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Office of Natural Resources Revenue
U.S. Department of the Interior
Building 53, Entrance E-20
Denver Federal Center
West 6th Avenue and Kipling St.
Denver, CO 80225

Re: Regulation Identifier Number 1012-AA20

Repeal of Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform

To Whom It May Concern:

I am submitting these comments to support the proposed repeal of the Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform (the "Final Rules") as an attorney who has represented oil and gas producers for over 30 years in connection with the gathering, transportation, processing, fractionation and marketing of natural gas, natural gas liquids and crude oil.[1] My practice includes assisting clients with federal royalty reporting and valuation including responding to data mining requests and assisting with compliance reviews, unbundling under the marketable condition rule, and audits.

These comments are limited to the federal oil and gas portions of the Final Rules.

The stated goal of the rulemaking was to provide regulations that:

(1) offer greater simplicity, certainty, clarity, and consistency in product valuation for mineral lessees and mineral revenue 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 of oil, gas, and coal produced from Federal leases and coal produced from Indian leases.

[1] These comments are my own and are not attributable to any of my clients.

These are very important goals. My observation is that companies want to correctly pay their federal oil and gas royalties and they want to know, at the time they submit their reports and payments, that everything is correct.

The goals of the rulemaking are consistent with and required by the due process clause of the United States Constitution in order for a regulation to be constitutional. The United States Supreme Court has held that the void for vagueness doctrine addresses at least two connected but discrete due process concerns: "first, regulated parties should know what is required of them so they may act accordingly; second, precision and guidance are necessary so that those enforcing the law do not act in an arbitrary or discriminatory way." *Grayned v. City of Rockford*, 408 U.S. 104, 108–109 (1972).

Unfortunately, as explained below, the Final Rules did not accomplish the stated goals. Instead, they made it harder for a lessee to know at the time it submits a federal royalty report whether the royalties have been properly calculated and reported and they increased the opportunity for arbitrary and discriminatory application of the regulations to individual lessees.

<u>"Miconduct" – a derogatory term with negative consequences for appropriate and lawful behavior</u>

The Final Rule added a new term "misconduct" which was defined as:

> Misconduct means 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.

ONRR explained that the new definition applied to and would be used in conjunction with new default provisions which allow ONRR to establish the value of a lessee's production in certain circumstances including "misconduct." The Final Rule defined "misconduct" to include sales prices more than 10% below what ONRR deems reasonable or allowances more than 10% above what ONRR deems reasonable.

In the rulemaking, industry expressed concerns regarding the misconduct provisions for several reasons.

First, industry took exception to the term "misconduct" because the term implies an element of intentional wrongdoing. The following exchange appears in the preamble to the Final Rule:

> Public Comment: Industry claims that the definition of misconduct is overly broad and argues that any common understanding of misconduct implies an element of intentional wrongdoing. Industry fears that ONRR may expand the use of the term to include even minor occurrences, such as simple reporting errors.
>
> ONRR Response: **According to Black's Law Dictionary, the term "misconduct" is "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."** Consistent with this definition, this final rule does not require behavior to be willful, knowing, voluntary, or intentional to constitute misconduct. We only intend to use this definition of the term "misconduct" for valuation purposes, not for imposing penalties. Thus, no intent is required. Moreover, FOGRMA does not mandate a particular mental state for a lessee's obligation to correctly report, account for, and pay royalties for purposes of royalty valuation. For example, under this final rule, if we determine that you improperly calculated the value of your gas due to misconduct, we will calculate the value of your gas under § 1206.144. However, if we determine that the misconduct was knowing or willful, we may pursue civil penalties under 30 CFR part 1241. [Emphasis added.]

The bolded sentence above does not appear in Black's Law Dictionary. All of the definitions of "misconduct" in Black's law dictionary contain exactly what industry stated – an element of intentional wrongdoing. The overall definition of "misconduct" in Black's Law Dictionary is, "A dereliction of duty; unlawful, dishonest, or improper behavior, esp. by someone in a position of authority or trust." See *Attachment 1.*

The Final Rule chose to use a highly derogatory term – one which could be damaging to an individual or company's reputation – to describe situations which the Final Rule claimed would not require intent. This was inappropriate and unnecessary. Using terms in regulations which are generally understood to be derogatory (regardless of how they are defined in the regulations) makes individuals and companies feel that there is a hidden purpose behind the regulations to disparage the regulated community. This kind of thing creates an unnecessary atmosphere of mistrust.

Furthermore, while ONRR claimed in training on the Final Rule that the 10% rule would not be automatic and that auditors would look objectively at each situation, the fact of the matter is that the 10% rule could be applied automatically, without regard to facts, and there would be no effective remedy. A lessee hit with a charge of "misconduct" because its sales price was more than 10% below what ONRR thought was reasonable would never be able to effectively appeal such a finding because the lessee would not be able to obtain through a FOIA request the information on which such a finding might be based. For example, if such a finding were based upon the royalty reports of other producers, those are not provided by ONRR in response to a FOIA request. The end result is that the 10% rule gave ONRR complete and unfettered discretion to find that a lessee's sales price or allowances constituted "misconduct" based upon the 10% rule.

Additionally, the Final Rule created a situation in which sales prices or allowances could appear to fall within the 10% rule simply because of how royalties are required to be reported on the Form ONRR-2014. Consider the following example:

> Producer A sells its residue gas at the outlet of a gas plant for $2.00 per MMBtu. Producer A reports the value of its residue gas as Product Code 03 valued at the $2.00 sales price.

> Product B transports its residue gas on an interstate pipeline from the outlet of a gas plant to a downstream sales point (such as a city gate) for a transportation charge of $0.30 per MMBtu and sells its gas at the downstream sales point for $2.30. Producer B reports the value of its residue gas as Product Code 03 at the $2.30 price and takes a transportation allowance for the $0.30 transportation charge.
>
> Both producers received a net value for their residue gas of $2.00 per MMBtu.
>
> However, on paper (i.e., in ONRR's royalty records), Producer A's sales price was more than 10% less than Producer B's sales price and therefore Producer A could be found to have engaged in "misconduct" as to its sales price so that ONRR could then decide the value of Producer A's production. Similarly, Producer B's transportation allowance is more than 10% higher than Producer A who has no transportation allowance and, therefore, Producer B could be found to have engaged in "misconduct" as to its transportation costs and ONRR could then decide the transportation allowance.

To make matters worse, under the Final Rule, ONRR eliminated transportation factors so now more producers will be in the shoes of Producer B. Consider the following:

> Producer C sells its gas at the outlet of a gas plant for a downstream published index price minus the purchaser's costs of interstate pipeline transportation from the outlet of the gas plant to the downstream sales point. Under the prior rules, the transportation deduction taken by the gas purchaser was a transportation factor and the sales price net of the transportation factor was supposed to be used for the Sales Value on the ONRR Form-2014. If the downstream sales price was $2.30 and the interstate pipeline costs deducted by the purchaser were $0.30, the price used for royalty reporting purposes was $2.00 per MMBtu. However, with the elimination of transportation factors, Producer C has to report the same way as Producer B.

Finally, detailed comments were filed in the rulemaking explaining the many reasons why producers might have different sales prices or transportation costs without that being grounds for ONRR defaulting to ONRR deciding the value of their production. See Attachment 2 for some of these comments. ONRR's response to the comments on Attachment 2 and all of industry's concerns that the 10% rules were arbitrary, capricious, and an abuse of discretion were that the 10% rules were "well conceived" and nothing more than "tolerances" to help determine proper valuation. There were no substantive responses in the rulemaking addressing any of industry's concerns that the 10% rules could be used in an arbitrary, capricious and abusive manner.

At the training on the Final Rules, ONRR essentially stated that ONRR would not misuse the 10% rules and that industry should just trust ONRR. When lessees who have every incentive to market their production for the highest prices and lowest costs that they can get are faced with the prospect that their marketing activities may be labeled as "misconduct" under the 10% rule, more is required in rulemaking that a "trust us" response. Lessees cannot know what other producers are receiving for their production or what costs other producers are incurring. (The antitrust laws prohibit competitors from exchanging that type of information.) If a lessee negotiates the best price and lowest costs it can negotiate, it should not run the risk of the 10% misconduct rule and have to incur the cost of reversing and rebooking later (a time consuming task that should not be considered a normal part of life for federal lessees), with interest liability and the threat of penalties.[2]

The definition of misconduct and the 10% rule achieved exactly the opposite of the stated purpose of the new rules – under the Final Rule no lessee can know at the time it pays its royalties whether it has done so correctly. These provisions of the Final Rule did not provide any certainty at all; instead they simply created a sense of hopelessness about ever being able to correctly value production and pay royalties. These provisions of the Final Rule are not the precision and guidance necessary so that those enforcing the law do not act in an arbitrary *or* discriminatory way." *Grayned v. City of Rockford*, 408 U.S. 104, 108–109 (1972).

ONRR Default Methodology If a Lessee Does Not Have Requested Documents

The Final Rule provides that ONRR may determine the value of oil or gas for royalty purposes if ONRR cannot determine whether the valuation or allowances are proper "for any reason, including but not limited to, you or your affiliate's failure to provide documents ONRR requests under 30 CFR part 1212, subpart B." See 1206.104(c)(3); 1206.110(f)(3); 1206.143(c)(3); and 1206.152(g)(3). The concern with this provision is the very broad "for any reason" language. Auditors sometimes request documents that are not the lessee's documents and that a lessee does not have any legal right to obtain.[3] This includes, but is not limited to, itemized capital costs, operating expenses, maintenance expenses and overhead expenses from owners of transportation systems and gas plants or the downstream contracts of the purchasers of oil, gas, residue gas or liquids; a list of producers (shippers) who shipped gas through each transportation/gathering system or through a particular plant, transportation/gathering agreements for large and small customers of a particular system and associated sample statements; processing agreements with large and volume customers of a particular processing plant and associated sample statements; etc.[4]

Comments were submitted during the rulemaking request that the proposed regulation be modified to be clearly limited to the failure of a lessee to provide its contracts and associated statements and invoices. No change was made. Again, this is not the precision and guidance necessary so that those enforcing the law do not act in an arbitrary *or* discriminatory way." *Grayned v. City of Rockford*, 408 U.S. 104, 108–109 (1972).

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[2] ONRR's civil penalty rules can be applied to situations in which a lessee has made the same "mistake" twice. Since "misconduct" under the Final Rule is outside a lessee's control, a lessee could be found to have engaged in "misconduct" under the Final Rule more than once. No lessee has the crystal ball necessary to avoid this risk.

[3] In some cases, there could also be antitrust issues associated with some of the documents a lessee might be asked to provide.

[4] See lists at http://www.onrr.gov/Unbundling/methodology.htm

Contracts

The Final Rule provided that all contracts, contract revisions, and amendments had to be in writing and signed by all the parties to those contracts. Where the lessee does not have a written contract, ONRR may use the default provision to determine value.

ONRR received multiple comments that some contracts which are not in writing are still legally enforceable under the Uniform Commercial Code and state contract law and that ONRR's definition of a contract in § 1206.20 includes oral contracts that are legally enforceable. Notwithstanding these comments, ONRR did not change its position.

This provision of the Final Rule caused significant issues because the Final Rule provision ignores contracts which are legally enforceable for all other purposes. Producers quickly learned that they did not have the leverage to force oil and gas purchasers and transporters to change their contracting practices to meet ONRR's definition of a contract. This put producers into a dilemma – make a spot sale of oil or gas based upon industry-standard oral contracts or make a sale at a lower price under a contract meeting ONRR's more restrictive standard. Lessees should not be required to have to choose between complying with the duty to market or with ONRR's more restrictive contract requirement. This provision did not achieve the goal of the rulemaking; it created nothing but uncertainty. All legally enforceable contracts under the Uniform Commercial Code or other state laws should be sufficient for the agency.

Unbundling

ONRR recognized in the Notice of Proposed Rulemaking the tremendous burden involved in unbundling and provided an option (the index based valuation method) for lessees who make non-arm's length sales or have no sales. The NOPR stated:

> We believe this index price option simplifies the current valuation methodology and provides early certainty. Many pipelines and services providers now charge producers "bundled" fees that include both deductible costs of transportation and non-deductible costs to place production into marketable condition. Both ONRR and lessees with arm's-length transportation contracts have found allocating the costs between placing the gas in marketable condition and transportation is administratively burdensome and time consuming. Similarly, when processing plants charge bundled fees that include non-deducible costs, the cost allocation is administratively burdensome and time consuming.
>
> Litigation also has complicated the application of ONRR's gas valuation regulations. Although litigation has clarified what constitutes marketable condition, its application is fact specific and time consuming. See *Devon* and cases cited therein.
>
> The proposed index-based option provides a lessee with an alternative that is simple, certain, and avoids the requirements to "trace" production when there are numerous non-arm's-length sales prior to an arm's-length sale and unbundled fees.

Industry commenters asked for an index-based option for lessees who make arm's length sales in order to simplify their unbundling burden. ONRR refused to propose an index-based option for lessees who make arm's length sales. The discrimination against producers who make arm's length sales is inexplicable.

Non-arm's length sales

Under the prior rules, if gas was not sold in an arm's length transaction (i.e., it was sold to an affiliate, it was used rather than sold, or it was not sold at the time it was removed from the lease but was instead put in storage), the value for federal royalty purposes was the first to apply of three benchmarks. The purpose of the benchmarks was to establish the value of production based upon comparable arm's length prices or other publicly available indicators of value (such as published Index Prices for natural gas). The Final Rule eliminated the benchmarks entirely, with no factual basis to do so, and forced lessees into one of two options, both of which were more difficult and less certain than the prior rules.

The first option, available only if gas was sold to an affiliate (i.e. not available if gas was used rather than sold), was to base value upon an affiliate's arm's length resale proceeds. While the Final Rule stated that transportation allowances could be taken from the affiliate's resale proceeds, industry had commented during the rulemaking that it can be very difficult to do so in situations in which an affiliate purchases gas from multiple fields, sometimes in several states, and resells on a commingled basis. The difficulty of netting back from downstream resales was not news to the agency. The Minerals Management Service had litigated with industry for years over the agency's attempt to circumvent benchmarks 1 and 2 and value gas sold to an affiliate on the affiliate's arm's length resale price. In all of that litigation, industry explained the difficulties associated with having to allocate back from affiliate resales to individual sources of production.[5]

In the preamble to the final rule, ONRR dismissed the industry comments with a statement which suggests that the industry comments were completely ignored or misunderstood. The preamble contains the following exchange:

> Public Comment: Several industry commenters asserted that tracing their affiliates' arm's-length gross proceeds is complicated and burdensome. One industry trade group remarked that § 1206.141(b) does not address costs unique to marketing and transporting Compressed Natural Gas (CNG) and Liquefied Natural Gas (LNG), where the first arm's-length sale may be at a distant international market.
>
> ONRR Response: The values established in arm's-length transactions are the best indication of market value. We recognize that changes in industry and the marketplace may make it difficult for a lessee to value its gas using the benchmarks. To address these difficulties, we eliminated the benchmarks in order to provide early certainty and gave lessees with non-arm's-length sales the option to value gas based on the first arm's-length sale or index prices.

[5] The MMS eventually lost in litigation. See, *Fina Oil and Chemical Co. v Norton,* 332 F.3d 672 (C.A.D.C. 2003).

The industry commenters were not expressing any concerns about applying the benchmarks. They were responding to the NOPR to eliminate the benchmarks and require value to be based upon affiliate resale proceeds. The ONRR Response that it was addressing "these difficulties" by eliminating the benchmark was not responsive to industry's comments. The effect of requiring royalties to be based upon affiliate resale proceeds is to deprive lessees of authorized transportation and processing allowances in situations in which tracing back to each source of supply is not possible.

The second option, an index-based valuation methodology, was complex, uncertain and unfair. It was an alternative option for lessees who sold to an affiliate and the only option available to lessees who used or stored production instead of selling it. The first difficulty was in determining the applicable index-price point. The Final Rule identified three possible scenarios for establishing the index-price point. In situations in which gas could be physically transported to more than one index pricing point, the Final Rule required that value be based upon the highest index pricing point to which the gas could flow. At ONRR's training sessions for the Final Rule, producers were told that they had to use the highest index pricing point *even if they had a contract to deliver gas to another index pricing point that month and even if the index pricing point with the highest index price was a pipeline which could not actually take the production because the pipeline was fully subscribed and had no excess capacity.* Requiring lessees to pay royalties based on values they cannot obtain is arbitrary, capricious and an abuse of discretion.

To make matters worse, the Final Rule provided, as to processed gas, that the processing, liquids transportation, and liquids fractionation allowances would be as posted by ONRR on its website for the geographic location of the lease and ONRR reserved the right to change these allowances at any time by changing the posting on its website. No standards were provided for ONRR's postings. Such a rule gives ONRR unfettered discretion as to the postings and makes it impossible for lessees to make informed decisions regarding the conduct of their business because they cannot know what the posted allowances will be.

Furthermore, the initial allowances set forth in the Final Rule were based on outdated information. For the processing allowance component, ONRR examined processing allowances that lessees and others reported from January 2007 through October 2011. The initial proposed T&F allowances were lower than current FERC interstate pipeline liquids transportation tariffs for the regions involved. Finally, the Final Rule did not include a transportation allowance from the wellhead to the plant for the liquids portion of the gas stream. This was pointed out during the rulemaking as an apparent oversight but in the Final Rule it was retained as justified as a "trade off" for the simplicity and certainty of the index-based method and it was emphasized that if a lessee did not like it, the lessee did not have to use the index-based option. The latter comment ignored the fact that the index-based option was the only valuation methodology in the Final Rules for lessees who used or stored production rather than selling it. There is no basis to deprive lessees of a transportation allowance which has been in the regulations for decades.

<u>Improper rulemaking as to lessees with keepwhole contracts</u>

During the training on the Final Rules, lessees found out for the first time that ONRR intended to apply the index-based "option" described above as the mandatory and only allowed valuation methodology for gas sold under keepwhole contracts including arm's length keepwhole contracts. There was no notice of this in the rulemaking and no opportunity for lessees to comment on this significant change. There is no justification for depriving lessees who sell gas under a keepwhole contract of allowances for transportation of the liquids component of the gas stream to the gas plant and all other actual allowances.

Having to change accounting systems and achieving less certainty

Perhaps one of the most costly provisions of the Final Rule was the cost for the accounting system changes that were required for reporting.

The Final Rule required lessees to value as processed gas for royalty purposes, gas sold under contracts that provide payment terms based on (1) a percentage of the volume or value of residue gas, plant products, or any combination of the two actually recovered at the plant; (2) the full volume and value of residue gas and/or plant products recovered at the plant, less a flat fee per MMBtu of wet gas entering the plant; (3) a combination of (1) and (2); and (4) the value of a percentage of the theoretical volumes of residue gas and/or plant products contained in the wet gas stream (so-called casing head gas contracts). The stated purposes of this change are:

(i) Protection against excessive transportation and processing allowances (i.e., the transportation and processing allowance caps would apply, and

(ii) Preventing lessees from structuring contracts to avoid the transportation and processing allowance caps.

Since November of 1991,[6] gas sold in arm's length percentage of proceeds contracts has been valued for federal royalty purposes as unprocessed gas. From a reporting standpoint, this means that a single line, using product code 04, can be used to report the sale based upon the net proceeds received by the lessee (subject to a minimum value equal to the value of 100% of the residue gas). The Final Rule reclassified POP and the other similar types of contracts described above as processed gas contracts for federal royalty valuation purposes.

The effect of this proposed change was that three lines of reporting were required instead of one: product code 03 for residue gas and disallowed plant fuel,[7] product code 07 for liquids, and product code 15 for fuel and lost & unaccounted for volumes between the BLM/BSEE approved point of measurement and the point of sale.[8] Transportation and processing also had to be

[6] 56 FR 46527, September 13, 1991.

[7] See fn. 2 in the December 18, 2014, Dear Reporter Letter concerning gas used or lost along a pipeline prior to the point of sale.

[8] December 18, 2014, Dear Reporter Letter concerning gas used or lost along a pipeline prior to the point of sale.

itemized. The total royalties owed were the same as under product code 04 but the reporting burden was significantly increased.

Because POP contracts have since November of 1991 been subject to the unprocessed gas valuation regulations, many companies did not have accounting systems set up to report anything other than a single product code 04 line. The Final Rule required a lessee to go from three reported data items (mcf, MMBtu, and value) to twelve reported data items (mcf/gallons, mmbtu), value, and transportation for three product codes plus a processing allowance). Some accounting systems could be modified by purchasing upgraded software but other systems had to be completely replaced in order to accommodate processed gas reporting. These costly changes were required at a time of significantly depressed oil and gas prices, making accounting system upgrades or changes cost prohibitive. Additionally, as anyone who has been through an accounting system upgrade or change knows, that cannot be done overnight. Even for companies who could afford to upgrade or replace their accounting system, the process can take a year or more to complete. Very few companies were able to complete the process in time to be able to report under the Final Rules for January production. The only other option for lessees was to have to manually prepare the Form ONRR-2014 csv files outside of and not integrated into their general accounting system. It is already very difficult for industry to meet reporting deadlines; introducing a manual process would add significant additional time and increase the potential for errors.

This change was unnecessary. Nothing has changed in terms of the nature of POP or other contracts that have pricing formulas tied to downstream residue gas or liquids values. The contracts are still for the sale of raw, unprocessed natural gas at the wellhead. Title passes at the wellhead and the purchasers are responsible for all nominations and scheduling of residue gas and liquids and for any imbalances they have between their scheduled quantities and actual production of residue gas and liquids. Lessees have as much incentive to minimize purchaser transportation and processing deductions under POP and similar types of contracts as they have to minimize transportation and processing costs under their own contracts.

If the goal was to subject the transportation and processing deductions taken by purchasers to the transportation and processing allowance caps, that could have been accomplished by providing that purchaser deductions are subject to the same caps as transportation and processing allowances. It was not necessary to change how these types of contracts are reported.

Similarly, the Final Rules eliminated transportation factors to facilitate data mining reviews. Again, for many lessees with accounting systems not set up to report transportation allowances, this change meant that they would have to manually prepare the Form ONRR-2014 csv files – outside of and not integrated into their general accounting system – or purchase expensive upgrades or entirely change their accounting system. The benefit to data mining is not outweighed by this significant cost to industry; the reporting will remain subject to audit.

Moving POP and similar contracts to the processed gas regulations and eliminating transportation factors did not offer greater simplicity; it made reporting more complex and much more expensive.

Finally, within a week after the Final Rules were issued, written requests were submitted to ONRR asking how to report certain provisions of the Final Rules which appeared to be in conflict. One request concerned liquids transportation and fractionation costs. The Final Rule provided that the Sales Value for natural gas liquids be reported at the gross value before the liquids transportation and fractionation ("T&F") costs and then the liquids transportation cost could be deducted in the transportation allowance and the fractionation cost could be deducted in the processing allowance. The question asked was if a producer sells its gas under a percentage of proceeds contract, should the liquids prices be grossed up just for the lessee's share of T&F or for 100% of the T&F and, if the latter, then would the lessee deduct 100% of the transportation in its transportation allowance (or only its POP percentage share) and 100% of the fractionation in its fractionation allowance (or only its POP percentage share). ONRR was never able to answer the question.

Rules which are so complex that the agency does not know what industry is required to do to comply with the rules do not achieve the stated goals of the rulemaking. If lessee guess wrong, they will have to reverse and rebook the prior reporting and pay interest. The threat of penalties for making reporting "errors" is also always present for lessees.

For the foregoing reasons, it is respectfully requested that the Final Rules be withdrawn.

Very truly yours,

Judith M. Matlock

Judith M. Matlock

Attachments

Attachment 1

Black's Law Dictionary (10th ed. 2014), misconduct

MISCONDUCT

Bryan A. Garner, Editor in Chief

Preface | Guide | Legal Abbreviations

misconduct (mis-**kon**-dəkt) (17c) **1.** A dereliction of duty; unlawful, dishonest, or improper behavior, esp. by someone in a position of authority or trust. See MISBEHAVIOR.

- **affirmative misconduct** (1897) **1.** An affirmative act of misrepresentation or concealment of a material fact; intentional wrongful behavior. • Some courts hold that there must be an ongoing pattern of misrepresentation or false promises, as opposed to an isolated act of providing misinformation. **2.** With respect to a claim of estoppel against the federal government, a misrepresentation or concealment of a material fact by a government employee — beyond a merely innocent or negligent misrepresentation.

- **employee misconduct** Misconduct engaged in by an employee esp. while on the job, but also possibly off the job (if the conduct harms the company in some way). • Employee misconduct could cover a broad range of behaviors, from minor infractions of company rules to criminal conduct.

- **gross misconduct in the workplace** Intentional or reckless behavior that might harm someone, esp. a fellow employee, or the employer. • Gross misconduct may include acts in disregard of the safety of others, unlawful discrimination, libel, harassment, and various criminal offenses.

- **juror misconduct** (1954) A juror's violation of the court's charge or the law, committed either during trial or in deliberations after trial, such as (1) communicating about the case with outsiders, witnesses, attorneys, bailiffs, or judges, (2) bringing into the jury room information relating to the case but not in evidence, and (3) conducting experiments regarding theories of the case outside the court's presence.

- **misconduct in office** See *official misconduct.*

- **official misconduct** (1830) A public officer's corrupt violation of assigned duties by malfeasance, misfeasance, or nonfeasance. — Also termed *misconduct in office*; *misbehavior in office*; *malconduct in office*; *misdemeanor in office*; *corruption in office*; *official corruption*; *political corruption.*

- **serious and willful misconduct** See SERIOUS AND WILLFUL MISCONDUCT.

- **wanton misconduct** (1844) An act, or a failure to act when there is a duty to do so, in reckless disregard of another's rights, coupled with the knowledge that injury will probably result. — Also termed *wanton and reckless misconduct.*

- **willful and wanton misconduct** (1866) Conduct committed with an intentional or reckless disregard for the safety of others, as by failing to exercise ordinary care to prevent a known danger or to discover a danger. See *gross negligence* under NEGLIGENCE. — Also termed *willful indifference to the safety of others.*

- **willful misconduct** (1804) Misconduct committed voluntarily and intentionally.

- **willful misconduct of an employee** (1884) The deliberate disregard by an employee of the employer's interests, including its work rules and standards of conduct, justifying a denial of unemployment compensation if the employee is terminated for the misconduct.

2. An attorney's dishonesty or attempt to persuade a court or jury by using deceptive or reprehensible methods.

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Attachment 2

Rulemaking comments regarding
why sales prices and allowances may different between producers

Sales Prices.

Proposed 1206.104(c)(2) provides that "ONRR may decide your value if you have breached your duty to market the oil for the mutual benefit of yourself and the lessor by selling your oil at a value that is unreasonably low. ONRR may consider a sales price to be unreasonably low if it is 10 percent less than the lowest reasonable measures of market price, including but not limited to, index prices and prices reported to ONRR for like quality oil."

Proposed 1206.143(c)(2) is an identical provision for gas, residue gas, and gas plant products. "ONRR may consider a sales price to be unreasonably low if it is 10 percent less than the lowest reasonable measures of market price, including but not limited to, index prices and prices reported to ONRR for like quality gas, residue gas, or gas plant products."

The preamble to the NOPR states that an "unreasonably low" price "may reflect a failure of the lessee to perform its duty to market gas for the mutual benefit of the United States, as lessor, and the lessee. The preamble further states that ONRR's authority to exercise this provision is discretionary and, in exercising this discretion, ONRR may consider any information that shows a price appears unreasonably low, and, thus, is not an accurate reflection of fair market value.

It does not follow that if a lessee has a price that is less than 10% below the lowest reasonable measures of market price, the lessee has breached its duty to market the oil or gas. The federal royalty interest is 1/8th or 1/6th; the lessee's interest is much greater. There is no incentive for a lessee to sell its oil or gas at less than the price it is able to obtain under its circumstances. Sales prices vary for a wide variety of reasons including, but not limited to:

> The quantity of oil or gas a lessee has available for sale in a particular market. (Lessees with more product to sell may be more attractive to buyers.)
>
> The supply and demand relationships in a particular market at the time a sales contract is negotiated. (Contracts entered into during periods of oversupply may have lower prices than contracts entered into during periods of shortages.)[1]
>
> The quality of the oil or gas a lessee has available for sale. (A lessee with gas rich in liquids may be able to command a better price than a lessee with lean gas

[1] A 10% measure of reasonableness in a $100 oil market is very different than a 10% measure in a $45 oil market.

during periods of favorable liquids prices.)

The type of sales contract – fixed price (price will not vary during the term and, therefore, could be higher or lower than the monthly spot prices) or index-based price.

Contract term – pricing can vary depending upon whether the contract is short term or long term

These are just some of the many factors that affect a particular sales price. The proposed change to the regulations, if adopted, would mean that no lessee could know at the time it submitted its royalty reports and paid its royalties that it had done so correctly. Whether the reporting and valuation is correct is left to the discretion of individual ONRR, state and tribal auditors. If a future auditor disagrees with the sales price a lessee was able to negotiate, the lessee will be required to reverse and rebook seven years of reporting and valuation or pursue a time consuming and costly appeal. The increased uncertainty associated with this proposed change will make the advisability of investment in federal oil and gas leases even more uncertain. This is not an improvement in the status quo.

The preamble to the final 1988 gas valuation regulations explains quite well why the gross proceeds accruing to the lessee is a proper measure of value:

> The MMS believes that the gross proceeds standard should be applied to arm's-length sales for several reasons. The MMS typically accepts this value because it is well grounded in the realities of the marketplace where, in most cases, the 7/8ths or 5/6ths owner will be striving to obtain the highest attainable price for the gas production for the benefit of itself. The royalty owner benefits from this incentive.
>
> It also adds more certainty to the valuation process for payors and provides them with a clear and logical value on which to base royalties. Under the final regulations, in most instances the lessee will not have to be concerned that several years after the production has been sold MMS will establish royalty value in excess of the arm's-length contract proceeds, thereby imposing a potential hardship on the lessee. This is particularly a concern for lessees who have long-term arm's-length contracts where sales prices under newer contracts may be higher. If MMS were to establish royalty value based on prices under those newer contracts, (i.e., prices which the lessee cannot obtain under its contract), the resulting royalty obligation could, in some instances, consume the lessee's entire proceeds.

The oil and gas markets are known for price volatility. As lessees struggle to survive in this market, one option might be to return to the pre-index price era when oil and gas were sold for fixed prices. This could provide a predictable and sufficient cash flow to continue producing, something reliance on index-based prices cannot do. The proposed change creates a significant disincentive to consider fixed priced contracts or any other pricing alternatives other than index-based pricing (because the index prices reflect the current month market price). Pricing creativity should be encouraged, not discouraged, because it can lead to consistent revenues despite volatility in oil and gas spot markets.

Furthermore, the proposed change does not have sufficient standards to prevent the exercise of discretion from being arbitrary, capricious and an abuse of discretion. What index prices would be relevant to a particular lessee's production? How would an auditor determine which values reported to ONRR are relevant to a particular lessee's production? Would product code 04 sales values (which are required to be increased to reflect the cost of services provided by purchasers to place gas into marketable condition rule) be included with product code 03 sales values (which are not adjusted for the marketable condition rule because the adjustments are in the transportation and processing allowances, not in the sales value). Just based on the marketable condition rule alone, a product code 04 reported sales price (with marketable condition adjustments) could easily be 10% or more higher than a product code 03 reported sales price, particularly in today's low price environment.

Finally, the proposed changes include an index-based valuation option for lessees that do not sell under an arm's-length contract. The proposed index-based valuation offers the prospect of certainty in exchange for paying royalties on higher values and lower allowances (10%, minimum of 10 cents and maximum of 30 cents). If some lessees elect this option, that will increase the reported sales values to ONRR further increasing the chances that other lessees' sales prices will be 10% or more below the non-arm's length index-based prices. Just because some lessees who do not sell under an arm's length contract elect the index-based valuation option does not indicate other lessees have breached their duty to market.

Absent evidence that a lessee actually failed to market gas for the mutual benefit of the United States, as lessor, and the lessee, the gross proceeds standard should continue to apply.

<u>Transportation and processing allowances</u>

Proposed 1206.152(g)(2) provides that" ONRR may determine your transportation allowance for residue gas, gas plant products, or unprocessed gas if ONRR determines that the consideration you or your affiliate paid under an arm's-length transportation contract does not reflect the reasonable cost of the transportation because you breached your duty to market the gas, residue gas, or gas plant products for the mutual benefit of yourself and the lessor by transporting your gas, residue gas, or gas plant products at a cost that is unreasonably high. ONRR may consider a transportation allowance unreasonably high if it is 10-percent higher than the highest reasonable measures of transportation costs including, but not limited to, transportation allowances reported to

ONRR and tariffs for gas, residue gas, or gas plant products transported through the same system." There is a similar provision as to oil transportation in proposed 1206.110(f)(2).[2]

Proposed 1206.160(a)(3)(ii) similarly provides that "ONRR may determine your processing allowance if ONRR determines that the consideration you or your affiliate paid under an arm's-length processing contract does not reflect the reasonable cost of the processing because you breached your duty to market the gas for the mutual benefit of yourself and the lessor by processing your gas at a cost that is unreasonably high. ONRR may consider a processing allowance unreasonably high if it is 10-percent higher than the highest reasonable measures of processing costs including, but not limited to, processing allowances reported to ONRR for gas processed in the same plant or area."

It does not follow that if a lessee has a transportation or processing cost that is more than 10% above what other lessees have reported or been charged under a tariff,[3] the lessee has breached its duty to market the oil or gas. Again, the federal royalty interest is $1/8^{th}$ or $1/6^{th}$; the lessee's interest is much greater. There is no incentive for a lessee to pay more for transportation or processing than it has to. Transportation rates vary for a wide variety of reasons including, but not limited to:

> The lessee's gas may be subject to a long-term or life of the lease transportation and/or processing agreement that was necessary in order to be able to market production at all. For example, some lessees are subject to life of the lease transportation and/or processing agreements that were offered right after FERC Order 636[4] when the former interstate pipeline purchasers decided to spin down or spin off their gathering and processing assets and producers objected at FERC. FERC required the pipelines to offer default contracts as a condition for obtaining approval of the spin down or spin off. The rates under these life of the lease agreements are not going to be the same as rates negotiated at other points in time.
>
> The available capacity in a transportation system or gas plant. If capacity has to be expanded to accommodate a new producer, the rates are going to be higher than if there is existing excess capacity. For example, gas plants are known to run more efficiently (i.e., recover more liquids) if they are operated close to capacity and that may provide an incentive for a gas plant owner to provide a discount to a producer to fill up a plant if the plant is not running at near capacity.

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[2] There appears to be a drafting error in 1206.110(f)(2) which ends with a reference to gas, residue gas, or gas plant product tariffs. The reference should be to oil transportation tariffs.

[3] Some tariffs allow rates to be discounted in certain circumstances. For example, interstate gas pipeline tariffs may provide for discount authority between a maximum and a minimum. Crude oil and liquids transportation tariffs may provide discounted rates to anchor or incentive shippers in exchange for long-term volume dedications under throughput and deficiency agreements. These discounts have been approved by FERC as necessary to fund new infrastructure development. See, for example, MAPL, July 1, 2006. 116 FERC P 61040, 2006 WL 2007551 (F.E.R.C.).

[4] FERC Order No. 636, Restructuring of Interstate Natural Gas Pipeline Services (Final Rule), Order No. 636, Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations, and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, III F.E.R.C. Stats. & Regs. [Regs. Preambles] ¶ 30, 939, April 9, 1992.

Certain shippers on intrastate pipelines and local distribution company systems may be given a discounted rate to keep the shipper from bypassing the system and connecting to an interstate provider.[5]

Transportation rates upstream of gas processing plants may vary based upon distance to the plant. Transportation allowances reported to ONRR cannot distinguish distance-related differences. Some transportation tariffs also have zone rates and not postage stamp rates. These differences cannot be distinguished in the transportation allowances reported to ONRR.

Processing costs vary depending upon the type of processing contract – fixed fee, keepwhole, and percentage of proceeds contracts are only three of the types of processing contracts that may be negotiated. Under keepwhole agreements and POP agreements, processing fees are based upon the value of products retained by the plant. Keepwhole and POP processing fees will be as volatile as gas and liquids prices. Processing allowances reported to ONRR cannot distinguish between processing fees under different types of contracts. Additionally, using index-based measures to evaluate the reasonableness of a particular lessee's processing fee may unfairly penalize a lessee who negotiated a fixed fee processing fee even though a fixed fee avoids the price volatility inherent in index-based fees and may be the more reasonable fee over time.[6]

Different lessees have different negotiating leverage based upon their size, the quantity of production they have, the quality of the production (rich in liquids for example), and other factors.

These are just some of the many factors that affect a particular transportation or processing cost. The proposed change to the regulations, if adopted, would mean that no lessee could know at the time it submitted its royalty reports and paid its royalties that it had done so correctly. Whether the allowances are deemed to be reasonable is left to the discretion of individual ONRR, state and tribal auditors. If a future auditor disagrees with a lessee that the lessee's transportation or processing costs were reasonable, the lessee will be required to reverse and rebook seven years of reporting and valuation or pursue a time consuming and costly appeal. The increased uncertainty associated with this proposed change will make the advisability of investment in federal oil and gas leases even more uncertain. This is not an improvement in the status quo.

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[5] See, for example, C.R.S. §40-3-104.3. The discount is given to keep the shipper on the system contributing something towards the cost of service; if the shipper is lost the remaining customers will have to cover the lost revenues.

[6] In July of 2008, gas prices exceeded $11.00 per MMBtu. A producer with a fixed fee transportation or processing agreement had lower transportation and processing fees than producers who had keepwhole or POP contracts. In contrast, during periods of low gas and liquids prices, the fixed fee producer may have higher transportation and processing fees than producers who have keepwhole or POP contracts. Over the life of the contract, all three types of contracts could have comparable transportation and processing fees but they will not be comparable on a short term basis.