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Armand Southall
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Attn: Regulation Identifier Number (RIN) 1012-AA13

Re: Comments on Office of Natural Resources Revenue (ONRR) Proposed Rule to Amend Federal Oil & Gas Valuation Regulations, 80 Fed. Reg. 608 (Jan. 6, 2015)

Submitted via: http://www.regulations.gov and U.S. mail

Dear Mr. Southall:

Chevron U.S.A. Inc. ("Chevron") appreciates the opportunity to comment on the Office of Natural Resources Revenue ("ONRR") Proposed Rule issued January 6, 2015 "Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform."[1] This rule would significantly alter regulations applicable to oil and gas valuation for royalties paid by oil and gas lessees on federal lands onshore and on the Outer Continental Shelf ("OCS").

Chevron is a member company of the American Petroleum Institute ("API") and the Council of Petroleum Accountants Societies ("COPAS"). As such Chevron endorses and supports the comments filed by API and COPAS on the Proposed Rule and incorporates them by reference.

Introduction and Summary of Chevron's Comments

Chevron is committed to working with the Department of the Interior on valid efforts to improve the regulations that "offer greater simplicity, certainty, clarity, and consistency in product valuation" and decrease compliance costs for all parties[2] but this Proposed Rule is not one of those valid efforts. ONRR provides insufficient reasons to put aside long-standing policy and regulations on which industry has relied for over a decade. While Chevron agrees that changes in the oil and gas industry may justify revisions to the valuation regulations, such as the use of index-based pricing, ONRR does not provide sufficient explanation for the indiscriminate addition of new obligations and standards, such as the proposed "Default Rule".

[1] 80 Fed. Reg. 608.
[2] Id.

The Administrative Procedure Act ("APA"), 5 U.S.C. § 551 *et seq.*, permits the setting aside of agency action that is "**arbitrary**" or "capricious," 5 U.S.C. § 706(2)(A). As the U.S. Supreme Court reaffirmed only weeks ago:

> [T]he APA contains a variety of constraints on agency decision making—the arbitrary and capricious standard being among the most notable. As we held in *Fox Television Stations*, and underscore again today, the APA requires an agency to provide more substantial justification when its new policy rests upon factual findings that contradict those which underlay its prior policy; or when its prior policy has engendered serious reliance interests that must be taken into account. It would be arbitrary and capricious to ignore such matters.

Perez, 135 S. Ct. 1199, 1209 (internal citations and quotations omitted).

The Court in *FCC v. Fox Television Stations,* 556 U.S. 502,515-516 stated that under this "narrow" standard of review an agency must "examine the relevant data and articulate a satisfactory explanation for its action."

> And of course the agency must show that there are good reasons for the new policy. The agency need not always provide a more detailed justification than what would suffice for a new policy created on a blank slate. **Sometimes it must--when, for example, its new policy rests upon factual findings that contradict those which underlay its prior policy; or when its prior policy has engendered serious reliance interests that must be taken into account. It would be arbitrary or capricious to ignore such matters**. In such cases it is not that further justification is demanded by the mere fact of policy change; but that a reasoned explanation is needed for disregarding facts and circumstances that underlay or were engendered by the prior policy. (emphasis added, internal citations omitted).

Fox, 556 U.S. 515-516.

Chevron shares ONRR's commitment to ensure a fair return to the public on production of oil and gas from federal leases, but a fair return must be balanced with the rights and legal obligations of federal lessees.

Default Valuation Rule

ONRR introduces a new Default Rule in § 1206.144, and in various triggers for application of the provision at § 1206.143 and elsewhere throughout the Proposed Rule. Chevron supports API's comments relating to the proposed Default Rule for royalty valuation.

1. Due Process Concerns

a. Default Rule is an Arbitrary Standard

ONRR states the purpose of the Proposed Rule is to "offer greater simplicity, certainty, clarity and consistency in product valuation…"[3] Practical application of the Default Rule as drafted would undermine certainty and leave oil and gas royalty lessors without consistent, regulatory framework for royalty payments and instead allow ONRR to insert its own judgment into royalty payment decisions without fair process to lessors. The Proposed Rule moves royalty valuation away from the established framework upon which lessors rely. As regulated entities, lessees "are entitled to know the rules by which the game will be played." *United States v. AMC Entm't Inc.*, 549 F.3d 760, 768 (9th Cir. 2008) (internal citation omitted); *see also Gen. Elec. Co. v. USEPA*, 53 F.3d 1324, 1333-34 (D.C. Cir. 1995). The Proposed Rule steps away from this concept entirely.

As described in § 1206.144, and triggered throughout the Proposed Rule, the default valuation rule removes certainty in gas valuation and allows for arbitrary decision making by ONRR without proper notice, explanation, or ability to appeal. Although the Proposed Rule purports to give certainty, ONRR concedes that it is granting itself "considerable discretion" in making valuation determinations, to include "discretionary factors and any other information the Secretary believes is appropriate."[4] The rules do not give any indication of when and in what manner ONRR might substitute its own, discretionary, valuation upon a lessee's gas valuation. The Default Rule also fails to state at what level within ONRR a decision would be made to place a lessee into the Default Rule. In practical application, the broad writing of the the Default Rule would allow any employee, of any experience or tenure with ONRR, to exercise ONRRs regulatory discretion to place a lessee into the unknown of the Default Rules. Similarly, no rule is proffered to give certainty of how ONRR would give notice of the determination, or to whom. A lessee is then given no right to appeal the decision to place the lessee into the default valuation. To summarize, there can be no certainty where:

- ONRR may consider any factors it considers relevant, but does not have to provide any hint of what those factors might be;
- ONRR fails to provide a framework for who within ONRR can make a determination to place lessee in the default valuation provision
- ONRR fails to provide a mechanism to give a lessee notice or the ability to appeal ONRR's determination;

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[3] 80 Fed. Reg. 608

[4] 80 Fed. Reg. 610

- ONRR proposes to use benchmarks it knows to be confidential (such as prices reported by other lessee) and therefore not subject to challenge. Use of confidential information to deny a lessee a reasonable ability to comply with ONRRs rules not only presents an arbitrary standard, but is also the exact opposite of the clarity and certainty it purports to pursue.

Rather than providing a clear and certain framework for valuation, under the Proposed Rule, ONRR may decide it dislikes any given lessee's reported oil or gas valuation for any reason and instead of allowing the lessee to correct ONRRs deemed error, may dictate the new valuation and corresponding royalty due. A mere inadvertent or insubstantial paperwork error could be enough to trigger the Default Rule. Unreasonably low arm's-length prices or unreasonably high allowances, with ONRR as the sole arbiter of what is "reasonable," also trigger the Default Rule. Moreover, ONRR could intercede even without any observed error if ONRR simply is not sure "for any reason" that a lessee "properly" valued oil or gas. In setting the new valuation, ONRR could consider "any information ONRR deems relevant" – including the current gas valuation benchmarks ONRR proposes to rescind for lessees' use, and other metrics or information unavailable to lessees.[5]

API's Comments identify and comment upon each instance where the proposed Default Rule appears in the Proposed Rule. Chevron agrees with APIs conclusion that this overreaching approach by ONRR is fundamentally unworkable, and no reasoned basis exists for it. The preamble to the Proposed Rule states that, "even with the changes outlined in this rule, royalty valuations will continue to be complex, and the markets for oil, gas, and coal will continue to evolve."[6] The Proposed Rule offers no assurance or check that ONRR's valuation determination would be any more fair, objective, or reliable than the lessee's reported data. This is particularly true since ONRR views itself as exempt from the same valuation rules binding on a lessee. ONRR cites *Independent Petroleum Ass'n of America. v. DeWitt*, 279 F.3d 1036 (D.C. Cir. 2002), as support for its role and discretion in determining value, when in fact that case <u>overturned</u> the agency's exercise of discretion in denying certain transportation allowances (i.e., unused firm demand charges for oil and gas pipelines). Like the agency's rationale there, the Proposed Rule offers little more than "raw ipse dixit" for promulgating its "default" provision and for how ONRR intends to use it. *Id.* at 1042. When a lessee is engaged in good faith efforts to value its oil and gas for royalty purposes, and particularly under negotiated arm's length contracts, it should not be penalized and forced to accept a different, potentially arbitrary value by ONRR. The Proposed Rule draws no line between those lessors who act deliberately, and those who do not. ONRR should refrain from setting aside a lessee's valuation absent evidence of actual errors or wrongdoing instead of leaving lessees to pay its royalty and cross its fingers, hoping that an inexperienced ONRR employee does not exercise his discretion and place the lessee into the default valuation provision, for which there is no right of appeal. Where ONRR

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[5] *Compare* 80 Fed. Reg. at 609 ("ONRR proposes to eliminate current benchmarks" for gas) *with id.* at 614 (Proposed Rule "allows ONRR to consider any criteria we deem relevant, as well as criteria similar to the current gas valuation benchmarks").

[6] 80 Fed. Reg. at 609.

discovers errors, the lessee should be required to do no more than correct those errors to conform to standards in the regulations

b. Misconduct Standard

The Proposed Rule defines misconduct as "any failure to perform a duty owed to the United States under a statute, regulation, or lease, or unlawful or improper behavior, regardless of the mental state of the lessee or any individual employed by or associated with the lessee."[7] The definition is vague and overbroad and lacks the information needed by a federal lessee to ensure compliance. Due process requires that the government provide citizens and other actors with sufficient notice as to what behavior complies with the law. Liberty depends on no less: "[B]ecause we assume that man is free to steer between lawful and unlawful conduct, we insist that laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly." *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972) The first part of the definition - "any failure to perform a duty owed to the United States under a statute, regulation, or lease, or unlawful or improper behavior" – has the potential to be so comprehensive it could bring in almost anything, even laws or obligations ONRR does not enforce. To comport with ONRR's goal of clarity and certainty, the first part of this definition should be edited to limit the application to specific statutes or regulations under which the lessee has royalty payment and reporting obligations, such as Federal Oil and Gas Royalty Management Act and Outer Continental Shelf Lands Act, which is what Chevron assumes is intended.

The second part of the definition – "regardless of the mental state of the lessee or any individual employed by or associated with the lessee" - includes unintentional errors and is not limited to actions that are willful, knowing, voluntary, or intentional. Again, this concept is overbroad and does not further ONRR's stated goal of increasing certainty and transparency in the valuation process.

Misconduct is commonly understood to involve an element of intentional wrongdoing. Under ONRR's new definition, however, even a good faith error is "misconduct," as is a minor paperwork error. It is beyond comprehension that an act can be considered "misconduct" if the actor does not know the standards that will be applied to his behavior. Also, under the proposed definition of "misconduct" a federal lessee would be responsible for the actions of "any individual employed by or associated with the lessee." Yet again, the definition is so expansive a federal lessee could not determine with any certainty who or what would be considered "associated."

Misconduct is used throughout the Proposed Rule hand-in-hand with the Default Rule. The practical impact of combining the low standard of care needed for ONRR to consider the action "misconduct," and, if misconduct, the ability of ONRR to use the Default Rule, is analogous to asking industry to hand over a blank check. Industry does not even know how

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[7] 80 Fed. Reg. 645

much to put into the bank account. ONRR should amend the definition to be more in line with the way it is used in the current regulations to allow a lessee an opportunity to justify its value or use another defined valuation methodology.

Combined with ONRR's Proposed Regulations pertaining to Civil Penalties, the unfettered discretion of ONRR to determine valuation and the lack of any consistent, regulatory framework, places royalty payors in an uncertain position where at any time, and for any, undisclosed, reason, ONRR can invoke the default rule, with no required notice to the payor, and presumably impose punitive civil penalties for any purported violation. ONRR's proposed new definition of a "knowing" violation of any valuation rule is illustrative of the broader punitive scheme of recent regulatory proposals, which is at odds with ONRRs stated goal of early industry certainty, flexibility and accurate compliance.[8]

Unwritten or Unsigned Contracts

Various sections of the Proposed Rule require that all contracts, amendments and revisions that support royalty payments or allowances must be in writing and signed by all parties. If the contract is not written or signed, ONRR may determine the value under the Default Rule. ONRR also fails to adequately explain why an unwritten contract that is enforceable by law is not sufficient to establish the royalty value, particularly if it is equivalent to the lessee's sales under its written contracts or to other contracts in the field or area. Moreover, the further requirement for signature is neither found in other provisions of the Proposed Rule, nor reflective of business realities. For example, some agreements have monthly addendums that are not executed by both parties, but are binding unless objected to as defined. Many other contracts or amendments have the signature of only one party. Other agreements may exist electronically or by email confirmation. In fact, ONRR's recent rule on the Service of Official Correspondence endorsed the use of one way electronic notification, without any written confirmation of receipt, as sufficient to provide lessees notice of ONRR action.

Some written contracts specifically provide for oral or telephonic transactions, or agreements verified in writing by one party. ONRR's proposed requirements for written and signed contracts again are inconsistent with the realities of industry procedures and the Proposed Rule's definition in § 1206.10:

> "Contract means any oral or written agreement… that is enforceable by law and that with due consideration creates an obligation."

For example, under Texas common law, contracts require mutual assent to be enforceable, and "[e]vidence of mutual assent in written contracts generally consists of signatures of the parties and delivery with the intent to bind." *Baylor Univ. v. Sonnichsen*, 221 S.W.3d 632, 635 (Tex. 2007). But "a contract need not be signed to be 'executed' unless the parties explicitly require

[8] 80 Fed. Reg. at 608.

signatures as a condition of mutual assent." *Mid-Continent Cas. Co. v. Global Enercom Mgmt., Inc.*, 323 S.W.3d 151, 157 (Tex. 2010). **A party may assent to a contract, thereby indicating its intent to be bound, "by acts and conduct in accordance with the terms.**" *Sibley v. Brentwood Inv. Dev. Co., L.P.*, 356 S.W.3d 659, 663 (Tex. App.—El Paso 2011. (emphasis added).

The Proposed Rule needs to be revised to recognize and accept these legally binding situations and to comport with ONRR's own definition of contract.

<u>Gas Valuation</u>

1. *<u>Gross Proceeds</u>*

Value for unprocessed and processed gas (residue and gas plant products) for royalty purposes is the gross proceeds accruing to the lessee or an affiliate under the first arm's-length contract, less an applicable transportation allowance. Chasing gross proceeds through multiple exchanges or transfers before the first arm-length sale is complicated and requires a lessee to establish royalty value based on a downstream sales price less applicable transportation allowances or location/quality differentials. This calculation presents particular issues for gas converted to LNG where the first arm's-length sale may be in a distant foreign market. If one of ONRR's goals is to update the regulations to reflect changes in the marketplace, it should be recognized that paying royalty on gross proceeds, with limited transportation allowance, on sales overseas would be untenable. An index-based valuation option should be available as an option for arm's-length sales.

2. *<u>Gas Index Price Valuation Option - § 1206.141(c) and 1206.142(d)</u>*

Chevron supports the option to choose index pricing for unprocessed and processed gas if the lessee does not sell gas under an arm's-length contract and Chevron strongly recommends the option be available for arm's length sales. Otherwise, the opportunity to utilize a standard deduction for transportation is denied for arm's length sales. However, ONRR takes one step forward by using the index option but two steps back in qualifying that option with mandates that lessee use an index that does not pertain to *how the lessee's gas actually flowed.* How does this provide certainty and allow compliance in a timely manner? It is unreasonable for ONRR to require that royalty be paid on a value lessees may not obtain. The lessee's duty to market production for the mutual benefit of the lessor and the lessee has never been construed to require the lessee to obtain the highest possible price for the production or to pay a royalty on that theoretically obtainable price.

To further complicate the index option, if a lessee physically has the capability to transport gas to more than one index pricing point, it must use the highest reported monthly bidweek price for <u>any</u> of those index points "whether or not there are constraints [e.g. lack of physical access]."

The physical ability to transport gas to more than one index pricing point does not automatically guarantee access to any one pricing point, or the ability to receive the highest reported monthly bidweek price available for any of those pricing points.

ONRR states that the best indicators of market value are the values established in arm's-length contracts[9]; however, ONRR is rewriting lessee's contract by dictating the terms under which the gas must be sold. Gross proceeds are no longer the standard although ONRR states more than once in the Preamble that the Proposed Rule would not alter the underlying principles of the current regulations, which gross proceeds is a cornerstone.

3. *Natural Gas Liquids*

Chevron supports the option to choose index pricing for NGLs, and strongly recommends the option be available to arms-length sales as they have the same tracing issues as those lessees with non-arms-length sales. Unfortunately, the proposed terms identifying the index price that you must use is unclear, and the allowed deductions appear to be not reflective of the current market. The Proposed Rule provides only that if the lessee does not sell under an arm's-length contract, then the lessee may elect the option of using index pricing and commercial price bulletins for residue gas and NGLs, respectively. But absent an arm's-length contract, commercial price bulletins are the only available valuation method under the Proposed Rule.

Transportation and Processing Allowances

1. *Categorical Denial Of Actual, Reasonable And Necessary Costs*

ONRR proposes to deny lessees the ability to deduct reasonable, actual, and necessary transportation and processing costs. It will no longer be an option to request approval to exceed the 50% limit on transportation costs and 662/3% limit on processing costs. If, as ONRR continues to admit, the value for royalty purposes of production from federal oil and gas leases must be established at or near the lease, then it is contradictory to eliminate the option to seek these exception for actual costs. The potential costs of transportation and processing are part of the economic analysis when planning and developing a project.

Transportation Allowance.

ONRR purports to reaffirm the principle that royalty should be valued at or near the lease by ONRR beginning with a "downstream" price or value and allowing deductions for the cost of transporting production to sales, but denying actually incurred transportation cost plainly violates that principle.

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[9] 80 Fed. Reg. 609

1. *Subsea Movement Of Production Offshore §§ 1206.152(a)(2)(ii) (gas), 1206.110(a)(2)(ii)(oil)*

The Proposed Rule reverses a longstanding policy upon which industry has come to heavily rely. The definition of Gathering would now be expanded to include the movement of "production from the wellhead to a platform offshore". As Gathering, the costs associated with all subsea movement of production would not be a deductible expense. In 1999 MMS, ONRR's predecessor, issued guidance that the subsea movement of production from deepwater leases[10] is a deductible transportation allowance and was not "gathering" as defined by the regulations. The guidance recognized the long distances traveled by much of the subsea movement of oil and gas from subsea manifolds to distant platforms (some 50 or more miles away) and the physical and economic barriers that preclude platform facilities from being constructed on each and every deepwater lease. Categorically determining that no subsea movement to the first platform can ever qualify for a transportation allowance is plainly arbitrary and capricious. The traditional principles of gathering onshore are wholly inapplicable to the unique deepwater environment.

2. *Arm's-Length Transportation Contract*

Subsection (a) reaffirms that if the lessee or its affiliate has an arm's-length transportation contract, the allowance is the "reasonable, actual costs" incurred. This is a new provision and effectively requires unbundling of arm's-length transportation agreements. There currently is no IBLA or federal court decision confirming ONRR's position that unbundling is required for arm's-length transportation contracts under the existing regulations. A compelling argument exists under the current rules that, if the lessee incurs transportation costs under an arm's-length contract, then all costs should be allowed, unless there is an express provision in the contract requiring the transporter to perform a marketable condition function.

3. *Non Arm's-Length Transportation*

ONRR is proposing disallow the lessee to apply for an exception from the requirement to compute actual costs if there is a FERC/state-approved tariff applicable to the pipeline and third parties are actually paying the tariff to transport product. One reason the ability to use the FERC approved tariff with affiliated pipelines is an important option is that pipelines may not share cost data if they are FERC regulated. Additionally, ONRR would reduce the rate of return used to calculate the return on investment from 1.3 to 1.0 times the S&P BBB bond rate. These changes lack justification in the Proposed Rule, and we second COPAS' comments opposing each of them. They also contradict the agency's articulated statements and positions regarding use of tariffs and the 1.3 times BBB bond rate.

[10] Leases in water depths greater than 200 meters

Conclusion

ONRR admits that even with these changes royalty valuation continues to be complex. Vague and overbroad rules will inevitably lead to more disputes and appeals. These actions will add to the already overburdened appeals process both at ONRR and the IBLA.

Chevron appreciates the chance to provide input on these significant proposed rules and welcomes the opportunity to provide additional input. If you have any questions on our comments please contact me.

Sincerely,

Greg C. Morby
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