ipaa
America's Oil & Gas Producers

January 31, 2000

Mr. David S. Guzy
Chief, Rules and Publications Staff
Royalty Management Program
Minerals Management Service
P.O. Box 25165
Mail Stop 3021
Denver, Colorado 80225-0165

By Electronic Mail and First Class Delivery

Re: Further Supplementary Proposed Rule, 64 Fed. Reg. 73820 (1999)

Dear Mr. Guzy:

In addition to its comments filed jointly with other trade associations, the Independent Petroleum Association of America ("IPAA") files this comment to underscore the concerns independent producers have over the Department's treatment of sales to affiliates and the lessee's purported implied duty to market production downstream at no cost to the lessor.

The Department has not changed its position on this issue throughout this three year proceeding. But in the Further Supplementary Proposed Rule, the Department at last tried to offer clarification of how the implied duty supposedly works and the justification behind it. 64 Fed. Reg. 73822-24. Unfortunately, the clarification and justification provide an explanation our members cannot understand. A brief, three-part example should make our difficulty clear. (Unless expressly noted, all sales described are outright sales to unaffiliated parties.)

Part 1: An independent producer sells oil to a third party at the lease in an outright sale for $10 per barrel. No one else selling oil from the same field receives a higher price. Under the proposed rule, that price is the proper royalty value, and the producer has satisfied his duty to market the production. (Proposed § 206.102(a)(1), and 64 Fed. Reg. 73823, left column.)

Part 2: The same company decides there is money to be made in buying oil in the field and moving it to Cushing, Oklahoma, for resale. The company creates an affiliate for that purpose. For $10 per barrel, the affiliate buys oil in the field from all *unaffiliated* producers, but not from its producing affiliate, who sells his barrels at the lease to a third party at the same $10 price. The affiliate moves the oil it bought to Cushing and resells it for $12 per barrel, making a $1 per barrel profit. Under the proposed rule, the independent producer still correctly values royalty at $10 per barrel and has satisfied his duty to market the production. The Department claims no share in the

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extra $2 of proceeds received or the $1 of profit earned by the affiliate which bought at the lease and sold in Cushing. (Proposed § 206.102(a)(1), and 64 Fed. Reg. 73823, left column.)

Part 3: The same producing company now decides to sell its own oil at the lease to its affiliate at $10 per barrel. (The affiliate is now the purchaser of all oil produced in the field, all bought at $10 per barrel.) The affiliate moves all the oil from the field to Cushing and resells for $12 per barrel, realizing a $1 per barrel profit. Under the proposed rule, the independent producer violates the lease by paying royalty at $10 per barrel and breaches its duty to market production. The Department claims that the royalty value per barrel is $12 minus *some* of the costs of moving the oil, resulting in a royalty value in excess of $11 per barrel. (Proposed § 206.102(a) & (a)(2), and 64 Fed. Reg. 73823, left column.)

From the standpoint of the independent producer, these three transactions are indistinguishable. Yet MMS ascribes different royalty consequences to the third transaction. Why? If, as the Department admits, "[l]essees may market at the lease without breaching the duty to market," 64 Fed. Reg. 73823, how can lessees be faulted for valuing sales to affiliates at the same price being paid for oil marketed at the lease at arm's length?

And the difference cannot be ascribed to the lessee's lease obligation to pay royalty on the "gross proceeds" it receives from its disposal of "lease production." Congress had made clear who the "lessee" is, and the term does not include affiliates marketing downstream. 30 U.S.C. § 1702(7). Additionally, the affiliate is not selling "lease production." It is instead selling a commingled stream of crude oil out of storage tanks at Cushing.

IPAA has previously provided the Department with extensive analyses of the purported duty to market and the Department's recent policy of discriminating against sales to affiliates.[1/] For brevity, we offer summary responses to points raised in the Department's most recent preamble. 64 Fed. Reg. 73822-24.

- The Department describes the implied duty as one to market "for the mutual benefit of itself [the lessee] and the lessor," but the Department refuses to share mutually in the lessee's costs of marketing.

[1/] These documents, already on file with Assistant Solicitor Heath and incorporated in this comment by reference, are *IPAA v. Armstrong*, Civ. No. 98-00531 (RCL): Plaintiff IPAA's Motion for Summary Judgment and Memorandum in Support, Plaintiff IPAA's Memorandum in Opposition to the Defendants' Motion for Summary Judgment, and Plaintiff IPAA's Reply Memorandum in Support of its Motion for Summary Judgment; *Taylor Energy Co.*, IBLA 94-828-R: Motion and Brief Amicus Curiae of the Independent Petroleum Association of America in Support of Taylor Energy Company's Petition for Reconsideration and Brief of Amicus Curiae of the Independent Petroleum Association of America in Response to the Minerals Management Service's Opposition to Taylor Energy Company's Petition for Reconsideration. For your convenience in later assembling the administrative record for this rulemaking, IPAA is forwarding additional copies directly to you by first class mail.

- The Department has yet to draw a rational distinction between downstream transportation costs (which may partly or fully be deducted from the downstream sales price under the proposal) and other kinds of downstream marketing costs (which may not). The Department cannot avoid explaining the distinction simply by alleging a "uniform longstanding practice." *See City of Los Angeles Dep't of Airports v. Dep't of Transportation*, 103 F.3d 1027, 1032-33 (D.C. Cir. 1997).

- The Department says it "has not knowingly permitted an allowance or deduction from royalty value for marketing costs." Yet in the *Marathon Oil Co.* case on which so much of the Department's position rests, the Department ordered Marathon to following a valuation formula which knowingly approved deductions for what the Department now calls marketing costs. That the order was ultimately incorporated into a settlement agreement does not excuse the Department's failure to address the inconsistency in its practice.

- The Department treats the implied duty to market as one member of a family of implied duties under federal oil and gas leases. IPAA has already shown, without rebuttal or response from the Department, that all of these duties are traceable to *explicit* language in the leases or in regulations incorporated by reference in leases. No explicit language supports a duty to market downstream without cost to the lessor.

- The Department is incorrect to argue that, if there is no implied duty to market, the Department would be forced to adopt a "'lowest common denominator' theory of valuation." The Department is well aware that arm's-length prices for an identical product in a market will not be identical, but will be in a range. In the past, the Department's practice has varied, sometimes requiring the highest price paid for a majority of the production, *see, e.g.,* 30 C.F.R. § 250.64 (1980), sometimes accepting the lowest price in the range, *e.g., Mobil Oil Corp.*, 112 IBLA 56, 62 (1989). The lack of an implied duty to market does not dictate how the Department handles

- The result of the Department's view is to impose a highly selective tax, at a rate equal to the lease royalty rate, on the profits a company derives from the purchase of oil from an affiliated producer. The Department has not been delegated the Congressional power to levy taxes. *See, e.g., Federal Power Comm'n v. New England Power Co.*, 415 U.S. 345 (1974); *Nat'l Cable Television Ass'n v. United States*, 415 U.S. 336 (1974).

Thank you for considering these points.

Sincerely,

Ben J. Dillon

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