# Congress of the United States

Washington, DC 20510

November 4, 2003

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OFFICE OF THE EXECUTIVE SECRETARIAT

The Honorable Gale Norton
Secretary
U.S. Department of Interior
1849 C Street, NW
Washington, D.C. 20240

Dear Secretary Norton,

We are writing to you to express our grave concerns about the proposed rule that the Minerals Management Service (MMS) released on August 20, 2003, which would amend the existing regulations for the valuation of crude oil produced from federal leases.

According to MMS, its proposals are merely "technical" amendments reflecting its "experience" under the oil valuation rules that became effective in June 2000. However, experts inform us that these "technical" amendments would cut California's royalties by nearly 8%, costing the state nearly $1 million in lost royalty revenues.

The specific changes that are most troubling to us are the following:

Unjustified increased rate of return for industry: Under the current oil valuation rules, MMS allows pipeline companies to get a rate of return on its undepreciated investments at the Standard & Poor's BBB junk bond rate. In the proposed rule, MMS recommends increasing this rate of return for industry to 1.5 times the Standard & Poor BBB rate. We are concerned because: (1) MMS's proposal to increase the rate of return to industry is based on an industry study that is inherently flawed, and (2) any increase in rate of return to industry would diminish royalty payments to the State of California.

Additional deductions for transportation of oil: MMS proposes several "additional" deductions, which taken together would increase deductions from royalty by about 22%. One of those deductions is for "line fill," or a company's proportional share of oil inventory throughout a pipeline. Since royalty is owed on the volume of oil produced every month – whether it is sold or maintained in inventory – it is unclear why this deduction is being proposed. MMS fails to explain why a producer should be reimbursed for its cost of carrying this oil.

Another proposed deduction of concern is for "line loss," or the volume of oil lost once oil enters a pipeline. Since royalties are calculated based on oil production at the lease – before the oil enters a pipeline – this deduction is unjustified.

Additionally, not all shippers are charged for line fill or line loss allowances. Those companies that do not pay should not be allowed these deductions.

Unreliable sources for oil valuation: MMS proposes to base its calculation of "differentials" or adjustments to oil prices for quality and location differences, based upon information from reporting services that are deemed by MMS to be too unreliable for use in determining market values.

We are confused why these changes are being proposed when there is insufficient evidence to justify these changes. Unlike the process leading up to the current rules, MMS's newly proposed rule on federal oil valuation is not the product of any audits that we have seen. In fact, the three-year cycle for audits of royalty payments under the 2000 rules is just beginning. Requests for access to the data underlying the proposals have been stymied by assertions of burden and confidentiality. It appears from the proposed changes that MMS only considered the input of industry and did not seek the input of states and tribes.

At the same time that Interior is proposing to rollback these royalty gains, it is refusing to change other royalty rules that were found to be seriously flawed by its own Inspector General. For example, the "royalty rate reduction" rules, administered by the Bureau of Land Management, have cut California's royalty revenues by an estimated $20 million annually – a 59% reduction in what the state would otherwise receive. It is our understanding that Interior has not responded to the April 2003 request from the California State Controller that these rules be terminated [letter attached]. Instead, it is rushing to amend a rule that, according to MMS, "is working well and accomplishes its objective of ensuring a fair return on federal resources."

In light of what appear to be substantial changes to the process for valuing oil produced on federal lands and their negative effect on California, we respectfully request that you reconsider and reject the proposed rule.

Thank you for your attention to this matter.

Sincerely,

Barbara Boxer
U.S. Senator

Dianne Feinstein
U.S. Senator

Lois Capps
U.S. House of Representatives

George Miller
U.S. House of Representatives

cc: Steve Westly, California State Controller

STEVE WESTLY
California State Controller

April 22, 2003

The Honorable Gale Norton
Secretary
The United States Department of the Interior
1849 C Street, N.W.
Washington, D.C. 20240

Re: **Stripper and Heavy Oil Royalty Reduction Programs**
**43 CFR § 3103 *et seq.***

Dear Secretary Norton:

I am writing to request the immediate termination of the Department of the Interior, Bureau of Land Management's royalty rate reduction program for stripper and heavy oil properties. California receives 50% of the royalty revenues from federal leases located within its borders. Under the California Constitution, I am the elected official with the responsibility to account for the state's receipt of such revenues.

As you know, the stated purpose of the BLM regulations was to provide federal lessees with an incentive to invest in stripper and heavy oil properties in order to increase production during a time of low crude oil prices. Both are blanket programs, under which relief may be self-implemented by lessees without any consideration of a property's economic viability and/or profitability. As a result, some of California's largest producing properties, which are operated by major oil companies, are eligible for royalty reductions.

From California's perspective, the only demonstrable result of these programs has been the dramatic decrease in its royalty income. Under state law, oil royalty receipts are dedicated to funding public education.

With regard to the stripper program, I am aware that BLM has taken the position that rate reductions did increase production. On the basis of BLM's study, the stripper program was extended indefinitely in 1998. Subsequent reviews, however, have called BLM's analysis into question. For example, in a March 2001 Audit Report, Interior's Inspector

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General concluded that the "scope of the study was insufficient" and highlighted that it ignored critical comments of its own field offices, the Minerals Management Service, and the U.S. Department of Energy (IG Audit Report No. 01-I-297 at 9-10; March 2001). Instead, BLM essentially gave the stripper program credit for a slight increase in production in one state, which even industry said might well have been attributable to other economic factors (*Id.* at 10). Other Inspector General Audit Reports on the stripper program suggest that BLM's inability to undertake any credible analysis is due to administrative neglect (*e.g.*, IG Audit Report No. 00-I-300; March 2000). This same neglect has allowed federal lessees to self-implement greater rate reductions than the BLM regulations would permit.

To my knowledge, BLM has not undertaken any analysis of the heavy oil rate reduction program, even though the rules themselves indicate that a review of program effectiveness would be advisable after September 10, 1999. I would note, however, that the program is inconsistent with industry's own views on the economics of heavy oil production ("Economic Models Verify Heavy Oil Profitability", Oil & Gas Journal at 91; December 22, 1997).

In short, although BLM "bears a responsibility to the beneficiaries of the statutory royalty provision" (*Peabody Coal Co.*, 93 IBLA 317, 327 n. 4 (1986)), it has been investing California education dollars in the oil industry for over 10 years and California's children have seen no return on their investment.

As a matter of sound public policy, we may be in general disagreement about the true value of corporate "incentive" programs for selected industries and markets. In my view, this should not be seen as a partisan issue: both President Reagan's DOE and the current White House Council on Economic Advisors rejected the notion that royalty holidays will increase domestic production.

However, what I hope that we can agree on is current market conditions. Under both the stripper and heavy oil rate reduction regulations, the programs may be terminated when the price of West Texas Intermediate (WTI) exceeds an adjusted regulatory base price for six months. As the attached spreadsheet shows, WTI has exceeded the adjusted regulatory base prices under both the stripper and heavy oil programs between September 2002 through February 2003. The factual underpinnings of those programs – low crude prices – simply no longer exist. It is time to reinvest in our children.

As noted by the Inspector General, ending the stripper and heavy oil rate reduction programs would not negate Interior's statutory authority to extend rate reduction relief. Instead, it would allow BLM to meet its "responsibility to the beneficiaries of the statutory royalty provision" through making careful investment decisions. (*Compare*

"Royalty That Slides With Oil Price Can Add Value To Producing Fields," Oil & Gas Journal at 92; March 22, 1999). The systemic problems that BLM and MMS (*see* IG Audit Report No. 99-I-782 (August 1999)) have had just monitoring lessee reports and payments under the programs is simply additional evidence that these are "lose-lose" programs for the governments.

In my view, there is no reason to delay announcing the termination of these programs. Given the decade of administrative neglect, BLM will never be in any position to rebut the IG's findings. Moreover, termination given the current market conditions is consistent with Interior's intent under both the stripper and heavy oil program. Thus, I ask you to respond to my request promptly. If you have any questions, please contact my Chief of Staff, Greg Larson, at (916) 324-8907.

Sincerely,

Steve Westly

STEVE WESTLY
California State Controller

SW/ac

Enclosure

cc: Rebecca W. Watson, Assistant Secretary, Land and Minerals Management
Kathleen B. Clarke, Director, Bureau of Land Management

| Year/Month | (1) WTI Average Price | (2) Implicit Price Deflator | (3) 1991 Base Year Deflator | (4) Inflation Adjustment (2 / 3) | (5) Stripper Base Price | (6) Adjusted Stripper Base Price | (7) WTI Under / Over Adj. Stripper | (8) Heavy Oil Base Price | (9) Adjusted Heavy Oil Base Price | (10) Heavy Oil Under / Over Adj. Heavy Oil Base |
|---|---|---|---|---|---|---|---|---|---|---|
| 2002 | | 2001 | | | | (5 * 4) | | | (8 *4) | |
| September | $29.67 | 109.37 | 117.6 | 0.93001701 | $28.00 | $26.04 | Over | $24.00 | $22.32 | Over |
| October | $28.85 | 109.37 | 117.6 | 0.93001701 | $28.00 | $26.04 | Over | $24.00 | $22.32 | Over |
| November | $26.27 | 109.37 | 117.6 | 0.93001701 | $28.00 | $26.04 | Over | $24.00 | $22.32 | Over |
| December | $29.42 | 109.37 | 117.6 | 0.93001701 | $28.00 | $26.04 | Over | $24.00 | $22.32 | Over |
| | | | | | | | | | | |
| 2003 | | 2002 | | | | | | | | |
| January | $32.94 | 110.75 | 117.6 | 0.9417517 | $28.00 | $26.37 | Over | $24.00 | $22.60 | Over |
| February | $35.87 | 110.75 | 117.6 | 0.9417517 | $28.00 | $26.37 | Over | $24.00 | $22.60 | Over |

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(1918 - 1994)

July 23, 2003

Rudy Baier
Fluid Minerals Group
Minerals, Realty and Resource Protection Directorate
Bureau of Land Management
U.S. Department of the Interior
1620 L Street, N.W. Suite 501
Washington DC 20036

Dear Mr. Baier:

By letter dated April 22, 2003, my client, California State Controller Steve Westly, petitioned Secretary Norton to terminate the Bureau of Land Management's royalty rate reduction regulations for stripper and heavy oil. I was recently informed by Ms. Deborah Gibbs-Tschudy of the Minerals Management Service that review of the Controller's request was routed to you, and that it was being processed as part of your office's consideration of a variety of different royalty "incentive" proposals.

Attached is a July 21, 2003 article in Tax Notes relevant to your projects. Given that the BLM rate reduction regulations continue to drain money away from California public schools, hopefully this article will help expedite your review of Controller Westly's request.

Sincerely,

Lee E. Helfrich