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May 5, 2015

Armand Southall
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Re: 80 Fed. Reg. 608 (January 6, 2015)

Dear Mr. Southall:

These comments are submitted on behalf of the California State Controller's Office (SCO) to the Department of the Interior's Office of Natural Resource Revenue's (ONRR) proposed "Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform", 80 Fed. Reg. 608 (January 6, 2015). Because California has no federal coal production, SCO's comments are focused on ONRR's proposals regarding oil and gas production, although it recognizes that some of its comments would apply to coal valuation as well as a result of ONRR's consolidated approach.

More detailed, section-by-section comments and recommendations are included in the Attachment to this letter. As will be seen, SCO fully supports many of ONRR's proposals and applauds its effort to pursue some long-overdue reforms. Continuing to rid the valuation regulations of "benchmarks" that were predictably dysfunctional since codification in 1988 and re-introducing administrative flexibility to valuation, within recommended limits, are just two reform proposals that SCO welcomes.

As ONRR is surely aware, the production of natural gas from federal leases in California today is not vast, particularly in comparison to that occurring in other States, such as New Mexico, or in the Gulf of Mexico. Still SCO remains concerned about the impact of ONRR's proposals for gas valuation on California's revenue interests.

ONRR, for example, did not address the concerns expressed by royalty recipients during the Advanced Notice of Proposed Rulemaking stage that prices in commercial price bulletins are subject to manipulation and indeed have been manipulated. If undervaluation results from manipulated bulletins, this will impact not only royalty revenues from use of the index option, but also from "first" arm's length contracts that reference index prices. *See e.g., Continental* Oil *Co. v. United States*, 184 F.2d 802,817 (9th Cir. 1950) (lessee not involved in undervaluation scheme still required to pay on statutory mandate of "value"). This is not an idle concern and should not have been casually dismissed by ONRR. 80 Fed. Reg. at 608. SCO and the State and Tribal Royalty Audit Committee raised similar concerns about crude oil posted prices during the comment proceedings leading to the 1988 regulations. ONRR's proposal with regard to "approval" of price bulletins does not delineate examples of the circumstances that would lead to an ONRR disapproval; ONRR's default provision for arm's length contracts with its transactional focus would not be triggered by wider spread market manipulation. Even as a prophylactic measure -- a warning to industry of potential consequences – modification of ONRR's proposals would be worthwhile. As the agency's own experiences demonstrate, millions in of potential revenue can be left uncollected by ONRR while it or a sister agency undertakes 6 plus year rulemakings to address a policy or market malfunction.

ONRR proposes transportation and processing allowance proxies for use by lessees that elect to use the natural gas index option. It also asks for input on other opportunities to streamline the valuation process, such as replacing actual cost calculations with some type of transportation schedule. 80 Fed. Reg. at 609. So long as such proxies do not reduce revenues, SCO is sympathetic to ONRR's concerns and is in agreement conceptually with a need to make new rules that can be applied with more confidence to evolving markets. *Id. See also IPAA v. Dewitt*, 379 F.3d 1036 (D.C. Cir. 2002)(recognizing that Interior must consider "administrability").

Yet, with all respect, in SCO's view the first step that ONRR needs to take is to acknowledge that to address evolving markets requires a policy framework that permits consideration of a wider range of reform opportunities. There is something incongruous about ONRR's recognition of changing markets, including the disappearance of lease markets (80 Fed. Reg. at 616), and its reaffirmation of a policy framework that embraces market valuation "at or near the lease." *Id.* at 609. ONRR's recognition that its governing statutes also specify calculation of volumes and values "*removed…from* the lease" (*Id.* at 615) is also difficult to square with the "at or near the lease" policy.

The "at or near the lease" policy, as a policy, can be changed by the Secretary in the exercise of her long recognized discretion to determine the value of production. 30 U.S.C. § 189; 43 U.S.C. 1334(a). It is worth emphasizing that the phrase "at or near the lease " does not appear in the valuation provisions of the OCS Lands Act or the Mineral Leasing Act relating to oil and gas (or coal). 30 U.S.C. § 226; 43 U.S.C. § 1336. *See also Amoco Production Co. v. Watson*, 410 F.3d 722, 727-28 (D.C. Cir. 2005), *aff'd sub nom., BP Am. Prod. Co. v. Burton*, 549 U.S. 84 (2006). The phrase is irrelevant to acknowledgment of gross proceeds as one acceptable valuation methodology. In fact, the primary administrative function of the phrase is to provide policy support for transportation and processing allowances and the complicated actual cost methodology. The Mineral Leasing Act or OCS Lands Act valuation provisions do not require transportation or processing allowances. Indeed the allowances have the effect of reducing the royalty rate below the minimum lease rate set by Congress.

The "at or near the lease" has precipitated much of the litigation challenging federal valuation rules and it is at the root of ONRR's administrative struggles with issues like unbundling. As a policy it offers no guidance to the resolution of the more complicated issues facing ONRR. An "underlying principle[]" (80 Fed. Reg. at 609) of a regulatory scheme should create coherence not discordance. It is not unlikely that ONRR's reaffirmation of the "at or near the lease" policy in this rulemaking will serve as the backbone of any challenge to, for example, any imprecision in the proposed allowance proxies.

In sum, the opportunities open to ONRR to address transportation and processing allowances are as wide as the Secretary's discretion to determine value. Thus, for example, to the extent an ONRR proposed proxy for transportation allowances is reasonable, it could be applied to the sales of all federal production, whether arm's length or non-arm's length. Indeed, as policies not specifically supported by statute, ONRR might even dispense with allowances or re-frame them depending on evolving market circumstances.

As discussed above and in the Attachment, SCO does not fully support all of ONRR's proposals. After over 30 years working in the federal royalty program, SCO is convinced that acceptance of its recommendations will streamline the process while protecting revenues. Nonetheless, SCO appreciates that most of ONRR's proposals are improvements and the agency deserves congratulations for taking steps towards adjusting rules to reflect new markets and marketing realities. Thank you for considering SCO's comments.

Respectfully,

Lee Ellen Helfrich

Lee Ellen Helfrich
Counsel to California State Controller's Office

Enclosure

SCO's Comments and Recommendations for Modification of Definitions Applicable to Oil and Gas Production

1206.20		
Arm's Length Contract	*Arm's-length contract* means a contract or agreement between independent persons who are not affiliates and who have opposing economic interests regarding that contract. To be considered arm's length for any production month, (A) a contract must satisfy this definition for that month, as well as when the contract was executed, and (B) the lessee or its affiliates were not captive sellers at the time of execution of the contract.	SCO recommends the addition of the concept of "captive sellers" to the definition of Arm's Length Contract. The addition would reflect a lessee's lack of equal bargaining power in captive market areas, which heightens the risk to the public of royalties being undervalued. SCO notes that its recommendation is consistent with ONRR's definition and proposals regarding Index Zones, which specifically require an active market. SCO's recommendation is also consistent (albeit broader and more direct) with ONRR's expressed concerns with the price deflating impact of coal cooperatives. *See also Continental Oil Co.v.United States*, 184 F.2d 802, 817 (9th Cir. 1950) (lessees who received less than value under ALC required to pay royalty on higher "value" as required by statute); *Shell Oil Co.* 52 IBLA 15 (1981) (recognizing negative impact of captive markets on contract prices)

1206.20		
Field	*Field* means a geographic region situated over one or more subsurface oil and gas reservoirs <u>or subsurface rock formations, which encompass</u> at least the outermost boundaries of all oil and gas accumulations known within those reservoirs, vertically projected to the land surface. State oil and gas regulatory agencies usually name onshore fields and designate their official boundaries. BOEM names and designates boundaries of OCS fields.	SCO recommends the inclusion of rock formations in the definition to reflect the subsurface difference in the production of oil and gas from shale.
Gathering	*Gathering* means the movement of lease production to a central accumulation or treatment or processing facility on the lease, unit, or communitized area, or to a central accumulation or treatment or processing facility off the lease, unit, or communitized area Gathering includes any movement of bulk production from the wellhead to a platform offshore.	SCO agrees with ONRR that the 1999 "Deep Water Policy" is inconsistent with the definition of gathering and should be rescinded. 80 Fed Reg. at 624. SCO also notes that transportation – the "transfer of minerals to shore" including oil and gas – is specifically defined as a "production" activity under the OCS Lands Act. 43 U.S.C. § 1331(m). Congress' definition casts legal doubt over the grant of all OCS transportation allowances. Production costs are not deductible from a royalty interest. *E.g., Garman v. Conoco Inc.*, 886 P.2d 652, 656 (Colo. 1994). Congress is not only presumed to know the cost differences that attach to different lease interests (*e.g.,* working interest, royalty interest) but also has greater authority than Interior to define what "production" encompasses in any particular leasing scenario. SCO recommends that ONRR seriously consider application of 42 U.S.C. § 1331(m) to all offshore pipelines. SCO recommends the inclusion of "processing

1206.20		
		facility" in the definition to reclassify the movement of production to a processing facility back to historic understandings of "gathering". *See The Texas Co.*, 64 I.D. 76, 80 (1957). SCO's recommendation will assist in simplifying and clarifying the federal royalty process, which ONRR stated is its goal in the rulemaking. 80 Fed. Reg. at 609. SCO fails to understand the utility of BLM or BSEE approval for a cost that is not deductible. SCO's experience is that such approvals, particularly retroactive approvals, complicate the audit and collection process. Deletion of the references to BLM and BSEE are recommended.
Marketable Condition	*Marketable condition* means lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser.	SCO recommends deletion of the "typical for the field or area" language from the definition of "Marketable Condition". As the decisions of the U.S. Court of Appeals for the District of Columbia demonstrate, the "marketable condition" obligation has no "geographical limits." *Amoco Production Co. v. Watson*, 410 F.3d 722, 729 (D.C. Cir. 2005), *aff'd sub nom., BP Am. Prod. Co. v. Burton*, 549 U.S. 84 (2006). While the concept of a "field" is bounded, ONRR's definition of "area" is so nebulous and vague that it invites dispute. After the court decisions, there is no rational reason for the Marketable Condition definition to suggest geographical limitation. Neither ONRR auditors nor lessees will be capable of demonstrating any particular sales contract is "typical" in some

1206.20		
		debatable geographic area. Typicality is no more administratively practicable than the old comparable sales benchmark.
Misconduct	*Misconduct* means any failure to perform a duty owed to the United States under a statute, regulation, or lease, or unlawful or improper behavior, regardless of the mental state of the lessee <u>or its affiliate(s)</u> or any individual employed by or associated with the lessee <u>or its affiliate(s).</u>	In light of ONRR's definition of "Affiliate" and its focus on the power to control by a lessee or of a lessee, SCO recommends the inclusion of affiliate behavior in the definition of misconduct.
Processing Allowance	*Processing allowance* means a deduction in determining royalty value for the reasonable, actual costs the lessee incurs for processing gas. <u>Processing allowance does not include any costs associated with the marketing of the production or placing the production in a marketable condition</u>.	SCO recommends inclusion of the highlighted language regarding marketing and marketable condition costs to avoid lessee confusion regarding the scope of actual costs. Reiteration of costs disallowed in both the definition and subsequent regulations promotes certainty and regulatory consistency. *See e.g.*, 80 Fed Reg at 624 (ONRR discussion of Deep Water Policy). SCO makes the recommendation above as an alternative to its recommendation *infra* that processing be reclassified as a non-deductible marketable condition cost.

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Transportation Allowance	*Transportation allowance* means a deduction in determining royalty value for the reasonable, actual costs the lessee incurs for moving: (1) Oil to a point of sale or delivery off the lease, unit area, or communitized area. The transportation allowance does not include gathering, <u>marketing or marketable condition costs, including but not limited to costs bundled into a transportation charge, or any cost, expense or fee not directly connected to the actual movement of the federal oil.</u> (2) Unprocessed gas, residue gas, or gas plant products to a point of sale or delivery off the lease, unit area, or communitized area, or away from a processing plant. The transportation allowance does not include gathering, <u>marketing or marketable condition costs, including but not limited to costs bundled into a transportation charge, or any cost, expense or fee not directly connected to the actual movement of the federal gas.</u> (3) ……	SCO recommends inclusion of the highlighted language regarding marketing, marketable condition and other types of non-deductible costs and expenses (*e.g.,* line losses, storage) in the definition of Transportation Allowance. SCO's rationale is identical to its recommended modification of the term "Processing Allowance", above. The above comments and those that follow should not be read as agreement by SCO to an actual cost methodology for calculation of a transportation allowance or to the application of allowances in determining royalty value. The discussion in the cover letter to these section-by-section comments is incorporated by reference to all provisions related to allowances.

SCO's Comments and Recommendations for Modification of ONRR Proposals Applicable to Crude Oil

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Current 1206.101(c)(1) **Director Agreements**	ONRR proposes a new "default" provision that would provide it with the flexibility to determine value in questionable circumstances. Given this flexibility, it is questionable whether "Director Agreements" remain a viable means of resolving calculation of future royalties, particularly given that such agreements could be challenged by are challengeable by federal royalty recipients. *E.g.*, *Chiang v. Kempthorne*, Civ. Action No. 04-199 (D.D.C. 2007)(State standing to challenge final agency actions regarding federal royalties). Moreover, there is a degree of confusing procedural conflict between such agreements and the recognition elsewhere in the proposals that only the Assistant Secretary has the authority to bind the Department to a particular valuation methodology in specific cases. If not deleted from the regulations, SCO recommends that this subsection be clarified by identifying the authority for it and explaining its role, through citations references or otherwise, under the valuation regulations.
Proposed 1206.101(c)(1) **ALC Sales**	SCO supports ONRR's proposal, discussed at 80 Fed. Reg. at 613, to disallow retroactive elections of applicable valuation criteria in the event the lessee misreports the nature of its contract. Unfortunately, it does not appear that the regulatory language at 1206.101(c)(1) actually captures ONRR's stated intent. SCO is concerned, however, that ONRR has created, albeit unintentionally, an ambiguity regarding redetermination of royalty value in such a circumstance. This ambiguity results from ONRR retaining discretion to re-determine value for the period of misreporting, *i.e.*, the use of the word "may" as opposed to "will" or "shall". *See also* Proposed 1206.104, 1206.105. In the event that the error results in an undervalued royalty payment, some re-

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	determination must be made by ONRR of the value of the production.
Current 206.103(b)(1) **Tendering**	SCO expresses no opinion on removal of the "tendering" option to value crude oil in the Rocky Mountain Region, except to note that, as an historical matter, SCO opposed use of such an option in California and nationwide during prior rulemaking proceedings.
Proposed 1206.102(d) and (e) **NALC Sales**	1206.102(d) and (e) address ONRR's authority to re-determine ANS or NYMEX value in any particular case or at the refinery gate where it is found to represent an unreasonable value. As SCO understands ONRR's proposal, it would re-determine "unreasonable values" according to the procedures set out in proposed 1206.05. To the extent that 1206.102(d) and (e) can be read to authorize ONRR to establish a value less than the ANS value, SCO recommends modification of 1206.102(d) and (e) to restrict ONRR's authority to reset value to situations where it is determined that the ANS value is "unreasonably low." To SCO's knowledge, there has been no credible claim that use of ANS yields an unreasonably high value in any situation where it was not the elected option of a lessee since the 2000 final rule authorizing use of ANS value. There is simply no history in California of prices set by the "market" – by industry itself – being too high.
Proposed 1206.104(c)(2) **Gross Proceeds Requirements**	SCO supports ONRR's proposal to reject gross proceeds under a lessee's or affiliate's arm's length contract when the price stated is "unreasonably low." As the agency notes, its proposal is consistent with a lessee's duty to act for the mutual benefit of the lessor and lessee by seeking the best price. We believe ONRR's explicit acknowledgement of this duty is a true step forward. For the following reasons, SCO cannot support ONRR's proposal to evaluate whether the lessee has met this duty only when the contract price is 10% below the lowest reasonable measure of value. First, ONRR does not explain the basis for its choice of a 10% trigger for initiating a re-determination. Depending on volumes and values, 10% can result in leaving

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	significant amounts uncollected under questionable circumstances. Without knowing the basis for ONRR's 10%, SCO cannot evaluate whether it sufficiently protects California's interests. Adding to our concern is the fact that ONRR selects 10% as the trigger for undertaking a re-determination of natural gas proceeds and coal too, which suggests that it was not selected based on any analysis or experience with relative pricing in these different markets. Second, the determination of what is the "lowest reasonable measure" for evaluating whether some contract price is even lower is ambiguous ("including but not limited to ...."). Third, ONRR does not commit to making a re-determination or even an inquiry if the contract prices fall on the wrong side of 10%. Yet, rather than recommending deletion of this proposed provision, SCO recommends that ONRR make the following modifications: (1) Given that State delegates often have more familiarity with the markets in their jurisdictions, the 10% should be re-framed as an automatic trigger for re-determination with ONRR committing to assist and address any "unreasonably low" contract price that falls inside ONRR's 10% that is referred to it by a State delegate. (2) Because of the difficulty of accessibility of comparable contract prices and the unreliability of unaudited reported information, the "lowest reasonable measure" for determining if an any particular price falls outside the 10% should be set by ONRR at the ANS or NYMEX price for oil and the highest index price for an active index zone for gas. Indeed, we recommend that the phrase "lowest reasonable measure" be changed to "lowest reasonable and publicly accessible measure." (3) If a contract price falls outside the 10% trigger, ONRR "shall" not "may" conduct a review of the value of the production after consultation with State delegates, if any, on both the necessity for a re-determination and the appropriate value. As discussed in the cover letter to these comments, SCO also recommends that ONRR include a provision for application of a default value to situations involving use of

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	index pricing from published bulletins referenced in the pricing provisions of contracts if it is determined that the index prices are undervalued as a result of market manipulation and other malfunctions resulting from misconduct, whether or not the lessee or its affiliates are involved in the misconduct. Acceptance of royalties on an undervalued basis from any lessee is not within ONRR's statutory mandate. *See Continental Oil Co.*, 184 F.2d at 817.
Proposed 1206.104(g) **Gross Proceeds Requirements**	SCO agrees with ONRR that any contract, revision, amendment, *etc.* must be in writing and signed by all parties. It is not a burdensome requirement to require of lessees and will avoid disputes concerning the very existence of a contract.
Proposed 1206.105 **"Default" Provision**	SCO agrees that ONRR should not be bound to any type of "benchmarks" in making a value determination or re-determination. Flexibility should allow ONRR to respond to unique circumstances, including regional and jurisdictional differences. While it is true that proposed 1206.105 is reminiscent of the pre-1988 valuation provision (80 Fed. Reg. at 614), it is also true that during that time period contract gross proceeds were considered the floor value. *See e.g.*, 30 CFR 221.47 (1976). SCO recommends that ONRR include floor values as a limit on Secretarial discretion. With all respect, there have been numerous times over the decades of the federal royalty program where questionable actions have been taken by Interior to reduce lessee obligations (*e.g.*, the Deep Water Policy) offshore gathering). Royalty recipients, at the very least, deserve the minimal guarantee that a floor value provides. For California, SCO recommends that ANS be established as the floor value for oil under 1206.105 and that the highest index price from approved commercial bulletins in an active index zone be the floor for gas. As noted above in the context of proposed 1206.104(c)(2), SCO also recommends that the regulation specifically commit ONRR to consult with State delegated offices regarding values

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	established under 1206.105.
Proposed 1206.108(e) **Value Determinations**	For the reasons stated in SCO's comments on proposed 1206.105, SCO recommends that floor values apply to both ONRR and the Assistant Secretary in issuing guidance and value determinations.
Proposed 1206.108(g) **Value Determinations**	SCO recommends deletion of 1206.108(g). First, it does not appear to be included in the gas and coal counterparts to 1206.108(g), which may indicate that its inclusion in oil was the result of a scrivener mistake. Second, it is confused by referencing subsection (d), which pertains to ONRR guidance not to determinations; ONRR does not issue "valuation determinations". Third, if it was intended to apply to ONRR guidance, the subsection is also inconsistent with subsection (d), which states that ONRR guidance is non-binding. The non-binding nature of agency guidance has been repeated confirmed by the courts. *IPAA v. Babbitt,* 92 F.3d 1248, 1256-57 (D.C.Cir. 1996). Because of its non-binding nature, an agency is free to retroactively apply decisions representing final agency action; lessees have no reliance interest in guidance. For ONRR to suggest otherwise, as it does in 1206.108(g), invites needless litigation as well as being legally questionable.
Audits and Reconciliations	SCO notes that the proposed oil regulations do not appear to contain a section dealing with the "finality" of audits, reconciliations, etc. as do the gas and coal regulations. *E.g.*, 1206.147.

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Proposed 1206.110 **Transportation General**	As discussed in SCO's cover letter, it is SCO's position, based on law, that determination of the scope and calculation of transportation allowances, as well as the determination of whether such deductions should be permitted at all, is one that falls within the Secretary's long recognized authority to determine value regardless of a lessee's particular sales arrangement.
Proposed 1206.110(a)(2)(ii) **Transportation General**	*See* SCO's comments on the proposed definition of "Gathering".
Proposed 1206.110(b) **Transportation General**	SCO supports ONRR's proposal to disallow lessee requests for retroactive changes to their royalty reports and payments. ONRR should follow this policy through to situations involving lessee failure to report allowances. If the lessee does not take advantage of an allowance by reporting it, it should not receive formal or informal ONRR approval to make a retroactive change, which would reduce its royalty payments. This at one time did reflect the policy position of ONRR's predecessor agency, MMS. SCO recommends that ONRR add a new subsection (h) to address the consequences of failure to report a transportation allowance. Such a situation falls outside ONRR's proposed 1206.110(f).
Proposed 1206.110(d) **Transportation General**	SCO supports ONRR's proposal to disallow requests by lessees to exceed the cap on transportation allowances. In SCO's view, however, ONRR should have gone further and re-evaluated the meaningfulness of the cap, 50% of sales value, which has been in existence for well over 60 years. The cap does stand as proof of a long standing policy that the Secretary maintains substantial discretion to limit allowances without regard to the actual costs incurred by a lessee. *E.g., Walter Van Norman Jr.*, 126 IBLA 375, 379 (1993)(discussing processing

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	allowances under 1920 rules as representing policy that the government is not bound to lessee's actual costs). Indeed in earlier years, Interior did not subsidize a lessee's choice of market and the 50% cap applied to transportation costs at the "first available market." *Walter Oil and Gas Corp.*, 11 IBLA 260, 265 (1989). Even though the current regulations are more industry friendly with regard to allowances, it is safe to conclude, that the minerals markets, including the intermediate markets like transportation, have changed dramatically since the 50% policy was first put into effect. Updating the cap is long overdue. For example, in California it would be surprising to see an onshore oil pipeline cost that exceeds $2.00 a barrel. The lowest first purchase price in the State over the last ten years was $31.68 onshore in December 2008. http://www.eia.gov/dnav/pet/pet_pri_dfp1_k_m.htm. The 50% cap exceeds $2.00 in transportation by a multiple of 8. To say a 50% cap will "ensure a fair return to the public" in such circumstances is quite a rosy characterization, if not simply misleading. 80 Fed. Reg. at 624. SCO recognizes that there may be regions of the country where the per barrel cost is greater or where more expensive forms of transportation, such as rail, may be more predominant. Indeed, the transportation costs offshore California can be double those onshore. To use those to establish a reasonable cap onshore would distort transportation realities and be contrary to the revenue interests of California and the public at large. It is not fair to the public to maintain a cap intended as a limit on deductions that does not meaningfully protect revenue interests. A cap should not be set so high that it precludes costs incurred by only a handful of outliers. It also is instructive in this regard that ONRR's calculation of the average cost of gas transportation for all onshore and offshore California is 10% of sales value. To posit that the 50% is realistic in the face of such averages would mean that there are some quite hefty per MMBtu outliers. For the forgoing reasons, SCO recommends that: (1) transportation allowance caps be calculated separately for each State with federal production and for each offshore region, and (2) that the cap be determined by the percentage derived from the average sales value

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	and average transportation cost in that State or region over the most recent 10 year period, and (3) that percentage will be updated by ONRR annually and published on its website. Thus, for example, if the average sales price for federal crude oil in State X from 2004 through 2014 was $50 and the average transportation cost over the same period was $5.00, the transportation allowance cap would be 10% in that State. If during the 2005 through 2015 period, the average sales price was $52 and the average transportation cost was $4.50, the cap would be reduced to 8.6%. A similar calculation based on average prices and transportation costs could be made for gas. Both the average sales prices and average transportation costs should be made publicly available by ONRR at the time the caps are published. The cap would be sensitive to both changes in value and in transportation costs on a basis that protects both State royalty recipients and the public at large. While the calculation would be based in part on unaudited (and presumably bundled) information reported to ONRR, use of which would err to the benefit of industry benefit, its function is as a cap not a proxy.
Proposed 1206.110(f) **Transportation General**	SCO incorporates by reference its comments to proposed 1206.110(d) and proposed 1206.104(c)(2). Consistent with those comments, SCO recommends the following with regard to transportation allowances under proposed 1206.110(f): (1) Given that State delegates often have more familiarity with the markets in their jurisdictions, the 10% should be re-framed as the automatic trigger for re-determination with ONRR committing to assist and address any "unreasonably high" transportation cost that falls inside ONRR's 10% that is referred to it by a State delegate. (2) Because of the difficulty of accessibility of comparable transportation charges and the unreliability of unaudited reported information, the "highest reasonable measure" for determining if any transportation allowance falls outside the 10% should be set by ONRR at the cap amount as calculated and recommended by SCO in its comments regarding proposed 1206.110(d) (3) If a reported transportation allowance falls outside the maximum 10% trigger, ONRR

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	"shall" not "may" conduct an investigation of the value of the production after consultation with State delegates, if any, on both the necessity for a re-determination and the appropriate value. SCO notes that should ONRR agree with its recommendations to modernize the 50% cap on allowances this proposed provision, at the very least, would decrease the administrative burden, including the probable appeals burden, of making re-determinations of transportation allowances.
Current 1206.111(b)(2) **ALC Transportation**	SCO agrees with ONRR that royalty is due on the volume, as well as the value, of production "removed" from a lease. SCO also agrees that this statutory principle supports ONRR's proposal to disallow including line losses, of whatever nature, in an actual costs methodology. 80 Fed. Reg. at 615. SCO strenuously disagrees that this statutory principle applies only in non-arm's length situations; labeling it a "fee" does not change its character as a reduction in royalty volumes. There is no rational basis for changing the classification of this cost based on the arm's length or non-arm's length nature of the contract. SCO, thus, recommends that lines losses be reclassified as non-deductible in arm's length transportation situations.
Current 1206.111(b)(5) **ALC Transportation**	SCO recommends that so-called "short term storage" be reclassified as nondeductible "storage". Royalty is due at the time of production. *BWAB Inc.*, 108 IBLA 250, 256-57 (1989). *See also U.S. v. General Petroleum Corp.*, 73 F. Supp. 225,258 (S.D. Cal. 1946), *aff'd Continental Oil Co. v. U.S.*, 184 F.2d 802 (9th Cir. 1950). This is a statutory requirement, not a matter within Interior's discretion. Application of this principle precludes the deductibility of all storage, whatever the reason for the decision to store. Moreover, the distinctions made between storage and short term storage, as well as others discussed herein, are the very type of arbitrary classifications that create confusion for

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	auditors, industry and the courts. *See e.g., IPAA v. Babbitt*, 91 F.Supp.2d 117, 127 (D.D.C. 2000), *rev'd, IPAA v. Babbitt,* 92 F.3d 1248 (D.C. Cir. 1996). Certainty and clarity would be advanced if ONRR would apply royalty principles in a consistent, across the board manner.
Current 1206.111(b)(9) **ALC Transportation**	The costs of securing a letter of credit are administrative in nature. They are unrelated to the direct costs of moving production; of operating the pipeline or other means of transport. Indeed costs of securing a letter of credit are akin to the administrative costs, legal fees, and marketing costs that are rightfully classified as non-deductible under 1206.111(c). SCO recommends that the costs of securing a letter of credit be reclassified as non-deductible.
Proposed 1206.111(c)(9) **ALC Transportation**	SCO supports ONRR's proposal to preclude the inclusion of booked line fill costs as a deductible component of a transportation allowance. Because it occurs after the point of royalty settlement, deeming the cost deductible is an indirect reduction in the volume of production. Under tariffs, typically line fill remains deliverable to a shipper. Thus, even without addressing marketability requirements, line fill should not be deemed deductible under the statutory principle that royalty is due on the date of production and on the total volume at the approved measurement point. *BWAB Inc.*, 108 IBLA 250, 256-57 (1989). *See also U.S. v. General Petroleum Corp.*, 73 F. Supp. 225,258 (S.D. Cal. 1946), *aff'd Continental Oil Co. v. U.S.*, 184 F.2d 802 (9th Cir. 1950). Nonetheless, ONRR is correct to view line fill as falling within a lessee's duty to market. It is a specification imposed by the pipeline related to efficient movement based on the condition of crude oil. It is thus analogous to the compression and dehydration costs involved in Devon *Energy Corp. v. Kempthorne*, 551 F.3d 1030 (D.C. 2008). .
Current 1206.110(g)	SCO fully supports ONRR's proposal to delete the provision that allows lessees to avoid separate reporting of transportation costs. The regulation, 1206.110(g), regarding

Regulation	
Transportation Factors	transportation factors never made administrative sense and its deletion is long overdue.
Proposed 1206.112(b)(3)(2) **NAL Transportation**	For the reasons set out at 80 Fed. Reg. at 615, SCO fully supports ONRR's long overdue proposal to calculate the return on undepreciated capital investment on an asset's salvage value.
Proposed 1206.112(c)(2)(ii) **NAL Transportation**	For the reasons set out at 80 Fed. Reg. at 615, SCO fully supports ONRR's long overdue proposal to treat theoretical and actual line losses as non-deductible. SCO, as discussed in connection with 1206.111(b)(2) above, believes fees associated with line loss should be non-deductible under the arm's length transportation allowance regulations as well. Whether a contract is arm's length or not is irrelevant to ONRR's legal rationale for its proposed 1206.112(c)(2)(ii).
Proposed 1206.112(i)(1) and 1206.112(i)(1)(i) **NAL Transportation**	For the reasons set out at 80 Fed. Reg. at 615, SCO fully supports ONRR's long overdue proposal to allow a pipeline to be depreciated only once even in situations involving a change in ownership.
Proposed 1206.112(i)(3) **NAL Transportation**	ONRR proposes to decrease the cost of capital from 1.3 times BBB to the BBB. SCO recognizes this as a worthwhile improvement to current non-arm's length transportation allowance calculations. SCO notes that transportation facilities are considered creditworthy and less susceptible to the ups and downs experienced by the production sector and other midstream energy markets.

SCO's Comments and Recommendations for Modification of ONRR Proposals Applicable to Gas Production

Current 1206.140(c)(3) **Director Agreements**	SCO incorporates by reference its comments to 1206.100(d)(3).
Proposed 1206.141(a)(4) **Unprocessed Gas Value**	SCO supports ONRR's proposal to reclassify all "wet gas" contracts setting post-processing purchase prices as sales of "processed gas" as opposed to "unprocessed gas". This will allow ONRR to capture values for royalty purposes based on changes in contracting practices and in the markets for wet gas that have occurred over the past several years.
Proposed 1206.141(b) **Unprocessed Gas Value**	SCO agrees that the benchmark system for non-arm's length situations under the current regulations is unwieldy for both ONRR and industry, and does not reflect the structure of the sales market for gas.
Proposed 1206.141(c) **Unprocessed Gas Value**	SCO acknowledges the theoretical appeal of an index based option for valuation of natural gas not sold under an arm's length contracts. Based on the information and rationale provided by ONRR, however, SCO is not in the position to endorse the approach as proposed. SCO cannot, for example, endorse ONRR's proposal to limit consideration of indices to the first index pricing point on a pipeline. While this might be an understandable limit if the transportation adjustment under the index methodology were based on actual costs, ONRR proposes a percentage of value proxy (albeit with a cents per MMBtu floor and cap) based on nationwide averaging (excluding GOM). In any event, ONRR does not provide any reasoning behind this and many of other of its choices. If ONRR goes forward with an index option, SCO also recommends that lessees perform a comparison of index values to the proceeds under their first arm's length contract, without consideration of an actual cost transportation calculation, and report and pay annually a true up of

	any additional royalty payment due. *See e.g.,* 30 CFR 1206.172 (Indian gas). Use of the proxy for transportation will simplify the true up for industry and ONRR. ONRR did not discuss this option, which was recommended by some States, in any detail. The only hint regarding ONRR's rejection of a true up was its opposition of "[v]ery large companies". 80 Fed. Reg. at 609. Before baldly asserting that that its index proposal "generally represents the gross proceeds net of transportations allowances accruing to the lessee" (80 Fed. Reg. at 618), it is recommended, at the least, that ONRR require the recommended true up for a pilot period to determine both its administrative practicality and the viability of index for protecting the public's revenue interests.
Proposed 1206.142(a) **Processed Gas Value**	As noted above with regard to proposed 1206.141(a)(4), SCO supports ONRR's proposal to value lessee sales to processing plants under contracts setting the price on the gas and products after processing as sales of processed gas under the regulations for valuation of processed gas The rationale provided by ONRR at 80 Fed. Reg. at 619 is incorporated by reference herein.
Proposed 1206.142(b) and (c) **Processed Gas Value**	SCO has no objection to proposed 1206.142(b) and (c), with the caveat that SCO's proposals to modify 1206.143 and 1206.144 will be fully applicable to evaluation of the contracts and that ONRR adopts SCO's recommendation to modify the definition of Arm's Length Contract. SCO has serious concerns about captive sales to processing plants in California; concerns that are reinforced by ONRR's conclusion regarding the limited markets for wet – unprocessed – gas. *See* 80 Fed. Reg. at 623 (ONRR discussion of proposed 1206.151). Indeed, if there is no market for wet gas, other than one dependent on prior processing of the gas, the notion that processing should remain deductible at all is subject to question under a straight forward application of the marketable condition rule. Processing is an intermediate service that places the gas in the condition expected by purchasers in the wider oil and gas market.
Proposed 1206.142(c) and (d)	SCO acknowledges the theoretical appeal of an index based option for valuation of natural gas not sold under arm's length contracts. Based on the information and rationale provided by ONRR, however, SCO is not in the position to endorse the approach as proposed. Part of SCO's rationale

Processed Gas Value	is set forth in the cover letter to these section by section comments and incorporated by reference herein and in the comments on 1206.141(c). If ONRR proceeds to adopt its index proposal, SCO also recommends that industry perform a "safety net" comparison of its index values to the first arm's length gross proceeds, without consideration of an actual cost transportation calculation, and report and pay annually a true up of any additional royalty payment due. *See e.g.,* 30 CFR 1206.172 (Indian gas). Use of a proxy for transportation will simplify the true up for industry and ONRR.
Proposed 1206.143 and Proposed 1206.144 **Gross Proceeds And "Default" Provisions**	SCO incorporates by reference its comments to ONRR's comparable proposal for oil, proposed 1206.104 and 1206.105
Proposed 1206.148 **Valuation Determination**	SCO incorporates by reference its comments to ONRR's comparable proposals for oil, proposed 1206.108.
Proposed 1206.151	SCO agrees with this proposal to the extent that it confirms that lease provisions, whether they provide for dual accounting or major portion analysis, control over the provisions of the regulations.

Dual Accounting	
Proposed 1206.152 **Transportation General**	SCO incorporates by reference its comments to ONRR's comparable proposals for oil, proposed 1206.110.
Current 1206.153(b)(2) **ALC Transportation**	SCO recommends reclassifying Gas Supply Realignment (GSR) costs as non-deductible. These costs are not remotely related to the costs associated with the actual movement of particular volumes of federal production. Instead, GSR costs are administrative and contractual in nature, resulting from federal regulatory requirements. On their face, GSR fees are more analogous to the non-deductible list of costs and fees listed in 1206.153(c). The U.S. should not subsidize industry federal compliance efforts through the royalty program.
Current 1206.153(b)(5) **ALC Transportation**	SCO recommends reclassification of Gas Research Institute (GRI) fees as non-deductible. As the rule notes, these fees are used for research efforts that may benefit the industry and the public as a whole. They are not remotely related to the costs associated with the actual movement of particular volumes of federal production, whether they are a mandatory part of a FERC tariff or not. That FERC tariffs include costs beyond those representing the actual cost of transportation for royalty purposes is well known to ONRR; that FERC requires the fee payment is not a reason to make a cost deductible. On their face, GRI fees are more analogous to the non-deductible list of costs and fees listed in 1206.153(c). Like lessee taxes, the public should not be required to subsidize a fee imposed on industry by a federal or state government through the royalty calculation.
Current 1206.153(b)(6) **ALC Transportation**	SCO recommends reclassifying Annual Charge Adjustment (ACA) fees as non-deductible. FERC imposes ACA fees on pipelines to recover the agency's operating expenses. ACA fees are not remotely related to the costs associated with the actual movement of particular volumes of federal production. On their face, ACA fees are more analogous to the non-deductible list of costs and fees listed in 1206.153(c). Like lessee taxes, the public should not be required to subsidize a fee

	imposed on industry by a federal or state government through the royalty calculation.
Current 1206.153(b)(7) **ALC Transportation**	SCO incorporates by reference its comments to 1206.111(b)(2).
Current 1206.153(b)(8) **ALC Transportation**	SCO incorporates by reference its comments to 1206.111(b)(5).
Current 1206.153(b)(9) **ALC Transportation**	SCO incorporates by reference its comments to 1206.111(b)(9).
Proposed 1206.154 **NAL Transportation**	SCO incorporates by reference its comments to ONRR's comparable proposals for oil, proposed 1206.112. For the reasons set forth in its comments to 1206.111(c)(9), SCO disagrees with ONRR that fuel used for transportation purposes should be deductible. 80 Fed. Reg. at 626. SCO recommends that ONRR specifically classify such costs as non-deductible.
Proposed 1206.159 **Processing Allowance General**	SCO incorporates by reference its comments to ONRR's comparable proposals for oil, 1206.110. Consistent with its prior comments and recommendations regarding the 50% transportation limit and the definition of "Gathering", SCO recommends that the cap for processing allowances be set at the minimum per gallon rate set forth at 80 Fed. Reg. at 620.

Proposed 1206.160 **ALC Processing**	SCO incorporates by reference its comments to ONRR's comparable proposals for oil, proposed 1206.111.
Proposed 1206.161 **NAL Processing Allowance**	SCO incorporates by reference its comments to ONRR's comparable proposals for oil, proposed 1206.112.