highest bidders. This represents between 10,000 and 25,000 barrels per day, much more volume than the federal royalty oil being valued. However, regardless of how much volume Conoco chooses to sell, 100% of Conoco's crude oil production is assigned the highest composite bid prices, including federal royalty oil. For the purpose of establishing value, it isn't relevant under Conoco's Competitive Bid Program whether Conoco uses its crude oil production for its own refineries or disposes of it in arm's-length, third party sales transactions, value determination is made using third party offers to buy the crude prior to the disposition decision. All owners of interest, including the federal and state governments, receive the benefit of the bid program's development of what we sincerely believe to be the highest market values available to Conoco at the lease. Bidders assign market value and bid according to their expectation that the higher the bid; the more likely they will have of having the winning bid. Since Conoco is required to sell a minimum of 10% of its offered crude oil bidders know that crude oil will be sold. Therefore, Conoco continues to ensure that bidders will continue to bid in the future. Because there are numerous bidders each bidder has an incentive not to submit "low-ball" bids.

To the extent that Conoco knows that there is an active market at the lease we offer crude oil under the program at the lease. Again, the intent is to establish the true market value as close as possible to the lease. Conoco believes that this appropriately measures the true intent of the lessor and lessee and meets the obligation of the lessee to market federal crude oil for the mutual benefit of both the lessee and lessor.

Moreover, due to the complexity (and inconsistency) of the application and interpretation of the regulations under the MMS proposed "Index" methodology concerning transportation, location and quality allowances and many more possible areas of disagreement under this proposed method, if a lease value can be reasonably established using "tendering", these vagaries are minimized, mitigated or mooted.

Analysis and Findings of Dr. Kalt (see Comments of Joseph P. Kalt submitted on May 27, 1997) Conoco Inc. is of the opinion that it is worth the MMS' time to revisit the comments submitted by Dr. Kalt on May 27, 1997 regarding the proposed oil valuation regulations by the MMS. In part Dr. Kalt stated:

> "I have conducted an intensive examination of the domestic market that exists for crude oil at lease level. As a result, I have acquired a large database and related information on arm's-length transactions occurring at the lease level in the U.S. crude oil fields. These data bear directly upon the proposed rule at issue in the proceeding.
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> "My examination of arm's-length transactions at the lease has revealed at least three particularly relevant findings.
>
> 1. There is an active market at the lease (or "wellhead") level. This market is highly competitive and involves major and minor integrated and non-integrated producers on the supply side, and numerous large and small integrated refiners and a very large number of independent marketers and brokers on the buying side.
>
> 2. The sustained existence and growth of more than one hundred non-integrated independent marketers who buy crude oil in transactions at the lease indicate a highly competitive system in which differences between wellhead values and values realized downstream from the lease represent real value that is added downstream from the wellhead. If these independent marketers, some of whom rank among the very largest of the first purchasers of crude oil, did not add value downstream of the wellhead, they would not survive the competition among the many purchasers of crude oil at the lease.
>
> 3. The actual transactions at the lease reveal market values that commonly vary significantly with supply and demand factors that are specific to individual locations, leases, and transactions." (emphasis added)

Dr. Kalt's comments provided above define the clear difference between valuing crude oil at the lease and some downstream location. For the MMS to say that there is no market at the lease or that the industry is attempting to fabricate a non-representative market to value federal crude oil totally overlooks and devalues Dr. Kalt's study and findings. The MMS has not produced any study of its own to support is position and thus is forced to rely on its uninformed and misguided perceptions.

Moreover, inasmuch as the MMS has proposed optional use of tendering programs for the valuation of Rocky Mountain area production as the first benchmark for valuing non-arm's length federal royalty oil, it is disingenuous for the MMS to say this method does not reveal market value at the lease. Conoco's recommendation is to extend the same methodology on a nation-wide basis. It would be considerably more efficient and cost effective for producers (and MMS auditors) to be able to employ a single valuation methodology to all domestic production.

<u>Conclusion</u>: Conoco respectfully requests that the MMS regulations include a producer election to value federal royalty payments on the basis of a tendering program as described herein. Such an election would be on a voluntary basis, and would neither displace nor exclude other options described in the proposed rules.

Sincerely,

John E. Clark

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mdb

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