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CONTROLLER'S DEPARTMENT
OWNERSHIP & ROYALTY

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Building 85
Denver Federal Center
Denver, CO 80215

Comments of Exxon Company, U.S.A. on amendments to Oil Valuation Rules to Establish Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil

Dear Mr. Guzy:

The Minerals Management Service ("MMS") proposes to amend its CFR Part 206 and 208 regulations governing valuation of oil produced from federal leases for royalty purposes. Exxon Company, U.S.A. ("Exxon") is a federal lessee and, because of the impact this rule would have on royalty payments, Exxon is an interested party.

The proposed rule would establish a new methodology for valuation of royalty oil and modify the royalty-in-kind program. In addition, the proposed rule would impose a new and burdensome reporting requirement on federal lessees. Although the MMS contends that the amendments would assign a value to crude oil that better reflects market value, the proposed valuation methodology requires federal lessees to pay royalty on a value that does not reflect market value at the lease. The proposal, in fact, would radically alter and unlawfully expand federal lessees' obligations. These issues are discussed in more detail in the attached comments.

Exxon appreciates this opportunity to comment on the proposed rule.

Sincerely,

W. L. Stone

Attachment

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**30 CFR Parts 206 and 208
62 FR 3742 (January 24, 1997)**

INTRODUCTION

The Minerals Management Service ("MMS") proposes to amend its 30 CFR Part 206 and Part 208 regulations governing valuation of oil produced from federal leases for royalty purposes. As a federal lessee, Exxon is an interested party as the proposed rule will have a direct impact on the royalty Exxon pays to the federal government. The proposed rule establishes an entirely new methodology for valuation of royalty oil and modifies the royalty-in-kind program. In addition, the proposed rule imposes a new and burdensome reporting requirement on federal lessees. Although the MMS contends that the amendments would assign a value to crude oil that better reflects market value, the proposal in fact would radically alter and unlawfully expand federal lessees' obligations. The proposed valuation methodology requires federal lessees to pay royalty on a value that does not reflect market value at the lease.[1] Exxon believes that the current royalty valuation methodology, if properly applied, captures market value at the lease and will continue to do so in the future. The MMS has failed to provide evidence in the record showing that the current rule should be abandoned.

I. The MMS Has Exceeded its Contractual and Statutory Authority

The MMS proposes to amend its valuation regulations and impose what is, in effect, an entirely new valuation methodology for royalty on production from federal leases in the United

[1] Exxon's comments are directed at valuing federal crude oil today and prospectively, based on known facts and information.

States. The proposed MMS valuation methodology exceeds the MMS' statutory and contractual authority.

A. Market Value at the Lease

Under the valuation methodology proposed by the MMS, the MMS is attempting to impose royalties on a value different than the value of the production at the well. To the extent that the MMS is attempting to assess royalty based on the value of crude oil after the production is removed from the leased premises to remote locations and markets, the MMS has exceeded its statutory and contractual authority to do so.[2]

The MMS' regulatory authority to determine the value of production on which royalties are due is limited by the governing statutes. Section 8(a) of the Outer Continental Shelf Lands Act requires the payment of royalty at a specified percentage "in amount or value of the production saved, removed, or sold from the lease." 43 U.S.C. § 1337(a). Likewise, the Mineral Lands Leasing Act requires the payment of royalty at a percentage "in amount or value of the production removed or sold from the lease." 30 U.S.C. § 226(b).

The legislative history of the Outer Continental Shelf Lands Act states that Congress recognized the need for fair leasing provisions which incorporate commonly understood terms of leases developed and in general use in the industry after a long period of trial and error, and the terms of leases granted by coastal states under which operations on the Continental Shelf have been conducted. H.Rep., No. 2078, 81st Cong., 2d Sess. at 9-10 (1950). Courts have relied on this statement of congressional intent to conclude that the Department of Interior cannot reverse long-standing policies in existence prior to enactment of the Outer Continental Shelf Lands Act because such policies were acquiesced to by Congress in enacting the statute.[3]

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2 Under many federal leases, the Secretary of the Interior may estabish minimum values for purposes of computing royalty. However, there are limits on this authority. For example, the Administrative Procedure Act, 5 U.S.C. §§ 551 *et seq.*, ("APA") prohibits agencies from acting in a manner that is arbitrary, capricious, an abuse of discretion, or not otherwise in accordance with law. The APA also prohibits agencies from violating constitutional safeguards or acting in excess of their statutory authority. These limitations on Department of Interior's authority to establish minimum values for purposes of computing royalty are discussed in more detail below.

3 *See, e.g., Amoco v. Andrus*, 527 F. Supp. 790 (E.D. La. 1981) (the MMS cannot change longstanding policy allowing for free use of beneficial fuel gas or unavoidably lost gas).

The focal point of valuation is the wellhead--the point at which the production of oil and gas is severed from the ground. In *United States v. General Petroleum Corp.*, 73 F. Supp. 225, 254 (S.D. Cal. 1947), the court interpreted the application of the Mineral Lands Leasing Act to the valuation of natural gas, holding that "[n]atural-gas royalties are payable on gas as it is produced *at the well.* It is the value of that gas which must be determined." (emphasis added.) The same analysis that is applicable under the Mineral Lands Leasing Act should be applicable to Outer Continental Shelf leases, given the similarity of language in the Outer Continental Shelf Lands Act. Where the MMS has attempted to impose royalties on something other than the value of the production saved, removed or sold from the leased premises, the courts have declared the agency's action to be in excess of its statutory authority.[4]

Just as in any contract, the parties to a federal oil and gas lease are entitled to rely upon the terms of their lease. The language of a typical Outer Continental Shelf lease form provides for royalties on the "amount or value of production saved, removed, or sold *from the leased area.*"[5] The language from a typical onshore lease form provides for royalties on the "production removed or sold *from the leased lands.*"[6] The oil and gas leases that private parties enter into with the Department of Interior are contracts of the United States. When the federal government enters into contractual relations, such as the oil and gas leases at issue here, "its rights and duties therein are governed generally by the law applicable to contracts between private individuals."[7] The federal government is bound by the contract terms of the lease as is any private lessor.[8]

The MMS does not have authority to change the terms of federal oil and gas leases unilaterally. In instances where the federal government has specifically set out to abrogate the essential bargain of contracts to which it is a party, the United States Supreme Court has

[4] *See, e.g., Diamond Shamrock Exploration Co. v. Hodel*, 853 F.2d 1159 (5th Cir. 1988).
[5] Form 3300-1 (February 1971). (emphasis added.)
[6] Form 3120-9 (September 1985). (emphasis added.)
[7] *Lynch v. United States*, 292 U.S. 571, 579 (1934).
[8] *See, e.g., Rosebud Coal Sales Co., Inc. v. Andrus*, 667 F.2d 949 (10th Cir. 1982) (oil and gas lease issued under the Mineral Lands Leasing Act created a commericial relationship, and court appplied typical contract law applicable to commercial transactions).

declared that such abrogation amounts to impermissible repudiation.[9] Unless a lease expressly provides otherwise, the "property rights of the lessee are determined only by those rules in effect when the lease is executed."[10] The MMS cannot unilaterally change the point of royalty valuation and thereby increase the royalty amount--in essence, abrogating the essential bargain of the oil and gas lease--in the absence of express authority to do so.

The Fifth Amendment prohibits the United States from annulling previously created contract rights.[11] Three facts are relevant to whether a Fifth Amendment taking has occurred: (1) the economic impact of the regulation on the claimant; (2) the extent to which the regulation interferes with the parties investment-backed expectations; and (3) the character of the government action.[12] With respect to the adverse economic impact on federal lessees, the proposed rule attempts to capture from the lessee a share of any value added to the production by the lessee after it is moved away from the lease. With respect to investment-backed expectations, when lessees entered into oil and gas leases with the federal government, lessees relied upon the valuation provision contained in the lease to determine the economics of the transaction. Changing the valuation point from that specified in the lease interferes with lessees' investment-backed expectations related to the royalty burden of federal oil and gas leases. For example, a lessee may not have bid, or may have bid less, on an oil and gas lease if the lease specified a valuation point at a location away from the lease. Finally, the character of the proposed government action here is to appropriate value added to the production by the lessee's downstream marketing efforts. Based upon the standard articulated by the United States Supreme Court, the movement of the royalty valuation point downstream under the proposed rule amounts to a Fifth Amendment taking.

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9 *See, e.g., United States v. Winstar*, 116 S.Ct. 2432, 2479 (1996) (Scalia, J., concurring); *Lynch v. United States*, 292 U.S. 571, 578-80 (1934); *Perry v. United States*, 294 U.S. 330 (1935).

10 *Union Oil Co. of California v. Morton*, 512 F.2d 743, 748 (9th Cir. 1975); *See, Pauley Petroleum, Inc. v. United States*, 591 F.2d 1308, 1325-26 (Ct. Cl. 1979), *cert. denied*, 444 U.S. 898 (1979).

11 The just compensation clause of the Fifth Amendment states "nor shall private property be taken for public use, without just compensation."

12 *Connolly v. Pension Benefit Guaranty Corp.*, 475 U.S. 211, 225 (1985).

In summary, the MMS' movement of the royalty valuation point in order to capture the value of crude oil at a location downstream from the lease is contrary to the MMS' statutory authority and is in violation of the terms of the oil and gas leases that the federal government has entered into. In addition, the movement of the royalty valuation point downstream constitutes a taking.

B. Expansion of the Obligation to Market

The MMS proposes to amend its valuation regulations to provide that federal lessees are required to market oil at no cost to the government. The MMS has exceeded its statutory and contractual authority with its attempt to create this new obligation.

There is no existing statutory or contractual requirement that a federal lessee market production at no cost to the federal government. Under existing regulations, federal lessees have a duty "to market the production for the mutual benefit of the lessee and the lessor" and they are required "to place [production] in marketable condition at no cost to the Federal Government or Indian lessor unless otherwise provided in the lease agreement." 30 CFR § § 206.102(b)(1)(ii); 206.102(i). However, federal lessees are not required *to market* production *at no cost* to their lessors.

The MMS tries to equate the requirement to place production in marketable condition with the duty to market. The MMS erroneously describes the proposed change in this obligation as a mere clarification. The preamble to the proposed regulations states:

> We did modify the paragraph on your obligation to place oil in *marketable condition* at no cost to the Federal Government *to clarify that it includes a duty to market the oil.*

62 FR 3746 (emphasis added). However, the regulatory obligation to put production in marketable condition is not the same as an obligation to market production at no cost.

1. The obligation to place production in marketable condition at no cost to the lessor cannot be expanded to encompass all marketing costs.

Never before in the MMS' duly promulgated regulations has the limited obligation to place production in marketable condition at no cost to the lessor been equated with a broad, all encompassing obligation to market for free. The MMS' current regulations, for example, define the phrase "marketable condition" as "lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area." 30 CFR § 206.101. Notably, this definition focuses on the *physical condition* that the production must be in so that it can be marketed under contracts typical for the field or area where the production occurs.

Thus, under the current "marketable condition" regulation, the only thing that a lessee is required to do at no cost to the lessor is to place the production in the physical condition necessary to market it under contracts typical for the field or area. The costs associated with marketing activities other than placing the production in marketable condition are not even remotely contemplated by the marketable condition rule, either in its present form or as it has evolved throughout its history.

The obligation to put oil into marketable condition originally was found in two Department of the Interior regulations. The first provision, governing federal onshore leases, provided that:

> Emulsion and dehydration. ...if all or any part of the product is unmarketable by reason thereof or on account of any impurity or foreign substance, the lessee shall put into marketable condition, if commercially feasible, all products produced from the leased land and pay royalty thereon without recourse to the lessor for deductions on account of costs of treatment or of costs of shipping....[13]

This provision remained and underwent minor changes over the years. Today it is found in 43 CFR § 3162.7-1(a), which provides: "The operator shall put into marketable condition, if

[13] 30 CFR § 221.31 effective June 1, 1942 (7 FR 4132, 4137).

economically feasible, all oil, other hydrocarbons, gas, and sulfur produced from the leased land."

The offshore counterpart of this regulation was promulgated in 1954 as part of the regulations adopted to implement the Outer Continental Shelf Lands Act. As originally promulgated, the regulation provided that:

> Emulsion and dehydration.
>
> The lessee shall put in marketable condition, if commercially feasible, all products produced from the leased land and pay royalty thereon without recourse to the lessor for deductions on account of costs of treatment.

30 CFR § 250.41 (1954).

Effective March 1, 1988, the marketable condition provision was incorporated in a new section 202 which currently provides:

> The lessee is required to place oil in marketable condition at no cost to the Federal Government unless otherwise provided in the lease agreement or this section.

30 CFR § 206.102(i).

In summary, no pre-existing regulatory support exists in the so-called "marketable condition" rule for imposing an obligation on federal lessees to market production at no cost to the federal government. Once production is in marketable condition, a federal lessee's obligation under the marketable condition rule ends.

2. The duty to market for the mutual benefit of the lessor and lessee does not carry with it a duty to market for the lessor for free.

The existing MMS regulations governing federal leases include a "duty to market for the mutual benefit of the lessee and lessor." 30 CFR 206.102(b)(1)(iii). The regulations do not, however, contain a requirement that a federal lessee market the production *for free*. The duty to market has never before been viewed as embodying the concept that the lessee must perform this marketing for free. After a marketable product has been obtained, all further costs in improving or transporting such product should be borne by both lessor and lessee.[14]

Although the MMS purports to rely on pre-existing authority for its assertion that a duty exists on the part of federal lessees to market lease production for free, the only authority the MMS cites is the decision of the Interior Board of Land Appeals in *Walter Oil and Gas Corp.*, 111 IBLA 265 (1989).[15] Of course, the Department of the Interior cannot create lease obligations by administrative decision any more than the MMS can "imply" them through its attempt to "clarify" pre-existing regulations. There is no support for the MMS' position that the lessee must bear all the costs of marketing production.

II. Departure from Current Regulations Without Justification

A. The Proposed Rule would be Invalid

The proposed rule is arbitrary and capricious and would not be valid if implemented because the basis and purpose of the proposed rule is not supported in reasoned decision-making or supported by factual evidence in the record. The MMS contends that the intent of the proposed rule is to "decrease reliance on posted prices and develop valuation rules that better reflect market value." 62 FR 3742. The data on which the MMS rely do not support the MMS' contention that posted prices do not reflect market value at the lease, the MMS' conclusion that the proposed index pricing methodology better reflects oil market value at the lease. *See* Section II. B. and C below.

We encourage the MMS to address the facts and issues raised in these comments. An agency must provide a nonarbitrary, reasonable basis for its rule.[16]

In addition, the Administrative Procedures Act requires that an agency "incorporate in the rules adopted a concise general statement of their basis and purpose."

[14] Kuntz, E., *A Treatise on the Law of Oil and Gas*, Vol. 3, § 39.4, p. 299 (1989).

[15] *California Co. v. Udall*, 296 F.2d 384 (D.C. Cir. 1961), cited in the *Walter* decision, does not hold that a lessee must bear all marketing costs. That case relates only to marketable condition.

[16] *See, e.g.*, *Independent Petroleum Association of America v. Babbitt*, 92 F.3d 1248 (D.C. Cir. 1996) (holding that DOI failed to give a sufficient nonarbitrary reason for treating take-or-pay settlements and take-or-pay payments differently for royalty purposes).

5 U.S.C. § 553(c). This requirement has been interpreted to mean much more than an agency's general statement of purpose. In *Motor Vehicle Manufacturers Assn., U.S. Inc. v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983), the Supreme Court made the following generalized statement as to an agency's statement of basis and purpose:

> Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.

Id. at 43. The Court in *State Farm* set aside the agency's recession of a rule that it had previously promulgated because of the inadequacy of the agency's consideration of other alternatives prior to rescinding the rule. *Id.* at 48. The Court stated that "an agency changing its course by rescinding a rule is obligated to supply a reasoned analysis for the change beyond that which may be required when an agency does not act in the first instance." *Id.* at 42. The Court concluded that judicial review should start from the presumption "against changes in current policy that are not justified by the rulemaking record." *Id.* In more recent cases, courts have applied the *State Farm* reasoned decision making test quite rigorously. *See, Beno v. Shalala,* 30 F.3d 1057 (9th Cir. 1994) (finding that the administrative "record contains a rather stunning lack of evidence that the Secretary gave plaintiffs' objections any such consideration"); *Northwest Resource Information Center, Inc. v. Northwest Power Planning Council*, 35 F.3d 1371, 1395 (9th Cir. 1994), *cert. denied, Pacific Northwest Generating Co-op v. Northwest Power Planning Council*, 116 S.Ct. 50 (1995).

In applying this analysis to the MMS' proposed rule, the MMS has not provided the reasoned analysis or the supporting evidence necessary to support its change to the current regulations. In the MMS' response to Exxon's Freedom of Information Act request, the MMS provided several consultant reports in which many conclusions were drawn without quantitative data supporting the conclusions.

The MMS has failed to provide sufficient rationale and data to permit meaningful comments on the proposed rule.[17] As the D.C. Circuit stated in *Connecticut Light & Power Co. v. NRC*, 673 F.2d 525, 530 (D.C. Cir.) *cert. denied*, 459 U.S. 835 (1982):

> If the notice of proposed rule-making fails to provide an accurate picture of the reasoning that has led the agency to the proposed rule, interested parties will not be able to comment meaningfully upon the agency's proposals.... As a result the agency may operate with a one-sided or mistaken picture of the issues at stake in a rule-making. In order to allow for useful criticism, it is especially important for the agency to identify and make available technical studies and data that has employed in reaching the decisions to propose particular rules. To allow an agency to play hunt the peanut with technical information, hiding or disguising the information that it employs, is to condone a practice in which the agency treats what should be a genuine interchange as mere bureaucratic sport.

673 F.2d at 530. Although the court upheld the NRC's adoption of a fire protection program in *Connecticut Light & Power Co.*, the court's concern was a public safety issue. *Id.* at 536.

The MMS has not supported its position with adequate evidence, nor has the MMS provided sufficient detail to enable the public to comment meaningfully on the rule. In support of its comments, Exxon is providing its comments based on the limited information and explanation that the MMS has provided to date. In support of its comments, Exxon submits the following: (1) an affidavit by Marshall Thomas of PVM Oil Consultants Inc.,[18] which supports Exxon's position (attached as Exhibit A); (2) comments of Professor Joseph P. Kalt [19] (attached as Exhibit B); and (3) relevant facts and case law.

B. Practical Elimination of Gross Proceeds Valuation Option

In the proposed rule, if a lessee purchased crude oil anywhere in the United States within the past two years, or if it is disposed of in an exchange or buy/sell agreement anywhere

17 It is important to note that the issue of royalty valuation is being disputed in private and state litigation at this time, and no resolution of the issue has been reached. The MMS appears to be relying on the plaintiffs' consultants such as Summit Resources, *e.g., Engwall v. Amerada Hess Corporation*, in crafting the proposed rule without consideration of the contrary views of defendants' consultants.

18 PVM Oil Consultants Inc. is a firm active in the commercial energy markets since 1971, with firsthand knowledge relating to oil market structure, role of NYMEX, market price behavior and valuation related issues.

19 *Professor* Kalt is a Ford Foundation Professor of International Political Economy at Harvard University, Kennedy School of Government, and a senior economist with the Economics Resource Group, Inc.

in the United States, or if the lessee's production is subject to a call, the lessee is excluded from relying on gross proceeds for royalty valuation purposes regardless of whether the sale of the production is arm's-length. 62 FR 3753. Although the MMS maintains that the proposed rule "retains the concept that for arm's-length sales, gross proceeds generally would be royalty value," 62 FR 3742, for all practical purposes, gross proceeds as a basis for royalty valuation has been abandoned for many, if not all producers.

Under the proposed rule, a lessee is excluded from relying on gross proceeds for all federal crude oil production if the lessee purchases any oil:

> Even if you have an arm's-length contract for the sale of your oil, you must value your oil under [the indexing provision] of this section...if you or any of your affiliates purchased crude oil from an unaffiliated third party in the United States in the two-year period preceding the production month.

According to the proposed rule, if, for example, a producer, Company A, made a one-time arm's-length purchase of 100 barrels of crude oil from Company Z in Wyoming in December 1996, Company A must value *all* federal production under the index-pricing methodology for two years. This would apply even if Company A never enters into another transaction with Company Z and all Company A's sales of federal crude oil occur in the Gulf of Mexico. No sales transaction that Company A enters into for the next two years can utilize gross proceeds actually received for royalty valuation purposes; for royalty purposes, every sale must be based on the MMS' proposed fictional index price methodology. The MMS failed to offer any explanation of its exclusion for a two-year period or exclusion of a lessee's total production for one transaction for the purchase of oil. There is nothing in the administrative record to support this arbitrary exclusion proposed by MMS.

Under the proposal, a lessee is excluded from using gross proceeds if the lessee "disposed [of oil] under an exchange agreement...." 62 FR 3752 (Proposed § 206.102(a)(4)). As defined by the MMS, the term "exchange agreement" includes buy/sell agreements. 62 FR 3751 (Proposed § 206.101). The MMS-stated basis for this exclusion is that "the prices stated in an exchange agreement *may not* reflect actual value." (emphasis added.) 62 FR 3744. The rulemaking record is void of any data showing that the MMS has identified actual buy/sell transactions occurring at prices below the range of values of other sales at the lease. In fact, the MMS' own statement reflects that exchange agreements *may* reflect value. Further, the MMS has provided no data to suggest that buy/sells are suspect but instead relies on unsupported general statements by its consultants.

Under the proposed rule, production subject to a crude oil call is excluded from gross proceeds valuation even if it is sold under an arm's-length sales contract. The MMS' stated basis for this change is as follows:

> As with multiple dealings between two parties, MMS would presume that the price of oil sold under arm's-length contracts subject to crude oil calls is suspect. This is because the sale terms may be liberal to the property buyer in return for a favorable product purchase price by the property seller.

62 FR 3744. The proposed rule would exclude production subject to a call regardless of whether the call has been exercised. Crude oil calls are legitimate, contractually negotiated provisions. The MMS has failed to provide any data showing the crude oil subject to a call is valued below the range of other sales at the lease.

The MMS' treatment of exchanges, buy/sells, and crude oil calls is a dramatic and unexplained departure from the current oil valuation regulations that were promulgated in 1988 after extensive consideration. In the preamble to the 1988 regulations, the MMS clearly took the position that gross proceeds was the best measure of value for arm's-length contracts.

> MMS maintains that gross proceeds to which a lessee is legally entitled under arm's-length contracts are determined by market forces and thus represent the best measure of market value.

53 FR 1184, 1186 (January 15, 1988).

> The MMS believes that, in the vast majority of cases, gross proceeds constitute market value. . . . 'Arm's-length' sales will not be accepted without question. The MMS will obtain needed information to ascertain that they are truly arm's-length as defined in the regulations.

Id. The MMS has not explained why these statements are no longer true.

The MMS did not include a blanket exclusion in the current regulations like the exclusion that the MMS has included in the proposed rule. "Arm's-length contract" is defined in the current regulations as "a contract or agreement that has been arrived at in the market place between independent, nonaffiliated persons with opposing economic interests regarding that contract." 30 CFR § 206.101. The MMS clearly provided that the MMS would "use the audit process to verify that contracts which are claimed to be arm's-length satisfy all the standards of the definition." 53 FR 1186. Rather than abandon the current system, the MMS should undertake audit efforts, as authorized by statute and regulation, to confirm that transactions valued on the basis of gross proceeds are truly arm's-length.

In the proposed rule, the MMS has not explained nor demonstrated why gross proceeds no longer constitutes market value, why the current definition of arm's-length sale no longer works, or why the current audit process fails to confirm whether contracts meet the arm's-length definition. Finally, the MMS has wholly failed to explain the purportedly changed circumstances justifying exclusion of a very large portion of federal production from royalty valuation based on gross proceeds. This dramatic departure from the current definition and treatment of arm's-length contracts is not supported in the record.

The MMS' proposed exclusion of such a large portion of federal production from gross proceeds valuation is clearly unreasonable, unjustified, and arbitrary. Certainly, a more efficient and less onerous option is available other than total abandonment of the valuation methodology promulgated in 1988 and that has been the basis for MMS royalty valuation even before 1988. For the reasons discussed above, the proposed rule is arbitrary and capricious and not otherwise in accordance with law.

C. Posted Prices

Posted prices reflect market value of crude oil at the lease,[20] as supported by the following evidence. When the MMS was considering changes to the royalty valuation regulations for oil in the late 1980's, the MMS considered moving away from posted prices and considered using futures and spot prices. The Associate Director for Royalty Management, in a *Memorandum to the Director dated 1987, ("Memorandum") made the following assessment:*

> Postings are, however, driven by the market, are sensitive to market changes, and are adjusted as market conditions require. While posted prices may, on occasion, vary slightly from actual market prices, they are undoubtedly market based. The MMS would be hard pressed to defend a position that futures prices are better, more accurate, and more current measures of royalty value for current production than are concurrent posted prices.--Posted prices are widely available. They exist for nearly all fields and areas for which royalty valuation is necessary. Further, since a field posting relates to oil with the same general quality characteristics, quality-based price adjustments are simple and accurate. The same cannot be said for application of spot or futures prices for royalty valuation.

Exhibit C at p. 3.

The MMS has failed to show why the Associate Director's statements are not true today. In a written presentation given to the MMS prior to the issuance of the proposed rule one MMS consultant stated, "Posted prices in many cases reflect the wellhead not delivered value" of crude oil. *See*, Reed Consulting Group, *Market Valuation of Domestic Crude Oil for Royalty Purposes*, at p. 9 (August 22, 1996).

Notwithstanding the fact that the MMS' consultants incorrectly suggest that "value" should be measured downstream of the wellhead or lease, this consultant correctly noted that posted prices reflect wellhead value. This observation is consistent with a lessee's obligation to pay royalty in "amount" or value of production saved, removed, or sold from the leased area." *See,* Section I.A. In addition, in a study conducted by Professor Kalt which supports his comments, Professor Kalt found that a range of posted prices exist at the lease which reflect the

[20] Exxon's posted prices reflect that price which Exxon is willing to pay when it purchases crude oil in a particular field or location.

market value of crude oil at the lease. Exhibit B at p. 5. Professor Kalt's study was based on several hundred thousand outright crude oil purchase and sale transactions from the early 1990s in Texas, New Mexico, and Oklahoma. Exhibit B at p. 4.

Posted prices have been and continue to be responsive to the current market at the lease. For example, Exxon changed posted prices on each of its 36 posted crudes over 120 times in 1996, including those postings applicable to federal oil. Further, Exxon's postings reflect current price differentials between various types and qualities of crude oil and between crude oils at different locations. When calculated as a differential to Exxon's posted price for WTI, the posting differentials between WTI and all of the other 35 posted crudes changed about 250 times in 1996. These changes in the differentials were made to reflect the continually changing relative market value of each of the crudes in Exxon's posting bulletins.

III. Methodology

A. Historical Overview

The index-pricing methodology proposed by the MMS using futures and spot prices for valuing federal crude works no better under current market conditions than it did in 1988, and there is no reason to believe it will work in the future. The MMS considered the use of futures or spot prices for royalty valuation when the current regulations were being drafted in 1988. The MMS rejected the use of spot prices concluding that "for purposes of oil royalty valuation, the application of futures and/or spot prices would be either contrary to existing law, lease terms and regulations, or too impractical and nonspecific to administer." Exhibit C at p. 1. After carefully considering the use of futures and spot prices, the Associate Director concluded:

> More important is the basic conclusion that, even if the study results do indicate that oil futures prices "lead" posted prices, this has no bearing on our valuation responsibilities. For royalty valuation purposes, we must apply market value existing at the time of production or sale. Whether postings are considered to lag futures prices or not, postings represent current offers to purchase oil and are adjusted as necessary to conform to market conditions. Further, oil futures and spot prices are available on such a limited basis as to make price adjustments for quality and/or transportation extremely difficult, if not meaningless.

Exhibit C at p. 3.

The conclusions reached during the redrafting of the regulations in 1988 are still relevant today. Professor Kalt comments that "actual transactions at the lease reveal market values that commonly vary significantly with supply and demand factors that are specific to individual locations, leases, and transactions." Exhibit B at p. 3. He concluded that posted prices fall within the range of market values. *Id.* at p. 5. As noted by Professor Kalt, "Because transactions at the lease level are not homogeneous, the use of NYMEX or market center prices in the manner proposed by the MMS could result in significant under or overpayment of royalties on federal crude oil." *Id* at p. 5.

As Professor Kalt concludes:

> A netback methodology that deducts transportation or location differentials from prices observed in transactions occurring at trade centers, including the NYMEX, is inherently remote from the lease level of the value-added chain. Such a netback methodology fails to account both for the demonstrable dependence of market value at the lease on supply and demand factors particularized to leases and transactions, and for the value added to crude oil by downstream marketing functions. As a result of these factors, the netback methodology proposed by the MMS would fail to measure accurately market value at the lease, and would also tend to produce prices that are generally higher than market value at the lease....

Exhibit B at p. 7. The MMS' conclusions in 1987 on the use of NYMEX future prices[21] and spot prices as a basis for royalty valuation are as sound today as they were in 1987.

[21] NYMEX has been trading crude oil options on light sweet crude oil since 1983, and therefore, NYMEX had five (5) years of experience with steadily increasing number of trades from its inception when the MMS considered using NYMEX in the regulations in 1988. *See*, the NYMEX report presented to the MMS on October 30, 1996. Still the MMS rejected this basis for the reasons stated.

B. California Valuation

In the MMS-proposed methodology, the starting point for valuing crude oil produced from federal leases in California and Alaska leases that is disposed of under non arm's-length sales contracts "is the average of the daily mean Alaskan North Slope (ANS) spot prices for the month of production published in an MMS-approved publication." 62 FR 3753 (Proposed § 206.102(c)(2)(ii)). The MMS reasoned that average ANS spot prices for valuing California and Alaska federal oil production is the best starting point for valuation because: (1) production is isolated; (2) ANS represents large volumes of oil delivered in to California for refinery feedstock use; (3) MMS consultants support ANS spot prices as best reflective of market value; and (4) using NYMEX with adjustments for California and Alaska crude oils would be difficult. 62 FR 3745.

However, using the average ANS spot price is *not* appropriate in valuing federal crude oil produced in California for the following reasons. First, the spot prices are in general not reliable. The ANS spot price assessment that the MMS proposes to use at Los Angeles and San Francisco are based on surveys made by the trade press. See Exhibit A at p. 29 ¶ 58. How the trade press determines its spot price assessments is unclear. Exhibit A at p. 30 ¶ 60. The spot price assessment may be based on an average of deals, it may be based on the price at which a company might have done a deal, or it might be in the "last deal done." *Id.* As Marshall Thomas observed, "the pricing services officially warn the oil trade that any use of published numbers is 'at your own risk.'" *Id.*[22] This unreliability of the trade press assessment depends primarily on the degree of liquidity of the market for which the crude oil is being assessed, and as Marshall Thomas states, "Judging by my own knowledge and the information and comments I have received from trade reporters, I believe that the relative degree of liquidity and accuracy of crude market price quotes vary appreciably." Exhibit A at p. 31, ¶ 62. Further, the published ANS price quotes in the trade press are indicative of the value of ANS delivered in waterborne cargo

[22] Marshall Thomas cites to Platt's Guide to Petroleum Specifications which provides that "Platt's neither encourages nor solicits companies or individuals to use its price data in contractual arrangements." Exhibit A at p. 30, ¶ 60 (citing to Exhibit D attached to Thomas' affidavit.)

volumes and not of the value of onshore California crude oils delivered by pipeline. Exhibit A at pp. 38-39, ¶ 78.

Second, many of the reported transactions to the trade press are buy/sells and exchanges which the MMS believes to be unreliable. *Id.* It is inconsistent for the MMS to reject such transactions at the lease and to rely on these transactions downstream. *Id.*

Finally, as concluded by the Associate Director of the MMS in 1987, spot prices do not capture the quality and location differentials of different crudes. Exhibit C at p. 2. The continued relevance of the Associate Director's statements is illustrated by the following example. The quality of ANS crude is significantly different than California OCS federal crude oil at Santa Ynez Unit. ANS crude oil is approximately 30°API gravity with a 1% sulfur level, while Santa Ynez Unit crude oil production is less than 19°API gravity and 5% sulfur. The MMS-proposed rule does not allow for an adjustment for the quality differential between the California OCS crude and the ANS spot price when the California OCS crude is sold at a market center. 62 FR 3755 (Proposed § 206.105(3)(iii)). Certainly, the ANS spot price does not reflect the value of the California crude oil being sold in San Francisco and Los Angeles based on quality differences. The quality of Santa Ynez Unit crude oil is more comparable to San Joaquin Valley ("SJV") crude oil than the higher quality ANS crude oil and thus the value is likely to be more similar to SJV. As seen in the example set forth on Exhibit F attached, using the ANS spot price to value California crude oil from federal leases could result in more than a $4.00 per barrel overvaluation.

The use of the ANS spot price as the beginning point for valuing crude oil from federal leases in and offshore California for royalty purposes does not work. Even the MMS recognizes that the ANS spot price might not be available or reflect a reasonable value in the future, and if that occurs, the MMS admits a need to rule amend Section 206.102(c)(2) to establish a substitute method. 62 FR 3753 (Proposed § 206.102(c)(3)). This recognition by the MMS highlights the weakness of the MMS' proposal to use the ANS spot price in the first place.

C. Non-California/Non-Alaska Valuation

The MMS' proposed starting point for valuing crude oil from federal leases for royalty purposes in non arm's-length sales of production from states other than California and Alaska "is the average of the daily NYMEX future settled prices (Cushing, Oklahoma) for domestic Sweet crude oil contract for the prompt month. The prompt month is the earliest month for which futures are traded on the first day of the month of production." 62 FR 3753 (Proposed § 206.102 (c)(2)(i)). The MMS provided three reasons for choosing this methodology: (1) NYMEX represents the price for West Texas Intermediate, a widely traded domestic crude oil at Cushing, Oklahoma; (2) one party cannot impact the NYMEX price; and (3) MMS consultants regard NYMEX as the best available measure of oil market value. 62 FR 3745.

Although NYMEX[23] may be a useful indicator of price direction, using NYMEX as the index pricing point for valuation for *all* federal crudes oil produced from states other than California and Alaska is inappropriate for the following reasons: (1) NYMEX is not a reflection of current market value at the lease as required by applicable statutes; (2) NYMEX is mainly a paper, not physical, barrel market; (3) NYMEX is used for speculation and hedging; and (4) NYMEX allows only standardized crude contracts to be executed.

1. NYMEX futures prices by definition do not reflect current market value at the lease as required by statute for royalty valuation.

The Outer Continental Shelf Lands Act and the Mineral Lands Leasing Act require that royalty be valued when crude production is removed or sold from the lease. 43 U.S.C. § 1337(a); 30 U.S.C. § 226(b). See also Section I above. When the MMS considered the use of futures prices in proposing the 1988 amendments to its regulations, the MMS concluded that even if the current regulations were modified to eliminate the language that royalty is to be valued "at the time of production" the applicable statutes would also need to be

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[23] NYMEX is an acronym for New York Mercantile Exchange which is a commodity exchange with 749 individual members consisting of bankers, refiners, marketers, and others. Exhibit A at p. 7, ¶ 13. "The primary economic role of NYMEX is to record prices through trades in an open marketplace (the commodity exchange floor)." *Id.*

amended.[24] Exhibit C at p. 1. Because the statutes require that royalty be valued when production is removed, or sold from the lease, Congress' clear intent is to reflect the current value. *Id.* By definition, futures prices would be inapplicable. Thus, the MMS concluded that the use of futures prices as a royalty valuation method was inappropriate. The MMS identified no change in NYMEX methodology which would justify its new proposal. As attested by Marshall Thomas in his attached affidavit:

> The fact that NYMEX futures prices may serve as a benchmark in some levels of crude oil trading, however, does not mean that one can easily mechanically adjust or 'net-back' from the NYMEX futures price in the manner that MMS proposes and arrive at the market value of crude oil at specific domestic leases. The market for a crude oil at the lease is very different from the market for NYMEX crude oil futures contracts, and the two cannot be linked in the manner proposed by the MMS....

Exhibit A at p. 10, ¶ 19. As further concluded by Marshall Thomas, "Because a market exists at the lease, value can be determined at the lease, and MMS should not abandon its historic focus on the market at the lease to value royalty crude oil." Exhibit A at p. 6, ¶ 11. The following discussion further highlights why using a futures index price does not reflect current market value at the lease.

2. NYMEX is a paper, not a physical, barrel market.

The NYMEX differs from the physical market because NYMEX is mainly a paper market. No crude oil is traded on NYMEX's trading floor. NYMEX trades crude oil solely under crude oil futures contracts. Exhibit A at p. 7, ¶ 14. The futures contract is an agreement to sell or purchase a specific amount of light sweet crude oil at a specific future date and place. *Id.*

Each contract pertains to 1,000 U.S. barrels of light sweet crude oil futures for delivery in Cushing, Oklahoma. Exhibit A at p. 8, ¶ 14. NYMEX averages 60,000 to 70,000 contracts daily which is equal to 60 to 70 million barrels a day on average with a high of 150,000

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24 Even if the Legislature amended the statutes, the leases with the MMS are governed by the rules in effect when the leases were executed and the leases cannot be unilaterally changed by the MMS. Therefore, if the statutes are amended, and the proposed regulation is implemented, the changes would be applicable only to future leases.

contracts or 150 million barrels daily on a heavily traded day. Exhibit A at p. 9, ¶ 16. This is more than 10 to 20 times the volume of crude oil produced on an average day in the United States. *Id.*

These traded volumes vastly exceed the 350,000 to 400,000 barrels per day of physical capacity at Cushing, even with Cushing's 25 million barrel storage capacity. Exhibit A at p. 9, ¶ 18. Although the futures contract obligations can be met by taking actual physical delivery of crude oil, only approximately 3.1% of the total NYMEX trading volume results in physically delivered crude oil to the buyer. *Id.* The physical barrel market at the lease is a very different market. At the wellhead, oil must be pumped, transported, or stored. Exhibit A at p. 14, ¶ 27. The buyer at the lease must determine whether actual physical barrels of crude oil are in fact produced, whereas the futures market participant deals solely with an abstract paper barrel. *Id.* As stated by Marshall Thomas, "The fact that crude oil is a physical product at the lease makes the creation of a valuation relationship between the NYMEX futures price and oil at the lease more complicated." Exhibit A at p. 14, ¶ 27.

3. NYMEX is primarily used for hedging and speculation.

The primary function of NYMEX crude oil futures trading is either to shift or hedge price risks through trading in futures. Exhibit A at p. 11, ¶ 20. While crude oil buyers protect themselves by buying futures in case market prices change, NYMEX is, in fact, clearly dominated by speculative interests. Exhibit A at p. 11, ¶ 22. In 1996, producers of crude constituted only 3% of the futures market; integrated oil companies, refiners and marketers represented a combined 25% of the futures market; and "speculative interests" constituted approximately 70% of the total volume of open interest which has increased since the late 1980s. Exhibit A at pp. 11-12, ¶ 22.

Thus, the NYMEX participants' interests are not aligned with those of a lessee whose concern is to produce and sell or refine crude oil. The level of commitment by a participant of NYMEX is thus much different than when a physical barrel of crude oil is produced and delivered to a purchaser.

The value of NYMEX crude oil futures contracts is influenced by many forces not found at the lease market. As Mr. Thomas attests, "The differences between a commodity futures benchmark like NYMEX LSC and physical wellhead supply are numerous." Exhibit A at p.14, ¶ 26. For example, price consideration, not physical supply, is the primary rationale behind trade in such futures. *Id.* Futures contracts can be traded and closed out without physical delivery which gives them "added value over the cumbersome physical barrel at the wellhead." *Id.*

4. NYMEX allows only limited standardized crude oil futures contracts to be executed.

The NYMEX standardized crude oil futures contract is very different than real crude oil at the lease for the following reasons.

a. NYMEX is limited to light sweet crude oils.

NYMEX allows only light sweet crude oil futures contracts to be executed.[25] Although there are several light sweet crude oils that can fulfill a NYMEX crude oil futures contract, the MMS proposal focuses on West Texas Intermediate (WTI) and fails to recognize the differences that exist between WTI and other NYMEX light sweet crude oils. Exhibit A at p. 13, ¶ 24. Further, as Marshall Thomas observed, "The NYMEX LSC is not the same as actual barrels of WTI at Cushing, and it is worlds apart from physical supplies of WTI at the lease, and even further different from other domestic grades." Exhibit A at p. 13, ¶ 25. The MMS proposal fails to capture all these differences between crude oil types and locations. The MMS makes a grave error by assuming that the futures price is a proxy for the price of WTI.

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[25] NYMEX has established specific domestic crudes with 0.42% sulfur by weight or less, and not less than 37 ° API gravity nor more than 42 ° API gravity to fulfill a crude oil futures contract. Exhibit A at p. 8, ¶ 15. NYMEX has deemed the following domestic crude oils to meet these specificiations: West Texas Intermediate; Low Sweet Mix; New Mexican Sweet; North Texas Sweet; Oklahoma Sweet; and South Texas Sweet. *Id.* Several foreign crude oils of not less than 34° API have been similarly deemed by NYMEX nor more than 42° API to satisfy NYMEX futures contracts including U.K. Brent and Norwegian Oseberg Blend, Forties, and Nigerian Bonny Light and Cusiana. *Id.*

b. NYMEX crude oils futures contracts are limited to FOB Cushing, Oklahoma.

The delivery location for NYMEX crude oil futures contracts is limited to FOB "any pipeline or storage facility in Cushing with access to ARCO's or Texaco Trading and Transportation, Inc.'s storage." Exhibit A at p. 8, ¶ 14. Cushing, Oklahoma is vastly different than other markets where crude oil is bought and sold.

Cushing has more than 25 million barrels of storage and more than a dozen major pipelines and interchanges for Midwest destinations. Exhibit A at p. 18, ¶ 34. Given Cushing's substantial storage facilities and vast, interconnected pipeline systems, the Cushing reference location in NYMEX's crude oil futures contracts "gives the futures contract added value from a physical standpoint." *Id.*

Cushing is a central aggregation and distribution point with access to many buyers, increasing the value of the product. *Id.* In contrast, the vast majority of crude oil produced in North America does not benefit at the lease from the infrastructure at Cushing. *Id.* In the United States, the average oil well produces at a rate of 11.4 barrels per day, with the stripper wells producing as little as 2 barrels per day. *Id.* Although offshore federal leases produce about 234 barrels a day on average, these supply volumes are very different from the 50 million to 150 million barrels per day that are traded on NYMEX. *Id.* In fact, few of these barrels "ever find their way to Cushing for physical delivery to satisfy NYMEX contracts, and many of the barrels could not even physically reach Cushing." Exhibit A at p. 19, ¶ 34.

The MMS' proposal fails to capture the valuation differences between marketing crude oil at Cushing, Oklahoma and marketing at the lease. For example, the use of NYMEX as a price indicator for application to the federal crude oil produced by Exxon in Wyoming and offshore Louisiana fails to capture the quality and location differences of these crude oils even with the proposed adjustments and allowances. Quality differences, locations, and other circumstances can greatly effect the price of crude oil. For example, using West Texas Sour as a valuation basis for Wyoming Asphalt Sour and Elk Basin crude oil appears to be required by the proposed rule, Exxon's posted price is <u>overstated</u> for royalty purposes when compared to the calculated value under the MMS' proposal at that point in time. *See*, Exhibit D attached.

As to location differences, the following example also shows how royalty will be undervalued using the proposed NYMEX methodology. Refiners in Salt Lake City have limited access to crude oil and are willing to pay a higher price for locally available crude oil. Using the NYMEX methodology proposed by the MMS, sweet crude oil delivered to Salt Lake City is valued by reference to the NYMEX West Texas Intermediate price. This fails to capture the current price premium in Salt Lake which is about $1.50 per barrel. However, this value difference is captured in Exxon's posting. This is just one example of how the prescribed methodology does not accurately measure the value of crude oil in different locations at the lease.

c. Timing of NYMEX crude oil futures contracts.

Crude oil futures contract prices are affected by timing. Exhibit A p. 16, ¶ 31. The crude oil futures contracts "trade forward 30 consecutive months, based on a quarterly schedule, and also may be long-dated, *i.e.*, provide for delivery in the 36th or 48th month." Exhibit A at p. 8, ¶ 14. As further shown by Marshall Thomas in Graph 1 of Exhibit C to his affidavit, the price variations over several years, which could be the life of a NYMEX contract, are many. For example, the price per barrel of crude oil ranged from $16.75 in 1995, $23.33 in early 1997, and $19.69 in early May of 1997. As explained by Marshall Thomas, "Futures market participants earn their rewards, if any, by determining when to buy and sell specific supplies over the life of each contract." Exhibit A at p. 17, ¶ 31. These price considerations are very different than price considerations for sale of oil at the lease which is priced each day as it is produced, in contrast to the NYMEX commodity quote, which applies to future barrels. Exhibit A at p. 16, ¶ 31.

d. Other costs associated with NYMEX contracts.

Trading crude oil futures contracts for NYMEX involves costs different than marketing crude oil at the lease including costs of holding a seat on NYMEX or costs associated with participating with member firms, brokerage fees, a deposit per crude contract, fee for scheduling barrels if a buyer does want physical delivery of crude oil and other costs associated with managing any such business. Exhibit A at p. 15, ¶ 29. This is very different than marketing at the lease which involves physical barrels of crude oil. Exhibit A at p. 16, ¶ 30. To realize NYMEX values for crude oil, a lessee would have to start another line of business--trading paper futures instruments. *Id.*

In conclusion, the fact that there is no simple consistent relationship to use the NYMEX valuation methodology proposed by the MMS to value all other crude oils due to variables of quality, location, infrastructure, timing, class of trade, and other factors. Exhibit A at pp. 19-20, ¶ 36-37. Everyday trade in the crude oil market reflects those variables and differences from NYMEX as a basis, and the MMS proposal "ignores the realities of the commercial market." Exhibit A at p. 20, ¶ 37. Therefore, the use of NYMEX as the starting point for valuing all federal crude oil, excluding that produced in California and Alaska, is arbitrary and capricious because it does not reflect current market value for the various crude oils at the lease.

D. Adjustments and other Allowances under § 206.105

The proposed rule includes various price adjustments and allowances. The MMS asserts that the "allowable adjustments and deductions would reflect the location/quality differentials and transportation costs associated with value differences between oil produced at the lease and oil at the index pricing point." 62 FR 3746. The stated purpose of these adjustments and allowances "is to reflect value differences for crude oil production of different qualities and at different locations *to derive value at the lease.*" 62 FR 3747 (emphasis added). The MMS specifically noted that the most difficult problem with the proposed rule is making appropriate location and quality adjustments when comparing NYMEX crude oil and the particular crude oil being valued. 62 FR 3745.

For the reasons explained below, the proposed adjustment and allowance methodology fails to meet the stated objective: to derive the value at the lease. The proposed adjustments do not take into account the quality or value of production at the lease or appropriate royalty settlement point.[26] The MMS has failed to provide appropriate adjustments between ANS spot prices or NYMEX future prices and the particular crude oil being valued.[27] The result is a royalty valuation methodology that imposes royalty on a value other than that at the lease. To the extent the royalty value does not reflect the value at the lease, the proposed rule exceeds the MMS' statutory and contractual authority.

1. Differentials between Index Pricing Point and Market Center. 30 CFR § 206.105(c)(1)(i)

The proposed rule includes a location differential that is intended to reflect the difference in value of crude oil at the index pricing point (e.g., Cushing) and the appropriate market center (e.g., St. James). The MMS explains that the differential would be the difference between the average spot price for the market center and the index pricing point as published in an MMS-approved publication.[28]

Although the MMS considered use of spot prices as a starting point for valuation, the MMS rejected spot prices in favor of the NYMEX. In rejecting spot prices in favor of NYMEX prices, the MMS articulated two reasons: (1) NYMEX prices are "perceived to best reflect current domestic crude market value on any give day"; and (2) minimal likelihood that any one party could influence them. 62 FR 2745.

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[26] 30 CFR § 206.103, which the MMS does not propose to change, requires that royalties "be computed on the quantity and quality of oil" at the approved royalty settlement point. The rule provides that if royalty is determined on a quality different than the quality at the royalty settlement point, the value will be adjusted for those differences. However, the proposed rule takes into account the quality of crude oil only at an aggregation point. The quality of crude oil at an aggregation point can be vastly different than the quality of the crude produced from a given lease that flows to the aggregation point. For example, sweet crude produced from a lease may be commingled and transported in a sour crude pipeline to an aggregation point. Thus, the quality at the aggregation point may be significantly different with a higher or lower gravity and sulfur content. A lessee may be rewarded or penalized when the quality of the crude oil at the lease (or appropriate royalty settlement point) differs from the quality of the crude oil at the MMS-identifed aggregation point.

[27] Director Quarterman has acknowledged that various factors must be considered when comparing crudes. She stated, "Thus, any comparison to Elk Hills crude oil must consider its advantage in blending with various crudes as well as the quality adjustment for its gravity." See, May 31, 1996 memorandum from Director Quarterman to Assistant Secretary, Land and Minerals Management. However, the proposed rule fails to provide appropriate adjustments and, in some instances, provides no adjustment for quality. See, Section III. D. d.

[28] The proposed rule does not describe the factors the MMS will consider in determining whether a publication is "MMS-approved." The proposal fails to include a procedure to request that a publication be added.

Some spot markets have insufficient volume trades to reflect reliable spot prices. Although the proposed rule does not use the spot price quote at various market centers as a starting point, the proposal uses the spot prices for calculating the location differential for the adjustment to the index price. Thus, the proposed location differential methodology relies directly on spot prices. The use of spot prices for calculation of the location differential poses the same problems that the MMS identified when it considered using spot prices as the starting point. The MMS has not provided any reasonable explanation of how it justified the use of spot prices in the location differential calculation when it rejected spot prices as a starting point for valuation.

2. **Location/Quality Differentials. § 206.105(c)(ii)-(iii)**

The proposed rule includes two methods to attempt to adjust for the location/quality differential between the market center and aggregation point: (1) an express location/quality differential under an arm's-length exchange agreement; or (2) a location/quality differential that MMS publishes annually based on data reported on Form MMS-4415.[29] The provision for use of an express location/quality differential can be used only when there is (1) a transaction between an aggregation point and market center; and (2) the agreement includes an express location/quality differential. In the absence of an express location/quality differential, the MMS requires lessees to use the MMS-published location quality differential.

The proposed rule provides that the MMS will calculate that differential using a "volume-weighted average" of the differentials reported on Form MMS-4415 for the previous reporting year and that lessees "must use MMS-published rates on a calendar year basis applying them to January through December production reported February through the following January." 62 FR 3754. The use of the MMS-published location differential raises a number of concerns that are discussed in more detail in Section IV.

29 The MMS notes that the location/quality adusments needed to derive the MMS-calculated lease value involves "considerarable administrative effort for all involved." 62 FR 3746. This administrative burden is discussed in detail in Section IV.

a. The MMS-published differential is not representative of, or responsive to, current market conditions.

The MMS-published differential does not reflect current market conditions nor does it respond to changes in market conditions. In the MMS' proposal, the published differential is between one and almost two years old when applied in any given month. Such a differential fails completely to reflect the frequent changes that occur in order to respond to market factors. As a consequence, although a lessee sells crude oil at the market price based on current market conditions, the lessee must pay royalty on a value that the MMS calculates which includes a differential reflecting the average of market conditions from the prior year.

For example, in 1995, the average annual differential between West Texas Intermediate and West Texas Sour was 88 cents per barrel based upon Platt's spot quotes. During 1996, the monthly average differential between West Texas Intermediate and West Texas Sour ranged between 76 cents per barrel to $1.88 per barrel with the annual average of $1.23 per barrel. Therefore, if the 1995 Platt's average differential was used in 1996, the crude oil would be overvalued by an average of $.35 per barrel. Similar situations exist in which the differential would be understated.

Factors such as refinery capacity or refinery down time, pipeline capacity, new production coming on the line, change in customer mix, supply upsets, and new pipelines can significantly impact location and quality differentials. Prices constantly fluctuate due to local market conditions and the crude supply. The MMS published location/quality differential will not adequately reflect market conditions when crude is sold.

b. The MMS-published differential fails to take into account changes in crude oil quality.

The proposed application of MMS-published location/quality differentials also fails to take into account changes in the quality of the crude stream. For example, Platt's currently quotes a price for Eugene Island crude. The Eugene Island crude oil stream is approximately 31° API gravity and the sulfur level is about 1%. The Eugene Island crude oil stream includes Poseidon crude oil. However, it is anticipated that the Poseidon crude oil will no longer be commingled with the Eugene Island crude oil stream during the summer of 1997. The resulting Eugene Island crude oil stream is expected to change from 31° API gravity to 35° API gravity with a sulfur level of about .8%. A published location/quality differential for the Eugene Island crude oil stream based upon the prior years' data would not reflect this significant change in the crude oil stream quality. Although the proposed rule allows a lessee to file a request for an MMS-published differential, this process does not allow the MMS to respond timely or effectively to changes in crude oil quality.

Crude oil quality changes will also occur for a variety of other reasons such as changes in production from new wells drilled, and increase in production of existing wells. Crude oil quality often changes frequently, but the MMS-published differential remains constant.

c. Proposed rule does not afford lessees an opportunity to challenge MMS-published differential.

Because the published location/quality differential is based on contract data submitted to the MMS which is highly confidential and proprietary, the data are considered proprietary pursuant to the Freedom of Information Act. 62 FR 3758.[30] Thus, the publication of the location/quality differential does not afford the lessee the opportunity to challenge the accuracy of the differential.

If all lessees submit contract data confidentially, the differential calculated by the MMS would be based on records that cannot be reviewed or challenged by a lessee.[31] Practically, the lessee would have no data other than its own contracts to support a challenge to the MMS differential. Even if the MMS were to mask and release data, masking would not eliminate the risk of competitive harm because in some areas crude oil is so thinly

[30] The proposed regulations as written do not explicitly provide that Form MMS-4415 will be treated confidentially, although the instructions on Form MMS-4415 do provide that the data will be confidential. Confidentiality needs to be provided explicitly in the regulations. Congress recognizes that the release of trade-secret type information could be very harmful, because government employees who wrongfully release any data are subject to penalties under the Trade Secrets Act. 18 U.S.C. § 1905. If the MMS is going to collect such contractual data, it must use the utmost care in protecting lessees from competitive harm.

[31] Although the MMS published a proposed rule governing release of third-party proprietary information on April 4, 1997 at 62 FR 16116, the comment period is still open.

traded that the identity of the parties submitting the data may be surmised. For example, at Silvertip, Wyoming and Cutbank, Montana, two pumping stations for crude oil delivered to refineries near Billings, Montana, there are currently only three purchasers on most contracts at those locations, one of which is Exxon. If the contract data from the three companies were masked and released by the MMS, each of the three companies would learn its competitors' crude oil pricing practices at those locations potentially risking competitive harm.

A lessee could be denied the statutory right to refunds if a lessee paid excess royalty because the MMS erroneously calculated the differential. Under the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996, if a lessee determines that a refund is due, the lessee must request a refund by filing a report that reflects the overpayment. 30 U.S.C. § 1721(a)(b)(1). In the report, the lessee must provide the Secretary with information that "reasonably enables the Secretary to identify the overpayment for which refund is sought; and provides the reasons why the payment was an overpayment." *Id.* The lessee will be unable to file a request with all of the relevant evidence necessary to support a refund, because of confidentiality. Therefore, these proposed regulatory provisions contravene the statutory right of the lessee to request a refund based on an erroneous location/quality differential. These proposed changes exceed the MMS statutory authority, and should not be implemented. 5 U.S.C. § 706(c).

d. The proposed rule fails to allow a location/quality differential for crude oil moved to an alternate disposal site.

The proposed rule fails to provide location/quality differentials for crude oil that is moved to an "alternate disposal point" such as a refinery. The rule provides for a location differential[32] based only on the market center nearest the lease where there is a published spot price for oil of "like quality."[33] 62 FR 3755 (Proposed § 206.105(c)(2)(ii)). Furthermore,

32 The location differential reflects the value difference between the index pricing point and the market center.

33 "Like-quality oil" is defined as "oil with similar chemical, physical, and legal characteristics." However, the rule provides no guidance on how similar or dissimilar crude oils can be to fit this definition. The MMS states that West Texas Sour and Wyoming Asphalt Sour are like-quality crude oils. West Texas Sour is 32° API gravity and 2.1% sulfur content. Wyoming Asphalt Sour is typically 23° API gravity and 2.7% sulfur content. The MMS has provided no guidance on how to value crude oil when a quoted spot price for a like "quality crude" oil at the nearest market center does not exist. There is no single standard in the industry for calculating quality adjustments for all crude oil.

the proposed rule provides no quality adjustment to reflect the differences between the API gravity, sulfur content, viscosity, metals content and other quality factors of the crude oil at the lease and the market center value of the "like-quality" crude oil at the market center.

For example, if a lessee sold its San Joaquin Valley (SJV) crude oil production to a refinery near the lease in California, the proposed regulations would require that the crude be valued at the spot price of ANS in Los Angeles or San Francisco, less transportation from the refinery back to the lease. The quality of SJV, approximately 13° API gravity and 1% sulfur, is substantially lower than ANS quality. Because of the SJV quality, the value of SJV at the lease should be lower than ANS to reflect the quality differences. The application of the MMS-proposed valuation methodology, however, would result in a value for SJV at the lease only slightly below the ANS price in Los Angeles or San Francisco, and substantially above the spot market price for the SJV because the proposed regulation only allows an adjustment for location. The proposed rule fails to allow any adjustment to reflect quality differences. The resulting MMS-calculated value is substantially above the market value of the crude at the lease and is in conflict with the expressed intent of the proposed regulations of allowing adjustment for both location and quality differences in assessing crude value differences in order to ascertain market value at the lease. Exhibit F. In the example, the MMS-calculated value is more than $4.00 higher than the spot quote for SJV.

If a lessee decides to move the SJV crude oil to Los Angeles or San Francisco for use in the lessee's own refinery or for sale to a third-party refinery, the proposed regulations require that the producer value the crude oil at the price of the market center crude, i.e., the ANS price, less the transportation cost of moving the crude to the destination refinery. The resulting MMS-calculated value will be lower than the MMS-calculated value for crude oil delivered to a purchaser near the lease. However, because no quality adjustments are permitted, the resulting calculated value under the MMS' proposal will still be above the spot market value for the crude. Exhibit F.

In summary, the proposed rule unfairly penalizes the lessee who transports lease production to a refinery by assigning a value without regard to quality differences. The MMS clearly fails to meet its stated objective of reflecting value differences for crude oil production of different qualities to derive a value at the lease.

3. Determination of Transportation Allowances

The MMS proposes to amend its regulations to modify its methodology for transportation allowances. Two concerns exist with respect to the MMS' proposal: (1) the elimination of the option to rely on the FERC tariff for transportation allowance purposes; and (2) the absence of guidance on certain sales.

a. Elimination of option to use FERC Tariff. 30 CFR § 206.105(b)(5)

Under the current regulations, a lessee receiving transportation services from unaffiliated pipelines is generally allowed a transportation allowance for the full price paid to the carrier (i.e., the contract price or tariff rate). A lessee that transports crude through affiliated pipelines is required to demonstrate the "reasonable, actual costs" incurred in providing such transportation. 30 CFR § 206.105(a)-(b). However, the current regulations provide an express exception for lessees that receive transportation on owned or affiliated pipelines with published tariff rates that have been approved by the FERC or the appropriate state regulatory agency. Thus, the proposed rule requires a pipeline owner lessee to use MMS-calculated "actual costs" for transporting federal crude oil on its pipeline while a non pipeline owner lessee is allowed to use FERC or state-approved tariff rates.

The MMS states two reasons to support its change: (1) the use of actual costs is fair; and (2) the existing exception for FERC or state-approved tariffs no longer viable after *Oxy Pipeline, Inc.*, 61 FERC ¶ 61,051 (1992) and *Bonitio Pipe Line Company*, 61 FERC ¶ 61,050 (1992). With respect to the first justification, limiting transportation deductions to "actual costs" as defined by the MMS is clearly unfair. The tariff rate paid to the carrier by both an affiliated and nonaffiliated shipper are the same. A lessee transporting on an affiliate pipeline is at a clear disadvantage under the proposed rule. Other producers shipping on the line are allowed to deduct the full tariff rate. It is fundamentally unfair to allow a lessee without an affiliate pipeline to deduct the full tariff rate for transportation when allowing a lessee with an affiliate pipeline to deduct only actual costs.

The second reason articulated by the MMS is that the use of FERC tariffs is no longer viable after *Oxy* and *Bonito*. The proposed rule eliminates the option for *both* onshore and Outer Continental Shelf ("OCS") pipelines. Neither *Oxy* nor *Bonito* raised any issue with respect to FERC jurisdiction over onshore lines. The rule fails to provide any justification for not allowing a lessee to rely on the FERC tariff for lines not located wholly offshore.

With respect to OCS pipelines, the proposed rule fails to take into account the Director's decisions in *Torch Operating Company, et al.*, dated January 18, 1997. The MMS relied on the *Oxy* and *Bonito* decisions as a basis for denying the use of FERC tariffs for all OCS oil pipelines. The January 18, 1997 decision rejected the MMS' denial of the exception requests.

> Because of the plethora of circumstances distinguishing the dispositions of production being shipped on different pipelines operating on or across the OCS, the simple jurisdictional determination in *Oxy* cannot be used as a blanket determination for all production being transported on all OCS pipelines. Without FERC's ICA jurisdictional determination for each pipeline, MMS cannot discern whether each of the Appellant's tariffs are approved....

Torch Operating Company, (January 18, 1997). This decision was issued prior to the publication of the proposed rule in the Federal Register, yet the proposed rule fails to mention this decision. The same rational that the MMS argued and that was clearly rejected in the administrative appeal is cited as the basis for its decision to eliminate the exception to use the FERC tariff. The MMS' unsupported conclusion that "the use of FERC approved tariff[s] [are] no longer a viable alternative" after *Oxy* and *Bonito* is clearly erroneous and is not a valid justification for the proposed change.

When lessees such as Exxon entered into leases with the Department of the Interior, it was never contemplated that lessees would be denied the right to deduct reasonable rates for services such as transportation. The MMS' denial of lessee's right to deduct reasonable rates for transportation services is not authorized by law or contract. In addition, the MMS' attempt to appropriate any profits associated with transportation services is tantamount to a Fifth Amendment taking. See Section I.A.

When the current rule was promulgated in 1988, after careful consideration, the MMS concluded that "it is unnecessarily burdensome and duplicative to recompute costs." In an effort to simplify procedures for both the lessee and MMS the regulations provide an exception to the requirement to compute actual costs "where the lessors interest is adequately protected." 53 FR 1211. The MMS noted that the rule contained protection from unreasonably high tariffs because of procedures built into the rule. The MMS has failed to articulate any rational basis why the current rule no longer adequately protects the MMS' interests.

b. Absence of Guidance on Transportation Costs for Lease Sales. 30 CFR § 206.105(c)

Proposed section 206.105 sets out the transportation allowances applicable to various dispositions of crude oil. 62 FR 3754-55. Depending on the ultimate disposition of the crude oil, the proposed rule permits deduction of "actual transportation costs" from the lease to aggregation point, from the lease to the market center, and from the lease to alternate disposal point. The rule fails, however, to take into account that when a lessee sells the crude oil at the lease, the lessee will have no "actual transportation costs" to deduct. The MMS-calculated value will reflect a market center value, yet the price the lessee actually receives for the crude oil will be lower than the market center price because the purchaser must bear the costs of transportation beyond the lease. The proposal, read literally, would provide no adjustment.

Not providing appropriate adjustments to the MMS-calculated value unfairly penalizes the lessee who will pay royalty on a value substantially higher than the amount received by lessee when sales are made at the lease. To not allow such adjustments from the market center price is inequitable. For this reason, the rule is arbitrary and capricious and exceeds the MMS' statutory and contractual authority.

E. Alternative Valuation Proposal

The MMS requested suggested alternatives "on ways to value federal oil production based on market indicators in the vicinity of the lease." 62 FR 3746. The best alternative is the current regulations for valuing federal crude oil based on market indicators in the vicinity of the lease. The evidence in this rulemaking shows that there is a lease market, and the current rules rely on this market to value the crude oil. Further, the MMS has not adequately supported its position that a need exists to amend the current regulations. The current regulations for valuing crude oil for royalty proposes were established in 1988 by rule. 53 FR 1218 (January 15, 1988). The current regulations divide sales transactions into arm's-length contracts and non arm's-length contracts. For arm's-length contracts, the royalty value is established on gross proceeds received by the lessee for the sale of the oil. The current definition of arm's-length transactions include all transactions by independent, nonaffiliated persons with opposing economic interests. 30 C.F.R. § 206.101.

For non arm's-length transactions, the value of oil production is determined using the first applicable benchmark of the following five benchmarks, provided that the values shall not be less than the gross proceeds accruing to the lessee: (1) the lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field, provided these are comparable to other posted prices or sales contract prices; (2) the arithmetic average of contemporaneous posted prices used in arm's-length transactions by persons other than the lessee for purchases or sales of significant quantities of like-quality oil in the same field; (3) the arithmetic average of other contemporaneous arm's-length contract prices for purchases or sales of significant quantities of like-quality oil in the same area or nearby area; (4) prices received for arm's-length spot sales of significant quantities of like-quality oil from the same field (or if necessary, from the same area) and other relevant matters, including information submitted by lessee concerning circumstances in the lease operation or saleability of the oil; or (5) a net-back method or any other reasonable method. 30 C.F.R. § 206.102. This benchmark system was established to provide a reasonable degree of certainty as to the criteria to be used for valuing oil for all concerned. 53 FR 1202.

The current regulations should be left in place because the regulations capture market value through a number of well-analyzed options or benchmarks. In addition, the MMS has audit rights to confirm that crude oil has been appropriately valued. The MMS should endeavor to use the current system to determine whether individual lessees are paying current market value at the lease.[34] Until the MMS determines and can adequately justify that the regulations do not work as written, the MMS should not change the current regulations.

When the current regulations were considered in 1987 the Associate Director of the MMS concluded:

> If arm's-length prices are acceptable for royalty valuation purposes, a reasonable proxy for current non arm's-length prices is <u>not</u> a futures prices, but, rather, an assessment of what is currently being obtained under arm's-length conditions.

Exhibit C at p. 2. Under the current regulations the MMS has a well-established audit program. Lessees have the systems in place to report royalty value to the MMS, and the current regulations provide certainty and better reflect oil market value at the lease than the new methodology proposed by the MMS.

The MMS is considering implementing a Royalty-In-Kind (RIK) program and is working with industry to establish such a program in a workable manner. If a reasonable RIK program is established by the MMS, such a program could provide a verification mechanism on the results of the current regulations for similar qualities, quantities, and locations of crude oil dispositions. For example, if the MMS takes RIK from leases, and sells the crude oil

34 For example, Exxon's posted prices reflect current market value of federal crude oils.

at the lease, the sale would provide the MMS with market data to compare with lessee's payment for royalty in value royalties made to the federal government.[35] In addition, if the MMS believes certain royalties paid in value are below market value at the lease, the MMS may audit to determine whether a higher value or different benchmark should be used in those particular cases. More thought and analysis would be necessary, but the use of the RIK program and the audit process with the current regulations for royalty in value would provide greater assurance to the MMS as to market value determinations.

IV. Proposed Reporting and Data Collection Requirement

A. Form MMS-4415

The proposed rule imposes a new and onerous reporting obligation on federal lessees. The Oil Location Differential Report, Form MMS-4415, must be filed by all federal lessees for all crude oil production sold, regardless of whether from federal, Indian, State, or private lands. 62 FR 3755 (Proposed § 206.105(d)). The current reporting obligations remain in place. Form MMS-4415 is a new and additional burden. The MMS claims that this form would:

> capture location differentials in all exchange agreements or other oil disposal contracts. MMS would use these data to calculate location differentials between market centers and aggregation points.

62 FR 3749. The proposed reporting requirement has numerous problems that do not support the above claims by the MMS. These problems include, but are not limited to, the immense burden and complexities associated with collecting requested data, and the lack of viability of the data once collected. The purpose of this section is to address these shortcomings.

The proposed regulation provides that:

[35] Any RIK program cannot impose marketing costs on the lessee as discussed in Section I. above.

> You must submit information on Form MMS-4415 related to all your and your affiliates' crude oil production, and not just information related to Federal lease production. All Federal lessees (or their affiliates, as appropriate) must initially submit Form MMS-4415 no later than 2 months after the effective date of this reporting requirement, and then by October 31 of the year this regulation takes effect and by October 31 of *each succeeding year.*

62 FR 3755.

B. Burden on the Payor and the MMS

The MMS has estimated the reporting cost imposed by the rule to be $800,000 per year to industry. 62 FR 3750. This is based on the assumption that on average, a payor would have 64 agreements from which data would need to be extracted. The MMS estimated that it would take 15 minutes to gather the information needed to complete Form MMS-4415. The MMS further assumed the labor costs to comply with the collection obligation to be $25.00 per hour. Because the requirement is not limited to crude oil from federal leases, a lessee must complete Form MMS-4415 on all transactions for all crude oil production in the United States whether from Federal, Indian, State or private lands.[36] Exxon believes that the MMS estimates are unrealistically low.

The time necessary to complete MMS-4415 will greatly exceed the 15 minutes estimated by the MMS. Much of the information is not easily obtained. A list of some of the research activities that will cause completion of the form to exceed 15-minutes are as follows:

- researching contract terms
- reporting transportation costs on a segment-by-segment basis where "oil traverses more than one aggregation point"
- research to determine existence of call on production
- collecting information from various parts of a company

[36] The MMS lacks the statutory authority to require a federal lessee to report on nonfederal transactions. In addition, the Secretary has no authority to require reporting of transactions involving federal production beyond "the point of first sale or the point of royalty computation whichever is later." 30 U.S.C. § 1713(a). Many of the transactions that the MMS would require reporting on are for nonfederal production or are beyond the point of first sale or royalty computation point.

- obtaining information from lessees, payors, and other parties to the contract
- completing forms for all changes in transactions

The reporting requirement places many unnecessary burdens on the lessee. Form MMS-4415 references the "payor," which may or may not be the same as the lessee. If only the lessee is required to report, the lessee may have insufficient data to complete the report. Similarly, the payor may have insufficient information to complete all the requirements of the form. If the payor and lessee are different and the payor reports on the lessee's transaction, should the payor provide the payor or lessee number for reporting purposes? The MMS failed to address these issues.

The proposed reporting requirement also fails to consider the realities of crude oil marketing. Crude oil is often commingled with crude from various sources, onshore and offshore leases, federal, state, or private leases and, at times, foreign crude. The barrels of crude oil are not traced to the point of ultimate disposition. Between the point of production and sale at the lease and the downstream market, numerous intervening transactions may occur at various points. The proposed rule imposes the burdensome requirement to report on each transaction.

The MMS has not clearly addressed the issue of frequency of reporting. An individual lease may be included in a contract one month, but not the next. The differential may change several times during the year in response to market conditions. Will a report be required each time any aspect of a contract changes? Requiring multiple reports would decidedly increase the reporting burden estimated by the MMS and the time required for the MMS to compile the data.

In the instructions for completing MMS-4415, the reporter is advised not to "include production subject to call rights where another party has the right to purchase oil at some predefined price basis or to match other purchaser offers." 62 FR 3758. In reality, if the holder of a crude oil call has not exercised its right, it may not be readily known to a reporting entity. Determining whether a call exists would require an expensive review of records. If the

MMS intends to exclude only production subject to a call where the call has been exercised, the MMS must clarify the proposed rule.

The MMS proposes to capture all "actual" transportation costs by segments. The actual transportation costs from the lease to an aggregation point are not tracked on a segment-by-segment basis as the MMS contemplates. Requiring the reporting of actual costs on a segment-by-segment basis adds to the already burdensome "actual cost" requirement.

Based upon the onerous obligation to report the data on the lessee's and its affiliate's crude oil production, "and not just information related to Federal lease production," the audit process will likely be time consuming and complicated. If the MMS identifies an error that impacted the location/quality differential, will the MMS retroactively adjust its published differential? Will the MMS refund royalties with interest if the differential is overstated or bill for royalties and appropriate interest if the differential is understated? Again, the MMS failed to address these issues in the proposed rule.

Much of the data collected will not be useful for the stated purpose -- publication of a location/quality differential between MMS-identified aggregation points and market centers. 62 FR 3754 (Proposed § 206.105(c)(i)(iii)). Only the reported transactions between aggregation points and market centers will provide MMS data needed for the MMS-published location/quality differential. Thus, transactions occurring between a lease and an aggregation point and sales at index pricing points would be of no relevance to the MMS-calculated differential. Lessees would spend significant money and time completing reports on such transactions that would be irrelevant to the MMS' stated purpose -- publication of differentials for each aggregation point and associated market center. 62 FR 3747.

Any MMS audit to ensure the accuracy of the information reported on Form MMS-4415 may result in an extraordinarily time consuming and costly audit process for both the MMS and lessees. The MMS would have to review every contract and applicable amendments related to a reported transaction, for federal and nonfederal contracts, and confirm that all required information was correctly reported and entered into the MMS data base correctly.

C. Lack of Statistical Viability of Data Collected

The information being collected on MMS-4415 appears to result in information that will be so diverse and sometimes duplicative that the accuracy of the data and the subsequent published location/quality differentials will be in question. The MMS has not explained the methodology it will use to calculate the location/quality differentials. The MMS must address the formula for calculating a weighted-average differential in various situations. The MMS-proposed data collection methodology contains several flaws that could cause duplicate reporting, misrepresentative data, and other concerns.

Duplicative data will be reported when two federal lessees are required to report the same transaction. However, when a transaction is between a federal lessee and a nonfederal lessee, however, only the federal lessee would be required to report. The MMS has failed to address how it will utilize or discard duplicative data in calculating a differential.

Another possible reported transaction may be an exchange between two federal lessees where one of the lessees has production subject to a call. If the amount of the exchange is 10,000 barrels with 20% of the party's production subject to call, one lessee will report 8,000 barrels and the other 10,000 barrels for the same transaction because production subject to calls are to be excluded. The proposed rule provides no explanation of how the MMS proposes to calculate the differential and take such real transactions into consideration.

In conclusion, the new data reporting requirement imposed by the proposed MMS rule is arbitrary and capricious because it collects data that is not relevant, causing an undue burden on lessees, and results in calculating a potentially inaccurate differential.

V. Miscellaneous Issues

A. Small Refiners Royalty-In-Kind (RIK) Program. 30 CFR § 208.4

The MMS proposes a change to the small refiners program by setting the sales price for the RIK oil at the value determined under proposed section 206.102(c)(2). 62 FR 3755 (Proposed § 208.4(b)(2)). The MMS currently sells RIK oil to small refiners at the value that the producers report. The MMS reasons that the new proposed pricing basis will provide certainty in pricing and simplify reporting for producers. 62 FR 3750.

Making this single pricing change to the small refiners RIK program does not address the innumerable issues that the MMS should address with respect to this program. The issues include some of the same issues that the MMS is considering in creating its own RIK program for crude oil. Although the MMS is currently working with interested parties to make changes to the small refiners RIK program, until the MMS considers and addresses all of the issues that are being raised by interested parties, the MMS should not make any change to the small refiners' RIK program. Some of the issues that should be considered include timing, delivery point, surety and notice.

In addition, the MMS specifically asked producers to address whether the proposed pricing meet the definition of fair market value under the Outer Continental Shelf Lands Act, 43 U.S.C. § 1331 *et seq*. The valuation methodology imposed in proposed § 206.102(c)(2) does not result in a fair market value of crude oil as explained above in Section III., Methodology, and should not be implemented.

B. Interim Final Rule

The MMS stated in the proposed rule that it may publish an Interim Final Rule "while it further evaluates the methodology in the proposed rule." 62 FR 3743. The MMS reasoned, "This approach would provide the flexibility to do a revision after the first year without a new rulemaking." 62 FR 3743. This interim final rule approach would violate the Administrative Procedures Act. 5 U.S.C. § 553.

Section 553 defines the four basic procedural requirements of the APA: publication; comment; timing; and petition. 5 U.S.C. § 553. An agency must publish notice of the proposed rule in the Federal Register unless the rule names specific persons who are either personally served or have actual notice of the proposed rule. *See* 5 U.S.C. § 553(b). The public must then be given an opportunity to comment on the rule. *See* 5 U.S.C. § 553(c). A proposed substantive rule cannot be published less than 30 days before its effective date. *See* 5 U.S.C. § 553(d). Finally, the agency must give the public a right to "petition for the issuance, amendment, or repeal of a rule." 5 U.S.C. § 553(e).

The APA does permit rulemaking without following the strict APA procedures when: (1) an agency published "interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice;" 5 U.S.C. § 553 (b)(3) (A); or (2) an agency finds for "good cause" that "notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest." 5 U.S.C. § 553(b)(3)(B). Of the two exceptions, only the "good cause" exception is even available as potential support for an exception with respect to the present rulemaking. The MMS, however, has not offered any legal justification to support an Interim Final Rule approach, and it is evident that case law does not support a good cause exception for this oil valuation rule.

The good cause exception is "narrowly construed and reluctantly countenanced." *American Federal Government Employees v. Block*, 655 F.2d 1153, 1156 (D.C. Cir. 1981); *United States v. Gavrilovic*, 551 F.2d 1099 (8th Cir. 1977). For example, courts have upheld new rules and regulations imposed without public notice and comment where public safety is at stake. *See, Hawaii Helicopter Operators Association v. FAA*, 51 F.3d 212 (9th Cir. 1995) (notice and comment procedure were not followed because the new air-safety rule was correcting conduct that caused 24 fatalities in the prior three years). However, good cause has not been found when an agency attempted to manipulate procedures for its own use,[37] or when any agency finds it inconvenient to comply with the APA.[38]

[37] *See, Alcaraz v. Block*, 746 F.2d 593 (9th Cir. 1984).

[38] *See, U.S. Steel Corp. v. U.S. E.P.A.*, 595 F.2d 207 (5th Cir. 1979).

No "good cause" can be shown to justify an interim final rule for royalty oil valuation, because normal rulemaking is not impractical, unnecessary or contrary to public interest in this case. Adopting an interim final rule to be in force for one year before issuing a Final Rule would magnify the uncertainty and costs that lessees and the federal government face.[39] Substantial time and effort would be spent in trying to comply with the Interim Final Rule, only to be replicated when the Final Rule is published. It also leads to more uncertainty for lessees and the federal government. Therefore, an interim final rule should not be implemented until all issues have been resolved.

CONCLUSION

For all of the above-stated reasons as thoroughly discussed and supported in Sections I.-V. above, the MMS-proposed oil valuation rule as written should not be implemented because the rule is arbitrary, capricious, and beyond the contractual and statutory authority of the agency. More specifically, the MMS proposes to move the valuation point downstream of the lease which is contrary to the MMS' statutory authority and in violation of the terms of the federal government's leases with lessees. The MMS also exceeds it statutory and contractual authority by proposing that lessees market oil at no cost to federal lessors.

Further, the proposed rule is arbitrary and capricious and should be withdrawn because the proposed rule is not supported by reasoned decision making or supported by factual evidence in the record in that the MMS-proposed rule establishes a new methodology for valuation without supporting the need for change from the current regulations which capture market value at the lease. The new valuation methodology as proposed by the MMS does not reflect current market crude oil value at the lease.

[39] The MMS has also failed to provide procedures to set up an interest bearing escrow account in which royalties paid under the Interim Final Rule are retained, and in the event that a Final Rule is not enacted or is very different from the Interim Final Rule, procedures should be put in place for refunding royalties paid with interest under the Interim Final Rule.

Finally, the MMS proposes a new and burdensome reporting requirement on federal lessees that attempts to capture more information than is necessary to support the MMS' proposal.

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