IPAMS

Independent Petroleum Association of Mountain States

From the desk of
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Date: May 13, 1998
To: David Guzy
With: MMS
Fax: 231-3385
Pages (including cover): 7

COMMENTS:
Original to follow by mail.

Please call 623-0987 to acknowledge receipt. Thanks.

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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

RE: Establishing Oil Value for Royalty due on Indian Leases
Notice of Proposed Rulemaking
63 F.R. 7089, February 12, 1998

Dear Mr. Guzy,

The Independent Petroleum Association of Mountain States (IPAMS) is pleased to have an opportunity to provide comments to the Minerals Management Service on the above-referenced rulemaking. IPAMS is a non-profit, non-partisan association representing over 1,000 independent oil and gas producers, service and supply companies, and industry consultants in a thirteen state Rocky Mountain region. We appreciate your granting our request for an extension of the comment period, as it enabled us to better analyze the proposed rule and its impact on small independent producers.

The business of exploring for oil and gas is a gamble. Even with the advent of technology that has greatly improved the odds, a producer can never be absolutely certain when he sinks a drill that he will find paying quantities of crude oil or natural gas. The continued volatility of crude oil and natural gas prices adds to the uncertainty of whether a producer will be able to keep his wells on line, or whether they will have to be shut in until prices improve and the wells become economic to produce again. In some cases, a significant or long-term drop in price could force producers to prematurely abandon or permanently plug wells because they are no longer economically viable to produce. A number of other economic factors weigh significantly in a producer's decision to continue producing or shut in a well, factors which are amplified in the cases of marginal wells or small independent producers.

Make no mistake about it: every producer of oil and natural gas in the business is well aware of the stakes.

Thousands of producers have taken Indian leases in good faith. In taking these leases, they agreed, in general, to pay a **higher** royalty percentage than is usually the case for federal, state and fee leases. In order to further boost royalty payments to the Indians, lessees agree to perform a dual accounting function and pay royalties on the **higher** of the two calculated amounts. Then, if determined that it would be **higher** still, they also agree to value their production on the **highest** price paid or offered for the major portion of oil production from the same field. In other words, lessees are already paying royalty on the **highest** price that can be calculated/determined for production from the same field or area.

What lessees never counted on was that MMS would change the rules of the game and also raise the stakes at some point in the future and require royalty payments based on the **highest** price available *anywhere* – even Wall Street! The proposed rule would require lessees to value their production based on the **highest** of three values: the lessee's gross proceeds, a NYMEX value, or the so-called "major portion" price. The NYMEX value must be the average of the five **highest** daily NYMEX futures settle prices at Cushing, Oklahoma, for the Domestic Sweet crude oil contract for the prompt month. The major portion price would now be calculated at the 75th percentile, instead of the historical – and more reasonable – 51st percentile.

Exacerbating the extraordinarily high valuation cost is the loss of a transportation allowance within the boundaries of a reservation or "designated area" (a term which is used to define a reservation or Indian lands in an area which may not be conterminous).

Increasing costs even further is the burdensome reporting requirement that all lessees of Indian lands *and* purchasers of Indian production submit the new MMS Form-4416, in addition to royalty reports which may have to be revised and resubmitted if the major portion price is higher than the lessee's gross proceeds price or the NYMEX price, as well as production reports and allowance forms. The data obtained from these new forms will form the basis for nebulous location and quality differentials used to adjust NYMEX prices, depending on where the production occurs and how the quality of the oil differs from oil bought and sold at market centers other than Cushing, Oklahoma. However, some of the data required is normally not known by either the lessee or the purchaser (who, in addition, may not even be aware he is purchasing Indian lease production).

What MMS is proposing to do is amend the lease contract without the consent of a party to the contract, namely, the lessee. There is no requirement that we know of in an Indian lease to value production on a NYMEX price. Nor is there any requirement for a lessee to bear the cost of transportation at no cost to the Indian lessor. MMS has substituted the terms of the lease with an outrageous standard that will be impossible for lessees to meet. There is no way a lessee can predict the five days during the month on which he can sell his oil at the best possible price. Yet that is what MMS evidently expects lessees to do. That is like asking a batter to hit 1.000 when even the best hitters average only .400.

IPAMS is unmitigatedly opposed to the use of NYMEX prices to value production. Indian lessors are already receiving uplift in value because of the dual accounting requirement and major portion provision of the leases. To require lessees to value their production at a price which few, if any, are actually receiving flies squarely in the face of any principle of fairness.

In the interest of saving time and trees, we herein incorporate by reference the comments IPAMS submitted on the federal crude oil valuation rule; most particularly, those comments related to use of a NYMEX price, a netback methodology, exchange agreements, the Form 4415, valuation guidance, and a lessee's duty to market at no cost to the lessor.

With regard to additional comments on the proposed rule, we offer the following:

<u>Section 206.51 – Definitions</u>

Lessee: The amended definition of lessee is far over-reaching. We believe the definition should stop after *"Lessee means any person to whom an Indian Tribe or allottee issues a lease, and any person assigned an obligation to make royalty or other payments required by the lease"*. The rest of the language muddies, not clarifies, the definition of lessee.

Like-quality oil: MMS needs to clarify what it means by the phrase "similar...<u>legal characteristics</u>" of crude oil.

Quality differential: Differences in quality are not related simply to the mechanical properties of oil. That is only part of the equation. You cannot define the quality of oil merely by what you can sell it for; that is too subjective a determination.

Transportation allowance: IPAMS has serious concerns with the amended definition of transportation allowance. It is grossly unfair to limit transportation deductions to transportation occurring outside MMS's designated areas. Essentially, MMS is now saying the designated area has become the lease for oil valuation purposes.

It is possible that the distance from the lease to the designated area boundary could be hundreds of miles. If the crude oil has to be transported across the designated area in order to reach whatever market is available, then the cost of doing so should be deductible. Indian lessors claim that because their leases are silent on the issue of transportation costs that there is no specific provision permitting such deductions. This is arguable reasoning. IPAMS would argue that because the leases are silent on the issue of transportation costs, there is *no reason not* to permit such deductions. Virtually all lessors, including federal, state and fee lessors, permit the deduction of reasonable transportation costs to transport production to market. It is a necessary cost of doing business.

Section 206.52

Subparagraph (a) – As discussed earlier, lessees of Indian lands enter into those lease contracts knowing that they will be required to value their production on the higher of a dual accounting method calculation or a major portion price calculated by MMS. However, IPAMS has a fundamental problem with requiring lessees to pay royalty on a price that is offered for paper barrels of oil traded at a futures market in New York City. Given the markets available for crude oil produced from federal leases which are located near many of the designated Indian areas, it is doubtful that the prices received for production from the designated areas track the NYMEX any better than those prices do. NYMEX prices are simply an unrealistic measure of value for most of the crude oil that is produced from Indian leases.

Subparagraph (b) – If, by some miracle, a lessee is able to receive a higher price than NYMEX, he may use his gross proceeds to value production, provided his gross proceeds also exceed the major portion price as discussed in Subparagraph (c). However, we question the odds of this occurring. This token nod toward gross proceeds gives lessees little hope. IPAMS asserts that if the lessee is selling his crude oil in an arm's-length contract, his gross proceeds should be the value for royalty purposes – the only exceptions being a higher dual accounting calculation or a higher major portion price that is based on what similar oil is selling for in the same field or area, not some other type of oil sold at a market distant to the lease.

Subparagraph (c) – This section describes how MMS will calculate the major portion price. IPAMS is extremely concerned that MMS has proposed to go from the historic major portion percentile of 50 plus 1 percent, up to 75%. This is an extremely costly proposal and one that virtually guarantees that a lessee's gross proceeds will seldom, if ever, exceed the major portion price. Indian lessors have argued that a "median" price does not impute a "major" portion price. However, IPAMS suggests that anything greater than a median price is a major portion price. IPAMS strongly recommends MMS use a more reasonable percentile in the 51 to 55 percentile range, if, indeed, any increase in the major portion percentile is warranted. We think it is not.

The regulations are unclear as to how they would apply to condensate.

Section 206.53

Subparagraph (a) – This section requires a lessee to make available upon request sales and volume data for production sold, purchased, or obtained from a designated area or from nearby fields or areas, including data on fee and state leases. We do not believe MMS has the authority to require a lessee to provide any data regarding non-Indian leases.

Subparagraph (d) – Once again MMS has included the highly controversial duty to market "at no cost to the Indian lessor" language. As MMS is well aware, this language is viewed as a significant expansion of the language requiring a lessee to place oil in marketable condition and market it for the mutual benefit of the lessee and lessor. Again, lessees are exposed to the possibility that an arbitrary and subjective determination will be made years after royalties are paid that the lessee breached some implied duty to market, requiring the payment of additional royalties as well as interest and penalty payments. IPAMS is strenuously opposed to the inclusion of this language in the regulations. Furthermore, we find little "mutual" benefit in this proposal.

Section 206.54

This section provides that a lessee may ask MMS to provide valuation guidance or propose a value method to MMS, and that MMS will promptly review the proposal and provide the requested guidance. Will MMS's valuation guidance be binding upon audit? As you know, IPAMS commented extensively on this issue in our comments on the supplemental proposed rule for federal crude oil valuation and we would reiterate those comments here. In addition, will a time limit be imposed on MMS in which to issue such guidance? In order to ensure lessees' certainty, a reasonable time frame must be established.

Section 206.60(a)(1)(ii)

We are curious why this section is reserved.

Section 206.61(c)(3)(iii)

This section provides that MMS will calculate a differential when it receives a lessee's request, or when it discovers that its published differential does not apply to a lessee's oil, and that MMS will bill for any additional royalty and interest due. How and when would MMS make this discovery? Why would additional royalty and interest be due if MMS decides later that its own calculated, published differential does not apply to a lessee's oil? What criteria would be applied in making such a determination? This opens the door for MMS or its auditors to make an arbitrary determination that a differential is not applicable and further beef up the coffers with additional royalty and interest payments.

Conclusion

By requiring payment on the highest price that is obtainable anywhere, MMS is effectively increasing the royalty rate. In other words, what MMS is not permitted to do under the terms of a lease, it is attempting to do by regulation.

It would appear there is no way the Indian lessors can lose under this proposal. To the contrary, it is IPAMS' belief that the Indians have everything to lose. We believe that the costs to comply with the proposed rule will result in the premature abandonment of marginal wells, early relinquishment of leases, and an overall decline in the leasing of Indian lands in the future. In its attempt to gain royalty on the highest price anywhere, MMS has taken royalty valuation to an unrealistic and unwarranted new level. There is a point at which maximizing revenues innately turns on itself and becomes the cause of revenue loss.

It can be argued that there will always be another company willing to lease Indian lands or take up where another lessee has left off. However, with the cost in tax and royalty of operating on Indian lands approaching and sometimes exceeding 40%, coupled with the burdensome administrative costs of complying with the proposed rule, there remains little incentive to lease, let alone drill and produce on Indian lands. IPAMS believes the rule will have a deleterious effect on the ability of small oil and gas producers, especially, to participate in oil and gas activities on Indian lands. We believe this is discriminatory and unfair.

IPAMS urges MMS to withdraw the proposed rule and develop regulations that are more equitable, that better approximate value at the lease, and that do not abruptly up the ante by imposing significant new administrative burdens and cost on lessees that were not contemplated at the time the leases were taken.

We appreciate your consideration of our comments. Please do not hesitate to contact me if you have any questions, or if you would like to discuss our comments in greater detail.

Sincerely,

Carla Wilson

Carla J. Wilson
Director of Tax and Royalty