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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 Sir or Madam:

The State and Tribal Royalty Audit Committee (STRAC) members of the Negotiated Rule-making Committee (Committee) thank the Minerals Management Service (MMS) for giving them the opportunity to participate on the Committee. The STRAC recognizes that given the new environment since FERC Order # 636, application of the existing federal royalty gas valuation regulations became more difficult. Bringing together a group of people with such diverse interests helped all participants achieve a better understanding of the complexities in gas valuation and work together to develop solutions to perplexing problems.

It is important to note that STRAC did not embrace all the recommendations developed by the Committee. We were concerned, and still are concerned, that many of the important consensus decisions were made in a vacuum, and we were not allowed to vote on the package as a whole. The process did not allow for changes to previous consensus decisions when other topics directly affecting those decisions came up. Based on this fact, STRAC representatives voted sideways (neither for nor against) on many of the issues on which we are providing comments. The STRAC offers the following comments in an attempt to return to the original objectives of the Committee which were revenue neutrality, accountability, certainty, and simplicity while keeping in mind current market conditions.

Alternative Valuation Standards for Unprocessed Gas and Processed Gas (206.454)

1. Safety Net

IMPORTANCE OF THE SAFETY NET

The STRAC is strongly opposed to any index-based methodology unless it incorporates a safety net. For the reasons given below, STRAC believes that the safety net is necessary during the first year this rule is effective and that it will continue to be necessary as long as index-based pricing applies. The safety net was the most critical component for STRAC in adopting the alternative valuation recommendation. Without a safety net, there would have been no consensus because STRAC is not convinced that indices represent market value. The STRAC is concerned that:

1) Indices represent only one type of sale in today's market, spot market sales, and exclude long term contracts; and

2) At the time of Committee negotiations, only approximately 30 percent of gas was sold on the spot market.

The safety net assures that index payors may have to "true-up" to a level that more closely resembles market value. It provides the only assurance that index-based values will not result in substantially lower royalty revenues than those received under gross proceeds. As an example, the safety net is the only way that the uplift on NGL's will be captured when liquids are paid on an MMBtu wellhead basis. Further, a shift has begun taking place regarding the mix of long and short-term contracts in the marketplace since this Committee developed its recommendations. The safety net provides assurance that the appropriate mix of contract sales is captured. See also our detailed discussion on options which can cause index payors to pay on artificially low prices.

In 1988, when the oil valuation rules were published, posted prices were believed to be representative of market value, and thus, were incorporated into the regulations in order to provide certainty and simplicity for non-arm's-length sales. Subsequently, however, the market changed, and now pricing centers in the U.S. have no relationship to prices being posted in fields or areas (See 60 Federal Register 65610, dated December 20, 1995). In other words, posted prices are not currently believed to be representative of market value. The STRAC believes the safety net will keep the regulations abreast of existing market conditions.

CAP ON THE "TRUE-UP" (206.454(e)(8) through (e)(10))

The STRAC strongly recommends eliminating the cap on the "true-up." It is important to note that the Committee reached consensus on capping an index payor's obligation prior to any discussions of options and elections. The numerous options and elections provided to index payors will impact the "lessee's weighted average index values" to the extent that those values have greater potential to be lower than market value or comparable to their own gross proceeds. If all these options and elections had been discussed prior to the vote on the cap, STRAC would never have agreed to capping the "true-up" value and consensus would never have been reached.

In the Committee negotiations, STRAC was strongly opposed to capping the amount companies must "true-up" to, if index prices fall below the median gross proceeds value (safety net calculation). The STRAC feels that index payors should never pay on less than market value. If the median gross proceeds value is higher than index value, index payors must pay on the higher value. There is no sound reason why index payors should pay less than market value. The rationale behind the safety net was to insure that index value would approximate gross proceeds. In allowing the cap, MMS has moved away from the long-standing regulatory requirement that royalty value would be no less than gross proceeds.

Caps inhibit MMS from arriving at royalty values comparable to gross proceeds. Index payors are allowed to use indices as value without revealing their own true gross proceeds. Through the use of the cap, they are provided a limit on their liability, and they have the right to challenge the true-up value determined through MMS's computations of other producers' average gross proceeds. Further, if index payors are allowed to pay on less than market value, gross proceeds payors are being held to a higher standard. This is clearly inequitable.

The median value approach already provides protection to the index payors by eliminating the higher priced contracts; therefore, there should be no cap. It is important to note that the safety net median value is already at the 50th percentile. Under the proposed rule, Index payors must only true-up to 105% for the first year and 50% of the difference between this 50th percentile value and the lessee's weighted average index value for following years. Retaining this provision in the proposed rule adjusts twice for anomalies and results in royalties lower than market value.

SUGGESTED CLARIFICATION ON SAFETY NET LANGUAGE

Although Section 206.454(a)(3)(v) makes reference to the fact that any MMBtu valuation method is subject to adjustment, we believe that payors will have difficulty understanding which particular section (and thus percentage) will apply. Therefore, we recommend inserting this additional language into each of the referenced sections:

206.454(a)(1)(I) ...the lessee may elect to value the gas using an index-based method under this section [insert] subject to adjustment in 206.454(e)(8)

206.454(a)(1)(ii)(A) ...an index-based method under this section [insert] subject to adjustment in 206.454(e)(8)

206.454(a)(2)(I) ...the lessee may elect to value the gas using an index-based method under this section [insert] subject to adjustment in 206.454(e)(8)

206.454(a)(2)(ii)(A) an index-based value under this section [insert] subject to adjustment in 206.454(e)(8)

206.454(a)(2)(iii)...then the lessee may elect to value the NGL's, elemental sulfur, and drip condensate associated with that residue gas using the same index-based value per MMBtu used to value the associated residue gas [insert] subject to adjustment in 206.454(e)(9).

206.454(a)(2)(iv) ...then the lessee may elect to value the NGL's, elemental sulfur, and drip condensate associated with that residue gas using the same price per MMBtu used to value the associated residue gas [insert] subject to adjustment in 206.454(e)(10).

In addition, there were typographical errors detected in the proposed rule. Section 206.454(e)(9)(ii)(B) states: "Multiply the difference by 50%," the correct percentage from the committee report is 65%. Section 206.454(e)(10)(ii)(B) states: 'Multiply the difference by 50%', the correct percentage from the committee report is 30%.

ZONES (Section 206.454(g))

In the Committee meetings, there was discussion of qualifying the zones by quality determinations. Even though it was not made part of this proposed regulation, STRAC wishes to comment that such detailed segregation is not in keeping with the factors and conditions agreed upon for zone determination. The STRAC recommends that all gas-related production in a zone be included in the calculation of the safety net for that zone, e.g. sour gas should not be excluded from sweet gas in a zone; processed and unprocessed gas should not be subject to different safety net calculations.

The STRAC feels strongly that some areas of the country do not lend themselves well to index pricing, and thus should not be considered zones with active spot markets. The Committee agreed that it was possible for any gas produced to eventually get to an index point. In developing this methodology, the Committee's intent was to allow the use of indices to establish value for the production that occurred fairly close to the index point. It was not the Committee's intent to force production from lands in Montana and North Dakota (where sales on the spot market are few and consist of casinghead gas sales in captive markets) to fall into a zone in which index pricing and the safety net would apply. It is possible that a zone could be drawn so that the single index pricing point hundreds of miles from the Williston basin would assure its inclusion under the index-based valuation methodology. Therefore, MMS must make the regulations clear so that zones reflect market conditions and zone boundaries are not under constant dispute.

We do not recall what "simplification" means under "factors/conditions for zone determination." We do not recommend that MMS make too-broad an interpretation of zones to include all of the Rocky Mountain Region in one zone for the purpose of simplification. The MMS should either further clarify what is meant by "simplification" or remove this from the criteria.

INTEREST WHEN INDICES ARE LESS THAN MARKET VALUE

The STRAC recommends that index payors be denied the interest holiday until the date MMS publishes the "snapshot," which is provided for in Section 206.454(e)(12)(iv); interest should be assessed from the date of underpayment. Use of the index-based alternative is an election on the part of payors. Because a company elects this option (which presumably is more favorable to them), this does not mean that the federal government should be denied the time value of money when index prices are demonstrated to be less than market value. For the purpose of calculating interest, underpayments should be presumed to have occurred equally throughout the calendar year.

In Committee negotiations, industry justified the interest holiday, per p. 43 of the report, based on the position that interest is not owed until the additional royalty value is established. Historically, royalty payors have been responsible for collecting sufficient information in the fields or areas in which they operate in order to properly ascertain value and make royalty payments. When FERC 636 came into effect, industry lobbied hard to be relieved of the additional administrative burden of gathering that information; in the development of this proposed rule, industry members were successful in shifting the burden to MMS. As a result of this successful transition, industry would also have MMS be penalized for the time value of money because MMS was not able to gather and verify this information in the month after production. The STRAC cannot support this premise. The MMS should not shoulder an increased burden for the benefit of index payors and also subsidize the election to pay on index prices by relinquishing the time value of money. Industry should not receive the benefits of index-based valuation and MMS the consequences. The STRAC believes, and the courts have upheld, that the royalty obligation accrues when the mineral is produced.

CREDITS AND REFUNDS ON THE SAFETY NET

The STRAC strongly supports that if the payor's annual weighted average value (based on index election) is higher than the final safety net median value, it would owe no additional royalty *and would not receive any credit or refunds* (preamble p. 56012 paragraph 10, and Section 206.454(e)). Selecting an index-based method and paying royalties on such is the payor's election. By making this election, it has agreed that the index-based value is the absolute minimum royalty value; therefore, no refunds should be allowed.

If a payor wants to avoid the risk that its index-based value may be higher than the gross proceeds median value, that payor may elect to pay on its own gross proceeds. The STRAC is not confident that gross proceeds payors are in dominate market positions and able to get the best possible prices. Also, index payors' values may be different from gross proceeds payors' values because index payors are able to select from a range of options (see the discussion on Options and Elections).

REPORTING ACCURACY AS IT RELATES TO THE SAFETY NET

The whole safety net concept is based on correct reporting. The validity of the safety net is contingent upon the accuracy of the data reported to MMS. The STRAC recommends that MMS carefully monitor all data reported and reinstate the penalties for inaccurate reporting. During presentations to the Committee by MMS employees, it was often demonstrated that the data was not accurate or timely, based on MMS parameters and edit checks. For example, the MMS threshold for minimum Btu was 400; the vast majority of gas was reported at an exact Btu of 1,000. This is clearly not accurate.

2. Options and Elections

Initially, STRAC representatives were opposed to allowing industry to select between options regarding royalty valuation methods; however, we recognized the need for compromise and were willing to allow elections in order to satisfy the needs of different constituent groups. The STRAC is opposed to options where it allows the payor to manipulate the royalty value so that it causes inequities between payors. Under any particular election, a payor would most logically elect whichever method minimizes its royalty burden. This undermines the market value approach on which royalties have historically been valued.

In order to dissuade royalty manipulation, the two-year period must be retained, recognizing that it may have either positive or negative effects during any period of election. We recommend that MMS spell out in the preamble the intent behind the options so that payors who use them understand the consequences of a particular election. The STRAC would also like to emphasize that under no circumstances should a payor be allowed relief from a chosen option because it has an adverse effect on the payor.

Two of the Committee's primary goals were to provide simplicity and certainty in valuation of gas produced from Federal leases. The STRAC believes that by allowing the payor numerous options, these goals were not accomplished. For example, there are four options for alternative valuation standards for processed gas (see 206.454(a)(2)). Depending on the option selected, there are additional sub-options to be selected by the payor.

The STRAC believes fewer options should be made available to payors because the proposed rule discriminates against payors with dedicated contracts; it also discriminates against payors that elect gross proceeds when contracts are not dedicated. For instance, companies that transport their own gas and sell under dedicated contracts have no options. For transportation, they must go with actual costs. Companies, however, that can select between index and gross proceeds and choose the index method have an array of options regarding transportation. The range of options results in inequitable treatment for different types of royalty payors; those with more options are going to be able to elect more favorable treatment.

Another case in point is one which correlates to "revenue neutrality." It is the option provided in the valuation of natural gas liquids through the use of an index or a residue gas price applied to wellhead MMBtu. A few Rocky Mountain states have concerns in two areas:

1. Liquid valuation and the independent market centers have no distinct relationship to the prices offered for residue gas. In fact, liquid values have historically tracked with the value of oil. This option, if left as is, could significantly decrease the royalty revenues received by MMS, and this decrease would not be offset by the reduction of costs associated with simplification. Nor would the loss of revenue be made up through the increase of the cap on the safety net.

2. Some regions require processing of gas streams to make a product meet pipeline specifications (coal seam gas). Because the plant by-products (CO_2) are not marketed, the costs associated with transporting and moving such are currently not deductible when deriving royalty values. By now allowing this option, costs associated with unmarketed by-products will be recognized. For example, the coal seam wellhead Btu is 960 and after processing the BTU is 998. Costs associated with the Btu change will be recognized by applying a residue price to the wellhead MMBtu.

The STRAC recommends that MMS make an in-depth review of all the options and elections to ensure that they are justified for all, equal to all, and most importantly, do not move away from the historical application of lease terms, royalty law, and fair market value.

Transportation v. Gathering

The revenue impact of the Committee's recommended change to the gathering definition (Section 206.451) was not examined, but STRAC believes it would have a negative impact on royalty. The STRAC recommends that this Committee proposal be revisited with a potential change to be implemented by MMS.

The STRAC feels that transportation, if more widely defined and incorporating some costs which used to be gathering, will have a major revenue impact in future onshore royalty collections. This proposed rule moves away from the long-standing expectation that higher prices would be received at those markets downstream where the gas is being transported; therefore, MMS was willing to share in the cost of transportation. This is no longer true. The current proposal allows the payor to deduct any cost of moving the gas; regardless of whether it will enable the payor to receive a higher price. Payors have a greater incentive to move the value of the commodity down to zero.

In an effort to reduce the potential negative royalty impact of the proposed rule, a few states recommend that the following definitions be incorporated into the final rule:

1. ***Transportation*** means actual, allowable, and reasonable costs associated with moving royalty bearing substances after the facility measurement point.

2. ***Gathering*** means costs associated with moving royalty bearing substances prior to the location of the facility measurement point.

This position is consistent with the definition of compression as defined in the proposed rule.

Takes v. Entitlements (Section 202.450 (d)) Agreements

In accordance with lease terms, royalties are due on the full amount of royalties attributable to the lease; therefore, all leases within mixed agreements as defined in the proposed Section 206.151 should be reported on an entitlements basis. The lease is the governing document. There should be no exemption for "small operating rights owners." There was lengthy discussion on the difficulties surrounding the tracing method and associated valuation problems under the old regulations. The administrative costs were extensive for all parties including industry, States, and MMS. The purpose of the committee was to simplify royalty reporting and valuation. Requiring payors to report on entitlements accomplishes that objective while at the same time reduces administrative costs and simplifies auditing.

Requiring payors to report on entitlements also eliminates the need to create an administrative system to deal with the 6-month true-up in tracking the credit, issuing refunds, or following-up collections for undertaken payors. The entitlements method would ensure that each federal lease receives 100% of the entitled royalty every month and would avoid difficult, complex and costly systems that yield benefit to very few royalty payors.

Payment under this alternative valuation proposal eliminates the problem of tracing gas production. This new rule eliminates the need to gather data and/or trace the production; therefore, the entitlements method is the most viable method for payment of royalties on mixed agreements. It is not the responsibility of the federal government to 1) trace royalty responsibility to and enforce such responsibility against non-federal lessees; 2) to be a party to industry gas balancing; and 3) to be involved in the monetary settling of over and under balances when either a sale or depletion occurs, especially considering the potential passage of a statute of limitations.

Topics on Which MMS Requested Comments

1. Contract Settlements

The MMS requested comments on contract settlement payments entered into prior to the effective date of a final rule with the payment coming either before or after the effective date of the final rule. The STRAC recommends that MMS apply the existing policies for contract settlements to both gross proceeds and index payors in such situations.

In the public hearing, members of industry stated that contract settlement monies collected should only be royalty bearing to gross proceeds payors. Industry further stated, *incorrectly*, that those amounts would be included in the safety net; those amounts were excluded from the safety net in Section 206.454(e)(3)(I). It was never the intent, at least on the part of the STRAC members of the Committee, to allow payors to elect index so they would not have to pay royalties on money already collected or money soon to be collected but attributable to future production.

The proposal by industry to require gross proceeds payors to pay on contract settlements while not requiring the same of index payors demonstrates another area of inequitable treatment. Further, royalty payments on contract settlements should be reported on a separate line so that it does not appear to be part of the index price, as the safety net calculation is compared to index values paid by index payors as a means of balancing this inequity.

2. Consequences of failing to complete safety net calculation in two years

The STRAC agreed to the safety net compromise only because we were assured that the safety net calculation would be completed in two years. We do not take a position on the options MMS offers--use initial snapshot, no additional royalty due, and suspend interest--except to say that the State's expectation is that if MMS fails to satisfy its responsibility to calculate the safety net, it must keep the States whole. In other words, it must calculate and pay interest to the States as if MMS had satisfied its responsibility and any underpayments had been paid timely.

In addition, we recommend that MMS look at what it means by "suspending interest." The Committee's proposal involved interest beginning from the date of the snapshot. Does MMS propose to write off <u>all</u> of the interest that would accrue from the date of the snapshot to the date MMS publishes the final safety net? Or is it considering merely giving relief from the date the safety net *should* have been calculated to the date it was actually calculated? Surely MMS does not propose to create a windfall for index payors by relieving them of interest that would clearly be their obligation under this proposed rule.

3. Valuation of gas sold under non-arm's-length sales contracts in areas with no active spot market (Section 206.452(c)(3) and 206.243(c)(3)).

The MMS requested comments on improvements to the existing benchmarks for valuing gas sold under non-arm's-length contracts in areas without active spot markets. For those non-arm's-length sales from leases that fall outside ~~of~~ a qualified zone, an alternate valuation method must be determined. Because the committee was unable to reach consensus on this issue, STRAC recommends the first applicable benchmark listed below be applied:

1. The weighted average of gross proceeds paid under comparable arm's-length contracts (without any deductions for marketing or placing production in marketable condition) in the field or area between third parties and the lessee or its affiliate; i.e. arm's-length contracts to which the lessee or its affiliate have access. In order to assure that the arm's-length contracts are arrived at in a free and open market, at least 50 percent of the lessee's or affiliate's last year's purchases in the field or area must be under arm's-length contracts in order for this benchmark to be used.

   Volume will be the sole factor in evaluating the comparability of arm's-length contracts. Comparable arm's-length contracts by volume will be those whose volumes are within minus 50 percent or plus 100 percent of the volume sold pursuant to the non-arm's-length sales being evaluated.

2. The weighted average of the arm's-length sales by the affiliate, except when those sales are to residential customers.

3. Other relevant matters including, gross proceeds paid under comparable arm's-length contracts in the same field or nearby fields, prices reported to FERC or the relevant public utility commission, netback method, or any other reasonable method.

Closing Comments

Because MMS proposed separate rulemaking for valuing gas from Federal and Indian lands, it would appear that MMS expects to maintain separate accounting systems and separate cost accounting systems for each of these types of leases. The purpose of the Federal Gas Valuation Negotiated Rulemaking Committee was to simplify royalty payments on natural gas produced from Federal leases, while reducing administrative costs, decreasing litigation costs, and maintaining revenue neutrality. The STRAC feels that maintaining a separate set of rules, and thus separate accounting systems for

Federal and Indian leases will result in higher administrative costs. This is in direct contradiction with the goals of the committee, and is not realistic in the current political environment where governmental functions are being reduced. The MMS needs to take a close look at this regulation to ensure that the purposes, goals, and objectives will be met.

The Committee did not address how "marketable condition" ought to be determined, given that MMS is no longer able to examine sales contracts. The MMS must decide how it will determine which costs are to be associated with putting gas into marketable condition, and thus, are royalty bearing, and which are not. The STRAC recommends that MMS address this topic in the final rule.

The MMS must take appropriate steps to assure that the results of the negotiated rulemaking do not conflict with historically based valuation practices and that one provision does not conflict with another. In making decisions on appeal, courts will have to determine whether the rule is consistent with case law and/or theories on which case law is based, or whether it is arbitrary and capricious. If MMS cannot point to a strong rationale which would support implementation of the Committee's recommendations, the resulting valuation method may not stand the test of appeal. The STRAC recommends that MMS reconcile its decision to go forward with a particular recommendation so that it is consistent with historical positions and that it explain this rationale in the preamble of the final rule. For example, the position that royalties should be based on market value has not changed and should not be difficult to support, provided it is not compromised by MMS's decisions on the final details. As another example, if MMS believes that including a safety net in the regulations equates to maintaining gross proceeds as a floor, it should so state in the preamble.

The STRAC appreciates being given the opportunity to participate in this process. If you have any questions, please contact any of the STRAC Committee members.

Sincerely,

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Wanda Fleming
Committee Member

George Staigle

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