

Section 23

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SUPERIOR COURT OF THE STATE OF CALIFORNIA  
FOR THE COUNTY OF LOS ANGELES

HONORABLE JACK TENNER, JUDGE PRESIDING (RETIRED)

PEOPLE OF THE STATE OF CALIFORNIA, )  
et al., )

Plaintiffs, )

vs. )

CHEVRON CORPORATION, et al., )

Defendants. )

No. C-587912

-----)  
REPORTER'S TRANSCRIPT OF PROCEEDINGS

Los Angeles, California

Thursday, February 11, 1993

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2523

1 you have that in your packet; is that right?

2 A. Yes, that is correct.

3 Q. What does 3083 show?

4 A. This is a list of pipelines, the major  
5 pipelines, that move crude out of the San Joaquin  
6 Valley. It shows their capacities, it shows the  
7 capacity of the Shell unit train, it shows an estimate  
8 of the amount of crude that is trucked, and then it has  
9 two other numbers showing consumption of crude oil in  
10 the San Joaquin Valley, and then it also shows some  
11 total production figures, some total capacity figures.

12 Q. And this shows the figures for all crude  
13 oil produced in the San Joaquin Valley?

14 A. That is correct.

15 Q. Why did you look at it in terms of all  
16 crude oil rather than just heavy crude?

17 A. That gives the best indication of what  
18 capacities are. When you look at heavy crude, there are  
19 a number of ways in which heavy crude can be transported  
20 and used, and one gets into certain ambiguities about  
21 how the crude is being transported or used if you focus  
22 just on heavy crude.

23 Q. Where did you get the figures for pipeline  
24 capacity shown on Exhibit 3083?

25 A. Several sources. My main source was

1 Mr. Ronco's article in The Oil and Gas Journal. There's  
2 a number of sources for the All American line. Oil and  
3 Gas Journal, the Point Arguello Pipeline Study was a  
4 source.

5 For the Four Corners system I originally  
6 got that number from the Point Arguello study, but then  
7 it was confirmed by the Ronco Oil and Gas article as  
8 well.

9 The Shell 48,000 barrels per day for the  
10 unit train -- I actually used the testimony here in this  
11 case as well as the Ronco article in The Oil and Gas  
12 Journal.

13 Total production came from the Division of  
14 Oil and Gas or the CCCOP.

15 Refineries. There is an Oil and Gas  
16 listing of refineries in the San Joaquin Valley.

17 Enhanced oil recovery. That also came  
18 from The Oil and Gas Journal as well as some Energy  
19 Commission sources as well.

20 Q. I see from the figures on the chart that  
21 the total pipeline capacity out of the San Joaquin  
22 Valley is some 960,000 barrels per day?

23 A. That is correct.

24 Q. If you add the unit train and trucking  
25 capacity, you get over a million barrels per day?

1 A. Yes, that is correct.

2 Q. What is the total San Joaquin Valley  
3 production of crude oil?

4 A. It is just beneath that. It is 702,000  
5 barrels per day. This is in 1987.

6 Q. Some San Joaquin Valley production was  
7 actually consumed in the valley?

8 A. Yes, that is correct.

9 Q. Where did you obtain the figures for  
10 refinery consumption and enhanced oil recovery use?

11 A. Primarily from the Oil and Gas Journal.  
12 The enhanced oil recovery gives you a total number, and  
13 then there is a rule of thumb, which is it takes a  
14 barrel to produce four barrels, and so I applied that  
15 rule of thumb.

16 Q. Your figure for total local consumption is  
17 222,000 barrels per day?

18 A. That's correct.

19 Q. And that leaves a net production of  
20 480,000 barrels per day to be transported out of the  
21 San Joaquin Valley?

22 A. Yes, that's right.

23 Q. And how does that compare with the  
24 pipeline capacity out of the valley?

25 A. It's less than half.

1 Q. Have you done the same kind of analysis  
2 for heavy crude produced in the San Joaquin Valley?

3 A. I have. I've had to make some assumptions  
4 to do that. I can tell you what they are.

5 Q. Let me put up Exhibit 3084 and ask you to  
6 turn to that. Is Exhibit 3084 similar to the chart  
7 we've just been looking at except that it focuses on  
8 heavy crudes?

9 A. Yes.

10 Q. And how did you define heavy crudes?

11 A. I defined it as anything 20 degrees or  
12 under.

13 Q. And in this case I see that you have  
14 concluded that the total production of heavy crude in  
15 the San Joaquin Valley in 1987 was approximately 554,000  
16 barrels per day?

17 A. Yes, that's correct.

18 Q. That figure is fairly close to what the  
19 plaintiffs' expert estimated for 1985?

20 A. I believe so.

21 Q. And how did you arrive at that number?

22 A. That number actually came from a group  
23 called Economic Insights, which I believe was based on  
24 California Division of Oil and Gas and the CCCOP.

25 Q. The pipeline capacities shown for heavy

1 crude on the top of Exhibit 3084 are slightly different  
2 in some cases than they were on 3083. Can you explain  
3 those differences.

4 A. Yes. The first four are identical. These  
5 are heated or heatable lines, so that their capacity to  
6 move heavy crude is the same as their capacity to move a  
7 lighter blend. The next lines, except for the Unocal  
8 Avila line, are not heated. I used a rule of thumb. I  
9 just reduced the capacity of the line to one third of  
10 its capacity to run a light stream. That is, I reduced  
11 it by a total of two-thirds.

12 So, for example, on the Chevron KLMR line,  
13 it is a 90,000-barrel-per-day line. I took 30,000  
14 barrels per day as its capacity to move heavy crude.

15 Q. And the heavy crude would be moved as a  
16 blend with light crude?

17 A. Yes, that's correct.

18 Q. All right.

19 A. I believe that is very conservative, by  
20 the way.

21 Q. In the case of Four Corners, the capacity  
22 you arrived at then was 43,000 barrels per day?

23 A. Yes.

24 Q. 24,000 barrels per day for the Unocal line  
25 going north?

1 A. Yes.

2 Q. Do you know what some of the components  
3 that run in that pipeline in addition to heavy crude?  
4

5 A. The "Unocal (McKittrick-Rodeo)"?

6 O. Yes.

7 A. It picks up some coker gas oils from the  
8 Santa Maria refinery and runs that up as well as heavy  
9 and light crudes to Rodeo.

10 Q. Looking at the total transportation  
11 available, including the unit train and truck modes, for  
12 heavy crude oil, what was the figure that you arrived at  
13 in terms of barrels per day for 1987?

14 A. 814.

15 Q. And the total production -- Let's talk for  
16 a moment about heavy crude used for local consumption in  
17 the San Joaquin Valley.

18 Enhanced oil recovery, I see, is the same  
19 108,000-barrel-per-day figure as on Exhibit 3083; is  
20 that correct?

21 A. Yes.

22 Q. Is that because heavy crude is used as  
23 fuel for enhanced oil recovery operations at the lease?

24 A. Yes, and because enhanced oil recovery is  
25 typically in heavy fields such as in the Kern field.

Q. What did you use for the local refinery

1 consumption figure?

2 A. That 8,000 barrels per day is actually the  
3 production of asphalt in the San Joaquin Valley. I have  
4 since found out that that is much less than the amount  
5 of crude that is actually used.

6 THE COURT: Is that because those  
7 refineries cannot refine heavy crude?

8 THE WITNESS: Oh, they do, your Honor.

9 THE COURT: Why does it drop from 114 to  
10 8?

11 THE WITNESS: Many of them do not run  
12 heavy crude, but --

13 THE COURT: Well, that's my question.

14 THE WITNESS: Yes, sir, that's correct.

15 THE COURT: Is that the difference in the  
16 drop?

17 THE WITNESS: Yes, that explains it.

18 THE COURT: All right.

19 BY MR. JUDSON:

20 Q. You used asphalt production as a surrogate  
21 for crude runs to get that 8,000-barrel-per-day figure?

22 A. Yes.

23 Q. Have you since looked at the data and  
24 reached any conclusions concerning actual runs of heavy  
25 crude at refineries in the San Joaquin Valley?

1           A.       Yes. They are much larger. You see, the  
2           only information I had to identify the refineries that  
3           could use heavy crude was indirect evidence. I knew  
4           that asphalt is a production that uses heavy crude. At  
5           the time I only had the output figures of asphalt.

6                    I have since found that a lot more heavy  
7           crude is used to make the asphalt. In fact 29,000  
8           barrels per day. So that figure is low by over 20,000  
9           barrels.

10                   In addition, there are refineries in the  
11           San Joaquin Valley that undoubtedly use some heavy  
12           crude. I just was not able to nail down exactly how  
13           much it was.

14           Q.       All right.

15           A.       So we know the number is less than the 114  
16           for the total crude run, but I had to make a  
17           conservative estimate of how much was less.

18           Q.       Based on the conservative asphalt  
19           production figure, what is the total crude locally  
20           consumed in the San Joaquin Valley that is heavy crude?

21           A.       It shows 116, but I now know that number  
22           is conservatively at least 20,000 barrels a day higher.  
23           So I would actually boost that to 136.

24           Q.       And even using the conservative figure for  
25           local consumption, what is the net production of heavy

1 crude that you have concluded must be transported out of  
2 the San Joaquin Valley to market?

3 A. 438,000 barrels per day.

4 Q. How does that compare with the total  
5 transportation capacity available?

6 A. It is significantly less, almost half.

7 Q. And again, if you added 20,000 barrels a  
8 day to the locally refined heavy crude, that number  
9 would be some 20,000 barrels lower?

10 A. Yes. It would be 418 instead of 438,  
11 because an additional 20 is used in the Valley.

12 Q. Turning back now to the fields having no  
13 alternative but one of the pipelines at issue to  
14 transport crude oil, have you analyzed the percentage of  
15 production that is accounted for by those fields?

16 A. Yes, I have.

17 Q. I would like to show you some pie charts  
18 and ask if they have been prepared under your  
19 direction.

20 THE COURT: This line of inquiry now is to  
21 those producers who have no other means of moving from a  
22 site to out of that site, right?

23 MR. JUDSON: That's correct.

24 THE COURT: All right.

25 BY MR. JUDSON:

1 Q. Exhibit 3085 is a pie chart showing the  
2 percentage of production having no means out of the  
3 field other than one of the pipelines at issue; is that  
4 right?

5 A. Yes, that's correct.

6 Q. What percentage did you calculate of the  
7 total San Joaquin Valley production that comprised that  
8 category?

9 A. About two tenths of 1 percent.

10 Q. Do you regard that as significant?

11 A. No, I don't.

12 Q. Did you do the same calculation for 1985?

13 A. Yes, I did.

14 Q. What was the comparable percentage for  
15 1985?

16 A. Less than two tenths of 1 percent.

17 Q. Did you do the same computation for 1987?

18 MR. McMAHON: What exhibit is that?

19 MR. JUDSON: The exhibit number is 3086.

20 BY THE WITNESS:

21 A. I did one for 1987 as well, yes.

22 BY MR. JUDSON:

23 Q. Does Exhibit 3087 show the results of  
24 that?

25 A. Yes.

1 Q. What is the comparable percentage figure  
2 for 1987?

3 A. Approximately two tenths of 1 percent.

4 Q. You described what you consider to be the  
5 market for the sale of crude oil in the San Joaquin  
6 Valley. Who is a typical participant in that market  
7 that might be seeking access to pipeline transportation?

8 A. A producer at one of the dots, those black  
9 dots, on the pipeline map that I have shown you earlier,  
10 either an independent producer or one of the major  
11 companies.

12 Q. What would a typical independent producer  
13 have to sell on the market?

14 A. It varies, of course. The total  
15 production from the fields on that map vary from  
16 anywhere from 10 barrels per day up to 170,000 barrels  
17 per day, although, of course, even in the case of the  
18 170,000 barrels per day, that is not just one company.  
19 Generally there are several companies producing from  
20 that field.

21 I would say a typical producer might have  
22 anywhere from one to ten thousand barrels per day that  
23 that producer wants to move to market, maybe a lot less  
24 in some circumstances.

25 Q. What are the alternatives for a producer

1 in those circumstances?

2 A. The alternatives are listed on my  
3 exhibits. It is the trunk lines that access the field.  
4 The crude could also be used internally in the Valley,  
5 refined in the Valley. It could be used for enhanced  
6 oil recovery. It could be transported on unheated lines  
7 or heated lines. It could go on the common carrier Four  
8 Corners line or the All American pipeline, as well as  
9 now the common carrier unheated lines in the Valley, or  
10 it could be trucked.

11 Q. Do all of these alternatives have the same  
12 cost?

13 A. No.

14 Q. Some are more expensive than others?

15 A. That's correct.

16 Q. Did you consider the relative cost of the  
17 alternatives in reaching your conclusion on essential  
18 facilities?

19 A. I considered it, yes.

20 Q. What is your conclusion with respect to  
21 the feasibility of other means of transportation?

22 A. In almost every case, these alternatives  
23 are feasible, economically feasible, and therefore they  
24 are not necessary -- Therefore there is no one trunk  
25 line or one transportation mode that is absolutely

1 necessary to move crude.

2 Q. What about for the producer that has a  
3 large amount of crude oil to move on the order of fifty  
4 to seventy thousand barrels per day? What are that  
5 producer's alternatives?

6 A. That was exactly the situation that the  
7 Point Arguello partners were in. as a result of the  
8 production off Santa Barbara, they had a very large  
9 amount of crude, fifty to seventy thousand barrels per  
10 day that had to be moved to market, and that analysis  
11 that was done for the County of Santa Barbara and for  
12 the Coastal Commission identified a very large number of  
13 feasible alternatives. They didn't have all the same  
14 costs, but they were all feasible alternatives to move  
15 the crude around.

16 Q. In your opinion, can new pipelines be  
17 built in California?

18 A. Absolutely.

19 Q. Do you have any examples?

20 A. The All American pipeline was built in  
21 1987. There is right now discussion, planning of the  
22 Southern California pipeline system, which would  
23 essentially go down the coast using railroad  
24 rights-of-way, and there have been many projects that  
25 have been discussed.

1 Q. And the Southern California pipeline that  
2 you mentioned is one that would carry heavy crude from  
3 the OCS, Outer Continental Shelf, production, on to  
4 Los Angeles?

5 A. That's correct.

6 MR. JUDSON: Your Honor, I would like to  
7 offer in evidence Exhibits 3083 and 3084, which are the  
8 spreadsheets showing alternatives, and the three pie  
9 charts, 3085, 3086, and 3087.

10 THE COURT: Have you already moved 3082?

11 MR. JUDSON: I was just getting to that,  
12 your Honor. And in addition, Exhibit 3082, which is the  
13 trunk line access map.

14 THE COURT: They will be received.  
15 (Defendants' Exhibit Nos. 3082, 3083, 3084,  
16 3085, and 3087 were rec'd in evidence.)

17 THE COURT: Let me ask the witness a  
18 couple questions here.

19 MR. JUDSON: Sure.

20 THE COURT: On some of these charts you  
21 used a considerable amount of time to talk about trunk  
22 lines.

23 THE WITNESS: Yes.

24 THE COURT: Tell me why you do that.

25 THE WITNESS: The trunk lines are the main

1 corridors. They are like the super highways in the  
2 San Joaquin Valley.

3  
4 THE COURT: I know what they are, but how  
5 do they figure in the issues in this case?

6 THE WITNESS: They are some of the main  
7 routes to move oil in terms of thinking --

8 THE COURT: Into the main lines? Is that  
9 it?

10 THE WITNESS: Into the main consumption  
11 centers of Los Angeles and San Francisco and Texas,  
12 possibly.

13 THE COURT: Let me ask you one other  
14 question on Exhibits 3083 and 3084. The difference  
15 between these two charts is one is Valley crude and one  
16 is heavy; is that right?

17 THE WITNESS: Yes. One is all Valley  
18 crude.

19 THE COURT: And the other is just heavy?

20 THE WITNESS: Yes, that's correct, your  
21 Honor.

22 THE COURT: Is what you are trying to show  
23 me on this chart all of the available transportation  
24 facilities including but not limited to the three that  
25 are involved in this litigation?

THE WITNESS: Yes, your Honor.

1 THE COURT: You want to show me by these  
2 charts that there are other available means other than  
3 the three involved here by the numbers you are showing  
4 me which you now describe as alternative transportation?

5 THE WITNESS: Yes, sir.

6 THE COURT: All right. They have been  
7 received, and thank you very much.

8 MR. JUDSON: No further questions.

9 THE COURT: What about these? What am I  
10 going to do with these copies of depositions here?

11 MR. JUDSON: I'm not going to ask about  
12 those.

13 THE COURT: All right.

14 MR. JUDSON: They are included in your  
15 packet, but I am not going to ask about them. In  
16 fact --

17 THE COURT: I want to be clear now,  
18 because there are some other documents here. I want to  
19 be clear about what we are talking about with this  
20 witness. 3082, 3083, 3084. 3082, 3089, 3090, 3091. Is  
21 that it?

22 MR. JUDSON: 3085, 3086, and 3087, your  
23 Honor, which are the pie charts are additional.

24 THE COURT: And 567. All right.

25 MR. JUDSON: And 3088 is the large map

Section 24

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*Via Facsimile*

March 25, 1997

Office of Management and Budget  
Information and Regulatory Affairs  
Desk Officer for the Department of the Interior  
725 17th Street, N.W.  
Washington, D.C. 20503

Attn: David Rostker

Re: Notice of Proposed Rulemaking on Establishing Oil Value for Royalty Due on  
Federal Leases and on Sale of Federal Royalty Oil (62 F.R. 3742) published  
January 24, 1997

Dear Sir:

Mobil Exploration and Producing U.S. Inc. (Mobil), a significant royalty payor on federal oil production, files these comments with the Office of Management and Budget in response to the Minerals Management Service's Notice of Proposed Rulemaking on Establishing Oil Value for Royalty Due on Federal Leases and on Sale of Federal Royalty Oil (62 F.R. 3742) published January 24, 1997. Mobil is a member of the Mid-Continent Oil and Gas Association and it adopts by reference and hereby incorporates the comments filed today on behalf of that and other trade associations, as well as the Barents Report dated March 25, 1997 which is attached to those comments.

The Barents Report sets forth a preliminary analysis based on data that was collected under severe time constraints. Mobil believes, however, that these comments provide sufficient evidence for the Office of Management and Budget to disapprove the collection of information under the Paperwork Reduction Act.

Office of Management and Budget  
March 25, 1997  
Page 2

Additionally, Mobil urges the Office of Management and Budget to request that the Minerals Management Service grant a more meaningful extension of the comment period so that all its constituents may have meaningful participation in this rulemaking. The Proposed Rule presents a radical departure from current practice. In addition to needing time to analyze the many substantive issues raised by the Proposed Rule, industry needs additional time to explore fully its administrative impact.

Sincerely yours,



David L. Bryant  
For the Firm

Counsel for Mobil

DLB:jb

cc: Mr. David Guzy  
Rules and Procedures Staff  
Royalty Management Program  
Minerals Management Service  
Department of the Interior  
P.O. Box 25165, M.S. 3101  
Denver, Colorado 80225-0165

APPENDIX 1MMS OIL ROYALTY VALUATION REGULATIONSA. Overview

MMS' royalty valuation regulations were revised on March 1, 1988. The revised regulations operate only prospectively, covering value determinations for oil produced on or after March 1, 1988. 53 Fed. Reg. 1184 (Jan. 15, 1988). Thus, the team considered two different, but conceptually similar, regulatory schemes.

Prior to March 1, 1988, MMS's royalty valuation regulations were at 30 CFR § 206.103 for onshore leases and at 30 CFR § 206.150 for offshore leases. 30 CFR § 206.103 stated:

The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production . . . be less than the gross proceeds accruing to the lessee . . . or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, . . . paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, . . . produced and sold from the field or area where the leased lands are situated

will be considered to be a reasonable value.

30 CFR § 206.150 contained similar directives:

The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or for a majority of like quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee . . . or less than the value computed on the reasonable unit value established by the Secretary.

30 CFR § 206.103 was promulgated in similar form in 1942 and 30 CFR § 206.150 was promulgated in similar form in 1954. The royalty valuation lease terms for both the standard onshore and offshore Federal oil and gas leases closely follow these regulations.

Neither these regulations nor the lease terms provide separate directives for valuation under arm's-length and non-arm's-length contracts. Both of these regulations set gross proceeds as minimum value and instruct MMS to consider posted prices as well as actual purchases and sales for oil produced from the same field or area in determining royalty value. Also, 30 CFR § 206.103 specifically relies on prices offered in "a fair and open market" for oil produced from the same field or area. Thus, in establishing royalty value, the regulations and lease terms emphasize the use of arm's-length contracts for oil produced from the same field or area as the oil being valued. Additional flexibility is imparted by including other relevant matters.

When MMS revised its regulations in 1988, it added more specific guidance for valuing oil not sold under arm's-length contracts. This is particularly relevant in California, because most oil is produced by integrated oil companies that "sell" it to their trading or refining affiliates or exchange it with third parties. Although the revised regulations maintained the principle that gross proceeds are minimum value for oil sold under both non-arm's-length and arm's-length contracts, they seemed to afford posted prices a more prominent role in valuing non-arm's-length sales. In valuing oil not sold under arm's-length contracts, the revised regulations continue to direct MMS to rely on arm's-length contracts for sales and purchases of oil produced from the same field or area as the oil being valued.

Specifically, on and after March 1, 1988, the present 30 CFR 206.102(b) provides that crude oil sold under an arm's-length contract will be valued at the gross proceeds accruing to the lessee under the contract. There is an exception if the contract does not reflect the total consideration actually transferred either directly or indirectly from the buyer to the seller. In that event, MMS has the option of requiring that value be established under the same "benchmarks" used for valuing oil not sold under arm's-length contracts, as discussed below. Value may not be less than the gross proceeds, including the additional consideration not reflected in the contract. 30 CFR § 206.102(b)(1)(ii). Furthermore, if MMS determines that the gross proceeds accruing to the lessee do not reflect the reasonable value of production due to misconduct or the lessee's failure to market the production for the mutual benefit of the lessor and

lessee, MMS shall require that the production be valued under its benchmarks. 30 CFR § 206.102(b)(1)(iii).

If crude oil is not sold under an arm's-length contract, the present 30 CFR § 206.102(c) provides that value shall be determined according to the first applicable of a series of specific "benchmarks" listed in a prescribed order. The first benchmark is a key to the present analysis. It establishes value as:

The lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like quality oil in the same field . . . [or, if necessary, area]; provided, however, that those posted prices or oil sales contract prices are comparable to other contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field . . . [or, if necessary, area]. . . . If the lessee makes arm's-length purchases or sales at different postings or prices, then the volume-weighted average price for the purchases or sales for the production month will be used.

This benchmark requires a dual "significant quantities" test. To use its own postings or oil sales contract prices for crude oil it sold at arm's-length as the value of crude oil not sold at arm's-length, the lessee's arm's-length sales and purchases must constitute "significant quantities" of like-quality crude in the same field or area. In addition, those arm's-length posted prices or oil sales contract prices must be comparable to other contemporaneous posted prices or oil sales contract prices for arm's-length purchases or sales in the same field or area, which

also must be for "significant quantities." In other words, both the arm's-length postings or oil sales contract prices to be used as the measure of value and the arm's-length postings or sales to which they are comparable must be for "significant quantities." Finally, if there are multiple postings or oil sales contract prices for arm's-length transactions, then the lessee must use the volume-weighted average of those prices.

If the required elements of the first benchmark are not met, then the second benchmark would be applied. It uses the arithmetic average of posted prices used in arm's-length transactions by persons other than the lessee for purchases or sales of "significant quantities" in the same field (or, if necessary, area).

The third benchmark uses the arithmetic average of contemporaneous arm's-length contract prices for purchases or sales by persons other than the lessee for purchases or sales of "significant quantities" of like-quality oil in the same field or nearby areas.

The fourth benchmark uses arm's-length spot sales of "significant quantities" of like-quality oil in the same field (or, if necessary, area). It also includes other relevant matters.

Ultimately, if all the above benchmarks fail, then value may be determined according to a "net-back method or any other reasonable method to determine value."

Under the net-back method, costs of transportation, processing or manufacturing are deducted from the proceeds received for the specific oil being valued, or from the value of the oil at the first point at which reasonable values may be determined by an arm's-length sale or by comparison to other sales of such products. 30 CFR § 206.101. The preamble to MMS's revised regulations explains that this valuation method is to be used "primarily where the form of the lease product has changed." The net-back calculation is started "at the first point at which reasonable values for any product may be determined by a sale pursuant to an arm's-length contract or by comparison to other sales of such products." 53 Fed. Reg. 1196 (Jan. 15, 1988).

**B. Significant Quantities**

The regulations do not define the term "significant quantities." However, the proposed rulemaking provided some guidance as to the meaning of the term. The preamble to the proposed rule stated:

The purpose of this phrase is to prevent abuses through application of unusually low or high postings under which little or no oil is actually purchased. The term "significant quantities" also is intended to be in relation to the volumes moving under typical purchases in the field or area. Thus, for a highly productive OCS field, to meet the significant quantities test, a larger volume would be required to be purchased under a posting than in a less productive onshore field.  
(Emphasis added.)

52 Fed. Reg. 1858, 1861 (Jan. 15, 1987).

Two relevant principles appear from this excerpt. First, the

C. Arm's-Length Contracts

The arm's-length definition sets out a two-part test. For a contract to be at arm's-length, it must be (1) arrived at in the market place between independent, nonaffiliated persons (2) with opposing economic interests regarding that contract. 30 CFR § 206.101.

Clearly, outright sales of oil are at arm's-length. However, much of California production is disposed of under straight exchanges and buy/sell agreements. The team does not regard straight exchanges as arm's-length contracts. Additionally, the MMS Payor Handbook, Volume III, Part 3, treats straight exchanges as non-arm's-length contracts.

However, MMS regulations and the MMS Payor Handbook are not specific about whether buy/sell agreements are at arm's-length. Under buy/sell agreements, both parties sell oil to each other at a specific price or prices and invoice each other accordingly; usually, both transactions are linked in the companies' accounting systems. The substantive effect is to effectuate an exchange, possibly with a price differential.<sup>1</sup> Clearly, buy/sell exchanges between different, unrelated oil companies are between independent, nonaffiliated persons. However, there is a question as to whether the oil companies have opposing economic interests regarding that contract. If they do not, the contract is not at arm's-length. If it is not at arm's-length, it would be valued

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<sup>1</sup>A frequent reason for these transactions is that each party produces oil at a point much closer to the other's refinery.

under the benchmarks and would not be used in the determination of the volume-weighted average price under the first benchmark. It is the lessee's burden to demonstrate that its contract is arm's-length. 30 CFR § 206.102(b)(1)(i).<sup>2</sup>

The team reviewed several buy/sell contracts. This review suggests that:

- The contracts are done for the convenience of both parties. In other words, the parties do not have opposing economic interests.
- The reference to price is to establish a price differential between two crude oils rather than to establish the underlying price.

Therefore, the team does not believe that the contracts it reviewed are at arm's-length.

MMS' Payor Handbook, Volume III, Part 3, Paragraph 3.3, states that the value of oil for royalty purposes under buy/sell exchange agreements is based on whether the sale is arm's-length or non-arm's-length. In light of what we learned about buy/sells in the California market, the team believes that before MMS

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<sup>2</sup>Aside from the arm's-length question, it is not apparent that buy/sell exchanges could meet a reasonable definition of sale or purchase when the mutual intent often appears to be to gain locational advantage rather than outright disposition of the oil.

issues a bill to a specific company, it should examine several large buy/sell contracts for that company to determine if that company typically enters into arm's-length buy/sell contracts. That review will guide MMS in determining whether to treat that company's buy/sell contracts as arm's-length contracts. As discussed above, if MMS determines that a company's buy/sell contracts are arm's-length contracts and represent actual purchases or sales, those contracts would not be valued under the benchmarks. Furthermore, they would be included in the volume-weighted average price used to value non-arm's-length sales under the first benchmark.

An MMS Director's decision, Cities Service Oil and Gas Corp., MMS-86-0538-O&G, is instructional in determining whether to treat that company's buy/sell contracts as arm's-length contracts (see Appendix 2 for details on that decision).

**D. Obtaining a Marketing Arm's Records**

At about the same time the team was formed, the Interior Board of Land Appeals (IBLA) held that MMS was not entitled to look at the records of an integrated company's marketing arm. Shell Oil Co., 130 IBLA 93 (1994). In this case, MMS attempted to obtain Shell's marketing arm's records to determine if Shell paid royalties on its gross proceeds. The IBLA held that under 30 CFR § 206.102(b)(1)(i), MMS could not obtain such records unless the marketing arm was a marketing affiliate. The IBLA stated that Shell's marketing arm was not a marketing affiliate under MMS's regulations. The IBLA held that MMS should have valued production based on the non-arm's-length sale from Shell to its

marketing arm. Such valuation should have been done under the above-discussed benchmarks.

MMS requested the IBLA to reconsider this decision. In Shell Oil Co. (On Reconsideration), 132 IBLA 354 (1995), the IBLA reversed its previous decision. It did so because MMS has statutory and regulatory authority to require the production of such documents to insure there has been compliance with its gross proceeds rule. This case is pending in U.S. District Court. Furthermore, in Santa Fe v. McCutcheon, No. 95-1221 (10th Cir. Apr. 10, 1996), the court held that MMS is entitled to such records to determine gross proceeds.

Until this litigation is concluded, MMS may be unable to obtain a marketing arm's records. However, this does not prevent MMS from issuing an order for such records. If the company refuses to provide such records pending litigation, MMS should value all sales from that company's production arm to its marketing arm based on other arm's-length sales. If MMS later determines that its bill did not reflect gross proceeds, it should then bill for any amounts due plus interest. The statute of limitations should not run for a specific company during any administrative or judicial litigation with that company when MMS is trying to obtain that company's marketing arm's records.

APPENDIX 2DIRECTOR'S DECISION ON BUY/SELL EXCHANGES

A 1987 MMS Director's decision (MMS-86-0538-O&G) dealt with the issue of buy/sell exchanges. The appellant, Cities Service Oil and Gas Corporation (Cities Service), entered into a buy/sell oil exchange agreement. Cities Service sold oil it produced in North Dakota and then purchased a like volume from the same entity "in an area that can be either further traded or moved to the Lake Charles [Louisiana] refinery." The Director ruled that the Appellant did not make a simple sale to a third party that could presumptively establish value. Rather, the appellant put together an exchange agreement. Excerpts of the rationale follow:

...If the Appellant's purchaser has a refinery in North Dakota and oil wells in Louisiana, it is to both parties' benefit to exchange crude oil since both parties are able to save the transportation costs involved in transporting the crude oil from its wells to its refinery 1,500 miles away from its wells....

...In the simplest exchange the parties could exchange barrels of crude oil without even assigning a sales price to either the crude oil sent or crude oil received....

...the critical factor is that each party takes possession of crude oil at its refinery in exchange for giving up crude oil at its wells....even though the parties may exchange invoices, the prices assigned...may not be equivalent to the fair market value....The parties can assign prices that are half the market value as long as there is a reciprocal undervaluation on the crude oil sent as well as the crude oil received....In short, the price...even between unrelated

oil companies, is not necessarily the fair market value of the crude oil.

The Director concluded there was a conspicuous difference between the Appellant's invoice price and the crude's fair market value because there was a posted price that established the prima facie fair market value. The team notes that regardless whether the posted price or some other standard represents market value, this decision stands for the principle that the price in a buy/sell exchange does not necessarily represent market value. Thus, if a posting doesn't reflect market value, neither would the buy/sell invoice price tied to that posting.

These observations are significant in light of the fact that MMS' royalty valuation regulations rely on prices established by arm's-length sales.



APPENDIX 3

United States Department of the Interior

MINERALS MANAGEMENT SERVICE

Royalty Management Program  
P.O. Box 25165  
Denver, Colorado 80225-0165

IN REPLY REFER TO:

MMS-VSD-EVB  
Mail Stop 3151

DEC - 6 1995

Memorandum

To: Assistant Secretary for Land and Minerals Management  
Director, Minerals Management Service

From: Interagency Team Leader, California Oil Valuation Issue *David A. Hubbard*

Subject: Option list

As requested by the Director in our meeting of October 31, the team has developed the attached list of proposed options for addressing potential oil royalty underpayments in California. The list is not necessarily all-inclusive; there are many possible permutations.

Also attached are estimates of potential collections (royalty and interest) for the various options. Obviously there are many assumptions and qualifications attendant with these estimates; they are best used as a measure of relativity among the options.

Attachment

DOI-000644

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Attachment

**Notes to Option List**

1. The option list on the following pages contains estimated potential royalty and interest collections if the Federal Government were successful in applying the various options to the ten largest royalty payors. These companies make up about 90% of the California royalty volume for the years 1984 to 1993. (But for each option where dollar estimates are given, a certain amount may not be collectable due to the MMS/EXXON global settlement. Similar problems may exist for Chevron.)
2. Some of the options presented could be applied in combination with one another. For instance, Option VI might be applied where audit demonstrates premia on individual arm's-length sales at the lease level, and another option might be applied to the lessee's non-arm's-length transactions.

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Option I. California Crude Oil Valuation based on Alaskan North Slope (ANS) Crude Oil Market Prices

DESCRIPTION

By using market prices for ANS crude oil delivered to Los Angeles, estimate the extent to which posted prices understate the California crude oil royalty prices MMS could have received. This approach, based on computations provided by Micronomics (one of MMS' consultants), would yield premia of about \$2.85 per barrel offshore and \$6.00 onshore in 1980, almost \$3.00 for all production in 1984, and \$1.00 to \$1.40 for all production in the late 1980's and 1990's. The premia would apply to all Federal royalty volumes of the companies for whom MMS might pursue underpayments.

JUSTIFICATION

Under the pre-1988 regulations, this procedure might be justified as the "...reasonable value of the product determined by the Associate Director..." based on the highest price paid for a part or majority of like-quality field production, price received by the lessee, posted prices, regulated prices (offshore only) and other relevant matters.

Under the 1988 regulations, the justification would have to be that none of the first three Benchmarks are applicable for valuing non-arm's-length transfers of Federal lease crude oil. This would depend on two arguments:

- o Exchanges (both pure exchanges and buy/sells) make up perhaps as much as 90% of overall trading, and are not contracts between companies with opposing economic interest. Therefore, they are not arms-length contracts for valuation purposes.
- o The remaining outright purchases and sales amount to only a small portion of the overall volume traded, and are not sufficiently "significant" to employ as a basis for valuation.

Then royalty values might be established by applying "other relevant matters" (Benchmark (4)).

POTENTIAL REVENUE COLLECTION

Under the assumption that unpaid royalties on 90% of the onshore production and 100% of OCS production potentially would be collectable, estimated unpaid royalties and accrued interest would total \$856 million for the period 1978 to 1993 inclusive.

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Option II. Apply Innovation & Information Consultants (IIC)  
Premia to All Royalty Production

DESCRIPTION

This option would apply the average premia above posting estimated by IIC for Shell and Texaco (and validated in part by the interagency team) during the 1980's to most California royalty production. (Estimated premia for 1978-80 and 1989-1993 were extrapolated from these data.)

Premia were estimated using companies' purchase and sales contracts. The premia are lower than the method used in Option I because they don't capture as much of the refiners' margin as does the Option I methodology. For most years prior to 1986, premia are in the \$1.00-\$1.85 range; in 1986 and beyond, they are between \$0.45 and \$0.78 per barrel. The premia would apply to all Federal royalty volumes of the companies for whom MMS might pursue underpayments.

JUSTIFICATION

Under the pre-1988 regulations, this procedure might be justified as "... reasonable value of the product determined by the Associate Director..." based on the highest price paid for a part or majority of like-quality field production, price received by the lessee, posted prices, regulated prices (offshore only) and other relevant matters. In addition, it may be said to represent a value not less than the reasonable unit value determined by the Secretary, including the highest price paid for a part or majority of production.

Under the 1988 regulations, either Benchmark (3) or (4) might be cited as the valuation method. Benchmark (1), using the lessee's posted or contract prices, might be bypassed because relatively little production apparently is sold at arm's-length at posted prices. Benchmark (2) might be bypassed for the same reason and because the posted prices of persons other than the lessee apparently are used mostly in exchanges, which may not pass the competing economic interest test.

POTENTIAL REVENUE COLLECTION

Under the assumption that unpaid royalties on 90% of the onshore production and 100% of OCS production potentially would be collectable, estimated unpaid royalties and accrued interest would total \$280 million for the period 1978 to 1993 inclusive.

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Option III. Apply premia estimated by MMS audit to all volumes of Federal crude produced by large royalty payors.

**DESCRIPTION**

This method would apply the approach employed by MMS auditors to Texaco and Shell during this study. That is, booked crude oil costs would be subtracted from booked sales revenues with transportation costs disallowed. Using this procedure, MMS auditors calculated premia for 1989 of \$0.89 per barrel. If similar records are not available for other companies, the procedure would simply use contract premia applied to all federal royalty production. Using the latter method, MMS auditors found premia for Shell of \$1.31 per barrel in 1984.

Depending on individual company circumstances and further audit, lessees might be permitted to demonstrate that actual transportation costs are associated with these premiums (allowing all transportation costs would reduce the \$0.89 premium above to about \$0.16). MMS would decide which costs are appropriate and thus how much the premia may be reduced.

**JUSTIFICATION**

Justifications for this approach would be similar to those discussed for Options 1 and 2 for periods before and after the 2/1/88 oil valuation rules were implemented. Further, the net revenues might be said to approximate the lessee's gross proceeds.

**POTENTIAL REVENUE COLLECTION**

Estimating potential revenues is difficult because the MMS audit work is not complete. Nor can one state with certainty how many of the companies would be assessed using contracts (per the procedure for Shell) or by the crude cost and sales revenue method (as for Texaco). If the premium derived for Shell (\$1.31/bbl) is applied before 1986 and the Texaco premium of \$0.89 is applied thereafter, collection estimates are \$316 million.<sup>2</sup> Of that amount, \$97 million is estimated using the

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<sup>1</sup> In addition to outright purchases and sales, buy/sell exchanges, most of which were simply employed to transport oil for others, were used as valid transactions for royalty valuation purposes in estimating this premium.

<sup>2</sup> January 1, 1986, is used as the "break" point because a dramatic, long-term drop in crude oil prices occurred about that time.

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booked cost and revenue methodology applied by the MMS auditors to Texaco's transactions. If all transportation costs are allowable, the premium drops to \$17 million. The total would then be \$236 million for this option; however, most of that estimate is derived using contract data just as in Option II.

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Option IV. Assume that some fixed percentage of Federal production is sold at a premium and apply a selected premium to that volume.

**DESCRIPTION**

MMS would assume that the lessee only received legitimate gross proceeds additions for some percentage of its production from Federal leases and apply a selected premium as in Option II or III to that volume. The percentage could be calculated, for example, by dividing the company's total sales and purchase volume at a premium by its total arm's-length transaction volume. (The latter could include all arm's-length outright sales/purchases, all arm's-length outright sales/purchases plus buy/sell exchanges, or all outright arm's-length sales/purchases plus all exchanges.) Selection of the denominator may depend on interpretations of which types of transactions are at arm's length, including "opposing economic interest" considerations. For example, buy/sell exchanges might not be considered to involve opposing economic interests.

The derived percentage could then be multiplied by (1) the selected premium and (2) production from each Federal lease to calculate royalties due by lease. The estimates provided here give a range based on data for Texaco and Shell applied to all the largest payors' Federal production.

**JUSTIFICATION**

The first valuation benchmark under the 1988 rules for oil not sold under arm's-length contract applies either the lessee's contemporaneous posted or contract prices for arm's-length purchases or sales of significant quantities of oil. If the lessee's arm's-length purchases/sales are at different postings or contract prices, then the volume-weighted average price for such transactions is to be used. Likewise, the third benchmark would apply the arithmetic average of other contemporaneous arm's-length contract prices for purchases or sales of significant quantities of like-quality oil. Thus if the lessee buys and sells significant quantities at arm's-length, it could be argued that the weighted average premium from these transactions could be applied to all of its non-arm's-length production. This option follows the same general logic.

Under the pre-1988 rules, this procedure might be justified as the reasonable value determined by the Associate Director, the highest price paid for a part or majority of production, or "other relevant matters."

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POTENTIAL REVENUE COLLECTION

Four different cases are presented, all using Texaco's 1989 volume data to estimate the percent of production sold at a premium. The first and second estimates apply the IIC premia; the first considers all arm's-length sales and purchases plus exchanges in estimating the percentage of Federal production sold at a premium, and the second uses all arm's-length sales and purchases plus buy/sell exchange volumes. The third and fourth estimates apply premia from the MMS audits; the third considers all arm's-length sales and purchases plus all exchanges in estimating the percentage of Federal production sold at a premium, and the fourth uses all arm's-length sales and purchases plus buy/sell exchange volumes. Collection estimates range from \$31.3 million for the first case to \$83.2 million for the fourth.

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Option V. Bill additional royalties only for specific volumes where MMS audit demonstrates third-party sales by lessee or its affiliate are at premium above posting--do company/lease apportionments based on field-level transactions.

**DESCRIPTION**

This approach would assess additional royalties where MMS audits show the lessee or the lessee's affiliate received premia above posting for specific field-level sales, but lease royalties for those fields were paid on postings. The allocation could involve, for example, the company's total field sales and purchases at a premium divided by its total field sales and purchases. This percentage could then be multiplied by (1) the weighted average premium and (2) production from each Federal lease in that field to calculate royalties due by lease. (For Texaco, because the numerous exchanges and complicated pipeline movements result in loss of identity of production, MMS auditors feel it would be difficult to discern specific field-level sales at premia and allocate them to specific Federal lease production. But this may not be the case for Shell or subsequent auditees where less complicated transactions occur.)

**JUSTIFICATION**

The MMS can make a case that premiums received by the lessee or its affiliates in specific sales represent gross proceeds to the lessee and should therefore represent royalty value.

**POTENTIAL REVENUE COLLECTION**

No dollar estimates can be provided until MMS audits demonstrate specific instances of sales at premia by field; any estimates would be speculative. Potential returns, however, likely would be somewhat less than those for Option IV., where a fixed percentage of Federal production is assumed to be sold at a premium.

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Option VI. Bill additional royalties only for specific lease volumes where audit demonstrates third-party sales by lessee or its affiliate are at premium above posting.

**DESCRIPTION**

This approach would assess additional royalties where MMS audits show the lessee or the lessee's affiliate received premia above posting for specific sales traceable directly to the lease, but royalties were paid on postings. (For Texaco, because the numerous exchanges and complicated pipeline movements result in loss of identity of production, MMS auditors feel it would be difficult or impossible to assign sales at premia to specific Federal lease production. But this may not be the case for Shell or subsequent auditees where less complicated transactions occur.)

**JUSTIFICATION**

The MMS can make a case that any premiums received by a lessee or its affiliates in specific sales represent gross proceeds to the lessee and should therefore represent royalty value.

**POTENTIAL REVENUE COLLECTION**

No dollar estimates can be provided until MMS audits demonstrate specific instances of sales at premia by lease; any estimates would be speculative. The returns, however, likely would be somewhat less than those under Option V., where "premia" sales at the field level would be allocated to Federal lease production rather than establishing a direct link between specific contracts and leases.

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Option VII. No attempt to collect additional royalties for past periods; instead, revise the MMS oil valuation rules.

**DESCRIPTION**

MMS would not try to collect additional royalties for past periods in California. Rather, it would pursue revising its oil valuation rules for prospective application. (It is assumed that regardless of the option chosen, MMS will actively pursue revising the rules.)

**JUSTIFICATION**

MMS would have to decide that the current rules don't provide enough flexibility to attempt to collect additional royalties.

**POTENTIAL REVENUE COLLECTION**

No additional royalty collections would result until the regulations were revised, and then only prospectively.