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P.O. Box 1864
Santa Fe, NM 87504-1864

Phone 505-982-2568
Fax 505-986-1094

staff@nmoga.org
www.nmoga.org

13 March 2000

Minerals Management Service
Royalty Management Program
Rules and Publication Staff
P.O. Box 25165, MS 3021
Denver, CO 80225-0165

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Re: MMS 30 CFR Part 206
Federal Register Volume 65, No. 3, Page 403
Establishing Oil Value for Royalty Due on Indian Leases

Dear Sir or Madam:

The New Mexico Oil and Gas Association (NMOGA) appreciates the opportunity to comment on the proposed rulemaking referenced above. NMOGA is one of the oil and gas industry's largest single state trade associations, representing over 220 members, many of whom produce oil from Indian lands in the San Juan Basin and throughout the United States. As such, this association has watched the development of this proposed regulation with great interest.

Summary

NMOGA opposes the adoption of this proposed rule in its current form for the following reasons:

- The three methods for arriving at a final "Major Portion" value under this proposed rule are inconsistent with the valuation language contained in the standard Indian lease form;
- The triple accounting required of lessees and royalty payors in the proposed rule is overly burdensome and unnecessary;
- The new, "Duty to Market" language contained in this rule violates the lease agreement and the laws governing the collection of Indian royalties;
- The new MMS Form 4416 is unnecessary and overly burdensome.

Major Portion

The typical language governing the concept of "Major Portion" pricing reads as follows:

> "During the period of supervision, "value" for the purpose hereof may, in the discretion of the Secretary, be calculated on the basis of the highest price paid or offered at the time of production for the major portion of the oil of the same gravity, and gas, and/or natural gasoline, and/or all other hydrocarbon substances produced and sold from the field where the leased lands are situated..."

The formula based on spot market prices contained in Section 206.52 of this proposed regulation requires the lessee to calculate a value based on "The average of the daily high spot prices for deliveries during the production month for the market center nearest your lease for crude oil most similar in quality to your oil." This provision is inconsistent with the lease agreement in several respects.

- MMS has presented no evidence that any purchaser has "paid or offered" to pay a price based upon this spot price formula, or any price that approaches the value this formula would attain.

- MMS has presented no evidence that, if any purchaser of Indian oil is using this formula as its pricing mechanism, the volumes purchased thereunder constitute the "major portion of oil of the same gravity" produced from any such Indian lands.

- The "market center nearest the lease" is in many cases hundreds of miles away from the lease, and in some instances it is debatable whether any of the oil "produced and sold from the field where the leased lands are situated" actually travels to the market center.

  The San Juan Basin is a prime case in point. The overwhelming majority of the Indian oil produced in the Four Corners Area is sold arm's length at the lease and delivered to the several refineries located in the Basin. The oil is converted to refined products at those refineries and never leaves the Basin.

  Yet this proposal would likely require that producers of Indian oil in the San Juan Basin value their production on spot prices established either at Midland, Texas, or Cushing, Oklahoma, market centers located hundreds of miles away from "the field where the leased lands are situated."

  The fact is that the "major portion of oil" from Indian lands in the San Juan Basin is sold arm's-length at the wellhead. That is a fact that MMS has chosen to ignore in this new regulation. Given that fact, NMOGA believes that the only rational reading of the lease agreements is that the "major portion" value for oil in the San Juan Basin should be obtained by surveying the prices received by lessees in arm's-length transactions at or near the lease, rather than attempting to back into a price established hundreds of miles away in a different state.

- The oil traded at these market centers is rarely "oil of the same gravity" as the oil produced from Indian leases. Again, this is especially true in the San Juan Basin, where the preponderance of Indian "oil" is actually condensate of a very poor quality that must be blended with other oil before it can even be refined.

In sum, the spot price formula described in the proposed regulation does not conform to the terms of the lease agreement that governs these royalty payments. It is evident that MMS has chosen to disregard the lease terms in search of a higher, proxy royalty value, even where simpler, more rational, and more appropriate means exist to approximate a "major portion" value. NMOGA urges MMS to remove this pricing mechanism from any final regulation.

Administrative Burden

The proposed requirement for lessees and payors to perform a "triple accounting" process in order to arrive at a final "major portion" value is onerous, unduly burdensome, unnecessary and cannot be rationalized as necessary under MMS's trustee relationship with Indian lessors. Especially onerous is the requirement that lessees continue to track their gross proceeds in spite of the artificially inflated value that will be created by use of the proposed spot price formula.

At its public hearing in Denver on February 8, MMS representatives, when asked if they could cite any historical instances in which the price paid for Indian oil royalties would have exceeded the inflated spot market formula price, could only point to a single example. This example involves oil with a uniquely high paraffin content produced on the Northern Ute Reservation. This was the sole justification offered for the use of three different methods to determine a final "major portion" value in this proposed rule.

NMOGA believes this is an abuse of the Secretary's discretion under the lease agreement. While it is obvious the entire proposed rule is little more than a search for a proxy value that will increase royalty payments to Indian lessors, NMOGA respectfully suggests the Secretary and MMS pick a single proxy value that satisfies the terms of the lease agreement. Placing an onerous administrative burden on every Indian lessee in order to ensure a single Indian lessor does not experience a possible reduction in cash flow is unreasonable. While the lease may allow the Secretary to choose a proxy value for determining the "major portion" price, it does not require or even arguably allow the Secretary to extract payment on the highest of three different proxy values.

A more reasonable method for protecting the cash flow of the Northern Ute Tribe exists in MMS's recently-finalized regulation governing Indian gas valuation. That rule allows Indian lessors who have concerns about the gas index-based "major portion" formula to "opt out" of using it, relying instead on negotiated agreements between the lessees and lessors, or gross proceeds if they so choose.

As stated above, NMOGA suggests MMS eliminate the spot price formula method from this regulation. However, if MMS insists upon retaining that feature of this regulation in spite of its non-conformity with the lease terms, NMOGA suggests MMS eliminate the requirement for lessees to continue to track their gross proceeds, and add an "opt out" provision to this rule for Indian lessors who believe the spot price formula would reduce their cash flow. Lessees who pay royalties to lessors who have "opted out" of the spot price formula would continue to pay on their gross proceeds, subject to MMS's subsequent major portion calculation.

Duty to Market

Sec. 206.53 (d) states:

> "You must place oil in marketable condition and market the oil for the mutual benefit of yourself and the lessor at no cost to the Indian lessor, unless the lease agreement or this part provides otherwise. In the process of marketing the oil or placing it in marketable condition, your gross proceeds may be reduced because services are performed on your behalf that normally would be your responsibility. If this happens, and if you valued the oil using gross proceeds under Sec. 206.52 (b), you must increase value to the extent that your gross proceeds are reduced."

NMOGA strongly opposes the imposition of this new duty on lessees of Indian lands for several reasons.

First, there is no logic to support such a duty. The language itself is contradictory, stating first that the duty to market the oil is "for the mutual benefit" of the lessee and lessor, then going on to state that the lessor will bear any of the costs incurred to perform such activities.

Second, such a duty is unreasonable when read in the context of the proposed regulation that surrounds it. Placing such a duty within a regulation that establishes valuation at a point far downstream of the wellhead implies that MMS must believe the lessee has a duty to market the oil to the point of MMS's choosing. This is clearly at conflict with the lease terms that grant the lessor an interest in the oil at the time of production, not at some distant point. The nature of the lessor's interest becomes clear when reading the royalty in-kind provision of a typical Indian lease agreement, which states:

> "...when royalty on oil produced is paid in kind, such royalty oil shall be delivered in tanks provided by the lessee on the premises where produced without cost to the lessor unless otherwise agreed to by the parties thereto, at such time as may be required by the lessor;"

Clearly, the lease requires that the lessor's interest in the oil accrues at the lease when the royalty is paid in kind. The lessor is then free to market the oil to its maximum advantage, and is unable to hold the lessee responsible for its costs of marketing in that setting. It

defies logic to assert that the nature of the lessor's interest and the lessee's duties under the lease are any different when the royalty is paid in value.

MMS Form 4416

NMOGA incorporates by reference the comments filed related to this new form by the Council of Petroleum Accountants Societies (COPAS). The form is overly burdensome, does not seek the data MMS really needs in order to determine location differentials to the relevant market centers, and is unnecessary. In its recent rulemaking on federal oil valuation, MMS developed a workable alternative to its proposed form 4415, and dropped that form from its most recent proposed regulation. NMOGA urges MMS to take the same steps in this rulemaking, and not burden the Indian lessees with one more purposeless form to file.

Transportation Costs

NMOGA commends the MMS for its decision to correctly allow the deduction of the costs of transportation that occurs on Indian lands. The previous proposal to disallow such costs was unreasonable and in conflict with the lease agreement, as well as longstanding practice.

At its public workshop on February 8, MMS posed a question to attendees regarding the calculation of actual costs in cases where a lessee owns a transportation line for which it is allowed a deduction from royalty payments. MMS is contemplating changing the "actual cost" calculation in its new regulation governing the valuation of oil royalties from federal lands, and asked for comments on whether such a change, if contained in a final federal regulation, should also be included in a final Indian oil regulation.

NMOGA emphatically recommends MMS incorporate any changes to the federal regulation into this regulation on Indian oil valuation, and further recommends that any such changes also be incorporated into the regulations governing the valuation of natural gas production from both federal and Indian lands. The changes being contemplated involve the determination of a fair rate of return on these lines, and the economic factors involved in such a determination do not vary whether such lines carry oil or natural gas, or whether the oil or gas was produced from federal or Indian lands.

In addition, the maintenance of separate calculation methods for differing products or land types would be burdensome and create unnecessary confusion in the reporting and auditing processes. Consistency, in this area, is a virtue.

Conclusion

The concept of "Major Portion" pricing is and always has been a search for a proxy price to substitute for the actual value of the oil or gas produced from Indian lands. Whether MMS is performing a weighted-average netback pricing exercise through a lessee's affiliate, calculating a value based on the index formula contained in this regulation, or calculating the

75th percentile of the prices reported each month by the lessees on MMS Form 2014, it is in the end simply substituting a theoretical, proxy value for the actual value of the production at the lease, the point at which the royalty interest accrues.

MMS proposes to substitute this new regulation for existing regulations that it has found to be difficult to enforce in the past. NMOGA finds it ironic that, just as MMS is on the verge of implementing new systems and a new organization structure that would better enable it to enforce the existing rules, MMS now proposes to abandon those rules for no apparent reason other than the belief that this new rule would result in a higher cash flow for Indian lessees. NMOGA believes this approach to be wrong-headed and a misapplication of the Secretary's authority to determine value under the lease agreement. Certainly, the framers of that lease form never envisioned that the Secretary would someday attempt to implement such an unworkable and arbitrary scheme designed to enforce such a seemingly simple portion of the agreement.

NMOGA strongly recommends MMS reconsider this proposed rule that has as its basis a single goal of increasing revenues to the lessor, and issue a new proposed rule that also considers factors such as simplicity, certainty and fairness to all parties to the lease agreement.

Sincerely,

Deborah D. Seligman, Director
Governmental Affairs

cc: Bob Gallagher, NMOGA President
NMOGA Executive Committee
David Blackmon, Chairman, NMOGA Royalty Committee
John Bordes, Chairman, NMOGA Tax Committee