

LISKOW & LEWIS

A Professional Law Corporation

One Shell Square
701 Poydras Street, Suite 5000
New Orleans, LA 70139
(504) 581-7979 Main
(504) 556-4108 Fax

822 Harding Street
Post Office Box 52008
Lafayette, LA 70505
(337) 232-7424 Main
(337) 267-2399 Fax

1001 Fannin Street
Suite 1800
Houston, TX 77002
(713) 651-2900 Main
(713) 651-2908 Fax

www.liskow.com

May 8, 2015

Jonathan A. Hunter

Direct: (504) 556-4131
jahunter@liskow.com

VIA <http://www.regulations.gov>

Office of Natural Resources Revenue
Attn: Mr. Armand Southall, Regulatory Specialist

Re: Proposed Rule to Amend Federal Oil & Gas Valuation Regulations
80 Fed. Reg. 608 (Jan. 6, 2015)
Regulation Identifier Number (RIN) 1012-AA13

Dear Mr. Southall,

On January 6, 2015, the Office of Natural Resources Revenue (“ONRR”) issued a Proposed Rule, which seeks to significantly amend (*inter alia*) the current regulations governing the reporting and payment of royalties related to gas produced from Federal and Indian leases. 80 Fed. Reg. 608 (Jan. 6, 2015). As a Federal and Indian lessee, XTO Energy Inc. (“XTO”) will be substantially impacted by many of the proposed revisions. We have been retained by XTO to submit this comment to ONRR’s Proposed Rule.

XTO’s responses to the Proposed Rule are largely reflected in the comments submitted by the American Petroleum Institute and the Council of Petroleum Accountants Societies. XTO writes separately to further comment on ONRR’s failure to comprehensively address “unbundling” in the Proposed Rule.

XTO believes that ONRR should fully address “unbundling” in the Proposed Rule, particularly if ONRR continues to maintain the position that lessees must “unbundle” third-party post-production fees into deductible and nondeductible components. ONRR has announced this position through a website and presentations at industry seminars, *see* <http://www.onrr.gov/unbundling>, but neither ONRR’s existing regulations nor ONRR’s proposed new royalty valuation regulations require Federal and Indian lessees to “unbundle” arm’s-length post-production fees charged by third parties. ONRR must promulgate any “unbundling” rules through the notice-and-comment rulemaking procedures that the Administrative Procedure Act (“APA”) requires for “substantive” or “legislative” rules. 5 U.S.C. § 553.

It is clear that ONRR’s existing “unbundling” initiative constitutes a “substantive” or “legislative” rule under the APA for numerous reasons, including the following:

May 8, 2015

- ONRR has repeatedly stated that “[w]hen a lessee pays a bundled rate under an arm’s-length contract, the lessee must unbundle that rate[.]” Disclaimer for ONRR Unbundling Website, <http://www.onrr.gov/unbundling>. “Unbundling” constitutes a substantive rule because it “purports to impose legally binding obligations . . . on regulated parties,” *National Mining Association v. McCarthy*, 758 F.3d 243, 251 (D.C. Cir. 2014), and imposes new “specific duties” on the regulated community, *Mendoza v. Perez*, 754 F.3d 1002, 1022 (D.C. Cir. 2014).
- ONRR has relied on its Unbundling Cost Allocations (“UCAs”) (numerical limits on deductions) during agency compliance reviews and audits. ONRR’s use of the UCAs to limit the agency’s discretion in individual audits and compliance reviews renders the “unbundling” initiative a binding “substantive” rule. *See Phillips Petrol. Co. v. Johnson*, 22 F.3d 616, 619 n.3 (5th Cir. 1994); *Appalachian Power Co. v. EPA*, 208 F.3d 1015, 1021 (D.C. Cir. 2000) (“If an agency . . . bases enforcement actions on the policies or interpretations formulated in the document . . . then the agency’s document is for all practical purposes ‘binding.’”); *Catholic Health Initiatives v. Sebelius*, 617 F.3d 490, 496 (D.C. Cir. 2010) (imposition of numerical limits constituted a “legislative” rule).
- ONRR’s “unbundling” initiative substantially diverges from ONRR’s long-standing practice of accepting deductions that include 100% of third-party post-production fees. *E.g.*, 53 Fed. Reg. 1230 (Jan. 15, 1988) (“The MMS has determined that payments under arm’s-length contracts are the best available indicator of reasonable, actual costs incurred by the lessee.”); 71 Fed. Reg. 24738 (April 26, 2006) (“The MMS normally accepts the cost as stated in the lessee’s arm’s-length processing contract as being representative of the cost of the processing allowance cost.”). Because ONRR’s “unbundling” initiative “effects a substantive change in existing law or policy,” it constitutes a “substantive” rule. *See Mendoza*, 754 at 1024.
- Indeed, ONRR has previously acknowledged the need to address “unbundling” via rulemaking. *E.g.*, Royalty Policy Committee, Subcommittee on Royalty Management, “Mineral Revenue Collection From Federal and Indian Lands and the Outer Continental Shelf” pp. xvii, 73 (Dec. 17, 2007) (“By the end of FY 2008, MMS should publish proposed revisions to the gas valuation regulations and guidelines to address the cost-bundling issue[.]”); 76 Fed. Reg. 30878 (May 27, 2011) (specifically soliciting comments regarding ways “to address the bundling issue” and acknowledging that lessees lack access to the proprietary midstream data needed to accomplish “unbundling”). ONRR’s acknowledgement of the need to include “unbundling” in a rulemaking further supports the conclusion that “unbundling” is a “substantive” rule. *See, e.g., Appalachian Power*, 208 F.3d at 1025-26.
- Notably, ONRR has implemented similar regulatory changes via notice-and-comment rulemaking. *E.g.*, 62 Fed. Reg. 65753 (Dec. 16, 1997) (amending regulations via notice-and-comment rulemaking; requiring lessees to unbundle to the extent required by Federal Energy Regulatory Commission Order 636).

May 8, 2015

Given the above, it is surprising that ONRR's Proposed Rule fails to address the "unbundling" of third-party fees. Moreover, ONRR itself seemed to recognize that its "unbundling" initiative warranted promulgation through notice-and-comment rulemaking when, in 2011, it sought comments on "unbundling" through its Advanced Notice of Proposed Rulemaking, 76 Fed. Reg. 30878 (May 27, 2011).

Unless and until ONRR promulgates its "unbundling" program through notice-and-comment rulemaking as required by the APA, 5 U.S.C. § 553, ONRR's "unbundling" program will remain unenforceable. Thus, XTO respectfully requests that ONRR publish an amended Proposed Rule for further public comment that will either: (i) comprehensively address "unbundling," specifically including the "unbundling" of third-party fees, or (ii) abandon the agency's current "unbundling" initiative. Should ONRR address "unbundling" in an amended Proposed Rule, XTO reserves its right to comment on the merits of the proposal during the notice-and-comment period.

Thank you for your time and attention to XTO's comments. XTO remains committed to working cooperatively with ONRR to improve the royalty valuation process.

Respectfully submitted,



Jonathan A. Hunter
LISKOW & LEWIS
701 Poydras Street, Suite 5000
New Orleans, Louisiana 70139-5099
Telephone: (504) 581-7979

Attorney for XTO Energy Inc.