Department of the Interior
Minerals Management Service

COMMENTS

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on the Proposed Rule
for Establishing Oil Value for Royalty
Due on Federal Leases and on Sale of Federal Royalty Oil

In Response to the Notice of
September 22, 1997
62 *Federal Register* 49460

Minerals Management Service
Royalty Management Program
Rules and Procedure Staff
Building 85, Denver Federal Center
Denver, Colorado 80225

VIA OVERNIGHT COURIER

Attn: David Guzy, Chief
Rules and Procedure Staff

Dear Mr. Guzy:

In response to the subject Notice, Coastal Oil & Gas Corporation, ANR Production Company, CIG Exploration, Inc., and Coastal States Trading, Inc. (collectively **Coastal**) offer the following Comments. These Comments are in addition to, and not in lieu of, its original and Supplemental Comments previously filed in this matter.

I. COASTAL

The Coastal Corporation is a diversified energy company with consolidated assets of over $11 Billion. The Coastal Corporation has operations in oil and gas exploration and production, natural gas transmission and storage, natural gas marketing, crude oil refining and marketing, coal, chemicals, trucking, and power generation.

II. BACKGROUND

A. Notice of Proposed Rulemaking.

On January 24, 1997 (62 *Fed Reg* 3741), the Minerals Management Service (the **MMS**) published a Notice of Proposed Rulemaking to amend the current Federal royalty crude oil valuation regulations (30 *CFR* Part 206). The proposal would require most Federal lessees to value oil for royalty purposes on the New York Mercantile Exchange (NYMEX) futures prices at Cushing, Oklahoma, less certain quality and location differentials (even though the oil was never moved or repositioned to Cushing or sold there), and a transportation allowance between the lease and the first Aggregation Point. Lessees would be required to file a new form (MMS 4415) so that the MMS would collect and publish quality and location differential data between Aggregation Points and six Market Centers (the **Proposed Rule**).

Following the publication of the Proposed Rule, the MMS conducted a series of public hearings in Houston, New Orleans, and other cities to gather oral comments and feedback.

Numerous petroleum industry groups representing thousands of Federal lessees, including, but not limited to, the American Petroleum Institute (API), the Domestic Petroleum Counsel (DPC), the Independent Petroleum Association of America (IPAA), the Council of Petroleum Accountant's Societies (COPAS), the Independent Petroleum Association of Mountain States (IPAMS), and the Rocky Mountain Oil & Gas Association (RMOGA), etc. (**Industry**), filed written Comments on the Proposed Rules. In addition, over 35 individual oil and gas exploration and development companies and crude oil trading companies, including Coastal, also filed written Comments on the Proposed Rules.

In summary, Industry and company Comments requested the MMS to withdraw the Proposed Rule on the grounds that:

(i) The MMS does not have the legal authority to value production away from the lease;

(ii) NYMEX futures prices are not comparable to and are not a valid indicator of value at the lease, even after deducting the MMS' proposed differentials and allowances;

(iii) The Proposed Rule is a radical departure from present lease terms and past practices for which there is no legal or factual support; and

(iv) The Proposed Rule is overly complex and would be expensive and burdensome to administer.

Most of the subject Comments also suggested, as a permanent solution for Federal royalty oil valuation, that the MMS take their royalty share of production In-Kind instead of In-Value (**RIK**).

Finally, the subject Comments suggested that in the interim, while the MMS prepares for RIK, the MMS could make relatively minor changes to the present valuation benchmarks which would address its concerns over Posted Prices without radically changing the whole royalty valuation system.

B. Notice of Supplementary Proposed Rule.

On July 3, 1997 (62 *Fed Reg* 36030), the MMS published a Notice of Supplementary Proposed Rule.

In response to that notice, Coastal and others filed Supplemental written Comments.

C. Notice for Comments on Additional Alternatives.

On September 22, 1997 (62 *Fed Reg* 49460), the MMS published a Notice requesting Comments on additional alternatives for the valuation of crude oil produced from Federal leases and scheduling a series of Workshops to discuss the Proposed Rule and various alternatives.

Following the publication of the subject Notice, the MMS held Workshops in Denver, Houston, Casper, Bakersfield, and Washington, D.C. with representatives of Industry, oil producing States, and public interest groups.

During the Workshops, the MMS stated that their goals in this rulemaking were (i) simplicity, (i) certainty, (iii) elimination of lessee auditing, and (iv) ensuring that lessees would know how much royalty to pay prior to the 20th of the month following the month of production.

These Comments are filed as Coastal's response to this Notice.

III. COASTAL'S POSITION

A. Royalty In-Kind.

Coastal endorses the goals of the MMS (as stated, above), and, therefore, Coastal believes that the MMS should take all its royalty share of production In-Kind at the first measurement point downstream of the wellhead or Lease. RIK is by far the easiest and most efficient method of eliminating royalty valuation problems and simplifying the Rules. By implementing RIK, the MMS is ensured of receiving the true value for their oil at or near the lease, while at the same time it virtually eliminates all lessor/lessee royalty valuation problems, perceived or real, thereby eliminating the necessity of the MMS to conduct lessee audits, and provides certainty and simplicity for both the lessee and the MMS.

B. The Proposed Rule.

For the reasons stated herein, in its original Comments, and its Supplemental Comments, Coastal remains opposed to any rule which, contrary to applicable Federal law and the terms of the Leases, values royalty at a point other than at or near the lease. Further, Coastal remains opposed to any rule which would use non-comparable (in quality, quantity, and term) futures contracts as the basis for establishing present valuation of oil at or near the lease. Coastal also remains opposed to any rule that does not allow the deduction of reasonable transportation, handling, and marketing expenses if value is established at a point downstream of the lease. In summary, if the MMS desires to participate in the mid-stream oil business, the MMS must be willing to take the risks and pay the costs inherent in such business.

C. The Benchmark Valuation System.

In the interim period, until the MMS fully implements RIK, Coastal recommends that the MMS adopt a Benchmark Valuation System for lessees who sell or transfer production to a mid-stream business affiliate. (Lessees who do not sell or transfer their production to an affiliate would continue to pay royalty based upon the price they received in arm's-length sales.) Coastal recommends the following Benchmarks:

(NOTES FOR ALL BENCHMARKS - Lessees should be permitted to select any Benchmark that the lessee believes is best suited to its situation [i.e., a menu of Benchmarks rather than a hierarchy of Benchmarks], and lessees should never be required to use any particular Benchmark against its wishes, unless that Benchmark is the only Benchmark applicable.)

(i) The price received by the lessee as the result of an arm's-length Bid-Out (also called Tendering) Program of Significant Volumes (as hereinafter defined) in the same field or area, or if sold downstream of the lease, the price received, less reasonable transportation, handling, and marketing expenses.

For royalty valuation purposes, a volume is deemed to be significant if it is equal to or exceeds a minimum reasonable percentage or volume of production (e.g., a percentage equal to the MMS' royalty share, plus 2%, or if production is transported by truck or tank car, a volume equal to a full load) (**Significant Volumes**).

(NOTE FOR BENCHMARK (i) - Adopting the concept of Significant Volumes and deleting any reference to "comparable contracts" would eliminate the problems and audit questions associated with like quantity and like quality issues as discussed in the Workshops.)

(ii) The price received and published by the MMS for RIK oil sold from another lease in the same field or area and sold at or near the lease, or if sold downstream of the lease, the price received and published, less reasonable transportation, handling, and marketing expenses.

(NOTES FOR BENCHMARK (ii) - A Significant Volume in this situation is the MMS's share of production from the subject lease, and, until the MMS fully implements RIK, the MMS should be required to take and sell, at a minimum, all of its share of production from selected leases in each major field or area in order to provide the price data for this Benchmark.)

(iii) The price received by the lessee or the lessee's affiliate in arm's-length sales of Significant Volumes in the same field or area;

(iv) The price paid by the lessee or the lessee's affiliate in arm's-length purchases of Significant Volumes in the same field or area;

(v) The gross proceeds received by the lessee's affiliate in the first arm's-length sale of Significant Volumes, less reasonable quality and location differentials, and less reasonable transportation, handling, and marketing expenses.

(vi) An applicable index, at or as near to the lease as possible, less reasonable location and quality differentials, and less reasonable transportation, handling, and marketing expenses.

(This last Benchmark would most likely be used, for example, in a situation where all the production is repositioned or transported to an affiliated refinery, or where there are no arm's-length sales of Significant Volumes, but may be selected as a Benchmark by any lessee to whom the Benchmarks apply.)

(NOTE ON PREVIOUSLY RECOMMENDED BENCHMARK - While Coastal, the IPAA, and others originally proposed an additional Benchmark based upon <u>third-party arm's-length sales or purchases</u> in the same field or area, Coastal now acknowledges that this Benchmark, desirable as it may be because it represents value at the lease, is probably not workable at this time due to the fact that this information is not generally available to other lessees on a timely basis, and even if it were, it would be based upon unaudited reports subject to change at a later time. Coastal, therefore, temporarily withdraws its recommendation for this Benchmark until such time as this data becomes readily available on a timely and reliable basis, either by the MMS, by electronically publishing data from a revised MMS Form 2014, or by independent publishers.)

D. The Gross Proceeds Rule.

In order to eliminate the numerous problems and second guessing associated with the auditing of lessees years after the date that royalties were computed and paid, and to bring certainty and finality to the valuation process, Coastal also recommends that the Gross Proceeds Rule be eliminated for all lessees using the Benchmarks so that the value established by an applicable Benchmark is the final value for royalty purposes. In any situation where the MMS believes that the lessee has selected a Benchmark that does not reflect the true value of the production at or near the lease, the MMS can and should take its royalty In-Kind.

E. Lessees with Affiliated Refineries.

During the Workshops, there was some discussion of Federal lessees who have refineries, or have affiliates with refineries, and the special valuation problems that may be related therewith. While Coastal acknowledges the fact that oil transported by a Federal lessee directly to its own refinery with no intervening arm's-length sales of any kind may justify valuation based upon an index Benchmark rather than a Benchmark based upon an arm's-length sale (and the Benchmarks recommended by Coastal provide for such an index), Coastal recommends that the focus of this discussion be on where the production is taken rather than on who the lessee is (i.e., a refiner or a non-refiner).

As the MMS knows, all oil is eventually taken to someone's refinery. Crude oil has no real value until it is refined into useable products. An arbitrary split of Federal lessees into refiners and non-refiners with different royalty valuation rules applicable to each group unfairly penalizes those lessees who may choose or have chosen to enter into the refining business, and would have a chilling effect on owning or building refineries in the USA.

The MMS should look solely to where the particular production is taken in determining which valuation method and/or which Benchmark is applicable. If all production is sold in an arm's-length transaction, royalty should be based upon gross proceeds (as it is now) regardless of the fact that the lessee may also own a refinery. If all or a portion of the production is sold or transferred to an affiliate, the Benchmarks should apply regardless of the fact that the lessee may also own a refinery. Only in the situation where all or almost all the production is sold or transferred to an affiliated refinery would indexing be the only applicable method of royalty valuation.

For example, in Coastal's own case, Coastal affiliates currently own and operate two active refineries, but Coastal's exploration and production companies sell very little of their production to those refineries. Specifically, the feedstock for Coastal's New Jersey refinery is 100% foreign crude oil, and the feedstock for Coastal's Texas refinery, located in Corpus Christi, is 99% foreign crude. On a very limited as needed basis, Coastal exploration and production companies sell a fraction of their oil production (actually condensate) from South Texas to its Corpus refinery. The fraction sold is both a small part of Coastal's total production from South Texas and a small part of the total volume of feedstock for the refinery. Such fractional sales do not adversely affect the price of condensate (or the value of royalty) in South Texas, and, therefore, Coastal should not be precluded from using the Benchmark system in valuing its production for Federal royalty purposes.

F. The Duty to Market and Marketing Costs.

First, under the terms of past and current Federal leases and applicable Federal law, the lessee does not have a duty to market the government's share of production at no cost to the government as stated in the Proposed Rule. Coastal acknowledges that the lessee has a duty to put the oil in "marketable condition" at no cost to the government, but this is not the same as a duty to market the oil at no cost. Coastal is strongly opposed to the unilateral imposition of a new and onerous duty on Federal lessees.

Second, Coastal believes that value is added to oil produced on the lease by its mid-stream affiliate who is responsible for transportation, buy/sells, exchanges, aggregation, blending, storage, and marketing the oil downstream from the lease, that this added value exceeds the cost of transportation alone, and that Coastal is entitled to be compensated for this added value.

As an example, if the MMS took its royalty share of production In-Kind at or near the lease, and hired a marketing agent to arrange for the sale and delivery of the oil to financially sound and reliable third parties, it is reasonable to assume that the MMS would pay the agent a fee for that service. If such a sale required transportation, blending, buy/sells, exchanges, guarantees, storage, aggregation, or other mid-stream activities downstream of the lease, it is also reasonable to assume that the MMS would not only pay the agent the actual cost for such transportation, but also an additional reasonable fee for the mid-stream activities. If this is true, why then is the MMS proposing to require Federal lessees to perform mid-stream oil marketing services at no cost to the government by refusing to allow a reasonable deduction from royalty for marketing and handling expenses incurred by Federal lessees downstream of the lease?

G. Value is a Range of Prices.

Contrary to the implied assumption in the Proposed Rule, the value of fungible commodities traded in the open market on any given day, such as stock, grain, livestock, and crude oil, is never a single price, but is always a range of prices. This range of prices is the result of the prices offered by various purchasers and accepted by various sellers that day. The range of prices is generally reported in the form of a "high" and a "low" price, with all other prices falling somewhere in between. While this range of prices can be averaged in various ways by persons compiling such data and published as a single "index price," half of all such actual sales would have been at prices above the index price and half of all such actual sales would have been at prices below the index price, and there may have been no actual sales at all at exactly the index price. This fact would be further skewed by the averaging of daily average index prices into a monthly average index price.

There are many factors influencing the prices of commodities on any given day. Some of these factors are: weather, general economic conditions, the stock market, international markets, volume, quality, location, anticipated demand, anticipated supply, availability, term, reliability of supply, availability of transportation, etc. Each seller may have had their own special reasons for accepting a particular price on a particular day and each purchaser may have had their own special reasons for offering a certain price on a particular day.

For the reasons stated above, it is unrealistic and unfair to attempt to set a single index price on all oil produced from Federal leases, and if Federal lessees are forced to pay royalty based upon a single index price, there will, by definition, have to be winners and losers.

H. Adoption of IPAA Comments.

Subject to the Comments stated herein, Coastal adopts the Comments of the IPAA, which have been or will be filed in this matter.

IV. CONCLUSION

Based upon the reasons stated herein, and in the other Industry Comments, Coastal urges the MMS to:

A. Withdraw the Proposed Rule;

B. Implement a full RIK program at the earliest possible opportunity; and

C. In the interim, in lieu of the Proposed Rule, adopt the Benchmark Valuation System described above, including the limited RIK program, the elimination of the Gross Proceeds Rule, and the allowance as a deduction from gross proceeds of all reasonable transportation, handling, and marketing costs.

RESPECTFULLY SUBMITTED this 31st day of October 1997.

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