Telecopier Transmission

from

Lobel, Novins & Lamont

Date Sent: 3/23/98

TO: Name: David Guzy

At:

Receiver's Telecopier Phone Number: (303) 231 - 3385

Sent by: Lee Helfrich + Hank Banta

Total Number of Pages Including This Cover Page: 12

Message:

Original by mail

The information contained in this facsimile transmission is intended only for the use of the individual or entity named above and may be legally privileged or confidential information. If the reader of this transmission is not the intended recipient, you are hereby notified that any dissemination, distribution or copying of this transmission is strictly prohibited. If you have received this transmission in error, please immediately notify us by collect telephone call and return the original transmission to us at the address below via U.S. Mail. Thank you.

Please contact Michele at Lobel, Novins & Lamont, 1275 K Street, N.W., Suite 770, Washington, D.C. 20005, telephone number (202) 371-6626, if there is any difficulty receiving this transmission. Our telecopier is set for automatic reception, 24 hours each day of the week, at (202) 371-6643.

LNL #: 1584

LAW OFFICES OF
LOBEL, NOVINS & LAMONT
SUITE 770
1275 K STREET, N.W.
WASHINGTON, D.C. 20005-4048
(202) 371-6626
TELECOPIER: (202) 371-6643

MARTIN LOBEL
JACK A. BLUM
LEE ELLEN HELFRICH
HENRY M. BANTA

OF COUNSEL
ALAN S. NOVINS
ARTHUR L. FOX II
DINA R. LASSOW
LEAH HADAD

WILLIAM JOHN LAMONT
(1916 - 1994)

March 23, 1998

By Fax: 303-231-3385

David S. Guzy, Chief
Rules and Publications Staff
Royalty Management Program
Minerals Management Service
P.O. Box 25165 MS 3021
Denver, Colorado 80225-0165

RE: Supplementary Proposed Rule: Oil Valuation, 63 Fed. Reg. 6113 (February 6, 1998)

Dear Mr. Guzy:

These comments are submitted on behalf of the California State Controller's Office (SCO) to the supplementary proposed rule on crude oil valuation published by the Minerals Management Service (MMS) on February 6, 1998.

SCO has submitted detailed comments three times during this rulemaking. In those comments, SCO discussed both the provisions it objected to and supported. Most of those comments remain relevant to MMS's current proposal and, rather than repeating them here, SCO incorporates them by reference. SCO also adopts by reference the comments submitted by the City of Long Beach. While some repetition is unavoidable due to the nature of MMS's current proposals, SCO wants to emphasize that its failure to address any particular issue in these comments should not be construed as a withdrawal of either its objection to or support of the issue.

Before commenting on MMS's new provisions, however, there are two issues that SCO would like to revisit by way of supplementing its previous comments. Those issues are the duty to market and overall balancing arrangements.

I. Supplementary Comments

A. Duty to Market

SCO fully supports MMS's adherence to its long held policy on the duty to market.

Industry's opposition to the obligation of a lessee to market the oil and gas it produces has increased at each stage of MMS's rulemaking. Initially, most of industry's focus was on MMS's reiteration that performance of the duty to market was "cost free" to the lessor. SCO's prior comments addressed this issue and are incorporated by reference herein.

More recently associations representing the independent sector have denied any duty to market, while continuing to assert an entitlement to pay royalties on the basis of gross proceeds. Taken together these two arguments -- gross proceeds and no duty to market -- are simply indefensible. In fact, they serve as the best rationale for abandoning all reliance on gross proceeds; a position, which as MMS know, has been taken by California through SCO and other entities, albeit for other reasons.

The duty to market is one of several lease obligations that courts and commentators have uniformly recognized and have said stem from the duty -- implied in every contract -- of good faith performance.[1] There is absolutely no reason to accept contract proceeds for royalty purposes if lessees reject any obligation to make good faith efforts to sell the production.

The reasons given publicly by the independents' associations have been based on fear -- fear that the government will re-value federal oil based on disagreement with the lessee's sales judgment. This is not a fear based in law or in reality. Only those producers who operate in bad faith or imprudently have anything to fear from the duty to market. MMS has put the burden on itself to prove bad faith and its burden is a difficult one. Contrary to the rhetoric being heard from the associations, it is not a burden that

---

[1] 5 Williams & Meyers Oil and Gas Law §802.1. Other lease duties stemming from the principle of good faith performance include: the duty to drill exploratory wells, the duty to make diligent efforts to produce, and the duty to protect against drainage. Id. at §804. The courts have held that to the extent that these duties are not expressed in a lease contract, they are necessarily implied as part of the mutual expectations of the parties. It is noteworthy that all of these duties are performed at no cost to the lessor.

can be met simply by showing that a lessee had different marketing options.

It has not been California's experience that bad faith conduct is prevalent in its independent sector. Most independents in California, as SCO has asserted elsewhere, have been prevented from realizing true value for their production. Yet it is certainly disturbing that the independents' own associations view bad faith imprudence by their members as a realistic fear or problem. In SCO's view, guarantees that such conduct will not be pursued by the federal government are not in the interest of the public or those many independents who operate in good faith.

Industry's arguments against the cost free nature of the duty to market are equally indefensible. The costs that industry lists are not new; nor are their marketing practices. For decades, whether lessees sold in local markets or distant ones, they did not deduct and (until recently) did not attempt to deduct their marketing expenses. This nearly universal practice on both federal and private leases demonstrates industry's own understanding of the cost free nature of its obligation to market. But more importantly, industry has not and cannot support its claim that its listed marketing costs enhance the value of oil. In its prior comments, SCO clearly demonstrated the falsity of industry's cost/value claims.

B. Overall Balancing Arrangements

MMS initially proposed a 2 year rule for addressing the problem of overall balancing arrangements. SCO supported this proposal but also supported excluding certain specific categories of transactions from its reach, e.g. purchases to fulfill contractual commitments. These exceptions responded to the concerns of certain independents, who, while denying overall balancing arrangements, stated that they did make occasional purchases that did not impact their gross proceeds. As an alternative, SCO proposed that MMS adopt a rebuttable presumption on overall balancing arrangements, subject to the same exceptions.

MMS continues to recognize the value impacts of overall balancing arrangements and their prevalence, especially with companies that do substantial trading. MMS, however, has rejected putting in place a clear rule addressing these arrangements. Instead, it proposes to place the burden on MMS to prove the existence of these arrangements on a lease by lease, contract by contract basis. SCO continues to oppose putting the burden on MMS to prove on a case by case basis that a given contract is subject to an overall balancing arrangement.

As a theoretical matter, SCO does not disagree with MMS's rationale that overall balancing arrangements impact whether or not a lessee has paid royalties on the basis of the "total consideration" received under a sales contract. The problem with MMS's approach is that it forces MMS to prove that an overall balancing arrangement exists, that a given contract is subject to it, and the amount of added consideration attributable to each purchase and sale subject to the agreement. This will involve complex tracking and matching of numerous transactions. It will involve access to a greater amount of documentation than currently is compiled during an audit, including the taking of oral testimony where such arrangements, as is often the case, have not been reduced to writing.

At the recent public hearing in Houston, a representative of a major integrated producer admitted that most, if not all, of its purchases and sales were subject to overall balancing arrangements. Obviously, this is equally true of this producer's trading partners. This admission is also consistent with the facts uncovered by MMS during its own investigation and with the information provided by States and independent consultants.

In short, there is substantial evidence that overall balancing arrangements exist and impact the royalties paid by the major payors of federal royalties. There is little in accuracy and even less in cost effectiveness or efficiency that can be gained by placing the burden on MMS to prove over and over again that these arrangements exist. While the 2 year rule had the benefit of being bright line, a presumption at least places the burden on the entity that maintains the data and gives that entity an incentive to produce rebuttal evidence. At the very least, MMS should clarify the nature of the burden it is placing on itself under its current proposal, making clear that it need only produce some evidence supporting a reasonable belief that a payor company maintains an overall balancing arrangement to trigger application of §206.103. This should be coupled with a certification requirement.

II. Current Proposals

A. Royalty in Kind/Tendering

SCO supports MMS's rejection of both a royalty in kind and tendering benchmark for valuation of crude oil in California. SCO would go further in its rationale for dismissing the utility of these methods, however, than MMS, which simply states, for example, that tendering has never been tried in California.

It is true, of course, that tendering has not been tried. But, more importantly, it and its twin, RIK, simply would not work in California. RIK and tendering are question begging proposals. They do not respond to or resolve the pricing problem in California and, accordingly, will not serve to capture true value for oil produced in the State.

The crude oil market in California is dominated by a handful of major integrated companies. These companies not only control the bulk of all production but also the transportation and refining facilities in the State. One example of this control is the continued operation of three heated pipelines in the State as private carriers -- indeed some federal oil in Midway Sunset is actually tied into the Mobil heated pipeline! Without access to transportation, producers must accept what they can get from the majors. These major companies are rarely willing to pay more than their own undervalued posted prices for crude oil.

Because of this control by the majors -- control that is increasing -- the posted price problem, as some have suggested, is not solely a "field market" problem. It is a problem that impacts pricing of crude oils throughout the State. There are no "Mini-Mart Markets" in California where prices for California crude oil are some how freed of the discredited posted price system. Rejection of posted prices as a basis for valuing crude oil requires rejection of tendering and RIK.[2]

There is no reason to believe that the federal government's entry into the market to sell its royalty share of production -- which today due to royalty rate reductions is often only 1 or 2 percent of even the government's most prolific California leases -- will provide the majors an incentive to alter their policies. Rather, the United States will be like the independent producers: "price takers, not price setters." See Comments of the California Independent Petroleum Association. In short, cheap oil is cheap oil, whether it is sold by the United States or Mom & Pop.

B. Proposed §§ 206.102, 206.103(e), 206.113(a) and 206.113(b)

For the reasons outlined below, SCO strenuously objects to MMS's new proposed §§ 206.102, 206.103(e), 206.113(a) and 206.113(b). It is SCO's position that these sections must be modified in order to make the MMS proposed oil valuation regulations even minimally acceptable.

---

[2] In SCO's view, the rejection by the independents' associations of posted prices undermines their arguments in favor of RIK.

MMS should return to its original blueprint. The gross proceeds methodology, if it is to be maintained, should be confined to first sales made at arm's length. All other production should be subject to valuation based on ANS spot prices.

1. Gross Proceeds

SCO opposes MMS's proposed §206.102, under which the gross proceeds rule would be vastly expanded. SCO notes that independent producers, through their associations, also oppose this proposal and acknowledge that it goes far beyond their needs and common trading practices.[3] SCO agrees that proposed §206.102 eclipses the need of the small independent producer.

Under new §206.102 in order to verify a gross proceeds royalty payment, MMS proposes to track the flow of federal oil through multiple transactions in order to find the downstream arm's length contract or contracts under which molecules of federal production or molecules of received production might have been sold. When those contracts are found, MMS will then work back upstream to adjust for any appropriate location or quality differentials in exchanges, and any legitimate transportation costs incurred in other types of transfers.

For SCO, this proposal is a huge step backwards, not only in terms of putting in place rules that will serve to capture true value, but also in efficiency and ease of administration.

First, it has been California's experience that methods that cannot be regularly verified and enforced -- methods that cannot be applied broadly and systematically -- result in monetary loss. Even assuming that the tracing proposal under §206.102 could be done reliably for the production from a single lease, MMS's proposal is not a methodology that lends itself to determining value on the thousands of leases in the federal lease universe. There will be no way under proposed §206.102 to guarantee that more than a small fraction of the royalties paid on the basis of gross proceeds were correctly paid. Moreover, any information compiled from one tracing exercise cannot be used to make judgments about payments made on other federal leases.

Second, proposed §206.102 invites transactions the sole purpose of which are to reduce royalties. MMS's regulatory incentives should be directed at fostering the receipt of true

[3] It, of course, should be noted that it was the same independent producer associations that first promoted this methodology to MMS.

value in the lease market. But under proposed §206.102, MMS proposes to provide an incentive, that obviously benefits only larger companies, to hide value through paper transactions. Again, SCO points to the price control era as demonstrating that companies easily entered into paper transfers -- even nominal arm's length transfers -- aimed at avoiding or skirting the Department of Energy's regulatory requirements.

Finally, it is not without note that this expansion of the "downstream" application of the gross proceeds methodology has facilitated industry's rhetoric on the duty to market. Confining gross proceeds to an arm's length first sale (if not abandoning gross proceeds altogether) erases from industry's duty to market rhetoric all of its wholly superficial appeal.

2. Location Differentials

SCO opposes MMS's proposed §206.113(b). Under that section, MMS proposes to use the actual transportation costs from the lease to a refinery for purposes of calculating a location differential for internal company transfers of oil from a lease directly to its refinery. This will not and cannot lead to an accurate or reliable location differential, which MMS effectively concedes by proposing §206.103(e). Moreover, the "information vacuum" that apparently led MMS to propose §206.113(b) simply does not exist in California. There is no reason that integrated companies in California that take crude directly for use in their refineries cannot use the differentials that MMS proposes to compile and publish under proposed §206.112.

SCO expresses no opinion on whether MMS in fact will experience difficulties obtaining applicable location differentials East of the Rockies or the extent of that problem. But, if the lack of such information is a problem in the Rocky Mountain area or, less likely, the Gulf, then SCO requests that MMS return to its original proposal and separate the rules applicable to California from those applicable East of the Rockies.

SCO and MMS began on common ground. Both recognize that the best and most accurate way of determining the relative value of oil at the lease and at the market center is by adjusting for location between those two points. Adjusting the market center index price by the location differential that captures the difference in value of the oil between those two points results in a <u>value at the lease</u>. Oil valued at the lease is not eligible for a transportation deduction. It is simply irrelevant where the oil is actually transported.

MMS does not and cannot assert that there is no transportation cost or exchange differential data from the major producing areas in California to the two major market centers. In fact, in its prior comments, SCO demonstrated that there was sufficient information available to calculate reliable location differentials on a zone basis in California. Inexplicably, MMS refused to even publish SCO's proposed zone method for comment, despite its reliability and ease of administration. But what MMS cannot ignore is the fact that the zone method was based on hard, extant data, the use of which is far preferable than a method that cannot be supported by law, economics or even logic.

MMS admits that its proposed §206.113(b) will not result in accurate location differentials. That, according to its preamble, is why it proposes §206.103(e), which will entitle integrated companies to come in and demonstrate a different basis for valuation of the crude oil. For SCO, however, proposed §206.103(e) serves as simply further grounds for its insistence that California be segregated from any application of §206.113(b).

SCO's objection to proposed §206.103(e) is demonstrated by looking at the first item of "relevant" information that MMS invites integrated companies to submit as a basis for a new valuation. MMS proposes that these companies submit evidence of their "Costs of acquiring other crude oil at or for the refinery." In the context of this rulemaking and the findings of the InterAgency Task Force, this proposal is nothing short of incredible.

In proposed §§ 206.103(e) and 206.113(b), MMS is addressing purchases, sales and internal transfers by the very companies that have posted undervalued prices in California. Those companies, according to MMS's own findings, purchase crude oil produced in and offshore California at prices based on postings. But, under §206.103(e), MMS proposes to permit these same companies to demonstrate the unreasonableness of index based pricing by evidence of their purchases made at undervalued postings. This provision, plain and simple, is an invitation to these companies to engage in persistent and constant litigation over use of index based pricing. SCO opposes providing integrated companies a back door means of valuation based on posted prices.

Even assuming a lack of reliable location differential data (which is not evident in California), MMS simply does not need to reopen this basic market value question on a case by case basis to get to the result that it thinks it needs, either in California or nationwide.

MMS could, at least in California, allow these companies to produce evidence solely on alternative location differentials. Thus, for example, the companies could come forward with exchange differentials used in trades of other crude oil. Or, MMS could look to the costs of transportation, if any, incurred by a refinery in its purchases of Alaskan North Slope crude oil. Netting such costs against the costs of transporting oil from a lease to the refinery would yield a more accurate location differential.

Both of these methods avoid re-opening the issue of the applicable value index and, more importantly, would avoid any back-door reliance on posted prices. But, even where relevant location differential information may be unavailable from an integrated company, it will have a data base, separate from its purchases and sales, that contains accurate value information that is not dependent on the discredited posted price system.

Every refiner will have documentation evidencing its optimization of output, i.e., the value to its refinery of various crude oils. At its most basic, optimization is the refiner's evaluation of the best possible mix of available crude oils to make the most profitable mix of refined products. Optimization requires that, at some point, every refiner must make an accurate internal assessment of the value of each type of crude oil it runs or potentially could run. This includes assessing the value of the refiner's own production against what is available for purchase.

This refinery value information is similar to that used by the court in the Kettleman Hills case for determining value; the court found that such values were linked to competitively set field prices. U.S. v. General Petroleum Corp., 73 F. Supp. 225 (S.D. Cal 1947), aff'd sub. nom., Continental Oil Co. v. U.S., 184 F.2d 802 (9th Cir. 1950). In part, optimization data provided to California in the Long Beach case revealed that integrated companies equated ANS with California produced crude oils. Today, even more sophisticated computer modeling exists that allows large integrated companies to make assessments of what crude oils are worth to their competitors on an instantaneous basis.

For MMS purposes, this type of information would serve as a more reliable and accurate proxy for value where the reasonableness of an index value is questioned solely because of inaccuracies resulting from MMS's location differential rules. Access to this data would be useful to MMS on a nationwide basis. As a means for testing the reasonableness of index prices, it is certainly preferable to consideration of contract prices, which are certain to be skewed, in whole or in part, by being based on undervalued postings. Collection of this type of information would also be of useful to MMS in determining whether §206.103(d) should be triggered.

While SCO proffers these options to the proposed §206.103(e) back door, it maintains that no back door that allows integrated companies to contest ANS values is necessary in California. SCO strenuously opposes any use of §206.103(e) or §206.113(b) for purposes of calculating location differentials or value for California production. Instead, SCO recommends:

(1) that a separate rule for calculating location differentials applicable in California be established, as was MMS's original intention,

(2) that MMS's published differentials or other reliable differentials used in other trades by an integrated company be used to adjust ANS prices, and

(3) that, under no circumstances, should an integrated company be permitted to challenge an index based valuation through evidence of purchases or sales made at postings related prices.

SCO also opposes §206.113(a), as currently drafted, because it continues to permit double dipping.

That section provides that where a company disposes of production under an exchange, it is entitled to deduct costs under §206.112 (a), (c) and (e). Both subsections (a) and (e) of §206.112 provide for quality adjustments, thus providing a double deduction for quality for crude oil at the lease and the market center.

Subsection (a) of §206.112 allows for a deduction of the location differential between the "lease and the market center." Subsection (c) of that section allows for a deduction for the costs of transportation from the lease to the aggregation point. As a result of §206.113(a), MMS will allow the lessee to deduct its cost of transportation from the lease to the aggregation point twice. Subsections (a) and (c) overlap in their locational "reach."

As SCO noted in its prior comments, this type of double dipping is a result of MMS's attempt to capture every conceivable type of marketing arrangement in its rules on location differentials. Avoiding this is a simple matter of re-characterizing §206.103 as offering application examples and specifically precluding any application that results in double deductions of location or quality.

III. Conclusion

Throughout this rulemaking, SCO has supported MMS. While SCO had objections to several provisions in MMS's first and second proposal, it was not unsympathetic to MMS's desire to find a balance between assuring the collection of true fair market value and providing some equity for those independents that have been equally victimized by undervaluation in the lease market. Though SCO has disagreed with certain technical details, it was willing to accept the direction that MMS was pursuing and indeed actively looked for and proposed alternatives to help move in that direction.

SCO cannot, however, support MMS's current proposal. It is of vastly different character and, indeed, takes a different direction by tipping the balance away from protection of the public's royalty interest in favor of private interests. The beneficiaries of MMS's current proposal are the very companies whose conduct precipitated the need for this rulemaking. There is nothing in the evidence, in equity or in efficiency that supports MMS's current proposal. Moreover, the current duty to market rhetoric casts substantial doubt on the viability of a gross proceeds methodology.

Again, SCO urges MMS to return to its original blueprint, under which gross proceeds under first sales made at arm's length (with a duty to market) remained available, but where all other production would be subject to valuation based on ANS spot prices.

Sincerely,

Lee Ellen Helfrich

Henry M. Banta