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American Petroleum Institute Comments on Alternatives for Establishing Oil Value for Production on Federal Leases, 62 FR 49460 (September 22, 1997)

Dear Mr. Guzy:

API welcomes this opportunity to submit written comments on the alternatives published at 62 FR 49460 (September 22, 1997) and the related discussions occurring at the September 30-October 1 workshop in Denver and October 7-8 workshop in Houston. These comments augment the extensive comments filed May 27, 1997, on the January 24, 1997, proposal and August 1, 1997, on the July 3, 1997, supplemental proposal.

At the outset, let me express some necessary reservations about the present process. Given the complexity and significance of the crude oil rulemaking, we are encouraged by the MMS' willingness to explore alternatives other than the original flawed January 1997 proposal. On the other hand, we are dismayed that the most recent alternatives were published without concrete details and with the expectation that industry, especially its trade associations, could participate in the scheduled workshops starting a week after the publication of the alternatives and submit meaningful comments within about forty five days.

Complicating matters further is that the MMS seems wedded to an indexing scheme, but has yet to explain why API's comments on the core elements of the original indexing proposal are misplaced. With industry having such profound reservations about indices like NYMEX futures prices and ANS spot prices for valuation of federal oil production, it should come as no surprise that industry is having difficulty fashioning minor variations on the indexing scheme so favored by the MMS. If the present benchmark system is imperfect, it hardly makes sense to scrap it in favor of an indexing scheme that is so demonstrably flawed.

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Notwithstanding these reservations, the recent workshops served a useful purpose by convening stakeholders and prompting interactive discussion of the core issues. To augment the extensive comments already filed by API, some of the specific questions raised at the Denver and Houston workshops are addressed below.

Indexing for Oil Valuation in General

At the core of API's previous comments is the conviction that NYMEX futures prices are a fundamentally unsound starting point for valuation of federal production. API's comments point out that NYMEX futures prices serve principally as a tool for hedging and speculating, API May 1997 Comments at 18-20, and reflect increments of added value not fully offset by the simplistic differentials contemplated. *Id.* at 20-33. API's comments also point out that the MMS' core assumption of no market at the lease is plainly wrong, *Id.* at 10-11, and that in 1987 the MMS itself considered and rejected the use of futures prices and spot prices for the valuation of federal oil production. *Id.* at 10.

Yet so far the MMS has offered no response whatsoever to these criticisms. Instead, at the workshops the MMS has emphasized that a methodology based on NYMEX futures prices (and ANS spot prices) offers simplicity and certainty. While API supports the quest for simplicity and certainty, and agrees that all parties would benefit from reduced administrative burdens and less disputes at the agency and in the courts, these objectives cannot lawfully be sought at the expense of fundamental fairness to the lessee and satisfying the statutory requirement that royalty be based on the "value of production." Indeed, even the MMS professes that the overall intent of this rulemaking "is to develop valuation rules that better reflect market value." 62 FR 49461(September 22, 1997).

Indexing for Oil v. Indexing for Gas

At the October 7-8 session, MMS staff asked API pointedly how industry could support indexing for purposes of gas valuation yet adamantly oppose it for oil valuation. While it is ironic that the MMS would now invoke a central element of the compromise reached by industry, the states, and the MMS during the gas valuation reg-neg -- which the MMS has now unilaterally abandoned -- API can offer a simple explanation. While different, API's positions for oil and gas are not inconsistent for the reasons explained below.

First, the index-based valuation methodology that emerged in the gas valuation reg-neg is fundamentally different than the indexed-based methodology reflected in the pending MMS oil valuation proposal. For gas, the indexing methodology, since abandoned unilaterally by the MMS after it had been proposed, would have used spot prices published for pipelines physically connected, and in close proximity, to the lease, subject to later adjustment based on comparison to arm's length sales in the same zone. In contrast, for oil, the indexing methodology now promoted by the MMS would use NYMEX futures prices (or ANS spot prices) representing markets distant from the lease, and would apply even if the sales in fact occurred at the lease. Beyond their common use of the term "index," the gas and oil indexing methodologies are simply not comparable.

Second, and more fundamental, because of the basic differences between oil and gas, the gas and oil segments of the petroleum industry are fundamentally different in ways which materially affect valuation. Whereas gas in its natural, produced state is essentially a simple compound with very few impurities and relatively invariant in quality, crude oil is a complex mixture of compounds with many impurities and widely varying in quality from area to area. While some processing of gas may occur to remove natural gas liquids, it is at the moment of production very close to a condition suitable for final use. In contrast, crude oil must undergo heavy refining and fundamental changes before any of its byproducts are usable for anything.

For valuation purposes, these marked physical differences manifest themselves in fundamental marketing differences, which in turn are reflected in the quality of the price data that is available. For example, gas spot prices are a sound measure of actual gas sales because they are based on physical sales on pipelines relatively close to the lease and representing a large percentage of total physical dispositions. Accordingly, gas spot prices are a useful measure of gas value, even in the absence of an arm's length transaction at the lease. In contrast, oil spot prices are "soft," often based on an "assessment" of prices by parties interviewed, irrespective of whether arm's length sales have actually occurred. Indeed, outright physical sales of oil at market centers, the starting point for the MMS' proposed methodology, represent a much smaller percentage of total physical dispositions than gas. In sum, oil spot prices are far less reliable than gas spot prices. Moreover, NYMEX futures prices are even more removed from the lease than spot prices and are an even poorer measure of the value of production at the lease.

Duty to Market

For years the MMS and industry have been locked in controversy over the extent to which a company has a duty to market and what costs constitute legitimate deductions from the gross proceeds realized in the sale of production. While industry in no way concedes the MMS' expansive position in these ongoing disputes, the asserted duty to market free of charge is no mere clarification of the existing MMS rules but is a major expansion of the existing requirement. *See Id.* at 34-38.

In addition, the MMS' proposed expansion of the duty to market is linked to the MMS' proposed indexing methodology. In the past, at least the MMS' expansive position on duty to market, reflected often in a narrow view of allowances, was linked to actual transactions, whether they be arm's length or non-arm's length sales. With its proposal to abandon the existing lease-based benchmark methodology in favor of a NYMEX futures prices or ANS spot prices methodology, however, the MMS would rely on the fiction that most oil sales transactions occur well downstream. When the unreliable, non-representative, and inherently averaged NYMEX futures prices (and ANS spot prices) are used as the starting point and simplistic, fixed differentials are used, it is hardly surprising that the resulting values are higher than the real value of production at the lease.

Even if the crude oil were sold far downstream, there are increments of value added by marketing that are ignored by the MMS proposal. *Id.* at 24-25. Worse yet, since most crude is not sold far downstream, the NYMEX futures prices and ANS spot prices that the MMS starts with reflect phantom transactions that never even occurred. *Id.* at 10-12.

Particular Benchmarks

API and many other commenters have already suggested that the MMS revise the existing regulations, which includes a series of benchmarks for non-arm's length contracts, instead of replacing it with a novel indexing scheme. *Id.* at 7-9. And at the Denver and Houston workshops, four benchmarks were a part of the wide-ranging benchmark discussion: 1. posted prices; 2. spot prices; 3. tender/bid out; and, 4. royalty-in-kind. API has definite views on each of these items.

1. Posted prices. What seems to have been forgotten in the present rulemaking is that in the protracted rulemaking leading up to the 1988 regulations, the use of posted prices was readily accepted by the original Royalty Management Advisory Committee and was readily accepted by the MMS when it promulgated the 1988 regulations. And, since then, industry has operated under that regulatory framework.

If, however, the MMS has decided to abandon posted prices as a benchmark, API has no problem, provided that the end result conforms to the statutory rubric: value of production at the lease. API has at no point opposed elimination of posted prices for future valuation of crude oil. What API members have resisted is retroactive abandonment of posted prices in the course of individual company audits. What API itself has opposed is substitution of another measure for valuation of future production (i.e., NYMEX) that cannot, we are convinced, when used with MMS' pre-established differential scheme, consistently arrive at the value of production at the lease.

2. Spot prices. While starting with spot prices at market centers has the advantage of starting the valuation process closer to the lease than starting with futures prices at an indexing point, this marginal benefit leaves unanswered the myriad reliability and accuracy problems noted previously by API in connection with federal production in California and Alaska, *Id.* at 10-14, and for federal production generally. *Id.* at 25-26. As explained more fully in connection with the preceding discussion comparing indexing for oil with indexing for gas, the spot price market for oil is simply not as developed for oil as it is for gas. Accordingly, API cannot, at this point, support use of spot prices for valuation of federal crude oil production.

3. Tender/bid out. At the Denver workshop, Conoco, an API member, described at length its tender/bid out program; Texaco, another API member, also pointed out that it had a somewhat similar system. As an available alternative for valuation of crude oil valuation, API believes such programs have merit and deserve close scrutiny as one possible way to amend the existing benchmark system. However, until critical operating details (e.g., the volume of production needed for qualification as a benchmark, minimum number of bids required, MMS pre-approval process, etc.) appear in an MMS proposal, any blanket endorsement would be premature.

4. Royalty-in-kind. API, along with the comments and testimony of many other industry trade associations and individual companies of all sizes and types, urge the MMS to explore the use of royalty-in-kind to avert the inherent complications of valuation. *Id.* at 40-41. To this overall endorsement API would add that royalty-in-kind, once operational, should also be usable as a benchmark for valuation of crude oil production of like quantity and quality. If the MMS has reservations about the continued use of posted prices and the existing comparable sales benchmarks, what better solution than using transactions to which the MMS itself is a party.

Non-uniform valuation regulations

At the Denver and Houston workshops, another topic of discussion was the desirability of promulgating oil valuation regulations with special provisions for the Rocky Mountain region, for California, for the OCS, and for companies with refineries. If the benchmark scheme were revised to include benchmarks like the tender/bid out and RIK approaches discussed at the workshops, no indexing would be required and non-uniform regulations would seem to be unnecessary, a major benefit for companies operating in several producing regimes. Nonetheless, API will address each of these items in turn.

1. Different regulations for Rocky Mountain region. At the workshops, most seemed to agree that the multi-state Rocky Mountain region exhibits some unique characteristics that could justify somewhat different treatment in the MMS' revised oil valuation regulations. API endorsement of different treatment, however, depends on the specific details of such differential treatment, which API would address in the course of the required rulemaking.

2. Different regulations for California. Unlike the Rocky Mountain region addressed above, which seems to exhibit some unique characteristics, API cannot endorse different treatment for California. Even if some different treatment were appropriate, API's earlier comments address the insufficiency of an indexing scheme using Alaska North Slope spot prices for valuation of federal production in Alaska and California. *Id.* at 13-14.

3. Different regulations for the OCS. Although the workshop discussions did not address the onshore-offshore distinction as sharply as the nation-Rocky Mountain region distinction noted above, such factors as lease size, gathering systems and aggregation points, could well lead to somewhat different regulations for the OCS. However, API endorsement again would depend on the specific details of such differential treatment.

4. Different regulations for companies having refineries. Of all of the possibilities discussed for non-uniform regulation, the notion of a simplistic rule that uses refinery ownership as the determinant of valuation methodology is the most objectionable for several reasons.

First, if companies owning refineries were categorically required to use the proposed indexing methodology, this would make unavailable some of the most promising benchmarks that have emerged in this rulemaking (e.g., tender/bid out, royalty-in-kind, etc.) which plainly have merit irrespective of corporate structure.

Second, having a refinery does not mean that a lessee will move all of its production (either physically or by trade) to its refinery. Even if a simplistic refiner-nonrefiner rule were tempered with an exception process by which a company having a refinery could request special treatment on a case-by-case basis, this would undercut the MMS' quest for simplifying the overall valuation process.

Finally, a simplistic valuation rule that imposes an index-based valuation methodology on companies having refineries is arbitrary, unfairly discriminatory and poses manifest legal problems. *See, e.g.*, Getty Oil Co., IBLA 80-430 (October 31, 1980)(reversing MMS Director decision to disregard the validity of transportation agreement simply because it was entered into by a parent company and its subsidiary) and Shell Western E&P, Inc., IBLA 87-47 (January 23, 1990)(setting aside MMS Director decision disallowing certain transportation costs solely on the basis that lessee was affiliate of pipeline operator).

In sum, the choice of valuation methodology should depend on the transaction-by-transaction behavior of the company, not *a priori* assumptions and the simple fact that it owns a refinery.

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When the MMS publishes a new proposal, API will file additional comments. in the meantime, API will provide you with additional information as it becomes available through the API analysis and consensus gathering process. If you have any questions on these comments, please contact David Deal of my staff at (202) 682 - 8261.

Sincerely,

Bill Frick

G. William Frick
Vice President, General Counsel and
Secretary