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David S. Guzy, Chief
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Minerals Management Service
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Post Office Box 25165, MS 3101
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VIA FACSIMILE TRANSMISSION

Dear Mr. Guzy:

On behalf of my clients, who are royalty owners in various Federal leases, I am hereby submitting comments on the MMS's proposed rulemaking concerning amendments to gas valuation regulations for Federal leases, 30 C.F.R. Parts 202, 206 and 211 as set forth in 60 Fed. Reg. 56007, dated November 6, 1995.

While the proposed amendments purport to relate only to the Federal government's royalties on natural gas produced from Federal leases, the impact of these amendments could have far larger implications. My clients believe it will simply be a matter of time until the valuation methodology contemplated by these amendments is implemented by producers across the board in calculating payments for all royalties on gas production from Federal leases.

The overall scheme of valuation which the proposed amendments represent is troublesome. Royalty owners typically represent a small economic interest in the proceeds of production, as compared to the working interest owners. Nonetheless, in the past, royalty owners have been able to hold producers at least somewhat accountable for proper payment of royalties by auditing producers to measure value against actual amounts received. The proposed amendments signify a departure from the basic economic consideration of measuring valuation for royalty purposes by actual receipts from sales of hydrocarbons. My clients fear that these amendments, if enacted, will create certain presumptions and place an undue burden on royalty owners to overcome them. My clients likewise fear that the end result of these proposed changes will be that the producers' opportunity to minimize their royalty obligations will be significantly enhanced, while the ability of royalty owners to protect their interests will be diminished. Neither of these results are consistent with the purposes for which these amendments are purportedly proposed.

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By way of example, the proposed transportation allowances under § 206.458 provides that "the lessee may deduct a transportation allowance representing the reasonable cost of transporting the residue gas and gas plant products...." (emphasis added). The only limitation on the cost deduction is that it not exceed 50% of the value of the unprocessed gas, residue gas or gas plant products. Even then, that limitation may be exceeded when excess costs are shown to be "reasonable and necessary." My clients, first of all, question the concept of providing any transportation allowances prior to the point at which gas is converted to marketable form. Notwithstanding, by moving from "actual" costs to "reasonable" costs, a certain presumption is created that an amount in excess of actual cost is acceptable, so long as it is within some range which MMS might find reasonable. While MMS may point to § 206.457(b)(2)(i) as providing some safety net against abuse, even that provision is based upon the concept of reasonability. Under this provision, MMS, in its auditing, will examine whether the contract rate paid reflects the consideration actually transferred, directly or indirectly, and if it reflects more than the actual consideration, then the transportation allowance may be subject to the provisions of § 206.457(c)(2), "reasonable and necessary."

If actual cost is not going to be the standard for determining what is "reasonable," then what will be the standard by which to measure such costs? The reasonable and necessary criteria should not be permitted to allow producers to deduct any costs in excess of actual costs, under any circumstances. Rather, the "reasonable and necessary" criteria should place a burden on producers to show that the actual cost is reasonable and necessary and, if not, then not even the actual costs should be permitted as the transportation allowance. Even then, the "reasonable and necessary" criteria should be tied to some objective standard. For example, the producer should establish that the costs incurred adds value to the gas in an amount which justifies the expense.

My clients have similar difficulty with the proposed "alternative" methodology for establishing "value" for purposes of calculating royalty payments. Past experience dictates that the use of the net back method to arrive at value has only served to provide producers with the opportunity to minimize value when calculating royalties. My clients believe that valuation for royalty purposes must have some basis in fact with respect to the proceeds received in the sale of hydrocarbons. The concept of mainline index valuation moves is even further removed from reality than the present net back method. The concept, as my clients understand it, has no basis in actual proceeds received for the production being valued. The valuation is based entirely on fictitious proceeds. Once again, the producers will be released from accountability to royalty owners and the burden of auditing of proper royalty payments will become more burdensome to them because of the difficulty of testing the fictitious price created through these new valuation methods. My clients believe the price used as the basis for royalty valuation should bear some recognized and readily ascertainable relationship to the proceeds actually received by the producers or their affiliates in the sale of their hydrocarbons.

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My clients strongly urge MMS to carefully reconsider the effect of the proposed amendments upon the ability of all royalty owners to audit producers in any meaningful way so as to ensure proper and full payment of all royalties owed production from Federal leases.

Very truly yours,

Mary E. Walta by Broder Kelly
Partner

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