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Sent: Monday, November 10, 2003 12:21 PM
To: MRM Comments
Cc: Gebhardt, Sharron; Rich Chivaro (E-mail); Marty Lobel (E-mail); M L (E-mail); Lisa Casalegno (E-mail); McClain, Jerry; Jeff Brownfield (E-mail); Vintze, Joseph; Hank Banta (E-mail)
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SCOComment.pdf (2 MB)

Attached are the comments of California State Controller Steve Westly to the proposed amendments to the federal oil valuation rules, 68 Fed. Reg. 50087. The attachments were forward to Ms. Gebhardt by E-mail on 11/9/03. We will also forward them to mrm.comments@mms.gov shortly. Lee Helfrich

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November 10, 2003

BY EMAIL & FAX

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RE: ***Comments, Proposed Rule "Federal Oil Valuation", 68 Fed. Reg. 50087***

Dear Ms. Gebhardt:

The following opposition to MMS's proposal to amend the federal oil valuation rules is submitted on behalf of California State Controller Steve Westly.

Throughout this rulemaking, MMS has represented to the public and the Congress that its proposals are merely technical amendments that, it says, are based upon its experience with and evaluation of the federal oil valuation rules, which became effective in June 2000. In its press releases and its power point presentations, MMS emphasizes its decision to move to NYMEX index pricing as the federal norm, which it states will increase federal revenues.

This rulemaking, however, is not about the NYMEX, and is, most definitely, not about increasing the public's royalty revenues. Instead, this rulemaking is about the current Administration's effort to settle a lawsuit that the oil industry was losing, and to settle it in a manner that will increase industry deductions from the public's royalty share. It is about giving up to industry what it was unable to wrench from the Clinton Administration through political interference.

Of course, MMS has not acknowledged that it spent at least two months in settlement negotiations with industry prior to initiating this rulemaking. Attachment (hereafter "A.") 1. MMS does not disclose that its proposals with regard to marketing and transportation deductions reflect, almost verbatim, the challenges industry leveled against the 2000 oil rules in court. *E.g.* A. 2. At most that lawsuit is given a passing reference by MMS as part of its "learning" experience. 68 Fed. Reg. at 50088, 50093.

MMS, in fact, attempts to distance itself from industry in its proposed rule. The agency repeatedly accepts full ownership of its proposals based upon *its* alleged experience, its evaluations and its reviews. But MMS has repeatedly refused to provide the public any details concerning what its experience demonstrates and how it supports the current proposals. Instead, the public is apparently being asked to blindly accept. MMS's "expertise" in these matters. Hiding behind *Chevron* deference[1], however, simply does not carry that far, especially for an agency that has been repeatedly criticized by courts, the General Accounting Office (GAO) and its own Inspector General for its neglect and mismanagement.

The State Controller's Office (SCO) has been working with MMS on royalty management matters for over 20 years. To SCO's knowledge, MMS has never completed a transportation audit. Moreover, during the time period covering this rulemaking, MMS was incapable of producing accurate royalty data from its computerized data base. Its so-called "royalty-in-kind" (RIK) experience was criticized by the GAO. "A More Systematic Evaluation of the Royalty-In-Kind Pilots Is Needed," GAO-030296 (January 2003). And, it has no data supporting that its NYMEX proposal accurately reflects market value of crude oil in California, or even accurately reflects industry's sporadic reliance on NYMEX in sales contracts for oil produced in the State.

SCO made several good faith attempts to obtain information from MMS with regards to its claims of experience with the 2000 oil rules. A. 3, 4, 5, 6. MMS's response to many key requests related to its proposal was that it had "no documents." *E.g.*, Requests #1 and 2, "Items sent in response to Lee Helfrich's Office" [DOI website]. The documentation it did provide does not support its proposals or is otherwise of highly questionable integrity. Possibly realizing this, MMS also claimed to have other data, which it could not disclose in a *public* rulemaking because it was "confidential, privileged and proprietary." A. 7.

MMS also refused to respond to congressional requests for information. Like SCO, members of Congress asked for access to material that MMS represented it had *before* initiating its public rulemaking. A. 8, 9. On October 31, 2003 – ten days before the end of the comment period – the MMS Director responded to the congressional requests by expressing her hope that "[t]he public comments we receive on the proposed rule may explain the commentors's views on any legal issues they identify." According to the Director, she could not "appropriately respond" to Congress by disclosing the information necessary to facilitate public review of MMS's proposal *because* the public comment period was still open. A. 10.

[1] *Chevron USA v. NRDC*, 467 U.S. 837 (1984).

What is not a secret about this rulemaking is that the current Administration at Interior opposes the Clinton era royalty reforms. In her first press statement after her appointment, the MMS Director highlighted her intention to change those rules. "MMS Head Vows to Look into Controversial Oil Valuation Rule," Oil Daily (April 5, 2002).[2] Some of the chief opponents during the rulemaking leading up to the 2000 oil rules were private clients of Interior's Deputy Secretary. *E.g.*, Contra Costa Times (April 4, 2003). It is noteworthy that at the same time that MMS is proposing amendments to the oil rule, it is also beefing up its RIK program, which was one of industry's main battle cries during the legislative fight over the 2000 oil rules.

At bottom, this is the only "experience" and "expertise" MMS has with regard to operation of the 2000 oil valuation rules.

A. MMS's Economic Analysis

One of the representations made by MMS that assists it assertion that its proposed rule is nothing more than technical "tweaking" is its economic impact analysis. According to MMS's analysis, what it proposes to give up in terms of deductions is almost perfectly offset by what it says it will gain by adopting NYMEX. 68 Fed. Reg. at 50101. Unfortunately, both MMS's data and its math are fuzzy.

1. Data Integrity

MMS claims throughout its proposed rule that it has been evaluating the efficiency and effectiveness of the 2000 oil rules for the past three years. MMS, however, is on a three year audit cycle, which means few, if any audits of federal lessee compliance with the 2000 oil rules have been initiated, let alone completed. Moreover, as a recent report of the Inspector General underscores, MMS has simply been neglecting its audit responsibilities; indeed MMS "auditors" cannot meet professional certification standards. Instead, over the past few years, MMS has been reassigning employees to implementation of its new "re-engineered" computerized compliance system. I.G. Report No. 2003-I-0023.

According to State and Tribal auditors, MMS's new computer compliance system does not work. Letter of July 21, 2003 from STRAC to Senator Jeff Bingaman. The accuracy and integrity of that data has also been negatively impacted because one of MMS's private contractors lost company data reports containing royalty information for

[2] The referenced article was included as an attachment to the "Preliminary Comments of California State Controller Steve Westly" (August 27, 2003). Those preliminary comments and all attachments are incorporated by reference herein. SCO also incorporates by reference all of the comments submitted on its behalf during the 2000 rulemaking, which are all readily available on DOI's website, and all other documentation referenced by SCO herein from the 2000 rulemaking. Finally, SCO incorporates by reference: Final Report, Crude Oil Marketing, prepared for MMS by Innovation & Information Consultants, Inc. (IIC, Inc.) (July 7, 1997); "Analysis of the Market Value of Various California Crude Oils", prepared for MMS by IIC, Inc. (April 17, 1998), and "Final Interagency Task Force Report on the Valuation of Crude Oil Produced from Federal Leases in California," (May 16, 1996).

several months in 2001 and 2002. MMS has not fully corrected this problem to date. A. 11.

MMS's inability to access actual lease data as part of its "evaluation" of the effectiveness of the 2000 oil rules is demonstrated by the across the board assumptions that it makes in its economic impact analysis. For example, the assumption that there is a 50-50 nationwide split between arm's length and non-arm's length sales contracts is ludicrous on its face. Integrated majors control approximately 70 % of federal production in California.

Until October 2001, MMS did not even require industry to report whether its sales and/or transportation arrangements were arm's length or not. The only means that MMS had to make these determinations were through audits, which, as noted, it was not conducting. After October 2001, industry was required to report the information, but, as noted, the accuracy and integrity of that data was adversely impacted by MMS's own systemic computer problems. And, of course, even to the extent MMS could access industry reports, the fact remains that the reported data is unaudited. Past audit findings and False Claims Act settlements cast considerable doubt on the advisability of relying on an honor system based on industry-generated information for purposes of making federal royalty policy. *See e.g., U.S. ex rel. Johnson v. Shell Oil Co.*, 33 F.Supp. 2d 1122 (N.D. 1999); "ExxonMobil to Appeal $3.5 Billion Alabama Verdict in Royalty Dispute," Inside F.E.R.C.'s Gas Market Report (December 22, 2000); "Making them pay: How big oil companies shortchange taxpayers on royalties," U.S. News & World Report 30 (May 14, 2001).

Recent press reports suggest that MMS is actively trying to avoid independent review of its computer programs. MMS's "expertise", for example, was recently the focus of an inquiry by the Special Master in the Indian Trust Fund case, *Cobell v. Norton*. MMS refused to permit the Special Master access. A. 12.

2. Royalty-in-Kind

In its economic impact statement, MMS backs out oil volumes that are being taken by the government in kind. While this reduces the overall impact of its proposed oil valuation rules, it also overlooks that, in administering the in kind program, Congress directed MMS to obtain results that equate with what the government would receive if royalty was paid in cash by lessees. Valuation rules are hardly irrelevant to MMS's RIK program.

For example, under the proposal MMS would allow industry some "additional" deductions – over and above the traditional operating and maintenance expenses – that, according to MMS, include deductions for line fill, shrinkage, letters of credit and the like. 68 Fed. Reg. at 50094-50095. When MMS takes royalty in kind, the federal government assumes these expenses. In the past, MMS has paid for these services by reducing the volumes that it would otherwise be entitled to under the lease terms. Reducing volumes is as much of a loss to the public as reducing revenue. Under MMS's

RIK program, the Strategic Petroleum Reserve receives less, under its oil valuation rules, the school children of California receive less.

Moreover, by re-defining more marketing and post-production expenses as "transportation" deductions for private lessees, MMS is in a better position to claim that its RIK programs are revenue neutral. In other words, MMS's institutional, "bureaucratic" interest (especially given its intent to expand the RIK program) is in direct conflict with the public's revenue interests.

3. Rate of Return

According to MMS, it proposes to increase the rate of return to 1.5 times the BBB bond rate because that increase "is within the range recommended by its own experts and close to the rate recommended by the industry experts." 68 Fed. Reg. at 50094. As is discussed below, this statement actually misrepresents the findings of MMS's own economists.

For purposes of the economic impact analysis, MMS concludes that this change would decrease federal royalties by a mere $3,560,283. 68 Fed. Reg. at 50099. In 2000, however, MMS's "own experts" concluded that doubling the BBB rating would cost the government $43 million.

> MMS collects $3 billion in royalties annually. Assume that 20% of these receipts are generated by lessees who own their own pipelines; and doubling the allowed rate of return as proposed by industry lowers the effective royalty rate by one percent point. Given a current composite lease royalty rate of say, 14%, it follows that the reduction in royalty receipts would be about $43 million.

Discussion of Rate of Return Issues (February 18, 2000), *attached to*, Request # 3 "Items sent to Lee Helfrich's Office" [DOI website]. Of course, under MMS's current proposal, industry would only be entitled to 1.5 times, not 2 times, the BBB rate. But under the analysis of MMS's own economists, this would result in a reduction in royalty receipts of $22.5 million, not $3.5 million.

4. NYMEX with a Roll

As noted, MMS's carrot to the public in this rulemaking is its proposal to apply NYMEX nationwide. Under its economic impact analysis, it claims that for the "Rest of the Country" (*i.e.*, not California), the public will see a gain of somewhere between "$4,303,913 to $11,658,663 per year." This, as its own analysis demonstrates, is almost all attributable to its estimate of a positive $0.30 roll – this "roll" would be added to the NYMEX calendar month average. 68 Fed. Reg. at 50097.

As MMS explains elsewhere, when oil prices are expected to decline, the "roll" will be positive or forward – it will result in bumping up the NYMEX calendar month price, and increase royalties in that month accordingly. However, when oil prices are expected to rise, the "roll" is a negative or backward – the "roll" will be subtracted from the NYMEX price, which will decrease royalties in that month accordingly. 68 Fed. Reg. at 50089.

For economists, this phenomenon is known as "backwardization vs. contango" Except for MMS's adoption of industry's "roll" terminology, this is not a new phenomenon; it was, in fact, known to MMS prior to its adoption of the 2000 oil valuation rules. At the time, MMS adopted the uniform view of economists, which concluded that, over time, this phenomenon produced a revenue wash. Thus, undertaking the calculation, which MMS now proposes to adopt, wasn't worth the administrative candle.

SCO knows of no recent economic literature that contests the view of economists. And, of course, the analysis of these experts does not support MMS's assumption of some kind of persistent $0.30 per barrel gain. MMS's analysis is based on a particular snapshot of time, which it does not even suggest is somehow uniquely reflective of how "backwardization/contango" impacts royalty revenues.

Different snapshots provide different answers. For example, using MMS's own figures for 1998,[3] the "Rest of the Country" would have been better off under the 2000 oil rules. For 10 out of 12 months that year, WTI spot prices exceeded both NYMEX and "NYMEX with a roll". In fact, for 1998, the "NYMEX with a roll" methodology would have, on average, reduced a NYMEX based royalty by $0.48 per barrel – the roll was consistently backwards.

Indeed, in 1998, MMS's proposed methodology would have produced an even more perverse result. MMS's formula is:

> (NYMEX calendar mo. avg. +/- roll) – (spot avg. WTI – spot price, royalty crude).

68 Fed. Reg. at 50097. Using MMS's own numbers for January 1998 and applying them to its Light Louisiana Sweet (*id.*) example produces a royalty base of NYMEX minus a backward roll of $0.27 less another $1.00.

> ($15.54 + (-$0.27)) – ($17.27 – $16.27) = $14.27

Even assuming the validity of MMS's proposed "WTI grade differential formula", the "Rest of the Country" would have been better off subtracting that dollar from the WTI spot price of $17.27 (royalty base of $16.27), or even the NYMEX with no roll price of $15.54 (royalty base of $14.54).

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[3] The prices used in this alternative snapshot were compiled by MMS and are part of Request # 5 "Items sent in response to Lee Helfrich's Office" [DOI website]. SCO cannot vouch for the reliability of the data collected by MMS. *See* discussion "Data Integrity" *supra*.

Moreover, it is worth reiterating that the "roll" results in a reduction to the NYMEX price when oil prices are expected to rise. This is hardly the time when governments want to be reducing their cash flow.

In short, MMS's projection of annual gain from its "NYMEX with a roll" proposal is illusory. Indeed, the only function of its economic impact analysis in this regard is to give the appearance that its proposals to increase industry's deductions are offset by a constant forward roll. However, the only thing constant under MMS's proposed rules is its proposals relating to transportation deductions, which will reduce royalty income whether oil prices are predicted to fall or to rise.

In other words, there is no carrot in MMS's proposal, only a stick.

5. WTI Differential

According to the comments submitted by the State of Wyoming, it is seeing NYMEX prices under sales contracts for Wyoming oil, which are not being adjusted for location.[4] [DOI website]. Indeed, according to those comments, Wyoming has actually seen sales at "NYMEX" plus – a fact that is an obvious reflection of the economic reality that Wyoming oil is more valuable to the Wyoming refinery market than WTI at Cushing is to the Wyoming refinery market. Refiners save money by buying oil produced closer to their refineries. *Cf. U.S. v. General Petroleum Corp.*, 73 F. Supp. 225, 238-246 (S.D. Ca. 1946), *aff'd sub nom, Continental Oil Co. v. U.S.*, 184 F.2d 802 (9th Cir. 1950).

MMS's proposed WTI differential does not take into account the potential for an uplift in value due to location. As MMS is well aware this uplift in value is often reflected in arm's length exchange agreements, and indeed can offset any downward adjustments relating to crude oil quality. Moreover, as Wyoming's comments show, there is no need to "locate" the NYMEX price – it can be adjusted *in the field* for quality differences alone.

Thus, under MMS's proposal for a WTI differential, industry will often receive a larger reduction to the NYMEX base price than economic reality would support. MMS's economic impact statement is based on comparing apples with oranges, rather than apples with apples.

6. Total Impact

MMS's economic impact analysis is confined to estimates regarding oil royalties. This results in a drastic understatement of the revenue loss potential if these proposals go

[4] Whereas MMS has been neglecting its audit program over the past few years, States and Tribes have continued to perform and complete audits. Through its audits, SCO has also seen some sporadic use of NYMEX prices in sales contracts for California oil production. Its reviews have been consistent with those of the State of Wyoming. While adoption of MMS's proposed "WTI Differential" may promote its use by industry as a means to reduce federal royalties, it is not a methodology that SCO has seen employed by industry through its audit work.

into effect. Just as MMS is trying to apply unchallenged provisions of its FERC 636 rulemaking to oil (*see* discussion Section B.3, *infra*), it will try to apply its expanded industry deductions to the determination of deductions from royalties due the public on other minerals, such as natural gas.

Moreover, having resolved any "doubts" with regard to classification of expenses as "marketing" or "transportation" in industry's favor, it will be free to apply these classifications, without analysis, to Tribal and Indian allottee leases. *Compare Jicarilla Apache Tribe v. Supron Energy Corp.*, 782 F.2d 855 (10th Cir. 1984)(faced with a decision where there is more than one choice, Secretary must adopt option in best interests of Tribe).

B. Transportation Deduction Proposals

1. Summary

In its proposed rule, MMS lists several expenses that it proposes to call deductible transportation costs. This list of expenses was generated by federal lessees; there was no prior discussion with other stakeholders with regard to the formulation of this list.

During the rulemaking leading up to the 2000 oil valuation rules, the majority of these expenses were defined by industry as non-deductible, "midstream" marketing costs. Industry objected to that rulemaking, in large part, because of MMS's reference to a cost-free duty to market, which would make these "midstream" marketing costs nondeductible. In the litigation over the 2000 oil valuation rules, industry also argued that these expenses were non-deductible "midstream" marketing costs, which federal lessees would not be able to deduct as a result of MMS's recognition of a "duty to market."

After making these representations to the federal government and a federal court, industry, through its two major trade associations, lost its challenge to the "duty to market" in a related case. *IPAA v. DeWitt*, 279 F.3d 1036 (D.C. Cir. 2002), *cert. denied*, 123 S. Ct. 869 (January 13, 2003). After the judiciary rejected its claims, industry returned to Interior with the request that these non-deductible "midstream" marketing costs be re-defined as deductible transportation costs. According to an industry representative at the March 2003 workshop in Washington DC, industry's previous representation to MMS and the court that these costs were-- as a matter of fact and industry practice non-deductible marketing costs-- was simply a "strategic" error, which it now asks MMS to ignore.

In short, without any analysis whatsoever, industry asks MMS and the public to accept its new definition of these expenses as deductible costs-a characterization that will reduce the public's royalty interests. No where does industry or MMS explain why this new categorization of expenses as deductible transportation is more believable or rational than industry's former categorization of these expenses as non-deductible marketing.

Misrepresentations of fact to a federal agency and a federal court, however, cannot be blithely sidestepped as matters of an ill-conceived litigation strategy.

In this rulemaking, MMS chooses to blindly accept industry's flip-flop. The agency does not even attempt to set out its standard for determining what is a "marketing" and what is a "transportation" cost. Having never completed an audit of a transportation allowance, this oversight might be understandable. But the agency's lack of expertise and experience is one of the very reasons that its proposed rule is premature and arbitrary. Reliance on an industry "honor system" has never served the public interest in matters relating to royalty management. MMS has no rational or factual basis for departing from Interior's historic practice of limiting transportation deductions to costs directly related to operating and maintaining a pipeline, as determined from the books and records of the transporter related solely to its transportation line of business.

2. Historical Context

Industry's complaint about the duty to market actually stems from MMS's final rule on the calculation of transportation allowances for purposes of the valuation of federal natural gas. Final Rule, "Amendments to Transportation Allowance Regulations for Federal and Indian Leases to Specify Allowable Costs and Related Amendments to Gas Valuation Regulations," 63 Fed. Reg. 65753 (December 16, 1997).

Under the 1988 valuation regulations for natural gas, as well as oil, MMS allowed industry to deduct tariffs approved by the Federal Energy Regulatory Commission (FERC) as a transportation allowance. Although MMS also stated that transportation allowances must be limited to the reasonable, actual costs of transportation, it would accept FERC approved tariffs based upon industry's representation that tariffs only included such expenses. Indeed, during that rulemaking, industry also asked MMS to recognize as deductible certain additional "post production" expenses, which it alleged were over and above the expenses included in a tariff. MMS rejected the deduction of post-production costs from federal royalties. *See* A. 13 at pp. 1-8 and authorities cited therein.

In 1992, FERC issued Order 636, under which it required the unbundling of the cost components that previously had been rolled into a lump sum charge. This revealed, for the first time, that tariffs included many of the expenses, which Interior-- even in 1988-- never intended to be deductible from royalty.

Shortly afterwards, MMS asked its stakeholders, through the Royalty Policy Committee and other organizations, to consider the implications of Order 636 as it related to deductions from royalty. Unfortunately, MMS did not have any practical experience with transportation allowances at this juncture. It had never conducted a transportation audit with regard to federal royalties. Nonetheless, MMS tried to reach a compromise with its stakeholders, directed at categorizing costs as either deductible transportation or nondeductible marketing costs.

As the States and Tribes complained, if there was any "doubt" about how to categorize a cost, MMS assumed it was deductible as transportation. 62 Fed. Reg. at 65754. This favoritism towards industry's preferred categorization-- whether it stemmed from politics or the agency's "information gap" -- led MMS to propose and eventually enact rules with regard to gas transportation, which could not withstand principled analysis. For example, MMS categorized Gas Research Institute fees as deductible transportation costs, despite the considerable administrative authority that government levies were not deductible from royalty. *E.g., Wheless Drilling Co.*, 13 IBLA 21 (1973). The sole reason that MMS categorized these fees as "transportation-relate" was because they were levied by FERC. Apparently for MMS, the fact that FERC regulates gas transportation was enough of a nexus for it to conclude that these fees were costs actually related to the movement of federal production. The agency did not seek to distinguish its opposing precedents.

Similarly, MMS made a facile distinction between long term and short term storage. This was directly contrary to Interior's long established rule that both "value" and "volume" are determined at the lease. Indeed, the distinction had nothing to do with industry practice or transportation realities, but was made solely on the basis of a lease provision that set when federal lessees were required to report and pay royalties. But, MMS even got that wrong in order to expand industry deductions from royalty. The governing statute requires royalty to be paid on the amount or value of production on the date of production, *whether or not the production has been sold. General Petroleum*, 73 F. Supp. at 257-258. This long standing interpretation, indeed, precludes industry's claims that it is entitled to deduct all of its midstream or sales specific expenses before paying royalties to the federal government. *See generally* A. 13.

"Good faith" compromise notwithstanding, industry challenged MMS's proposed changes to the calculation of transportation deductions applicable to natural gas valuation. *IPAA v. Armstrong*, 91 F. Supp. 2d 117 (D.D.C. 2000). First, industry argued that there was no cost free duty to market. Second, it asserted that MMS's categorization of certain costs was arbitrary and capricious. Of course, with regard to the latter, industry focused its challenge only on those costs that MMS had said would be non-deductible – industry had no interest in challenging the expenses that MMS placed in the deductible category. Thus, the lawfulness of MMS's categorization of costs as "deductible transportation" under the gas rules was not at issue in the *Armstrong* case -- *the case cannot be read as upholding the agency's determination with regard to those costs.*

The *Armstrong* case was pending during the protracted rulemaking over Interior's proposed reforms of the federal oil valuation rules. During the entire 2000 rulemaking, industry consistently defined the costs listed in MMS's current proposed rule as "midstream" marketing costs, which would be non-deductible because of MMS's position regarding the cost free duty to market. A. 14, 15. The characterization of these costs as marketing was made by industry to both the Department and the Congress. According to an IPAA representative: "MMS will be happy to learn IPAA did our homework assignment. For midstream activity we have compiled a list of costs". A. 16. The list (*see* A. 14) was based upon a survey of IPAA's membership regarding what "downstream" costs would be non-deductible under the MMS rule. In other words, this was industry's classification of the identified costs based upon industry practice. A. 16.

Indeed, in addressing issues relating to actual transportation costs during the oil valuation rulemaking, industry focused only on the issues of rate of return and depreciation. Although MMS had not initially proposed any changes to the treatment of these matters as set forth in its 1988 rules, industry raised both in its comments as a result of MMS's proposal to delete its rule regarding use of FERC tariffs, 30 CFR 206.105(b)(5) (1989), in non-arm's length transportation situations. According to industry, MMS needed to address these matters because of industry's belief that 206.105(b)(5) rendered MMS's rule on calculating reasonable, actual costs, 30 CFR 206.105(b)(2), meaningless and that they rightfully had ignored the latter rule. Industry's belief, of course, is not supported under case law governing interpretation of statutes and regulations. It cannot be assumed that MMS promulgated regulatory flotsam. *See e.g., Fina Oil and Chemical Co. v. Norton*, 332 F. 3d 672 (D.C. Cir. 2003).

The oil rules were published as final on March 15, 2000 and were scheduled to become effective in June 2000. 65 Fed. Reg. 14022.

On March 2000, the district court ruled in industry's favor in the *Armstrong* case on natural gas transportation, holding that there was no cost free duty to market downstream of the lease, and finding MMS's categorization of those costs, which industry specifically challenged, to be arbitrary and capricious. 91 F. Supp. 2d 117 (D.D.C.2000). The next month, IPAA and API brought suit challenging the 2000 oil rules. *IPAA v. Baca*, Civ. No. 00-761 (RCL); *API v. Baca*, Civ. No. 00-887 (RCL) (consolidated)(hereafter "*Baca*").

In January 2001 (after the change in Administration), IPAA and API moved for summary judgment in the *Baca* case. *E.g.*, A. 2, 17. As they had represented to the MMS, IPAA/API represented to the district court that the costs, addressed in the current proposal, were "midstream" marketing costs that would be non-deductible under MMS's new 2000 oil rule.

> "During the rulemaking, industry expressed its concern that MMS would use the duty to market provision to second guess lessees' marketing decisions and to claim royalty on value added downstream of the lease in the midstream market....Activities such as storage, blending, risk management, aggregating volumes, and satisfying customer preferences add value to which the government is not entitled to share. Industry also argued that legally there is no express or implied duty to market at no cost."

A. 2 at p. 11. As during the rulemaking, industry also confined its challenge to MMS's transportation allowance regulations to the issues of rate of return and depreciation. A. 2 at 35-37. The only exception was IPAA's inclusion of the non-deductibility of terminaling costs in its discussion of the transportation allowance provisions of the 2000 rules. *Id.* at 37. Oddly, counsel for IPAA did not inform the court that the reference to the non-deductibility of terminaling was part of the 1988 oil valuation rules, which he surnamed during his employment at Interior. *See* 30 CFR 206.101 (1989)(definition of "gross proceeds"). The 2000 rules simply continued the policy set under the 1988 rules defining "gross proceeds" as including "[r]eimbursements for harboring or terminaling fees." Industry never challenged the 1988 rules in court.

While industry was successful in its challenge before the district court (91 F. Supp. 2d 117), Interior prevailed on appeal in a decision dated February 2002 – a month after industry's motions for judgment in *Baca*. *IPAA v. DeWitt*, 279 F.3d 1036 (D.C. Cir. 2002). Interior's position with regard to the cost free duty to market was upheld. The only cost, challenged by industry under the arbitrary and capricious standard, that the court of appeals said that it would not defer to under *Chevron* was "unused firm demand charges". According to that court: "...Interior has offered no "distinction" at all, only an unusually raw ipse dixit ... *While some reason may lurk behind the government's position, it has offered none, and we have no basis for sustaining its conclusion.*" *Id.* at 1042-1043 (emphasis supplied).

Shortly after Interior's "duty to market" victory in *DeWitt*, however, the newly installed MMS Director vowed to reopen the "duty to market" issues. Indeed, an entire package of changes to the royalty management program was under consideration at the Secretarial level by March 2002. A. 19. This package included changes to the 2000 oil rules. In the meantime, industry asked the court of appeals for an *en banc* rehearing of its February 2002 decision. This petition was denied in June 2002, without a single judge voting in favor of rehearing. Nonetheless, industry petitioned the Supreme Court for *certiorari* in September 2002.

Industry and Interior also began negotiations with regard to the oil valuation rules no later than September 2002, which lasted through, at least, December 2002. A. 1. During these negotiations, industry provided MMS with at least one new document supporting its assertions with regard to transportation allowances. API Capital Cost Study (December 11, 2002), Request # 3 "Items sent in response to Lee Helfrich's Office" (DOI website). Obviously, this document, which is dated December 2002, could not have been part of the rulemaking record leading up to promulgation of the 2000 oil rules and thus was not part of the record in the *Baca* case.

Moreover, in November 2002, MMS's Office of Enforcement, which is the Office with the delegated responsibility over processing Interior settlements of royalty issues, began running comparisons of NYMEX prices (with and without a roll) vs. arm's length prices. These comparisons were for the years 1998 through 2002. *Id.*, Request # 5. How MMS managed to compile these figures is unknown. During that time period: (1) MMS did not require lessees to report whether transactions were at arm's length or not-- this was not made part of reported information until October 2001, and (2) MMS did not learn until the Spring of 2002 that its contractor had lost lessee reports, a problem which to this date has not been completely corrected.

Although the negotiations between Interior and industry involved the potential settlement and revision of matters determined through a *public* notice and comment rulemaking, Interior did not attempt to include other stakeholders in these discussions (*compare* Executive Order 12866, Section 4), and, indeed, has never formally notified the public that its current rule stems from these settlement discussions.

In January 2003, the Supreme Court, predictably, denied industry's petition to review the *DeWitt* decision – Interior's victory in the natural gas/duty to market case. Shortly thereafter, on February 3, 2003, MMS prepared an "Outreach Plan" for addressing changes to the oil valuation rules. Request # 10 "Items sent in response to Lee Helfrich's Office" (DOI website). Interestingly, MMS's Outreach Plan did not include any plans for any "outreach" to industry stakeholders – their input had obviously been obtained during the secret settlement negotiations.

The "message" of the Outreach effort was that MMS was making "technical" changes in light of its experience under the 2000 oil rules and would be holding workshops to obtain comments on 5 issues. While the issues listed mirrored the issues raised by industry in their challenge to the oil valuation rules, MMS made no mention of any relationship between its proposals and the *Baca* litigation. *Id.*; 68 Fed. Reg. 7086 (February 12, 2003).

The expenses that industry had previously defined as midstream marketing costs, were now presented as potential "transportation" costs. MMS discouraged the public from raising other potential changes to the 2000 oil rules. 68 Fed. Reg. at 7086 ("Because we believe the current rule is working well and is not in need of extensive revision, we request that workshop participants focus on the specific issues identified above...if there are other significant issues, participants may address those in their comments, *if time permits*" (emphasis supplied)).

As a result of complaints that the public was being blind-sided, MMS agreed to allow submission of written comments until March 31, 2003, and agreed to put its notes of the workshops and any written comments on its website. MMS did not completely live up to its commitment: it published the comments of only one entity[5], when there were at least three submitted. *See e.g.*, A. 15[6]. MMS also did not respond to SCO's request that the agency provide the information it had referred to during the workshops "to facilitate the preparation of meaningful comments". A. 3.

One of the documents that MMS did not post on its website was the itemized list of expenses that industry was now asking the agency to deem to be deductible transportation. A. 15. SCO had specifically requested such a listing during the workshop in Washington DC. MMS forwarded the list to SCO's counsel on April 1, 2003, the day

[5] Comments of the State of Wyoming [DOI website].

[6] The Project on Government Oversight had submitted written comments at the DC workshop on March 6, 2003.

after its comment period closed. *Id.* Every item on industry's list had previously been defined by it as a "midstream" marketing cost or was otherwise non-deductible under the MMS's 1988 rules (*e.g.*, terminaling). *Compare* A. 2, 14, 15, 16.

At the workshops, MMS indicated its intent to move forward with changes to the oil valuation rules quickly. Apparently, this effort was delayed by the Office of Management and Budget. A. 18. Whereas MMS had represented to the public that it was making mere technical changes, OMB believed that MMS's proposed rule was a "significant regulatory action" because it raised "novel legal or policy issues" under Executive Order 12866. *See* 68 Fed. Reg. at 50101.

Given MMS's characterization of its efforts as "technical" corrections in its Notice about the workshops, that MMS even submitted the proposed rule for OMB review was itself unusual. *See* Executive Order 12866, Sections 3(f); (6). *See also* "OMB's Role in Reviews of Agencies' Draft Rules and the Transparency of Those Reviews," GAO-03-929 (September 2003). Even after OMB's decision with regard to the significance of MMS's proposed amendments, the agency continued to represent to the public that it was merely making "technical" amendments that "do not alter the basic structure or underlying principles of the June 2000 rule". 68 Fed. Reg. at 50088. *See also* A. 6.

As noted, MMS published its proposed rule on August 20, 2003. 68 Fed. Reg. 50087. Although it knew of the level of congressional interest during the 2000 rulemaking, it published the rule for notice and comment shortly after Congress recessed and set a short 30 day comment period. *Compare* Executive Order 12866, Section 6(a)(1) (comment periods of not less than 60 days). In the preamble, MMS continued to refer to its proposals as technical amendments based upon its own experience and evaluation of the effectiveness of the 2000 federal oil rules.

For the first time, MMS acknowledged industry's litigation over the 2000 oil rules, but only to the extent that "information learned during litigation challenging the 2000 rules indicate a potential for improving those rules in some respects." Of course, the *Baca* litigation was based on the administrative record compiled *prior to* promulgation of the 2000 rules-- MMS could not have "learned" anything "during" that litigation that it did not know before. 68 Fed. Reg. at 50088. Moreover, as noted, the costs listed in its proposed rule were defined as midstream marketing costs, not transportation deductions, by industry in the *Baca* litigation. In short, whatever MMS "learned" did not come out of the *Baca* case, let alone Interior's victory in *DeWitt.*

MMS did not address any of the negative comments it had received during the workshops. *E.g.*, Comments of the State of Wyoming [DOI website].

With regard to transportation cost deductions, in its proposal MMS adopted industry's wish list of deductions in the order that industry presented them. *Compare* 68 Fed. Reg. at 50094-50095, *with* A. 15. The only costs on industry's list that MMS did not put in the "transportation related" category were gauging and scheduling fees.

Absent from MMS's preamble discussion is any analysis of how it determined that certain costs were "transportation-related" as opposed to "marketing-related." Instead, MMS simply states its "belief" that the costs were related "to the movement of crude oil to markets away from the lease." 68 Fed. Reg. at 50094. This of course is identical to the "unusually raw ipse dixit" that that the court of appeals condemned in *DeWitt*, 279 F.3d at 1042-1043.

Three days later on August 23, SCO again requested information from MMS regarding the information it reviewed in connection with its proposals to amend the oil valuation rules. A. 4. This request included information relating to MMS's "experience" with determining actual costs of transportation. MMS responded on or about September 5, 2003, that it had "no documents". In its cover note, MMS also stated that certain unidentified material existed but could not be provided for review in connection with the public notice and comment rulemaking because it was "privileged, confidential, or proprietary." A. 7.

Several members of Congress made similar requests for information, including specifically the "justification" MMS had "for defining each of these costs as deductible transportation costs." A. 9. *See also* A. 8. The congressional requests noted that the information sought was needed "to complete a comprehensive analysis of the proposed rule" for purposes of submitting comments. A. 8. Like SCO's requests, all of the documents requested by Congress related to information that MMS had represented it evaluated or gained through its "experience" with the 2000 oil rules. A month after receiving these requests, the MMS Director responded:

> Because we are now in the period that is open to receipt of comments from the public and have not promulgated a final rule, many of your questions are not ones we can appropriately respond to at this time. Additionally some of the data you request is proprietary. The public comments we receive on the proposed rule may explain the commentors's views on any legal issues they identify. A. 10.

MMS did, however, extend the public comment period to November 10, 2003; a somewhat meaningless gesture given its refusal to provide either Congress or the public with a coherent explanation for its distinctions related to deductible costs, or any of its other "technical" amendments.

3. MMS's Proposed Additional "Deductible Costs."

There is no evidence that MMS ever conducted an independent review of the cost components in a bundled oil tariff, or that it investigated the downstream activities of oil producers, marketers or transporters. *Compare* 30 U.S.C. 1717 (Interior authority to conduct investigations/issue subpoenas in royalty matters). As noted, MMS has never completed a transportation audit. Indeed, MMS admits that it "does not routinely collect detailed allowance information between the payor and transporter or the cost components used to calculate a non-arm's length allowance rate." 68 Fed. Reg. at 50098-50099.

It is true that MMS sells federal production as part of its RIK programs. However, there is no evidence that transporters have simply opened their books to MMS so that it could review the cost components of their charges. There is no evidence, in other words, that MMS is being treated any differently than any other "independent, non-integrated" oil producer. Other than blind reliance on industry – which has itself flip-flopped on these issues – MMS has absolutely no informational or experiential basis upon which to make any determination that any particular cost is a "marketing" cost or a "transportation" cost.

Through investigations, subpoenas and audits, MMS could educate itself with regard to these matters. And, after developing a factual foundation, MMS could address various costs on a case-by-case basis. However, as noted below, this is unnecessary, because as a matter of historical interpretation, actual transportation costs, for purposes of royalty deductions, has consistently been limited to the direct costs of operation and maintenance of the transportation facility. All other costs were considered non-deductible "post-production" costs.

MMS's information vacuum, however, undoubtedly explains its "ipse dixit" categorization of the costs it does isolate as either "transportation" or "marketing." *Cf. DeWitt.* 68 Fed. Reg. at 50094-50095. MMS does not even attempt to analyze the distinction between "transportation" and "marketing" and it proposes no standard for application. Many of the costs that it specifies are naked of any discussion; others are simply categorized as "transportation" because "MMS believes", like a child who has lost her first tooth, that the cost is transportation–related. MMS cannot even assure the public that this rulemaking represents the end of the oil royalty deduction road – that there aren't more costs that industry can segregate and then analogize to expenses that MMS has already deemed as "transportation related" if this rule goes forward.

This is not an idle concern. It is obvious that MMS has carried over certain cost deductions identified in its natural gas transportation rules, and in the 2000 oil rules as if they carried some kind of immunity from challenge. As noted, industry's failure to contest the treatment of certain cost categorizations does not stand as precedent that those costs that it did not challenge are valid.

For example, storage costs have never been deemed deductible from royalty, whether storage was long term or short term. Indeed, as early as 1946, the court rejected industry's argument that DOI could not collect royalty on stored gas until the gas was sold. This was because under the plain statutory language royalty "accrues as the gas is produced," not when the sale is made. *General Petroleum*, 73 F. Supp. At 257-258. In addition, the court rejected industry's arguments that it should deduct line losses resulting from transportation. *Continental Oil Co.*, 184f.2d at 820.

MMS does not explain its departure from this historic interpretation – indeed it did not explain it during the litigation over the natural gas deductions. But, it is nonetheless clear that as a matter of historic practice, these costs were non-deductible because volumes were to be measured before any of these "downstream", "midstream" or "post-production" costs were assumed. To allow such deductions reduces the public's rights as "royalty" owners, *which by definition is a non-cost, non-risk bearing interest.*

Under *General Petroleum*, it is clear that many of MMS's proposals depart from historic practice – and ipse dixit classifications do not meet MMS's burden to provide a clear rationale for departure from this practice. The costs that have been non-deductible since the *General Petroleum* decision include MMS's current proposals with regard to short term storage, line loss, line fill, shrinkage. 68 Fed. Reg. at 50094-50095. All of these costs relate to losses in volume. Royalties on these volumes were to be reported and paid ***before*** they were stored or lost.

Moreover, MMS's refrain that costs fall within the transportation category because they are "incurred for the movement of oil"[7] is not only ridiculous, but it too is flatly inconsistent with historic practice. Enhanced recovery operations, gathering and even laying the drill pipe all relate to the "movement of oil." None have ever been considered deductible expenses because the public has a "royalty" interest, not a "working interest" in the production from federal lands. A royalty interest is cost/risk free; working interest payments are net of costs. *See* A. 13 at 12-15. On the other hand, fees for the administration of quality banks, and the cost of carrying inventory on the company books have absolutely no relationship, direct or indirect, with the "movement of oil."

The costs associated with reasonable, actual and necessary transportation have, rightly or wrongly, been treated as deductible from even the cost-free royalty interest by courts and the Interior Department. However, because those costs are, in fact, a departure from the long accepted meaning of a "royalty" interest, what is deductible transportation has always been narrowly defined. It is useful to recall that, as a matter of historical fact, these deductions stem from the inability of the early wildcatters to convince the integrated transportation monopolies, like Standard Oil, to extend their transportation facilities to newly discovered fields. The courts thus allowed a transportation deduction when a producer was forced to build its own pipeline.

MMS's current focus on the "movement of oil" as opposed to the internal costs of operating and maintaining a pipeline is clearly at odds with Interior's long held practice. The calculation of the transportation deduction was confined to expenses related "directly" to the "operation and maintenance" of the pipeline. 30 CFR 206.105(b)(2) (1989). It is noteworthy that these costs are not determined from the vantage point of the shipper and fees that it is charged, but instead from the vantage point of the transporter and its internal costs. Historically, the line between "transportation" and "post-production" or "marketing" costs was drawn from the books of the transporter, viewed

[7] 68 Fed. Reg. at 50094.

separately and apart from any of its affiliates' or any of its other lines of business. In this way, the erosion of the government's cost/risk free royalty interest was contained.

In this rulemaking, MMS does not even pretend that the costs it proposes to let industry deduct are directly related to the transporter's internal costs of operation and maintenance of the pipeline. Indeed nearly all of its proposals relate to fees and costs imposed on a shipper and the risks that shipper takes over and above the calculation of internal costs of operations and maintenance of the transporter. The royalty owner has already compensated the producer for these costs -- the royalty owner gave up 7/8ths of the oil from its lands in payment for the assumption by the producer of these costs, fees and risks.

Attempting to categorize particular costs as "transportation" or "marketing" lends itself to the fuzzy classifications that MMS makes. As noted, transportation for purposes of royalty deductions has always been narrowly construed. The costs that MMS is now proposing to classify do not easily fall within either of the categories that it has chosen to use. This is, at least partially, the fault of industry itself, which changes the terminology with regard to various cost components – from "post-production" to "midstream marketing" to "transportation" – in its incessant effort to reduce its royalty liability by transforming the public's royalty interest into a working interest. The terms "downstream" or "post-production" costs – the deduction of which was rejected by MMS in 1988 – clearly suggest a broader category of non-deductible costs than "marketing", which suggests costs associated exclusively with sales activity. Non-deductible costs have always included expenses beyond "marketing" (*e.g.*, gathering, measurement, storage).

By returning to historic principles and practices, the line between the deductible and the non-deductible is clear. Direct costs incurred by the transporter (as opposed to the shipper) for operation and maintenance of the facility are deductible; everything else is nondeductible.[8]

4. Rate of Return

The MMS proposal to move to a rate of return of 1.5 times the BBB bond rate will lead to extraordinary over-recovery of the rate of return earned by oil pipeline companies – a gift that will keep on giving because of MMS's re-depreciation rules.

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[8] SCO is assuming that MMS does not intend the exaggeration of its proposed deductions, which is suggested in its proposed rules. 68 Fed. Reg. at 50094-50095. For example in its discussion of letter of credit costs, MMS suggests that a lessee would be entitled to "include" $375 in its transportation deduction calculation, rather that 12.5% (or whatever the current royalty rate is) of that sum. MMS's proposal with regard to hub transfer fees suffers from a like failure of precision. MMS suggests that those fees become deductible if the "shipper" did not sell the oil at the hub. However, those costs do not somehow change character, and become unrelated to a sale of oil, simply because the volumes may have been transferred through various affiliates or marketers before being sold at the hub (*e.g.*, daisy chain arrangements). If the cost of the hub fee was passed back to the federal lessee, it remains a cost of the sale.

In 1988, MMS adopted the BBB bond rate as the rate of return to be used by industry in calculating the oil transportation deduction. "The MMS believes that the use of an appropriate rate of return based on the corporate bond rate adequately considers the risk associated with a transportation system and that there is no rational basis for increasing a rate of return by arbitrarily adding percentage points simply to increase the allowance granted to a lessee." 53 Fed. Reg. 1184, 1213.[9] While industry opposed use of the BBB rate during the 1988 rulemaking, it did not challenge that rule in court. During the 2000 rulemaking, industry again raised the rate of return issue, asserting that the BBB rate should be replaced by the "weighted average cost of capital" approach. 65 Fed. Reg. at 14051. MMS rejected this approach as "less representative of lessees that typically build or own pipelines." *Id.*

> "Different projects and investments will be expected to involve very different levels of returns. They also may be funded in different ways. For example, a pipeline investment likely would be much less risky than investment in a wildcat drilling operation and thereby command a lower rate of return.
>
> MMS expects that lessees will finance pipeline investments in the least costly manner available. MMS's research indicates that most recent pipeline investments are largely through debt rather than equity. For those pipelines, the BBB bond rate is a very favorable rate to claim as a cost for the lessee, because most large operators can borrow money at lower rates.

Id.

MMS does not challenge these conclusions regarding the reasonableness of use of the BBB bond rate in its current proposal. Nonetheless, it now proposes to adopt industry's previously rejected proposal regarding "some weighted average rate of return." 68 Fed. Reg. at 50094. Having made, without any explanation, that departure from its historic rejection of the weighted average approach, MMS then asserts that its proposal to adopt a rate of 1.5 times the BBB "is within the range recommended by its own experts and close to the rate recommended by industry experts." *Id.*

The MMS studies, however, **do not** support moving to 1.5 times the BBB. Instead, the MMS studies were an evaluation of industry's request that the agency move to a "weighed average" approach – MMS's experts rejected that proposal as an initial matter:

> "If industry can borrow at a lower rate than the opportunity cost of equity, it is not clear why we should allow inclusion of the return to equity from other projects as a cost for the purposes of computing transportation allowance.

[9] These regulations were issued in final under the signature of J. Steven Griles, who then served as Assistant Secretary for Land and Minerals Management, and who now serves as the Interior Deputy Secretary. The 1988 regulations were also approved and surnamed by counsel to IPAA in the *Baca* litigation, who at the time was an Interior associate solicitor.

> If the return on equity is substantially greater than the cost of debt, it is less likely that the WACC will accurately reflect the near future financing characteristics of the transportation system. In recent years, the industry has relied more heavily on debt financing than in previous years.
>
> There is no single, generally accepted accurate measure of the industry-required rate of return on equity.
>
> Most methods used to estimate return on equity employ inputs such as stock price, dividends, and projected earning growth, which are highly volatile.
>
> Those equity and debt measures that are available in the literature relate to industry sectors that are less than a perfect proxy for operators who are slo owners of their offshore transportation systems.
>
> The returns that the company would accept to build and operate the transportation system involve much less risk that other activities, e.g., wildcat drilling."

Request # 3, "Items sent in response to Lee Helfrich Office" (Discussion of Rate of Return Issues, 2/18/00) [DOI website]. However, MMS's experts opined that ***if*** a weighted average approach were used – despite their objections – the multiple over BBB should be no more that 1.1 to 1.4. *Id.*

As noted in December 2002 – during the Interior/industry settlement meetings on the 2000 oil rule – industry again advocated use of a weighted average approach. Its new study recommended a multiple of 1.6 to 1.8 times the BBB. *Id.* (API Study, Capital Cost of Pipeline Assets). Interior then asked its experts to re-visit the issue and they determined that their earlier work in 2000 was still valid. However, the experts did opine that ***if*** Interior accepted industry's weighted average approach, the "most likely multiplier" to the BBB rate would "be 1.3." *Id.* (Cost of Capital for Pipelines, 7/2/03).

In short, to conclude, as MMS does in its current proposal, that its own experts supported use of a weighted average approach with a multiplier of 1.5 times the BBB is nonsense. Instead, MMS's experts were again asked to review industry's proposal, and they again found that it was flawed even under a weighted average approach.

The API study is, as MMS's experts concluded, fatally flawed in a number of ways. The most blatant error in its study is that it examines returns in the *wrong* industry. The entire study is focused on "the cost of capital faced by petroleum producing firms". All of the subsequent analysis and work, including work performed by Ibbotson Associates, is focused on members of the producing industry, which as a general rule do not own pipelines. Some work focuses on the integrated companies, but again a number of these firms do not own pipelines or transportation represents a minor aspect of their business. For example, there are 95 firms shown in Tables B-1 and B-2, which is one of the samples used in API's study to compute returns. Only 9 of the 95 firms shown on those tables own a significant pipeline assets. Table C-1, which shows another sample of companies used in the API's analysis includes only 17 out of a total of 30 companies with significant pipeline assets. And finally, Exhibit 5 to the Ibbotson study includes only 10 out of a total of 21 companies that have any significant pipeline assets.

This is a critical error and renders the analysis in the API's study meaningless because the proper focus should be on the return to pipeline assets since the proposed rule is focused on the return to owners of transportation systems. Exploration and production and refining and marketing are much riskier businesses than oil pipeline transportation, and therefore one would expect these industry areas to command higher returns than the pipeline business.

Review of data published by the U.S. Department of Energy, Energy Information Administration (EIA), demonstrates this fact very clearly. Table 1 shows the return on investment earned by leading petroleum companies by industry segment for 2000 and 2001. As can be seen, the pipeline segment (in bold) has generated significantly lower returns (6-9% vs. 10-17%) than either exploration and production or refining and marketing. Given the lower risks of the pipeline business relative to these other industry areas, this means that investors are willing to accept a lower return when investing in these types of companies, and thus the cost of capital facing firms in the pipeline business will be lower. Thus by focusing on the wrong industry segment, API's analysis leads to a significant overstatement of the return to pipeline assets.

Further, oil pipelines are usually funded by a large proportion of debt and thus pipeline companies tend to have a very different (more highly levered) capital structure than do integrated oil companies or production companies. Since the cost of debt is considerably less than the required return on equity, this means that even if the return on equity for production and pipeline segments were the same (which they are not due to different business risks), pipeline companies would have a lower cost of capital due to the higher proportion of debt in their capital structure.

Table 1
Return on Investment by Line of Business

	2000	**2001**
Line of Business:		
U.S. Petroleum	13.2%	13.1%
Oil & Gas production	17.1%	13.1%
Refining/Marketing	9.6%	14.5%
Pipelines	**6.0%**	**9.7%**

Source: www.eia.doe.gov/emeu/perfpro/btab08.html

Direct observation of the returns earned by companies engaged in the pipeline business is, as MMS's studies conclude, a very good place to start to determine an appropriate return.[10] As MMS's studies show, the returns shown in Table 1 are about equal to the S&P BBB rate when adjusted for taxes

Table 2 shows that moving from the S&P BBB rate to S&P BBB times 1.5 would increase the allowed return by 4 full percentage points based on data covering the 1998-2002 period. Assuming an undepreciated pipeline valued at $80 million that ships 80,000 b/d, that difference could be as much as $0.11 per barrel.[11]

Table 2
S&P BBB Rate vs. S&P BBB Times 1.5

	1998	**1999**	**2000**	**2001**	**2002**
S&P BBB Annual Average	7.13%	8.02%	8.75%	8.29%	7.86%
S&P BBB * 1.5	10.70%	12.03%	13.13%	12.44%	11.79%
Difference	3.57%	4.01%	4.38%	4.15%	3.93%

In sum, for MMS to represent to the public that its current proposal to adopt 1.5 times the BBB as the rate of return is confirmed by its own experts is simply false. All that the MMS economists were asked to do is evaluate industry's own application of its own, preferred approach to determining a rate of return. And, MMS's economists found that industry's representations in that regard lacked credibility. There is no indication in MMS's own studies that its economists supported use of the weighted average approach over use of the BBB bond rate. Indeed, the ultimate conclusion of MMS's economists was that its findings in 2003 were "consistent" with the work they had completed "over 3 years ago" in conjunction with the Clinton era royalty reforms. *Id.*

What is evident is that MMS's current proposal to adopt 1.5 times the BBB is the result of a compromise with industry; most probably reached during the time Interior and industry were negotiating a settlement of the *Baca* litigation. The multiplier of 1.5 proposed by MMS is almost a classic example of "splitting the baby" between industry's claim, based on the API study, of a multiplier of 1.6 to 1.8, and MMS's experts finding that use of a "weighted average approach" would result, at most, in a multiplier of 1.1 to 1.4. Of course, both results beg the question of whether a "weighted average approach" is appropriate in the first instance – MMS's experts thought not and there is no evidence that they have changed their views and, more importantly, no market facts that would

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[10] See Request #3, "Items sent in response to Lee Helfrich's Office" ("Cost of Capital for Pipelines," July 2, 2003) [DOI website]

[11] Assume the current S&P BBB rate is 8% then the S&P BBB times 1.5 is 12%. The annual allowed return on $80 million at 8% is $6,400,000 which divided by 29,200,000 barrels (80,000 * 365) is $0.2192. The return on $80 million at 12% would be $0.3288 per barrel or a difference of about $0.11 per barrel.

support changing those views. But, MMS elides this key issue in seeking comments from the public.

It is noteworthy that the only "substantive" reference to the *Baca* litigation in MMS's proposed rule is in reference to the rate of return issue. 68 Fed. Reg. at 50093. In MMS's discussion, industry's argument is shown to be tied to its disappointment with MMS's decision in 2000 to reject FERC tariffs for transportation allowance purposes. In essence, industry asserts that MMS's adoption of the actual cost method for non-arm's length transportation arrangements in 1988 was little more than a sop to the public's interest in limiting deductions from royalty – a bit of regulatory flotsam intended to keep up appearances. Industry's own success in the *Fina* case[12], however, demonstrates the faulty nature of its current "logic." Policies made through public rulemakings are binding on the government and those that they regulate – regulations are to be read as a whole and no provision is meaningless. To change those policies demands more in the nature of record evidence than industry's disappointment that it could not realize on its hidden agenda.

5. Re-Depreciation

When MMS initially published proposed changes to the 1988 oil valuation rules in 1997, it did not propose any modifications to the determination of the actual and reasonable costs of transportation for allowance purposes. Because of changes in FERC jurisdictional decisions and the unbundling of tariffs, however, MMS did propose to delete any alternative use of tariffs for the determination of transportation allowances in non-arm's length situations. As noted above and accurately summarized by MMS in the final 2000 rules:

> Industry commenters argued that they only agreed to the MMS actual-cost method under the 1988 regulations because of the provision to use FERC tariffs. They oppose MMS proposing to revoke use of tariffs without allowing an adequate transportation allowance rate that reflects the value of the production at market centers.

65 Fed. Reg. at 14049.

SCO would first note that the 1988 oil valuation rules, including the transportation allowance provisions were promulgated as a result of a notice and comment public rulemaking – the finalization of those rules was not dependent upon industry's "agreement" with the provisions. Moreover, as noted previously, industry's belief that the FERC tariff provision rendered other provisions of those rules meaningless is an interpretation at odds with basic principles of regulatory and statutory construction.

In their briefs to the district court in the *Baca* case, the industry associations also contended that promulgation of the 2000 oil rules – after three years of rulemaking, multiple public hearings, and several republications for comment – were "tainted" by the

[12] *Fina Oil and Chemical Co. v. Norton*, 332 F.3d 672 (D.C. Cir. 2003).

parallel pursuit of False Claims Act suits by the Justice Department and private relators. While this accusation resulted in considerable controversy in Congress, it eventually came to naught – it was, in essence, a red herring argument created by counsel to one of the associations to unnecessarily complicate both the False Claims Act proceedings and the rulemaking.[13] Moreover, it misstates the record on the impact of industry's effort, albeit effective, to promote congressional interference in the rulemaking process.

Nowhere is this more apparent than in the authorization under the 2000 oil valuation rules for re-depreciation of transportation facilities. It is noteworthy, indeed, that this change from the 1988 rules was first proposed by MMS in 1999[14]. This reversal in historic practice occurred after non-public meetings between MMS, industry representatives[15] and members of Congress. The notes related to those meetings indicate the pressure put on MMS by industry and Congress to increase the calculation of the cost components in determining reasonable actual costs. "Notes – meeting on MMS's proposed oil valuation rule" (July 9, 1998) [DOI website]; "Notes – 7/22/98 meeting on MMS's proposed oil royalty valuation rule" [DOI website]. During those meetings, MMS explained that it had not proposed any changes to determining actual costs of transportation. Shortly thereafter, Congress extended its second moratorium on Interior's appropriations for FY 1999 barring it from using funds to finalize its proposals to change the oil valuation rules. 65 Fed. Reg. at 14024.

The obvious problem with re-depreciation of transportation facilities is that it allows original owners to re-capture amounts, which those owners had previously deducted from federal royalties. The royalty owner is forced to assume the costs of re-depreciation of the same asset at the higher basis represented by the sales price of the facility to a new owner. After re-depreciation was first proposed, "States expressed concern that allowing a rate of return on some base value after the pipeline is fully depreciated amounts to an unnecessary gift to industry." 65 Fed. Reg. at 14058. Moreover, it is obvious that the risk associated with purchase of a pipeline, which is already servicing a known producing field, is minimal.

Congressional pressure eventually led MMS to adopt a compromise position, which reduced the revenue drain associated with the recapture problem by limiting the number of times a facility could be re-depreciated because of a change in ownership. This "balance" of "the competing considerations" (65 Fed. Reg. at 14070), however, is inherently arbitrary and without rational or factual basis.

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[13] One example of industry's misleading "puffing" of the issue of regulatory "taint" in the *Baca* case is the characterization in IPAA's brief of the "Thompson Report" as a report of the Senate Committee on Energy and Natural Resources. In actuality, the Senate Committee never authorized or adopted that report.

[14] MMS has first proposed changes to the 1988 rules for comment in 1997. Initially MMS did not propose any changes to its rules on calculation of actual costs of transportation.

[15] According to press reports, at least two of the industry representatives at those meetings, Shell and Devon, were clients of Interior Deputy Secretary Griles' private lobbying firm.

In short, taken as a whole, what MMS proposes to give up to industry through its current proposal matches what industry was unable to impose on the public's royalty interest through political interference in the 2000 rulemaking.

SCO has never taken the position that the 2000 oil valuation rules did not contain provisions that were challengeable. It is SCO's position that MMS should return to its historic position and disallow re-depreciation of pipeline facilities.

C. Joint Operating Agreements

It is important to underscore that, according to the MMS representatives at the DC workshop, the only reason that there is any issue with regard to joint operating agreements (JOAs) is because a single company chose to change its business practices after the issuance of the 2000 oil rules. The 2000 oil rules do not address JOAs directly. Instead, in the preamble discussion, MMS noted that sales by an operator of the production of co-lessees would be considered non-arm's length.

This remark by MMS in its 2000 preamble is, of course, consistent with the case law treatment of joint venture arrangements, and reflects Interior's historic interpretation of non-arm's length arrangements. *Fina, supra.* Moreover, it is consistent with the practical realities of the "proceeds" received by co-lessees under JOAs. Co-lessees are working interest owners. As such they share in costs that royalty owners do not incur. The nature of very lease interests between a royalty owner and a working interest owner differ. A. 13 at 12-15.

By entering into separate "sales contracts' with co-lessees, the operators are, in essence, creating contract proceeds, which include values net of costs that would otherwise not be deducted from a royalty interest. MMS's proposal facilitates this game by proposing that these parallel contracts to the JOA be treated as arm's length contracts – thus enabling the parties thereto to remit royalties on the stated proceeds under the contracts. Co-lessees, in essence, are given a "deduction" benefit, which they would not receive if their royalty liability was calculated under the non-arm's length rules.

MMS's effort to minimize the impact of this proposal is facile. By treating these parallel contracts as arm's length, it invites more participants in JOAs to change their contractual arrangements, at least on the surface, to the detriment of the public's royalty interest.

D. Grace Period

MMS proposes to amend Section 206.121 regarding the "grace period" under the 2000 oil valuation rules. Under the 2000 rule, interest liability was waived for royalty adjustments made for the first three months after the June 2000 effective date. MMS proposes that lessees be barred from making these adjustments unless they are reported within 90 days of the effective date of its current amendments.

SCO agrees that sufficient time has passed and that any needed adjustments to royalties reported and paid in the three months after June 2000 should have been made long ago. However, it is unclear whether in making this proposal, MMS is also deleting the restriction on such adjustments under the 2000 rules. Under those rules, adjustments could only be made if they resulted "from systems changes needed to comply with the new requirements imposed under this subpart that were not requirements under the predecessor rule." SCO objects to MMS dropping this restriction.

E. MMS's Rejection of ANS

Another telling flaw in MMS's proposed rule is its proposal with regard to valuing crude oil produced in California. After several years of investigation and the commission of independent studies in the 1990s, Interior concluded that posted prices in California did not represent the true fair market value of the State's crude oil. *See e.g.*, studies incorporated by reference in footnote 1, *supra*. The published spot prices for California crude oil – Line 63 and Kern River – are not only based on the average of undervalued posted prices, but are also characterized by limited trade activity. This fact has not changed. Request # 4, "Items sent in response to Lee Helfrich's Office" [DOI website].

Those same studies concluded that the best proxy for the fair market value was the spot price for Alaska North Slope (ANS) crude, delivered into California. As a result, ANS was adopted as the index price for valuing federal crude oil produced in California.

Adoption of ANS prices was not without controversy. California had been in litigation with the major companies over posted prices for years. In the early 1980s, California, through SCO, brought the undervaluation problem to the attention of the Interior Department. Despite the fact that other federal agencies – DOE, Commerce, the Federal Trade Commission – had all recognized the pricing problem in California, Interior refused to do anything to correct for the royalty losses. Moreover, it refused in the 1988 regulations to adopt the alternative valuation methodologies proposed by California, and supported by all the mineral producing States and Tribes, that would have reduced the negative impact of undervalued postings on royalties. Many of the officials involved in rejecting California's request have returned to service at the Interior Department. *See e.g.*, footnote 9 *supra*.

Interior's choice to ignore undervaluation in California in the 1980s did not make that problem disappear, and California continued to urge Interior to adopt sounder valuation policies. By the 1990s, the problem of undervalued posted prices was becoming more apparent east of the Rockies – a problem that California had warned Interior about back in 1986 to 1988. Other States were pursuing the issue. Interior could no longer ignore the problem, which led to its studies of the California market and the Justice Department's pursuit of a False Claims Act suit. Industry, of course, opposed these efforts and, as noted, was represented in court and before Congress by some of the same people who had been involved in rejecting California's evidence of undervaluation in the 1980s.[16] Indeed, Interior's current Deputy Secretary testified on behalf of the oil company defendants in the False Claims Act suit.

In its current proposal, MMS deletes all use of ANS prices for valuing California crude oil without even mentioning its investigations, the studies, the conclusions in the preamble of its 2000 oil rules, and indeed without mention of any of the controversy.[17] MMS did this without contacting California and without reviewing any of SCO's audits of federal production. The information that it has disclosed to the public relating to California does not even suggest a reason to drop the ANS index for valuation of crude oil in the States. Request # 4, Request # 8, "Items sent in response to Lee Helfrich's Office" [DOI website].

At least by implication, MMS seems to suggest that it has some how sidestepped its need to address use of ANS by proposing to apply NYMEX prices in California. California has never opposed the fact that NYMEX prices are a valid indicator of fair market value, especially east of the Rockies. California has also never opposed the fact that NYMEX prices, due to their greater transparency, are less likely to be subject to manipulation by industry.

However, MMS's NYMEX proposal for California is nothing more than a thinly disguised return to use of discredited posted prices for valuing federal crude oil produced in the State. Indeed, MMS's proposal will wipe out all of the revenue gain that California expected to realize under the 2000 oil rules. 65 Fed. Reg. at 14083-14084.

The "devil is in the details". For California, the revenue loss is not attributable to the use of NYMEX as a base index *per se*, but in MMS's proposal for *adjusting* the NYMEX price for use in calculating royalties in California. The proposed rule would adjust the NYMEX price[18] for quality and location using, as a proxy, the mathematical difference between theWTI spot price and the spot prices for crude oils, which were rejected by MMS for use in California under the 2000 oil rules. The proposed rule is not

[16] Given that even under MMS's own number, California's royalty revenues are at greatest risk if the proposed rules become effective, there is at least a suggestion that the State is being retaliated against for being one of Interior's biggest critics. There is, indeed, disturbing evidence that the current Interior Department does retaliate against its critics. *See* Preliminary Comments of California State Controller Steve Westly at 2-3. For example, when States and Tribes questioned the issuance of new guidelines, which were inconsistent with a statute and prior policy, the MMS Director responded with the suggestion that Congress could always amend the law to delete federal revenue sharing. *Id.* at 3. More recently, Interior wanted States and Tribes to agree to an anti-whistleblower clause in their contracts to conduct federal audits.

[17] *Cf. Motor Vehicle Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983); *Seminole Rock & Sand Co.*, 325 U.S. 410 (1945); *Darrell Andrews Trucking Inc. v. Fed. Motor Carrier Safety Admin.*, 296 F.3d 1120 (D.C. Cir. 2002).

[18] The NYMEX price is for a crude oil of roughly 39° API and 0.4% sulfur which is lighter and lower in sulfur than virtually all California federal royalty production.

clear as to which of the previously discredited California spot prices[19] could or would be used, but, if left to industry choice, it would undoubtedly be the one that would lead to the lowest royalty value.

The clear effect of MMS's creation of the "WTI differential" is to use California spot prices as the valuation basis for all California federal royalty production. Consider the following:

> Proposed formula = NYMEX – (NYMEX – Cal. Spot price) where (NYMEX – Cal. Spot price) is the "WTI Differential."
>
> Consider the formula in algebra terms:
>
> X-(X-Y) = price, and thus by elimination:
> Y = price
> where: X = NYMEX
> Y = California spot price
>
> Mathematically it can be shown in the same manner:
>
> \$30-(\$30-\$20) = \$20
> where: \$30 = NYMEX
> \$20 = California spot price

Thus by definition the proposed rule represents a clear and direct substitution of California spot prices for ANS – not NYMEX for ANS as represented by MMS. The NYMEX price has nothing to do with the proposed formula except to act as a "red herring" disguising the true intent and effect of the proposed rule.

During the five year process that led to the establishment of the new royalty rule in 2000, MMS and others indicated that local California spot prices were not a reliable index of market value for California production. MMS stated: "it is the spot market for local California crude oils, not ANS crude that is thinly traded and thus leads to unreliable prices." Later MMS stated:

> ANS spot prices have the advantage of regular transactions of sufficient liquidity to establish a fair market price. Spot prices for Kern River crude and Line 63 are suspect indicators of market value because they reflect only thinly traded volumes.[20]

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[19] Three spot prices are quoted for California crude oils: Line 63 at Hynes Station in Los Angeles which is approximately 29° API and 1.02% sulfur; THUMS which is quoted in Long Beach and is 17° API and 1.5% sulfur; and Kern River, quoted in the field near Bakersfield at 13.4° API and 1.1% sulfur. See Platt's, "Methodology and Specifications Guide: Crude Oil," August 2003.
[20] 65 Fed. Reg. at 14053.

MMS has offered no proof that any of these circumstances have changed. Although the volume of ANS moved into the West Coast has declined slightly, it still represents 37 percent of the total crude oil run in West Coast refineries.[21]

Furthermore, data from MMS's files indicate that in conversations with Platt's, MMS learned that between 4-6 cargoes are traded per month, and serve as the basis for ANS spot prices which Platt's considered to be a reasonable basis for its assessments. Four to six cargoes of ANS reflects approximately 50,000 barrels per day (b/d) of production and is significantly more volume than is reflected by any of the California spot price assessments (or even all of them combined). Request # 4, "Items sent in response to Lee Helfrich's Office" [DOI website].

These same data indicate that Kern River, which is the most actively traded California spot stream, involves trades of only about 7,000 b/d of production. Line 63 and THUMS reflect lower volumes, probably less than half the Kern River volume. Other trade publications confirm that the volume traded in California spot crude oils is minimal and generally only occurs when there is a refinery upset, closure or other extraordinary event, which further confirms the notion that these prices are highly suspect.

The California marketplace remains a relatively closed market dominated by a few large companies that own a major share of the production, transportation systems and refineries in the State. As a result relatively small volumes of oil move on an arm's length basis, again a fact clearly recognized by MMS in 2000:

> MMS does not believe that in most instances in California there are sufficient arm's length sales at the lease to derive an accurate comparable sales value.[22]

California spot prices are not tied to actual transactions or to very limited transactions. Moreover, transaction prices for Line 63 are higher than what the price reporting agencies reported.

Comparison of Line 63 with ANS, two crude oils of comparable quality,[23] indicates that ANS is priced higher than Line 63. Figure 1 presents such a comparison over the last eight and a half years. As can be seen ANS has averaged about $0.75 per barrel higher than Line 63.

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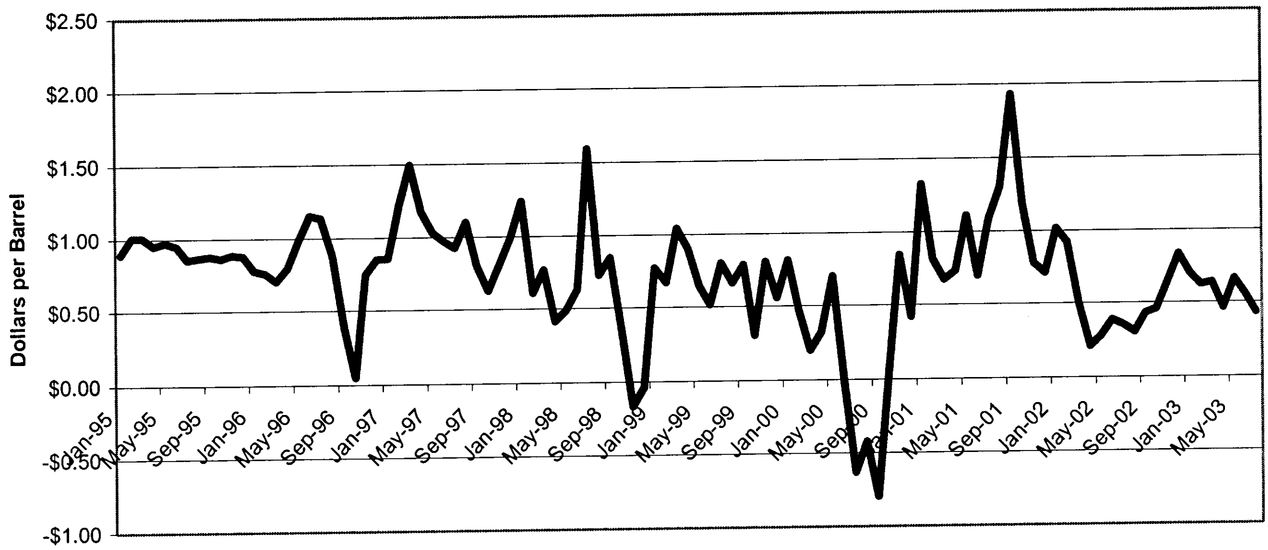
[21] Energy Information Administration, Department of Energy, *Petroleum Supply Annual 2002*, Table 16.

[22] 65 Fed. Reg. at 14053.

[23] Both crudes are priced delivered in the Los Angeles area at 29° API and have very similar sulfur levels, approximately 1.1%.

Figure 1
Difference Between ANS Spot Price and Line 63 Spot Price
1995-2003YTD



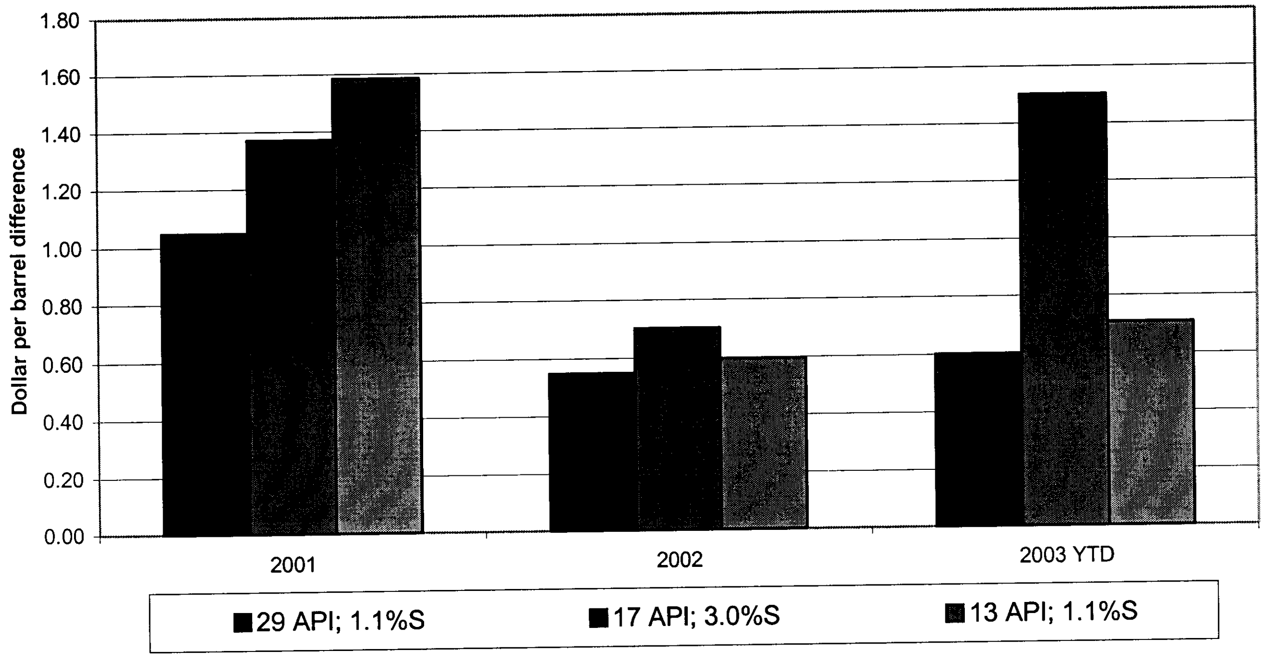
MMS rejected the use of California spot prices in 2000, and it has provided no indication, nor can it, that market conditions have changed such that these prices are now a reliable indication of market value. Further, MMS accepted the use of ANS spot price with quality and location differences for valuing California production, and there is no indication that market conditions have changed such that this price cannot still be used as the basis for valuation. At the time MMS stated:

> ANS is the best measure of market value in that area [California] when oil is not sold at arm's length.[24]

ANS spot prices reflect 7 times more volume than the largest traded California spot crude oil, and it remains a better indication of market value than any California spot price. This can be seen in Figure 2, which compares the difference between the value determined for various quality California crude oils under the current rule vs. the proposed rule over the last two and a half years. As can be seen in all cases the proposed rule would lead to a reduction in the value of each type of crude oil of between $0.60 per barrel and as much as $1.60 per barrel. It is important to note that in contrast to MMS's current economic impact analysis, the impact is an unambiguous loss in value and royalty revenue as a result of this proposal.

[24] 65 Fed. Reg. at 14059.

Figure 2
Differential Impact on California Market Value of Current Rule vs. Proposed Rule



In addition, as MMS is well aware, there are no barrels of WTI being refined in the California market. Even if there were, California crude oils would be more valuable to the California refinery market than WTI. *See* discussion *supra* "WTI Differential". Yet, as MMS recognizes (68 Fed. Reg. at 50090), its WTI differential imposes an implicit location penalty on California crude oil, which is inconsistent with economic reality.

Finally, it is apparent that MMS has not conducted any analysis of quality differences in different regions of the country. MMS does not, for example, represent that the quoted quality differences applied in California are identical to those quoted east of the Rockies. If, as MMS suggests, it sees a value in standardizing the application of quality differences, it must first make such a comparison and resolve the reasons for any regional variations. For MMS to instead rely on the mathematical difference between spot prices quoted in publications, which it itself questions (68 Fed. Reg. at 50088), is the height of arbitrary action.

In short, MMS's proposal to switch from ANS to, in essence, the discredited local California spot prices did not come from any data in its own files, or any data that it has deigned to provide to the public during this current rulemaking. Instead, like every other proposal in this rulemaking, MMS is simply proposing to adopt industry's position during the 2000 rulemaking, but attempts to disguise what it is doing through new terms, labels and formulas.

During the 2000 rulemaking, SCO acknowledged that reliance on ANS spot prices for valuing California crude oil may become unreliable in the future. NYMEX may indeed be a viable alternative in that event. However, there is no evidence that ANS is no longer a viable valuation methodology for California. Based on the foregoing, SCO, however, would not object to the following alternative: the higher of ANS, as adjusted under the 2000 oil rules, or the NYMEX as a field price adjusted only for quality based upon California gravity bank differentials.

Respectfully,

Lee Helfrich

For California State Controller Steve Westly