KOCH

KOCH OIL COMPANY

JUL 3 1997

July 29, 1997

VIA AIRBORNE EXPRESS

Minerals Management Service
Royalty Management Program
P.O. Box 25165
MS 3101
Denver, Colorado 80225-00165

RE: Proposed Rules of the Department of the Interior, Minerals Management Service 30 CFR Parts 206 and 208, 62 FR 3742 "Establishing Oil Value For Royalty Due on Federal Leases and on Sale of Federal Royalty Oil," January 24, 1997, as amended July 3, 1997.

Dear Sir or Madam:

Koch Oil Company is pleased to submit the enclosed comments regarding the above-referenced proposed rule.

As set out in our comments, we believe that the proposed rule will have adverse direct and indirect effects on the United States crude oil market. We therefore urge that the proposal be withdrawn.

Very truly yours,

Karl N. Hesse

Karl N. Hesse
Attorney at Law

Enclosure

P.O. Box 2256 ▪ Wichita, Kansas 67201 ▪ 316/828-5500

COMMENTS OF KOCH OIL COMPANY
on
THE PROPOSED RULES OF THE MINERALS MANAGEMENT SERVICE
relating to
ESTABLISHING OIL VALUE FOR ROYALTY DUE ON FEDERAL LEASES AND ON SALE OF FEDERAL ROYALTY OIL

Introduction: Koch Oil Company

Koch Oil Company (KOC) is headquartered in Wichita, Kansas, and has offices in Houston, Dallas, Midland, Oklahoma City, Tulsa, Denver, and Bakersfield. KOC is an independent purchaser of crude oil. As such, it purchases and gathers crude oil from leases in various parts of the country, and then transports it to downstream markets to be sold. KOC holds no federal lease interests and no operating interest in any crude oil producing field.

KOC's sister company, Koch Exploration Company, is a crude oil production company that has, within the last few years, terminated virtually all of its United States production operations. Since 1990, only about 1.5% of the crude oil which KOC has purchased in the United States was purchased from Koch Exploration Company. KOC therefore considers itself an "independent purchaser" of crude oil and has assessed the proposed regulations from the viewpoint of an independent purchaser.

Summary of KOC's Position

Koch Oil Company opposes the proposed regulations on several grounds. KOC's main concern is that the proposed regulations are not based upon sound, market-based economic principles which are necessary for the efficient operation of a liquid commodity market. Instead, the proposed regulations contemplate one entity, a federal agency, that would be charged with the responsibility of guiding the constantly changing crude oil market. KOC believes that the proposed regulation, if implemented, will seriously undermine the effectiveness of the United States crude oil markets. In short, implementation of the proposed regulations would lead to inefficiencies in the marketplace, more administrative burdens on market participants, and ultimately, higher prices paid by the consumer.

I. A Free Market, Not An Artificial Market, Is The Best Determinant Of Value For Crude Oil And Other Commodities.

For centuries, the free market has proven itself to be the most efficient means by which to value commodities. When buyers and sellers are free to act within a marketplace in a manner that satisfies their individual needs and desires, prices are negotiated and maximum societal wealth ultimately is created. Sellers have the economic incentive to obtain the highest price possible for the commodity, whereas buyers are looking to keep as many resources in their pocket as possible. Somewhere in the middle, buyers and sellers agree to a price for the commodity. The ultimate price agreed upon is a product of the individual needs of the players at any one point in time, together with a plethora of other dynamic factors (including competing buyers and sellers and even the weather, to name just a few). Indeed, the price resulting from this process is truly a "market price."

The market responds to this pricing process by producing more or less of the commodity. If there is a shortage or overage of the commodity, the market, if not intruded upon, will "self-correct" the imbalance. Through this process, there is never too much or too little of the commodity for an extended period of time.

The free market therefore provides a natural tendency toward self-correction, a tendency which is guided by individual initiatives. When the market is disturbed by an arbitrary action (governmental price fixing, for example), inefficiencies occur. By way of example, these inefficiencies can take the form of artificial and unnecessary shortages or surpluses which distort the market and dampen the incentive of the individual to create societal wealth. Only if left undisturbed will the individual initiatives that are taken in a market result in resources being allocated to their best use. Indeed, never in this nation's history, if not the world's history, has any entity or individual been able to appropriately allocate resources more efficiently than a free market.

The proposed regulation is a step backward, making efficient allocation of resources less likely. Further, KOC believes that the MMS has overlooked the secondary effects of the proposed rule on the United States crude oil markets. As stated previously, when the marketplace for any commodity is disturbed, inefficiencies occur, and the incentive of the individual to create societal wealth is dampened. Crude oil markets are no exception. The proposed rule will act as a form of "price fixing," thus prompting inefficiencies in the market.

The main problem with the rule in this regard is its prescription for how crude oil should be valued for purposes of calculating royalties due to the MMS. The proposed regulation provides that the rule for valuation of crude oil sold in an arm's-length transaction is to be based upon "gross proceeds" accruing to the operator. The regulations go on to carve out several exceptions to this rule, the effect of which is to apply an artificial price (i.e. a NYMEX price) as the first step in determining the value of crude oil in virtually all purchase transactions on federal lands--including negotiated, arm's-length transactions. By defining virtually all transactions on federal lands as "non-arm's length," the MMS has magnified its abandonment of basic market principles and has cast its net too wide. In short, the proposed regulations are an intrusion into the marketplace which will result in misallocation of this nation's crude oil resources.

II. The Mechanics of the Proposed Regulations Are Overly Technical, Confusing And Incapable of Producing Royalties Based Upon A "Fair Market Price."

In addition to being fundamentally flawed in their attempt to create an artificial market, the mechanics of the proposed regulations are overly technical and confusing. They are likely to produce obsolete results at almost all times. As such, the regulatory mechanism would almost never reflect current market conditions or lead to payment of royalties based upon a "fair market price."

First, the proposed rule specifies that the NYMEX futures price is to be used as a basis price for the calculation of royalties in virtually all crude oil purchase transactions on federal lands. This creates reliance, in all such cases, on one specific unrelated future sale by unrelated parties in unrelated downstream markets. As many companies pointed out in the public meetings regarding the proposed regulations, the NYMEX is a futures spot price which does not bear a relationship to <u>all</u> crude oil pricing in <u>every</u> case.

This point is readily demonstrated by the MMS' attempt to use an article from KOC's April 1995 customer newsletter, ***At Your Service***, to support the proposed regulations. On at lcast thrcc occasions, and in a letter to the editor of <u>Business Week</u>

Magazine, the MMS attempted to create a nexus between the pricing mechanism in the proposed regulations and the reference to the NYMEX in KOC's article, entitled "From the NYMEX to Your Check." [1] However, the article does not support strict reliance on the use of the NYMEX in crude oil pricing. Rather, the article points out only a few of the dynamic factors that may come into play in determining the price of crude oil. The article did not begin to describe the complexity associated with the many segments in the value chain between the wellhead and a market (NYMEX, for one), such as:

- Marketing of lease crude oil (brokerage companies)
- Gathering of lease crude oil (truck and pipeline gathering companies)
- Storage and terminalling of crude oil (terminal/storage companies)
- Quality optimization of crude oil (refinery supply companies)
- Mainline transportation of crude oil (common carrier pipeline companies)
- Hedging/Risk Management (trading companies)

Each of these segments has its own "market" that is driven by supply/demand capacity and hundreds of other dynamic market and natural forces. Some companies can provide all or most of the segments in the value chain, while others specialize in one or a few segments. Promulgating one specific "NYMEX netback" methodology to calculate royalties presumes unchanging relationships in these value chain segments.

Adopting NYMEX as "the" one true price base for all crude oil wherever located in the United States (except California) is as irrational and unworkable as adopting the location and quality differential between a Bowman County, North Dakota lease and the Fort Laramie/Guernsey market as "the" one true differential for all crude oil wherever located in the United States.

[1] A copy of KOC's letter to the MMS referencing misuse of the newsletter article is included as Attachment "A". A copy of MMS' response to KOC's letter is included as Attachment "B".

Second, even if there were a sound rationale for use of the NYMEX futures price as the price basis for valuation of crude oil in all places (with the exception of California), the proposed "netting back" method is, by itself, still unrealistic and objectionable. Publishing a list of location and quality differentials will virtually ensure unfair and inaccurate pricing. At almost all times, the list will be obsolete and thus will not reflect current market conditions. This is because no one can have the knowledge sufficient to draft and implement a set of regulations and make calculations that would provide for the myriad of constantly changing factors which come into play in crude oil markets and pricing.

Indeed, the proposed regulations cannot produce a realistic valuation of crude oil for any individual lease because the MMS could not possibly accurately consider the following changing factors which come into play in crude oil pricing: quality, gravity and location of crude oil; ease of access to the lease (road conditions, transportation mode which may be via truck during one month and via pipeline the next); competitive factors (which competing companies are attempting to purchase crude oil in the area); resale market conditions; supply and demand; weather; foreign politics; and consumer desires and needs. In addition, the market's perception of each of the foregoing factors adds another component to the valuation and pricing of crude oil.

It will be difficult, if not impossible, for the proposed pricing mechanism to make appropriate adjustments for other market forces which may play a part in the pricing of crude oil in the field. For example, the proposed regulations cannot take into account specific objectives of certain purchasers like Koch, which may be willing to pay a higher price for crude oil for a long-term contract commitment, or other purchasers who are willing to pay higher prices for greater volumes of crude oil. Adjusting the differentials annually does not remedy this defect since these factors are in a state of constant change.

Local crude oil markets are simply too complex for even the most informed individual, group of individuals, or consultant to adequately capture in the proposed pricing mechanism. It will mean, literally, measuring and incorporating countless individual initiatives, all of which are constantly changing. Thus, the proposed regulations, in most instances, would fail to establish a "fair market value" for crude oil at any given time.

III. <u>The Proposed Valuation Regulations Would Have An Adverse Effect On Purchasers And Other Market Players</u>

As an independent purchaser of crude oil at the wellhead, KOC provides a valuable service to the operator, the interest owners and the consumer. For example, once it purchases crude oil from the lease, KOC 1) assumes the risk of loss for the crude oil between the wellhead and the market; 2) assumes the risk of price volatility between the time of purchase and the time of resale; 3) assumes environmental risk; 4) assumes risk associated with constantly changing customer and consumer demand; and 5) often assumes the responsibility of paying directly to the interest owners (including the Federal Government) the funds to which they are entitled.

While KOC does not own any producing rights on any lands (federal or otherwise) and therefore does not operate any properties, KOC often pays federal royalties as a payor on behalf of lessees or operators from whom it buys crude oil. When it is the "payor," KOC pays royalties to interest owners based upon its contract with the field production operator, an arm's length negotiated price. In most cases, this service (known as "holding the basic division order") is a valuable one to an operator who does not have the resources or the expertise to disburse funds to the appropriate owners.

In order to provide this service in the context of the proposed regulations, KOC would likely incur cost through paying operators and other working interest owners based upon one price, and paying the royalty based upon another price. Basing royalty on an artificial "market price" with artificial deducts stacked on top will create administrative and accounting burdens for payors like KOC, very possibly making it uneconomic for them to carry out this function. This would force the disbursement burden back to the operator, who could better spend his time producing crude oil, exploring new ways to enhance oil production, or engaging in other activities in which he has a comparative advantage.

In essence, the proposed regulations fail to recognize value added services which purchasers like KOC provide in the United States crude oil market. As such, KOC questions whether it will be economical for it to continue to provide these services in the future to sellers of crude oil produced on federal lands.

Finally, KOC believes that the proposed regulations will not create more profit for the government; rather, they will create more work for the government and the MMS as well as a new set of more serious problems. The MMS might well end up spending more money to make less money. Take, for example, the requirement that MMS will publish a set of "location/quality differentials." Completing such a task will certainly take many hours of research, audits and drafting on the part of MMS. The task of keeping it up to date will be even more onerous, indeed impossible, since the differentials will, literally, change from day-to-day, hour-to-hour, and moment-to-moment, depending on market factors. At all times, the "location/quality" differential publication will contain stale MMS numbers that do not reflect actual market conditions. It will result in burdensome, costly and confusing data reporting requirements, data distortions as transaction volumes change in individual markets, and disputes over special adjustments for quality variations and other issues created by averaging and estimating. Increased transaction costs for the MMS, producers and purchasers will ultimately be passed on to the consumer in the form of higher prices.

ATTACHMENT A

KOCH

KOCH OIL COMPANY

RANDOLPH C. ALDRIDGE
PRESIDENT

May 15, 1997

Ms. Cynthia Quarterman
Director, Minerals Management Service
Department of the Interior
1849 C Street, NW
Washington, DC 20240

Dear Ms. Quarterman:

During the past two months, the Minerals Management Service (MMS) has cited, quoted and distributed a statement of Koch Oil Company in correspondence and discussions relating to the proposed rulemaking on crude oil valuation. These actions have contributed to a fundamental mischaracterization of Koch Oil Company's position on the issue. We therefore request that the MMS cease each of these activities.

The statement, entitled "From the NYMEX to Your Check," was written in 1995 as an article in a Koch Oil Company newsletter, which was subsequently added to the Company's Internet site. The purpose of the statement was merely to describe the crude oil "market" in terms of the complex pricing process at both the NYMEX and the wellhead. We also described several of the factors that determine the difference between the NYMEX price and the wellhead market price.

In a March 10, 1997 letter from the MMS to *Business Week*, our statement was expressly cited and used to defend the proposed rule against criticism contained in an article published in the magazine. During meetings with congressional staff and House members on March 11 and 12, the MMS referred to our statement as indicating industry support for the proposed rule. In addition, the MMS quoted the statement during its public meeting on the rule in Houston on April 17.

On each of these occasions, in explaining and promoting the rule, the MMS used our statement as an advocacy tool. This was done without our knowledge or permission. There was no disclaimer noting that use of the statement did not indicate Koch Oil Company's position on the merits of the proposal. As a result, the MMS created the impression, whether intended or not, that Koch supports the rule. This was clear from comments we received about our position.

The industry's use of the NYMEX pricing mechanism does not establish the validity of the pricing mechanism in the proposed rule. There is no appropriate justification for attempting to suggest, as the MMS has done, that our statement about the NYMEX helps to demonstrate petroleum industry support for the proposed rule. In fact, Koch Oil Company strongly opposes the rule and will file comments outlining our objections.

In general, we believe that the pricing mechanism in the proposed rule would not produce a fair market value at the wellhead. The proposed monthly pricing adjustments for location and quality differentials would not properly measure the various segments of the value chain that affect the wellhead price, such as marketing, gathering, storage, quality optimization, transportation, and hedging. Each of these segments has its own market that constantly changes in response to supply-demand fluctuations. This defect in the MMS proposal is not eliminated by reliance on NYMEX pricing as the starting point for the price calculation.

For this reason, and for the reasons outlined above, the MMS should not use our statement in promoting and defending the proposed rule. We request that the MMS cease the following activities: distributing copies of the statement, quoting from it during meetings, and making further references to it in oral or written communications.

Sincerely,

Randolph C. Aldridge

Randolph C. Aldridge

cc: Hon. Frank H. Murkowski
Hon. Don Nickles
Hon. Wendell H. Ford
Hon. John B. Breaux
Hon. Dale Bumpers
Hon. Mary Landrieu
Hon. Barbara Cubin
Hon. Chris John
Hon. Carlos Romero-Barcelo
Hon. Don Young
Hon. George Miller
Hon. James A. Gibbons
Hon. Solomon P. Ortiz
Hon. William "Mac" Thornberry
Hon. W.J. "Billy" Tauzin

ATTACHMENT B

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Washington, DC 20240

JUN - 4 1997

MMS-RVD
Mail Stop 3150

Mr. Randolph C. Aldridge
President
Koch Oil Company
P.O. Box 2256
Wichita, Kansas 67201

Dear Mr. Aldridge:

Thank you for your letter of May 15, 1997, addressing your concerns about recent Minerals Management Service (MMS) quotations from Koch Oil's Internet site. We are sensitive to your concerns and by no means meant to imply that Koch Oil endorses the Federal crude oil valuation proposed rulemaking.

When MMS began the rulemaking process, we asked for participation by affected parties as we have done in past rulemakings. Unfortunately, no oil company stepped forward to become part of the rulemaking team. MMS relied upon representatives from the states and Indian communities and on economic and industry consultants for input into the proposal. Because the New York Mercantile Exchange (NYMEX) is not widely understood by the general public, we looked for examples to show that it was a tool that has gained acceptance by industry. As part of this effort, we came across the article at your Internet site. We believe the article supports our statements that the NYMEX price is used by oil marketers as a benchmark in the daily exchange of oil throughout the United States.

However, in view of your concerns, I have directed my staff to no longer refer to the article to make the point about how NYMEX is utilized by industry. Please be assured that we have never attempted to represent Koch's position as endorsing the proposed rule and we never intended our comments to be construed in such a manner.

We look forward to receiving your comments on the proposed rulemaking. If you have further concerns about this matter please do not hesitate to contact me at (202) 208-3500.

Sincerely,

Cynthia Quarterman
ACTING FOR Director