MONTEREY RESOURCES
David B. Kilpatrick
President

May 16, 1997

Minerals Management Service
Royalty Management Program
Rules and Procedures Staff
P.O. Box 25165
MS 3101
Denver, CO 80225

Re: Revised Comments on Proposed Rules for Oil Royalties

Dear Sir or Madam:

Monterey Resources, Inc. ("Monterey") submits these revised comments on the Minerals Management Service's proposed rules concerning the determination of royalty value for oil produced from federal oil and gas leases, 62 Fed. Reg. 3742 (Jan. 24, 1997).

BACKGROUND AND SUMMARY OF MONTEREY'S POSITION

Monterey is the successor-in-interest to California assets previously owned and operated by Santa Fe Energy Resources, Inc. Monterey is thus the lessee of federal leases in the Midway-Sunset field in the San Joaquin Valley of California. The Midway-Sunset field is the largest producing oil field in the contiguous United States; in terms of current barrels of production, Monterey is the largest producer in that field.

Most of the oil produced in the Midway-Sunset field is heavy crude. Monterey currently produces about 22,500 barrels per day from its federal leases in Midway-Sunset, and as a result pays about $5 million in royalties annually to MMS on this production. Monterey's current net crude oil production in California is about 51,000 barrels per day, the bulk of which is heavy oil.

Monterey does not own any refineries, nor is it affiliated with any companies that have interests in a refinery. As a result, Monterey does not post prices for the purpose of *purchasing oil. Monterey is strictly in the business of maximizing the price it can get for its* oil, and sells all of its oil production to unaffiliated third parties. In order to maximize the price it receives, Monterey purchases light oil for blending with its heavy crude, and then exports the blended crude to markets outside of California. The proposed rules would therefore require Monterey to value all of its federal oil production under the Alaska North Slope ("ANS") index method, rather than under its arm's-length contracts.

The MMS's proposal requiring use of ANS prices to value heavy oil is not in accord with the Administrative Procedure Act, 5 U.S.C. § 706, because it is arbitrary, capricious, an abuse of discretion, and contrary to the Mineral Leasing Act of 1920. As explained below, ANS prices do not reflect the value of heavy oil production, and the proposed location/ quality differentials will not lead to a fair market value for heavy oil in the San Joaquin Valley. The ANS method will instead lead to an artificially high value for heavy oil. Whatever the merits in favor of using ANS prices to value light crude oil, MMS should use a different method to value heavy oil. That method, at least in the case of independent companies like Monterey, should be the value obtained in arm's-length contracts. Alternatively, it should be the market value as established by the actual cash transactions of that day as reported in well-recognized publications (e.g., Dow Jones Telerate, Reuters, and Platts Oilgram) for oil produced in the Midway-Sunset field.

COMMENTS ON MMS'S PROPOSAL

I. MMS Should Continue to Rely on Arm's-Length Contracts.

Under the Mineral Leasing Act of 1920, royalty from onshore federal leases is a percentage of the "value of the production removed or sold from the lease." 30 U.S.C. § 226(b). The term "value" as used in the Mineral Leasing Act means the "reasonable market value; that price which a product will bring in an open market, between a willing seller and a willing buyer." See United States v. General Petroleum Corp., 73 F. Supp. 225, 235 (S.D. Cal. 1947), aff'd sub nom. Continental Oil Co. v. United States, 184 F.2d 202 (9th Cir. 1950). In addition, the point at which value is determined is the wellhead or some other point within the lease boundaries. Id. at 235, 254.

In 1988, MMS reiterated these long-standing principles on royalty valuation when, in adopting comprehensive new royalty regulations, it specifically stated that the best measure of the value of oil produced from a lease is the sale price under an arm's-length contract. See 53 Fed. Reg. 1184, 1186 (Jan. 15, 1988) ("MMS maintains that gross proceeds to which a lessee is legally entitled under arm's-length contracts are determined by market forces and thus represent the best measure of market value.") For some 75 years, since enactment of the Mineral Leasing Act of 1920, "gross proceeds" received under arm's-length contracts have guided royalty valuation on federal leases.

By contrast, the proposed rules give mere lip-service to the rule that oil sold under arm's-length contracts should be valued in accordance with the proceeds received. See proposed § 206.102, 62 Fed. Reg. at 3752. MMS has proposed such sweeping exceptions to this rule that, as the agency itself acknowledges, very little federal oil production will be valued using arm's-length contracts. 62 Fed. Reg. at 3744. These exceptions are that oil subject to crude oil calls or an exchange agreement will be valued under the proposed index method. Moreover, if a lessee buys any oil from a third party in the preceding two years, then all of the lessee's federal oil production must be valued under the index system.

Monterey understands that various oil and gas industry associations are submitting specific comments on the exceptions for crude oil calls, exchange agreements, and purchases. Monterey supports and incorporates those comments, but wants to emphasize a point about MMS's proposal that any oil purchases will subject the lessee's entire production to the index valuation method. Monterey acquires small amounts of third party crude oil for resale, and in periods of oversupply it will purchase light crude for blending with its heavy crude for shipping out of California. The shipment of the blended crude out of California serves to improve the resultant market for heavy crude in the San Joaquin Valley. Thus, the MMS benefits from Monterey's oil purchases. Yet MMS's proposed rules effectively penalize Monterey for purchasing other oil, by forcing Monterey to use the ANS index method to value all of its oil.

In any event, MMS's exceptions to the arm's-length contract rules are not necessary because an independent like Monterey ultimately sells all of its production under an arm's-length contract. There are, accordingly, valid market-based contracts that cover all of Monterey's federal lease production. Those contract prices can and should be used to value the oil, for they represent the price of the oil "in an open market, between a willing seller and a willing buyer." General Petroleum, 73 F. Supp. at 235. Where the ultimate sale occurs at a point downstream from the lease because of exchanges, a transportation allowance can be readily computed to arrive at a leasehold or wellhead value.

With respect to MMS's concern that companies do not have sufficient economic incentive to use a real market price in buy/sell agreements, Monterey sells substantial quantities of oil to unaffiliated third parties without the use of buy/sell agreements. Those contract prices can be used to verify or even determine the royalty value of oil subject to a buy/sell agreement. Monterey's actual sales of like-quality oil under arm's-length contracts are a far better indicator of market value than the proposed ANS method (as we discuss below).

II. ANS Prices Do Not Reflect the Market Value of Heavy Crude.

A second fundamental problem with MMS's proposed rules is that they rely on ANS prices in Los Angeles to value heavy oil produced over 125 miles away in the San Joaquin Valley. ANS prices, even after adjustment for the location and quality differentials proposed by MMS, do not reflect the "value of the production removed or sold from lease" in the Midway-Sunset field. MMS's proposed royalty valuation method, particularly as it applies to heavy oil, is thus contrary to the Mineral Leasing Act, 30 U.S.C. § 226.

ANS crude is substantially different from California heavy crude produced in the Midway-Sunset field. ANS oil is a light crude with a gravity of about 28° API; Midway-Sunset oil is a heavy crude with a gravity of 11° to 12° API. Consequently, the markets for ANS crude are not the same as they are for Midway-Sunset crude. ANS crude can be refined in any refinery, whereas heavy crude must be refined in facilities having special equipment. In addition, transportation options are much more limited for heavy oil: heavy oil must be moved in a heated pipeline, and aside from proprietary pipelines, there are only two heated pipelines which transport heavy crude from Midway-Sunset to market centers (one north and one south). Moreover, refineries typically cut back on heavy oil first when product demand declines or upset conditions occur.

Because of the less favorable characteristics of heavy oil — and the more restricted options for transportation and refineries — the market value of heavy oil is less than the value of ANS light crude. More important, however, is that whereas market prices for heavy crude are typically determined by regional conditions, ANS prices are determined by a single Alaskan producer and the landed price of foreign crude. There is no strong positive correlation between ANS and heavy oil prices.

Monterey recognizes that MMS is trying to develop a system that is as uniform and administratively convenient as possible. However, the same reasons that led MMS to propose a different method than NYMEX for valuing California production also require using a different method for valuing heavy oil. Just as NYMEX cannot be effectively used to value oil in California, ANS cannot be effectively used to value heavy oil. In this regard, in comments on the MMS's advance notice of proposed rulemaking, the State of California (at pages 5-6) urged MMS to adopt a different royalty method for California oil, explaining: "West Texas Intermediate is not Kern River Heavy and Cushing is a long way from Bakersfield." Monterey agrees with California on this point, but it is also true that Alaska North Slope light crude is not Kern River Heavy.

In trying to use ANS prices to value heavy oil, MMS is ignoring its long-standing practice to value oil (or gas) by reference to an arm's-length contract price or value for "like-quality" production. See 30 C.F.R. § 206.102(c). "Like quality" production is defined as production with "similar chemical, physical, and legal characteristics." Id. at § 206.101. Alaska North Slope light crude and Midway-Sunset heavy crude are not like-quality crude oils.

That heavy oil should be distinguished from light oil is further demonstrated by the Bureau of Land Management's decision to grant royalty relief for heavy oil. 61 Fed. Reg. 4748 (Feb. 8, 1996). In giving this royalty relief, BLM recognized unique aspects of heavy oil production. Thus, there is recent precedent in the Department for treating heavy oil differently from light oil.

III. <u>The Location/Quality Differentials Do Not Solve the Problem.</u>

MMS's proposed location and quality differentials will not transform the ANS price into a fair value for heavy crude. As a threshold matter, this is because ANS prices will fluctuate in response to market forces that do not produce the same changes in heavy oil prices. Without a strong correlation between ANS and heavy oil prices, there is no way to derive a differential formula that will adjust ANS prices so that they consistently reflect an accurate market value for heavy oil.

Even apart from the problem with using ANS prices as a starting point, the MMS's proposed location and quality differentials will not work for Midway-Sunset heavy oil. First, the differentials are supposed to be based on actual differentials in exchange contracts or on MMS published differentials based on the prior year's reports (Form 4415). Heavy crude is not typically traded for ANS at Los Angeles (Monterey does not do so), so exchange agreements will not yield the data. In addition, the MMS-published differentials will be at least one year out of date.

To check MMS's proposed method against its arm's-length contract prices, Monterey compared the numbers presented by MMS for September 1996. MMS calculated a value for Midway-Sunset oil of $16.27. (Appendix G to Preamble.) Monterey's arm's-length aggregate contract prices for that month were about $15.75 per barrel, or 52¢ less than MMS's theoretical value. That MMS's calculation leads to a higher royalty value than Monterey could obtain on the open market is compelling evidence that MMS's proposal does not work fairly or reliably in the case of heavy oil.

At the hearing in Lakewood, Colorado on April 25, 1997, a member of the MMS team that developed the proposed rules (Mr. Kronebusch) described how MMS calculated the value for Midway-Sunset oil in Appendix G to the Preamble. He explained that the major part of the differential between ANS prices and the value for Midway-Sunset oil was an adjustment of 25 cents per degree of gravity difference. <u>See</u> Transcript of April 25, 1997 Hearing at 112. This approach is incorrect and too simplistic. The gravity bank of 25 cents per degree is designed to account for relatively small differences in gravity of comparable crude oils. It is not intended to -- and in fact does not -- equate heavy crude with light crude. This helps to explain why MMS's sample calculation for September 1996 is more than 50¢ off the arm's-length contract prices in the field.

IV. <u>MMS's "Net-Back" Approach is Not a Proper or Accepted Valuation Method.</u>

MMS's proposed valuation method bears some resemblance to a "net-back" approach, by taking the value of a certain type of oil at a point downstream from the lease and working back to a supposed valuation at the lease. The typical example of a net-back approach is where one takes the value of processed gas at a point downstream and subtracts processing and transportation costs to arrive at a theoretical leasehold value. <u>See Piney</u>

Woods County Life School v. Shell Oil Co., 726 F.2d 225 (5th Cir. 1984); see also Marathon Oil Co. v. United States, 807 F.2d 759 (9th Cir. 1986), cert. denied, 480 U.S. 940 (1987) (upholding use of net-back method to value natural gas produced in Alaska but sold in Japan).

While courts have upheld the use of a net-back method to calculate royalties in some cases, they have cautioned that this method is the "least desirable method of determining market price … ." Piney Woods, 726 F.2d at 239 (5th Cir. 1984), quoting Montana Power Co. v. Kravik, 586 P.2d 298, 303-04 (Mont. 1978). No doubt recognizing the difficulties in computing a market value using the net-back method, the MMS's current regulations list the net-back method as the last in the hierarchy of benchmarks (number five out of five) for valuing oil transferred under non-arm's-length contracts. See 30 C.F.R. § 206.102(c) (1996). The net-back method is generally applied only as a last resort when there are no arm's-length contracts in the field establishing a market value at the lease or well.

There are two principal flaws in MMS's proposed use of a net-back type of method for valuing heavy oil in the San Joaquin Valley. First, a net-back approach should only be employed where there are no arm's-length contracts in the field from which a royalty value can be derived. Here, there are numerous arm's-length contracts — Monterey's own contracts as well as the contracts between other companies — demonstrating the market value for oil in the Midway-Sunset field. There is no need to attempt a net-back type of calculation.

Second, a true net-back method starts with the downstream value of the oil or gas for which the royalties are due, i.e., the oil or gas that was produced from the leases in question; it then deducts the actual costs incurred in getting the oil or gas to the downstream valuation point. Here, by contrast, MMS is proposing to start with the value of a markedly different crude oil that was produced thousands of miles away from the Midway-Sunset field, and to deduct theoretical (not actual) differences in value between the leasehold and Los Angeles. Since a true net-back method is the "least desirable" method of calculating market value, it follows that MMS's proposed method using an entirely different crude oil is not a proper or accepted method to calculate the royalty value of heavy oil.

V. As an Alternative, MMS Should Rely on Published Prices for Heavy Oil Transactions.

Monterey believes that MMS should rely principally on arm's-length contract prices to value heavy oil. If, however, MMS prefers to rely on published sources, Monterey submits that prices published in Dow Jones Telerate (or in other publications, such as Platts Oilgram or Reuters) reflect the fair value of heavy oil at an aggregation point near the Midway-Sunset field.

In its preamble to the proposed regulations, MMS acknowledged the existence of spot prices published for different types of California crude oil at different locations, but chose not to rely on them because "none of these prices attaches to large enough volumes for MMS to recommend that they apply as royalty value." 62 Fed. Reg. at 3745. MMS then explained that it proposed using ANS prices because they cover large volumes of oil delivered into the California market. Id.

While the transactions reported in Telerate and other publications for Midway-Sunset heavy oil may not involve the same gross volumes as ANS transactions, they nonetheless cover a majority of the oil produced in Midway-Sunset, which are certainly sufficient to accurately reflect the true market value of heavy oil for royalty payments. Monterey estimates that transactions covering between two and one-half and three and one-half million barrels are reported each month in those publications. There is no better indication of the value of heavy oil in the San Joaquin Valley than the arm's-length contract themselves. In this regard, we note that for the sample month in MMS's proposed rules (September 1996), the price reported in Telerate was within three cents of Monterey's arm-length contracts.

VI. MMS's Proposal Would Impose Enormous Administrative Costs.

To come up with the location/quality differentials, MMS proposes to require lessees to file a Form 4415, "Oil Location Differential Report." This form must be filed annually for every contract where oil is exchanged between non-affiliated parties; it must also be filed even for exchanges involving non-federal production. For purposes of the Paperwork Reduction Act of 1995, MMS states that "the burden to complete this report is estimated at one-quarter hour." 62 Fed. Reg. at 3758.

Monterey has three observations on this proposed form. First, it will not provide the information necessary to calculate a location/quality differential for heavy oil, because heavy oil is not typically exchanged for ANS oil in Los Angeles. Thus, at least with respect to valuing heavy oil, the report serves no useful purpose.

Second, the information obtained will be a year old when MMS calculates the so-called differential. Such stale information cannot reliably be used to determine the market value of oil.

Third, there is no way this report can be completed in 15 minutes. The report requests extensive information about each exchange (transfer location, volume, quality, pricing, and adjustments). For all of its crude oil production — both federal and private — Monterey engages in hundreds of exchanges each year, which would ultimately require thousands of manpower dollars for form completion. In addition, companies like Monterey would have to develop new computer systems to accumulate the information. Given the limited utility of the information, it makes no sense to impose this burden on lessees.

VII. Conclusion

MMS's desire for an administratively convenient system cannot override the mandate of the Mineral Leasing Act of 1920 that royalty is due on the value of production at the lease. The value of heavy oil production at the Midway-Sunset field is not equivalent to the value of Alaska North Slope light crude oil delivered to Los Angeles, less some historical and arbitrarily-determined location and quality differential.

MMS should make at least two fundamental changes in its proposed regulations. First, MMS should return to its historic reliance on arm's-length contract prices so that independents like Monterey who ultimately sell all of their production to unaffiliated third parties can pay royalties based on those contract prices. Second, MMS should not use ANS prices to determine the value of heavy crude oil. Instead, where arm's-length contract prices are not used, MMS should rely on published prices for Midway-Sunset heavy oil.

Very truly yours,

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