Coastal
The Energy People

May 27, 1997

COMMENTS on
The Minerals Management Service's
Proposed Rules for Establishing Oil Value
for Royalty Due on Federal Leases
and on Sale of Federal Royalty Oil
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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 of Proposed Rulemaking, dated January 24, 1997, Coastal Oil & Gas Corporation, ANR Production Company, CIG Exploration, Inc., and Coastal States Trading, Inc. (collectively **Coastal**) offer the following comments on the subject proposed rules (**Proposed Rules**):

I. COASTAL

The Coastal Corporation is a diversified energy company with consolidated assets of over $10 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.

As a crude oil producer, Coastal is a relatively small company, only producing approximately 12,000 barrels per day (combined crude oil and condensate), but a significant portion of this production is from Federal leases (onshore and offshore) and Indian leases.

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As a crude oil purchaser/marketer, Coastal States Trading, Inc., is both a first-purchaser of crude oil and condensate at the lease (about 35,000 barrels per day, of which 23,000 barrels per day is purchased from third parties), and a significant bulk trader (about 400,000 barrels per day) making it a medium-sized crude oil marketing company.

II. BACKGROUND

On December 20, 1995, the Mineral Management Service (**MMS**) published an Advance Notice of Proposed Rulemaking on Valuation of Oil from Federal and Indian Leases (60 *Federal Register* 65610, et seq.), and solicited comments from the oil & gas industry (**Industry**).

Unfortunately, in 1996, virtually all the major oil companies and most, if not all, of the medium-sized oil companies, such as, Coastal, were named as defendants either in MMS or State royalty audits and enforcement actions and/or private state-wide and nation-wide class-action lawsuits alleging undervaluation of royalty oil. As a result, these companies, and companies who thought they might be named as defendants in the lawsuits, were reluctant to candidly discuss crude oil valuation issues with the MMS. The Industry requested the MMS to postpone its rulemaking.

Rather than postpone its rulemaking, the MMS consulted in private with so-called "experts" in crude oil marketing. Regrettably, some of these "experts" had serious conflict-of-interest problems due to the fact that they also had financial interests in either one or more of the above-mentioned lawsuits or in the royalty interests of certain of their clients.

On January 24, 1997, without input from the Industry or Industry groups, such as, the IPAA and the API, the MMS published the subject Notice of Proposed Rulemaking.

III. SUMMARY OF COASTAL'S POSITION

A. For the reasons stated below, Coastal strongly opposes the Proposed Rules, and urges the MMS to withdraw the Proposed Rules in favor of (i) taking Federal royalty oil in-kind, or (ii) the amendment to the 1988 Rules proposed by the IPAA.

B. Coastal acknowledges the fact that the MMS has serious concerns about relying upon posted prices as the means of determining the value of Federal royalty oil, particularly when the posting is made by the same producer who is valuing the oil for royalty purposes. Coastal also acknowledges the fact that the MMS has been criticized for allowing producers to use posted prices in valuing royalty oil, and that this issue has become a political issue, particularly in California.

C. Coastal is an active member of the Independent Petroleum Association of America (**IPAA**) and has been involved in the drafting of IPAA's Comments, filed with the MMS on May 15, 1997. Coastal supports and adopts the Comments submitted by the IPAA in this matter.

D. As a short-term, but immediate, solution to the perceived problems of royalty oil valuation, Coastal supports the position of the IPAA to amend the 1988 Rules to eliminate references to posted prices, and to rely instead on (i) gross proceeds received at or near the lease, and (ii) for non-arm's length transactions, gross proceeds received at or near the lease if such prices are within the range of prices received in arm's-length transactions at or near the lease for like quality oil.

E. As the ultimate solution to the entire problem of royalty valuation and compliance enforcement, Coastal supports the position of the IPAA that the government take its royalty share of production in-kind.

F. Further, as more particularly described in the IPAA's Comments and below, Coastal opposes the Proposed Rules on the following grounds:

1. The Proposed Rules are unsupported by any credible evidence;
2. The assumptions underlying the Proposed Rules are unfounded and erroneous;
3. The Proposed Rules ignore the costs and risks of trading on the NYMEX;

4. The Proposed Rules would require royalties to be based upon artificial oil prices and adjustments, resulting in an obligation to pay royalties on phantom income.

5. The Proposed Rules would value oil at a location far removed from the lease;

6. The Proposed Rules would impose increased financial and reporting burdens;

7. The Proposed Rules would impose a new obligation to market oil without compensation to the lessee; and

8. The Proposed Rules, as written, would almost certainly lead to litigation.

IV. A RADICAL CHANGE FROM THE PRESENT RULES IS UNNECESSARY TO ACHIEVE THE MMS' OBJECTIVES

The MMS has stated that the objectives of the Proposal are to (i) add certainty, (ii) simplify the existing Rules, (iii) decrease reliance on posted prices, and (iv) assign a value to crude oil that better reflects market value. These are laudable objectives, and Coastal and the IPAA support the MMS in this endeavor, however, Coastal would like to see them accomplished in a manner that is less disruptive to the Industry than the Proposed Rules and is tied to market value at the lease as measured by proceeds received in arm's-length transactions.

Coastal believes that the 1988 Rules could be amended relatively easily by merely removing the references to posted prices, accepting gross proceeds for arm's-length transactions, and establishing benchmarks for non-arm's lenght transactions based upon the prices received at or near the lease if such prices are within the range of prices received in arm's-length transactions in the same field or in the same area for like quality oil, and, based upon the data the MMS currently receives and/or the prices the government receives from its own sales of royalty oil, to timely report the range of comparable prices.

V. THE GOVERNMENT SHOULD TAKE ITS ROYALTY OIL IN-KIND.

If the MMS truly wants to simplify the Rules, provide certainty, and ensure that it is receiving market value for Federal royalty oil, this is hands down the best solution. All references to the valuation of oil would removed from the Rules. Auditing of lessees would be limited to an audit of volumes of oil produced and saved from each Federal lease. The market value of Federal royalty oil would be the value received by the Federal government for the sale of its oil in the open, competitive marketplace (the textbook definition of fair market value). This has proven to be a workable solution, as shown by the success of the Canadian government in Alberta, and requires no substantial changes to the Rules, since the MMS generally already has the right to take its oil in-kind. Coastal would support legislative changes in Federal Law, if necessary to implement an in-kind program.

Naturally, if the Government took its royalty oil in-kind, and it did not sell its oil at or near the lease, it would pay its proportionate share of all downstream costs and expenses and it would assume its proportionate share of all downstream risks.

VI. THE PROPOSED RULES ARE UNSUPPORTED BY CREDIBLE EVIDENCE

Based upon the Freedom of Information Act requests filed by several Industry groups in this matter, there appears to be no credible evidence in support of the base assumptions relied upon by the MMS as justification for changing the 1988 Rules (for example, that there is no longer any market at the lease for crude oil). In fact, the only support for the change cited by the MMS is that it solicited the advice of certain "consultants" and "experts," some of whom are well known to Industry as having ulterior motives and financial interests in the outcome of pending oil royalty litigation. Not only are there no economic studies, scientific studies, or peer-reviewed published papers to support the radical changes proposed by the MMS, there are not even any substantiated MMS audit results which would even begin to justify the magnitude of the changes that would be required under the Proposed Rules.

Further, based upon those same Freedom of Information Act requests, there appears to be no credible evidence supporting the accuracy of the formulas used to net back the Cushing, Oklahoma value to the lease. There is not one iota of evidence that the Proposed Rules as written would result in a value for any given lease production that is any closer to the "true market value" (note - there is no single "true" value - only a range of values) of Federal royalty oil at the lease than that determined under the 1988 Rules. The MMS has even publicly admitted that the Proposed Rules will need to be changed after the MMS has some experience with them. In fact, there is evidence from respected sources, people experienced and knowledgeable in crude oil marketing, that the Proposed Rules would substantially overvalue or undervalue oil at the lease.

VII. THE ASSUMPTIONS UNDERLYING THE PROPOSAL ARE UNFOUNDED AND ERRONEOUS

Among the MMS' stated or implicit assumptions which are of concern to Coastal are the following:

A. The MMS assumes there is no market at the lease, and that most oil is sold at spot prices at "major market centers."

This is absolutely not true. There is an active crude oil market at the lease. In fact, most oil is sold at the lease. While it is true that large quantities of oil are sold at so-called market centers, that oil is largely lease oil that has been aggregated and transported by oil marketers and re-sold in bulk sales transactions (minimum 1,000 barrel lots) by traders who guarantee delivery. The fact of a lease market would be easily proven if the MMS took Federal royalty oil in-kind at the lease and offered it for sale to the highest bidder.

This assumption also ignores that fact that a great deal of oil is sold on term contracts, not the spot market, and is not reported as sales at the market centers.

B. The MMS assumes that the NYMEX price is the best indicator of market value.

This is not true. The New York Mercantile Exchange (**NYMEX**) price is a futures price - the price of oil that is scheduled for delivery in future months - not the price of oil delivered in the present month, the month of production. It is a price that is sensitive to world-wide rumors and speculation, not actual United States production and demand data. While it is true that posted prices and spot sales contract prices often move in conjunction with and are sensitive to the NYMEX price, little, if any, oil is actually sold or purchased at the lease at an undiscounted NYMEX futures price.

C. The MMS assumes that small volumes of oil at the lease, composed of various types and grades, should be priced the same as large volumes of oil at major market centers hundreds of miles from the lease, composed of consistent types and grades, and sold in bulk lots of at least 1,000 barrels.

This is simply not a realistic assumption. Three dozen eggs on the farm are not worth the same price as a warehouse full of eggs in the big city.

The egg dealer has invested in trucks to collect and deliver eggs, and warehouses to store eggs. He has contracted with farmers to purchase eggs, and he has contracted with retailers to sell eggs. The dealer has employees - drivers, inspectors, packers, and salesmen - and insurance and overhead expenses. The dealer has assumed the physical risk of transporting eggs, the cost of storing the eggs, and the market risk of fluctuating egg prices. As a result, the egg dealer cannot reasonably and logically pay the farmer the same price, less only actual transportation expenses, that he receives from his retail customers. If he did, he would quickly be out of business because not only would he make no profit, he would not even cover his overhead.

The same principles apply to the crude oil business. A crude oil marketer also has employees, insurance, office space, office equipment, online services, and overhead expenses, not to mention experience and expertise in the crude oil marketing business, (which to its credit the MMS admits it does not). He has also assumed certain risks inherent in the business - transportation, storage, fluctuating prices, delivery guarantees, etc. Like the egg marketer, the oil marketer cannot reasonably and logically pay royalty at the lease based upon the same price, less only actual transportation expenses, that he receives for bulk sales of oil at distant market centers and stay in business.

Coastal concurs with the statement made by the Scurlock-Permian Corporation representatives (April 1, 1997, at the public hearing on the MMS' proposed crude oil RIK pilot program presentation in New Orleans) that Scurlock, a major purchaser and refiner of crude oil) would not be willing to purchase the Federal government's royalty share of crude oil at the lease on the same terms as those now being proposed by the MMS in the Proposed Rules. The reason is obvious - there is no compensation for the risks and expenses incurred by the crude oil marketer in taking title to the oil, arranging and paying for its movement from the lease to its ultimate sales point, and arranging for its final sale.

D. The MMS assumes that any lessee who purchased crude oil in the United States in the past two years for any reason cannot enter into an arm's-length contract, and that any oil which is subject to a call on production, regardless of the terms of that call or whether the call is ever exercised, cannot be the subject of an arm's-length transaction.

These assumptions are apparently based upon the presumption that if the slightest possibility of price collusion may exist in a transaction, however unreasonably remote that possibility may be, the only remedy is to disregard the entire category of transactions altogether. This is more than a little like throwing out the baby with the bath water. There is no reasonable or logical rationale for taking such a drastic view. In order for price collusion to occur in the subject scenarios, it would require more time and effort on the part of the conspirators than the price advantage would be worth, not to mention the risk of being caught and punished for a felony crime. In addition, the MMS has an adequate remedy available to it now - the right of audit and the right to adjust payments in the event royalty is found to have been based upon a price which is less than the market value under the 1988 Rules.

VIII. THE PROPOSED RULES IGNORE THE COSTS AND RISKS OF TRADING ON THE NYMEX

The NYMEX price is the price of crude oil in a crude oil contract - a contract for guaranteed deliveries, and guaranteed receipts, of specific volumes (usually in lots of 1,000 barrels), of a specific type and grade of crude oil (usually West Texas Intermediate), for a guaranteed price. Failure to deliver or receive oil on the due date of a contract, or conversely, delivery or receipt of too much oil, or delivery of a different type or grade of oil, is subject to costly penalties and/or charges.

There is no allowance for variation in production due to normal tolerances, problems with the well, or over production. If one wishes to sell at bulk prices relative to the NYMEX prices, one must be prepared to guarantee specific performance, without tolerance. Normally, the lease purchaser/crude oil trader maintains inventories, pipeline transportation space, bank guarantees, insurance, staff and equipment, and other functions necessary to financially and operational move crude oil to and make sales at a bulk trading point. If the Government wishes to receive this price, then the Government should assume these risks and obligations. Query - why would any prudent lease purchaser pay bulk market center prices at the lease, and then assume all the risks of transporting that oil to a market center to resell it at the same price?

IX. THE PROPOSED RULES WOULD REQUIRE ROYALTIES TO BE BASED UPON ARTIFICIAL OIL PRICES AND ADJUSTMENTS, RESULTING IN AN OBLIGATION TO PAY ROYALTIES ON PHANTOM INCOME.

The Proposal would require royalties to be paid upon values determined in accordance with a complicated and unrealistic formula that is totally unrelated to the real world movement of the subject oil and the real world prices received by the lessee for that oil. In fact, the MMS has stated that the gross proceeds actually received by the lessee are irrelevant to the amount of royalties due on that oil. If the MMS had any actual experience in the crude oil marketplace, it would know, as all crude oil marketers know, that it is not possible to value crude oil at the lease based upon the price determined in accordance with the Proposed Rules. To the extent that the price under the Proposed Rules is greater than the price actually received by the lessee at the lease, the difference is phantom income - income which is attributable to the lessee for royalty obligation purposes, but which the lessee never receives. The Proposed Rules appear on their face to be an unlawful attempt to raise the Federal royalty rate in contravention of the terms of the leases and Federal Law.

X. THE PROPOSED RULES WOULD VALUE OIL AT A LOCATION FAR REMOVED FROM THE LEASE

Under current Federal Law and leases, and pursuant to years of Industry and MMS practice, the only place the MMS may lawfully require the valuation of royalty is at or near the lease. The Proposed Rules, despite the MMS' claim to the contrary, values all crude oil, except for Alaska and California, at Cushing, Oklahoma, regardless of where it is produced and regardless or where it is actually sold. Coastal believes that the MMS' position is arbitrary, capricious, and an abuse of discretion.

XI. THE PROPOSED RULES WOULD IMPOSE INCREASED FINANCIAL AND REPORTING BURDENS

A. Implementation of the Proposal would require Federal lessees to change their accounting systems.

Most Federal lessees already have two accounting systems in place - one based upon actual income, and one designed specifically to comply with 1988 Rules - but lessees currently have no accounting systems designed to comply with the Proposed Rules. It will be very expensive and time-consuming for Federal lessees to design, set up, test, and run such a system, especially when there is no proof that such a system will result in a more accurate oil value, and more especially when the MMS has publicly stated that the system may have to be changed within after the first year. Coastal does not believe the MMS has properly considered the high cost of these changes.

B. The Proposal would require time-consuming compilation and reporting of large amounts of data not currently reported, and which would be quickly out of date.

The Proposal would require that all oil exchanges, from and to any location, involving Federal and non-Federal oil, be reported on a new form - MMS 4415. The MMS proposes to use the data collected on this form to publish annual quality and price differentials between major market centers and major aggregation points.

One of the problems with this concept is that the differentials published by the MMS would apparently be an average (the Proposed Rules do not elucidate), but would be required to be used by all lessees. Another problem is that it requires reporting of all transactions, not just those involving oil from Federal leases, and not just those involving MMS-designated major market centers and major aggregation points. It is difficult to see how all this data is relevant to the Proposed Rules. It is also difficult to ascertain the MMS' legal authority to require the reporting of data on non-Federal leases. Finally, such differentials are constantly changing, and it is very naive to propose the use of differentials based upon data compiled in the previous year as valid figures for the current year.

XII. THE PROPOSED RULES IMPOSE A NEW OBLIGATION TO MARKET OIL WITHOUT COMPENSATION TO THE LESSEE

Section 206.102(e) states that the lessee must "market the oil for the mutual benefit of the lessee and the lessor at no cost to the Federal Government." Coastal strongly objects to the inclusion of this language. We can find no support in the Federal Law or the leases for such a statement. Coastal believes that the MMS' position is arbitrary, capricious, and an abuse of discretion. Even if all the other changes suggested herein are incorporated into the Proposed Rules, Coastal could not, and would not support a rule which contained the above-quoted language.

XIII. THE PROPOSED RULES WOULD ALMOST CERTAINLY LEAD TO LITIGATION

Coastal believes the Proposed Rules would not in fact add certainty to valuation, simplify the regulations, or reduce the time and expense of auditing and litigation. Quite the contrary, Coastal believes that the Proposed Rules unnecessarily complicate the regulations, will increase the time and expense of auditing, and will promote litigation. Coastal believes that the Proposed Rules, as written, would not pass judicial muster if tested in a court of law, as they surely would be. Coastal urges the MMS to withdraw the Proposed Rules, as it has withdrawn its proposed valuation rule for natural gas, before it embroils the entire Industry and the MMS in protracted, expensive, and acrimonious litigation that is harmful to all concerned.

XIII. CONCLUSION and RECOMMENDATION

In conclusion, Coastal strongly urges the Minerals Management Service to withdraw the Proposed Rules, for the reasons stated in these Comments, the Comments of the IPAA, and the Comments of other Federal lessees and Federal crude oil purchasers filed in this matter.

A. As a permanent solution to the actual or perceived valuation problem, Coastal urges the Federal Government to <u>take its royalty oil in-kind.</u>

B. In the alternative, as a short-term quick solution, the MMS should <u>amend the 1988 Rules</u> as suggested by the IPAA to (i) eliminate references to posted prices, (ii) use gross proceeds received at or near the lease for arm's-length transactions, and (iii) to use gross proceeds received at or near the lease for non-arm's length transactions if the price received is comparable to the range of prices received in arm's-length transactions at or near the lease for like quality oil, as promptly reported by the MMS.

C. At the very least, the MMS should institute a pilot program to take a substantial amount of the Federal government's royalty oil in-kind as soon as possible (i) to gain first-hand knowledge about the crude oil market, and (ii) to ascertain the range of prices that represent market value of oil at the lease before recommending radical changes to the 1988 Rules which are complex, burdensome, unrelated to proceeds received by most lessees, and which the MMS itself admits may not accurately reflect market value at the lease.

D. The MMS should delete any reference in the Proposed Rules to an obligation to market oil at no cost to the government.

Sincerely,

Robert G. Teeter

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