



Comments to the Supplementary Proposed Rule on Oil Royalty Valuation

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I want to begin by protesting again the way this meeting was made necessary by Big Oil's ability to gain access through their campaign contributions. I am embarrassed that the interns who have come in to Washington this summer to see how their government works will see through this process who their government is really working for, and how public policy should not be made.

I very much appreciate Representative Maloney and Representative Miller's leadership in ensuring that the Department of Interior hear the voices of the less politically powerful at this 11th hour. I also want to commend you Secretary Armstrong and Director Quarterman for the real steps forward that were taken with the issuance of the original proposed Rule in January 1997.

That being said, I would like to take the opportunity — since we now know where the proposed Rule is going — to point out my fundamental concerns about its direction since the original proposal was issued. I strongly believe that in the past year, we started taking giant leaps backward once Big Oil started using its allies in the Senate to put the squeeze on Interior.

What I believe has happened is that what seemed to amount to small concessions here and there to Big Oil's very heavy-handed demands — when all added up in the current language — amount to such a complete concession to Big Oil as to make this entire Rulemaking a failure. The longer the rider is in effect, the more time industry has to whittle the Rule down — which was of course their intent. Once the dust cleared over the past week, I realized that the Big Oil lobbyists

had succeeded in quietly and incrementally getting nearly everything they wanted. Each of the demands they have made over the last couple of years by themselves were relatively insignificant, but when they are all put together, as they are in the Supplemental Proposed Rule, the total package is worse than the current Rule.

For example, first MMS extended the opportunity for the major integrated companies to pay royalties on gross proceeds and not index prices for "arms length" transactions. This was very troubling, yet we still testified in favor of the proposed Rule in February because overall the Rule was still a step forward.

Secondly, combining that concession with returning to the old definition of "affiliate", where it is only assumed that one company "controls" another if it owns in excess of 50%, means it becomes that much easier for a major oil company to pay royalties on gross proceeds and not index prices. Even if a company has a 10% interest in a joint venture, it could easily sell low to its affiliate, knowing it will benefit at the other end from that company's profits. I know MMS may argue that the burden is on industry to prove it is not an affiliate, but I think you will agree that this system has been a resounding failure in identifying phoney arms-length transactions.

On top of these two elements, MMS made an additional concession as a result of the oil industry's scare tactics that "duty to market" was a new and unfair burden placed on them. We all knew this argument was specious, but nevertheless, MMS is proposing to put in writing that it will not second-guess a company's marketing decisions, but will only rely on this duty to catch someone who is inappropriately entered into a substantially below-market transaction for the purpose of reducing royalty. Yet how will MMS auditors — the same ones who have missed the billions of dollars of already underpaid royalties owed under the current Rule — be able to discover the inappropriate transaction if they can't, at some level, second-guess the company's marketing decisions? In fact, "duty to market" must involve second-guessing or it is meaningless.

Finally, in addition to these three factors, the MMS' commitment not to look beyond the first transaction (a change, by itself, in favor of which I testified), combined with MMS's unwillingness

to incorporate our suggestion to require companies to disclose overall balancing arrangements means that we are making MMS into the three monkeys who see no evil, hear no evil and speak no evil. In the current environment where balancing arrangements are a regular part of doing business, why are we proposing to legalize what is currently illegal? In fact, the language will have the effect of stopping the DOJ in the future from collecting what will be owed from the underpayment of royalties by defining it as no longer being an underpayment.

The greatest irony is that industry's favorite buzzword throughout this process has been "certainty", yet at each step of chipping away at the proposed Rule, we are getting less certainty — in the presumption of control of an affiliate, in whether a major will pay royalties on index or gross proceeds, and finally on the requirement for MMS auditors to prove overall balancing arrangements means we end up with less certainty as to whether major oil companies will be paying what they owe.

In closing, I have four recommendations:

1. Rather than rely on defining the transaction, which is very complicated, define the seller — either as a major integrated company or independent as defined by in IRS code 613A(c) or as in Representative Maloney's bill, H.R.3932. Allow independents to pay royalties on gross proceeds and require majors to pay royalties on index. Period.
2. Rather than rely on percentage ownership and controlling interest for the definition of "affiliate" for arms-length transactions, simply look to see if there is any economic interest in another company. If there is, royalties should be paid on index and not on gross proceeds. The current move to water down the definition of "affiliate" weakens the strength and certainty of the "arms-length" definition.
3. If MMS decides to retain the affiliate language, require companies to open-up their books when they sell below market prices to prove they don't have balancing arrangements. The proposed Rule continues to rely on MMS taking companies to court, which results in

litigious stalemates with few positive results. I want to emphasize that this recommendation is a poor substitute to simply requiring the majors to pay index.

4. MMS should reinstate language in the Final Rule that would specifically require companies to disclose their overall balancing agreements (subject to audit) shifting the burden from MMS back to the companies. Again, this auditing requirement is made necessary by the complication of allowing the majors to pay royalties based on gross proceeds.

I believe these recommendations are critical to ensure that the American public does not end up rewarding Big Oil and its henchmen in the Congress for delaying the Rule by giving them everything they want.