OFFICE OF THE
CITY ATTORNEY
OF
LONG BEACH

ROBERT E. SHANNON
CITY ATTORNEY

HEATHER A. MAHOOD
ASSISTANT CITY ATTORNEY

City Hall
333 West Ocean Boulevard
Eleventh Floor
Long Beach, California 90802-4664
(562) 570-2200
FAX (562) 436-1679

WORKERS' COMPENSATION SECTION
Eighth Floor
(562) 570-2245
FAX (562) 570-2220

July 31, 1998

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,
63 Fed. Reg. 38355 (July 16, 1998)

Dear Mr. Guzy:

The City of Long Beach and the State of California hereby respond to the Notice of the Minerals Management Service, 63 Fed. Reg. No. 136, p. 38355, July 16, 1998. We applaud MMS, Assistant Secretary, Robert Armstrong, and MMS Director, Cynthia Quarterman, for continuing to support regulations which base the values of non arm's-length transactions on index prices in California and the Gulf Coast. As the comments below indicate, we are not in 100 percent agreement with the proposed regulations. We nonetheless agree with the basic approach proposed by MMS and believe that MMS and the states which share in MMS revenues will receive prices more approximating market values than the MMS regulations presently in effect and those regulations proposed by the oil industry.

There are three major areas encompassed by the proposed regulations: the valuation of crude, the deduction of transportation costs and the adjustment for quality differences between index crudes and federal royalty crudes. We have some objections and suggestions for each of these areas.

## I.

## VALUATION OF ROYALTY CRUDE OIL

### A. *Valuation Of Crude Oil Sold On Arm's Length Transactions (Gross Proceeds Methodology)*

The present proposed regulations would value crude sold on arm's-length transactions on the gross proceeds received on the sale. We opposed use of gross proceeds for any purpose in our submissions to MMS on May 27, 1997. We did so for several reasons. First, our experience has been that oil companies misrepresent the gross proceeds they receive. They pay royalties on the basis of posted prices even when they receive bonuses over posted price. They attempt to hide the bonuses they receive by burying them in complex exchanges. They oppose audits of their transactions to prevent discovery of the prices actually received. The use of gross proceeds to value crude will entail massive and expensive audits and lead to disputes over audits to determine the gross proceeds received for royalty oil. Second, we know that the gross proceeds received for California crudes, even when bonuses are paid, are still well below the market price of those crudes, as indicated by the spot price of ANS landed in California. Thus, the gross proceeds methodology will yield in California a price below market value.

Despite these objections to the gross proceeds methodology, we are sympathetic to the complaint of the independent producers that they are unable to obtain market value (i.e. index value) for their sales of federal royalty oil. We are thus in favor of regulations that would permit independent producers and only independent producers to pay on the basis of gross proceeds for arm's-length sales, subject to the comments below concerning, *inter alia*, monitoring, exchanges, balancing agreements and affiliates.

For this purpose, we believe MMS should adopt the IRS' definition of "independent producer," IRS Code 613(A)(c), i.e., those producers producing less than 50,000 barrels of oil per day and who do not own, are not owned by and are not affiliated with a refinery. Because independent producers and others have sometimes underreported gross proceeds, independent producers using the gross proceeds method should be required to certify the prices they report subject to penalties in the event of fraud.

We do object to MMS' proposed regulations which would permit major oil companies to use the gross proceeds method for arm's-length sales. Major oil companies have the ability to receive market value when they sell crude. Any failure on their part to receive market value for sales of royalty oil should not excuse them from paying market value.

The Solicitor's Office of the Department of Interior has apparently raised a concern that different treatment of independent producers would violate the Equal Protection Clause of the United States Constitution. This concern is without merit. Crude oil regulations embodied in many federal programs have a long history of different treatment for different parts of the industry. The

Mandatory Oil Import Program (MOIP) which existed from 1959 to 1973 had a small refiner bias which gave independent refiners extra import tickets which they traded for domestic crude oil. The Entitlements Program, which existed from 1974 through 1980 also favored independent refiners. The Windfall Profits Tax exempted small producers from paying the same tax rate as large, integrated producers paid. Presently, IRS Code 613(A)(c) has an exemption for independent producers and royalty owners regarding the depletion allowance. The House and Senate bills recently introduced regarding mandatory RIK sales have a small refiner bias. All of these examples indicate that it is common practice in regulations affecting the petroleum industry to single out different parts of the industry for different treatment. We see no reason why regulations allowing only independent producers to use the index pricing method for arm's-length sales, because of the independent producers' lack of market power, would violate the Equal Protection Clause.

*B. The Need To Monitor Sales Prices*

The January 1997 proposed regulations provided: "The royalty value you report is subject to MMS' monitoring, review and audit." Sect. 206.102. The February 1998 proposed regulations drop that language. This language should be reinstated. It is important for MMS to preserve these powers if the gross proceeds method is used to value any royalty oil. Federal lessees have misreported the proceeds received for royalty sales and so MMS needs to monitor transactions to determine whether lessees are correctly reporting gross proceeds. It is especially important that MMS assert its right to monitor oil company transactions if gross proceeds is used to value crude.

*C. The Exclusion For Exchanges Is Not Broad Enough*

Because oil companies have frequently used exchanges to hide the value of crude, MMS has prohibited the use of the gross proceeds method when crudes are exchanged. Unfortunately, the definition of "exchanges" is too narrow and has the effect of allowing oil companies to continue to use the gross proceeds methodology for certain kinds of exchanges. The present definition of exchange excludes:

(1) exchanges where the crudes are received and delivered in the same location, such as time trades;

(2) exchanges of crudes for products;

(3) multi-party exchanges such as daisy chains involving more than two companies, as, for example, where A delivers to B, B delivers to C and C delivers to A.

The definition of "exchange" should cover these types of exchanges.

*D. Overall Balancing Agreements*

The gross proceeds method should not be used for sales of one company to another when the companies have an overall balancing agreement. A balancing agreement is an agreement between two companies whereby the number of barrels of crude oil received and delivered on all transactions, i.e., outright sales, outright purchases, and exchanges, are kept even. Such agreements present exactly the same problem for crude oil valuation as do exchanges. Companies which are parties to such agreements have no incentive to insure that the absolute prices of crudes received and delivered reflect market value. MMS correctly rejects the use of gross proceeds for sales subject to overall balancing agreements. But the proposed regulations place the burden on MMS to determine whether balancing agreements exist and which crudes are subject to them. The proposed regulations should be modified to require the oil companies to reveal the existence of overall balancing agreements, if they seek to value royalty crude using the gross proceeds method.

*E. Affiliates*

The proposed regulations correctly exclude from the gross proceeds method crude oil sales to affiliates which are controlled by or which control lessees or under common control. The definition of "affiliate" has undergone a change in the July 8, 1998 proposed rules. It is proposed that ownership by one company of 10 to 50 percent of another company creates a presumption of control. In previous proposals, ownership by one company of over 10 percent of another company would constitute control.

The new proposal is objectionable for the following reasons. First, the burden should be explicitly placed on the lessee to identify any affiliation or ownership interest by or in the entity to which it sells royalty crude. There is presently no mechanism for MMS to know when control is an issue. Second, in the situation involving 10 to 50 percent ownership, the regulations should provide criteria for determining whether the lessee has met its burden of overcoming the presumption of control. We fear that in practice MMS auditors will assume that ownership of up to 50 percent does not constitute control. Third, the regulations should make clear the lessee may not use the gross proceeds methodology for exchanges between the lessee and another company whether or not the lessee owns, is owned by or under common ownership with the purchasing company even when the ownership is less than 10 percent. The regulations regarding ownership control and exchanges act independently to prohibit the use of the gross proceeds method.

In summary, we urge MMS to permit the use of gross proceeds methodology:

(1) only for independent producers, i.e., those producing less than 50,000 barrels per day and which do not own, are not owned by and are not affiliated with a refinery;

(2) only for arm's-length sales to entities which

lessees do not control, are not controlled by or under common control;

(3) only for outright sales which are not tied to exchanges or subject to overall balancing agreements;

(4) only if MMS has the right to monitor the sales of lessees and the sales of any entity affiliated with the lessee if the lessee sells to affiliated entities, and

(5) only if the independent producers certify, subject to penalties for fraud, their sales prices.

## II.

## TRANSPORTATION

Under the proposed regulations, transportation costs from lease to sales point (Sect. 206.109(a)) when using the gross proceeds method of valuation and from lease to refinery (Sect. 206.113(b)) when using the index pricing method of valuation are fully deductible expenses without regard to the distance. These provisions permit oil companies to deduct the entire cost of transportation from OCS leases in California to the Gulf Coast and from leases in the Permian Basin to Midwest refineries. This is clearly indefensible.

We agree that certain transportation expenses should be deductible expenses. Crude oil which is produced away from a market center is worth less at the lease than it is at the market center. The difference in the market value of crude between a lease and a market center is equal to the cost to transport crude from a lease to a market center. Thus, the only transportation costs which should be deductible are those incurred in moving crude from a lease to the nearest market center. Transportation costs incurred to move crude past the nearest market center should not be deductible. In the case of OCS crude produced in California, the transportation cost should be limited to that required to move OCS crude to Los Angeles, which is the nearest market center.

An additional problem with respect to the proposed regulations regarding transportation costs is that they do not require that lessees use the least expensive method of transporting royalty oil to market. This failure to require companies to use the least expensive transportation creates incentives for companies to use their own transportation facilities even when cheaper alternatives exist.

III.

## QUALITY ADJUSTMENTS

The proposed regulations (Sect. 206.112) provide that adjustments for quality of crude should be made when using index pricing. The reason for the provision is that the royalty oil may differ in quality, *i.e.*, gravity and sulfur content, from the index crudes. The proposed regulations adjust for gravity and sulfur in part by looking to "arm's-length exchange agreements." Quality adjustments should not be based on exchange agreements. Quality adjustments in exchanges can be manipulated in a manner similar to the absolute price terms for crude oil. We know that oil companies are capable of overstating or understating the effect of quality on the value of crude oil. For example, major oil companies have for years disparaged California crudes as of poor quality meriting low prices, even though their internal documents show huge profits to be made by refining them.

We propose that MMS use gravity and sulfur banks in common carrier pipelines near federal leases to adjust for differences in quality between royalty crudes and index crudes. The gravity and sulfur banks on common carrier pipelines are the result of competition among a number of companies and represent objective criteria for making appropriate quality adjustments.

## IV.

## GATHERING VS. TRANSPORTATION

MMS has requested comment on the deductibility of gathering costs for deep water leases. We are opposed for several reasons. The Deep Water Royalty Relief Act allows companies to avoid paying royalties on millions of barrels of OCS oil produced in the Gulf of Mexico. 43 U.S.C. §1337. Industry does not need additional discounts for this production. Moreover, the oil companies seek to deduct gathering costs because of the absence of an oil platform. But the absence of a platform means that the oil companies experience significant savings in deep sea oil production. This is not a reason to grant them still more savings. Finally, we do not believe that MMS would be able to hold the line and permit the deduction of gathering costs only for deep sea leases. Smaller producers would undoubtedly object that their gathering expenses should also be deductible expenses. In short, allowing deductions for deep water gathering costs is a slippery slope which will lead to the deduction of all gathering costs.

## CONCLUSION

We appreciate MMS' resolve the obtain market value for federal royalty oil. We hope that our comments are useful in achieving that end.

Very truly yours,

ROBERT E. SHANNON, City Attorney

By: James N. McCabe
James N. McCabe,
Deputy City Attorney

JNM:pw