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January 31, 2000

VIA FACSIMILE AND U.S. MAIL
Mr. David S. Guzy
Chief, Rules and Publications Staff
Royalty Management Program
Minerals Management Service
P.O. Box 25165, M.S. 3021
Denver, Colorado 80225-0165

Re: Further Supplementary Proposed Rule, Establishing Oil Value for Royalty Due on Federal Leases, 64 Fed. Reg. 73,820 (Proposed Dec. 30, 1999)

Dear Mr. Guzy:

Vastar Resources, Inc. ("Vastar") is one of the largest independent, non-integrated oil and gas companies in the United States.[1] Vastar appreciates this opportunity to comment on the proposal by the Minerals Management Service ("MMS") to modify the valuation procedures for crude oil.[2] In addition to its own comments, Vastar supports and adopts the comments jointly submitted by the American Petroleum Institute, the Independent Petroleum Association of

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[1] Vastar and its subsidiaries, Vastar Offshore Inc. and Vastar Pipeline Company, own an interest in a number of offshore pipeline systems in the Gulf of Mexico. These include: the High Island Pipeline System, Bonito, Ewing Banks 826, South Pelto 10, South Timbalier 53, and East Cameron 46 pipelines. These pipelines are co-owned with other producers, and some of the lines are utilized by third-party shippers. The pipelines move crude from the Outer Continental Shelf ("OCS") to onshore refineries, and Vastar and its co-owners have tariffs in place for several of the movements on these lines.

[2] Vastar previously submitted comments, filed May 29, 1997, in response to MMS's initial Notice of Proposed Rulemaking published on January 24, 1997 at 62 Fed. Reg. 3742. These comments supplement those previously filed.

America, and the Domestic Petroleum Council (the "Joint Comments"), all trade associations in which Vastar is a member. Vastar's comments will focus on those areas where Vastar has specific concerns or insights additional to those in the Joint Comments.

MMS requested comments on certain specific issues related to these proposals, and the first section of Vastar's comments addresses these issues. The second section of Vastar's comments focuses on additional issues, including Vastar's objection to MMS's proposal to eliminate Federal Energy Regulatory Commission ("FERC") and state regulatory agency tariffs as proxies for actual transportation costs in calculating transportation allowances for non-arm's-length transactions. As explained more fully below, Vastar instead advocates continued acceptance of FERC and state tariffs as representative of actual transportation costs. In the absence of tariffs, Vastar supports the development of transportation allowances based upon the market price for transportation services, rather than the arbitrary non-arm's-length transportation allowance MMS proposes. Vastar believes the framework it advocates for transportation allowances is more consistent with the goals enunciated by Congress in authorizing the lease of federal lands and collection of royalties for crude oil production therefrom. The framework is consistent as well with the longstanding emphasis of the Department of the Interior (the "Department") on using market transactions to set crude oil value for royalty purposes.

I. Comments on Specific Issues

MMS specifically seeks comments on the following matters on which Vastar wishes to respond:

A. Whether existing paragraph § 206.105 (b)(2)(B) of the current regulations, which provides an alternative for transportation facilities first placed into service after March 1, 1988, should be retained in light of the changes MMS

proposes to the calculation of actual transportation costs and in light of MMS's belief that the alternative has been used in few, if any, situations.[3]

Vastar submits that the alternative for transportation facilities first placed into service after March 1, 1988 is no longer necessary in light of the proposed changes in the calculation of actual transportation costs.

B. Whether the allowable rate of return on capital investment for affiliated producers, which is currently the Standard and Poor's Industrial BBB bond rate, should be modified and if so, what the rate should be.[4]

Vastar submits that the BBB rate is demonstrably inadequate. In its place, as discussed in the next section below, a rate of return based on economically sound criteria that more closely estimates the true cost of capital of companies like Vastar should be accepted. Alternatively, the proposal in the Joint Comments, which recommends adoption of the BBB bond rate times two, should be adopted. That proposal has the virtues of simplicity, determinability, and ease of application, while significantly lessening the unfairness inherent in the current BBB rate limitation.

C. Whether there is any other method of determining the appropriate rate of return applicable to transportation systems for oil production from federal lands.[5]

The MMS should reexamine its policy of disregarding the approach to rate of return employed by the FERC. The FERC approach responds directly to the U.S. Supreme Court's repeated holding that investors in regulated companies are constitutionally and statutorily

[3] Further Supplementary Proposed Rule, Establishing Oil Value for Royalty Due on Federal Leases, 64 Fed. Reg. 73,820, 73,834 (proposed Dec. 30, 1999) (hereinafter, the "December 1999 Proposal" or "proposal").

[4] Id.

[5] Id.

entitled to a reasonable opportunity to earn a fair rate of return on their invested capital.[6] The constitutional entitlement to a fair rate of return derives from the Due Process Clause, which protects individuals and companies against deprivation of their property without due process and just compensation. As the Supreme Court concluded in a well-known decision on this subject, a regulated company "is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties."[7] Similarly, in Hope Natural Gas, the Court observed:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on debt and dividends on the stock . . . . By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[8]

The FERC is thus charged with setting rates based on a reasonable return for pipelines when measured against comparable investment opportunities. It has extensive experience in measuring pipeline risks, and it has devised sophisticated yet easily applied formulas for determining the pipeline's cost of capital based on those risks. While hardly generous, the

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[6] E.g., FPC v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944); Chicago, M. & St. P. Ry. v. Minnesota, 134 U.S. 418, 458 (1890).

[7] Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n, 262 U.S. 679, 692 (1923).

[8] 320 U.S. at 603 (citation omitted).

results obtained under the FERC's approach have far more grounding in real-world financial experience and expectations than the flat debt rate employed by the MMS.

Attached to these comments is a Verified Statement from Professor J. Peter Williamson, the Laurence F. Whittemore Professor of Finance, Emeritus, at the Amos Tuck School of Business Administration at Dartmouth and a recognized expert on the rate of return methodologies applied by the FERC and various state regulatory agencies.[9] As Professor Williamson describes, agencies such as the FERC use sophisticated financial models to estimate the cost of equity capital in order to compensate the regulated company's investors fairly for making their capital available for use in providing the transportation service. The model used by the FERC and most other agencies for this purpose is the Discounted Cash Flow ("DCF") model. That model essentially infers the cost of equity capital from publicly available stock market data on dividend yields and expected rates of growth in earnings in future years. The theory is that the investor, in purchasing the stock at a particular price, is buying a stream of future earnings. By calculating the discount rate necessary to equate that stream of future earnings to the current stock price, the DCF model permits the regulator to determine the market's expected cost of equity capital for that particular company. With some variations over time, this well-tested model has been successfully applied by the FERC and many other agencies for more than two decades.

Professor Williamson explains that the FERC's current application of the DCF model to oil pipelines utilizes a sample group of publicly traded companies that are solely or predominantly in the oil pipeline business. The DCF model is applied to this sample group to

[9] See Attachment A (hereinafter, "Williamson V.S.").

produce a range of estimates for the cost of equity capital of the oil pipeline industry generally. The median of the range is deemed by the FERC to be the cost of equity for the average-risk oil pipeline. Upward or downward adjustments are then made in the case of companies whose business and financial risks vary markedly from those of the average company.

Applying the version of the DCF model used in the FERC's most recent oil pipeline rate of return decision,[10] Professor Williamson determined that the cost of equity for the sample group presently ranges from 13.26% to 18.92%. The median is 15.33%, which equates to the FERC's estimation of the cost of equity of the average oil pipeline company. Compensating the investors in an oil pipeline with a level of return significantly below this 15.33% estimate would deprive them of fair compensation for a real cost of doing business. Equally important, it would deprive investors of the proper incentive to invest in pipelines subject to MMS royalties (at least where affiliate relationships are involved) when other investments of comparable risk can be expected to earn a return of 15.33%. As Professor Williamson concludes:

> The current MMS policy appears to assume that oil pipelines are financed entirely by debt carrying an interest rate equal to the average for S&P BBB industrial bonds. This is a quite unrealistic assumption. It may well have originated in a wish to keep the matter of cost of capital simple, but it results in seriously understating the true cost of capital.[11]

For all of these reasons, if MMS determines that a cost of service must be calculated for OCS lessees' non-arm's-length pipeline movements, then fairness and compliance with settled law dictates that lessees be permitted to include in their allowable costs an economically defensible equity-based return component. Anything less will unfairly transfer to the MMS a

[10] SFPP, L.P., 86 FERC (CCH) ¶ 61,022 (1999).

[11] Williamson V.S. at 7.

significant portion of the rewards for investment in OCS assets that properly should remain with lessees.

D. Whether a company-specific or industry-wide weighted cost of capital should be used to determine the rate of return.[12]

As explained in the preceding section, Vastar advocates use of the DCF model employed by FERC. FERC's current application of the DCF model to oil pipelines utilizes a sample group of publicly traded companies that are solely or predominantly in the oil pipeline business. The DCF model is applied to this sample group to produce a range of estimates for the cost of equity capital of the oil pipeline industry generally. The median of the range is deemed by the FERC to be the cost of equity for the average-risk oil pipeline. Upward or downward adjustments are then made only in the case of companies whose business and financial risks vary markedly from those of the average company. This general approach would be appropriate for use by the MMS.

II. Vastar's Additional Comments

A. Effective Date of the Proposed Regulations

It is not clear when the new rule will become effective. However, Vastar – and indeed most lessees – will require a minimum of six months to implement the changes required by the new rule. Vastar therefore suggests an effective date that is at least six months after publication of the final rule.

Implementation of the new oil valuation rule will require substantial software changes to Vastar's accounting system. Vastar is already in the process of making substantial changes to its accounting system to accommodate the new Indian gas valuation rule, which went into effect on

[12] December 1999 Proposal, 64 Fed. Reg. at 73,834.

January 1, 2000 (and permitted close to five months of lead-in time to make system changes).[13] Even if Vastar were not in the process of completing implementation of software changes associated with the Indian gas rule, it could not make the necessary software changes associated with the oil valuation rule in less than six months without substantial expense. The necessity of doing another set of software changes to comply with the new oil valuation rule shortly after making software changes to comply with the Indian gas rule is both onerous and unfair. Moreover, Vastar will need at least as much lead time – if not more – to devise and implement software changes for the new oil valuation rule as it did for the Indian gas valuation rule. In sum, at least six months will be required for Vastar to make the necessary changes to its accounting system to comply with the new oil valuation rule; therefore, we request a minimum six month period of time between the publication of the final rule and its effective date.

B. Value Determination Provision

Vastar appreciates the changes that the MMS has made so far with respect to clarifying that value determinations may be issued by the Assistant Secretary and that those decisions will be binding and appealable to the federal courts.[14] However, Vastar believes that two matters should be clarified further and that MMS should eliminate a new requirement on issuing value determinations.

First, Vastar believes that MMS should make it clear that a definitive response is required from MMS or the Department when a party requests a value determination. As currently written,

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[13] See Final Rule, Amendments to Gas Valuation Regulations for Indian Leases, 64 Fed. Reg. 43,506 (Aug. 10, 1999).

[14] December 1999 Proposal, 64 Fed. Reg. at 73,845 (proposed 30 C.F.R. § 206.107(c)).

the provisions of the rulemaking do not place any obligation on MMS or the Assistant Secretary to respond "yes" or "no" to a request for value determination. Vastar believes that a definite response – even if negative – is preferable so that the requesting party knows precisely where it stands with respect to its value determination. Furthermore, a negative determination should be appealable when made by MMS. Currently, the proposal contains no provision for recourse if MMS refuses to issue a value determination.

Second, MMS should clarify under what specific circumstances it will issue a value determination. As currently written, the rule states that a value determination may not be given in "hypothetical" or "fact-specific" situations.[15] Since facially, those two exclusions seem to cover all possible occasions when a party might request a value determination, this would not appear to reflect what was intended. Therefore, we suggest that MMS put forward a clearer set of criteria for when it will not issue a value determination. Vastar agrees that a hypothetical value determination may be inappropriate; however, Vastar can see no comparable reason to preclude fact-specific determinations as a general rule. If MMS or the Department is concerned about making a particular value determination because all the relevant facts are not available or are unreliable, it may simply deny the value determination request. Vastar therefore suggests deletion of the language excluding issuance of "fact-specific" value determinations.

Finally, Vastar does not believe that the new requirement in the proposed rule to identify record title or operating rights owners and designees for each lease subject to a value determination is necessary or feasible.[16] Vastar has no way of knowing on a day-to-day basis

[15] Id. (proposed § 206.107 (b)(3)).

[16] See id. (proposed § 206.107 (a)(2)).

who all the record title holders or operating rights owners and their designees are for each lease in which it has an interest. The identity of those entities can change on a daily basis, often retroactively, without Vastar ever finding out about the change. The Department itself is responsible for maintaining that information through MMS for the offshore, and through the Bureau of Land Management for the onshore. Therefore, the Department should have that information readily available to it without requiring lessees to become involved. In any event, there appears to be no reason why this information would be relevant to a value determination, nor does there appear to be any reason why the absence, incompleteness or inaccuracy of this information would affect the legitimacy of a value determination. Since this provision was not set forth in any earlier version of the rule and MMS has offered no rational basis for its inclusion, Vastar requests that this provision not be included in the final rule.

C. Election to Use Spot Prices

Vastar objects to the indexing election provision of the rule to the extent that it requires a two-year election applicable to all of the lessee's producing properties.[17] Two years is too long a term for the election of indexing. MMS seems to be concerned that allowing lessees to change their valuation methodology will result in the manipulation of royalty obligations. However, in trying to address that concern, MMS has overcompensated in the wrong direction. As the Department has recognized over the past few years, the oil marketplace is very dynamic and consequently requires a great deal of regulatory flexibility to keep up with evolutionary changes. In that context, a two-year election is far too long to set in place any methodology. It would be much wiser to leave open the possibility for adaptations in methodologies based on changes in

[17] Id. at 73,844 (proposed § 206.102 (d)).

the marketplace, rather than being tied to one methodology for two entire years. A one-year election period is more than adequate to guard against any potential manipulation of royalty value, but is short enough to reflect current market realities.

In addition, assuming a party elects to use an index, the selected index should not apply to all the lessee's properties. Vastar – and no doubt most lessees – has production in areas where no index exists, has production in areas where multiple indices could apply, and has production that is never transported to a market center or is transported well beyond a market center. In those cases, an index would not necessarily be the best indicator of value and a company should be able to exclude those properties from its election and instead elect properties for indexing on a pipeline system basis. Although the rule does not specifically address this possibility, it is clear that in applying the new rule the MMS will have to make specific accommodations for each royalty payor and each property. It would be far better for the rules explicitly to provide for this eventuality than to remain silent or implicitly reject the possibility.

D. Clarification of Proposal Regarding Allowance of Location Differentials Where a Lessee Uses Index Pricing But Does Not Physically Transport Its Own Crude Oil to a Market Center/Index Point

It is not clear whether the proposed regulations permit a transportation allowance in "buy/sell" arrangements, in which a lessee takes its production to a location other than a market center/index point, such as a refinery. Vastar engages in a number of transactions of this nature and seeks clarification regarding whether the rule will permit the transportation allowance to reflect actual transportation costs for every barrel that has actually been moved to market, even if it was the subject of an exchange. It is unclear whether Proposed § 206.112 addresses this situation, but Vastar requests that MMS affirm that it will be able to take a transportation allowance in this situation.

E. Transportation Allowances for Non-Arm's-Length Transactions

The Mineral Leasing Act ("MLA")[18] and the Outer Continental Shelf Lands Act ("OCSLA")[19] authorize the Secretary of the Interior to establish and collect royalties on oil produced from federal lands. The intent of Congress in creating a framework for the development of publicly-owned natural resources was at least two-fold: to encourage the development of these resources for the Nation's use while at the same time, securing a fair return in royalties to the public. When enacting OCSLA with respect to offshore leases for example, Congress explicitly declared its intention to:

> preserve, protect and develop oil and natural gas resources in the Outer Continental Shelf in a manner which is consistent with the need (A) to make such resources available to *meet the Nation's energy needs as rapidly as possible*, (B) to balance orderly energy resource development with protection of the human, marine, and coastal environments, (C) to *insure the public a fair and equitable return* on the resources of the Outer Continental Shelf, and (D) to *preserve and maintain free enterprise competition*.[20]

Similarly, with respect to onshore leases, the U.S. Court of Appeals for the District of Columbia Circuit has stated:

> The Secretary of the Interior . . . [h]as a responsibility to insure that [the public's] resources are not physically wasted and that their extraction accords with prudent principles of conservation. . . . He may also establish "reasonable values" for royalty purposes. Of

[18] 30 U.S.C. § 226 (1986 & Supp. 1999).

[19] 43 U.S.C. § 1301 et seq. (1986 & Supp. 1999)

[20] 43 U.S.C. § 1802(2) (emphasis added).

> course, his duties have another aspect. The public does not benefit from resources that remain undeveloped, and the Secretary must administer the Act so as to provide some incentive for development.[21]

That responsibility to provide adequate incentives for development is equally applicable under OCSLA.[22] In fulfilling Congress' purposes, the Department is required to perform an often difficult balancing act. However, the Department must keep Congress' mandate in mind as it proceeds with creating and implementing policies that affect the future of the offshore as well as onshore leases.[23] The Department's royalty policies should therefore reflect an effort to achieve balance between the interests of collecting royalties and encouraging development of federally-owned resources; the Department should not tip the balance in favor of attempting to collect a maximum royalty at the expense of development.

To sacrifice development of resources in favor of collecting more royalty is wholly inconsistent with congressional intent, and over the years, Congress has made this point

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[21] California Co. v. Udall, 296 F.2d 384, 388 (D.C. Cir. 1961).

[22] See 43 U.S.C. § 1802(2) (A), (D).

[23] With respect to oil production in the United States, the Department should recognize that the Nation's major oil and gas producers have divested themselves of onshore and shallow water Gulf of Mexico interests and concentrated their exploration and production efforts in the United States almost exclusively on the Gulf of Mexico deepwater. See e.g., John M. Biers, "Texaco, McMoRan Cut Exloration Deal; Offshore Sites Farmed Out to N.O. Company," The Times-Picayune (New Orleans), Dec. 22, 1999, at C1 (stating "[t]his agreement is the latest in a string of moves by major oil companies to redirect resources away from the mature continental shelf-region toward new properties elsewhere in the Gulf and abroad"); James Norman, "Shell Oil Looks to Veteran Downstram Boss as CEO," Platt's Oilgram News, Apr. 30, 1999, available in LEXIS, Energy Library, PONEWS File (stating "[b]y selling mature properties in the shallow waters of the Gulf of Mexico 'shelf,' Shell frees up cash for more promising deepwater plays"). The continued viability of the federal onshore and shallow water area of the Gulf as a producing region rests squarely on the shoulders of independent oil and gas producers such as Vastar. The Department, through its royalty policies, should not discourage continued development of these areas.

abundantly clear. An example is the 1978 amendment of OCSLA, where Congress restated its intention for the Department to create a proper balance on the OCS by authorizing alternative leasing techniques. The legislative history demonstrates that Congress thought those alternative techniques would help the Secretary of the Interior "strike a proper balance between securing a fair return to the Federal Government for the lease of its lands, increasing competition in exploitation of resources, and providing the incentive of a fair profit to the oil companies, which must risk their investment capital."[24]

Yet, the Department's latest transportation allowance proposal moves the Department away from attaining this balance. The proposal penalizes a lessee's investment in pipeline assets and what is more, deprives oil companies of a fair profit on their pipeline assets despite the fact that they are already at risk in their exploration activities. Instead of adhering to the intent of Congress, the proposal eliminates the use of FERC tariffs, rejects the use of comparable arm's-length transactions as representative of actual transportation costs in non-arm's-length transactions and continues to refuse to accept a realistic definition of "actual cost." This policy serves only to maximize royalties at lessees' expense and does nothing to encourage the development of federal leases. But MMS steadfastly maintains that its policy is "fair to lessees."[25]

Since the December 1995 initiation of this rulemaking, several commenters have expressed disagreement with MMS's policy and urged MMS to closely reexamine it. The MMS has resisted these urgings, and as a result, its most recent Further Supplementary Proposed Rule

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[24] H.R. Rep. No. 95-590, at 54 (1978), reprinted in 1978 U.S.C.C.A.N. 1450, 1461.

[25] Notice of Proposed Rulemaking, Establishing Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil, 62 Fed. Reg. 3742, 3746 (proposed Jan. 24, 1997) (hereinafter, the "January 1997 Proposal").

contains only a few changes to the current rule. Vastar supports some of these changes. Specifically, Vastar supports MMS's proposal to allow a change in ownership of a pipeline to result in a new depreciation schedule for purposes of the transportation allowance calculation.[26] Vastar also supports the proposal to permit continued deductions of a return on capital after a pipeline has been fully depreciated.[27] Vastar is nonetheless compelled to voice its respectful disagreement with several other aspects of the December 1999 transportation allowance proposal as inconsistent with what is "fair to lessees" and inconsistent with Congress' intent.

As an initial matter, if "actual costs" including a return on investment are to be used to value transportation allowances, MMS should engage in an open dialogue about what elements constitute actual costs and represent a reasonable return on investment for transporting crude oil today and why. It should not issue an edict about what costs will be recognized and at what rate of return and end the discussion there. If so, it must be prepared to explain in detail why it has reached its conclusion. To do otherwise would be arbitrary and capricious.

Yet, in its December 1999 Proposal, MMS continues to offer little in the way of substantive justification for its adherence to the actual cost rule, stating only that MMS "continue[s] to believe that the cost of service is most appropriate in determining deductions for royalty purposes. This is consistent with longstanding valuation and allowance principles."[28] However, Vastar respectfully disagrees with MMS's definition of the "cost of service" because the transportation allowance proposed by MMS fails to reflect the true cost of service. On the

[26] December 1999 Proposal, 64 Fed. Reg. at 73,834 (proposed 30 C.F.R. § 206.111(g)(2)).

[27] Id. (proposed 30 C.F.R. § 206.111(g)(3)).

[28] December 1999 Proposal, 64 Fed. Reg. at 73,834.

contrary, MMS's current and proposed transportation allowances for non-arm's-length transactions are wholly arbitrary. Attached to these comments is the Affidavit of Adam B. Jaffe, a Professor of Economics at Brandeis University.[29] As Professor Jaffe explains in more detail, the true cost of pipeline transportation services is the market price for such services. If the "cost of service" for transportation allowance purposes fails to reflect the market price, as MMS proposes, the long-run development of federally-owned resources will be inhibited,[30] in contravention of Congress' intention that the Department "strike a proper balance" between securing royalties and encouraging resource development.

1. MMS Should Accept FERC or State Regulatory Agency Tariffs as Representative of the Real Economic Cost of Service

MMS's proposal to abandon the use of FERC or state regulatory agency tariffs as a proxy for the actual costs of non-arm's-length transportation lacks any credible explanation or justification. First, although MMS has repeatedly cited FERC's disclaimer of jurisdiction over non-interstate OCS pipeline transportation as justification for ignoring FERC tariffs, FERC's disclaimer in no way justifies MMS's latest proposal. FERC disclaimed jurisdiction only over non-interstate OCS transportation regulation under the Interstate Commerce Act;[31] yet, MMS

[29] Attachment B (hereinafter, "Jaffe Aff.").

[30] See Jaffe Aff. at 6-7, 14-15.

[31] The FERC continues to retain jurisdiction over OCS oil pipelines under the OCSLA. The OCSLA prohibits "discriminatory" treatment by pipelines crossing the OCS. See 43 U.S.C. § 1334(f). Notably, MMS's insistence that pipelines charge affiliates "actual cost" rather than the tariff rate appears to violate the filed rate doctrine, which prohibits common carriers from charging shippers any rate other than that in the applicable tariff. The Supreme Court has explained that a filed tariff exclusively "governs the legal relationship between shipper and carrier . . . . 'In order to render rates definite and certain, and to prevent discrimination and other abuses, the [Interstate Commerce Act] requires the filing and publishing of tariffs specifying the rates adopted by the carrier, and makes these the legal rates, that is, those which must be charged to all shippers alike.'" Maislin Indus., U.S., Inc. v. Primary Steel, Inc., 497 U.S. 116, 126 (1990)
(Continued ...)

proposes to ignore all tariffs, including onshore as well as state regulatory agency tariffs. FERC's disclaimer of jurisdiction over transportation in the narrow context of some OCS movements cannot justify MMS's action with regard to all onshore intrastate and interstate, and OCS interstate movements – the transportation contexts are simply unrelated.

Second, the December 1999 Proposal asserts, without offering *any* supporting data or information, that "FERC tariffs often exceed the transporter's actual costs."[32] On the contrary, and unlike MMS's proposal, FERC tariffs reflect the true cost of service, and are based upon what occurs in the marketplace.[33] An equally rigorous royalty collector, the State of Alaska, accepts the Trans Alaska Pipeline System's average tariff as a deduction from royalty.[34] If the State of Alaska has a problem with that tariff rate, it challenges the rate before the appropriate regulatory agency. MMS should do likewise, because FERC tariffs reflect the true cost of transportation service, and accepting FERC tariffs for royalty purposes is thus consistent with the market-based valuation philosophy that the Department has long upheld.

Further, MMS's refusal to allow affiliated producers to use tariffs as a proxy for actual costs while permitting non-affiliated producers to do so amounts to unfair discrimination against

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(citing Arizona Grocery Co. v. Atchison, T. & S.F.R. Co., 284 U.S. 370, 384 (1932) (internal punctuation omitted)). The only relevant exception to the filed rate doctrine is where the tariff has been invalidated by FERC. Williams Pipe Line Co. v. Empire Gas Corp., 76 F.3d 1491, 1494 (10th Cir. 1996) (citing Maislin). Otherwise, pipelines may not deviate from charging shippers the tariff rate. Maislin, 497 U.S. at 127 ("[u]nder the [ICA], the rate of the carrier duly filed is the only lawful charge. Deviation from it is not permitted upon any pretext.") (citing Louisville & N. R. Co. v. Maxwell, 237 U.S. 94, 97 (1915)).

[32] December 1999 Proposal, 64 Fed. Reg. at 73,835.

[33] For the remainder of this discussion, reference to FERC tariffs or tariffs generally includes those tariffs set by FERC as well as by state regulatory agencies.

[34] See Jaffe Aff. at 8-9.

affiliates. It is undisputed that, from the Department's perspective, tariffs made in arm's-length transactions are appropriate transportation allowances because they are the lessee's "actual costs." If a producer purchases that same pipeline, however, the situation changes overnight. Under the current MMS rules and the new proposal, the new pipeline owner will no longer be allowed to take the same transportation allowance. This is both unfair and theoretically indefensible. Moreover, as Professor Jaffe observed, such discrimination may, in the long run, distort firms' decisions regarding affiliate transactions and vertical integration and would likely reduce investment in the development of Gulf resources.[35]

There is no difference to the Department whether a lessee transports oil at the same rate on its own pipeline or on one owned by a third party. As one Federal District Court has stated in the past: "[w]hen, instead of paying for the service to be done by someone else, the lessees performed that service for themselves and for the government, they were entitled to have the government royalty . . . bear its proportionate share of these costs which daily accrued against them."[36] Accordingly, the Department should bear its proportionate share of the costs of transporting oil to market and accept as valid the same tariffs that were paid the day before pipelines were purchased.

Continued acceptance of FERC tariffs is also consistent with the Department's own precedent. On several occasions, the Department has indicated that it is not appropriate to treat lessees differently for royalty purposes simply because of an affiliation with a pipeline. In Shell

[35] Jaffe Aff. at 6-7, 15.

[36] United States v. General Petroleum Corp., 73 F. Supp. 225, 257 (S.D. Ca. 1946), aff'd sub nom. Continental Oil v. United States, 184 F.2d 802 (9th Cir. 1950) (hereinafter "United States v. General Petroleum Corp.").

Western E & P, Inc.,[37] the Interior Board of Land Appeals considered whether a lessee affiliated with a pipeline should be treated the same as non-affiliated lessees, so that affiliated lessees could deduct the entire tariff as a transportation allowance instead of excluding the pipeline's income taxes from the tariff as MMS insisted. The Board concluded that "MMS's policy, while 'intended to preclude abuse and overcome audit burdens,' unfairly discriminates against lessees who are affiliates of pipeline operators."[38] The Board made it clear that:

> In the absence of some manifestation that affiliated companies are using their corporate relationship to defeat MMS royalty collection efforts, the general rule recognized in Getty Oil Co. applies.[39]

Companies do not formulate their corporate structure to defeat royalty obligations. Pipeline owners should be treated the same as any other lessee that ships on a pipeline and should be able to deduct all of their transportation costs from royalty payments.

In sum, FERC and state regulatory agency tariffs are based on real economic transportation costs, consistent with the Department's philosophy of looking to the market to

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[37] 112 IBLA 394 (1990) (hereinafter "SWEPI").

[38] Id. at 400.

[39] Id. (citing Getty Oil Co., 51 IBLA 47 (1980)). In Getty Oil Co., the Interior Board of Land Appeals refused to set aside an agreement between Getty and its wholly owned affiliate in the absence of impropriety. The Board cited Judge Learned Hand's opinion in United States v. Weissman, 219 F.2d 837 (2d Cir. 1955) in concluding: "It is true that there can be legal transactions between two corporations all of whose shares are owned by a single individual, and that the same obligations will arise out of them as would arise, had they been between either corporation and a third person." See also Mobil Producing Texas & New Mexico, Inc., 115 IBLA 164, 178 (1990) (denial of a transportation allowance for income taxes solely because it involves an affiliate of the pipeline operator is improper); Mobil Exploration and Production U.S., Inc., 148 IBLA 172, 185 (1999) (ALJ Hughes concurring "The issue presented is whether Mobil, as owners of the pipeline who also pay to use the pipeline, may property deduct payments to the pipeline, ... I find no basis for disallowing Mobil use of the tariff as its transportation allowance when other parties . . . have been allowed to do so.").

make valuation determinations. Thus, tariffs should not be dismissed as unreasonable or unreliable representations of transportation costs and MMS should embrace them as appropriate transportation allowances where they exist. Moreover, MMS's presumption that FERC tariffs "exceed" actual costs is without basis, and MMS's failure to adequately justify its proposal is arbitrary and capricious.

2. In the Absence of Tariffs, MMS Should Accept Transportation Allowances for Non-Arm's-Length Transportation Based Upon Arm's-Length Transportation Contracts for Comparable Transportation Services

Even where tariffs are not in place, MMS should move toward more transparent, competitively defined costs and resist the urge to return to an era of unwieldy, prescriptive "actual cost" calculations. In keeping with long-standing Departmental policies, when establishing transportation allowances for non-arm's-length transactions, the Department should first consider arm's-length transportation contracts for comparable transportation services. Thus, in this case, the Department should look to several indicators: (1) transportation charges paid by third-party shippers on affiliated pipelines; (2) transportation charges paid by third-party shippers for transportation services comparable to that provided by affiliated pipelines; (3) transportation charges paid by a producer before it acquired interests in a pipeline; and (4) the tariffs maintained by the prior owner of the pipeline before the pipeline became affiliated.[40]

As the Department acknowledged when last revising its valuation rules, arm's-length transportation charges to third-party shippers are particularly relevant where there are several

[40] See Jaffe Aff. at 10-13.

alternatives for shippers to use when transporting their oil,[41] especially where pipelines are underutilized, suggesting competitively low rates.

Indeed, the fundamental underpinning of all the Department's valuation regulations both past and present has been that the market should set value for royalty purposes.[42] If one looks back to the first disputes concerning the manner in which oil should be valued for royalty purposes and forward to more recent disputes, the one common thread is that the Department has said it wants to insure that the marketplace – not some arbitrary formula – determines royalty values. Examples are Continental Oil Co. v. United States, California v. Udall, and Marathon Oil Co. v. United States, in which the Department sought to value oil based on sales in the market even though the market was away from the lease.[43] More recently, the Department has alleged that companies have inappropriately paid oil royalties based on posted prices.[44] The

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[41] See discussion at p.23, infra, regarding the initial proposal for the current rule, in which MMS proposed that the non-arm's-length transportation allowance be based upon the volume-weighted average prices of arm's-length contracts.

[42] See 43 U.S.C. § 1331(o) (1986) (defining "fair market value" as average unit price at which a mineral was sold); see also Proposed Guideline and Request for Comments on How to Value Oil for Royalty Purposes From Federal and Indian Onshore and Offshore Leases, 47 Fed. Reg. 53,822, 53,822 (Nov. 11, 1982) ("The Royalty Management Program of MMS must assure that the [f]ederal [g]overnment and Indian lessors receive fair market value for their royalty oil.").

[43] Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961); Marathon Oil Co. v. United States, 604 F. Supp. 1375 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 480 U.S. 940 (1987).

[44] December 1999 Proposal, 64 Fed. Reg. at 73,821.

valuation methodology the Department has preferred in that context is arm's-length sales by the lessee's affiliates.[45]

The Department is not alone in its thinking. Oil and gas law treatises have long recognized that an arm's-length sale should be the first resort in royalty valuation.[46] At every point in establishing valuation standards, the Department has held firm to that principle.[47] That position has been true whether or not the production being valued is itself disposed of in an arm's-length transaction.[48] In fact, the Interior Board of Land Appeals has noted that "[i]f a transaction is not at arm's length, some other manifestation that the price is nonetheless an accurate portrayal of the article's worth is required. It must be a price which independent buyers

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[45] Id. ("This rulemaking proposes to amend the current regulations by eliminating posted prices as a measure of value and relying instead on *arm's-length sales prices* and spot market prices as market value indicators.") (emphasis added).

[46] See e.g., 3A W.L. Summers, The Law of Oil and Gas § 590 at 129 (1958 perm. ed.); 3 Williams and Meyers, Oil and Gas Law §§ 650, 650.2 (1993). Numerous other government entities recognize the value in using arm's-length transactions for valuation purposes. For the purpose of calculating U.S. taxable income, for instance, the Internal Revenue Service requires that the transfer prices between affiliated multinational companies be based on arm's-length transactions for similar goods or services. See Jaffe Aff. at 9-10.

[47] See Shell Oil Co., 70 I.D. 393, 394 (1963) (citing the prior rule, 30 C.F.R. § 250.64, which directed the Department to determine oil value with reference to "the highest price paid for . . . production of like quality in the same field or area" as well as to "the price received by the lessee" and "posted prices"); 30 C.F.R. § 206.102(a) (current rule) (relying on arm's-length contract price to determine oil valuation); December 1999 Proposal, 64 Fed. Reg. at 73,821 (proposing to value oil based on "arm's-length sales prices").

[48] See Shell Oil Co., 70 I.D. at 394 (1963) (citing the prior rule, 30 C.F.R. § 250.64, which directed the Department to determine oil value with reference to "the highest price paid for . . . production of like quality in the same field or area" as well as to "the price received by the lessee" and "posted prices" for non-arm's length contracts as well as arm's-length contracts). The current rule, 30 C.F.R. § 206.102(c), relies to a large degree on arm's-length contract prices to determine the value of oil sold under non-arm's-length contracts. The December 1999 Proposal seeks to value non-arm's length oil sales based on arm's-length prices or spot prices. See 64 Fed. Reg. at 73,829-30.

in arm's length transactions would be willing to pay."[49] It is not surprising then that this thinking was transferred to establishing transportation allowances for non-arm's-length contracts during the rulemaking process that led to the current regulations.[50]

In that process, the Department initially proposed using volume-weighted average prices of arm's-length contracts as an exception to the so-called "actual cost" calculation for non-arm's-length transportation allowances. However, the final regulation dropped this provision with only the most cursory statement.[51] In the end, the final regulation continued to provide an exception to calculating "actual costs" for non-arm's-length transportation allowances using FERC or state regulatory tariffs measured against arm's-length contracts.[52]

In those instances where arm's-length contracts have not existed or have simply been too difficult for lessees to obtain easily before paying royalties, the Department has shown a willingness to resort to independent, more transparent market-based measures of arm's-length

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[49] Getty Oil Co., 51 IBLA 47 (1980) (citing Acme Mfg. Co. v. United States, 492 F.2d 515, 520 (5th Cir. 1974)). Although the IBLA cited the case name as Acme Mfg. Co. v. United States, the name of the case appearing at 492 F.2d 515 is Creme Mfg. Co. v. United States. The misnomer is likely an unintended error on the Board's part, as Creme appears to support the assertion for which Acme was cited by the IBLA.

[50] See Further Notice of Proposed Rulemaking, Revision of Oil Product Valuation Regulations and Related Topics, 52 Fed. Reg. 30,826, 30,849 (proposed Aug. 17, 1987) ("August 1987 Proposal for the Current Rule").

[51] In support of the current rule, MMS simply declared it to be "in the best interests of the [g]overnment, [s]tates and Indians to base oil transportation allowances on actual, reasonable costs plus return on investment." Final Rule, Revision of Oil Product Valuation Regulations and Related Topics, 53 Fed. Reg. 1184, 1211 (Jan. 15, 1988) (codified at 30 C.F.R. § 206.105) (hereinafter, the "1988 Final Rule"). This terse, conclusory explanation did not meet administrative law requirements that an "agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'" Motor Vehicle Mfrs. Ass'n v. State Farm Mut., 463 U.S. 29, 43 (1983) (quoting Burlington Truck Lines, Inc. v. United States, 371 U.S. 156, 168 (1962)).

[52] 30 C.F.R. § 206.105(b)(5).

prices (e.g., spot prices or New York Mercantile Exchange ("NYMEX") futures prices) rather than devising some more complicated formula.[53] The same should be true for valuing transportation allowances.

Similarly, in the past several years, the FERC has moved steadily away from more prescriptive ratemaking practices in favor of indexing or market-based methodologies for pipeline rates. The FERC has explained the numerous benefits associated with these methods,[54] noting, for example, that a system in which base rates are periodically indexed up or down based on an inflation measure is efficient, simple and stable, and it provides appropriate economic incentives to pipeline operators. "Under indexing, pipelines adjust rates to just and reasonable levels for inflation-driven cost changes without the need of strict regulatory review of the pipeline's individual cost of service, thus saving regulatory manpower, time and expense."[55] The indexing scheme supports rate stability by protecting shippers from rate increases greater than

[53] See, e.g., Final Rule, Amendments to Gas Valuation Regulations for Indian Leases, 64 Fed. Reg. 43,506 (Aug. 10, 1999) (adopting spot prices for valuing gas on Indian lands); January 1997 Proposal, 62 Fed. Reg. 3742 (proposing to value oil from federal leases based on crude oil futures prices on the NYMEX); Notice of Proposed Rulemaking, Establishing Oil Value for Royalty Due on Indian Leases, 63 Fed. Reg. 7089 (proposed Feb. 12, 1998) (proposing to use NYMEX futures prices to value oil from Indian leases); December 1999 Proposal, 64 Fed. Reg. at 73,829-30 (seeking to value non-arm's length federal oil sales based on arm's-length prices or spot prices); Notice of Proposed Rulemaking, Amendments to Gas Valuation Regulations for Federal Leases, 60 Fed. Reg. 56,007 (proposed Nov. 11, 1995) (proposing index prices for valuing federal gas).

[54] Final Rule, Revisions to Oil Pipeline Regulations Pursuant to the Energy Policy Act of 1992, 58 Fed. Reg. 58,753, FERC Statutes and Regulations, Regulations Preambles, 1991-1996 ¶ 30,985, at 30,948 (1993); Final Rule, Market-Based Ratemaking for Oil Pipelines, 59 Fed. Reg. 59,148, FERC Statutes and Regulations, Regulations Preambles, 1991-1996 ¶ 31,007, at 31,179-80 (1994).

[55] FERC Statutes and Regulations, Regulations Preambles, at 30,948.

the inflation rate.[56] Further, indexing is a form of incentive regulation that supports productive efficiency better than traditional cost-of-service regulation.[57]

Likewise, the FERC has encouraged the use of market-based rates.[58] Pipelines that demonstrate a lack of market power in specific origin and destination areas can charge market-based rates to and from those locations, rather than rates strictly tied to costs.[59] Such market-based rates are the hallmark of the lighter-handed form of rate regulation mandated by Title VIII of the Energy Policy Act of 1992.[60] Moreover, the FERC has declared that it is "confident that the information provided to it by the procedural requirements [for market-based rates] will permit the Commission to make informed decisions about market power and prevent the possibility of abuses of market power."[61]

In defining transportation allowances, the Department should carefully consider the steps it has already taken away from prescriptive formulas and take close note of the example set by the FERC – an agency steeped in traditional cost-of-service ratemaking – and move toward more transparent, competitively-defined measures. The alternative is a return to an era of unwieldy "actual cost" calculations, which is both unnecessary and unreflective of real-world business transactions. Therefore, Vastar recommends that the MMS not hastily disregard using arm's-

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[56] Id. at 30,948-49.

[57] Id. at 30,948.

[58] Final Rule, Market-Based Ratemaking for Oil Pipelines, 59 Fed. Reg. 59,148, FERC Statutes and Regulations, Regulations Preambles, 1991-1996 ¶ 31,007 (1994).

[59] FERC Statutes and Regulations, Regulations Preambles, at 31,179.

[60] 42 U.S.C. § 7172 (Supp. 1993); FERC Statutes and Regulations, Regulations Preambles, at 31,179.

[61] FERC Statutes and Regulations, Regulations Preambles, at 31,180.

length transportation transactions in determining non-arm's-length transportation allowances. As noted above, arm's-length transactions are both historically and economically the most acceptable basis for measuring the validity of non-arm's-length transactions. Those facts, in combination with the relative simplicity of employing the methodology, strongly support MMS's adopting this methodology for calculating non-arm's-length transportation allowances or, at the very least, using this methodology to verify the reasonableness of such transportation allowances.

3. In Any Event, The Department Should Allow Deductions Reflecting the Real Economic Cost of Transportation Service

If the Department refuses to accept arm's-length transportation charges or FERC or state regulatory agency tariffs as adequate proxies for determining non-arm's-length transportation allowances, it must allow *all* reasonable actual transportation costs, rather than an arbitrary amount that maximizes royalty payments. Although the December 1999 Proposal would permit lessees that do not own pipelines to deduct all of their actual transportation costs, the same is not true for lessees that own pipelines used to transport their own production, as to whom MMS proposes to continue to limit what may be classified as "actual costs" for non-arm's-length transportation. What is not adequately recognized in the proposal is, among other items, the actual cost associated with income taxes, pipeline loss allowance, and the allocation of corporate overhead. And, as discussed above, the proposal sets the rate of return at an arbitrary and unreasonably low level.[62] As Professor Jaffe explains, however, this proposal does not reflect

[62] The Department has indicated in the past that certain exclusions or limitations placed by MMS on transportation allowances may be unreasonable and arbitrary. For example, in Mobil Producing Texas & New Mexico, Inc., the Interior Board of Land Appeals found that MMS's prior policy of capping operating costs at 10 percent of the undepreciated initial or adjusted investment cost when calculating transportation allowances might "not reasonably
(Continued ...)

the real economic cost of service. Moreover, "[t]his approach suffers . . . from a number of well-known shortcomings, including high administrative burden, reduced efficiency incentives, lack of sufficient data, and an inability to respond appropriately to changes in underlying market conditions in a timely manner."[63]

If the Department insists upon calculating its own transportation rates for non-arm's-length transactions, it should recognize the precedents set by ratemaking agencies for decades as the proper cost analysis. MMS has said that it does not have to recognize FERC precedents because the two agencies have different missions.[64] Those differences, however, confirm that the FERC's precedents should be recognized. The FERC has been entrusted by the Congress with the role of setting "just and reasonable" rates for oil pipelines under the Interstate Commerce Act.[65] MMS has no such mandate or expertise in determining costs of transportation for oil pipelines and should leave this work to the experts at the FERC.[66]

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represent value transportation adds to the product and its application defeats the reason for giving a transportation allowance." 115 IBLA at 172. Although there was not enough information to reach a conclusion about the reasonableness of the cap in that instance, the Department made it clear that unreasonable and arbitrary limitations on transportation allowances would not be permitted.

[63] Jaffe Aff. at 13; see also Jaffe Aff. at 5-7.

[64] August 1987 Proposal for the Current Rule, 52 Fed. Reg. at 30,851 ("MMS does not believe that the FERC's obligations in developing tariffs and those of MMS in developing transportation allowances are sufficiently similar to warrant use of similar procedures.").

[65] See 49 U.S.C. § 60502 (1997); see also Association of Oil Pipe Lines v. FERC, 83 F.3d 1424, 1428-29 (D.C. Cir. 1996).

[66] In 1981, the Interior Board of Land Appeals considered whether to apply the ICC's (the predecessor agency to the FERC) oil pipeline rate-of-return standards, which had been set in the 1940's, to transportation allowances. Shell Oil Co., 88 I.D. 1 (1981). The IBLA ultimately decided not to adopt the ICC standards advocated – not because they were irrelevant – but because they were too old. Id. at 5-6 (stating "[t]o the extent that economic conditions facing the oil pipeline industry have changed since 1948 . . . the conclusions of the ICC in its earlier cases

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If MMS nevertheless concludes that a detailed cost of service must be calculated, then both law and fairness require that all of the relevant and reasonable costs incurred in providing that service should be included in the transportation allowance.

The proposal falls short of that standard in several important respects. As described below, the proposed regulations either expressly or implicitly understate non-arm's-length transportation costs as compared to those that would be recognized by the FERC and other regulatory agencies under traditional cost of service principles, in such areas as rate of return, income taxes and pipeline loss allowance. In addition, the proposed rule regarding the allocation of corporate overhead is sufficiently uncertain in terms of its application that, unless it is clarified, it may result in the unfair exclusion of real costs incurred in connection with the transportation activity.

The effect of these various defects, if uncorrected, would be to fail to recognize all legitimate transportation-related costs and, in turn, to overstate significantly the royalty properly owed to MMS. In addition to the rate of return, which is discussed above in Parts I.B and I.C., these excluded or understated costs are:

a) Income Taxes

Although it has been expressly rejected as "untenable," the MMS rule excluding federal and state income taxes as a permissible transportation allowance component for non-arm's-

as to appropriate rates of return are equally as much artifacts of a bygone era"). The Board concluded "[i]t is evident from our investigation that a fair rate of return depends greatly on the economic conditions and other circumstances of the case at the time involved." Id. at 6; but see Conoco, Inc., 109 IBLA 89, 95 (1989).

length transactions continues to be the prevailing MMS policy. That policy is unsustainable both as a matter of economics and of essential fairness.

The current regulation states, in the context of allowing inclusion of certain types of overhead amounts in the transportation cost, that "State and Federal income taxes and severance taxes and other fees, including royalties, are not allowable expenses."[67] Such taxes and fees are allowable, however, if included in the actual cost of third-party transactions.[68] The sole factor determinative of whether taxes and fees may be included in the transportation allowance is whether the transportation service is or is not being provided by an affiliate.

The stated basis for the rule is the MMS characterization of income taxes as "an apportionment of profit rather than a valid operating expense."[69] As a matter of logic, that view would be expected to result in a return component that reflects the obligation to pay income taxes out of the company's profit (i.e., a "pre-tax" return). However, the agency also specifically refused to establish a rate of return that accounts for income tax liability.[70] The rule was purportedly grounded on the perceived potential for abuse in tax attribution between affiliated entities.[71] No real-world examples of such abuse were provided, nor was there any explanation

[67] 30 C.F.R. § 206.105(b)(2)(iii).

[68] Id. at § 206.105(a)(1).

[69] August 1987 Proposal for the Current Rule, 52 Fed. Reg. at 30,850.

[70] 1988 Final Rule, 53 Fed. Reg. at 1212.

[71] SWEPI, 112 IBLA at 399-400 (rejecting the MMS policy "[i]n the absence of some manifestation that affiliated companies are using their corporate relationship to defeat MMS royalty collection efforts").

as to why the absolute exclusion of a tax allowance for affiliated movements was adopted rather than a remedy more directly tailored to the agency's specific concern.[72]

The MMS policy of permitting inclusion of income taxes as an allowable transportation cost for third-party movements but not for movements on an affiliated pipeline was the subject of an appeal from a decision of the Director of MMS, which had affirmed an order of the Royalty Valuation and Standards Division disallowing federal and state income taxes as transportation costs for purposes of calculating royalties owed to MMS. There, a lessee with a non-arm's length transportation contract sought to use its FERC tariff as a basis for calculating its transportation allowance. MMS accepted the use of the FERC tariff, but demanded that federal and state income taxes be eliminated in computing the allowance. MMS explained that its policy regarding taxes in non-arm's-length situations is "premised on the impossibility of accurately allocating the correct tax burden to the pipeline, as well as the other activities of the pipeline/producer . . . . The MMS policy is a reasonable measure intended to eliminate the potential for abuse that could result from expense manipulation between pipelines and production facilities not wholly independent of each other."[73]

The Interior Board of Land Appeals rejected this disparity in the treatment of arm's length and non-arm's-length situations. In SWEPI, the IBLA deemed this rationale to be unsound, observing that:

> MMS appears untroubled by the general concept of allowing a lessee to include income taxes paid by a pipeline as an element of transportation costs, since it allows a deduction if there is a published tariff for a common carrier

[72] See Rio Grande Pipeline Co. v. FERC, 178 F.3d 533, 542-43 (D.C. Cir. 1999) (rejecting FERC per se cost exclusion because of failure to consider less extreme and more flexible alternatives).

[73] See SWEPI, 112 IBLA at 399.

> which includes income taxes as transportation costs. When there is no published tariff, as in the instant case, only lessees who are affiliates of pipeline owners are not allowed to deduct income taxes as transportation costs. . . . MMS' application of the [rule against allowing income taxes] only when the lessee is an affiliate of the pipeline owner is untenable.[74]

In sum, income taxes are a very real and substantial cost of providing transportation service from the OCS. The MMS proposal to continue excluding taxes from the allowable transportation cost is both unfair and without a rational basis, and should not be applied to lessees in the event a cost of service calculation is required for non-arm's-length pipeline movements.

b) Pipeline Loss Allowance

The December 1999 Proposal expressly prohibits deductions for "payments (either volumetric or for value) for actual or theoretical losses" under a non-arm's-length transportation contract.[75] MMS thus excludes from the transportation allowance a significant element of the cost of providing pipeline service from OCS leases. The costs of pipeline losses are real, demonstrable and among the category of expenses that are traditionally – and appropriately – allowed in determining overall transportation costs. MMS does not prohibit such costs in the transportation allowance for third-party movements, and there is no rational basis for excluding them solely in the case of pipeline movements for affiliates.

Since oil losses can rarely be ascribed to an individual shipper's volumes, the purpose of the Pipeline Loss Allowance ("PLA") is to spread the cost of the normal amount of pipeline loss equitably among all shippers. That can be done either in the form of a monetary charge that is

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[74] Id.

[75] December 1999 Proposal, 64 Fed. Reg. at 73,848 (proposed § 206.118).

included in the pipeline tariff, or by calculating the pipeline's obligation to deliver as a percentage of the oil tendered. Thus, FERC and Texas Railroad Commission pipeline tariffs typically provide that a pipeline may deduct a percentage of volumes for evaporation and loss during transportation, with the net balance to be the quantity deliverable by the pipeline.[76]

Notwithstanding this consistent acknowledgement that pipeline losses are among the core group of pipeline costs that are conventionally and properly passed through to shippers (and thus appropriately included in a lessee's transportation allowance), the MMS regulations exclude the costs of pipeline loss in the case of transportation for affiliates. To Vastar's knowledge, the only justification for that rule is "the difficulty of demonstrating that losses are valid and not the result of meter error or other difficult to measure causes."[77] That, of course, is no more true in the case of affiliated pipeline movements than for third-party movements. In each case, the actual experience of the pipeline can be tested to assure that the PLA is fair and reasonable; the "difficulty" cited by the MMS is no greater if the shipper is a pipeline affiliate than if it is not.

Pipeline losses, in short, should be included in the calculation of the transportation allowance whether or not the transportation is provided by an affiliate.

c) Allocation of Corporate Overhead

The December 1999 Proposal clearly provides that overhead that is directly attributable and allocable to the operation and maintenance of the transportation system may be taken as an

[76] See, e.g., 16 TAC § 3.66(9)(C) (1999), Texas Railroad Commission, Oil and Gas Rule 71, Pipeline Tariffs, Section 9(A), included in Vastar Pipeline TRC Tariff No. 1, section 9(A); ARCO Pipe Line Co., 52 FERC (CCH) ¶ 61,055, at 61,245 (1990).

[77] August 1987 Proposal for the Current Rule, 52 Fed. Reg. at 30,853.

allowable expense.[78] However, the proposed regulations do not specify how the allocation is to be made, the type of documentation that is required to sustain the expense, or the degree of estimation that is permissible. This has resulted in a degree of uncertainty that has worked to the significant disadvantage of lessees such as Vastar. Vastar submits that an allocation of overhead based on a reasonable formula of the type that has been accepted by the FERC should be accepted by the MMS for purposes of the valuation determination, so long as the input data applied to the formula is itself reliable, reasonable and available for review and audit by the MMS.

The two overhead allocation methods most commonly used by the FERC are generally known as the Massachusetts formula and the Kansas-Nebraska (or KN) formula. The Massachusetts formula, which has its origins in the decisions in Midwestern Gas Transmission Co.[79] and Distrigas of Massachusetts Corp.,[80] "allocat[es] parent overhead costs to a subsidiary on the basis of the average of the ratios that the subsidiary's labor costs, gross plant, and gross revenues have to the parent."[81] Each of those items typically is readily available both to the company and to the agency with oversight authority, and where one is not, or for any reason one of the factors is not suited to the task, alternatives may be proposed.[82] The other commonly used

[78] December 1999 Proposal, 64 Fed. Reg. at 73,847 (proposed § 206.111(f)).

[79] 32 F.P.C. 993 (1964), modified, 44 F.P.C. 721 (1970).

[80] 41 FERC (CCH) ¶ 61,205 (1987).

[81] Id. at 61,554; see also, e.g., Mojave Pipeline Co., 81 FERC (CCH) ¶ 61,150, at 61,176-78 (1998).

[82] See, e.g., SFPP, L.P., 86 FERC (CCH) ¶ 61,022, at 61,083 (1999) (company proposed modified Massachusetts formula in which barrel miles would be used as a proxy for revenue where revenue was itself the ultimate issue in the case).

formula – KN, derived from Kansas-Nebraska Natural Gas Co.,[83] – is a two-factor approach, in which total direct labor costs and capital investment (or gross plant) are used.[84] The KN formula is typically used to allocate overhead costs as among different functions within a company (such as among the various pipeline entities within VPL). Under each formula, the intent is to find a fair and objective measurement of the principal factors that give rise to the overhead costs being incurred – that is, some mix of property, labor and revenue.

Overhead amounts of the type involved here are routinely included in the body of costs that a pipeline includes in calculating its rates. There is simply no sustainable policy basis for treating those costs differently depending on whether the transportation service is being provided to an affiliate or a third party. If the overhead amounts are properly determined and allocated to the relevant assets, there is no less reason to include them in the transportation allowance for affiliated movements than for third-party movements.

III. Conclusion

It is true that under the terms of federal leases, the Department is entitled to share in the "amount or value" of a Federal lessee's oil or gas production.[85] However, that entitlement in no way extends to sharing in the "amount or value" of a Federal lessee's other lines of business. As Professor Jaffe notes, "[s]etting a transportation allowance below the market price for transportation would be economically equivalent to a confiscation by MMS of part of the

[83] 53 F.P.C. 1691, 1721-22 (1975), aff'd, Kansas-Nebraska Natural Gas Co. v. FPC, 534 F.2d 227 (10th Cir. 1976)

[84] See, e.g., Questar Pipeline Co., 74 FERC (CCH) ¶ 61,126, at 61,455 (1996); Panhandle Eastern Pipe Line Co., 46 FERC (CCH) ¶ 61,183, at 61,615 (1989).

[85] See 43 U.S.C. § 1337(a)(1)(A).

economic returns associated with transportation investments, or equivalently, a unilateral increase in the royalty rate itself."[86] The Department may not overstate royalty obligations by arbitrarily excluding categories of significant actual costs from the transportation allowance or refusing to accept tariffs or comparable arm's-length transactions as representative of actual costs for non-arm's-length transportation. Instead, the Department must provide for a fair royalty while encouraging development of federally-owned natural resources. To do otherwise would be inconsistent with the intent of Congress.

Respectfully submitted,

Norma J. Rosner / [illegible]

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[86] Jaffe Aff. at 6.