



IPAMS
Independent
Petroleum
Association
of
Mountain
States

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November 5, 1997

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

RE: Establishing Oil Value for Royalty Due on Federal Leases
Notice of reopening the public comment period
62 F.R. 49460; September 22, 1997

Dear Mr. Guzy:

As always, the Independent Petroleum Association of Mountain States (IPAMS) is pleased to have an opportunity to provide comments to the Minerals Management Service on the alternatives discussed in the above-referenced notice and those discussed during the seven workshops convened by MMS. Please see IPAMS' previously filed comments dated May 28, 1997, and August 4, 1997, which we incorporate here by reference, for further discussion on certain topics.

IPAMS is cautiously optimistic with the process by which this rulemaking is evolving. Moreover, we appreciated the invitation to participate in the recent workshops. MMS's willingness to depart from its original proposed rule by eliminating the two-year purchase provision and modifying the crude oil call and exchange restrictions will permit the majority of IPAMS members to value their production on the gross proceeds they receive. For those members subject to non-arm's-length valuation, IPAMS strongly endorses MMS's exploration of alternatives to NYMEX for determining royalty value.

As you know, IPAMS is opposed to the use of NYMEX as a benchmark for valuing production sold non-arm's-length. Rather, we prefer a valuation methodology that far more dependably establishes the value of production at the lease. If NYMEX is to be used at all, it should be used only as a last resort, after a producer has failed to qualify under any other, more

The Independent Petroleum Association of Mountain States (IPAMS) is the regional trade association in the Rocky Mountains that represents independent oil and natural gas producers operating in a 13-state area in the West.

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appropriate, benchmarks. Moreover, as noted previously, NYMEX will not work in the Rocky Mountain Region.

BENCHMARKS

IPAMS strongly believes a practicable benchmark system can be developed for use nationwide. The concept is simple: if a producer cannot qualify under the first benchmark, he moves to the second. If he cannot qualify under the second benchmark, he moves to the third. And so on, until he reaches a benchmark under which he can qualify. It should not matter to MMS whether a producer qualifies under the first benchmark or the last benchmark as long as MMS receives the appropriate royalty value.

With respect to the various benchmarks discussed during the workshops, IPAMS is not prepared to offer more specific comments until additional details are proposed. However, IPAMS offers the following comments in the hope it will assist MMS in developing the benchmarks. IPAMS will also file further comments once MMS has presented a more concrete proposal.

Tendering or Bid-Out Program

IPAMS supports a tendering or bid-out program as a first benchmark because it is simple to calculate and administer, and it meets the goals of simplicity and certainty. We are not opposed to MMS pre-approval of a tendering plan submitted by a company describing the producing area, percentage of total production to be tendered, the minimum number of bids, and other details. However, IPAMS cautions MMS to maintain flexibility in determining the conditions for a tendering program since what may be viable for one producer may not be viable for the next producer. This flexibility will allow MMS to adapt the tendering plans to different situations. IPAMS suggests that a sufficient percentage of production to be tendered would no doubt be less than, but in no way should exceed, the royalty percentage either onshore or offshore, respectively.

Comparable Sales

IPAMS also supports a value based on comparable sales occurring at or near the lease (a "lease-based" benchmark) as an alternate first benchmark. As you know, our Crude Oil and Royalties Committees expended a great deal of effort to determine what are the elements of comparability and submitted them during the October 13th workshop in Houston. IPAMS believes that comparability should be determined based on like quality, like quantity, similar

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timing of sale, and transportation and access to market. We offer the following recommendations, which we have further refined since the Houston workshop.

Like Quality

Like quality would be determined based on gravity, sulfur content, distillation, and established ASTM or other characteristics recognized by the industry for specific grades of crude oil.

Like quality crude oil would generally come from the same geographic area or formation. A comparable geographic area would generally be described as desirably within a five-mile radius. However, there are situations – offshore and in the Rocky Mountains, especially – where true like quality crude oil may be produced at a distance considerably farther than five miles. On the other hand, there are situations where production within a five mile radius, because of access (or lack of access) to different transportation systems, may command a significantly different price. Therefore, IPAMS urges MMS to craft the regulations to be flexible enough to accommodate those situations.

An acceptable gravity variance would be within 10° (ten degrees) one way or the other.

Sulfur content would be distinguished as follows: over 0.5% sulfur content would be deemed sour; 0.5% or under sulfur content would be deemed sweet; H₂S content would be considered separately.

To determine similar distillation curve, IPAMS recommends using boiling points and fractions published by the Department of Energy (formerly by the Bureau of Mines). These are readily available and standard within the industry. An acceptable variance would be plus or minus 5%.

The regulations must be able to recognize significant differences between crude oil types as they exist from time to time; those differences must be addressed on an exception basis.

Like Quantity

IPAMS has not settled on any one amount, but in general, believes that to be considered comparable, sales volumes should be within 25% of each other.

Transportation and Access to Market

IPAMS recognizes that these two factors are basic to value determination. Therefore, IPAMS proposes that the method of transportation also be compared because value is usually

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a function of how the crude oil is transported and the markets to which it has access. For example, one can assume if crude is in the same pipeline it has access to the same market and if trucked, it would have to be trucked to the same market.

Timing of Sale

Comparable sales must reflect approximately the same time period. Therefore, IPAMS proposes two alternatives and recommends that the producer be permitted to elect one or the other for a time certain. Prices would be compared to prices received in sales made under the same election.

The first would be to use the same date of delivery.

The second would be to use an "equal daily pricing" method where the purchaser calculates a daily weighted average as follows:

In the month of September there are 30 days. For a total of 5 days during the month, the price was \$20.88 per barrel. For a total of 3 days the price was \$20.50. For a total of 22 days the price was \$20.00. Multiply \$20.88 X 5; \$20.50 X 3; and \$20.00 X 22. Add the three totals together and divide by 30 (days). The sum is the daily weighted price for the month.

The daily weighted price would apply to the total month's deliveries

Both of these practices are common in the industry.

Timely Availability of Data

IPAMS also recognizes MMS's concern with respect to the timely availability of data upon which to determine comparability. IPAMS has discussed a proposal whereby the first purchasers would report all transactions electronically to an independent data gathering company by a date certain following the month of production.

The data would include the lease number, operator, field, volume, grade, gravity, type of transportation, price paid arm's-length, and any unusual conditions (i.e., special trucking). This information is already submitted to state taxing entities. The data gathering company would aggregate data by field and grade and determine a weighted average value after considering special adjustments for gravity or special transportation.

Although there are still additional details to be worked out, IPAMS believes this process would clearly establish the market value at the lease; permit tendering, even if the sale is to an

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affiliate; enable timely dissemination of information to all parties; ensure confidentiality of data; and reduce the government's administrative burden. This process would also embrace the concepts of value based on outright arm's-length sales and purchases in the field or area; value based on the range of arm's-length prices reported to MMS by field; and value based on a lessee's or its affiliate's arm's-length purchases in the field or area – other benchmarking alternatives submitted in comments and/or discussed during the workshops for which there is support.

Netback from a Spot Market

Even though netting back from a spot market price may, in some instances, advance the starting point for valuation nearer to the lease, MMS has stated on numerous occasions that netting back is the least desirable method for valuing production. Further, as IPAMS asserted in earlier comments on the proposed rule, arm's-length contracts that establish the value of oil in the field do exist and should be used first in determining value. On the other hand, none of MMS's proposed approaches would result in a reliable lease value. Moreover, despite support from the states and industry, including IPAMS, MMS also chooses to disallow those components of value which are added by marketing downstream of the lease. Therefore, IPAMS still opposes a netback method.

Negotiated Method

MMS expressed some support during the workshops for any negotiated valuation method to which MMS, the affected state and the producer could agree. IPAMS supports use of a negotiated method because we believe it meets the objectives of certainty and simplicity and allows for flexibility and creativity in determining a method for valuation. However, IPAMS underscores that it would be critical for both the Royalty Valuation Division and the Compliance Verification Division to approve any negotiated method in order to avoid future audit conflicts.

Royalty Taken In-Kind

The discussion of royalty-in-kind as a benchmark indicated there is little support for this concept, at least among the states. However, IPAMS believes that RIK can be useful as a benchmark for valuing like quality and quantity crude oil production. We would also be remiss if we did not again encourage MMS to seriously consider more widespread use of royalty-in-kind as a viable resolution of the seemingly endless complexities of non-arm's-length valuation. We applaud MMS's current efforts to initiate several RIK pilot programs and believe that, if these pilots are structured correctly, MMS will realize the many advantages of taking its royalty share of production in-kind and will expand the federal RIK program as a result.

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DUTY TO MARKET

As emphasized in our earlier comments, notwithstanding any other modifications to the proposed rule, IPAMS is still threatened by the "duty to market at no cost to the federal lessor" language. Contrary to MMS's assertion that it is a simple clarification of existing authority, IPAMS maintains it is an enormous expansion of existing authority. As you know, IPAMS' paramount concern is that on audit, a producer will be deemed to have breached his duty to market if he failed to market downstream and obtain the highest possible price. There is no assurance that at some point in the future MMS will not decide that every producer, regardless of how or where his production is sold, will be required to pay royalties on a downstream value because of this new "duty to market".

IPAMS continues to recommend that the language be deleted from this and all future regulations.

VERIFICATION

At the outset of the workshops MMS stated it wants to be able to verify that specific transactions are true arm's-length contracts and that the price received reflects the total proceeds. IPAMS members would be willing to certify to these issues on the MMS Form-2014. We suggest a phrase be added to the signature paragraph certifying that the sale is an arm's-length transaction and that the price received reflects total consideration for the production. Where MMS determines prices are outside a particular tolerance or threshold, it could verify those contracts on an exception basis. The only certain method for verifying the type of transaction and the total proceeds is through audit.

CONCLUSION

IPAMS concurs with MMS's desire to promulgate regulations that ensure simplicity and certainty. However, we do not believe these objectives are unilateral to MMS, nor that they should come at the expense of fairness to the producer. Producers, too, want simplicity and certainty. IPAMS' position is that:

- Valuation regulations must satisfy the statutory requirement that royalty be based on the value of production at or near the lease.
- Value is defined as "that price which a product will bring in an open market between a willing seller and a willing buyer".

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- The Mineral Leasing Act defines the point at which value is determined to be at the lease or wellhead or some other point within the lease boundaries.
- The best measure of market value is the price reflected in an arm's-length contract.
- The best benchmarks are those which rely on market value at the lease.

Again, IPAMS is pleased, for the most part, with the modifications MMS has made to the original proposed rule, and we are encouraged that MMS has been willing to discuss alternatives to the NYMEX method.

While MMS (and the states) seem wedded to some kind of indexing method, IPAMS believes the proposed rule fails to meet the objectives of simplicity and certainty, particularly from industry's perspective. Neither has MMS yet justified its dramatic departure from the current benchmark system or its perceived need to go to a NYMEX valuation method.

Therefore, IPAMS is still not convinced of the need for a brand new overall valuation scheme for crude oil. We believe a revision of the benchmarking system is all that is necessary to allay concerns with the present benchmarks and to meet MMS's, the states', and industry's objectives.

Thank you for your consideration of our comments. Please feel free to contact me if we can answer any questions or provide further clarification of any of our recommendations.

Sincerely,



Carla J. Wilson
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c.c. Deborah Gibbs-Tschudy
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