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May 8th

Armand Southall, Regulatory Specialist  
Office of Natural Resource Revenue  
PO Box 25165, MS 61030A  
Denver, Colorado 80225

Senator Tom Udall  
Senator Martin Heinrich  
Congressman Michelle Lujan-Grisham  
Congressman Steve Pearce  
Congressman Ben Ray Lujan

By Email

RE: Docket No. ONRR-2012-0004  
RIN 1012-AA13  
Consolidated Federal Oil & Gas and  
Federal & Indian Coal Valuation Reform

Dear Mr. Southall:

The Independent Petroleum Association of New Mexico (IPANM) is a New Mexico oil and gas trade association which represents more than 300 small businesses that responsibly develop oil and natural gas resources on Federal, State, Tribal and fee lands in our state. IPANM members are directly and substantively impacted by this proposed rule regulating reporting and payment of Federal oil and gas production.

IPANM previously submitted a letter dated February 13, 2015 requesting additional time for comment. We also requested the ONRR to hold a stakeholder meeting in New Mexico to address specific parts of your proposal that affect operators in our state. The comment time period was extended, which we appreciate, but

unfortunately IPANM never received any response to our formal request for the stakeholder meeting.

We offer the following comments related to the proposed rule for consideration at this time:

IPANM strongly urges the Office of Natural Resource Revenue (ONRR) to withdraw this proposed rule in its entirety and commence a fresh stakeholder engagement process. Any discussions and proposed rule on the subject of royalty valuations should include holding discussions not only with IPANM and our member stakeholders consisting of both large and small companies, but also with other trade associations particularly in states directly affected by this proposal. As noted below, because this proposal directly targets New Mexico's resources, we would also recommend that New Mexico's Federal and State legislators and the Executive are involved in any stakeholder process. In addition, IPANM fully supports, incorporates and adopts the comments of the Council of Petroleum Accountants Societies (COPAS), the American Petroleum Institute (API) and the Independent Petroleum Association of America (IPAA) with our submittal today.

### **Compliance with Existing Law**

IPANM agrees with ONRR that the allocation of costs to place gas into marketable condition has of recent date become administratively burdensome and time consuming. However, IPANM does not believe that this proposed rule is in compliance with the Royalty Simplification and Fairness Act of 1996 (RSFA) or the Accounting Relief for Marginal Properties (RIN 1010-AC30). Further, IPANM members contend that the proposed rule fails to achieve ONRR's stated goals "to provide regulations that (1) offer greater simplicity, certainty, clarity, and consistency in product valuation for mineral lessees and mineral recipients; (2) are more understandable; (3) decrease industry's cost of compliance and ONRR's cost to ensure industry compliance; and (4) provide early certainty to industry and ONRR that companies have paid every dollar due."

In support of IPANM position, our member operators in New Mexico report that they have spent significant time, legal and accounting resources and financial expenditures to comply with ONRR's current interpretations of marketable condition, especially regarding "unbundling" and applicable permissible royalty allowances. Our operators have been told outright by ONRR staff that because the 'unbundling' program was rolled out in New Mexico first, that we were the proverbial "guinea pigs" for "unbundling". While our membership still has significant difficulty with both the legal foundations and the effective implementation of 'unbundling' and ONRR's current stances on royalty allowances, IPANM remains committed to compliance with regulations to ensure accurate reporting and ensuring "every dollar due" is timely paid.

New Mexico is a unique oil and gas producing state, with a large number of marginal producing wells (less than 15 BOEPD or less than 90 MCFD) for which Congress intended "to provide accounting, reporting, and auditing relief that will encourage lessees to continue to produce and develop" these marginal properties. This proposed rule seems to continue to target New Mexico operators and creates unfavorable production and reporting conditions which promotes premature abandonment of wells, restrictive and unnecessary reporting obligations and oppressive retroactive penalty enforcement opportunities for ONRR. We contend that Royalty Simplification and Fairness Act was placed into law to encourage, promote and extend the economic life of marginal producing wells on all Federal lands, and this proposed rule should be consistent with those goals rather than create a unique sub-class of operators in one state fighting excessive regulatory burdens.

### **Ideas & Comments**

In this proposed rulemaking ONRR states that it seeks "ideas and comments" regarding "the potential for creating standardized schedules for transportation and processing allowances to reduce the need to rely on case-by-case operator reporting and agency review of actual costs and ONRR has requested detailed comments that

elaborate upon specific situations”. IPANM reiterates the obvious need for renewed stakeholder engagement sessions to accomplish this goal. ONRR last sought stakeholder feedback on this important royalty reporting matter in 2011. At that time, there was disagreement between larger operators and smaller operators with regard to various reporting matters. That limited feedback is now quite dated, the commodity price environment has deteriorated significantly and the reporting and audit interpretations by ONRR have changed materially because of recent legal decisions. A renewed stakeholder engagement and industry dialogue process should occur immediately to put a fresh perspective upon this rule prior its adoption and implementation.

### **Misconduct**

In this proposed rule there are a large number of material proposed changes and modifications associated with reporting and payment of royalties which ONRR unfairly mischaracterizes as ‘misconduct’. ONRR claims that these operator actions, whether intentional, willful or accidental is still “misconduct” and the subsequent penalty is merely “a valuation mechanism, not an enforcement tool.” However, IPANM does not believe it was Congress’s intent for ONRR to create a new administrative penalty provision, broadly labeled as “misconduct”, while disallowing a reporter’s Constitutional due process appeal rights. IPANM believes this particular provision to be an unfair and subjective enforcement tool which may be applied in an arbitrary and capricious manner. Without due process addressing an operator’s intent, these provisions in the proposed rule open the door to extensive future litigation. Clearly, rather than threaten penalties based on an unconstitutional expansion of the concepts of ‘misconduct’ ONRR should seek a more cooperative working relationship between ONRR, delegated authority states (such as New Mexico), operators and industry trade groups (such as IPANM). IPANM recommends the removal of the “misconduct” provisions throughout the proposed rule.

### **Negative Small Business Impact**

ONRR states that “This proposed rule would raise novel legal or policy issues but would simplify the valuation regulations, thus reducing the possibility of impacts as a result of any novel legal and policy issues.” Further, ONRR states, “that this proposed rule would not have a significant economic effect on a substantial number of small entities under the Regulatory Relief Act (5 U.S.C 601 et seq.)” These statements indicate that this proposed rule is a “Significant Regulatory Action”, and deserves additional congressional scrutiny and oversight because of its material impact upon the public. IPANM strongly disagrees with ONRR misrepresentation regarding the impacts on the oil and gas industry, stakeholders and the general public. We further contend that the novelty of the legal concepts proposed in this rule will negatively impact IPANM small business member companies.

For example, it appears to our membership that the cumulative effect of recent ONRR piecemeal rule changes, such as RIN 1012-AA05 *Amendments to Civil Penalty Regulations* and RIN 1012-AA08 *Clarification of Appeal Procedures*, recent “Dear Payor” letters dated November 21, 2012, February 5, 2013, August 8, 2013 and December 18, 2014 combined with this proposed rule have set the chess-board for ONRR’s aggressive retroactive enforcement of alleged reporting and alleged royalty underpayment violations. However, IPANM cannot more strongly emphasize the importance of proscriptive rule enforcement, especially when ONRR is proposing novel legal and/or policy concepts and when New Mexico is the prime ‘guinea pig’ to test out these theories. For example, in the ‘unbundling’ scenario, ONRR maintains that operators have been incorrectly deducting transportation costs in our royalty calculations. Thus, ONRR maintains that operators must demand from third party pipeline and treatment plants their cost figures in order to build ‘defensible’ calculations for the deductibility of transportation, gathering and dehydration costs charged to the operators. However, by definition an ‘independent’ operator is non-integrated and thus the cost of the transportation of natural gas will be proprietary information maintained by a third party. As an alternative to using the cost figures, ONRR staff has obtained its own figures from these gathering systems and plants

and has ‘unbundled’ several plants. Interestingly, the ONRR has focused on unbundling mostly New Mexico plants. These figures are published on its website and operators are to use these figures or take no deductions at all. ONRR published the most recent figures on April 2015, but revised the figures to be used for reports filed in 2008, 2009, 2010, 2011, 2012, 2013 and 2014. According to the ONRR website, when new numbers are published for a year, reporters must retroactively replace previous figures reported<sup>1</sup>. If the numbers subsequently change, the reporter must change the figures again. This retroactive reporting of the transportation figures exemplifies how the figures are nothing more than a fiction and places IPANM members in a constant game of ‘gotcha’ with the ONRR enforcement staff IPANM would urge the ONRR to replace the current scheme with prospective figures, much like the federal mileage or taxation numbers, so that reporters seeking to follow the law have the legal obligation to use the published numbers for the year they are announced but they will not change. IPANM supports the application of proscriptive rule changes and application of reasonable audit and enforcement mechanisms that validate our industry’s good faith efforts at reporting compliance.

### **Oil Allowances**

IPANM is also concerned about the precedent that this rule proposal is creating for subsequent rule-making interpretations that may likely remove historical permitted oil transportation allowances.

### **Index Pricing**

IPANM recommends that the proposed “Index Pricing” relief be applicable to both arm’s length transactions as well as non-arm’s length transactions. As proposed,

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<sup>1</sup> **Example on ONRR website (5/7/15):**ONRR publishes UCAs for 2010.

- 1 You use 2010 UCAs to estimate 2011, 2012, and 2013.
- 2 ONRR publishes UCAs for 2011 and 2012.
- 3 You replace estimated values for 2011 and 2012 (there is no change for 2013).
- 4 You use 2012 (most current) UCAs for future reporting period estimates.

small New Mexico Independent operators would be placed at a significant competitive disadvantage without facilitating this equitable relief mechanism for all producers/reporters of Federal minerals. This type of fair administrative relief will undoubtedly increase the projected actual cost of this rule in excess of \$ 100 million, which may subject this rule to the Small Business Regulatory Enforcement Fairness Act. For the same reasons, this rule appears to be subject to the Unfunded Mandates Reform Act because of its unique targeted impact upon New Mexico's oil and gas producers and our economy. The creation of a unique class for the purpose of regulation or enforcement without due justification may also be a violation of the Equal Protection clause. Thus, an additional necessary layer of legislative review is critical to protect New Mexico, which appears to be a distinct geographic region of focus with substantial and disproportionate financial impacts upon the small businesses in our state.

IPANM believes that ONRR's proposal to utilize the "highest reported monthly bid week price" for index pricing relief to be patently unfair to industry, unrealistic, punitive, arbitrary and capricious. This pricing methodology was developed without support from industry, but is heralded in the proposed rule as a method for industry to simplify its administrative burden. ONRR's proposal would burden small operators with the added subscription expenditures to "Platts Inside FERC" bulletins or other market commodity informational trade bulletin publications. Effectively requiring operators to subscribe to the reporting services will unnecessarily raise the administrative costs to operators.

ONRR's proposal would actually disconnect market sales price reality for products (monthly or daily settlement type prices) from theoretical "highest reported" multi-hub bid week prices five (5) days before any actual settlement occurs. Historical bid week pricing volatility is being used by ONRR to the detriment of operators. ONRR estimates that this "small" price increase is only 3.6 percentage points. IPANM member companies operate many wells at much smaller margins than what a 3.6 percent gross pricing margin may indicate. IPANM also believes that few operators

will use this index pricing option as proposed by ONRR with such a substantial and unequitable pricing level, but if a reasonable index pricing methodology could be created a majority of operators would select this reporting methodology to the benefit of industry and ONRR.

Congress and ONRR have clearly contemplated fair alternative valuation relief methods applicable for marginal properties. IPANM supports the proscriptive use of a fair index price reporting methodology, for both arm's length and non-arms' length transactions, for marginal properties such as those prevalent in New Mexico, and for all Federal minerals. IPANM members believe that the prospective use of fair index price reporting will have negligible fiscal impacts and promote production of Federal minerals. A diverse stakeholder group, with New Mexico representation, can develop several pre-approved alternative valuation methods which would meet the stated objectives of this rule change without unnecessarily penalizing New Mexico's extractive economy.

IPANM would support use of widely published and readily accessible index hub monthly settlement prices or average of daily settlement prices (i.e. El Paso – San Juan, El Paso Permian – Permian, etc.) as the basis price for an index price reporting and the calculation of royalties. Notably ONRR has proposed using “monthly average prices” for NGLs index pricing, which is a reasonable concept IPANM may support in the context proposed. Using distinct monthly hub average/settlement type index prices, for both NGLs and natural gas, as the basis for royalty payments is clearly a transparent and reasonable starting point for reporting simplicity. IPANM would propose that ONRR post the applicable respective monthly index prices on its website going forward and to avoid confusion. Should ONRR opt to use this methodology, however, as noted above, the numbers, once published cannot change and enforcement cannot be retroactive.

**Singling New Mexico producers out:**

IPANM believes that inconsistent and/or belated application of “unbundling” at some processing facilities, especially involving high efficiency cryogenic fractionation and compression allowances unfairly penalizes New Mexico’s natural gas when compared with other states. ONRR’s basis of determining the allowable index transportation deduction of “not less than 10 cents per mmbtu or more than 30 cents per mmbtu” does not appear to be regionally applicable or supported with sufficient current documentation. This permissible deduction should be reviewed in greater detail before implementation to achieve a more reasonable and acceptable range of allowances.

IPANM’s review of the proposed rule also raised the concern that New Mexico producers appear to be singled out negatively in the position taken by ONRR’s proposed Index transportation and fractionation (T&F) allowances (5 cent disadvantage – 7 cents vs 12 cents) and Natural Gas Liquids (NGL) deduction (5 cent disadvantage – 22 cents vs 27 cents) when compared with other onshore producing states (Wyoming, Utah, Colorado, etc.) with Federal lands. A consequence of the implementation of this proposed rule would be reduced oil and gas development and production on Federal lands in New Mexico. New Mexico producers are being placed at a disadvantage. Index pricing methodology should not create inequities amongst states or distinct regions.

**POP Contracts**

IPANM disagrees with ONRR’s proposed “departure from current practice” to which, “would value POP contracts, percentage-of-index contracts, casing head contracts, and contracts with any such variations of payment based on volumes or value of those products as processed gas.” Stakeholder engagement and discussion with industry is the appropriate method to address ONRR’s concerns to achieve mutually acceptable interpretations of existing contractual structures that do not immediately penalize small independent New Mexico oil and gas producers. ONRR’s unilateral disallowance of current acceptable business practices and prior

authorizations throughout the proposed rule is troubling. Grandfathering type provisions should be included throughout this new rule.

IPANM objects to ONRR's proposed provisions to eliminate historical Percent of Proceeds (POP) allowances to 66-2/3 percent. ONRR represents this change to be revenue neutral, but a number of New Mexico contracts in particular could be negatively impacted. IPANM recommends that POP contracts be addressed more fully through stakeholder meetings to minimize reporting complications.

Previous rule makings and precedent have supported maintaining relief options and not retroactively rescinding relief and/or guidance. IPANM supports maintaining all alternative valuation relief options to support continued production of minerals on Federal lands. IPANM is concerned that ONRR is arbitrarily changing the binding nature of prior guidance communications to industry/reporters. Industry's due process provisions are being impacted where IPANM members rely upon ONRR guidance, which previously were binding upon ONRR and the delegated States, which now may no longer be binding or applicable.

IPANM disagrees with this proposed rule change "to eliminate the current provision allowing lessees to deduct the costs of pipeline losses, both actual and theoretical, under non-arm's length transportation situations."

### **Default Valuation Provisions & Elimination of Historical Approvals**

IPANM is concerned about ONRR's proposed use of "default valuation provisions" and "default provisions" which arguably deny portions of operator's due process appeal rights and without reasonable consideration toward alleged amounts of underpayment and/or time involved with administratively correcting alleged reporting violations.

IPANM objects to ONRR's elimination of historical processing allowances in excess of 66-2/3 percent of the value of NGLs. Prior approvals should be grandfathered to

avoid causing the premature abandonment of marginal properties and to honor prior guidance issued by ONRR.

IPANM objects to ONRR's proposal to eliminate the historical ability for operators to request and receive extraordinary processing cost allowances. New Mexico has significant helium gas resources that historically required special processing systems. This allowance may be necessary in the future and ONRR's estimate that industry's existing lessees will have to pay an annual \$ 18.5 million increase in royalties because of this change. This is a significant unnecessary negative impact upon those particular operators, which may cause premature abandonment of formerly economic Federal minerals.

IPANM is concerned about the breadth and number of modified definitions, including the elimination of the definition of "Allowance" in the proposed rule. Given the importance and legal significance of the term allowance, its clear unambiguous definition should be included. As noted above, eliminating New Mexico from the "Rocky Mountain region" definition places our state in a unique class from other producing states without any legal justification to do so.

IPANM objects to ONRR's proposal to eliminate historically permissible provisions for allowing lessees to deduct the costs of pipeline losses both actual and/or theoretical that are permitted on-lease as long as they are duplicative. These historical losses have been determined necessary for placing gas into marketable condition. ONRR should allow a grandfathering provision to allow previously approved exceptions and/or extraordinary allowances that have historical precedence. To change the playing field at such a late date will cause marginal wells to be prematurely abandoned that would be inconsistent with the RSFA.

### **Conclusion**

In conclusion, IPANM and our member companies urge ONRR to withdraw this proposed rule at present and initiate a fresh stakeholder engagement process to

address these material and substantive concerns. IPANM commends ONRR for proposing the Index pricing option, although in the proposed rule change New Mexico small businesses are disproportionately impacted in a negative manner. IPANM had requested a stakeholder meeting to discuss all the issues raised in these comments but ONRR failed to address our request. We are again asking for a dialogue to develop a more reasonable Index Pricing valuation reporting relief option, which will be fair to the public and promote responsible energy development.

We look forward to working with ONRR to improve the clarity and efficiency of oil and gas royalty valuation reporting in the days ahead. Please feel free to contact me directly or through our organization at the above letterhead address.

Thank you.

Respectfully submitted,  
INDEPENDENT PETROLEUM ASSOCIATION OF NEW MEXICO

  
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