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MAY 1997
RECEIVED

Mr. David S. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
Building 85
Denver Federal Center
Denver, Colorado 80225

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

Dear Mr. Guzy:

The City of Long Beach and the State of California hereby respond to the Notice of Proposed Rulemaking, which would modify the valuation procedures for both arm's-length and non-arm's-length crude oil transactions.

I.

GENERAL COMMENTS

MMS is to be congratulated for its new proposed pricing regulations. Specifically, we agree with MMS's proposed index pricing using ANS spot prices for federal leases in California and Alaska and using the average of the daily NYMEX futures settle prices for the Domestic Sweet Crude Oil Contract for the prompt month for federal leases outside of California. We also agree with MMS's total abandonment of posted prices to value federal royalty oil.

We disagree with MMS's retention of the Gross Proceeds methodology for valuing royalty oil in certain arm's-length transactions, although we recognize that MMS intends that this methodology be severely limited. We are concerned that despite MMS's efforts to limit its applicability, the method will continue to be used in a significant number of transactions.

We agree that quality and location adjustments must be made for royalty crude and we offer some suggestions as to how information may be gathered and some of the principles which should guide MMS's further regulations on these issues.

II.

THE GROSS PROCEEDS METHOD OF VALUING CRUDE OIL

SECTS. 206.102(A) AND (C)

We propose that MMS eliminate the use of gross proceeds to determine the value of royalties whether for arm's-length sales by the lessee or arm's-length sales by an affiliate of the lessee. We object to the Gross Proceeds Method of Valuing Crude Oil for the following reasons:

1. The gross proceeds received for sales of royalty crude are not an accurate indicator of the market value of crude. Index pricing (ANS prices for the West Coast and NYMEX prices elsewhere) should always be used because it is an accurate indicator of the market value of crude.
2. The gross proceeds method is difficult and expensive for MMS to properly monitor and enforce.

3. The commingling of crudes and the accounting records of oil companies make it impossible in many instances to determine what gross proceeds are received for royalty crudes.

4. Exchanges are defined too narrowly under the proposed regulations, with the result that the gross proceeds method would apply to many more crude transactions than MMS intends.

Additionally, if the gross proceeds method is to be used at all, it ought to be limited to sales of royalty crude by independent producers.

A. THE GROSS PROCEEDS METHODOLOGY WILL NOT REFLECT THE MARKET VALUE FOR FEDERAL ROYALTY OIL

For reasons described below, ANS spot sales prices in California are the most accurate indicator of the market value of federal royalty oil produced in California. Gross proceeds from the sale of royalty oil, however, will seldom reflect the market value of federal royalty oil. There are many factors that depress sales prices for California crudes. Three major oil companies who are posters in California own three heated pipelines and operate them free from common carrier requirements. Thus, the pipeline owners can dictate the terms of access to their pipelines, including the price they will pay for oil. Where the private pipeline owner is the only efficient access to a producer's crude, that pipeline owner can dictate the price it will pay for the crude oil. That price is typically the posted price. When major oil companies purchase crude at prices above posted prices, they never pay a price equivalent to the price that they pay for ANS crude oil in California. Independent refiners will find it difficult to pay much more for California crudes than the majors pay if they want to stay competitive with major oil companies. Historically, the gross proceeds method has not resulted in prices equal to the spot price of ANS, and it is unlikely to achieve parity with ANS prices in the future.

B. THE COMMINGLING OF ROYALTY CRUDE WITH NON-ROYALTY CRUDES AND OIL COMPANY ACCOUNTING PROCEDURES WILL RESULT IN ROYALTIES LOWER THAN MARKET VALUE

Royalty oil is frequently transferred from an oil company that produces the crude to its affiliate that sells the crude. After it is transferred to its affiliate, it is commingled with other crudes. The impossibility of tracing crude oil produced from federal leases when it is commingled with other crude oils will result in lower royalties. When selling a commingled stream that contains federal royalty oil, oil companies have an incentive to attribute the sales price to the royalty oil portion of the commingled stream when the sales price is low as well as an incentive to attribute the sales price to the non-federal royalty oil portion of the commingled stream when the sales price is high. These incentives will result in artificially low reported gross proceeds.

The Interagency Task Force concluded correctly that accounting procedures in oil companies made it impossible to trace the prices received for federal royalty oil when such oil was transferred from the company producing the oil to its affiliate.[1] These accounting procedures lead to intractable problems in determining the gross proceeds received for the sale of federal royalty oil.

C. THE GROSS PROCEEDS METHODOLOGY REQUIRES EXTENSIVE AND EXPENSIVE MONITORING

In order for MMS to monitor the gross proceeds received for sales of royalty oil, it would have to undertake an enormous and costly review of the contracts for the sale of federal royalty crude. The proposed regulations provide that MMS has the right to look at "arm's-length sales and volume data" (Section 206.102(d)(2)), but there is no indication in the proposed regulations that MMS intends to monitor the actual contracts on a regular basis or that MMS has the funds to conduct such thorough audits of contracts and other relevant information. Without such monitoring, oil companies cannot be expected to report the true gross proceeds, given their past practices. Oil companies typically reported posted prices as the basis for royalty payments, even when they were paying and receiving bonuses for California crudes.[2]

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[1]Final Interagency Report On The Valuation Of Oil Produced From Federal Leases in California, May 16, 1996, pgs. 49-50.

[2]Final Interagency Report On the Valuation Of Oil Produced From Federal Leases in California, May 16, 1996, pg. 44.

Monitoring by MMS of the actual transactions is too costly and burdensome. The State of California and the City of Long Beach found that the oil companies hid the amount they paid for California crudes. Bonuses over posted price, for example, were often disguised by such devices as excessive transportation payments. Only by reviewing the actual transaction contracts and, in many cases, the oil companies' economic analyses of such contracts is it possible to determine the true price paid for crudes. When the Interagency Task Force did analyze the crude oil transactions in California, it concluded the most outright purchases and sales were at a premium over postings.[3]

D. **"EXCHANGE AGREEMENTS" ARE DEFINED TOO NARROWLY**

We agree with MMS that crude prices stated in an exchange agreement may not reflect actual value. The reason is that oil companies have a mutual incentive to price crude oils below market value for royalty and tax purposes. They thus have an incentive to price crudes on exchanges below market value as long as the relative values of the crudes are preserved and as long as the exchanges are kept in approximate balance. The balances do not have to be exact for exchange partners to benefit from lower than market crude prices in exchanges. As long as the savings in royalties and taxes exceeds any losses for exchange imbalances, oil companies still have an incentive to price crudes in exchanges below market value.

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[3]Final Interagency Report On The Valuation Of Oil Produced From Federal Leases In California, May 16, 1996, pg. 44.

Our experience in the Long Beach litigation is that oil companies contracted in their exchanges to keep the volumes balanced and they usually kept their exchanges in balance. To the extent that exchanges were not balanced the parties would transfer an outstanding imbalance to another ongoing exchange or offset imbalances on one exchange with outstanding imbalances on another exchange.

We agree with MMS that gross proceeds may not be used to value crude disposed of under an exchange agreement. We believe, however, that the definition of "exchange agreement" is too narrow. Sect. 206.100. The narrow definition has the effect of increasing the number and kinds of transactions to which the gross proceeds method would apply. The definition of "exchange agreement" is too narrow for five reasons: (1) it excludes exchanges in which the receipt and delivery take place at the same location; (2) it excludes multi-party exchanges; (3) it excludes transportation exchanges; (4) it excludes net-out and other overall balancing agreements; and (5) it excludes exchanges involving crude for products. The result of the narrow definition of exchanges is that the gross proceeds method has a far broader application than that intended by MMS.

(1) The proposed regulations define exchanges as involving different locations for the receipt and delivery of crude oil. This definition excludes exchanges, such as time trades, that involve receipt and delivery of crudes at the same location. Time trades are exchanges in which a given volume of crude oil is

delivered at one time at a designated location in exchange for the same volume of crude at another time, frequently at the same location. Time trades are often entered into as an accommodation when a company has a temporary excess of oil for various reasons, including an unexpected increase in production, a refinery disruption or a pipeline problem.

Oil companies have the same incentive to understate the prices of the crudes exchanged in time trades as they do in any other exchange. The implicit exclusion from the definition of "exchange" of receipts and deliveries at the same location would permit the use of the gross proceeds method for these exchanges.

We propose that MMS close this loophole by eliminating the words "at a specified location" and "at another location" in the definition of "exchange agreement."

(2) The proposed definition of "exchange" applies to two-party exchanges, but not to exchanges involving more than two parties, and to situations where the initial leg of a multi-party transaction was an outright sale. For example, three-party exchange is one in which A trades with B which trades with C which trades with A. The extreme form of a multi-party transaction takes the form of daisy chains which involve many companies.

We propose that MMS close this loophole by adding the words "from any other person" after "in exchange for reciprocal deliveries" in the definition of "exchange agreement."

(3) A third problem is that the proposed regulations specifically distinguish transportation agreements from exchange

agreements. Initially, we suggest that MMS clarify the effect of excluding transportation agreements from the definition of exchange agreements. We believe that MMS is not proposing to apply the gross proceeds method to a transportation agreement, i.e., that the prices of the federal royalty crude oil stated in the transportation exchange be subject to the gross proceeds valuation. We believe also that MMS would apply the gross proceeds method only when the crude delivered back on a transportation exchange to the royalty lessee or its affiliate is itself sold under an arm's-length transaction. An example might make this clear. Suppose A, a royalty lessee, takes royalty production and enters into a transportation agreement with B whereby A delivers royalty crude to B's pipeline at one location and A receives crude from B's pipeline at another location. If A then takes the crude received from B and sells it to C in an arm's-length transaction, A's crude would be valued on the basis of the gross proceeds received from C on the arm's-length transaction. But in no event would the gross proceeds method be applied to A's royalty crude on the basis of any pricing terms in the transportation agreement between A and B. We believe that MMS intended to value the crude on the basis of the contract between A and C and not on the basis of the contract between A and B. MMS should make this point more clearly.

If our understanding is incorrect and MMS would permit the use of pricing provisions in a transportaion agreement to value federal crude, we would object. Transportation agreements are a type of exchange agreement and the price terms reflect the relative value differences in the crudes exchanged but not the absolute value of the crudes. The pricing provisions of transportation agreements are not arm's-length.

We object to the use of gross proceeds even as to crude which was received back on a transportation agreement and is sold on an arm's-length transaction. Using the example above, we would object to gross proceeds for an arm's-length transaction of A's sale of crude to C which transaction takes place after the transportation agreement between A and B. We object for all of the reasons we give against any use of the gross proceeds method and in addition for the reason that the crude which A sells to C is not the same quality as that of royalty crude. When A's royalty crude is put in B's pipeline for transportation, it is commingled with other crudes and B delivers a commingled stream back to A, which usually has a different quality than the royalty crude A delivered to B. It is the commingled stream which A eventually sells to C.

Finally, the proposed regulations give no definition of a transportation agreement. Transportation agreements need to be carefully defined if they are to be treated differently than other exchanges. Most exchanges involve deliveries and receipts at different locations and to that extent have a transportation component. Thus, almost every exchange can be characterized as a transportation agreement. Because oil companies have an incentive to broaden the scope of transportation exchanges under the proposed regulations, they can be expected to maintain that most exchanges are transportation exchanges. Indeed, an expert for Marathon Oil

Company recently testified that exchanges exist to transport crude oil.[4] The lack of a definition threatens to make meaningless the exclusion of the gross proceeds method for royalty crude disposed of on exchange. We would prefer that the gross proceeds method not be used at all, or, if it is used, that it not be used if royalty crude is disposed of on a transportation agreement. But, if MMS intends to permit the use of the gross proceeds method when royalty crude is disposed of on a transportation agreement, MMS should clearly define "transportation agreement" so as to include only "in/out" exchanges whereby the royalty lessee enters into an agreement to use B's pipeline or B's trucks, tankers, trains or other transportation vehicle, and A receives from B a commingled

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[4]In Engwall v. Amerada Hess Corp., Fifth Judicial District, County of Chaves, State of New Mexico, Case No. CV-95-322, Bruce M. Kramer, Professor of Law at Texas University School of Law, testified in Court on behalf of Marathon Oil Company as follows:

> Q. If you have some oil, and you don't want to put it in a pipeline and ship it for hundreds of miles, can you do a buy-sell and effect the same arrangement?
>
> A. Certainly, a buy-sell agreement is another way of essentially getting oil from point A, where it is produced, to point B, where it can be certain downstream activities can occur.
>
> Q. Would it be fair to say that that is just another way to transport oil?
>
> A. Yes. It is another acceptable -- commercially acceptable mechanism to get oil from where it is produced to where it can be further utilized.

(Transcript of Proceedings, Vol. 3, Jan. 15, 1997, at 434.)

stream of equal volume from the same pipeline, truck, tanker, train or transportation vehicle.

(4) A fourth problem with the definition of "exchange" is that the regulations fail to address net-out agreements and overall balancing arrangements. Net-out agreements are not referenced as exchanges by the oil companies. We believe that net out agreements should be subject to Sect. 206.102(a)(6) because such agreements reflect reciprocal arrangements between buyers and sellers. But to be clear we would suggest that MMS define net out agreements as equivalent to exchange agreements. Net-out agreements are agreements in which two companies agree to keep the volumes of crude on all their transactions in balance. They are sometimes referenced in outright purchases and sales. Net-out agreements function in effect as super exchanges, a clearinghouse for all of the purchases, sales and exchanges involving two companies.

(5) A fifth problem with the proposed definition of "exchange" is that it fails to address exchanges involving crude oil for products. Oil companies from time to time exchange crude oil for finished or unfinished products. Just as much as exchanges involving crude oil for crude oil, such exchanges can hide the true value paid for royalty crude oil. A nominal price paid for the royalty oil can be supplemented by discounts on products that are concurrently purchased by the company selling the royalty oil which would affectively result in a premium on the royalty crude.

E. THE PURCHASE OF CRUDE OIL BY A ROYALTY HOLDER AFTER THE SALE OF ROYALTY CRUDE SHOULD BAR THE USE OF THE GROSS PROCEEDS METHOD, SECT. 206.102(a)(6)

We agree with MMS that MMS's proposed regulations which would preclude use of an alleged arm's-length contract price paid by a purchaser or its affiliates as value when during the two years preceding the production month the royalty holder or its affiliate bought oil, gas or any other goods or services from that same producer, Sect. 206.102(a)(6). Such purchases by the royalty owner cast doubt on whether the price received for royalty crude reflects the market value of the crude. MMS has correctly pointed out that the prices for crude stated in exchanges or buy/sells often hide the real consideration for the transaction.

We believe that this proposed regulation does not go far enough in two respects. First, we think that the regulation should be applied not only to purchases from other producers but to purchases from any other oil company from which the royalty holder or its affiliate bought oil, gas or any other goods or services.

Second, the proposed regulations make no provision for the situation in which a reciprocal purchase takes place after the royalty crude is sold. A federal royalty lessee may sell its federal royalty oil in one month and use the gross proceeds method of valuing the production, even though the lessee has agreed to purchase crude from the buyer of its royalty oil in a subsequent month. The regulations should provide that the royalties will be reevaluated if the lessee purchases crude from its purchaser within a given time period, such as, three months after the sale of royalty crude.

F. <u>IF THE GROSS PROCEEDS METHOD IS TO BE USED AT ALL, IT SHOULD BE LIMITED TO SALES OF FEDERAL ROYALTY OIL BY INDEPENDENT PRODUCERS</u>

The apparent rationale of MMS in maintaining the gross proceeds methodology is to protect independent producers from paying royalties on the basis of index prices when they are unable to realize an index price in their sales of royalty oil. 62 Fed. Reg. 3744. Although we maintain that the gross proceeds methodology is never appropriate, if it is used at all, it should be reserved for independent producers. We propose that the regulations define independent producers as those producers who do not refine crude oil and who do not produce more than 10,000 barrels per day in any one state. We propose further that, if the gross proceeds method is to be retained, the gross proceeds method be available only to independent producers.

III.

<u>THE VALUATION OF FEDERAL ROYALTY OIL IN CALIFORNIA NOT SOLD UNDER AN ARM'S-LENGTH CONTRACT, SECT. 206.102(c)(2)(ii)</u>

A. <u>California Should Have a Different Market Indicator From the Rest of the Country</u>.

We agree with MMS that the California oil market is sufficiently distinct from markets in the rest of the country that federal royalty oil produced in California should have a different market index value from that of the rest of the country. California obtains most of its oil from Alaska and California. Comparatively little California crude is exported. As the oil companies and the federal government have long recognized, California constitutes a separate market for crude oil.

B. <u>The Price of ANS Landed in California is the Appropriate Index For Valuing Federal Royalty Oil</u>.

West Coast Refineries have consumed ANS in very large quantities since the early 1980's. ANS crude competes directly with California crude oils as refinery feedstocks in California. Most refiners in California have for years run some volume of ANS and some refiners ran large quantities. For example, during the period 1982 through 1995, California refiners ran an average of 725,000 barrels per day of ANS crude oil, which represents over 40% of the total crude run in California refineries [see Graph A, attached].

Since the early 1980's, all California refiners have viewed ANS as the one crude that was available in adequate supply if needed to supply their refineries. Because of its availability and the large quantity consumed by California refiners, the market price of ANS should be the basis for a competitive price for California crude oils. Yet, from the early 1980's through the present, the market price of ANS on the West Coast has been significantly higher than posted prices of similar California crudes (adjusted for location) such as Ventura, Signal Hill and

Buena Vista [see Graph B, attached]. It is priced significantly higher than all California crudes adjusted for quality and for location. ANS spot prices are reported publicly on a daily basis in national publications such as the Wall Street Journal, Platts, Bloomberg, and others.[5] We recommend use of an average of the prices reported.

Oil company documents produced to the City of Long Beach and the State of California show that the major oil companies, including the posters, evaluated the actual value of California crudes by comparing them to the spot prices paid for ANS in California. The price of ANS in California was viewed by the oil companies as the market value of crudes.[6]

C. <u>Posted Prices Do Not Reflect The Market Value of California Crudes</u>.

There is overwhelming evidence that posted prices in California have not reflected the market value of California crude for many years. This evidence includes:

- The price of ANS crude landed in California is higher than posted prices for comparable California crudes and for California crudes adjusted for quality differences and transportation costs [see Graph B, attached].

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[5] Dow Jones/Telerate; Oil and Gas Journal Energy Database; Oil Price Information Service (OPIS); Petroleum Argus; Petroleum Intelligence Weekly; Reuter's; The Oil Daily.

[6] Final Interagency Report On The Valuation Of Oil Produced From Federal Leases in California, 5/16/96, Appendix IV.

- Sell-offs of California crudes by the City of Long Beach, the State of California and the federal government consistently yield bonuses over posted prices.
- Arco has been selling large volumes of Wilmington crude at prices above postings.
- Spot prices of California crudes that are centered around Arco's common carrier pipelines are consistently above postings.
- Oil companies, including major oil companies, have paid bonuses over posted price for years.
- Posted prices for California crudes are consistently below market prices for comparable crudes in the Gulf Coast area.

Based on these and other facts, MMS has correctly rejected posted prices for valuing federal royalty oil in California.

IV.

THE VALUATION OF FEDERAL ROYALTY OIL OUTSIDE OF CALIFORNIA NOT SOLD UNDER ARM'S-LENGTH TRANSACTIONS, SECT. 201.102(c)

A. The NYMEX Price is a Valid Indicator of the Market Price of United States Crudes Outside of California.

The NYMEX price is uniquely qualified as an indicator of the market value of crudes. Unlike posted prices, which are the result of unilateral decisions by individual oil companies with no public accounting as to how they are determined the NYMEX crude transactions constitute a huge volume of crude in a market that is public and has a very large number of oil company participants. Millions of barrels of crudes are bought and sold each day [see Graph C, attached]. The number of barrels traded on NYMEX exceeds the total world production of crude oil [see Graph D, attached]. The NYMEX price is established by trading which cannot be controlled by any one oil company or small group of oil companies. The closing price on the NYMEX reflects a fair market value since it represents the consensus of a large number of willing buyers and sellers regarding the value of a standard quality of crude oil at a given point in time at a specified location. Because there are many different and diverse participants in the market with differing interests, it cannot be controlled or manipulated by one company or a few companies.

The price quoted on NYMEX has become a market benchmark for the pricing of all domestic crude oil, except possibly California crudes, and provides a dominant international price signal. A number of foreign crudes, including Saudi Arabian crudes, are linked in their contract prices to the NYMEX price. The State of Alaska has tied the price of ANS in part to the NYMEX price.

B. Posted Prices for Non-California Crudes Do Not Reflect Market Value.

Posted prices for crudes outside of California do not reflect market values of those crudes. There are a number of indicators that posted prices for crudes outside of California do not reflect the market value of crudes. The evidence includes the following:

- The posting-plus market since 1988 shows Texas oil almost always commanding a premium over posting [see Graph E, attached].
- Comparisons of the NYMEX or WTI spot prices with the posted prices of WTI crudes indicate that at least since 1987, the NYMEX and WTI spot prices have exceeded postings on average by $.70 per barrel adjusted for transportation [see Graph F, attached].
- A comparison of the spot price of WTS with the posted price for WTS indicates that since 1987 the posted price has ranged from the low of $.30 to as much as $2.70 per barrel below the spot price of WTS adjusted for transportation [see Graph G, attached].
- The companies which post WTI, WTS and many other crudes East of Rockies consistently post different prices from one another indicating that none of them can be accepted as the market price for WTI.
- Sell-offs conducted by the Texas General Land Office and the University of Texas have yielded bonuses over posted price since 1989.

- Phillips admitted in 1992 that posted prices should be equal to the NYMEX price less the cost to transport crudes from the lease to Cushing, Oklahoma, but all available evidence indicates that it has not.
- Arco settled royalty claims with various states and other royalty holders East of Rockies in 1993 by making payments reflecting prices above postings.

V.

PURCHASES OF CRUDE OIL

The regulations should define "purchases" as meaning "outright purchases," i.e., purchases which are not tied to reciprocal sales. Section 206.102(a)(6) prohibits the use of the gross proceeds method if the lessee purchased crude oil from an unaffiliated company in the last two years. Section 206.102(a)(4) prohibits the use of the gross proceeds method if the royalty crude is disposed of on exchange. Exchanges are defined to include buy/sells. Section 206.102(a)(4) would appear to be superfluous if the reference to purchases in Section 206.102(a)(6) includes not only outright purchases but also exchanges and buy/sells.

VI.

DETERMINATION OF TRANSPORTATION ALLOWANCES

AND OTHER ADJUSTMENTS, SECT. 206.105

We agree with MMS that the index prices should be adjusted for location and quality. The objective of the regulations is to base royalties on the value of federal crude at the lease. The value of federal crude at the lease will differ from that of index crudes depending on location and quality. We agree also that quality adjustments include gravity and sulfur componants. We have objections to some of the proposed regulations as to how adjustments for quality and location in California would be made.

The proposed regulations in some places recognize the distinction between a location differential and a quality differential and provide separate definitions of each. 62 Fed. Reg. p. 3752. In other places the regulations confusingly refer to a "location/quality differential" as if there was no difference between location and quality differentials. For example, the regulations provide an allowance for "a location/quality differential that MMS will publish annually based on data MMS collects on Form MMS-4415. MMS will calculate <u>that</u> differential ...." Sect. 206.105(c)(1)(iii). The regulations should avoid the inherently confusing terminology of a "location/quality differential."

The proposed regulations refer to a "arm's-length exchange" in several places, <u>e.g.</u> 62 Fed. Reg. 3755 without defining the term. Elsewhere, MMS recognizes that the price terms in an exchange often do not reflect the value of crudes traded because the price terms are not arm's-length. MMS should define "arm's-length exchange" in such a way that MMS does not appear to be endorsing the price terms contained in exchanges but only the differentials contained in such exchanges.

A. Quality Adjustment

We agree with MMS that a quality adjustment should be made as between the index crudes and the federal royalty crude where royalty crude differs in quality from the quality of the index crude being used. We disagree with the method by which MMS proposes to arrive at quality differentials. The proposed regulations would obtain information from the oil companies based on their exchanges to determine an appropriate quality adjustments. Based on our experience reviewing oil company exchanges, exchanges frequently do not separate quality and location differentials. They often contain a single differential which represents a combination of quality and location factors. Thus, exchanges usually will not provide information which would be sufficient to allow MMS to identify the quality component of a differential to permit an adjustment between royalty crude and index values.

We propose that for federal production in California the regulations adjust for differences in gravity by using the gravity bank used on the Arco common carrier pipeline system in California. The gravity bank is the result of arm's length negotiations among oil companies. We propose also that the regulations adjust for differences in the percentage of sulfur in royalty crude oil in California versus ANS by the sulfur bank used on the All-America Pipeline tariff, which is the result of arm's-length negotiations among oil companies. The gravity bank and sulfur bank information is public and does not necessitate any reporting by the oil companies or monitoring by MMS. We believe that outside of

California gravity banks and sulfur banks in common carrier pipelines should be used to adjust for quality and sulfur differences from WTI.

B. Location Adjustments

We agree that the index crudes should be adjusted by actual cost of moving crude oil from the lease to the market centers.

We agree with MMS's approach to obtain information from the oil companies as to transportation costs. We propose that MMS use a modified version of the Oil Location and Differential Report ("Report") (see below).

Producers of OCS California crude should be limited to a transportation allowance reflecting the cheapest alternative as between transporting the royalty crude to Los Angeles or San Francisco. OCS crude, such as Pt. Arguello crude, is presently transported both to Los Angeles and San Francisco. The transportation deduction rules should not make the OCS producers economically indifferent in their choice of whether to transport OCS crude to Los Angeles or San Francisco. Producers would be indifferent if they were permitted to deduct the full cost of transportation to one destination even if that cost were higher than the transportation cost to the other destination. Thus, MMS should require that any transportation deduction for California OCS crude be limited to the cheaper alternative, and MMS should determine which destination is cheapest for each OCS lease in California.

VII.

MMS SHOULD NOT PERMIT A SEPARATE VALUATION METHODOLOGY FOR CRUDE WHICH IS MOVED TO ALTERNATE DISPOSITION POINTS

It is clear that MMS's overall objective in proposing the new regulations is to ensure that royalties are based on the value of production at the lease. This admirable goal has been compromised by a separate valuation for royalty crude in California moved to "alternative disposal points" which bypass aggregation points. Sect. 206.105(c)(3)(ii). The valuation methodology for crude moved to alternative disposal points is objectionable because: (1) it does not even attempt to measure the market value of crude at the lease; (2) it effectively abandons ANS valuation and replaces it with thinly traded spot prices; (3) it permits double recovery of transportation costs; and (4) it permits lessees to deduct the entire cost of transporting royalty crude to any destination in the United States, if not offshore. We propose that for all of these reasons the regulations not provide for a separate valuation methodology for movement of royalty crude to alternate disposition points.

1. <u>The Valuation Methodology For Crude Oil Moved To Alternate Disposition Points Fails To Measure The Market Value Of That Crude At The Lease</u>.

The methodology for calculating royalties for crude oil which is moved to alternate disposition points does not attempt to measure the market value of royalty crude oil. It permits adjustments which should not be considered in determining the market value of crude, such as the deduction of all transportation costs, even if they exceed transportation costs from the lease to market centers.

The market value of a crude at the lease does not change depending on its destination. There is only one market value of a given crude at a given lease, and thus all federal crude should be evaluated the same way, irrespective of where it is shipped. The same valuation methodology should be used for crude moved to alternate disposition points as crude moved to MMS recognized market centers.

2. <u>The Proposed Regulations For Movement To Alternate Disposition Points Abandon ANS Index Pricing</u>.

Where the lessee moves lease production to an alternate disposal point, the lessee subtracts from the ANS price the difference between (a) average spot prices for the production month at the aggregation point nearest the lease for which spot prices for like-quality crude oil are published; and (b) the spot prices of ANS crude oil at the associated market center/index pricing point (62 Fed. Reg. p. 3748 and Sect. 206.105(c)(3)(ii)). The result of this adjustment is that the spot prices become the sole measure of the value of the royalty crude. The formula is "ANS-(ANS-spot prices)=spot prices". We object to any proposal which would reject ANS as the basis for measuring the market value of California royalty crude oil.

MMS elsewhere recognizes that spot prices for California crudes do not attach to large enough volumes for MMS to recommend that they be used to value royalty oil. 62 Fed. Reg. p. 3745.[7] We object to any use of spot prices for valuation of royalty crude oil in California.

3. <u>The Proposed Regulations Permit A Double Allowance For Transportation Costs For Crude Oil Moved To Alternate Disposal Points</u>.

Section 206.105(c)(2)(ii) provides that a company which moves its lease production directly to an alternate disposal point, and does not move it through an aggregation point (for example when a company moves its federal production directly to its own refinery) computes its location differential by adding (a) its actual cost of transporting its production to its refinery, and (b) the difference between the ANS price and the spot price at the aggregation point nearest the lease. 62 Fed. Reg. at p. 3755. The spot price of crude at the aggregation point nearest the lease reflects not only the quality of the crude but its location relative to the market centers, for example, Los Angeles and San Francisco. The spot prices reflect in part the cost of moving the crude from the aggregation point to a market center. Thus, the proposed regulations permit double dipping of transportation cost deductions.

For example, assume producer A moves Midway-Sunset crude from the lease directly to its refinery in Bakersfield, bypassing any MMS listed aggregation points. Under such circumstances the

[7]From the period 1985 to the present, Kern River spot prices have averaged only 4 cents higher than posted prices.

producer is allowed to deduct its actual transportation costs plus the actual difference between the spot price of ANS and the spot price of Kern River crude (the spot price of a crude at an aggregation point nearest the lease). Because the spot price of Kern River is quoted at the lease, it already includes an implicit transportation deduction relative to the value of ANS at the market center. Thus to allow this difference along with a deduction for actual transportation costs would constitute a double deduction for transportation.

4. The Proposed Regulations Permit Full Deduction Of Transportation Costs From The Lease To Any Alternate Disposal Point To Which The Lessee Chooses To Send Its Crude.

If the lessee moves crude directly to an alternate disposal point it is permitted to deduct the actual transportation costs from the lease to the alternate disposal point. The proposed regulations place no restriction whatsoever as to where the alternate disposal point can be relative to the lease. Failure to provide for such a limitation means that, for example, a federal lessee in California can move crude to its refinery in the Gulf Coast and deduct the entire transportation costs. Moreover, the proposed regulations provide an unintended incentive to ship crude by truck, because trucks bypass aggregation points. We propose that the maximum transportation cost deduction be no more than the cost of moving the crude by pipeline from the lease to the nearest market center, e.g., Los Angeles and San Francisco on the West Coast.

VIII.

OIL LOCATION AND DIFFERENTIAL REPORT

We believe that the Oil Location and Differential Report ("Report") is deficient in the following respects: (1) it provides no guidelines for determining appropriate transportation costs; and (2) it assumes falsely that exchanges in California move crude from aggregation points to market centers and that transportation cost information from aggregation points to market centers is readily available to the oil companies.

First, in order for the reported transportation costs to be meaningful, the Report should limit information about transportation costs to transportation differentials used in in/out exchanges, i.e., exchanges of the form "A places crude in B's pipeline and B delivers an equal volume of the same or similar crude back to A at a point further down the pipeline." Another type of exchange contains location differentials in which the crude receipt and delivery points are not on the same pipeline. This type of exchange provides no basis for determining actual transportation costs from the lease to the market centers. We propose that the Report seek information concerning transportation costs as reflected only in transactions wherein the receipts and deliveries of crude are on the same pipeline.

Second, in our experience with the California market, exchanges take place at the lease and not aggregation centers. The Report seems to be based on the premise that exchanges take place at aggregation points and will show the cost of transportation from aggregation points to market centers.

MMS should make clear that the transportation data requested in the Report is not limited to transportation from aggregation points to market centers.

We have some additional minor comments about the Report. Under Contract Type and Id, the information requested is too narrow. Some contracts which the oil companies designate as exchanges are nonetheless not non-cash. Therefore, the second box should be captioned simply "Exchange." There should be a fourth box as well, called "Other" to take into account new types of transactions. Also, the buy/sells of oil companies usually have two contract numbers, one for the buy side of the transaction and another for the sell side of the transaction. Therefore, "(s)" should be placed after the word "number."

IX.

RIK VALUATION

The MMS proposal with regard to the RIK valuation is too vague. MMS proposes to tie the RIK valuation to the index pricing provisions of 30 CFR 206:102(c)(2). If this proposal means that RIK crude would be valued according to the same adjustments and transportation allowances as other federal royalty oil, then we would have no objection. Otherwise MMS should specify in detail how RIK oil is to be valued.

CONCLUSION

We appreciate the opportunity to present comments on MMS's proposed regulations. We are pleased with MMS's decision to move to market based indicia of the value of federal royalty crude oil. We hope that our comments are useful in MMS's final formulation of its regulations.

Respectfully submitted,

James N. McCabe
Deputy City Attorney

MBM:apm
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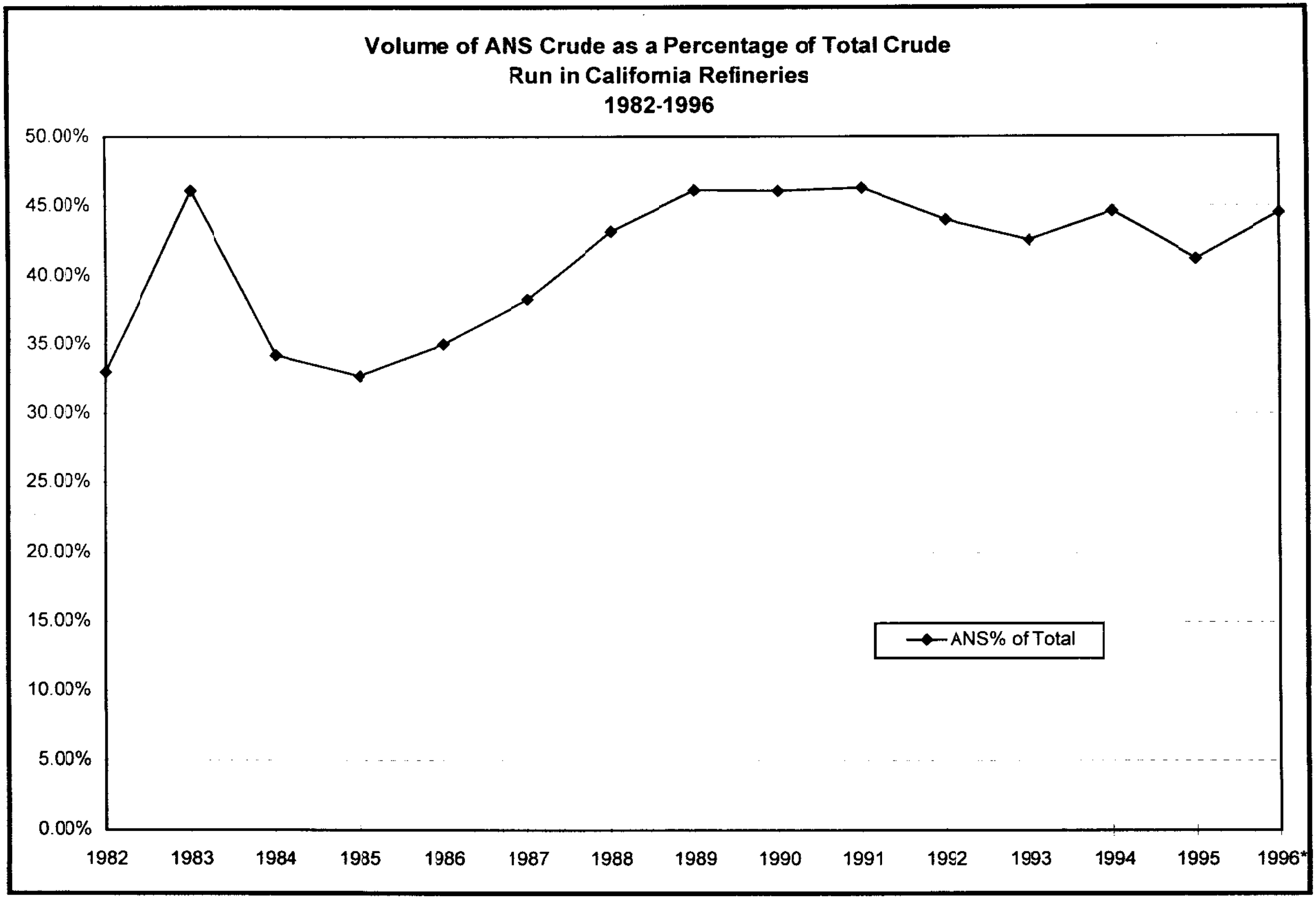
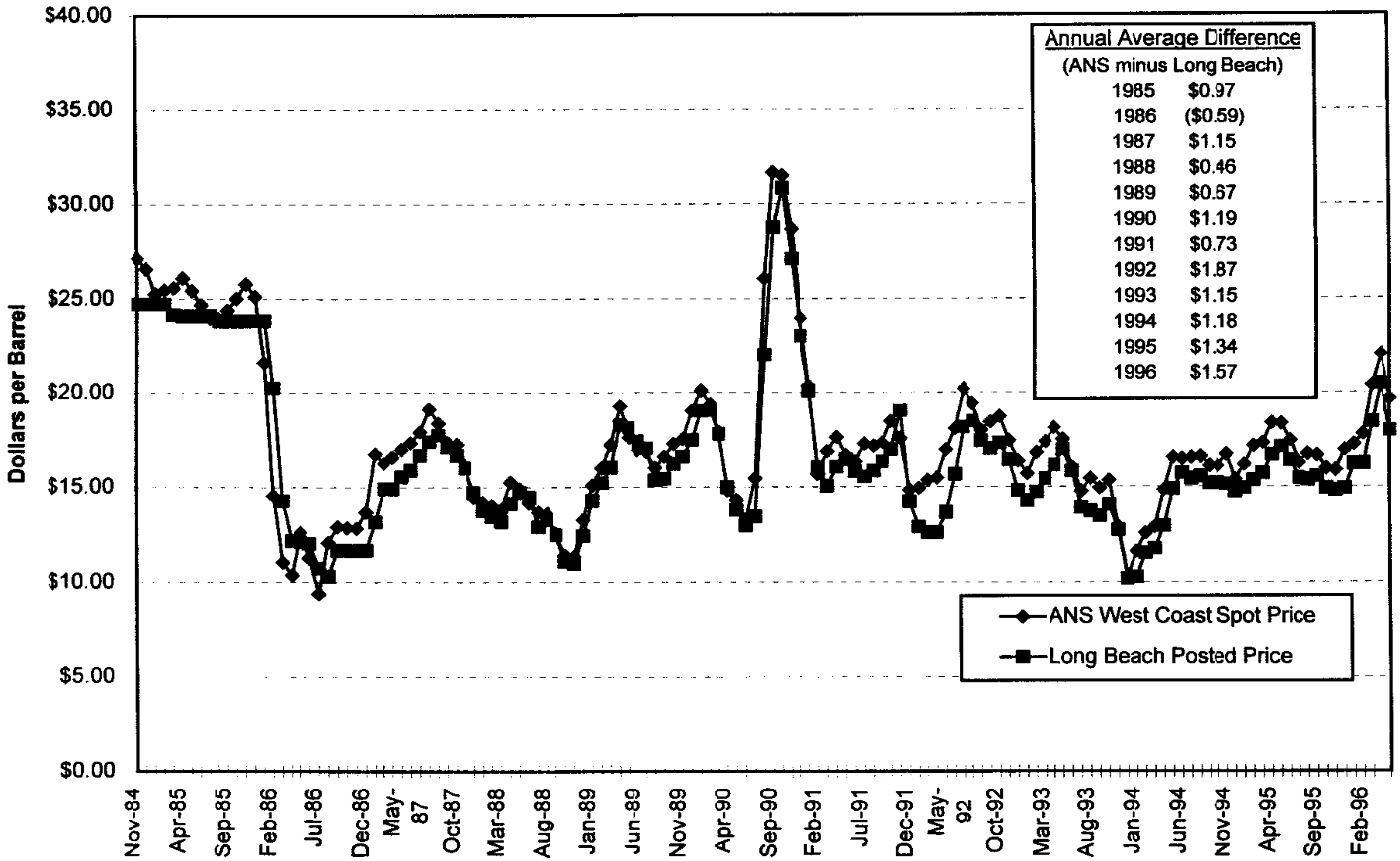


*1996 data are for first half of the year only.

Graph A

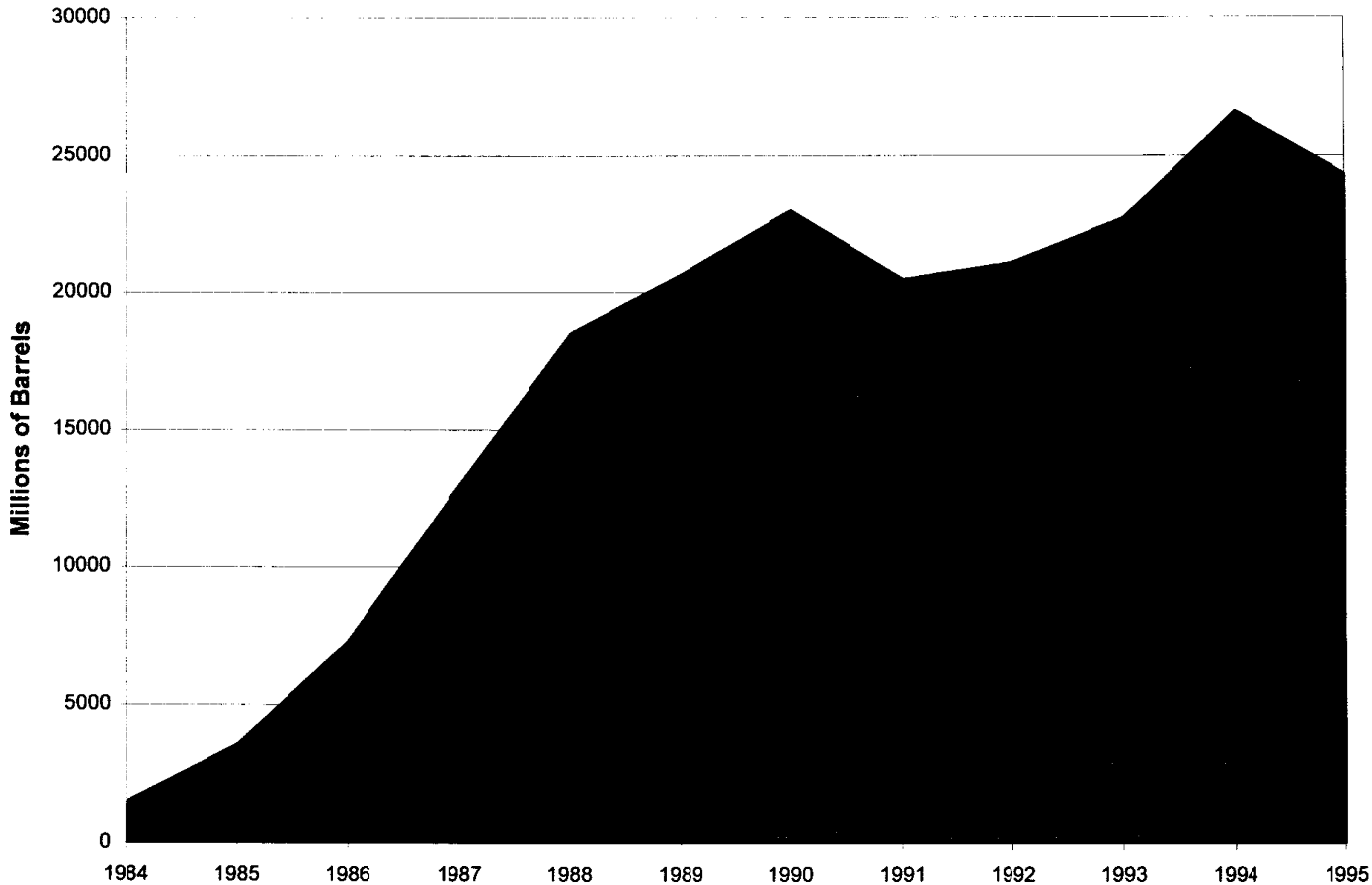
ANS West Coast Spot Prices vs. Long Beach Posted Price
November 1984-May 1996



Source: Telerate: 1984-87, DRI/Platt's: 1988-1996

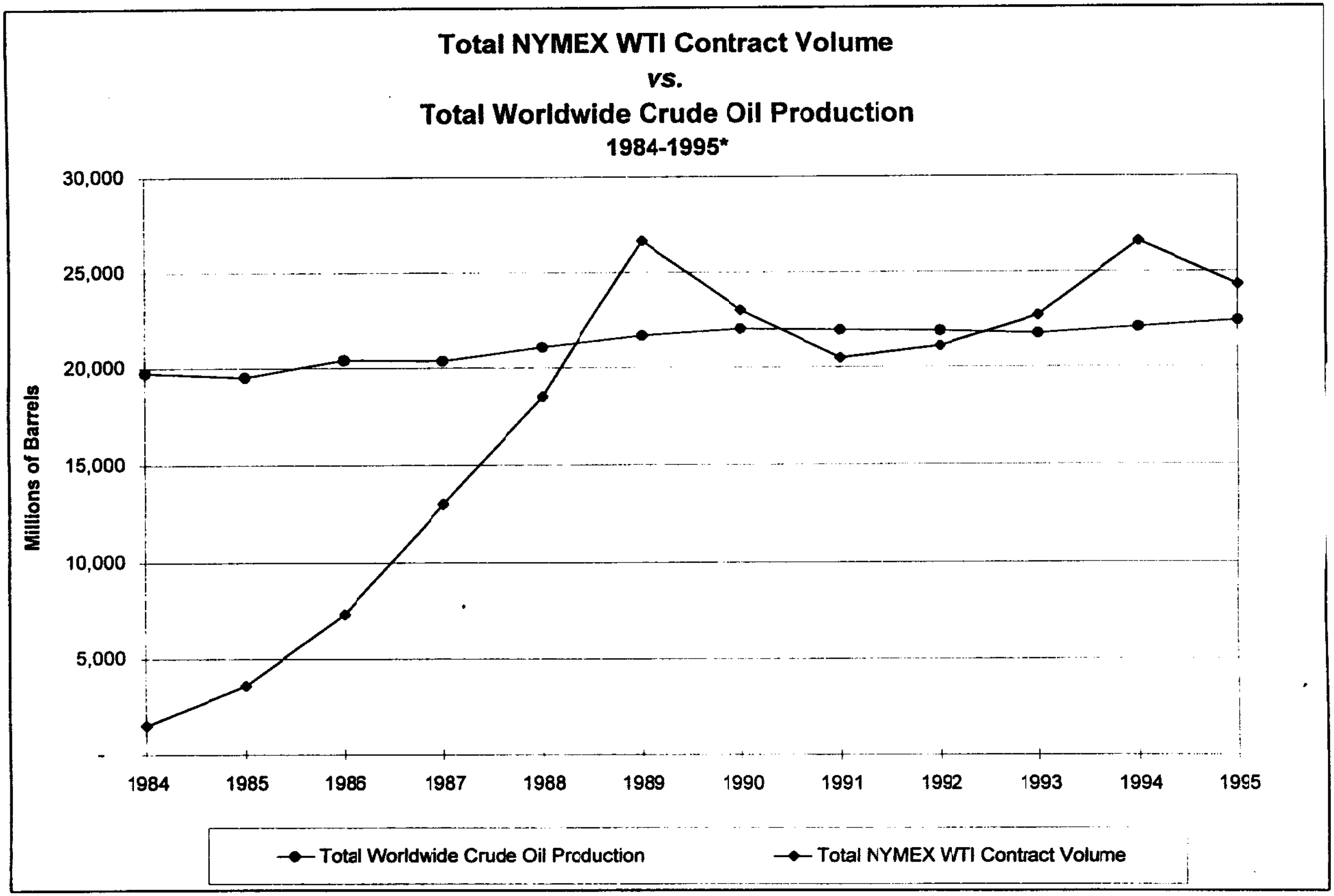
Graph B

NYMEX Volume of Crude Oil Futures Transactions



Source: Horsnell Mabro (1993), NYMEX

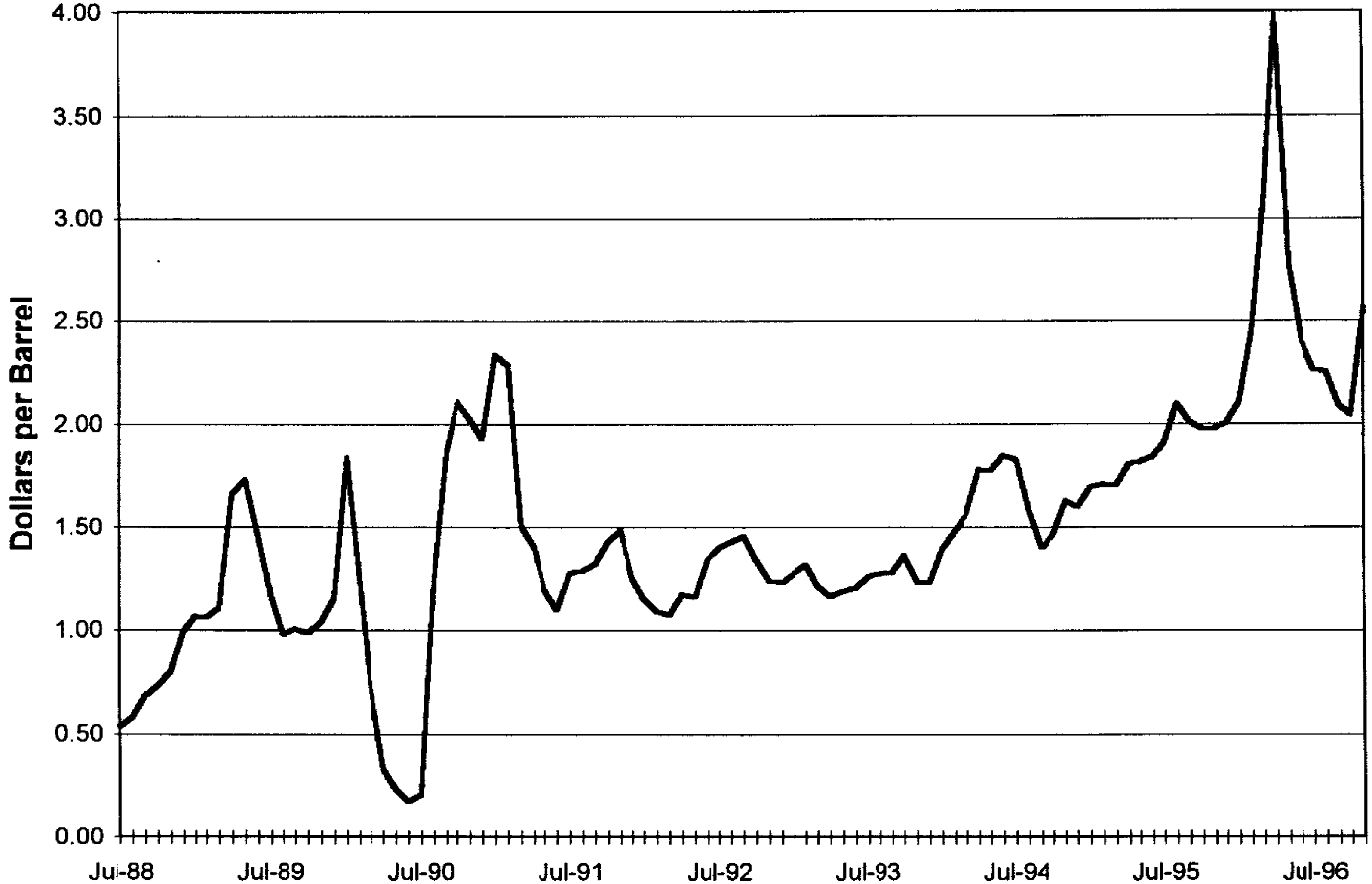
Graph C



*1995 worldwide production is estimated
Sources: Oil and Gas Journal Publications, NYMEX Stats

Graph D

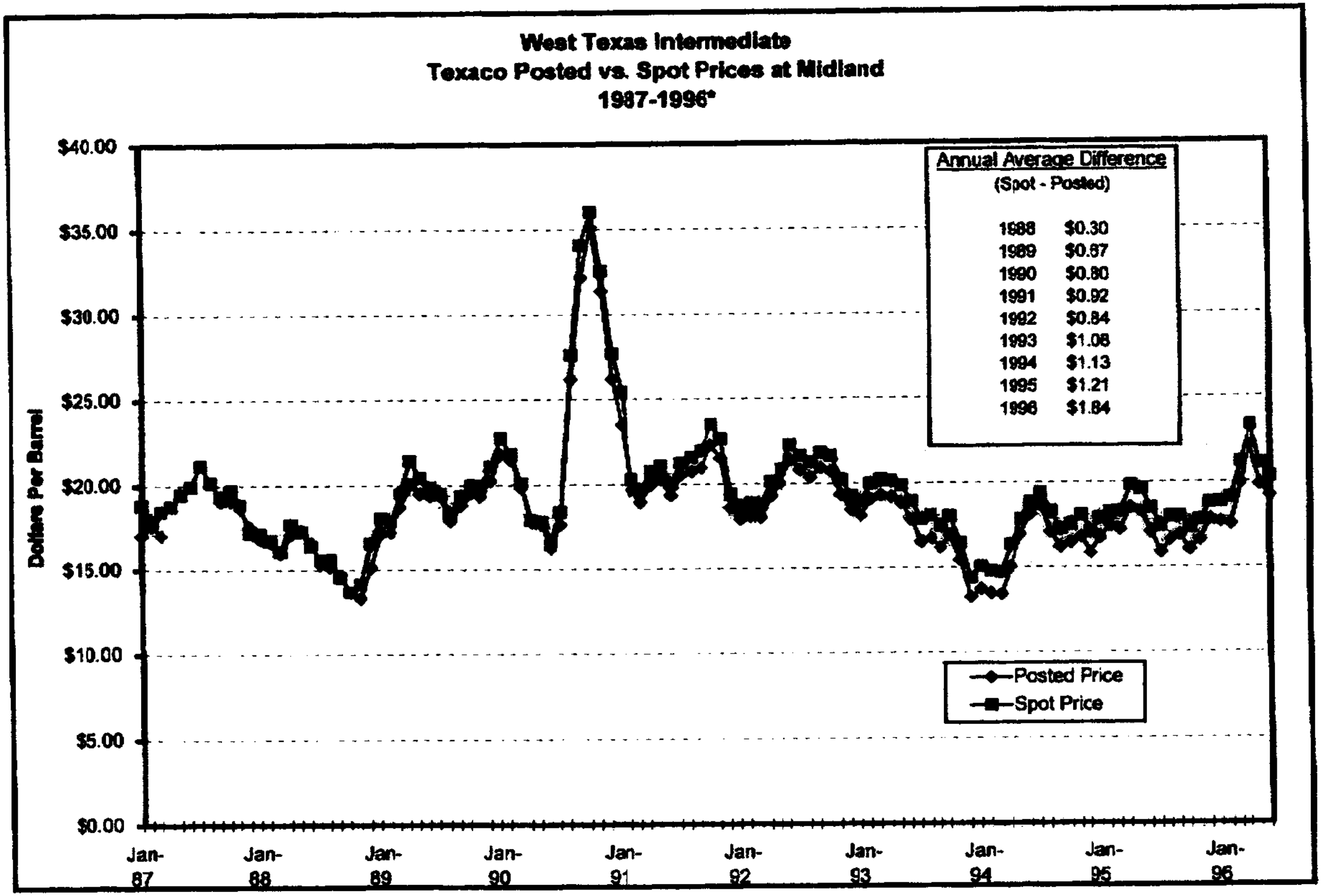
P-Plus Premium Over WTI Posting
July 1988 - December 1996



Source: Platt's.

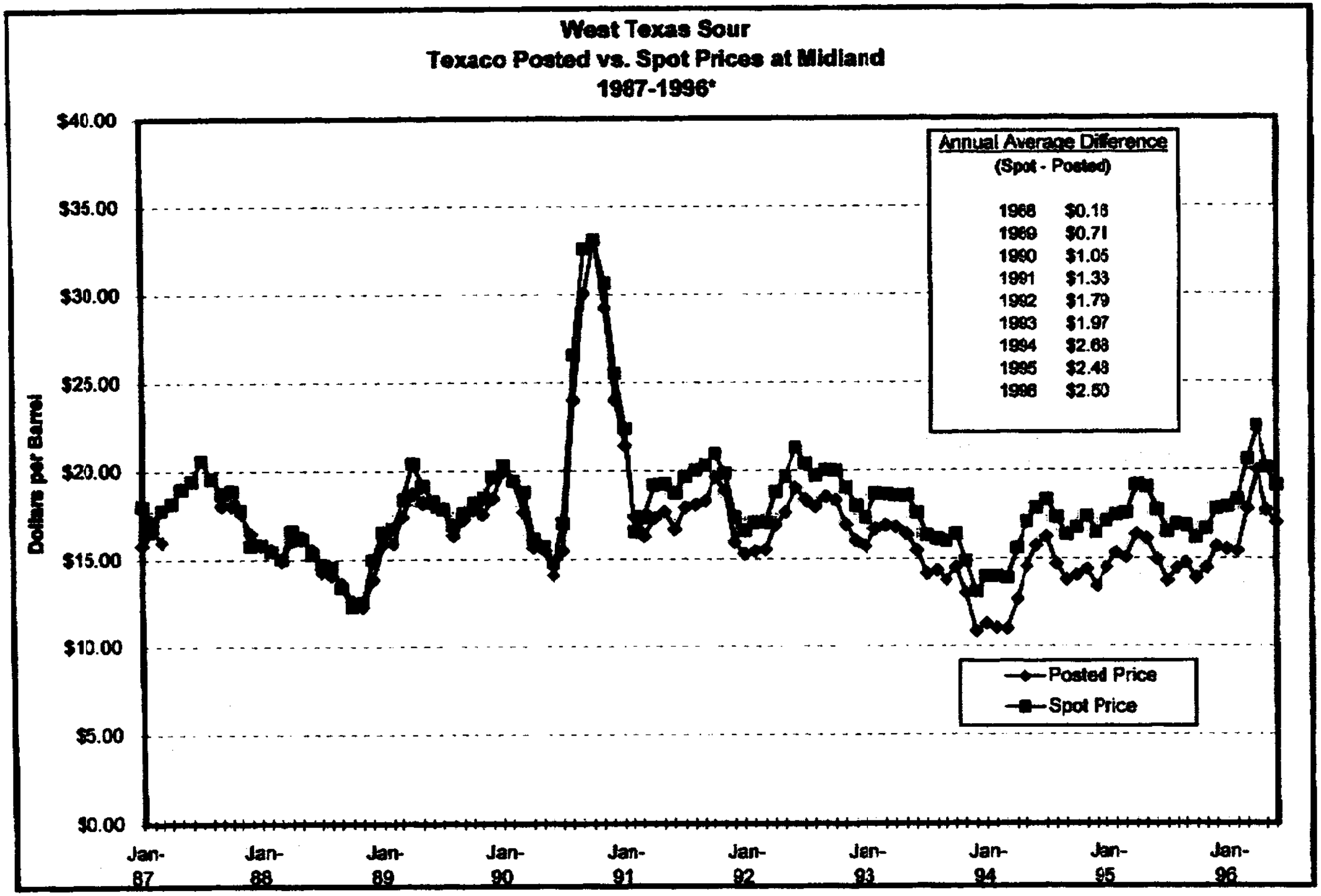
All premia are monthly averages.

Graph E



Statistics are monthly averages. Posted Prices are adjusted for Transportation Costs. *1996 data are for first half of the year only.

Graph F



Statistics are monthly averages. Posted Prices are adjusted for Transportation Costs. *1996 data are for first half of the year only.

Graph G