BHP

Americas Region
BHP Petroleum

May 23, 1997

Minerals Management Service
Royalty Management Program, Rules and Procedures Staff
P.O. Box 25165
MS3101
Denver, CO 80225-0165

Re: Notice of Proposed Rulemaking, 62 Fed Reg. 3742 (January 24, 1997)

Dear Sir /Madam:

BHP Petroleum (Americas) Inc. ("BHP") appreciates this opportunity to comment on the Minerals Management Service's notice of proposed rulemaking regarding the value of crude oil for the purpose of calculating royalties on production from federal leases. BHP is an exploration and production company headquartered in Houston, Texas, with its U.S. exploration activities focused in the Gulf of Mexico. BHP is currently the fifth largest leaseholder in the deepwater area of the Gulf of Mexico. BHP is a subsidiary of The Broken Hill Proprietary Company Limited and has both a crude oil marketing affiliate based in the U.S. and a refining affiliate in Hawaii.

BHP opposes the proposed new valuation scheme. Nothing in the public record supports the need for amendment of the current regulations. It does not make sense to dismantle a set of regulations which operate smoothly, on established principles, when there has been no demonstration of a need for change. The proposed rulemaking would alter the established points of reference by which crude oil is valued for royalty payment purposes. Without MMS's having shown that present valuation methods are invalid or defective, the proposed rulemaking is at best premature, at worst capricious.

BHP supports the comments made by the Domestic Petroleum Council. In particular, we fully endorse the DPC's the recommendation that the Minerals Management Service adopt a full-scale program for taking royalty in kind. In addition, we would like to emphasize the following points:

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1. **The NYMEX/ANS valuation scheme is overly broad.** Even with location/quality differentials and transportation allowances, the proposed NYMEX/ANS based royalty valuation scheme does not take into account the complexities involved in reaching a fair price for production from each of the thousands of oil wells in the United States. The NYMEX scheme would force many producers to pay royalties on "values" higher than the prices they are realistically able to obtain for their production.

2. **The MMS's proposed definition of arm's-length transactions is unjust.** Crude oil sales by a producer whose refining affiliate purchases crude oil should not be treated as suspect. A company such as BHP, whose refining affiliate buys all refinery feedstock on the open market, and not one barrel of crude oil from BHP, is not in a position to manipulate prices at the lease. Further, first sales of crude oil subject to buy-sell agreements between non-affiliated companies should be treated as arm's length transactions and royalties should be determined accordingly. The proposed rulemaking assumes that all buy-sell arrangements are collusive and have the effect of depressing wellhead sale prices. In fact, buy-sell arrangements between non-affiliated companies are more likely to have the effect of keeping wellhead prices up. Unless misconduct has occurred, sales subject to buy-sell agreements should be treated as any other arm's length transaction.

3. **MMS can solve any perceived problem by simply taking its royalty in kind.** If it is MMS's genuine conviction that it is not getting its fair share of the value of crude oil, MMS can solve the problem very simply--without changing the current regulations--by taking royalty in kind. MMS already has a limited royalty-in-kind program, which need only be expanded to market the federal government's entire share of production.

<u>DISCUSSION</u>

THE NYMEX/ANS VALUATION SCHEME IS OVERLY BROAD

The proposed rulemaking would eliminate reliance on posted prices as indicators of value. The MMS says that posted prices "no longer relate to how most crude oil is marketed." (62 Fed. Reg. at p. 3743). Under the proposed rulemaking, MMS would, with certain very limited exceptions, require a producer to ignore the prices on which it is actually paid by the purchaser and pay royalties based on NYMEX or ANS spot market prices. For leases not in California or Alaska, MMS proposes that the royalty value would be the average of the daily NYMEX futures settlement prices for the Domestic Sweet Crude Oil contract for the prompt month, adjusted for location and quality differentials and transportation costs. For leases in California and Alaska, the royalty value would be determined by reference to the ANS spot market price, again adjusted for location and quality differentials and transportation costs. Valuation of crude oil based on NYMEX and ANS is inappropriate because many producers would be required to pay royalties on "values" higher than the best price they are realistically able to obtain for their oil.

<u>THE NYMEX IS NOT REFLECTIVE OF VALUE AT THE LEASE</u>.

MMS attempts to justify its proposal by saying that "[s]ince many contract prices are tied to postings, the influence of posted prices is magnified. MMS is proposing a different valuation approach because market conditions have changed...Given the mounting evidence that posted prices frequently do not reflect value in today's marketplace the proposed valuation standards do not rely at all on postings." (62 Fed. Reg. at p. 3744).

The rationale behind the NYMEX/ANS valuation scheme is based on misunderstandings and inaccuracies about the workings of the marketplace. For example, MMS says that NYMEX prices were "regarded by many of the experts MMS consulted to be the best available measure of oil market value." (Fed. Reg. 62 at p. 3745) This statement greatly oversimplifies the complexities of the crude oil market. The NYMEX is the best indicator of value for **one, particular** type of market transaction; but it is certainly not the best indicator of the value of a sale at the lease level.

The NYMEX futures market is an economically distinct and different market from the lease level crude market. NYMEX is concerned with one-off contracts which involve the guaranteed delivery by a seller of a guaranteed quality and volume of oil. NYMEX has developed a standardized crude oil contract which pertains only to the future sale of light, sweet crude oil in lots of 1000 barrels each, at a specified market center. NYMEX permits trading in its crude oil futures contracts for delivery in the next 30 consecutive months, plus certain "long-dated" futures contracts, including 36 and 48 months prior to delivery. The NYMEX crude oil futures contract is a commodity instrument, not an actual barrel of crude oil.

Crude oil sold at the lease is comprised of completely different circumstances. Lease sales generally concern commitments which do not involve a guaranteed volume or term and do not involve a location other than the wellhead or the nearest delivery point. Undeniably, companies which purchase lease oil are influenced by NYMEX when they are setting postings, but that does not mean that there is a simple, direct, or automatic relationship between NYMEX prices and value of a specific crude oil sold from a specific lease. There are basic risk and marketing issues at work in the NYMEX which bear no resemblance to the sale of a specific crude oil at a specific lease. NYMEX and lease oil values do not move in tandem with each other. The NYMEX futures price is sufficiently different from the value of crude oil at the lease, that it cannot be adjusted to arrive at an correct value at the lease. The NYMEX approach assumes a mechanical relationship that simply does not exist.

Comparing sales on the NYMEX to sales at the lease is an apples-and-oranges comparison; and the application of differentials proposed by MMS will not solve the inherent problems. MMS's proposed "location/quality" differential, which is intended to adjust value from "market center" to "aggregation points" is a fixed value that MMS proposed to calculate on a yearly basis based on stale data from the prior year. The proposal that MMS calculate exchange differentials to account for location and quality differences on an annual basis is conceptually defective. Timing is an essential element in crude oil sales. Oil at the wellhead is priced each day as it is produced. Futures prices also fluctuate daily, as do market center spot prices. In actuality, location/quality differentials can easily fluctuate significantly month-to-month. Therefore, any annual published differential would be merely ideological and not a reflection of true differential values.

MMS says that for "any given production month, the market center-index pricing point location/quality differential would be the difference between the average spot prices for the respective locations as published in an MMS-approved publication...The purpose of this differential is to derive a NYMEX price at the market center by adjusting the NYMEX price at the index pricing point to the general quality of crude typically traded at the market center..." (Fed. Reg. at p.3747). This sentence demonstrates how the NYMEX valuation scheme is flawed. MMS would value oil on the NYMEX with differentials based on the "general" quality of oil "typically" traded at the market center. There are literally thousands upon thousands of leases and wells in this country, each of which differs from each and every other well and lease in the country as to location, quality and/or quantity of production. Some leases are extremely remote, or may produce small quantities of heavy and/or sour crude oil. The value of oil from such leases is necessarily compromised by these factors. Almost certainly, a producer who produces large quantities of light sweet crude oil at a location near a market center has greater control over the price that can be negotiated for its production. The MMS proposal to set general location/quality differentials, especially the proposal that such differentials be set only once per year, oversimplifies the workings of the real world of crude oil markets and would surely lead to unfair valuations

To create rules applicable and fair to all crude oil producer situations would be too complex and burdensome under the NYMEX valuation scheme. It is because there are so many field-by-field differences in oil value, based on numerous quality, location and market differences, that the posting system arose in the first place. Posting is the way the industry recognizes the many variations that can occur. Because it would be virtually impossible to set a posted price for each and every well in the country, posting is, itself, a somewhat generalized pricing method. However, it is a more reliable starting point for determining lease-level value, than the NYMEX scheme would be. The MMS scheme of relating NYMEX futures prices to the value of crude oil at the lease would produce royalty values that do not reflect the true value of crude oil at the lease. For that reason, the proposed rulemaking should not be adopted.

<u>THE ANS SPOT MARKET IS NOT REFLECTIVE OF LEASE VALUES</u> Equally, the proposed rulemaking does not take into account the realities of the ANS spot market. With respect to California and Alaska, the proposed rule would utilize the ANS spot market price as the benchmark for valuation, in place of the NYMEX futures price.

MMS cannot seriously propose to utilize the ANS spot price for royalty valuation of crude oil produced in California without abandoning altogether the precept that royalty is based on market value. The pricing of ANS crude cannot be compared to the pricing of crude oil produced in California. Prices in California derive from the same or similar market factors which apply in other parts of the United States. The factors which drive ANS spot pricing are, on the contrary, unique to Alaska.

Alaska's crude oil is produced by three major producers, Exxon, ARCO and a subsidiary of British Petroleum ("BP"), who together produce approximately 1.5 Million to 1.8 Million barrels of oil per day. During the past two years, virtually all of the oil produced by ARCO and by Exxon has been consumed by ARCO and Exxon in their respective refineries. During that period, the vast majority of spot sales of Alaskan crude oil have been made by one producer, BP. However, BP sells most of its production on term commitments and into the export market. It is estimated that less than half of BP's production, or only about 10% of Alaskan production, is sold on the spot market. The bulk of Alaska's production never enters the spot market and has no impact on market value. That MMS would value all West Coast production by reference to sales by a single company on what amounts to one tenth of Alaska's production is inequitable

Moreover, the standard pricing method for spot sales of Alaskan production obscures the value of the crude oil. All spot sales are made on a delivered basis, which means that the terms of the sale include delivery of the crude oil, on seller-controlled vessels, to the purchaser's designated discharge point, such as its refinery. The crude oil purchaser may not take delivery at a location other than its discharge point without incurring a seller-imposed penalty, and it is impracticable, under Jones Act regulations, for a crude oil purchaser to provide its own transportation for the crude oil. The price charged by the crude oil seller is a single figure, which incorporates both the value placed on crude oil and the value placed on shipping, neither of which is identified. Further, the price charged by the seller depends on the discharge location and the tonnage capacity of the vessel utilized for the sale, though neither the delivery locations nor the vessel data are public information. No one, with the exception of the seller, knows the value placed on the crude oil or the transportation components of the price. Consequently, absent disclosure by the seller of extensive information which has been heretofore kept private, and which varies from sale to sale, there is no way of knowing, or even making an educated guess, whether the price charged in any particular sale is a "market" price.

Most importantly, California's heavy crude oil and Alaska's light crude oil are not comparable in the market place. Most California production is heavy oil, which cannot, absent extra processing in a catalytic cracker or a coker, be used to obtain products other than heavy-ends such as asphalt. ANS, which is a light crude oil, can be processed into gasoline, jet fuel and other light end products. Depending on refinery capabilities, refiners have a clear preference for one type of crude oil over the other and would not deem the two types of crude oil to be interchangeable. Generally, a refiner which buys the lower-priced California crude oil would not consider buying the higher-priced ANS;

and a refiner which buys ANS would not be able to process California crude oil in its refinery.

In the preamble to the proposed rule, MMS calculated that the value of heavy crude oil from the Midway-Sunset field in California would be, using the adjusted ANS price, $16.27 per barrel. In reality, the September average spot price for Midway-Sunset crude oil, as reported by the Dow Jones Telerate, was just $15.72 per barrel; and the posted price averaged $15.98 per barrel for the month, finishing the month at $16.25 per barrel. The September average spot price reported by Platt's Oil Gram for Kern River heavy crude was only $15.67 per barrel. Clearly, even after the application of differentials, MMS would attribute a higher value to California crude oil than the price a producer is, in the real world, able to obtain for its production. The result would be that the California producer would be assessed royalty on a price that is higher than the price he is able to obtain and thus, in actuality, bear a royalty burden higher than that contemplated by the oil and gas lease and higher than the burden borne by Alaska producers.

In summary, the vast majority of Alaskan crude oil which enters the spot market is sold by a single producer, which sells on a single set of terms, at a price in which the cost of crude oil is not distinguished from the cost of transportation. The factors which drive ANS spot price are singular, and certainly not equitable indicators of the factors which influence California prices. To proclaim ANS spot prices the benchmark by which all West Coast crude oil sales are judged would do West Coast producers a serious injustice.

THE MMS'S PROPOSED DEFINITION OF AN ARM'S LENGTH TRANSACTIONS IS UNJUST

Under the proposal, only a very limited number of sales would still be deemed to be arm's length and still qualify for the current royalty valuation approach. The vast majority of crude oil sold in this country would not qualify to be treated as it has in the past. It has long been settled that volumes of production are measured and valued at the wellhead or, if the sale is off the lease, at the point of first sale. This approach has been endorsed by the courts and has been followed by the MMS. MMS now proposes to value production, and collect royalties, on the basis of the NYMEX and thus to capture the fruits of downstream marketing.

A. CRUDE OIL SALES BY A PRODUCER WHOSE AFFILIATE PURCHASES CRUDE OIL SHOULD NOT BE TREATED AS SUSPECT

Under the proposal, a lessee may not rely on its gross proceeds if it, or any affiliated company "purchased crude oil from an unaffiliated third party in the United States in the 2-year period preceding the production month" Proposed Section 206.102 (a)(6) 62 Fed. Reg. 3753. The restriction applies without regard to the purpose of the purchase. It applies whether or not the lessee is also selling other oil to the party from whom it has bought within the two prior years. MMS would treat lessees which purchase oil as suspicious because of the mere possibility that the parties cold manipulate the contract price. This portion of the proposed rulemaking appears to be clearly aimed at refiners and a the MMS's apparent harbored suspicion that refiners have both the incentive and the means to collaborate with one another to buy and sell crude oil at prices lower than market value.

BHP is particularly concerned about the apparent inferences made by the MMS with regard to refiners and to the possibility of price manipulation. It is apparent that MMS finds suspect the transactions of integrated refiners which both produce oil and use at least some of their own oil in their refineries. From the fact that some producers of oil are also buyers and refiners of crude oils, MMS concludes that lease sales by the producing affiliate are not to be trusted as indicators of value.

BHP, as noted at the beginning of these comments, is an exploration and production company, and a subsidiary of The Broken Hill Proprietary Company Limited. Another subsidiary of Broken Hill, and an affiliate of BHP, is BHP Petroleum (Hawaii) Inc., a refiner located in the state of Hawaii. Although BHP is a producer, all of the crude oil used by BHP's refining affiliate is bought on the open market; not one barrel of feedstock comes --either directly or indirectly-- from BHP's own production on the mainland. BHP, therefore, does not have any incentive to keep the prices of its wellhead sales low. It is precipitous to indict a whole segment of the petroleum industry and change the valuation methodology merely because there is a possibility that some producer/refiners have the means and opportunity to manipulate prices. It is a complete overreaction by the MMS to paint an entire segment of the industry with one brush when, as exemplified by BHP, there are individual cases which belie the MMS's generalizations about the industry. Without real proof that overall lease level pricing by producers whose affiliates buy crude oil is not genuine, it would be wrong to treat sales at the lease as anything other than arm's-length sales.

B. CRUDE OIL SALES SUBJECT TO BUY-SELL AGREEMENTS BETWEEN NON-AFFILIATED COMPANIES SHOULD BE TREATED AS ARM'S LENGTH TRANSACTION. MMS says that "the widespread use of exchange agreements and reciprocal sales ...cast doubt on the usefulness of many apparent arm's-length sales prices as a good measure of market value." (62 Fed. Reg. at 3744) MMS defines an exchange agreement as an agreement by one person to deliver oil to another person at a specified location in exchange for reciprocal oil deliveries at another location. Exchange agreements, as defined by the MMS, may or may not specify prices for the oil involved. Buy/sell agreements, which specify a price to be paid at each exchange point and may appear to be two separate sales within the same agreement, are considered to be exchange agreements. MMS states that the reason it would not accept the contract price for oil subject to an exchange agreement is that "the prices stated in an exchange agreement may not reflect actual value. For example, if the market value of oil were $20 per barrel, the two parties to the exchange each could price their oil at $18 bbl. The parties can insure that each remains whole by using a location/quality differential in the agreement" (p. 3744).

MMS provides no instances where such collaboration between producer and purchaser has actually occurred, nor does MMS even say that it has a reasonable suspicion that price manipulation has occurred. The proposed rule is based upon the presumption that all transactions in which there is the slightest possibility that two parties could, if they so chose, set a bad faith price are invalid indicators of market value. MMS says that "a producer may have less incentive to capture full market value in its sales contracts if it knows it will have reciprocal dealings where it may be able to buy oil at less than market value" (Fed. Reg. 62 p. 3743). The evidence of which we are aware suggests, to the contrary, that, if anything, buy/sell arrangements have served to keep lease prices up, not bring them down.

BHP is particularly concerned about the MMS's proposed treatment of crude oil subject to buy-sell agreements. MMS's reasoning might be logical if the producer were to resell the same barrels of oil under the same set of terms and conditions as the first sale, or if the producer were selling to an affiliated company. However, MMS has not shown that such "sham" sales form the basis of the proposal. Moreover, MMS has not shown that first sales which are subject to buy-sell arrangements between non-affiliated companies result in gross proceeds which are less than the gross proceeds of the types of sales MMS would deem to be arm's-length sales.

Where the first sale is not a "sham" sale and where the downstream resale involves terms and conditions different from the first sale, the first sale should be deemed to be arm's length and the first sale should dictate the valuation for royalty payments. In a "real" downstream sale, the producer (or its marketing affiliate) does not simply buy back the same barrels of oil it initially sold and resell them, on otherwise identical terms and conditions, at a higher price. In truth, the downstream sale is completely different in character than the first sale of the crude oil. In a typical sale downstream of the first sale at the lease, the terms of the sale include obligations that the seller must: a) guarantee to deliver one or more lots (consisting of 1000 barrels each) of oil; b) guarantee that the oil delivered will meet certain grade and quality specifications; and c) deliver the oil to the buyer at a specified market center.

In order to meet its obligations, the producer's marketing affiliate often "bundles" crude oil by acquiring oils of varying quantities and qualities from various locations. Some of the bundled crude oil may be crude oil which the marketing affiliate has purchased from the initial purchaser, some will be purchased from others in the market place. By the time a barrel of bundled crude oil reaches the market center where it is sold, its original grade and quality, its original volume and its original location are no longer discernible. The crude oil has lost its identity as production of the original grade and quality from a particular lease, and should no longer be treated as production from a particular lease.

A further distinction between the value of lease sales and downstream sales lies in the risks assumed by the downstream seller. At the lease level, the crude oil producer does not guarantee its purchaser delivery of oil—the producer delivers whatever it produces, which may be more, or less, than anticipated by the parties. The marketing affiliate which buys back the production and resells it downstream takes on the risk of guaranteeing the buyer delivery at a specific market center of a certain grade, quality and volume of oil. There is a constant risk that the producer may not be able to meet its obligations without losing money.

For example, a producer may operate a lease which consistently produces several thousand barrels of oil a day. Based on the expected production from that lease, the producer's marketing affiliate enters into a contract to deliver hundreds of thousands of barrels of oil to a refiner, at a market center, on a certain date. After the contract is made, something goes wrong at the lease which results in the well being shut in for a month. The producer's marketing affiliate is not able to buy back the oil that is produced at the lease, because there is no oil produced at the lease. However, the marketing affiliate has a legal obligation to the refiner to deliver. In order to meet its obligations, the marketing affiliate has to go to the market place and purchase oil from another source. The oil purchased on the open market could easily cost the marketing affiliate more than it will realize from the sale to the refiner. A great deal of money could be lost in such an instance.

Market influences, too, if not predicted with accuracy by the producer's marketing affiliate, can result in the loss of money. In the commodities market, which is highly volatile and unstable, the prospect of losing money in the resale of crude oil is--just as with other commodities such as gold, pork bellies and wheat-- a very real threat. The MMS proposal simply ignores many of the costs and risks that would have to be incurred by a lessee which engages in downstream marketing.

If there is so much risk associated with reselling crude oil, why do producers have marketing affiliates who engage in such transactions? Among other things, buy/sell agreements serve to protect the price the producer receives at the wellhead. This is the very heart of BHP's objection to the proposal and why we oppose it so strenuously. By retaining the right to re-purchase the oil, the producer discourages the lease level purchaser from offering too low a price on the oil. If the initial sale were the end of the dealing between the producer and the purchaser, the purchaser (especially in situations where there is little competition to buy the oil) could offer a low price for the oil and the producer would have no option but to accept it. In effect, the downstream trades can help keep lease-level prices at fair market value. Thus, buy/sell arrangements not only afford protection to those who enter into such agreements; they also benefit producers who do not engage in downstream marketing and the MMS, by ensuring that fair market value is received for the lease oil.

The idea that the appropriate market value was not being captured or recognized at the lease seems to have influenced MMS considerably in this proposed rulemaking, but the premise is mistaken. The market center price will often, although by no means always, exceed the lease market price, at least in absolute terms. MMS apparently believes that it is entitled to the value that the producer might receive if, in a ideal world, the producer always made the right decisions about its buy-sell agreements and always made money on those agreements. However, the complexity of the market and unexpected occurrences in lease operations prevent anyone from always getting what he wants. The crude oil market is sensitive and volatile.

It appears that MMS wants to share the rewards of downstream marketing, as if it had shared in the risks—but without actually assuming any of the risks. If MMS is not willing to share the risks and losses the producer and its affiliates are sure to encounter downstream of the wellhead, then what MMS is really asking for is a tax in the form of a portion of the gross income a producer and its affiliates eventually make on crude oil production. What MMS has proposed is, when the facts are considered, enormously inequitable.

Clearly, in light of the continued viability of the lease sale price as the correct indicator of market value and in light of the differences between wellhead sales and downstream sales, it is not realistic or fair to treat crude oil subject to a buy-sell agreement as non-arm's length nor is it fair to value such crude oil other than by reference to comparable arm's length sales. A buy-sell is not necessarily a sham. If it is not a sham, then it should not be treated as such. Presumptions, possibilities and suppositions which are not founded on actual facts or occurrences do not form a proper basis for changing the regulations. Without real proof that lease level pricing is not a genuine reflection of market value, it would be wrong to change the way in which crude oil subject to buy-sell agreements is treated.

MMS CAN REMEDY ANY PERCEIVED PROBLEMS BY TAKING ROYALTY IN KIND

If MMS believes that it has not been receiving or may not receive as much value for crude oil as it should, there is a simple, workable solution which does not require the massive overhaul contemplated by the proposed rulemaking. The solution is expansion of the royalty-in-kind (RIK) program. MMS already has the option to take its royalty in kind and MMS already has a limited RIK program. Currently, the price charged by MMS when it sells crude oil to refiners is identical to the value reported by the producers of the crude oil. BHP proposes that MMS should disassociate itself completely from the process of pricing its RIK oil by referencing producer sales and from the business of regulating how producers ascertain value. The price received by the producer should be ignored. By expanding the RIK program to include all royalty oil from all federal leases, the MMS will have the ability to market its share of crude oil on the terms and conditions it believes will yield the value to which it is entitled. Market value would, very simply, be the price MMS is able to realize.

There is an RIK program already in existence in the Province of Alberta whereby all oil royalty is taken in kind and which, we understand, has been successfully administered by the respective governments. The existing program could serve as a model from which the MMS could, if needed, modify its existing limited RIK program.

We believe that it is a show of good faith and a strong belief in the statements made in this commentary that members of the petroleum industry are willing to recommend that MMS market its own crude oil. MMS has a large enough volume of royalty oil, as well as the power and the resources, to enter the market place on equal footing with any crude oil marketer. By so doing, there would be no need to promulgate the proposed rulemaking, but MMS concerns about posted prices, and valuation on downstream sales would, nonetheless, be obviated. We respectfully request that MMS give this recommendation its very serious consideration.

We thank MMS for its consideration of BHP's comments.

Sincerely,

MaWeil

for **E. A. BLAIR**
PRESIDENT

BHP

Americas Region
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RECEIVED

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MMS attempts to justify its proposal by saying that "[s]ince many contract prices are tied to postings, the influence of posted prices is magnified. MMS is proposing a different valuation approach because market conditions have changed...Given the mounting evidence that posted prices frequently do not reflect value in today's marketplace the proposed valuation standards do not rely at all on postings." (62 Fed. Reg. at p. 3744) .

The rationale behind the NYMEX/ANS valuation scheme is based on misunderstandings and inaccuracies about the workings of the marketplace. For example, MMS says that NYMEX prices were "regarded by many of the experts MMS consulted to be the best available measure of oil market value." (Fed. Reg. 62 at p. 3745) This statement greatly oversimplifies the complexities of the crude oil market. The NYMEX is the best indicator of value for **one, particular** type of market transaction; but it is certainly not the best indicator of the value of a sale at the lease level.

The NYMEX futures market is an economically distinct and different market from the lease level crude market. NYMEX is concerned with one-off contracts which involve the guaranteed delivery by a seller of a guaranteed quality and volume of oil. NYMEX has developed a standardized crude oil contract which pertains only to the future sale of light, sweet crude oil in lots of 1000 barrels each, at a specified market center. NYMEX permits trading in its crude oil futures contracts for delivery in the next 30 consecutive months, plus certain "long-dated" futures contracts, including 36 and 48 months prior to delivery. The NYMEX crude oil futures contract is a commodity instrument, not an actual barrel of crude oil.

Crude oil sold at the lease is comprised of completely different circumstances. Lease sales generally concern commitments which do not involve a guaranteed volume or term and do not involve a location other than the wellhead or the nearest delivery point. Undeniably, companies which purchase lease oil are influenced by NYMEX when they are setting postings, but that does not mean that there is a simple, direct, or automatic relationship between NYMEX prices and value of a specific crude oil sold from a specific lease. There are basic risk and marketing issues at work in the NYMEX which bear no resemblance to the sale of a specific crude oil at a specific lease. NYMEX and lease oil values do not move in tandem with each other. The NYMEX futures price is sufficiently different from the value of crude oil at the lease, that it cannot be adjusted to arrive at an correct value at the lease. The NYMEX approach assumes a mechanical relationship that simply does not exist.

Comparing sales on the NYMEX to sales at the lease is an apples-and-oranges comparison; and the application of differentials proposed by MMS will not solve the inherent problems. MMS's proposed "location/quality" differential, which is intended to adjust value from "market center" to "aggregation points" is a fixed value that MMS proposed to calculate on a yearly basis based on stale data from the prior year. The proposal that MMS calculate exchange differentials to account for location and quality differences on an annual basis is conceptually defective. Timing is an essential element in crude oil sales. Oil at the wellhead is priced each day as it is produced. Futures prices also fluctuate daily, as do market center spot prices. In actuality, location/quality differentials can easily fluctuate significantly month-to-month. Therefore, any annual published differential would be merely ideological and not a reflection of true differential values.

MMS says that for "any given production month, the market center-index pricing point location/quality differential would be the difference between the average spot prices for the respective locations as published in an MMS-approved publication...The purpose of this differential is to derive a NYMEX price at the market center by adjusting the NYMEX price at the index pricing point to the general quality of crude typically traded at the market center..." (Fed. Reg. at p.3747). This sentence demonstrates how the NYMEX valuation scheme is flawed. MMS would value oil on the NYMEX with differentials based on the "general" quality of oil "typically" traded at the market center. There are literally thousands upon thousands of leases and wells in this country, each of which differs from each and every other well and lease in the country as to location, quality and/or quantity of production. Some leases are extremely remote, or may produce small quantities of heavy and/or sour crude oil. The value of oil from such leases is necessarily compromised by these factors. Almost certainly, a producer who produces large quantities of light sweet crude oil at a location near a market center has greater control over the price that can be negotiated for its production. The MMS proposal to set general location/quality differentials, especially the proposal that such differentials be set only once per year, oversimplifies the workings of the real world of crude oil markets and would surely lead to unfair valuations

To create rules applicable and fair to all crude oil producer situations would be too complex and burdensome under the NYMEX valuation scheme. It is because there are so many field-by-field differences in oil value, based on numerous quality, location and market differences, that the posting system arose in the first place. Posting is the way the industry recognizes the many variations that can occur. Because it would be virtually impossible to set a posted price for each and every well in the country, posting is, itself, a somewhat generalized pricing method. However, it is a more reliable starting point for determining lease-level value, than the NYMEX scheme would be. The MMS scheme of relating NYMEX futures prices to the value of crude oil at the lease would produce royalty values that do not reflect the true value of crude oil at the lease. For that reason, the proposed rulemaking should not be adopted.

<u>THE ANS SPOT MARKET IS NOT REFLECTIVE OF LEASE VALUES</u> Equally, the proposed rulemaking does not take into account the realities of the ANS spot market. With respect to California and Alaska, the proposed rule would utilize the ANS spot market price as the benchmark for valuation, in place of the NYMEX futures price.

MMS cannot seriously propose to utilize the ANS spot price for royalty valuation of crude oil produced in California without abandoning altogether the precept that royalty is based on market value. The pricing of ANS crude cannot be compared to the pricing of crude oil produced in California. Prices in California derive from the same or similar market factors which apply in other parts of the United States. The factors which drive ANS spot pricing are, on the contrary, unique to Alaska.

Alaska's crude oil is produced by three major producers, Exxon, ARCO and a subsidiary of British Petroleum ("BP"), who together produce approximately 1.5 Million to 1.8 Million barrels of oil per day. During the past two years, virtually all of the oil produced by ARCO and by Exxon has been consumed by ARCO and Exxon in their respective refineries. During that period, the vast majority of spot sales of Alaskan crude oil have been made by one producer, BP. However, BP sells most of its production on term commitments and into the export market. It is estimated that less than half of BP's production, or only about 10% of Alaskan production, is sold on the spot market. The bulk of Alaska's production never enters the spot market and has no impact on market value. That MMS would value all West Coast production by reference to sales by a single company on what amounts to one tenth of Alaska's production is inequitable

Moreover, the standard pricing method for spot sales of Alaskan production obscures the value of the crude oil. All spot sales are made on a delivered basis, which means that the terms of the sale include delivery of the crude oil, on seller-controlled vessels, to the purchaser's designated discharge point, such as its refinery. The crude oil purchaser may not take delivery at a location other than its discharge point without incurring a seller-imposed penalty, and it is impracticable, under Jones Act regulations, for a crude oil purchaser to provide its own transportation for the crude oil. The price charged by the crude oil seller is a single figure, which incorporates both the value placed on crude oil and the value placed on shipping, neither of which is identified. Further, the price charged by the seller depends on the discharge location and the tonnage capacity of the vessel utilized for the sale, though neither the delivery locations nor the vessel data are public information. No one, with the exception of the seller, knows the value placed on the crude oil or the transportation components of the price. Consequently, absent disclosure by the seller of extensive information which has been heretofore kept private, and which varies from sale to sale, there is no way of knowing, or even making an educated guess, whether the price charged in any particular sale is a "market" price.

Most importantly, California's heavy crude oil and Alaska's light crude oil are not comparable in the market place. Most California production is heavy oil, which cannot, absent extra processing in a catalytic cracker or a coker, be used to obtain products other than heavy-ends such as asphalt. ANS, which is a light crude oil, can be processed into gasoline, jet fuel and other light end products. Depending on refinery capabilities, refiners have a clear preference for one type of crude oil over the other and would not deem the two types of crude oil to be interchangeable. Generally, a refiner which buys the lower-priced California crude oil would not consider buying the higher-priced ANS;

and a refiner which buys ANS would not be able to process California crude oil in its refinery.

In the preamble to the proposed rule, MMS calculated that the value of heavy crude oil from the Midway-Sunset field in California would be, using the adjusted ANS price, $16.27 per barrel. In reality, the September average spot price for Midway-Sunset crude oil, as reported by the Dow Jones Telerate, was just $15.72 per barrel; and the posted price averaged $15.98 per barrel for the month, finishing the month at $16.25 per barrel. The September average spot price reported by Platt's Oil Gram for Kern River heavy crude was only $15.67 per barrel. Clearly, even after the application of differentials, MMS would attribute a higher value to California crude oil than the price a producer is, in the real world, able to obtain for its production. The result would be that the California producer would be assessed royalty on a price that is higher than the price he is able to obtain and thus, in actuality, bear a royalty burden higher than that contemplated by the oil and gas lease and higher than the burden borne by Alaska producers.

In summary, the vast majority of Alaskan crude oil which enters the spot market is sold by a single producer, which sells on a single set of terms, at a price in which the cost of crude oil is not distinguished from the cost of transportation. The factors which drive ANS spot price are singular, and certainly not equitable indicators of the factors which influence California prices. To proclaim ANS spot prices the benchmark by which all West Coast crude oil sales are judged would do West Coast producers a serious injustice.

THE MMS'S PROPOSED DEFINITION OF AN ARM'S LENGTH TRANSACTIONS IS UNJUST

Under the proposal, only a very limited number of sales would still be deemed to be arm's length and still qualify for the current royalty valuation approach. The vast majority of crude oil sold in this country would not qualify to be treated as it has in the past. It has long been settled that volumes of production are measured and valued at the wellhead or, if the sale is off the lease, at the point of first sale. This approach has been endorsed by the courts and has been followed by the MMS. MMS now proposes to value production, and collect royalties, on the basis of the NYMEX and thus to capture the fruits of downstream marketing.

A. CRUDE OIL SALES BY A PRODUCER WHOSE AFFILIATE PURCHASES CRUDE OIL SHOULD NOT BE TREATED AS SUSPECT

Under the proposal, a lessee may not rely on its gross proceeds if it, or any affiliated company "purchased crude oil from an unaffiliated third party in the United States in the 2-year period preceding the production month" Proposed Section 206.102 (a)(6) 62 Fed. Reg. 3753. The restriction applies without regard to the purpose of the purchase. It applies whether or not the lessee is also selling other oil to the party from whom it has bought within the two prior years. MMS would treat lessees which purchase oil as suspicious because of the mere possibility that the parties cold manipulate the contract price. This portion of the proposed rulemaking appears to be clearly aimed at refiners and a the MMS's apparent harbored suspicion that refiners have both the incentive and the means to collaborate with one another to buy and sell crude oil at prices lower than market value.

BHP is particularly concerned about the apparent inferences made by the MMS with regard to refiners and to the possibility of price manipulation. It is apparent that MMS finds suspect the transactions of integrated refiners which both produce oil and use at least some of their own oil in their refineries. From the fact that some producers of oil are also buyers and refiners of crude oils, MMS concludes that lease sales by the producing affiliate are not to be trusted as indicators of value.

BHP, as noted at the beginning of these comments, is an exploration and production company, and a subsidiary of The Broken Hill Proprietary Company Limited. Another subsidiary of Broken Hill, and an affiliate of BHP, is BHP Petroleum (Hawaii) Inc., a refiner located in the state of Hawaii. Although BHP is a producer, all of the crude oil used by BHP's refining affiliate is bought on the open market; not one barrel of feedstock comes --either directly or indirectly-- from BHP's own production on the mainland. BHP, therefore, does not have any incentive to keep the prices of its wellhead sales low. It is precipitous to indict a whole segment of the petroleum industry and change the valuation methodology merely because there is a possibility that some producer/refiners have the means and opportunity to manipulate prices. It is a complete overreaction by the MMS to paint an entire segment of the industry with one brush when, as exemplified by BHP, there are individual cases which belie the MMS's generalizations about the industry. Without real proof that overall lease level pricing by producers whose affiliates buy crude oil is not genuine, it would be wrong to treat sales at the lease as anything other than arm's-length sales.

B. CRUDE OIL SALES SUBJECT TO BUY-SELL AGREEMENTS BETWEEN NON-AFFILIATED COMPANIES SHOULD BE TREATED AS ARM'S LENGTH TRANSACTION. MMS says that "the widespread use of exchange agreements and reciprocal sales ...cast doubt on the usefulness of many apparent arm's-length sales prices as a good measure of market value." (62 Fed. Reg. at 3744) MMS defines an exchange agreement as an agreement by one person to deliver oil to another person at a specified location in exchange for reciprocal oil deliveries at another location. Exchange agreements, as defined by the MMS, may or may not specify prices for the oil involved. Buy/sell agreements, which specify a price to be paid at each exchange point and may appear to be two separate sales within the same agreement, are considered to be exchange agreements. MMS states that the reason it would not accept the contract price for oil subject to an exchange agreement is that "the prices stated in an exchange agreement may not reflect actual value. For example, if the market value of oil were $20 per barrel, the two parties to the exchange each could price their oil at $18 bbl. The parties can insure that each remains whole by using a location/quality differential in the agreement" (p. 3744).

MMS provides no instances where such collaboration between producer and purchaser has actually occurred, nor does MMS even say that it has a reasonable suspicion that price manipulation has occurred. The proposed rule is based upon the presumption that all transactions in which there is the slightest possibility that two parties could, if they so chose, set a bad faith price are invalid indicators of market value. MMS says that "a producer may have less incentive to capture full market value in its sales contracts if it knows it will have reciprocal dealings where it may be able to buy oil at less than market value" (Fed. Reg. 62 p. 3743). The evidence of which we are aware suggests, to the contrary, that, if anything, buy/sell arrangements have served to keep lease prices up, not bring them down.

BHP is particularly concerned about the MMS's proposed treatment of crude oil subject to buy-sell agreements. MMS's reasoning might be logical if the producer were to resell the same barrels of oil under the same set of terms and conditions as the first sale, or if the producer were selling to an affiliated company. However, MMS has not shown that such "sham" sales form the basis of the proposal. Moreover, MMS has not shown that first sales which are subject to buy-sell arrangements between non-affiliated companies result in gross proceeds which are less than the gross proceeds of the types of sales MMS would deem to be arm's-length sales.

Where the first sale is not a "sham" sale and where the downstream resale involves terms and conditions different from the first sale, the first sale should be deemed to be arm's length and the first sale should dictate the valuation for royalty payments. In a "real" downstream sale, the producer (or its marketing affiliate) does not simply buy back the same barrels of oil it initially sold and resell them, on otherwise identical terms and conditions, at a higher price. In truth, the downstream sale is completely different in character than the first sale of the crude oil. In a typical sale downstream of the first sale at the lease, the terms of the sale include obligations that the seller must: a) guarantee to deliver one or more lots (consisting of 1000 barrels each) of oil; b) guarantee that the oil delivered will meet certain grade and quality specifications; and c) deliver the oil to the buyer at a specified market center.

In order to meet its obligations, the producer's marketing affiliate often "bundles" crude oil by acquiring oils of varying quantities and qualities from various locations. Some of the bundled crude oil may be crude oil which the marketing affiliate has purchased from the initial purchaser, some will be purchased from others in the market place. By the time a barrel of bundled crude oil reaches the market center where it is sold, its original grade and quality, its original volume and its original location are no longer discernible. The crude oil has lost its identity as production of the original grade and quality from a particular lease, and should no longer be treated as production from a particular lease.

A further distinction between the value of lease sales and downstream sales lies in the risks assumed by the downstream seller. At the lease level, the crude oil producer does not guarantee its purchaser delivery of oil—the producer delivers whatever it produces, which may be more, or less, than anticipated by the parties. The marketing affiliate which buys back the production and resells it downstream takes on the risk of guaranteeing the buyer delivery at a specific market center of a certain grade, quality and volume of oil. There is a constant risk that the producer may not be able to meet its obligations without losing money.

For example, a producer may operate a lease which consistently produces several thousand barrels of oil a day. Based on the expected production from that lease, the producer's marketing affiliate enters into a contract to deliver hundreds of thousands of barrels of oil to a refiner, at a market center, on a certain date. After the contract is made, something goes wrong at the lease which results in the well being shut in for a month. The producer's marketing affiliate is not able to buy back the oil that is produced at the lease, because there is no oil produced at the lease. However, the marketing affiliate has a legal obligation to the refiner to deliver. In order to meet its obligations, the marketing affiliate has to go to the market place and purchase oil from another source. The oil purchased on the open market could easily cost the marketing affiliate more than it will realize from the sale to the refiner. A great deal of money could be lost in such an instance.

Market influences, too, if not predicted with accuracy by the producer's marketing affiliate, can result in the loss of money. In the commodities market, which is highly volatile and unstable, the prospect of losing money in the resale of crude oil is--just as with other commodities such as gold, pork bellies and wheat-- a very real threat. The MMS proposal simply ignores many of the costs and risks that would have to be incurred by a lessee which engages in downstream marketing.

If there is so much risk associated with reselling crude oil, why do producers have marketing affiliates who engage in such transactions? Among other things, buy/sell agreements serve to protect the price the producer receives at the wellhead. This is the very heart of BHP's objection to the proposal and why we oppose it so strenuously. By retaining the right to re-purchase the oil, the producer discourages the lease level purchaser from offering too low a price on the oil. If the initial sale were the end of the dealing between the producer and the purchaser, the purchaser (especially in situations where there is little competition to buy the oil) could offer a low price for the oil and the producer would have no option but to accept it. In effect, the downstream trades can help keep lease-level prices at fair market value. Thus, buy/sell arrangements not only afford protection to those who enter into such agreements; they also benefit producers who do not engage in downstream marketing and the MMS, by ensuring that fair market value is received for the lease oil.

The idea that the appropriate market value was not being captured or recognized at the lease seems to have influenced MMS considerably in this proposed rulemaking, but the premise is mistaken. The market center price will often, although by no means always, exceed the lease market price, at least in absolute terms. MMS apparently believes that it is entitled to the value that the producer might receive if, in a ideal world, the producer always made the right decisions about its buy-sell agreements and always made money on those agreements. However, the complexity of the market and unexpected occurrences in lease operations prevent anyone from always getting what he wants. The crude oil market is sensitive and volatile.

It appears that MMS wants to share the rewards of downstream marketing, as if it had shared in the risks—but without actually assuming any of the risks. If MMS is not willing to share the risks and losses the producer and its affiliates are sure to encounter downstream of the wellhead, then what MMS is really asking for is a tax in the form of a portion of the gross income a producer and its affiliates eventually make on crude oil production. What MMS has proposed is, when the facts are considered, enormously inequitable.

Clearly, in light of the continued viability of the lease sale price as the correct indicator of market value and in light of the differences between wellhead sales and downstream sales, it is not realistic or fair to treat crude oil subject to a buy-sell agreement as non-arm's length nor is it fair to value such crude oil other than by reference to comparable arm's length sales. A buy-sell is not necessarily a sham. If it is not a sham, then it should not be treated as such. Presumptions, possibilities and suppositions which are not founded on actual facts or occurrences do not form a proper basis for changing the regulations. Without real proof that lease level pricing is not a genuine reflection of market value, it would be wrong to change the way in which crude oil subject to buy-sell agreements is treated.

MMS CAN REMEDY ANY PERCEIVED PROBLEMS BY TAKING ROYALTY IN KIND

If MMS believes that it has not been receiving or may not receive as much value for crude oil as it should, there is a simple, workable solution which does not require the massive overhaul contemplated by the proposed rulemaking. The solution is expansion of the royalty-in-kind (RIK) program. MMS already has the option to take its royalty in kind and MMS already has a limited RIK program. Currently, the price charged by MMS when it sells crude oil to refiners is identical to the value reported by the producers of the crude oil. BHP proposes that MMS should disassociate itself completely from the process of pricing its RIK oil by referencing producer sales and from the business of regulating how producers ascertain value. The price received by the producer should be ignored. By expanding the RIK program to include all royalty oil from all federal leases, the MMS will have the ability to market its share of crude oil on the terms and conditions it believes will yield the value to which it is entitled. Market value would, very simply, be the price MMS is able to realize.

There is an RIK program already in existence in the Province of Alberta whereby all oil royalty is taken in kind and which, we understand, has been successfully administered by the respective governments. The existing program could serve as a model from which the MMS could, if needed, modify its existing limited RIK program.

We believe that it is a show of good faith and a strong belief in the statements made in this commentary that members of the petroleum industry are willing to recommend that MMS market its own crude oil. MMS has a large enough volume of royalty oil, as well as the power and the resources, to enter the market place on equal footing with any crude oil marketer. By so doing, there would be no need to promulgate the proposed rulemaking, but MMS concerns about posted prices, and valuation on downstream sales would, nonetheless, be obviated. We respectfully request that MMS give this recommendation its very serious consideration.

We thank MMS for its consideration of BHP's comments.

Sincerely,

Mia Weil

for **E. A. BLAIR**
PRESIDENT