John E. Clark
Consultant, Mid-Continent Accounting Section
Accounting & Information Management
Upstream North America

Conoco Inc.
P. O. Box 1267
Ponca City, OK 74602-1267
(580) 767-5044

May 13, 1998

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

Dear Mr. Guzy:

RE: MMS Proposed Rule for Establishing Oil Value for Royalty Due on Indian Leases, 63 Fed Reg. 7089 (February 12, 1998)

Conoco Inc. ("Conoco") welcomes this opportunity to submit the enclosed comments to the Minerals Management Service ("MMS") with respect to the above referenced Proposed Rule.

Conoco is a wholly owned subsidiary of E.I. DuPont de Nemours and Company. In 1997, its worldwide production of crude oil, condensate, and natural gas liquids averaged 374,000 barrels per day and its world wide natural gas production averaged 1,210 million cubic feet per day. During the five-year period ending December 31, 1997, Conoco remitted royalty payments to the MMS in excess of $408 million.

Conoco further adopts by reference and hereby incorporates the comments filed on behalf of the American Petroleum Institute and the Council of Petroleum Accountants Societies.

Thank you for the opportunity to comment on this matter. If you have any questions, please contact me at (580) 767-5044.

Sincerely,

John E. Clark

Lt
Enc.

cc:
R. C. Harvey, Houston
R. R. Fritz, Houston

Comments of Conoco Inc.
Regarding
Department of Interior
Minerals Management Service
Notice of Proposed Rulemaking
Establishing Oil Value for Royalty Due on Indian Leases
30 CFR Part 206

On February 12, 1998, the MMS issued its notice of proposed rulemaking regarding valuation of Indian royalty oil. Under II. General Description of the proposed rule, Federal Register, Vol. 63, No.29, Page 7090, the Minerals Management Service ("MMS") describes the requirements of the lessees (and purchasers) under this new proposed regulation. The proposed rule requires that royalty value be based on the highest of three different values:

(1) A value based on NYMEX futures prices.... *(using the five highest NYMEX closing quotes during a trading month)....* adjusted for location and quality differences; (or)
(2) The lessee's or its affiliate's gross proceeds adjusted for appropriate transportation costs; ... (or)
(3) An MMS-calculated major portion value based on prices reported by lessees and purchasers in MMS-designated areas typically corresponding to reservation boundaries.

Administrative Burden

This proposed rule would place several requirements on lessees ***and purchasers*** of Indian royalty oil that are of serious concern to Conoco Inc. ("Conoco"). First, it requires that three(3) separate methods for lease crude valuation be created within Conoco so that the company would hopefully be in compliance with the proposed regulations. This would place a significant economic and administrative burden on Conoco. Conoco does not currently have the systems nor processes in place to meet the requirements of this new proposal. The cost of developing such systems would be very expensive and is not cost justified.

NYMEX Net-back Method

Conoco has already commented at length with regard to the proposed rules for valuation of Federal royalty oil and why a NYMEX or trade center pricing scheme is unreasonable for determining the value of crude oil at the lease. Additionally, we have addressed the inappropriateness of using NYMEX as a "market center" benchmark value for certain areas of the United States to any extent. Two specific geographic areas that we have addressed are the Rocky Mountain area and the Four Corners area of New Mexico. And, of course, there is Indian royalty oil production in both of these areas. Conoco wishes to adopt by reference and hereby incorporates the comments it filed relating to the MMS proposed rule "Establishing Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil" dated January 24, 1997 and the MMS' two supplemental proposed rules issued later in 1997. In the simplest terms, Conoco objects to the MMS' attempt to

"leapfrog" over the ***real and appropriate*** market value for oil, namely that value established ***at the lease***. The net-back scheme proposed by the MMS relating to Indian royalty oil ***does not fairly nor reasonably value oil at the lease***.

Additionally, the MMS has proposed that the five highest daily NYMEX futures price quotes be averaged to determine the starting point in this method. *The American Heritage Dictionary* defines "major" as "Of greater number, quantity, or extent." It also defines "majority" as "A number more than half of the total number of a given group." Therefore, the average value of the top 51% of Indian royalty oil produced in a given field would represent the "major portion" value under the method, not the top 25% as proposed by the MMS by using the five highest NYMEX daily quotes. Since Indian royalty oil is produced every day and not on just the days when the five highest NYMEX closing prices occur, then arguably an average of the NYMEX closing prices for <u>all</u> the trading days in a month would provide a better starting point for such a net-back scheme. A lessee will never get a purchaser to agree to pay the average of the five highest NYMEX closing quotes when selling Indian royalty oil. Therefore, the lessee would need to make up any difference out-of-pocket.

<u>**Gross Proceeds**</u>

Conoco does not object to the second royalty valuation (i.e. gross proceeds) method as a stand-alone method. However, the gross proceeds method has to be a value established at the lease and not some distant trade center except in those rare instances where there is no lease market. For all arm's-length transactions this method, on a stand-alone basis, is both fair and reasonable. However, assuming that this is the very best value a lessee can realize in an arm's-length sale at the lease, but the NYMEX or major portion calculation produces a higher value, the lessee, under the proposed rule, would be responsible for making up any "value" shortfall. (In reality the lessee will not know what the NYMEX or major portion values are until sometime after the production of the oil and therefore would be facing a significant economic risk.)

<u>**Major Portion Method**</u>

Conoco does not object to an MMS-calculated major portion value, if designed fairly. However, Conoco does object to the MMS placing a data gathering burden on the industry and specifically a regulatory burden on the ***purchaser*** of Indian royalty oil through a definition that places the purchaser in the same regulatory position as that of the lessee. Unless the purchaser and lessee are one and the same or have a corporate affiliation, the purchaser has no ties to the lessee other than a routine business arrangement. Trying to make them equally responsible to collect and report certain data will most likely significantly lower the number of purchasers of Indian royalty. The burden and associated risk would simply be too great. Conoco is certainly opposed to being placed in a position of reporting data to the MMS on Form MMS-4416 where it is buying barrels outright from Indian lessees so that the MMS can perform a major portion analysis. Conoco objects to any such data collection and reporting requirements and faced with such a requirement would most likely choose not to buy Indian royalty oil. It seems logical to assume that other purchasers of Indian royalty oil would make the same choice. This extensive data collection and reporting requirement would be an added cost

and administrative burden associated ***only*** with Indian royalty oil which would effectively place it at an economic disadvantage to other sources of crude.

What really makes this new proposed rulemaking onerous is that lessees would ***never*** have certainty that they have paid the ***correct*** price for Indian royalty oil. The lessee would always be subject to some retroactive analysis or calculation by the MMS that could increase the value for royalty purposes. There is no time limit within which the MMS must establish the "highest" of the three different values. Therefore, a lessee could be notified that more Indian royalty is due months, if not years, after the date of production. This is patently unfair to the nonintegrated producers. Furthermore, for integrated producers, once product has been made from the Indian royalty oil and sold downstream of the refinery, the industry has lost all opportunity to recover the higher cost of its refinery feedstocks coming from Indian oil. All of these aspects add costs to the decision of investing and producing on Indian lands. Should these costs be considered prohibitive or noncompetitive relative to other lease opportunities, the industry may well begin to by-pass Indian lands as a place to do business.

LEGAL ANALYSIS

I. THE PROPOSED "MAJOR PORTION" VALUATION IS CONTRARY TO THE PLAIN TERMS OF INDIAN LEASES

Starting in 1936, many standard-form Indian oil and gas leases began to include a so-called "major portion" provision, which generally provides, in pertinent part, that: "During the period of supervision, "value" for the purposes hereof may, in the discretion of the Secretary, be calculated on the basis of the highest price paid or offered (whether calculated on the basis of short or actual volume) at the time of production for the major portion of the oil of the same gravity ...produced and sold *from the field where the leased lands are situated...* " *(See* Form 5-154h, 3(c) (Apr. 24, 1936) (emphasis added).) In construing this provision, the IBLA and federal courts have emphasized two key points: (1) the "major portion" must be valued on the basis of prices paid or offered for *oil produced in the same field* as the leased lands; and (2) the lease terms restrict the "highest price" to the price paid (or offered) for the *major portion* of the oil produced and sold from the production field. In *Pawnee v. United States* for example, the United States Court of Appeals for the Federal circuit held that MMS did not breach its fiduciary duty to the Indians by failing to "enable them to receive the benefits of gas royalties computed upon the market value determined by the highest price paid or offered for like quality gas at the time of production," because that standard was contrary to the express terms of the Indian leases. 830 F.2d 197, 191 (Fed.Cir. 1987). As the court in that case explained: "The [Indian's] demand royalties based on the highest market price or value at the time and/or place of production, but the governing regulation and the leases expressly restrict the highest price "for the *major portion*" of the gas 'produced and sold from the field where the leased lands are situated'." 830 F.2d at 191 (emphasis court's).

The proposed use of the 75th percentile price is also contrary to the "major portion" provisions of Indian lease agreements. MMS proposes to "arrange the reported values . . . from highest to lowest" and then choose, as the major portion value, "the value of the 75th percentile (by volume, including volumes taken in kind) starting from the lowest value." (63 Fed. Reg. 7101.) Just as the IBLA explained with respect to the median (50th percentile) value used in *Supron Energy Corp.*, the value of the 75th percentile is "the price at which, or above which, [25% of the oil is] sold and, at the same time, the price at which, or below which, the other [75%] was sold." 46 IBLA at 188. Twenty-five percent is plainly not the "major portion." *See Ladd Petroleum Corp.*, 127 IBLA 163, 173 (1993) (more than 50% is majority); *see also* Webster'' New College Dictionary, 660 (defining "majority" as "a number more than half of the total number of a given group").

II. THE PROPOSED RULE EXCEEDS THE STATUTORY AUTHORITY OF THE SECRETARY OF THE INTERIOR

A. The Proposed Valuation Methodologies and "Major Portion" Calculation Effectively Increase the Royalty Rate, and Therefore Exceed the Secretary's Statutory Authority.

NYMEX index pricing does not represent value in the producing field, as required by the plain terms of Indian lease agreements. The proposed rule – by valuing production at a point off the lease, by denying transportation costs from the lease to the boundary of the reservation, and by denying integrated lessees the value of their midstream assets and services – effectively raises the royalty rate on production from Indian leases, in contravention of the leases ' "regulations" provision. Although the royalty percentage remains intact, application of that percentage to a value higher than that intended by the lease is the economic equivalent of raising the royalty rate.

B. The Secretary Has No Authority to Require Indian Lessees to Transport Lease Production Off the Lease, to the Boundary of the Reservation or Elsewhere, at No Cost to the Lessor.

In contrast to the current regulations and the consistent interpretation of Indian lease agreements over the past seventy-five years, the proposed rule would limit transportation allowances to the "actual cost" of moving lease production from the "designated area" boundary to a point of sale or delivery off the designated area, and would no longer permit a transportation allowance for the cost of moving lease production from the lease to the designated area boundary. (63 Fed. Reg. At 7094.) This proposed change, according to MMS, is "based on consistent feedback from Indian lessors that such costs should not be permitted." (*Id.*) Specifically, the Indian lessors "say that since their leases typically are silent on transportation costs, there is no specific provision permitting such deductions." (*Id.*) However, the Indian lessors "acknowledge that costs to move production away from the reservation/designated area may be legitimate deductions." (*Id.*)

Although Indian leases are "silent on transportation costs," they also *value lease production at the lease*. Implicitly, therefore, if lease production is sold at a point *off the lease*, the lessee is entitled to deduct from the royalty value the costs incurred in moving the lease production to the off-lease point of sale.

C. MMS Has No Authority To Require Indian Lessees To Market Indian Lease Production At No Cost To The Lessor Or At A Location Away From The Lease.

The proposed rule wrongfully attempts to require Indian lessees (1) to bear all costs of marketing crude oil, *i.e.* with the Indian lessors receiving the benefit cost-free, and (2) to bear such marketing duties and costs at locations away from the lease. (*See* 63 Fed. Reg. at 7093-94.) MMS asserts that the proposal would "clarify" the existing regulations, and "is consistent with several Interior Board of Land Appeals decisions construing this duty. *See Walter Oil and Gas Corporation,* 111 IBLA 260 (1989)." (*Id.*) MMS is wrong on both points.

This change is not a "clarification;" it is a major departure from lessee obligations under existing Indian leases and to current regulations. While Indian lessees are currently required by MMS regulations to place crude oil in a "marketable condition" at the lease, they are not required to market the product at no cost to the government, let alone at market centers. As MMS Director Cynthia Quarterman recently acknowledged, "[t]he government is entitled to a royalty on the value of production in marketable condition *at the lease*."

D. The Proposed Record-Keeping and Audit Provisions Exceed the Secretary's Statutory Authority.

Proposed section 206.53(a) would require the lessee to make available sales and volume data for production sold, purchased, or obtained from the designated area or from nearby fields or areas, including sales and volume data from private and State leases. In addition, the proposed rule purports to require anyone who produces, sells, purchases, exchanges, or refines oil produced from Indian lands to complete and file the proposed Form MMS-4416.

III. THE PROPOSED RULE IS NEEDLESSLY COMPLEX AND UNWORKABLE

A. Requiring Indian Lessees to Compute Royalty Value Two Different Ways in Order to Make Multiple "Highest Price" Comparisons Unnecessarily Complicates Royalty Valuation and Increases Costs.

The proposed rule would require lessees to compute royalty value using both the NYMEX-based index pricing and downstream, "gross proceeds" methods in order to perform the first "highest price" comparison. Thereafter, the lessee would be required to perform yet another comparison, to determine whether the MMS-published "major portion" value is higher than the royalty value initially reported by the lessee. This

proposed duplicative royalty computation and multiple comparison would unnecessarily complicate royalty valuation, increase costs, and reduce certainty with no countervailing benefit (other than to artificially, and unlawfully, inflate the royalty value for Indian lease production).

B. Computation of the Resale "Gross Proceeds" May Be Impossible, Because it is Generally Not Possible to Track the Downstream Disposition of Indian Lease Production or Crude Oil Received in Exchange for Indian Lease Production.

Lessees would effectively be required under the proposed rule to determine the ultimate disposition of each barrel of Indian lease production in order to compare the downstream "gross proceeds" to the NYMEX-based index price. For the same reason, Indian lessees would also effectively be required to determine the ultimate disposition of oil received in exchange for Indian lease production.

Once crude oil is commingled there is simply no way to distinguish between Indian and non-Indian oil, or between Indian oil from different leases. Therefore, it is generally not possible to actually trace the ultimate disposition of Indian lease production, or of oil received in exchange for Indian lease production.

IV. THE PROPOSED RULE WOULD IMPOSE AN ENORMOUS ADMINISTRATIVE BURDEN ON INDIAN LESSEES WITH NO COUNTERVAILING BENEFIT

A. The Cost of Compliance Would Increase Dramatically Under the Proposed Rule.

The proposed rule would dramatically increase the cost of compliance.

In addition, the proposed rule would result in a dramatically increased audit burden on both MMS and industry. Calculating allowable allowances and adjustments, and determining the appropriate prices would make future audits significantly more complicated.

B. Completion of the Form MMS-2014 Would Become Extraordinarily Burdensome and Costly.

Reporting systems that currently create MMS-2014s for electronic filing would have to be reprogrammed.

V. MMS HAS FAILED TO CONSIDER LESS BURDENSOME AND MORE RELIABLE ALTERNATIVES, SUCH AS TENDERING AND TAKING INDIAN ROYALTY IN KIND

A. Conoco's Tendering Program is a Far Less Burdensome and Much More Reliable Benchmark for Royalty Valuation than the NYMEX Pricing Alternative Proposed by MMS. See discussion in prior federal oil valuation comments.

B. The Least Burdensome and Most Reliable Alternative Would be for the Indian Lessors to Take Their Royalty in Kind.

VI. THE PROPOSED RULE DOES NOT PROVIDE AN ADEQUATE BASIS FOR PUBLICATION OF EITHER AN INTERIM OR FINAL RULE

A. The Proposed Rule Fails to Provide a Sufficient Statement of Basis and Purpose or Explain Why MMS is Changing Settled Principles of Royalty Valuation.

B. MMS Has Failed to Consider Comments Received in Response to the Proposed .Rule for Valuation of Federal Lease Production.

Despite the similarity between the proposed rule and the rule proposed in January 1997 for valuation of federal oil, and notwithstanding the fact that the same office was responsible for drafting both proposed rules, MMS has not fully considered comments received in response to the proposed rule for valuation of Federal lease production.

C. MMS Has Not Complied with Executive Order 12630.

Executive Order 12630 requires MMS and other executive departments and agencies to "review their actions carefully to prevent unnecessary takings" and to "account in decision-making for those takings that are necessitated by statutory mandate." 53 Fed. Reg. 8859 (1988). Specifically, the Executive Order requires MMS to "identify the takings implications" of the proposed rule and "address the merits of [the proposed rule[in light of the identified takings implications." *Id.* At 8862. The underlying purpose of the Executive Order is to ensure "[r]esponsible fiscal management and fundamental principles of good government" by requiring "government decision-makers [to] evaluate carefully the effect of their administrative, regulatory, and legislative actions on constitutionally protected property rights." *Id.* At 8859.

MMS did not comply with Executive Order 12630, based on its certification that "the rule does not represent a governmental action capable of interference with constitutionally protected property rights." (63 Fed. Reg. At 7098.) Given the fact that the proposed rule is contrary to the express provisions of existing Indian oil and gas leases and flies in the face of seventy-five years of settled law and contract-backed expectations, MMS's certification is erroneous and unjustified. Accordingly, MMS should comply with the requirements of Executive Order 12630.

D. MMS Has Not Complied With Executive Order 12866.

The Office of Management and Budget has determined that the proposed rule is a "significant regulatory action" within the meaning of Section 3(f)(4) of Executive Order 12866. That section provides that a " '[s]ignificant regulatory action' means any regulatory action that is likely to result in a rule that may . . . [r]aise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in this Executive order." 58 Fed. Reg. 51735, 51738 (1993).