REV. 11-96

Gary E. Johnson
Governor

John J. Chavez
Secretary

STATE OF NEW MEXICO

Taxation and Revenue Department

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FAX TRANSMITTAL COVER SHEET

To: MMS

Attention: Dave Guzy

Telephone: Fax 303-231-3385 Voice

From: New Mexico Taxation & Revenue Dept

Telephone: Fax Voice

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Date: April 27,1999

Mr. David Guzy, Chief, Rules and Publications Staff
Minerals Management Service, Royalty Management Service
Rules and Publication Staff
PO Box 25165, MS 3021
Denver, Colorado 80225-0165

Dear Mr. Guzy:

By Federal Register Notice dated March 12, 1999, the MMS reopened the comment period related to the proposed supplementary proposed federal oil valuation rule, which was published in the Federal Register on July 16,1998. With this notice, the State of New Mexico Taxation and Revenue Department offer the following comments related to the overall issues being discussed and the various items identified by industry in the two workshops that the Department attended.

GENERAL COMMENTS

The State of New Mexico and the Taxation and Revenue Department continues to fully support the efforts that the MMS has undertaken in their effort to define the appropriate market value for oil production on federal lands. Considering participation in the various workshops over the past three years and more recently two of three workshops, this Department heard very little new concepts from the oil industry. In general, the items presented were the same concepts identified in workshops in Houston, Texas in 1997. What the Department did recognize was that the process had unfortunately become very political and it is our feelings that the political involvement has hampered the federal effort to assure that the federal royalties are being paid correctly. The Department continues to believe that the proposed rule will have little impact on the majority of independents in the State of New Mexico. We continue to believe that the regulations are not changing the historic application of gross proceeds as royalty value when an arm's-length contract exists, nor are they changing the general concept of valuation when a federal lessee markets the oil beyond the lease. We continue to believe that if the product is transported downstream of the lease for valuation purposes, that the regulations recognize the appropriate eligibility of transportation costs. New Mexico does believe however that the rule will have a significant impact on major integrated companies who are also federal lessees and it is appropriately justified. No longer can the federal government recognize that a posted price recognizes market value and from a historical point this is what the majors consistently used. The State of New Mexico questions these naysayers when the Corpus Christi antitrust litigation against every major integrated company and major marketer has just been settled for approximately $191 million dollars. This litigation recognizes exactly what the MMS and their experts have been saying since 1995. The State of New Mexico and the Taxation and Revenue Department expects to receive its tax revenue share from this settlement. We offer the question, when can the federal government expect to receive its fair share?

SPECIFIC COMMENTS

Breach of Duty-Second Guessing:

Considering the most recent workshop discussions, it appears that the oil industry is totally misunderstanding the efforts that the MMS has gone through to fully clarify their position. The Department fully agrees with the MMS position relating to the breach of duty to market issue and does feel that clarification and specificity in the regulations can go along ways in stating the position of the MMS. We are quite confused by industry's issues, because it appears that on one hand they want clarification so no second guessing can occur, but on the other hand they do not want specifics because it makes the appearance of the possibility of second guessing. The issue of "Breach of Duty" is not a new federal position. The issue has been litigated for years and we refer to a New Mexico Supreme Court decision in Darr v. Eldridge, dated November 19,1959. The decision by the supreme court clearly stated that there is an implied covenant on the part of the lessee in a mineral lease to make diligent efforts to market the production in order that the lessor may realize on his royalty interest. This duty to market issue has never been interpreted to permit a lessor to second guess a lessee's price simply because another producer received a higher price in a comparable sale in the same field. MMS in their rule making process fully state is that the duty to market language protects the lessor against imprudent, negligence or bad faith actions of a lessee, and the burden is on the government to prove a breach of duty. This is not an easy burden nor can it be stated that it is met by pointing to higher field prices obtained by others. The very recognition by MMS of arm's-length contract prices in its proposed regulation assures that the government can not go beyond that price in the absence of proof of imprudence or negligence. The Department also does not feel that that the issue is a back-door way of increasing federal royalties. The intent of the proposal is to recognize fair market value, and when a major integrated company moves their production to their refinery or markets it at a market center, the appropriate valuation of that product is the actual price received or an independent derived market center price less actual transportation costs from the lease to the point of valuation. This application in no way is intended to recognize an artificial value but is fully intended to derive a market value on the oil through a net-back calculation back to the federal lease.

Field or Area Comparability-Value

MMS in their regulation proposal is correct in recognizing a spot market net-back calculation option to federal lessees who either market the production at major market centers or who uses such federal production to operate their refineries. While we agree that arm's length sales of oil do exist at the lease, we do not agree that the production amounts are significant enough to warrant a determination of market value. From New Mexico's experiences, we have seen from a transactional point of view that the sales packages are minimal in quantities and market power is very limited, however as a whole, the minimum quantities when put together represent a significant amount of volumes. Because the minimum quantity transaction does not represent the quantities that most majors control, the Department can not support any type of valuation concept that looks to what may be comparable transactions in a field or area.

Industry proposed a benchmark process whereby if at least 20% of production is sold or their affiliate purchase's 20%, and they are recognized as "arm's length within a comparable area, than the value of their affiliated transactions would be based on the weighted average prices of those third party transactions. The concern that we have with this proposal relates to what may dictate market value. The following is an example of our concern:

Total field production = 2000 BBLS per day
Affiliate federal lessee produces = 200 BBLS per day
Federal lessee sales as arm's length 40 BBLS per day(20%)

Considering the industry proposal, because the federal lessee sales 20% arm' length, the arm's length contractual price will be used to value the remaining 160 BBLS per day that was provided to their affiliate. Our concern relates to the fact that their production represents only 10% of the overall field production and their arm's length sales represent only 2% of the total field transactions and from a valuation point of view, we can not support that the arm's length price received recognizes market value for the product.

The State of New Mexico does support the general concept of recognizing tendering programs in their proposed regulations. We feel that the values they are receiving are significantly greater that posted prices and generally are greater than the prices being received by federal lessees who do not have the production to package such bid outs. However, we are concerned in the areas of: percentage of production bid out, number of bids and methodology structure. Further analysis and discussion are warranted to develop a framework and structure that may be allowed under this federal proposal.

<u>Transportation Deductions</u>

The MMS in their proposal continues to recognize the long standing requirement of using actual costs when calculating transportation arrangements that may be considered arm's length or non arm's length. Industry in their proposal wanted MMS to recognize a benchmark process similar to the 20% gross value calculation defined above. From the Department's point of view, any movement away from an actual cost calculation impacts the concept of fair market value and in many ways puts lessees that have the non arm's length transactions on a different level than lessees who do not have the equity to build their own lines or the market power to negotiate lower rates. The concept of actual cost must remain applicable to all federal lessees regardless of who controls the transportation facilities.
One other concern that New Mexico requests to be considered is one of if the changes are made to oil, than the regulations are different between oil and gas. If consistency is warranted, than the regulations should be comparable, and New Mexico stands to lose a significant amount of their share of the federal royalties if both the oil and gas regulations are changed to follow the industry recommendations.

<u>Binding Determinations</u>

MMS in their proposal also clarified that because of RFSA restrictions and past issues and concerns, that valuation decisions written by the Royalty Management Program within the MMS would not be binding. Industry in their workshop comments emphasized that all written correspondence or decisions should be binding.

While we understand the industry concerns, New Mexico believes that a binding decision is only as good as the information that supports it. If the information proves to be inaccurate, incomplete or new information is identified and decisions are binding, than what grounds exist for the federal government to protect their rights? What New Mexico recommends is that the regulations identify the non binding determination and allow federal lessees to pay as they have with the understanding that if an audit occurs and the finding developed follow the determination, based on no new facts, that interest will be calculated and recognized as due on the federal royalty amount. This assessment can than be appealed under the RFSA requirements and defined time limits and the record fully developed.

In concluding, the State of New Mexico can only hope that the federal regulations being proposed can be finalized and published in the near future. We feel that the workshops were beneficial in continuing the dialogue on issues related to misunderstanding the proposal however no new ideas were identified that would change our opinion on where the regulations need to go. We continue to support the gross proceeds concept throughout the regulations and we continue to support the net back concept as the only method to represent market value at the lease where a federal lessee chooses not to trace their federal production or where a major integrated company owns a refinery and sales do not occur in significant field quantities.

Sincerely,

John J. Chavez

John Chavez, Secretary
New Mexico Taxation and Revenue Department