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August 1, 1997

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David S. Guzy
Chief, Rules & Procedures Staff
Mineral Management Service
Building 85
Denver Federal Center
Denver, Colorado 80225

Dear Mr. Guzy:

The City of Long Beach and the State of California hereby respond to the Supplementary Proposed Rule of the Mineral Management Service ("MMS") on Crude Oil Valuation, 62 Fed. Reg. 36030 (July 3, 1997).[1]

I.

GENERAL COMMENTS

The City and State have generally been supportive of MMS' proposed new pricing regulations. We especially support MMS' proposed index pricing using ANS spot prices for federal leases in California and Alaska and using the average of the daily NYMEX futures settle prices for the Domestic Sweet Crude Oil Contract for the prompt month for federal leases outside of California. We view the Supplementary Proposed Rule an unfortunate and unnecessary step backward from the index pricing methodology.

[1] We agree with the comments submitted by the California State Lands Commission.

The Supplementary Proposed Rule is an overreaction to the complaints of the independent producers. Although we are sympathetic to some of the concerns raised by the Independent Petroleum Association of America ("IPAA") and the Independent Petroleum Association of Mountain States ("IPAMS"), we believe that the Supplementary Proposed Rule goes much farther than necessary to meet their concerns and creates a significant erosion of MMS' proposal to use index pricing to value federal royalty oil.

We are equally concerned with the fact that MMS chose to modify its proposed regulations in response to the views of a small minority of those who commented on the original rule and who represent a relatively small constituency in terms of the overall royalty payment to the federal government. More disturbing is the fact that the Supplementary Proposed Rule is the result of meetings between MMS and the independent producers and we were not given the opportunity to meet with MMS to respond to the arguments of the independent producers even though we sought to have such a meeting before the Supplementary Proposed Rule was published. Furthermore, the Supplementary Proposed Rule was instituted before MMS had a chance to review all of the comments submitted in response to the Notice of Proposed Rulemaking of January 24, 1997.

It is particularly unfair to revise the proposed rules without consideration of the States' comments as to why gross proceeds should be abandoned altogether. The revised rule allows much greater application of gross proceeds by eliminating the two-year rule, by permitting use of gross proceeds for "competitive" calls, by permitting valuation where oil is moved on exchanges and buy/sells, and by relying on representations of third parties as to contractual interpretation regarding calls in the overall balancing arrangements.

The City of Long Beach and the State of California firmly oppose these modifications to the proposed rule and request the opportunity to comment further on the filings made by the industry and others, if MMS is considering any other changes of the proposed rules.

The Supplementary Proposed Rule goes far beyond accommodating any legitimate points raised by the independent producers. Their objections, as stated in the Federal Register for July 3, 1997, is that exclusion, in Section 206.102(a)(4), from the gross proceeds methodology of crude oil subject to calls, is too broad because (a) some calls are unexercised, and (b) some calls are merely rights of first refusal whereby a company holding the call has only a right to match the highest price offered for the royalty crude. The independent producers objected also to the two-year rule of Section 206.102(a)(6) on the ground that it is unfair to preclude the use of the gross proceeds methodology when some companies have to purchase crude oil (a) to meet shortfalls in production where the production is sold under contract with a guarantee of a given number of barrels, and/or (b) for lease operations such as fuel consumption at the lease or as a diluent to move other crude oil through pipelines.

The appropriate and narrow response to the first objection of the independent producers is to carve out exceptions from Sect. 206.102(a)(4) of the January 24th proposed rules for (a) unexercised calls, and (b) calls which are only rights of first refusal. Likewise, the appropriate response to the second problem is to make two exceptions to Section 206.102(a)(6) of the January 24th proposed rules. One exception can be created for crude purchases required to meet a shortfall of production, but only where the production is sold under contract at a guaranteed volume and the contractual volume is usually met by the production. (The second clause is intended to prevent gaming whereby the producer and purchaser agree to set the contractual volume higher than anticipated production in order to get around the two year rule.) A second exception to Sect. 201.102(a)(6) is for purchases of crude necessary for lease operations.

The Supplementary Proposed Rule does not narrowly focus on the independent's legitimate concerns. We are especially concerned that legitimate concerns of small independent producers not be used as an excuse for wholesale retreat on the January 24 proposed rules for the benefit of major oil companies. We will now discuss the Supplementary Proposed Rule in detail.

II.

CRUDE OIL CALL, SECTION 206.102(A)(4)

In the January 4th proposed rules, any crude subject to a call was required to be valued by the index pricing methodology and not the gross proceeds methodology. Under the July 3rd

Supplementary Rule, crude oil calls will be excluded from the gross proceeds methodology only if they are considered to be non-competitive. As discussed above, this Supplementary Rule goes far beyond what is necessary to take into account the concerns of the independent producers. First, the definition of non-competitive calls as proposed by MMS is vague and ambiguous. The Supplementary Rule leaves it open to the producer to interpret what it means. It is unlikely that any oil industry participant will agree that any call is non-competitive.

Second, the Supplementary Rule places a great audit burden on MMS to verify whether a call is or is not competitive. MMS should not rely on representations of a third party as to whether a call is competitive or not.

We are also opposed to excepting from the index pricing methodology calls which are subject to a Most Favored Nations ("MFN") provision. MFN clauses put a damper on competitive bidding because of a reluctance of bidders to bid, knowing that their bids can be matched by the entity having the call on the production. Furthermore, there is no guarantee that the price received under a MFN provision is representative of market value.

Accordingly, we recommend that the only modification in 206.102(a)(4) be that the gross proceeds methodology be available to crude oil calls except in the case of an unexercised call. All exercised calls should not be permitted to be used for valuation unless they can be specifically shown to reflect arm's-length values using 206.102(c)(2) as the benchmark.

III.

DELETION OF THE TWO-YEAR RULE, SECTION 206.102(a)(6)

The basic premise underlying MMS revised rules published in January is to exclude from the gross proceeds methodology sellers who had purchased crude within the last two years. MMS was correct in stating that "multiple dealings between the same participants while apparently at arm's length, may be suspect concerning the contractual price terms" (62 Fed. Reg. p. 3743, January 24, 1997). We agree with this rationale for the two-year rule and we don't believe that any evidence has been forthcoming that contradicts this view. The two-year rule could be preserved with a narrow exception for minimal amounts of crude oil purchased under the limited circumstances of making up production shortfalls or operating a lease which were the primary concern of the independent producers regarding the two year rule.

IV.

OVERALL BALANCING ARRANGEMENTS, SECTION 206.102(a)(ii)

We agree with MMS that where companies have agreed to an overall balance between volumes bought and sold that such companies should not be able to use the gross proceeds methodology but must rely on the index methodology. Supplementing Section 206.102(4)(ii) does not entirely rule out the use of the gross proceeds methodology even when there is an overall balance agreement between volumes bought and sold. This subsection can be read to require that companies use index pricing only in the circumstances in which the contract price does not represent "market value in the field or area." Oil companies could reason that even though they have an overall balance in the volumes bought and sold, the contract price nonetheless does represent market value in the field or area. Such claims would raise insurmountable difficulties for MMS to monitor whether in fact, despite an overall balance, contract price represented market value in the field or area.

Moreover, the subsection contains the apparently self-contradictory phrase "an arm's length contract between a buyer and seller in which the contract price does not represent market value." How could the contract be arm's length, if in fact it did not represent market value in the field or area?

We believe that "market value in the field or area" can only be determined by the spot price of ANS in California adjusted for quality and transportation. As the Long Beach records showed and the Interagency Task Force found, this is the method the major companies themselves used for determining what they would be willing to pay for California crude oils, including heavy California crudes. It should be the method employed by MMS for determining the market value of California crude oils. Any suggestion that market value in the field or area can be better determined by comparable sales is flawed. Long Beach will be glad to respond in more detail as to why the comments of Texaco, Mobil, API and others who have incorrectly argued that ANS is the wrong benchmark for determining the value of California crude oil.

V.

EXCHANGE AGREEMENTS, SECTION 202.102(a)(6)

In the January 24th Federal Register, MMS proposed to eliminate any reliance on exchanges or buy/sells in valuing crude oil production. This was the correct approach. In the Supplementary Rule, MMS would give the lessee a choice in using the gross proceeds methodology or index pricing methodology where the production is exchanged and the receipt crude is sold in an arm's length transaction.

We note that no explanation is provided by MMS as to why it has made this change, although it appears again to have been in response to concerns raised by independent producers. Since no rationale has been offered publicly by independent producers for this change, it is difficult to respond to their concerns.

We have two objections to the revision. First, MMS assumes the exchange differential reflects an arm's-length value that compensates for the difference between quality and location between the crude oil received and given up. While we agree that generally this may be the case, there are situations where exchange partners may have an incentive to establish value differentials that do not fully reflect arm's length value differences. For example, suppose companies A and B have two exchange agreements. As with an overall balance agreement, they can manipulate the exchange differentials on the two exchanges so that the economic effect is a wash, but the value difference on one exchange (the one used to value federal royalty oil) does not reflect an arm's length value. A second objection is the additional complexity and audit burden this exception puts on MMS to trace production through several layers of transactions. This would require a significant increase in the documentary evidence required to determine compliance and ascertain value actually received in the transactions.

VI.

FORM 4415

MMS states that it will collect information only on exchanges between aggregation points and market centers. It is still not clear whether MMS will collect information on exchanges that do not involve federal production. If MMS does not collect such information, then the sample for many movements may be so small as not to be very helpful. MMS may need data on exchanges that involve non-federal production. MMS needs to clarify this point.

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CONCLUSION

We hope that the Supplementary Rule does not portend a retreat on the central advance contained in the January 24 proposed rules: the use of index pricing and the abandonment of posted prices. We urge MMS to tailor any changes to the January 24th proposed rules to those necessary to meet small, independent producers who lack market power.

Sincerely,

M. Brian McMahon

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on behalf of
THE CITY OF LONG BEACH
and THE STATE OF CALIFORNIA

MBM:apm

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