State of Montana

Marc Racicot, Governor

Department of Revenue
Mick Robinson, Director

Natural Resource and Corporation Tax Division

February 5, 1996

David Guzy
Minerals Management Service
Royalty Management Program
Rules and Procedures Staff
P.O. Box 25165, MS 3101
Denver, CO 80225-0165

RE: "Amendments to Gas Valuation Regulations for Federal Leases" published in the Federal Register November 6, 1995, at 60 F.R. 56007

Dear Mr. Guzy:

The State of Montana thanks the Minerals Management Service (MMS) for giving it the opportunity both to participate in the negotiated rulemaking, and to provide comments on the resulting proposed rule (referenced above). It is commendable for MMS to have included its constituents in the development of regulations for valuing gas. The creation of the negotiated rule-making has clearly had positive results. Each of the representatives brought the perspective of his or her constituent group to the table, which created the opportunity for all sides to be better informed and contributed to full and rich discussions of options and issues.

Many respondents are likely to take the position that the Committee was unable to accomplish one of its major objectives--simplicity. The attempt to satisfy the diverse and conflicting needs of the group, combined with a consensus-based decision-making approach, guaranteed that the outcome would be complex. Clearly, the resultant rule is complex; many options exist which lead to suboptions and so on. Montana believes that the development of options, i.e., creating layers of complexity, was the only way by which the group could reach consensus. The process itself guaranteed that the outcome would not be simple.

The MMS is now faced with the difficult task of determining whether the Committee's recommendations could be modified into a rule that is simpler and easier to understand. While Montana is sensitive to the pressures that MMS is or will be experiencing as it develops the final rule, it urges MMS to take appropriate measures to assure revenue neutrality.

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The MMS had made major shifts which resulted in convening the negotiated rule-making Committee. For the first time, MMS is considering the cost of applying the rules, both for MMS and for royalty payors, as part of the royalty equation. It has sought to reduce those costs and at the same time protect revenues. The MMS must make certain that in pursuing its goal to reduce administrative costs for producers, it does not compromise the basic rules of royalty valuation or assume an administrative burden out of proportion with Congressional objectives to reduce the size of the federal government. In weighing whether to assume any additional administrative burdens, MMS must, however, continue to assure that royalties are based on market values.

DEFINITIONS (Section 206.451)

Dedicated: Montana recommends that the definition of a dedicated contract be changed to be interpreted more broadly where contracts are not language specific. If all production has historically been sold under a particular contract to one purchaser, that contract should be deemed to be dedicated whether or not it lists each well or each lease specifically.

Gathering: Montana does not concur with the definition of gathering in the proposed rule. Nor does it agree with the recommendation made by STRAC in this area. Instead, Montana suggests that all movement of gas prior to the first point downstream of the compressor be considered gathering. This definition is in better keeping with the concept of "marketable condition" since most compression performed boosts gas to pipeline specs, making it marketable.

INDEX-BASED METHOD (Section 206.454)

Royalty value moves from an exact to an approximate number; actual point of sale is ignored; sales contracts which contained marketable condition criteria are no longer important. Therefore, MMS must re-examine the definition of marketable condition.

The use of an index-based method in this proposed rule involves a major change in the way federal gas is valued. Since 1942, gross proceeds have been the minimum value on which producers of gas on federal lands paid royalties.[1] What gross proceeds were owed the producer and under what conditions gas was marketable were determined in accordance with terms of arm's-length sales contracts. The index-based method moves away from reliance on actual sales and actual sales contracts.

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[1]In Hoover & Bracken Energies, Inc. v. United States Department of Interior, 723 F.2d 1488 (10th Cir., 1983), the Tenth Circuit U.S. Court of Appeals determined that oil and gas royalties payable to the federal government should be based upon the entire consideration which the Lessee received for the gas produced from the lease. In moving away from gross proceeds as a basic tenant of value, MMS will never again have certainty that it has received total consideration paid for production from federal leases.

Montana suggests that the index-based approach literally assumes that the only market for gas is at the index pricing point. Therefore, the gas is not in marketable condition until it reaches the index pricing point. Thus, MMS's attempt to clarify gathering and transportation, and even compression, is pertinent only to gross proceeds payors; **index payors must get the gas to the index pricing point without deduction.**

The MMS needs to decide whether all gas valued under the index-based method is marketable at the wellhead, or whether none of it is marketable, since there are no sales contracts to rely upon for determining marketability. In the event that MMS takes the position that all gas is fully marketable at the wellhead (i.e., contrary to the recommendation above), Montana offers these questions for consideration:

1. Since index prices are, at best, an approximation of market value, why would MMS allow an offset of an approximate value with an exact, and very generous, deduction for transportation?

2. Would MMS presume that transportation is incurred in every instance?

   A. Producer/pipelines that deliver gas through farm taps in the same fields in which the gas is being produced will be allowed the same deductions for transportation that are allowed for producers who actually incur transportation expenses. The federal government, if it allows for transportation in every instance, is granting deductions that reduce the value of the gas to the lowest possible level. This is not in keeping with the federal government's trust responsibility; the federal government has a fiduciary obligation to obtain the highest legitimate and reasonable advantage in the leasing of these lands. Such new treatment of transportation cannot fulfill that responsibility nor result in revenue neutrality.

   B. Where a publication indicates a price for the Rocky Mountain region, production within that region should not be further reduced by transportation.

Indices do not represent market value (Section 206.454).

Montana concurs with STRAC's comments detailed in its response to the referenced Federal Register notice that indices have not been shown to represent market value and hereby incorporates STRAC's comments on that topic into its response. For instance, in one field in Montana, producers are receiving from arm's-length sales gross proceeds which are easily twice the amount of any index within a thousand mile radius.

Even if, in some areas of the country, indices did represent market value at the time of the Committee's negotiations, they cannot be presumed to always represent market value, given the constantly changing marketplace. In MMS's public hearing on the proposed rule January 22, 1996, a company testified that it used the futures market to minimize fluctuating spot market prices. The Committee did not consider the impact of trades on the futures market in determining royalty value. Montana believes this to be a flaw in the proposed regulation because it believes the lessee has the duty to market the gas.[2]

THE SAFETY NET

The safety net must not only be maintained but be expanded in order to assure that index payors pay on prices that represent market value.

Montana concurs with STRAC with regard to the need for a safety net (Section 206.454(e)) and hereby incorporates STRAC's comments (p. 2-6) with regard to that topic in this response.

Further, Montana believes that there is some danger that the safety net calculation as defined in the proposed rule may result in calculation of average prices that are lower than true market prices. Montana has found differences to exist between diligence in marketing on the part of gas well gas producers and casinghead gas producers. In one long-term contract in the Williston Basin, a casinghead producer, required to market gas for environmental reasons, entered into a long-term contract for index prices in Ventura, Iowa, less transportation of $.72/MMBtu. The producer netted $.34/MMBtu according to the settlement statements. The casinghead gas producer entered into this agreement because it was guaranteed revenues from its oil stream. Clearly, this producer was less diligent in obtaining the best price for the mutual benefit of the lessor and lessee than the gas well gas producer whose pricing provisions on its long-term contract reach $5.00/MMBtu by the year 2000. We believe that the casinghead gas producer's transaction is far removed from market value.

If the options were available in the field described above, which producer is likely to pay under the gross proceeds method? Which is likely to pay under the index method? If, as we would suppose, the casinghead gas producer elects to pay on gross proceeds, $.34/MMBtu is the value which will be included in the safety net. Unless there is no representative volume of gross proceeds payors within a zone, the gross proceeds of index payors are not included in the calculation. Montana believes this to be a flaw in the proposed rule and that, lacking the gross proceeds of index payors, the safety net will not be reflective of market value.

Montana recommends 1) that the safety net calculation be expanded to always include a statistically valid sampling of the gross proceeds of index payors, and 2) that payors providing, or volunteering to provide, necessary documentation so prices can be verified not be rewarded through reduced royalties for supplying information that is required under lease terms.

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[2]MMS-84-0056-OCS.

The safety net is needed because that is the only way the uplift on NGLs can be captured for those who elect to pay on wellhead MMBtu.

Montana concurs with STRAC with regard to the additional need for a safety net when index payors elect to pay on a wellhead MMBtu and hereby incorporates STRAC's comments (p. 2) with regard to that topic in this response.

The safety net assures that conditions of a changing marketplace will be captured.

Montana concurs with STRAC with regard to the concern that while posted or published prices might be reflective of market values at a particular point in time, that there is danger in assuming, in a constantly changing marketplace, that that will remain true. Montana hereby incorporates STRAC's comments (p. 2) with regard to that topic in this response. As an additional example, Montana wishes to point out that producers who were selling on the spot market at the time of the negotiations are now entering into long-term sales. Thus, indices represent an even lower percentage of sales in the marketplace than they did at the time of the negotiations.

The cap on the safety net must be eliminated so that index payors do not pay on less than market value.

Montana concurs fully with STRAC on this topic and hereby incorporates STRAC's comments (p. 3) with regard to that topic in this response.

Zones from which the safety net will be calculated should not be determined simply on the basis of quality differences.

Montana concurs fully with STRAC on this topic and hereby incorporates STRAC's comments (p. 4) with regard to that topic in this response.

Simply because produced gas could physically move to an index pricing point hundreds, or thousands, of miles distant does not mean that such produced gas should be included in a zone, and thus become eligible for indexed-based valuation.

As illustrated in the discussion under the safety net in #1, one producer in the Williston Basin contracted for an index price in Ventura, Iowa. This is probably because there is no index pricing point in the Williston Basin; the closest index point is in Wyoming, on a pipeline to which that producer does not have access. A zone would have to be large in order to include both the Williston Basin and an index pricing point in the same boundaries, but nothing in the regulations precludes this from happening. Montana recommends that clarifying language be included.

The STRAC response, on p. 4, discusses that some areas, particularly the Williston Basin area in Montana and North Dakota, do not lend themselves well to index pricing. It would be difficult for production to physically flow to an index point nearby because the pipeline systems going through the basin do not have access points, or else the amount of gas which could flow through existing intra- and/or interstate pipelines is limited due to lack of capacity. While the Committee's recommendations set a starting point for establishing criteria for zones with active spot markets, Montana recommends MMS review this criteria to see if both access points and pipeline capacity for physically moving the gas are fully conveyed.

Montana expects that the greatest potential for the creation of a new index pricing point near Montana would be in Canada, if the flow of gas is a major consideration. Montana suggests that MMS develop a position as to how it would potentially create a zone, part of which was outside the United States. How would it gather information to calculate a safety net if half the producers had no obligation to the U.S. government? How would it obtain documents to verify gross proceeds?

Index payors who are "trueing-up" under the safety net should not be granted an interest holiday while MMS labors to perform responsibilities formerly the responsibility of industry.

Montana concurs fully with STRAC on this topic and hereby incorporates STRAC's comments (p. 5) with regard to that topic in this response.

The preponderance of options and elections provided to index payors is inequitable and results in the likelihood that they will pay less than market value; therefore, such elections should be reduced or eliminated.

Montana concurs fully with STRAC on this topic and hereby incorporates STRAC's comments (p. 6-7) with regard to that topic in this response.

The two-year election period must be retained in order to dissuade royalty manipulation.

Montana concurs fully with STRAC on this topic and hereby incorporates STRAC's comments (p. 6) with regard to that topic in this response.

MMS must focus on proper reporting and reinstate penalties where appropriate in order to assure the validity of the safety net calculation.

Montana concurs fully with STRAC on this topic and hereby incorporates STRAC's comments (p. 6) with regard to that topic in this response.

GATHERING V. TRANSPORTATION

The proposed change in the definition of gathering will have a negative revenue impact.

Montana concurs with STRAC (p. 7) that the change in the definition of gathering will have a negative impact on royalties collected. For that reason, Montana offers the suggested change listed under "Definitions" above.

The MMS is being too generous in granting transportation when such transportation does not enhance the value of the gas.

Montana concurs fully with STRAC on this topic and hereby incorporates STRAC's comments (p. 8) with regard to that topic in this response.

Transportation will have a major impact on future royalty collections. (Section 206.456 and 206.457)

Montana is concerned, with the advent of this regulation in general as well as the redefinition of gathering specifically, combined with FERC Order No. 636, that much of what was formerly considered value attached to the gas will be reclassified as transportation. For that reason, Montana's representative worked hard to assure that the Committee supported the provision in the current rule which limited the transportation deduction to 50% of the value of the gas. If MMS believes that such steps would better capture the market value of gas, Montana recommends it consider raising that limit so that no more than 25%, for instance, of the value of gas can be subtracted for transportation.

MISCELLANEOUS

The MMS should not incur huge administrative costs in reconciling volumes by granting an exemption for "small operating rights owners" to pay royalties on sales while others must pay on entitled share of production.

Montana concurs fully with STRAC on this topic and hereby incorporates STRAC's comments (p. 8-9) with regard to that topic in this response.

The MMS must take appropriate steps to assure that the results of the negotiated rulemaking do not conflict with historically based valuation practices, or if they do that the new basis for royalty valuation is applied consistently.

Montana concurs fully with STRAC on this topic and hereby incorporates STRAC's comments (p. 11) with regard to that topic in this response.

Montana's representative recognized the need for compromise and was willing to compromise in order to satisfy the needs of different constituent groups. All such negotiations were entered into under the assumption that where a payor elects an option that subsequently turns out to be higher than another pricing scheme, that the courts will hold that particular payor to his/her election. Montana is very concerned that the basis for this assumption is contradicted by a ruling of the Interior Board of Land Appeals (IBLA), on Conoco, Inc. 110 IBLA at 244. In this case, IBLA ruled that in the procedure paper, MMS would have accepted the low prices; therefore, market value was defined as the low prices. As a result, IBLA ruled MMS could not assess on higher than the lowest prices. We recommend that MMS consider this and any other potential interpretations by the courts as it considers spot market prices, and low gross proceeds prices. The MMS must take whatever steps are necessary to insure that one of its major objectives in this rule, revenue neutrality, is obtained.

COMMENTS ON TOPICS ON WHICH MMS REQUESTED INPUT

Index payors should not be allowed royalty relief from contract settlements where such contract settlements apply to gross proceeds in past times and apply to future production.

Montana concurs fully with STRAC on this topic and hereby incorporates STRAC's comments (p. 9) with regard to that topic in this response.

The MMS simply must fulfill its obligation to calculate the safety net in two years; if it fails to do so, the States must be paid as if MMS had fulfilled its obligation.

Montana concurs fully with STRAC on this topic and hereby incorporates STRAC's comments (p. 9) with regard to that topic in this response.

The improved benchmarks must incorporate the concept of looking through the sales of affiliates to capture arm's-length gross proceeds as a basis for royalty value in areas where there is no active spot market.

Montana recommends that the first arm's-length sale by the affiliate be used to establish value except when those sales are to residential customers. Montana would reorder the benchmarks offered by STRAC, so that #2 is first, followed by #1 as second, and STRAC's suggested #3 is third.

Montana feels that MMS cannot define "gross proceeds" without looking to third-party independent transactions. Producers and their affiliates are responsible to the same managers and to the same stockholders. For companies to move profits away from the wellhead benefits them two ways, from a state tax perspective and from a royalty perspective. Montana believes that MMS must always look through the affiliate to truly determine market value.

Thank you for giving us the opportunity to participate in this process. If you have any questions, please contact me or Wanda Fleming at (406) 444-2441.

Sincerely,

Don Hoffman, Chief
Natural Resource Bureau