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January 31, 2000

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Exxon Mobil Corporation Comments on Minerals Management Service Further Supplementary Proposed Rule on Valuation of Crude Oil Produced on Federal Leases, 64 FR 73820 (December 30, 1999)

Dear Mr. Guzy:

Exxon Mobil Corporation, (ExxonMobil), hereby incorporates by reference the earlier comments of its predecessors in this rulemaking as its comments on the Minerals Management Service (MMS) Further Supplementary Proposed Rule on Valuation of Crude Oil Produced on Federal Leases, 64 FR 73820, dated December 30, 1999 (proposed rule). In addition, ExxonMobil incorporates by reference the prior and most recent joint comments of the American Petroleum Institute, U.S. Oil and Gas Association, Independent Petroleum Association of America, the Domestic Petroleum Council, the Independent Association of Mountain States, and the Western States Petroleum Association (joint comments). ExxonMobil will comment at this time only to emphasize, clarify and supplement these other comments. As one of the largest payors of federal royalties, ExxonMobil has participated fully in each phase of the rulemaking process in an effort to contribute toward a fair and workable oil valuation rule.

The MMS has made important changes during the course of the rulemaking, which include:

- Recognizing gross proceeds received in arm's length transactions as an appropriate basis for valuing oil for federal royalty purposes,
- Making it clear that MMS will not second-guess marketing decisions by arm's length sellers,

- Asking for input on fair transportation allowances,
- Eliminating Form MMS-4415, and
- Providing for lease-based transactions as comparables in the Rocky Mountain region benchmarks.

However, there are still fundamental flaws with the proposal, including:

I. MMS has yet to undertake a fair, thorough and unbiased review of the data submitted by industry, which establishes the existence of an active competitive market for crude oil at the lease. MMS should consider this additional market information in order to fairly evaluate the best valuation methodology to adopt in the final rule.

II. MMS should confirm through specific language in the rule that it is complying with the statutory and contractual requirement that royalties be assessed only on the value of production at the lease, not on the value of downstream post production activities such as downstream marketing and transportation.

III. MMS should improve approaches to valuing non-arm's length transactions in order to eliminate uncertainty and better approximate the value of production at the lease :

   A. Lease-based methodologies are the best reflection of lease value and are the simplest to implement and audit;

   B. If an index is used, any starting point index must be a price at or near the lease and be for crude of like quality;

   C. If index methodologies are imposed, MMS must provide a more reasonable and certain methodology for calculating market based and responsive location and quality differentials;

   D. Any reference to refinery value should be eliminated because it is inappropriate and unlawful;

   E. In order to arrive at the value of production at the lease, MMS must allow deductions and/or adjustments based on fair and reasonable transportation rates.

IV. MMS should provide ample time to implement the final rule.

The attached comments illustrate areas where changes are required to make the rule fair, workable, and in accordance with lease terms and the governing statutes. ExxonMobil urges the MMS to give full and fair consideration to the issues outlined in these comments. It is in every stakeholder's best interest to move forward with a rule that is fair to all lessees, regardless of size, structure, or marketing strategy, and, most importantly, that is consistent with controlling lease and statutory obligations. The proposed rule fails to achieve these requirements.

Finally, ExxonMobil continues to believe that a workable Royalty in Kind (RIK) program is a preferable alternative to the disputes that will result from the rule if promulgated as currently proposed. ExxonMobil applauds the MMS for its diligent efforts to test RIK through its pilot programs. As the MMS continues to work with the industry and other stakeholders in developing and managing the pilots, the program should grow stronger and more effective for all parties concerned.

Sincerely,

Rick T. McGovern
North America Production Controller's
Ownership Regulatory Affairs Manager

Further Supplementary Proposed Rule on Valuation of Crude Oil Produced on Federal Leases, 64 FR 73820 (December 30, 1999)
ExxonMobil Comments

I. MMS has yet to undertake a fair, thorough and unbiased review of the data submitted by industry, which establishes the existence of an active competitive market for crude oil at the lease. MMS should consider additional market information in order to fully and fairly evaluate the various proposed valuation methodologies.

The MMS has not fully and fairly considered all available sources of information regarding the existence or lack of existence of a viable market at the lease. In the preamble to the proposed rule the MMS noted that it relied on studies commissioned by States and advice from MMS consultants (Innovation & Information Consultants, Inc. (I.I.C.); Micronomics, Inc.; Reed Consulting Group; and Summit Resource Management, Inc.). The MMS also has noted its reliance on these same sources in other venues, such as the Interagency Task Force report and Congressional testimony.

Each of the consultants listed is or was a consultant to plaintiffs or is a plaintiff engaged in lawsuits against oil producers over royalty valuation. Despite the voluminous information submitted by industry for the MMS' consideration, the assumptions on which the rule is based have not changed since the original proposal. ExxonMobil does not suggest that the MMS should not seek the advice of consultants with differing views from ExxonMobil, only that at the very least, MMS should consider the issues from more than one viewpoint.

In its most recent submission to the Office of Management and Budget, the MMS notes that it asked industry members to participate in the rulemaking team but advises that they declined to participate. Department of the Interior, Record of Compliance for a Rulemaking Document, RIN:1010-AC09, Threshold Analysis, at 3. The MMS then discusses the consultants it used. The MMS' roster of consultants has not changed since the inception of the rule, a fact the MMS clarified at its workshop on January 20, 2000 in Washington, D.C. Although MMS notes industry's initial reluctance to participate, there has been ample opportunity since that time for the MMS to evaluate other resources concerning market value data. The industry has been actively involved in the proposed rulemaking since 1997 when the original proposed rule was published even to the point of providing experts and making solution oriented proposals.

II. MMS should confirm through specific language in the rule that it is complying with the statutory and contractual requirement that royalties be assessed only on the value of production at the lease, not on the value of downstream post production activities such as downstream marketing and transportation

In its prior comments on the rule, ExxonMobil has detailed its arguments that royalty is owed on the value of production at the lease. ExxonMobil has further demonstrated how the valuation methodology proposed by the MMS attempts to impose a value different from the value of production at the lease. As recently as the January 2000 workshops, MMS representatives reiterated that royalties are owed only on the value of production at the lease. It is imperative that the MMS construct the rule to reflect this fundamental principal 1) by providing that, for arm's length transactions, royalty payments are due on the lessee's gross proceeds adjusted to reflect the value of the production at the lease and 2) by providing a valuation methodology for non-arm's length transactions that most closely approximates the value of production at the lease.

III. MMS should improve approaches to valuing non-arm's length transactions in order to eliminate uncertainty and better approximate the value of production at the lease

Without improvements, the proposed "royalty formula" has too many uncertainties. Depending on the circumstances, this methodology could lead to over or under valuation of royalty. The MMS is not entitled by either statute or contract to more (or less) than the value of production at the lease. It should be unacceptable for the MMS to have the lessee pay an "estimated" value of production that can later be second-guessed.

A. Lease-based methodologies are the best reflection of lease value and simplest to implement and audit

An index method is attractive to the MMS but ignores the true complexity of the marketplace. The problem is that without lease value information, the "differentials" the lessee must subtract to obtain lease value are often subjective and speculative. Comparables are the best indicator of the value of production at the lease. While it is apparent that the MMS has rejected the use of comparables in all areas except the Rocky Mountain Region, the MMS has failed to articulate a reasonable justification for its rejection.

At a minimum, comparables must be used to have any certainty in developing location/quality differentials to determine value at the lease. The MMS should expressly include comparables as a basis in the guidelines for a lessee obtaining the approval of a location/quality adjustment. The use of comparables is not a new concept; it is widely accepted by real estate appraisers, state and local taxing authorities, and by other assessors of economic value. It has also been historically accepted by the MMS.

A more straightforward approach to determining value would be a program using comparables at the lease rather than using comparables to establish location/quality differentials. It would provide greater certainty for the MMS and the lessee. The MMS has stated publicly that the comparables portion of the current regulations is difficult to administer because of the latitude of the guidelines for comparability. ExxonMobil urges the MMS not to let its historical concerns over the use of comparables prevent it from developing an option to use comparables on a nationwide basis. Since comparables must be a part of any methodology, even index-based (for the purpose of establishing differentials), the easiest and most direct way to eliminate subjectivity and enhance the auditability of these comparables is through the use of a comparables methodology to establish value, not just differentials.

B. If an index is used, any starting point index must be a price at or near the lease for oil of like quality

The MMS has not provided a consistent methodology for valuing crude for all of its federal leases. For example, although the mineral leases have similar royalty provisions whether in California, the Rocky Mountains, or the Gulf of Mexico, the MMS has provided distinct methodologies for each region. The regional method for the Gulf of Mexico contemplates a "market center nearest your lease for crude oil similar in quality to that of your production." In California, the MMS provides only for ANS as a starting point, and in the Rocky Mountain Region, it provides for a WTI Cushing starting point.

As has been discussed in prior comments, ANS is not of like quality, location, or value to most of the oil produced in California and WTI is not of like quality, location, or value to a substantial amount of the oil produced in the Rocky Mountain Region. It would be much better, if indexes are to be used at all, for the MMS to use the same methodology for these regions as it uses for the Gulf of Mexico. Accordingly, MMS should provide for the use of the "market center nearest your lease for crude oil similar in quality to that of your production" whereever indexes are required to be used. ExxonMobil also urges the MMS to provide an appeal process so that lessees will have a remedy if they disagree with the index or publication that MMS requires.

The required use of ANS for valuing California crude is particularly troubling. Three separate California juries have resoundingly concluded that ANS cannot be used to determine the fair market value of California crude. Moreover, in reaching this conclusion, all of the juries were presented with and rejected the very same consultants' studies that MMS is relying on in this rulemaking.

Most recently on August 30, 1999, in City of Long Beach v. Exxon, the jury rejected the ANS pricing mechanism when it declared that the defendant Exxon, on behalf of itself and its contract partners, all of whom had been paying on posted prices, had paid reasonable worth. Notably, both the plaintiffs and the defendants argued that "reasonable worth" was the equivalent of "fair market value." A copy of the jury verdict in Long Beach and excerpts from the testimony of experts in that case are attached to these comments as Attachment A. In light of the State of California's comments at the recent Washington workshop that the ANS valuation theory of the proposed rule is not the same as the ANS valuation theory rejected by the Long Beach jury, ExxonMobil urges the MMS to consider the entire public record of the Long Beach litigation and to make that record a part of the record in this rulemaking. The Long Beach result clearly is a relevant matter that must be fully considered by MMS before it adopts a final rule requiring California crude to be valued based on ANS index prices.

The ANS valuation methodology in the proposed rules was also rejected by the juries in Mission Resources v. Texaco and Union Oil Company of California v. Pioneer Oil & Gas. In Mission, the plaintiff claimed it was damaged by certain Texaco conduct which resulted in its receiving less both for its crude oil production and for its crude oil-producing properties. Peter Ashton, President of I.I.C., was Mission's expert. He testified that he believed that "ANS crude oil sales in San Francisco are the best measure of what the value or price of Mission's heavy production would have been" but for Texaco's conduct.

The jury in Mission, by awarding '"zero"' damages to the plaintiff, unequivocally rejected the I.I.C. approach. Mission Resources, Inc - II v. Texaco, Inc., 94 F.3d 652 (9th Cir. 1996). A copy of the Mission decision and excerpts from the deposition of Peter K. Ashton in that case are attached to these comments as Attachment B.

In Union Oil, Pioneer cross-claimed against Unocal asserting that its posted prices for certain California crude oils did not reflect market values. Mr. Ashton testified on behalf of Pioneer that the market value for California crude oil should have been based on the price of ANS crude adjusted for quality and transportation. Once again, the jury flatly rejected this approach by finding that Pioneer had a claim against Unocal but awarding it zero damages. A copy of the jury verdict in Union Oil and excerpts from the condensed transcript of the testimony of Peter Ashton in that case are attached to these comments as Attachment C.

We urge the MMS to review the entire public records of these cases and to make those records a part of this rulemaking.

The Long Beach, Mission and Union Oil juries considered all of the facts presented by both sides, and they clearly and unequivocally rejected the very theory that MMS has accepted here. By contrast, as noted above, MMS appears to be relying only on the biased, self-interested views of the plaintiffs' experts. Moreover, MMS knew of the theories of these consultants before they were hired, since they already were working for the plaintiffs in the California litigation. At the very least, the record in this rulemaking should reflect that MMS has carefully examined its reliance on its consultants in light of these jury verdicts.

Additionally, ANS comes from a declining field. As a practical matter alone, this raises questions about whether or not the proposed rule is flexible enough to handle a situation where there is little or no ANS trading on the spot market. If the rule is finalized as proposed, MMS will have to propose a new rule once ANS is no longer a viable spot price. Given the time delays in any rulemaking process, there likely will be at least some period of time in which lessees will not be able to pay their royalties in accordance with the regulations because the index price mandated by the regulations is no longer available. These are just some of the problems that arise when a single index is mandated. A lease comparables methodology, by contrast, would be more reflective of the market and much more flexible in responding to changes in the market.

C. If index methodologies are imposed, MMS must provide a more reasonable and certain methodology for calculating market based and responsive location and quality differentials;

If, after evaluating the comments, the MMS elects to use an index netback methodology, then ExxonMobil urges the MMS to provide basic criteria on what will be accepted in the approval process for location/quality differentials. Any final rule must contain a provision that states that the purpose of the location/quality differential or adjustment is to approximate a value of production at the lease.

The MMS definitions in Section 206.102 for location/quality differentials are limited in scope to exchange agreements. The definitions correctly recognize that such differentials "may represent all or ***part*** of the difference between the price received for oil delivered and the price paid for oil received under a buy/sell exchange agreement." ***[emphasis added]*** However, there is no criteria included for the "location/quality adjustment" that must be approved by the MMS (Section 206.112 (f)). This "location/quality adjustment" will probably serve as the basis for most of the index netback valuation calculation even when it is used as an option to trace arm's length gross proceeds. It is vital, therefore, that if the index methodology is used, the manner for determining a location/quality differential must be spelled out in the final rule.

MMS acknowledges in Section 206.101 *Quality Differential,* a quality difference "results from differences in API gravity, sulfur content, viscosity, metals content, and other quality factors between oil delivered and oil received." In addition, refinery configuration and downstream unit capacity utilization can impact crude values in ways not dictated by gravity alone. Another component of location/quality differentials should be a spot to term differential such as the differential the MMS recognized in the Small Refiner program. This is an example of one, but certainly is not inclusive of all aspects of differentials that should be recognized. ExxonMobil therefore suggests that the MMS broaden its location/quality differential definitions and at a minimum go back to the definitions for location differential and quality differential that were originally proposed. The definitions would read as follows:

> **Location differential** means the value difference for oil at two different points.
>
> **Quality differential** means the value difference between two oils due to differences in their API gravity, sulfur content, viscosity, metals content, and other quality factors.

In addition, no express guidance is provided for obtaining approval of a location/quality differential. Guidance could include the review of the difference between arm's-length transactions at or near the lease and the index pricing point. The method should also be responsive to markets since differentials are not static but can change.

Without relying on lease-based valuation data, it will be difficult, if not impossible for the MMS to evaluate and approve a location/quality adjustment that will closely approximate the lease value, especially on a long term basis. The MMS runs the risk that the index-based methodology may under or overstate the value.

D. Any reference to refinery value should be eliminated because it is inappropriate and unlawful

ExxonMobil is concerned about how the proposed rule would value oil that is used by a lessee or its affiliate as refinery feedstock. The proposal states that the lessee must use the daily mean spot prices published for the market center nearest the lease for crude oil similar in quality to the lease production, adjusted for the transportation cost of moving the crude from the lease to the refinery and also adjusted for quality differences based on any arm's-length exchange differentials or quality-banks encountered between the lease and the refinery.

Although the proposed rule purports to allow the lessee to propose an alternative valuation method if it believes that the adjusted index price does not reflect the reasonable value of the oil at the refinery, the MMS is not entitled by either statute or contract to the reasonable value of the oil at the refinery. Royalties are only due on the value of production at the lease.

Though the MMS is not entitled to collect royalties on the value at the refinery, if it attempts to go forward with its proposal as written, there are serious flaws with its assumptions. For example, the MMS does not provide clear guidance on how best to determine the refinery value including adjusting purchases for location, quality, and transportation back to the refinery and since the MMS is only entitled to the value of production at the lease, the MMS has not provided guidance on how the lessee would calculate adjustments back to the lease once a refinery value was derived.

At the Houston workshop, MMS representatives explained that MMS will not require lessees to submit information regarding the value of refined products and the costs of the refinery, and MMS assured lessees at the workshop that value would not be based on refined products. However, despite the agency's assurances, lessees have been issued audit requests for this very information.

In sum, ExxonMobil urges the MMS to eliminate this portion of the regulations. The rule should also expressly state that the agency's review is limited in scope to raw crude streams and does not extend into or beyond the refinery.

E. In order to arrive at the value of production at the lease, MMS must allow deductions and/or adjustments based on fair and reasonable transportation rates

Federal leases provide that a lessee shall recover its "reasonable cost" for transporting federal production. In order to approximate a value at the lease for federal crude oil, allowances for the "reasonable cost of transportation" must equal the commercial transportation rate for each individual pipeline. The assertion that the MMS should only allow "reasonable <u>actual</u> transportation costs" as provided in the current regulations and proposed rule is inequitable.

When a lessee moves production through its or an affiliate's pipeline for which published tariffs are on file with the FERC, such tariff rates should be considered as the appropriate rate for transportation allowance purposes in calculating federal royalties. The MMS' failure to consider the FERC's prior determination concerning the appropriate transportation charge for a particular pipeline is arbitrary for a number of reasons. First, it disregards the FERC's clear expertise, experience and established procedures in such matters. Second, it creates the substantial likelihood that two different federal agencies will establish multiple, different transportation rates to be applied to the same pipeline. Finally, even if the MMS feels it can distance itself from the FERC's determination of a reasonable transportation rate, how can it remove itself from Congress' determination in the Energy Policy Act of 1992 that such rates were just and reasonable? It is of great concern to ExxonMobil that two different agencies of the United States government could have such varying policies.

Where FERC tariffs do not exist, the MMS has asked for a discussion of the rate of return for affiliated pipelines. As discussed above, ExxonMobil urges the MMS to consider a commercial rate of return in such instances. The joint trade association comments address the calculation of such commercial rates and ExxonMobil supports those comments.

In any event, the MMS should add language to the rule to protect the confidentiality of the transportation cost information provided by a lessee or its pipeline affiliates. The regulation should clearly state that such information is privileged and confidential and protected by Exemption 4 of the Freedom of Information Act. Furthermore, the regulation should provide that the information provided to the MMS is for use only in determining royalty transportation allowances and for no other purpose.

In addition, ExxonMobil suggests that in Section 206.109 (a), the MMS delete the statement "If MMS takes its royalty in kind, see Section 208.8." Section 208.8 (b) provides that "MMS will reimburse the lessee for the reasonable cost of transportation to such point in an amount not to exceed the transportation allowance determined pursuant to 30 CFR part 206." The reference to Section 208.8 in Section 206.109(a) is circular in nature and unnecessary. Furthermore, when the MMS takes in kind, reimbursement of reasonable costs as allowed by the lease may differ from in value because of the role the MMS has in nominating and receiving deliveries.

IV. Ample time to implement the proposal should be provided

The MMS has indicated in the public workshops that it will publish the rule on March 15 or 16, 2000 with an effective date of June 1, 2000. Aside from the issue of whether or not the MMS is allowing itself enough time to review the comments, the effective date is unworkable. Consider some of the steps that a company must address in order to implement the rule:

- Evaluate the meaning of the rule and train employees
- Determine what valuation methodology applies to each of its properties including the evaluation of choosing an alternate methodology

- Develop recommendations for location/quality differentials
- Obtain approval for location/quality differentials
- Attempt to get information on pipeline "actual" costs as defined by MMS from affiliated pipelines on tariff lines
- Calculate transportation rates using "actual" costs formula
- Build or modify system to use index methodology, if necessary, rather than lease-based methodologies

The MMS in its reengineering efforts has stated that 18 months would be necessary for system changes to implement the new Form MMS-2014. Similarly, industry needs time for scoping a new system or a systems modification, developing the system, testing the system, training on the system, and implementing the system. At a minimum, 18 months should be provided for such an immense effort.

It was argued by the MMS in the Houston workshop that the change should not be as overwhelming as redesigning the MMS reporting system. Lessee's current revenue and reporting systems are based on lease values that are also used to record company earnings for the value of equity crude. Major redesigns of these systems could be required to perform dual capacities of paying and reporting royalties on a basis different from that used for recording earnings. This would be especially true should the MMS continue to require the use of "actual costs" for the transportation allowance. Many oil pipeline, that are affiliates of lessees, would have to totally develop new reporting systems to capture cost of service information based on MMS regulations, rather than the current reporting requirements of FERC and other regulatory bodies. The complete start from scratch approach required by this rule for pipeline cost data, is at least parallel to the redesign of the MMS reporting system.

The development and approval of a location/quality differential will also require a very large work effort. The MMS publicly stated in its January 19, 2000 workshop in Houston, that a lessee could pay on estimates while waiting for the approval of its differentials. ExxonMobil believes this approach to be unacceptable and unreasonable. It also asks MMS to cite the authority on which it relies to allow payments to be based on estimates. Industry and MMS need to move forward on a new rule that is not based on estimates, second-guessing, and retroactive adjustments. Furthermore, the Federal Oil and Gas Royalty Simplification and Fairness Act only provides for an estimated payment for one month and no longer. This provision is located in (30 U.S.C. 1721 (j)) and reads as follows:

> A lessee or its designee may make a payment for the approximate amount of royalties (hereinafter in this subsection 'estimated payment') that would otherwise be due for such lease by the date royalties are due for that lease. When an estimated payment is made, actual royalties are payable at the end of the month following the month in which the estimated payment is made.

Clearly the MMS should consider the immense burden necessary to implement the proposed rule and provide a realistic effective date.

In addition, since the MMS is planning a reengineering change in 2001, it is extremely burdensome for a lessee to make system changes now for the final oil valuation rule and more perhaps overlapping changes in 2001. ExxonMobil encourages the MMS to minimize the number to systems changes required of royalty payors.

In closing, ExxonMobil believes more review time should have been provided to create a complete record. While some areas of the proposed rule did not change, there were revisions that needed extensive review. In addition, the broad discretion over the approval of location/quality differentials seems to beg for further discussion and would best be handled in a workshop type setting.