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Mr. David S. Guzy
Chief, Rules and Publications Staff
Royalty Management Program
Minerals Management Service
P.O. Box 25165, M.S. 3021
Denver, Colorado 80225-0165

Re: *Further Supplementary Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases*

Dear Mr. Guzy:

Texaco Inc., on behalf of itself and its affiliates, including Texaco Exploration and Production Inc. ("TEPI"), appreciates the opportunity to submit these comments on the Further Supplementary Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases that was published in the Federal Register on December 30, 1999 (64 Fed. Reg. 73820). Texaco has actively participated in the rulemaking process by submitting extensive comments and suggesting alternative valuation methodologies in response to the January 1997 Notice of Proposed Rulemaking, the September 1997 Notice of Reopening of the Public Comment Period, the February 1998 Supplementary Proposed Rule, and the July 1998 Further Supplementary Proposed Rule. Texaco representatives have also attended the public hearings that MMS has held on the rulemaking, including meetings involving MMS, industry representatives, and Members of Congress.

Despite the unusual number of proposals and extensive opportunity for public comment, the further supplementary proposed rule still fails to meet the fundamental goal of adding more certainty to valuation of Federal lease production. On the contrary, the proposal contains a great deal of ambiguity, requiring, for example, MMS to determine affiliate status and to approve individual requests for quality adjustments. In addition, the proposal still fails to establish a workable means for providing binding value determinations. More importantly, the proposal still fails in large part to measure the true value of crude oil production at the lease. Texaco has previously commented on the substantive and procedural flaws in MMS's various proposals. Although the proposed rule fails to correct most of the deficiencies noted by those comments, Texaco will not repeat its previous comments here.[1]

The evolution of the proposed valuation methodology and MMS's evolving rationale are nevertheless worth noting because they underscore the fact that, at least for integrated lessees, the proposal does not measure the value of crude oil produced from federal leases. The January 1997 proposal would have valued most Federal oil production using either New York Mercantile Exchange ("NYMEX") or Alaska North Slope ("ANS") prices, ostensibly adjusted to arrive at a value at the lease. The proposed location/quality adjustments would have included adjustments from the index pricing point to the market center and from the market center to aggregation points near the lease. Texaco's comments noted that as a matter of law, federal lease crude oil production must be valued at the lease. Texaco's comments, and the attached reports prepared by the independent experts Texaco retained, demonstrated that neither the NYMEX futures market nor ANS prices are an appropriate benchmark to value crude oil in a producing field and that the proposed adjustments to the index prices did not correct the proposal's deficiencies.

In reopening the public comment period in September 1997, MMS noted that a "State commenter suggested that MMS could simplify the process without sacrificing *value* by using published [crude oil] spot prices instead of NYMEX." 62 Fed. Reg. 49460, 49462 (Sep. 22, 1997) (emphasis added).[2] Accordingly, "MMS request[ed] comments on this alternative and whether MMS should then allow actual costs of transportation when production actually flows to the market center where the spot price is published." *Id.*

The February 1998 proposal adopted in part the State commenter's suggestion to use spot prices instead of NYMEX pricing for oil produced from areas other than California, Alaska, and the Rocky Mountain Area. As with the January 1997 proposal, the February 1998 proposed index pricing included quality and location adjustments from the market center to aggregation points near the lease. For oil ultimately sold by an affiliate of the lessee at arm's length, including oil received in an arm's-length exchange, value was to be based on the gross proceeds received under the lessee's or its affiliate's arm's-length contracts, less only the "actual" cost of transportation. Texaco's comments pointed out that there are far simpler and more reliable measures of market value at the lease than the flawed valuation methodologies contained in the supplementary proposed rule, including for example tendering and taking MMS's royalty in kind, which MMS had (and has) failed to adequately consider. The comments also demonstrated that the supplementary proposed rule, like the January 1997 proposal, still failed to measure market value at the lease for most federal lease production because ANS is not an appropriate measure of California lease production, spot prices are not an appropriate benchmark to value

1 For purposes of the administrative record, however, Texaco hereby incorporates its previous comments and the statements made by its representatives during the public hearings.

2 Notably, in suggesting this alternative, neither the State commenter nor MMS addressed the issue of whether crude oil spot prices could be used to *accurately* measure federal lease production.

crude oil in a producing field, and NYMEX futures-based pricing is particularly inappropriate for the Rocky Mountain Area. Furthermore, Texaco's comments observed that the tracing required by the supplementary proposed rule was needlessly complex and probably unworkable.

The December 1999 proposal addresses the tracing problem of the February 1998 proposal by allowing lessees to "elect" to value their production not first sold or exchanged at arm's length using the same three-part index pricing structure proposed in February 1998. Although Texaco appreciates the deletion of the burdensome and largely useless proposed Form MMS-4015, MMS still has not adequately addressed the quality and transportation adjustments that must be made in order to use index pricing as a proxy for the value of lease production. As a consequence, the December 1999 proposal, just as the earlier proposals, fails to measure the value of oil produced from the lease. The further supplementary proposed rule therefore exceeds the statutory authority of the Secretary. In particular, the proposed valuation methodology conflicts with the plain language of the Mineral Leasing Act of 1920 ("MLA"), the Outer Continental Shelf ("OCS") Lands Act, and the terms of Texaco's federal leases. The proposal is also arbitrary and capricious because it abruptly changes decades of settled policy and practice without a reasoned basis and irrationally treats similarly-situated leases differently. Moreover, even if the Secretary had the requisite statutory authority to adopt the proposed valuation methodology, the proposal could not lawfully be applied to Texaco's existing leases. For all of these reasons, Texaco urges MMS to reconsider its proposal and adopt a valuation method, such as comparable sales, that accurately measures the value of production saved, removed, or sold from federal leases.

I. THE PROPOSED VALUATION METHODOLOGY EXCEEDS THE STATUTORY AUTHORITY OF THE SECRETARY

A. The Secretary is Required by Statute to Measure Royalty Value at the Lease

Both the Mineral Leasing Act and the Outer Continental Shelf Lands Act expressly limit the Secretary's discretion in setting lessees' royalty obligations. The MLA mandates that leases "shall be conditioned upon the payment of a royalty at a rate of not less than 12.5 percent in amount or *value of the production removed or sold from the lease*." 30 U.S.C. § 226(b)(1)(A) (emphasis added). Similarly, the OCS Lands Act requires that royalties from OCS leases be obtained based on "the amount or value of the production saved, removed, or sold." 43 U.S.C. § 1337(a)(1)(A). Hence, the plain language of both Acts requires that federal royalties be based on the value of the *lease production*, and not on the increased value attributable to *downstream assets and services* or the value of "similar" oil sold in market centers. *See, e.g., Diamond Shamrock Exploration Co. v. Hodel,* 853 F.2d 1159, 1165 (5th Cir. 1988) ("It is obvious from a complete reading of all the relevant statutes, regulations and lease provisions, that royalties are not due on 'value' or even 'market value' in the abstract, but only on the value of *production saved, removed or sold* from the leased property."); *United States v. General Petroleum Corp.*, 73 F. Supp. 225, 258 (S.D. Cal. 1946) ("The Act, regulations and leases contemplate royalty payment to be made on the original production *at the well.*"), *aff'd sub nom. Continental Oil Co. v. United States*, 184 F.2d 802 (9th Cir. 1950); *Mobil Producing Texas & New Mexico, Inc.*, 115 IBLA 164, 171 (1990) ("Normally gas is sold and valued for royalty purposes at the wellhead.")

B. By Using Downstream Resale Prices and Not Allowing Appropriate Deductions for Value Added Downstream of the Lease, the Further Supplementary Proposed Rule Would Improperly Claim Royalties on More than the Value at the Lease

Once crude oil leaves the field in which it is produced, its value is generally increased. *See, e.g.*, Comments of Benjamin Klein, at pp. 15-17 (attached as Ex. 2 to Texaco's May 28, 1997 Comments). This increased value is attributable to numerous services and assumptions of risks, including for example: (a) transportation services, including the need for substantial inventory to fill crude oil pipelines necessary for the crude oil to flow to its destination; (b) storage services, including the use of major storage facilities at market centers, inventory to fill tanks and personnel to maintain the inventory; (c) assumptions of risks, including economic risks of changes in the price of crude oil before its resale, credit risks, environmental risks, and risk of product loss incurred away from the lease; (d) administrative services including office facilities and salaries for personnel involved in technical as well as marketing services; and (e) administrative overhead. In addition, crude oil is frequently blended downstream of the lease with other crudes. Crude oils may be blended for a variety of reasons, such as mixing together a heavy, viscous crude with lighter crudes to facilitate more efficient movement of the blended stream through an unheated pipeline or blending together crudes of different qualities to achieve the specifications desired by a particular refinery. These downstream services both change the physical composition of the crude oil and increase its value because they bring the oil closer to the point of consumption and aggregate it into the volume, with the particular specifications, and at the location and time desired by a downstream purchaser.

It is not surprising, therefore, that the price of oil at a downstream resale point or market center is generally substantially higher, after performance of these services and assumptions of risks, than the fair market value of the product removed or sold from the lease. In addition, crude oil sold at a downstream resale point or market center usually cannot be traced back to any particular lease. Whether or not blended with a different grade of crude, crude oil produced from numerous federal and non-federal properties is commingled in a pipeline where the identify of particular barrels of lease production is lost. As a result, it is generally impossible to determine the actual downstream resale price of a particular barrel of lease production.

For all of these reasons, the most accurate measure of the market value of production at the lease is arm's-length purchases and sales of like-quality crude oil in the same producing field. *See Shamrock Oil & Gas Corp. v. Coffee*, 140 F.2d 409, 410 (5th Cir.) (to determine "market price" the court must look to "the price that is actually paid by buyers for the same commodity in the same market"), *cert. denied*, 323 U.S. 737 (1944); *Piney Woods Country Life Sch. v. Shell*

Oil Co., 726 F.2d 225, 240 (5th Cir. 1984) (the "best means of determining the market value at the well ... would be to examine comparable sales"), *cert. denied*, 471 U.S. 1005 (1985); *Ashland Oil, Inc. v. Phillips Petroleum Co.*, 554 F.2d 381, 387 (10th Cir.) ("It is obvious that comparable sales or current market price is the best [evidence of value], and second would come the work-back method."), *cert. denied*, 434 U.S. 921, *reh'g. denied*, 434 U.S. 968 (1977); *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118, 122 (Tex. 1996) ("Market value is the price a willing seller obtains from a willing buyer.")

By contrast, both downstream resale prices and spot prices for oil sold in market centers include increased value from downstream assets and services that is not part of the value of production and would not be reflected in the market price at the lease regardless of whether the oil is sold to an affiliate or at arm's-length to an unaffiliated party. Accordingly, courts have consistently held that the value added downstream of the lease is not properly included in the royalty base for federal oil and gas leases. *See, e.g., Amerada Hess Corp. v. Department of Interior*, 170 F.3d 1032, 1037 (10th Cir. 1999). For example, in *California Co.*, the District of Columbia Circuit, in defining the term "value of production," took care to note that it had *not* included any value added downstream of the lease:

> Let us here insert a cautionary parenthesis. No transportation costs are involved in this case. *The Secretary is not here claiming that costs incurred in moving gas from the field in the neighborhood of the wells to a distant selling point are includable in the royalty base.* This gas was conditioned by the seller and delivered to the purchaser in the field within a short distance of the wells. There were no transportation costs.... Neither are manufacturing costs involved here. The product was not transformed.

296 F.2d at 387 (emphasis added).

Similarly, in *Marathon Oil Co. v. United States*, the district court, although finding that in the absence of comparable sales at the lease MMS could properly consider downstream resale prices "as a means to determine the reasonable value of production at the lease," also made clear that it was necessary to deduct from the resale prices the costs incurred downstream of the lease – including a reasonable rate of return on the lessee's capital assets – in order to "yield an estimated wellhead value for the gas." *Marathon Oil Co. v. United States*, 604 F. Supp. 1375, 1385-86 (D. Alaska), *aff'd*, 807 F.2d 759 (9th Cir. 1986), *cert. denied*, 480 U.S. 940 (1987). *See also Piney Woods Country Life Sch.*, 726 F.2d at 240 ("On royalties 'at the well,' therefore, the lessors may be charged with processing costs, by which we mean all expenses subsequent to production, relating to the processing, transportation, and marketing of gas or sulfur. We emphasize, however, that processing costs are chargeable only because, under these leases, the royalties are based on value or price at the well. Processing costs may be deducted only from valuations or proceeds that reflect the value added by processing.")

Consistently, although the Interior Board of Land Appeals ("IBLA") has held that downstream resale prices are a "relevant matter" that may be considered in valuing lease production, particularly in the absence of a market at a lease "where the oil would ordinarily be sold and valued," *Shell Oil Co.*, 52 IBLA 15, 20 (1981), it has also consistently made clear that value added downstream of the lease must be deducted from the resale prices in order to properly value production for royalty purposes. *See, e.g., Blue Dolphin Exploration Co.*, 148 IBLA 72, 76-77 (1999); *Xeno, Inc.*, 134 IBLA 172, 178 (1995). Throughout the rulemaking, MMS has consistently ignored this critical qualification.

In *Xeno, Inc.*, for example, the IBLA explained that:

> This Board has also held that the sale price received by an affiliate of the lessee in the first arm's-length transaction is properly considered in determining the value of gas produced under the gross proceeds rule.
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> * * *
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> However, this does not conclude the inquiry into the proper valuation of production for royalty purposes. When gas is valued at a point downstream from the wellhead where the value of production is ordinarily determined, allowances are generally required for the value added to the gas after production.

134 IBLA at 179-80; *accord Blue Dolphin*, 148 IBLA at 81 (allowance for cost of manufacturing appropriate when liquid hydrocarbons were already in marketable condition); *Exxon Corp.*, 118 IBLA 221, 255 (1991) (manufacturing allowance is appropriate for cost of operations, including dehydration, that are not needed to condition the product for market); *Mobil Producing Texas & Mexico, Inc.*, 115 IBLA at 172 ("A transportation allowance recognizes that the price received for a product at a distance from the point of production is not the value of the product at the point of production because the costs incurred in transporting the product have added value to it.")

1. Proposed 206.102(a)

For oil not first sold at arm's length, proposed section 206.102(a) would – by using downstream resale prices and not allowing appropriate deductions for value added downstream of the lease – include in the royalty base the value of affiliates' or other persons' downstream assets and services. The proposal accomplishes this result through two methods. First, it changes the gross proceeds rule to impute to the lessee the proceeds accruing to the lessee's affiliates and any other person to whom the lessee sells or transfers oil at less than arm's length, asserting that "[t]he United States as lessor has always shared in the 'benefit' of 'downstream' marketing away from the lease...."[3] Second, it asserts that the affiliates' and other persons'

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[3] Notably, the IBLA in *Seagull Energy Corp.*, 148 IBLA 300 (1999), expressly rejected this "enterprise" theory of the gross proceeds rule when MMS attempted to include proceeds accruing to the lessee's affiliate. The proposed rule would go even further, and would impute to the lessee gross proceeds accruing to *non-affiliates* to whom the lessee had sold or transferred oil in a non-arm's-length transaction.

services and risks incurred in moving the oil to a downstream market are part of the lessee's implied obligation to market lease production at no cost to the lessor.

MMS has changed its explanation of the supposed "duty to market" since the start of this rulemaking. In the January 1997 proposal, MMS stated that it had "modif[ied] the paragraph on [the lessee's] obligation to place oil in marketable condition at no cost to the Federal Government to clarify that it includes a duty to market the oil." 62 Fed. Reg. at 3746 (Jan. 24, 1997). Then, citing only *Walter Oil & Gas Corporation*, 111 IBLA 260 (1989), MMS asserted that "[t]his is consistent with several Interior Board of Land Appeals decisions construing this rule." *Id.* By contrast, in the December 1999 proposal, MMS adopts the rationale of the Acting Assistant Secretary's May 18, 1999 decision in *Texaco Exploration and Production Inc.*, MMS-92-0306-O&G, asserting that the duty to market is distinct from the duty to place oil in marketable condition, and that the lessee has an independent duty to market for the mutual benefit of the lessor and lessee at no cost to the lessor.

Ignoring the cases that are contrary to its desired result and drawing instead from language in earlier IBLA cases in which the issue was not presented, the further supplementary proposed rule contends that the following principles have been established: (1) federal lessees have an implied duty to market production, (2) MMS has never permitted an allowance for any costs of increased value other than the "actual cost" of transportation, processing costs, and, for leases which so provide, an operating allowance, (3) marketing and other costs are not deductible regardless of whether the lessee bears them directly or they are incurred by an affiliate or other entity, and (4) the location of the market at which the lessee chooses to sell its production does not change its "marketing" obligation. 64 Fed. Reg. 13822. Thus, according to the proposal, although a federal lessee is not obligated to market its production downstream of the lease, if it *chooses* to do so, it must market the oil for the "mutual" benefit of itself and the lessor but wholly *at its own cost* except for certain transportation costs. *Id.* In making this argument, MMS overlooks the fact that under the proposed rule, it would not be the lessee that is marketing its production downstream; rather it would be the lessee's affiliates or other persons to whom the lessee sold lease production at less than arm's length.

In any event, contrary to the assertions made in the proposed rule, except for the Acting Associate Director's recent decision in *Texaco Exploration and Production Inc.*, No. MMS-92-0306-O&G (1999), which was *never heard by the IBLA* and which suffers from the same flaws as the proposed rule, the case law does not provide any basis for finding an implied duty to market production, particularly downstream of the lease, at no cost to the lessor. Indeed, where a market exists at the lease and the lease production is in marketable condition, the IBLA has specifically held that the lessee is neither required to "bear the costs of downstream marketing" nor to include such "costs ... in its 'gross proceeds' for purposes of computing royalties." *Seagull Energy Corp.*, 148 IBLA 300, 316 (1999).

While the IBLA has held that federal lessees have a duty to market lease production, it has consistently held that the duty is an element of the lessee's *express* regulatory obligation to place its production in marketable condition. *Amerac Energy Corp.*, 148 IBLA at 88 ("A lessee is required to place its production in marketable condition at no cost to the lessor. 30 C.F.R. § 206.102(i). An element of this so-called marketable condition rule is the duty to market production.") Equally as important, the IBLA has limited that duty to the first available market because that is the only market relevant to determining the value of the lease production. For example, in *Xeno, Inc.*, the IBLA noted that its decision in *Beartooth Oil & Gas Co.*, 122 IBLA 267 (1992), *vacated and remanded sub nom. Beartooth Oil & Gas Co. v. Lujan*, CV-92-99-BLG-RWA (D. Mont. Sept. 22, 1993), had been reversed in part because "the Board erred in applying the marketable condition rule without considering the conditions under which gas will be accepted by a purchaser under a sale contract typical for the field or area." *Xeno, Inc.*, 134 IBLA at 182 n.14.

Furthermore, the IBLA has rejected the very assertions made in the proposed rule, unequivocally holding that "the obligation to market the product 'is not a covenant read into the lease by implication,'" *Viersen & Cochran*, 134 IBLA at 164 n.8, and that "it [is] not necessary for [the lessee] to bear the costs of downstream marketing where the [product] sold at the wellhead was in marketable condition and where a market existed there," *Seagull Energy Corp.*, 148 IBLA at 316.

Contrary to MMS's assertions, none of the IBLA or court cases upon which the proposed rule relies holds that a federal lessee has an implied duty to market lease production downstream of the lease at no cost to the lessor:

California Co. involved the sale of gas *in the producing field*, not downstream of the lease. In fact, as noted above, the court specifically "insert[ed] a cautionary parenthesis" to make clear that "[t]he Secretary is not here claiming that costs incurred in moving gas from the field in the neighborhood of the wells to a distant selling point are includable in the royalty base." 296 F.2d at 387. Far from holding that there was an *implied* duty to market the lease production, much less to do so downstream at no cost to the lessor, the court simply noted that the lessee had a *regulatory* duty, "clearly spelled out in the Secretary's regulations" to *prevent waste*, *i.e.*: "'The lessee is obligated to prevent the waste of oil or gas and to avoid physical waste of gas the lessee shall consume it beneficially or market it or return it to the productive formation.'" *Id.* (quoting 30 C.F.R. § 221.35 (1959)).

In any event, at issue in *California Co.* was not the lessee's duty to market, but rather, whether the lessee had to bear the costs of conditioning the gas to meet the specifications required by the sales contract. In that case there was not "a market for the gas in the condition it comes from the wells," and "[t]he only market ... was for this gas at certain pressure and certain minimum water and hydrocarbon content." 296 F.2d at 388. The court concluded the value of the oil for royalty purposes was the fair market value of the production in marketable condition. *Id.*

The IBLA cases on which the proposed rule relies are similarly inapt, and, even if some of their dicta could be read to support the proposed rule's assertions, it has been overruled by the IBLA's more recent, express holding in *Seagull Energy Corp.*, 148 IBLA at 316. The first case cited in the proposed rule, *Walter Oil & Gas Corp.*, 111 IBLA 260 (1989), involved a small producer who engaged an independent marketer to market its lease production. The IBLA held that the lessee could not deduct the fees it paid to the independent marketer from the proceeds it received in selling the lease production because:

> the buyers of Walter's gas were willing to pay the contract price for the gas, and this price included the fees Walter paid to Commet for its services.... Thus MMS properly concluded that the gross proceeds from the disposition of the gas produced by Walter from its Federal leases included the fees Walter contracted to pay Commet.

111 IBLA at 264. Under the proposed rule, by contrast, the lessee would not be deducting any amount from the proceeds the *lessee* received; rather, the proposal would impute to the lessee the gross proceeds accruing to its *affiliates* or *other persons* upon reselling the oil downstream of the lease.

In *Arco Oil & Gas Co.*, 112 IBLA 8 (1989), another case cited in the proposed rule, the lessee sought to deduct the costs of a marketing arrangement that enhanced its ability to market the production at a higher price than might otherwise be obtainable. The IBLA refused to grant an allowance, holding that:

> The costs of creating and developing a market for the royalty share of production are not incurred solely because no market exists adjacent to the lease. Rather, these costs would have been incurred by lessee, whether or not there was a market for the production at or adjacent to the lease, in an effort to secure the highest price obtainable for disposition of the royalty share of production. No allowance will be recognized by the Department where a lessee, as here, would have borne similar costs attributable to the creation and development of markets regardless whether production was sold on or adjacent to the lease.

112 IBLA at 10-11. In contrast to the facts of *Arco Oil & Gas*, under the proposed rule the added costs would be incurred by the lessee's affiliates or other persons, not by the lessee, and the costs would not be incurred by the lessee whether it first sold the oil at arm's length or at less than arm's length.

Three other cases cited in the proposed rule, *Amerac Energy Corp.*, 148 IBLA 82 (1999), *Yates Petroleum Corp.*, 148 IBLA 33 (1999), and *Taylor Energy Co.*, 143 IBLA 80 (1998), involved marketing arrangements in which the price paid to the lessee was based on a percentage of the marketer's net proceeds. In all three cases, the IBLA concluded that a sale by the lessee did not occur until the marketer sold the production to third parties, and accordingly held that the percentage deduction from the marketers' proceeds represented an unallowable marketing fee. *Amerac*, 148 IBLA at 88; *Yates*, 148 IBLA at 34; *Taylor*, 143 IBLA at 81. Under the situation contemplated by the proposed rule, by contrast, the first sale would occur at the lease.

In sum, not only has the IBLA expressly rejected the position taken by the proposed rule, but even the earlier IBLA cases cited in the proposal do not support it. There simply is no contractual or other authority to impose an obligation on federal lessees to market production downstream of the lease at no cost to the lessor. Accordingly, the proposed rule's failure to allow a deduction for the value of services and risks incurred downstream of the lease improperly captures that added value in the royalty base in contravention of the plain language of the MLA and OCS Lands Act. *See Marathon Oil Co. v. Andrus*, 452 F. Supp. 548, 553 (D. Wyo. 1978) (holding that an analogous Notice by the Secretary, which purported to capture in the royalty base lease production that was unavoidably lost, by "expanding and enlarging upon the legislative enactment, is manifestly contrary to the Mineral Leasing Act [and] to the end the Notice is plainly erroneous under the standard of review in the Administrative Procedure Act").

2. Proposed 206.103

Proposed 206.103 imposes an artificial, alternative value based on the monthly average of daily mean spot prices for "similar" quality oil at the nearest market center as opposed to measuring the value of federal lease production. When MMS first proposed the use of index pricing in the January 1997 proposal, it correctly recognized that the value of crudes vary based on differences in their API gravity, sulfur content, viscosity, metals content, and other quality factors. *E.g.*, 62 Fed. Reg. at 3747. However, the December 1999 proposal fails to adjust the index price (either up or down) to reflect differences in quality between the lease production and the oil on which the index price is based. Proposed 206.112 would require adjustments for location/quality differentials specified in arm's-length exchange agreements and premia or penalties determined from a pipeline quality bank, but those adjustments account only for the difference between the lease production and the oil ultimately disposed of. They have nothing to do with the difference in quality between the lease production (or oil ultimately disposed of) and the "similar" oil on which the spot price is based. Hence, even if there was a location/quality differential specified in an applicable arm's-length exchange agreement and even if the oil was transported through a pipeline with a quality bank, those adjustments still have nothing to do with trying to equate the quality of the spot price oil to the quality of the lease production. For example, if a particular lease produces Light Louisiana Sweet ("LLS") at 53 degrees API, and the oil is transported through the Sea Robin Pipeline to Erath, the oil would be valued under the proposed index pricing using the Platt's spot price for LLS at the nearest market center, St. James. The Platt's St. James LLS has an average gravity of 37 degrees, yet the proposal fails to provide any means of adjusting the index price to account for the dramatic difference in the quality of lease production. Another example is crude oil that moves on Bonito to St. James with a quality bank average stream gravity of 33.1 to 34.8 degrees; the oil would be valued under the proposed index pricing using the Platt's spot price for Bonito at the nearest market center, St. James. The Platt's St. James Bonito has an average gravity of 35.3 degrees, yet the proposal fails to provide any means of adjustment. The disconnect between the proceeds-based adjustments contemplated by the proposal and the use of index pricing is even more apparent in California. For example, TEPI's Kern River production averages 13 degrees, yet under the proposal it would be valued using spot prices for ANS, which averages 28 degrees, resulting in a $2.25/barrel increase in the royalty value.

During the public workshop in Houston on January 19, 2000, MMS stated, in response to concerns expressed by industry representatives, that if the location/quality adjustments in the proposed rule did not cover a particular lease production, the lessee could seek approval for a quality adjustment from MMS under proposed 206.112(f). Relying on individual requests for quality adjustments is not only burdensome to both industry and MMS, but it is completely inimical to MMS's stated goal of providing more certainty in the valuation of Federal oil. Even small differences in API gravity, for example, can significantly affect the value of the oil, particularly for ANS (as the example used in Appendix G of the January 1997 proposal demonstrates). Moreover, by failing to account for the difference in quality between the index oil and lease production, the further supplementary proposed rule violates the statutory mandate that royalties be valued based on the value of oil saved, removed or sold from the lease.

In 1987, the MMS Associate Director for Royalty Management appropriately rejected a proposal to use spot prices to value federal lease production, reasoning that it would be "contrary to existing law, lease, terms, and regulations, or too impractical and nonspecific to administer.")Letter from Associate Director for Royalty Management to Director, MMS, "Review of Analysis Titled 'Crude Oil Royalty Valuation Monitoring System,' Policy, Budget, and Administration" (Feb. 12, 1987).) The Associate Director further noted that while MMS could change the regulations, as MMS is attempting to do in the further supplementary proposed rule, the use of spot prices would still be precluded by existing statutes and federal lease terms, both of which require that royalty be paid based on a percentage of the amount or value of production removed or sold from the leased lands. As we noted in our comments in response to the February 1998 proposal, neither the underlying statutes, lease terms, nor basic economic principles have changed since the Associate Director's 1987 letter. Accordingly, proposed 206.102(a) would, if promulgated as a final rule, be unlawful.

C. The Transportation Allowance is Inadequate and Probably Illusory

Texaco's previous comments have demonstrated why the proposed allowance for "actual costs" of transportation fails to consider the full cost, let alone value, of midstream transportation assets and services. In addition, for the reasons set forth in comments filed by Equilon Enterprises LLC ("Equilon"), a joint venture of Texaco Inc. and Shell Oil Company, in response to the February 1998 proposal, computing "actual costs" under proposed 206.111 would be extraordinarily difficult, if not impossible. Texaco supports and incorporates the April 1998 comments filed by Equilon Enterprises LLC and the comments being filed in response to the supplementary proposed rule by Equilon Pipeline Company LLC ("Equilon Pipeline") and Equiva Trading Company ("Equiva").

Much of the oil sold by TEPI to Equiva is transported through pipelines owned by Equilon Pipeline. If, under the proposed rule, Equiva and Equilon Pipeline are determined to be "affiliates" of TEPI or if the transactions with Equiva and Equilon Pipeline are determined to be other than arm's-length, TEPI would be forced to elect index pricing for all of its sales to Equiva – because it would be virtually impossible to trace the ultimate disposition of oil sold to Equiva – and would be limited to "actual costs" of transportation under proposed 206.111. For the very same reason that it is virtually impossible to trace the ultimate disposition of the production from any particular lease, it is also virtually impossible to accurately compute the "actual costs" of transporting that production under proposed 206.111. When Equiva purchases crude oil from TEPI, it generally commingles the oil with oil purchased from other producers, and once the oil is commingled, it cannot be traced to downstream sales transactions. In addition, there are multiple delivery points within Equilon's pipeline system, which further complicates any attempt to allocate transportation costs. Moreover, as Equilon noted in its April 1998 comments, its accounting system was not designed to capture lease specific volumes and associated transportation costs for each barrel because there is no business reason for it to need such data. It is therefore impossible to assign an actual transportation cost associated with particular downstream resale contracts to barrels purchased by Equiva from a particular lease. Neither TEPI nor Equilon Pipeline has the data or computer systems available to accurately calculate the "non-arm's-length" transportation costs under proposed 206.111.

Equilon's comments pointed out other legal barriers to compliance with proposed 206.111, including for example the Interstate Commerce Act prohibition on "knowingly disclosing to another person … information about the nature, kind, quantity, destination, consignee, or routing or property tendered to that carrier," 49 U.S.C. § 16103(a), and the non-discrimination requirements of the OCS Lands Act, 43 U.S. § 1334, and Interstate Commerce Act, 49 U.S.C. § 15501. The further supplementary proposed rule fails to address, much less correct, these deficiencies.

Commendably, the further supplementary proposed rule would provide that a change in ownership of a transportation system would result in a new depreciation schedule for purposes of the allowance calculation. In addition, the proposal appears to recognize the inadequacy of the BBB bond rate of return. Texaco urges MMS to hold a workshop on transportation and quality adjustments and to give adequate attention to these important issues before finalizing the rule.

II. THE PROPOSED VALUATION METHODOLOGY IS CONTRARY TO THE PLAIN LANGUAGE OF TEXACO'S FEDERAL LEASES

The proposed rule is also contrary to the express terms of Texaco's leases, and, for that reason as well, is unlawful. Federal oil and gas leases are contracts. *See Enron Oil & Gas Co. v. Lujan*, 978 F.2d 212, 214 n.2 (5th Cir. 1992) ("Oil and gas leases are 'both conveyances and contracts.' … The method by which royalty is to be calculated is a contractual provision.") (citation omitted), *cert. denied*, 510 U.S. 813 (1993). The Supreme Court has held that when the federal government chooses to enter into a contract, "its rights and duties therein are governed generally by the law applicable to contracts between private individuals." *Lynch v. United States*, 292 U.S. 571, 579 (1934) (cited with approval in *United States v. Winstar Corp.*, 518 U.S. 839, 895 (1996)); *see also Perry v. United States*, 294 U.S. 330, 352 (1935) ("When the United States, with constitutional authority, makes contracts, it has rights and incurs responsibilities similar to those of individuals who are parties to such instruments. There is no difference except that the United States cannot be sued without its consent.") (citation omitted); *Sinking-Fund Cases v. United States*, 99 U.S. (7 Otto) 700, 719 (1879) ("The United States are as much bound by their contracts as are individuals. If they repudiate their obligations, it is as much repudiation, with all the wrong and reproach that term implies, as it would be if the repudiator had been a State or a municipality or a citizen.")

Accordingly, MMS is just as bound by the terms of its oil and gas leases as is any private lessor. *See, e.g., Rosebud Coal Sales Co. v. Andrus*, 667 F.2d 949 (10th Cir. 1982) (applying standard contract law to federal oil and gas lease transactions); *Standard Oil Co. v. Hickel*, 317 F. Supp. 1192, 1197 (D. Alaska 1970) ("The Government's rights and obligations as lessor of public lands are no different from those of any other lessor."), *aff'd*, 450 F.2d 493 (9th Cir. 1971). As the district court aptly observed in *United States v. General Petroleum Corp.*:

> it must be remembered that the government's role is taken to be no different from that of any private lessor or proprietor, for while the Kettleman Hills lands involved are public mineral lands, and as such until their disposition are under the supervision and control of Congress, the government as to such lands acts in a proprietary capacity, and treats with them in the same way as does the private landowner. Regardless of the type of lease Congress might authorize, a lease executed in accordance with what it *has* authorized becomes a private contractual matter and is to be interpreted according to the general rules of law respecting contracts between individuals. And regardless of what Congress has authorized, unless the authorized provision is mandatory, it may not be "read in" if the Secretary omitted to include it.

73 F. Supp. 224, 234 (S.D. Cal. 1947) (footnotes omitted), *aff'd sub nom. Continental Oil Co. v. United States*, 184 F.2d 802, 807 (9th Cir. 1950) ("[t]he rights of the parties are determined by the provisions of the leases, read in light of the provisions of the Mineral Leasing Act").

Texaco has hundreds of producing federal oil and gas leases, some of which have been in effect for over seventy-five years. Like the MLA and OCS Lands Act, Texaco's leases generally require that royalties be based on a stated percentage of the amount or value of production from the leased lands. Although the leases typically grant the Secretary the right to establish "reasonable minimum values" for purposes of computing royalties, they expressly limit his discretion in doing so, requiring that due consideration be "given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices and to other relevant matters." Under the familiar canon of *ejusdem generis*, general terms that follow specific ones are construed to encompass only matters similar to those specified. *See, e.g., Tax Analysts v. Internal Revenue Service*, 117 F.3d 607, 614 (D.C.

Cir. 1997) (citing *Gooch v. United States*, 297 U.S. 124, 128 (1936)). Thus, "other relevant matters" must be read in light of the more specific terms that precede it. The first three matters – "highest price paid for a part or for a majority of production of like quality in the same field," "the price received by the lessee," and "posted prices" – all relate to prices paid for lease production *at the lease*. However, the further supplementary proposed rule deliberately fails to give *any* consideration to comparable arm's-length sales at the lease. 64 Fed. Reg. at 73824.

Moreover, nothing in any of Texaco's leases gives the Secretary the right to unilaterally expand the lessee's royalty obligation by including in the royalty base the increased value of downstream assets and services. To the contrary, the lease terms require that royalties be based on the value production at the lease. Accordingly, by failing to value royalties at the lease, the further supplementary proposed rule would materially breach the terms and conditions of Texaco's leases.

The proposed transportation allowance for non-arm's-length transportation arrangements similarly conflicts with the express terms of Texaco's leases. The leases generally provide that the lessee, if it has an affiliated pipeline company, will "accept and convey ... at reasonable rates and without discrimination the oil or gas of the Government or of any citizen or company not the owner of any pipe line...." Proposed 206.111, on the other hand, essentially requires integrated lessees to move Federal oil at a rate substantially lower than the full market price charged for movement of third party production, which directly contravenes the express terms of Texaco's leases.

III. THE PROPOSED VALUATION METHODOLOGY IS ARBITRARY AND CAPRICIOUS

Even if the Secretary had the requisite statutory authority to base federal crude oil royalties on values away from the lease, which he does not, the proposed valuation methodology would still be arbitrary and capricious because it departs from MMS's long-standing, consistent practices without a reasoned basis and irrationally treats similarly situated leases differently.

Since the enactment of the MLA almost eighty years ago, MMS has consistently accepted arm's-length prices in the producing field as the proper value for purposes of computing federal oil and gas royalties. *E.g., Santa Fe Energy Resources, Inc.*, MMS-90-0400-O&G, at 4 (May 20, 1992). This policy and practice has consistently been upheld in administrative decisions of the IBLA and Director of MMS. *See, e.g., Mobil Producing Texas & Mexico, Inc.*, 115 IBLA at 171 ("Normally gas is sold and valued for royalty purposes at the wellhead."); *Mobil Oil Corp.*, 112 IBLA 56 (1989) (non-arm's-length contract prices acceptable as the basis for royalty provided it falls with the range of prices received in the same field or area under arm's-length contracts); *Getty Oil Co.*, 51 IBLA at 51 (non-arm's-length sales prices acceptable for royalty valuation where comparable to the price independent buyers in arm's-length transactions would be willing to pay.")

In the further supplementary proposed rule, just as in the earlier proposals, MMS seeks to depart from this long-standing practice, both by imputing to the lessee the proceeds received by affiliates and others in reselling oil downstream from the lease (without allowing adjustments to the resale prices to account for the value added downstream of the lease) and by using spot prices of "similar" oil at the nearest market center to value lease production. The comments previously filed by Texaco and others have amply demonstrated the existence of an active, competitive market at the lease.[4] During the public workshop in Houston on January 19, 2000, a representative of the pipeline industry explained that he could confirm the existence of an active market at the lease because of his experience in the transportation business that supports the lease market. MMS has not cited any evidence, and Texaco is unaware of any, that would suggest there is not an active, competitive market at the lease. Moreover, MMS does not contend that arm's-length prices at the lease fail to accurately measure the value of lease production. Indeed, MMS asserts that "[i]t is longstanding MMS policy to rely on arm's-length prices as the best measure of value, and we have no intention of changing this." 64 Fed. Reg. at 73829. Nevertheless, MMS rejects the use of arm's-length transactions at the lease to value oil not sold at arm's length because it believes it can collect higher royalties by valuing production on the higher price realized on the sale of the oil downstream. *See* 64 Fed. Reg. at 73823.

In similar circumstances, courts have held that it is unreasonable for an agency to depart from its long-standing practices without a legitimate basis for doing so. *See, e.g., Cotton Petroleum Corp. v. United States Dep't of Interior, Bureau of Indian Affairs*, 870 F.2d 1515, 1526 (10th Cir. 1989) (Assistant Secretary's disapproval of a communization agreement without reference to factors required under established agency guidelines deemed arbitrary and capricious); *Pharmanex, Inc. v. Shalala*, 35 F. Supp. 2d 1341, 1348 (D. Utah 1999) (FDA's failure to consider its own longstanding prior interpretation of a statute, and to explain why that interpretation no longer applied, constituted sufficient ground to invalidate a new interpretation); *NAACP v. United States Secretary of Labor*, 865 F. Supp. 903, 912-13 (D. D.C. 1994) (Department of Labor's unexplained change in longstanding policies regarding payment practices held arbitrary and capricious); *Stellacom, Inc. v. United States*, 783 F. Supp. 647, 655

[4] *See, e.g.*, Texaco's May 28, 1997 Comments, at pp. 13, 33-35, and Tab 4; Independent Petroleum Association of America's May 15, 1997 Comments, at p. 9; Dr. Joseph P. Kalt's May 27, 1997 Comments, at pp. 3, 5; Mobil Oil Corporation's May 27, 1997 Comments, at pp. 2, 6-7; Rocky Mountain Oil & Gas Association's May 28, 1997 Comments, at p. 3; Scurlock Permian Corporation's April 17, 1997 Comments, at p. 2; Conoco, Inc.'s August 1, 1997 Comment's, at pp. 1-2; Koch Oil Company's July 29, 1997 Comments, at pp. 2-4; Marathon Oil Company's August 1, 1997 Comments, at p. 3; Union Pacific Resources Company's November 5, 1997 Comments, at pp. 3-4; Texaco's April 6, 1998 Comments, at p. 2; Coastal Oil & Gas Corporation, *et al.'s* April 6, 1998 Comments, at p. 6; Marathon Oil Company's April 7, 1998 Comments, at p. 2; Mobil Oil Corporation's April 7, 1998 Comments, at pp. 5-6; Oryx Energy Company's April 3, 1998 Comments, at p. 2; The Barents Group L.L.C.'s July 31, 1998 Comments, at p. 25; Conoco, Inc.'s July 30, 1998 Comments, at pp. 2, 4, 6; Hunt Oil Company's July 23, 1998 Comments; Marathon Oil Company's July 31, 1998 Comments, at p. 4; and Shell Oil Company's July 31, 1998 Comments, at pp. 1-2.

(D. D.C. 1992) (Small Business Administration's amendment of its regulations held arbitrary and capricious because it was an unexplained departure from a near thirty-year practice).

In *Marathon Oil Co.*, for example, the court considered whether MMS's attempt to change its then fifty-year old policy that royalty was not due on oil used in lease production or unavoidably lost was arbitrary and capricious. As the court in that case explained:

> For more than half a century, both the government, as lessor, and all of its lessees have understood and have been governed by the pertinent statutes to the end that all oil and gas used on the lease for ordinary production purposes or unavoidably lost were not subject to royalty payments to the government. Nor has the Department attempted to collect royalties on the aforesaid oil and gas unavoidably lost or used in venting or flaring in the processing facilities until the issuance of the NTL-4 Notices. Thus, the question for determination is whether requiring plaintiffs and intervenors to pay royalties on this type of oil and gas is arbitrary and capricious.
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> This Court cannot lose sight of the general rule that, when the executive department charged with the execution of a statute gives a construction to it and acts upon that construction for many years, the Court looks with disfavor upon a change whereby parties who have contracted in good faith under the old construction may be injured by a different interpretation.

452 F. Supp. at 551. Relying in part on *California v. Deseret Water Oil and Irrigation Co.*, 243 U.S. 415, 421 (1917), in which "[t]he Supreme Court supported the binding effect of such departmental rulings and practices on the grounds that such administrative rulings and practices had become a 'rule of property,'" the court struck down the new policy, concluding *inter alia* that it was arbitrary and capricious. *Marathon Oil Co.*, 452 F. Supp. at 552; *accord Amoco Prod. Co. v. Andrus*, 527 F. Supp. 790, 791 (E.D. La. 1981) (holding that it was arbitrary and capricious for DOI to reverse its "long-standing policy to exempt from royalty payments Lost and Used Hydrocarbons"). *See also Independent Petroleum Ass'n of Am. v. Babbitt*, 92 F.3d 1248, 1250 (D.C. Cir. 1996) (holding that "DOI impermissibly departed from its established practices in attempting to collect royalties on" a take-or-pay settlement payment).

The proposed rule is also arbitrary and capricious for another, independent reason: it treats similarly situated leases differently. It is a fundamental precept of administrative law that agencies are required to treat like cases alike. *See Freeman Eng'g Assocs.*, 103 F.3d at 178 ("Further, an agency may not 'treat like cases differently.'") (quoting from *Airmark Corp. v. FAA*, 758 F.2d 685, 691 (D.C. Cir. 1985)); *LaShawn A. v. Barry*, 87 F.3d 1389, 1393 (D.C. Cir. 1996) (*en banc*) (treating like cases alike is "the most basic principle of jurisprudence"); *Henry v. INS*, 74 F.3d 1, 6 (1st Cir. 1996) ("administrative agencies must apply the same basic rules to all similarly situated supplicants"). There is no rational basis for applying different valuation methodologies to similarly situated lease production based solely on the corporate structure of the lessee or the fact that one lessee sells its production at arm's-length while the other chooses to refine it. *See Phillips Petroleum Co.*, 109 IBLA 4, 9 (1989) (concluding it was arbitrary and capricious for MMS to accept Department of Energy ceiling price for natural gas liquid products at one plant but not at others); *see also Shell Western E&P, Inc.*, 112 IBLA 394 (1990) (holding that MMS may not apply royalty valuation rules in a manner that unfairly discriminates against integrated lessees). As the District of Columbia Circuit held in *Independent Petroleum Association*: "The treatment of cases A and B, where the two cases are functionally indistinguishable, must be consistent. That is the very meaning of the arbitrary and capricious standard." 92 F.2d at 1260.

Even for integrated lessees, the proposal irrationally applies different index pricing rules for oil produced in California. The proposed index pricing rules for oil produced everywhere except California require the lessee to use spot prices for the market center nearest the lease and crude oil similar in quality to the lease production.[5] Yet for California production, the proposal uses spot prices from a far away market for a crude with dramatically different quality characteristics from the oil produced from leases in California. Because the proposed valuation methodology fails to treat like cases alike, it is arbitrary and capricious.

IV. THE PROPOSED VALUATION METHODOLOGY CANNOT LAWFULLY BE APPLIED TO TEXACO'S EXISTING LEASES

Even if the proposed valuation methodology were not unlawful and arbitrary and capricious, it still could not be applied to Texaco's existing leases.

A. Application of the Proposed Valuation Methodology to Texaco's Existing Leases Would be Contrary to the Well-Settled Presumption Against Retroactive Legislation and Regulations

Regulations have the force and effect of law only when they are promulgated pursuant to a statutory grant of authority. *See Chrysler Corp. v. Brown*, 441 U.S. 281, 308 (1979); *accord, Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988) ("It is axiomatic that an administrative agency's power to promulgate legislative regulations is limited to the authority delegated by Congress.") There is a time-honored presumption against retroactive legislation and regulations. *Bowen*, 488 U.S. at 208 ("Retroactivity is not favored in the law. Thus, congressional enactments and administrative rules will not be construed to have retroactive effect unless their language requires this result.") Throughout its history, the Supreme Court has consistently declined to give retroactive effect to statutes burdening private rights unless

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[5] For the Rocky Mountain Region, proposed 206.103(b)(3) establishes Cushing, Oklahoma and West Texas Intermediate as the market center nearest the lease and crude oil similar in quality to the lease production.

Congress has made clear its intent to do so. *Landgraf v. USI Film Products*, 511 U.S. 244, 270 (1994). As the Court in *Landgraf* explained:

> [T]he presumption against retroactive legislation is deeply rooted in our jurisprudence, and embodies a legal doctrine centuries older than our Republic. Elementary considerations of fairness dictate that individuals should have an opportunity to know what the law is and to conform their conduct accordingly; settled expectations should not be lightly disrupted.

511 U.S. at 265 (footnotes omitted); *accord Hughes Aircraft Co.*, 520 U.S. at 946 ("We have frequently noted, and just recently reaffirmed that there is a 'presumption against retroactive legislation [that] is deeply rooted in our jurisprudence.'... Accordingly, we apply this time-honored presumption unless Congress has clearly manifested its intent to the contrary.") (citation omitted).

The presumption against retroactivity is rooted in concerns of fundamental fairness. *See, e.g., Eastern Enters. v. Apfel*, 524 U.S. 498, 118 S. Ct. 2131, 2151 (1998) ("Retroactive legislation ... presents problems of unfairness that are more serious than those posed by prospective legislation, because it can deprive citizens of legitimate expectations and upset settled transactions.") (citations and internal quotation marks omitted); *Clark-Cowlitz Joint Operating Agency v. FERC*, 826 F.2d 1074, 1082 n.6 (D.C. Cir. 1987) (evaluating the permissibility of retroactive application "boil[s] down ... to a question of concerns grounded in notions of equity and fairness"); 2 Joseph Story, *Commentaries on the Constitution of the United States* § 1398, at 272 (5th ed. 1891) ("Retrospective laws are, indeed, generally unjust; and, as has been forcibly said, neither accord with sound legislation nor with the fundamental principles of the social compact.") The presumption applies with particular force when the "new provisions affect[] contractual or property rights, matters in which predictability are of prime importance." *Landgraf*, 511 U.S. at 271. *See also Sinking-Fund Cases*, 99 U.S. at 721-22 (holding that Congress "cannot unmake contracts that have already been made, but it may provide for what shall be done in the future, and may direct what preparation shall be made for the due performance of contracts already entered into").

The hurdle is even higher for retroactive regulations than for retroactive statutes; not only must the regulation expressly provide that it is retroactive, but Congress must have expressly authorized the promulgation of retroactive regulations. *Bowen*, 488 U.S. at 208 ("a statutory grant of legislative rulemaking authority will not, as a general matter, be understood to encompass the power to promulgate retroactive rules unless that power is conveyed by Congress in express terms").

The Supreme Court's decision in *Bowen v. Georgetown University Hospital* is instructive in this regard. That case involved cost reimbursement regulations promulgated by HHS under the Medicare program. HHS first published the regulations in 1981, changing the methods for calculating cost limits on reimbursable Medicare costs. 488 U.S. at 206. The district court invalidated the regulations because the Secretary had violated the APA, 5 U.S.C. § 553, by not providing notice and an opportunity for public comment. *Id.* Three years later, HHS reissued the same regulations but made them retroactive to July 1, 1981. *Id.* at 207. The district court once again struck down the regulations. The District of Columbia Circuit affirmed, and the Supreme Court granted *certiorari* to consider whether the Medicare Act authorized retroactive rulemaking. *Id.* In particular, the Court analyzed the following provision of the Medicare Act:

> Such regulations shall . . . (ii) provide for the making of suitable retroactive corrective adjustments where, for a provider of services for any fiscal period, the aggregate reimbursement produced by the methods of determining costs proves to be either inadequate or excessive.

42 U.S.C. § 1395x(v)(1)(A) (1994).

The Court began its analysis with the well-established principle that an administrative agency's power to promulgate regulations is limited to the authority delegated by Congress. 488 U.S. at 208. The Court concluded that the Medicare Act permitted the Secretary to make retroactive adjustments on a case-by-case basis but not to promulgate retroactive regulations. In reaching this result, the Court reiterated the well-settled principle that because "[r]etroactivity is not favored in the law," legislation and regulations will not be construed to have retroactive effect unless their language explicitly requires retroactive application. 488 U.S. at 208 (citations omitted). The Court then expanded on this principle to state that "a statutory grant of legislative rulemaking authority will not, as a general matter, be understood to encompass the power to promulgate retroactive rules unless that power is conveyed by Congress in express terms." *Id.* at 208. In addition, the Court emphasized that a court should not uphold an agency attempt to apply a regulation retroactively if Congress has not explicitly authorized the agency to regulate retroactively "[e]ven where some substantial justification for retroactive rulemaking is presented . . . ." *Id.*

The Mineral Leasing Act and Federal Oil and Gas Royalty Management Act even more plainly preclude retroactive regulations than the Medicare statute at issue in *Bowen* because, unlike the Medicare statute, neither the MLA nor FOGRMA even permits retroactive adjustments on a case-by-case basis. *Compare* 42 U.S.C. § 1395x(v)(1)(A) ("Such regulations shall . . . (ii) provide for the making of suitable retroactive corrective adjustments"), *with* 30 U.S.C. § 189 ("The Secretary of the Interior is authorized to prescribe necessary and proper rules and regulations....") *and* 30 U.S.C. § 1751(a), (b) ("Rules and regulations issued to implement this Act shall be issued in conformity with section 553 of title 5 of the United States Code, notwithstanding section 553(a)(2) of that title.") Thus, the mineral leasing laws certainly cannot be said to evidence clear and emphatic Congressional intent that the Secretary be permitted to promulgate retroactive regulations. Accordingly, the Secretary lacks the statutory authority to apply the proposed valuation methodology to Texaco's existing leases.

B. Application of the Proposed Valuation Methodology to Texaco's Existing Leases Would Effect an Unconstitutional Taking Without Just Compensation in Violation of the Fifth Amendment

Applying the proposed valuation methodology to Texaco's existing lease agreements would also effect a taking without just compensation in violation of the Takings Clause of the Fifth Amendment. The Takings Clause prohibits the government from taking private property "for public use, without just compensation." U.S. Const., amend. V. Application of the new valuation methodology to Texaco's existing leases would constitute a "taking" within the meaning of the Takings Clause because it would take from Texaco, without compensation and for the government's own use, Texaco's "rights in specific property which are of substantial value." *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 601 (1935) (holding unconstitutional the Depression-era Frazier-Lemke Act, enacted to save mortgaged farms from foreclosure).

Texaco has vested property rights in its oil and gas leases. *E.g., Continental Oil Co.*, 184 F.2d at 810 ("Leases of the kind here involved are predicated upon large expenditures of money, time and effort in making the required discoveries and in bringing these properties into production. The rights of the lessees are valuable property rights."); *see also Lynch v. United States*, 292 U.S. at 579 ("Valid contracts are property, whether the obligor be a private individual, a municipality, a State or the United States. Rights against the United States arising out of a contract with it are protected by the Fifth Amendment.") Applying the proposed methodology to Texaco's leases would impair Texaco's vested rights because it would effectively raise the royalty rate by assessing royalties on not only the value of lease production, but also on the enhanced value of downstream assets and services. In this respect, the proposed valuation methodology is more closely analogous to a "confiscatory regulation" than to an "economic regulation." *See Phillips v. Washington Legal Found.*, 524 U.S. 156, 166-67 (1998) (a "confiscatory regulation" results in a physical taking of property, whereas an "economic regulation" can cause only an indirect taking); *see also Eastern Enters.*,[6] 118 S. Ct. at 2146

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6 *Eastern Enterprises* involved a challenge to the Coal Industry Retiree Health Benefit Act of 1992 ("Coal Act"), Pub. L. No. 102-486, § 19142(a)(2), 106 Stat. 3036, 3037 (1992), codified at 26 U.S.C. § 9701, which purported to "identify persons most responsible" for certain post-retirement health care liabilities for retired coal miners, and assessed against those persons an annual premium to cover the liabilities. Eastern Enterprises conducted extensive coal mining operations until 1965 when it transferred its coal-related operations to a subsidiary, which eventually sold the business in 1987. By the time the Coal Act was enacted, neither Eastern Enterprises nor any of its affiliates was even engaged in the coal mining business, yet it was assessed an annual premium of more than $5 million. Justice O'Connor, joined by the Chief Justice and Justices Scalia and Thomas, concluded that the Coal Act, as applied to Eastern Enterprises, effected an unconstitutional taking because it imposed a severe, disproportionate and extremely retroactive burden. 118 S. Ct. at 2153. Justice Kennedy likewise concluded that the Coal Act was unconstitutional, but found that it violated the Due Process Clause of the Fifth Amendment rather than the Takings Clause. *Id.* at 2154. Justice Breyer, joined by Justices Stevens, Souter, and Ginsburg, agreed with Justice Kennedy "that the plurality views this case through the wrong legal lens" because the "case involves, not an interest in

(observing that "takings problems are more commonly presented when 'the interference with property can be characterized as a physical invasion by the government, than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the common good'") (quoting *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978)).

Through the proposed valuation methodology, MMS seeks to take unto itself the value added by Texaco's affiliates' downstream assets and services, which the Fifth Amendment forbids in the absence of just compensation. *See Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 164-65 (1980) (holding that "Seminole county's taking unto itself . . . the interest earned on the interpleader fund while it was in the registry of the court was a taking violative of the Fifth and Fourteenth Amendments"). The proposal is therefore contrary to Texaco's constitutional rights, privileges and immunities.

C. Application of the Proposed Valuation Methodology to Texaco's Existing Leases Would Deprive Texaco of Its Property Without Due Process in Violation of the Fifth Amendment

Application of the new royalty valuation methodology to Texaco's existing leases would also deprive Texaco of property "without due process of law" in violation of the Due Process Clause of the Fifth Amendment. Statutes have been held to violate the Due Process Clause when they are irrational and arbitrary. *See Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 15 (1976); *Association of Bituminous Contractors, Inc. v. Apfel*, 156 F.3d 1246, 1255 (D.C. Cir. 1998) (for legislation with retroactive effect to satisfy the Due Process Clause "the 'retroactive application of legislation [must] itself [be] justified by a rational legislative purpose'") (quoting *Pension Benefit Guar. Corp. v. R. A. Gray & Co.*, 467 U.S. 717, 729-30 (1984)). The presumption against retroactivity, discussed above, is closely tied to the protections afforded by the Due Process Clause. Both preclude the government from unfairly interfering with reasonable investment-backed expectations. As Justice Kennedy explained in *Eastern Enterprises*:

> If retroactive laws change the legal consequences of transactions long closed, the change can destroy the reasonable certainty and security which are the very objects of property ownership. As a consequence, due process protection for property must be understood to incorporate our settled tradition against retroactive

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physical or intellectual property, but an ordinary liability to pay money, and not to the Government but to third parties." *Id.* at 2161, 2162. However, the four-Justice minority disagreed with Justice Kennedy's and the plurality's conclusion that the Coal Act was unconstitutional as applied to Eastern Enterprises. *Id.* Because the proposed rule involves an interest in property, the Takings Clause is the correct "legal lens." Whether analyzed under the Takings Clause or Due Process Clause, however, the result should be the same: application of the proposed valuation methodology to Texaco's existing leases would be unconstitutional.

> laws of great severity.... Both stability of investment and confidence in the constitutional system, then, are secured by due process restrictions against severe retroactive legislation.

Eastern Enters., 118 S. Ct. at 2159 (Kennedy, J., concurring in judgment and dissenting in part).

In investing in federal oil and gas leases, Texaco reasonably relied on MMS's and its predecessors' long-standing interpretation of the royalty valuation rules. Texaco and its affiliates further relied on that long-standing interpretation when they invested in blending facilities, pipelines, and other downstream assets. By seeking additional royalties under a dramatically new valuation methodology, the proposed rule would both breach the government's lease contracts with Texaco and unfairly upset Texaco's reasonable investment-backed expectations. Because "it is fundamentally unfair and unjust, in terms of [Texaco's] reasonable reliance and settled expectations, to impose that liability," application of the proposed valuation methodology to Texaco's leases would violate the Due Process Clause of the Fifth Amendment. *Eastern Enters.*, 118 S. Ct. at 2164 (Breyer, J., dissenting).

V. AREAS REQUIRING CLARIFICATION

While Texaco respectfully urges MMS to reconsider the entire proposal, should MMS decide instead to promulgate the proposal as a final rule, five aspects require clarification.

A. Index Pricing Election

Proposed 206.102(d)(2)(i) appears to limit the election to use index pricing to circumstances in which the lessee's *affiliate* resells the oil under an arm's-length contract, yet proposed 206.102(a)(2) includes both sales to affiliates *and non-arm's-length sales to other persons*. As a result, the proposal appears to require the lessee to trace the ultimate disposition of oil first sold to a *non-affiliate* under a non-arm's-length sale without the option of using index pricing. Attempting to trace the ultimate disposition of oil sold to a non-affiliate would undoubtedly be even more burdensome than attempting to trace the disposition of oil sold to an affiliate. At the Houston workshop, MMS stated that the proposal was intended to allow the election whenever the lease production is not first sold at arm's length. MMS should make appropriate changes to the proposal to express this intent.

Texaco appreciates MMS's clarification at the Houston workshop that if a lessee makes an election to use index pricing, the election applies only to oil sold non-arm's-length, either to an affiliate or another person, and does not apply to oil sold by the lessee under an arm's-length contract. Thus, for example, if TEPI were to sell 40 percent of its lease production under its tendering program in arm's-length sales, and 60 percent to an affiliate, but made an election to use index pricing under proposed 206.102(d), only the oil sold to the affiliate would be valued using index pricing and the oil sold at arm's-length under TEPI's tendering program would be valued based on the proceeds accruing to TEPI from the tendering sales.

B. Rocky Mountain Region Benchmarks

In recognition of the difficulty of tracing production in some exchanges and affiliate resales, the further supplementary proposed rule provides the option for the lessee to use index pricing. However, the Rocky Mountain benchmarks for production not sold at arm's length do not allow a comparable option for production from the Rocky Mountain Region. Consequently, unless a lessee has an MMS-approved tendering program, the proposal would require the lessee to trace the ultimate disposition of lease production in order to determine whether the second benchmark applies. For the reasons set forth in Texaco's April 6, 1998 comments, and apparently acknowledged by MMS for production everywhere other than the Rocky Mountain Region, it may not be possible to track the ultimate disposition of production from any particular lease or of crude oil received in exchange for lease production. There is no reason to expect that tracing production from the Rocky Mountain Region will be any less difficult than tracing production from other parts of the country. Accordingly, MMS should modify the Rocky Mountain benchmarks to provide an index pricing option for lessees that do not dispose of their oil under an MMS-approved tendering program.

C. Value Determinations by MMS Staff

Under proposed 206.107(d)(2), value determinations by MMS staff would not be appealable. The commentary accompanying the proposal asserts that a right of appeal is unnecessary because "[a] lessee that disagrees with a value determination by MMS may … choose not to follow the determination, since it would not be binding on the lessee." 64 Fed. Reg. at 73833. Although the MMS staff determinations may not technically be "binding," they nevertheless represent an authoritative interpretation by MMS of its regulations. Hence, a lessee who knowingly fails to comply with such a determination could be exposed to allegations under the False Claims Act, 31 U.S.C. § 3729(a) for having falsely reported the value of its federal lease production. Even baseless allegations can be time-consuming and expensive to resolve. Thus, by failing to provide a right of appeal, the proposal may effectively discourage lessees from seeking valuation determinations if there is any chance that MMS will disagree with the lessee's proposed valuation methodology. MMS should revise the proposal to provide a right of appeal from all value determinations, whether signed by the Assistant Secretary or by MMS staff.

D. "Settlement Agreements"

Proposed 206.100(b)(2) would provide that the regulations do not apply to the extent they are inconsistent with "[a] settlement agreement between the United States and a lessee resulting from administrative or judicial litigation." The phrase "resulting from administrative or judicial litigation" unnecessarily restricts the scope of this provision and may lead to disputes about whether or not the parties were in "litigation" at the time they reached an agreement. The phrase "resulting from administrative or judicial litigation" could simply be deleted. Alternatively, MMS could replace it with "resulting from or arising out of an administrative or judicial action."

E. Definition of "Month"

For production from leases in California or Alaska, proposed 206.103(a) requires the calculation of an average of the daily mean ANS spot prices during the calendar month preceding the production month. For production from leases in the Rocky Mountain Region, proposed 206.103(b)(3) requires the calculation of a monthly average of the daily mean spot prices for WTI at Cushing, Oklahoma but does not specify whether "month" is a calendar month or a trading month. For leases everywhere else, proposed 206.103(c)(2) requires calculation of a monthly average of the daily mean spot prices for the market center nearest the lease for crude oil similar in quality, but, again, does not specify whether "month" is a calendar month or a trading month.

When spot prices are used in actual crude oil transactions, they are based on a "trading" month, which begins on the 26th day of the first month and ends on the 25th day of the second month. Using a "month" different from the month actually used in the industry needlessly complicates the already burdensome requirement to compute royalty value and adjustments under the proposal. There is also no reason to define "month" differently in different sections of the regulation. Accordingly, MMS should clarify that the monthly average of daily mean spot prices – for all three geographic regions – means the trading month.

VI. CONCLUSION

Texaco urges MMS to withdraw the "Further Supplementary Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases" because it does not provide for value at the lease and it unfairly and unlawfully attempts to boost government revenues by effectively raising the royalty rate for integrated lessees' federal crude oil production. The proposed rule exceeds the statutory authority of the Secretary because it adopts a valuation methodology that conflicts with the plain language of the Mineral Leasing Act of 1920, the Outer Continental Shelf Lands Act, and the terms of Texaco's leases. The proposal is also arbitrary and capricious because it abruptly changes decades of settled policy and practice without a legitimate reason, and irrationally treats similarly situated leases differently. Moreover, even if MMS were to promulgate the proposal as a final rule, the proposed valuation methodology could not lawfully be applied to Texaco's existing leases. Texaco stands ready to assist MMS in any effort to clarify or improve methods to ascertain values of crude oil at the lease, as required by statute and the terms of Federal oil and gas leases.

Sincerely,

James C. Pruitt

James C. Pruitt