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July 24, 1998

By Fax: 303-231-3385

David S. Guzy, Chief  
Rules and Publications Staff  
Minerals Management Service  
P.O. Box 25165, MS 3021  
Denver, Colorado 80225-0165

RE: Further Supplementary Proposed  
Rule on Establishing Oil Value for  
Royalty Due on Federal Leases (July  
16, 1998)

Dear Mr. Guzy:

These comments to MMS's July 16 notice on potential modifications to its proposed rule of February 6, 1998 are submitted on behalf of the California State Controller's Office ("SCO").

As SCO understands it, MMS's reopening of the comment period on July 9 and its July 16 supplementary proposal evolved from the insistence of certain members of the Senate Oil and Gas Caucus that Interior meet privately with industry representatives to discuss the proposed oil valuation rules. SCO understands that Interior agreed to the private meeting because of the funding moratorium that Congress put on new oil valuation rules in the supplemental appropriations law and because Interior wants to avoid any continuation of that moratorium in its fiscal 1999 appropriations. For over a year, SCO has urged MMS to publish the oil rules in final. It, of course, opposes any further delay through a funding moratorium.

Under these difficult circumstances, MMS should be congratulated for its attempt to provide those excluded from the

private meeting an opportunity to provide comments on the issues discussed.

Generally, SCO notes that industry's assertions that it has not had a fair opportunity to present its views and that MMS has not been responsive to those views are incredible. MMS has gone above and beyond the norm in providing interested parties the opportunity to present written comments and to appear at public hearings and workshops. And, the record shows that industry has availed itself of every opportunity. In fact, SCO was somewhat surprised that the notes of the July 9 meeting indicate that industry did not raise a single issue that had not already been thoroughly debated.

The record also shows that MMS has made considerable concessions to industry. Indeed, SCO expressed the view in its last set of comments that MMS had gone too far in accommodating industry's views. There are many aspects of the February 6, 1998 proposed rule that are objectionable to SCO. Nonetheless, it cannot be said of MMS that it did not approach the middle ground in that proposal.

In short, the recent portrait being painted of MMS by industry and its supporters with regard to new oil valuation rules is, simply put, inaccurate and unfair.

In the time allotted, SCO cannot address all of the issues raised by industry in the July 9 meeting. Our prior comments and those of the City of Long Beach on those issues are incorporated by reference herein. The following are SCO's comments on the specific issues raised in MMS's July 16 supplementary proposal.

#### 1. Exchanges

SCO supports MMS's proposal to substantially eliminate the tracing of production through multiple exchanges or other non-arm's length transfers. As pointed out in prior comments, even if it were possible to conduct such tracing in a single instance, the exercise is not administratively realistic given the size of MMS's lease universe. SCO notes that industry, including the independents' associations, also submitted comments opposing expanded tracing. While at a July 21 press conference the independents back-tracked and now advocate support for complicated downstream tracing<sup>1</sup>, they have not demonstrated why their previous position that such tracing was impossible and an overly burdensome "nightmare" was wrong.

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<sup>1</sup> See Platt's Oilgram News, July 21, 1998.

## 2. Affiliate

SCO disagrees with MMS's proposed return to the definition of affiliate in the 1988 regulations. MMS's definition in its February proposal was bright line and thus advanced the very certainty that industry has been complaining is lacking from the 1988 regulations. The 10 to 50% presumption complicates audits and invites factual disputes, document access disputes and litigation.

The notes from the July 9 Senate meeting, however, indicate that MMS is predisposed to make a change to the affiliate definition. In light of that, SCO makes the following suggestions for modification of MMS's most recent proposal on the affiliate definition.

(a) SCO recommends deleting the reference to affiliation from the definition of arm's length. Transactions between affiliates are by definition not arm's length. However, transactions between nominally unaffiliated persons can also be non-arm's length, e.g. exchanges. And unaffiliated persons (under the proposed definition) can still have common economic interests in an enterprise or transaction. SCO believes that the continued reference to affiliation in the arm's length definition confuses the issues by suggesting that proof of non-affiliation is sufficient to establish an arm's length transaction. It is our understanding that many MMS auditors stop their analysis if ownership interests are below 50%. Whether intended or not, the wrong message is being sent by the current definition of affiliate. As MMS has previously noted, separation of the affiliate definition increases the clarity of the rules; SCO's recommendation is consistent with that conclusion.

(b) SCO recommends that MMS specifically define the burden that a lessee must carry to rebut the presumption. MMS's explanation at a July 21 public meeting sponsored by Representatives Carolyn Maloney and George Miller suggested that it is RVD's current policy to require clear and convincing evidence of non-affiliation (i.e., that it requires proof from the lessee that the contract is in fact arm's length)<sup>2</sup>. Stating explicitly the nature of a lessee's burden would add clarity and certainty to the rule. It should also be re-stated that the lessee, not MMS auditors, have the ultimate burden of proof on all issues of affiliation, as on all aspects of the royalty calculation

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<sup>2</sup> We note that this policy is apparently applied when companies seek advance approval that their contracts are arm's length, but not all companies seek such approval and an advance decision is not required.

(c) SCO recommends deleting the references to "control" in the definition or, at least, add that affiliation includes the "ability to control." The concept of "control" as it relates to ownership percentages is not meaningful in terms of certain common business relationships. For example, a general partner in a limited partnership has management control and legal control of partnership affairs. However, it is not uncommon that the general partner has a minor ownership interest. Under MMS's definition, a lessee with an 80% limited partnership interest in a marketer would not be deemed affiliated with the marketer because of the control language. We are sure that this result is not the Service's intention and we are equally certain that MMS does not want to invite litigation over such issues. Similar problems exist with general partnerships and joint ventures. Adding "ability to control" would also address corporate interests of less than 50%, where those with common economic objectives can combine to dictate corporate activities.

(d) SCO recommends that MMS clarify that to rebut the 10 to 50% presumption or to take advantage of the below 10% non-affiliation provision, the related entity must open its books to audit. This should be a precondition to any related entities availing themselves of the advantage of being found unaffiliated. As MMS is aware, accessing documentation from related entities has been a source of complication and litigation. SCO does not believe that a lessee should be entitled to take advantage of the arm's length rule by closing off the administrative ability to review the lessee's application of the rule.

### 3. Duty to Market

SCO has consistently supported and continues to support MMS on the duty to market issue. The notes of the July 9 Senate meeting indicate that MMS was under considerable pressure to modify its duty to market provision. SCO appreciates MMS's attempt to accommodate on this issue, but agrees with Director Quarterman that if anything more needs to be said, it should be done in the preamble and not in the rule. SCO does not believe that in an area of evolving law and changing market practices, it is possible to capture in regulatory language all of the "conditions where marketing at the lease won't [or will] trigger MMS actions." [July 9 notes] Moreover, SCO believes that MMS has gone beyond what those attending the July 9 meeting requested, which was simply an assurance that MMS would not "second guess" a lessee's arm's length contract price simply because it was below index.

If regulatory language is to be included, great care must be exercised that MMS does not water down the public's lease rights or make the duty to market administratively difficult to enforce. If the rule itself is to be changed, SCO recommends the following modifications to MMS's July 16 proposal.

(a) MMS acknowledged at the July 9 Senate meeting that the duty to market would not allow it to "second guess" a lessee's business judgment. SCO agrees that the duty to market would not permit MMS to require an arm's length lessee to remit royalties on a higher price simply on proof that a higher price existed. In other words, without more, MMS cannot substitute its business judgment on price for the price obtained by a lessee in an arm's length contract.

Nonetheless, SCO shares the concerns expressed by several participants at the July 21 House meeting that there is always a degree of "second guessing" involved in any inquiry into whether a lessee has met its duty to market. For simple example, if an MMS auditor found that a lessee had three offers of equal terms except for price, but the lessee accepted the contract with the lowest price, SCO believes it is MMS's obligation to ask why and the lessee's obligation (because it has exclusive control over the relevant data) to demonstrate a valid business reason that serves the monetary interests of both the lessor and lessee. Thus, SCO recommends that MMS clarify that it is not reducing MMS's audit, investigation and document access authority. Lessees and affiliates should also be required to maintain and disclose all records justifying their arms-length contracts.

(b) In SCO's opinion, MMS's preamble language coupled with its proposed regulatory language, could be read to unnecessarily limit the protection afforded to a lessor by the duty to market. SCO understands that this would be contrary to MMS's intention, which is simply to assuage industry's fears, albeit unfounded, that MMS will require payment on an index price any time the arm's length price is below index.

MMS's examples (i.e., the reference to "misconduct" and acts "for the purpose of reducing royalty") suggest that MMS must prove that a lessee took affirmative and intentional steps to harm the lessor's interests before a breach of the duty to market will be found. While SCO agrees that bad faith actions for the purpose of reducing royalties would establish breach, such actions are not the only types of acts that would show a breach of the duty to market. Actions that fall below those that would be taken by a prudent operator (e.g., negligence) would also establish breach of the duty to market. The third sentence of §206.102(c)(2)(ii), as worded, is also unnecessarily limiting. If a lessee is negligent or acts in bad faith in selling the production, whether the sales price is \$0.05 below index or \$2.00 below index is irrelevant -- the government is entitled to the difference. However if a contract is "substantially below market value" and the lessee cannot provide an explanation (e.g., legitimate business reason, captive market), a breach of the duty to market should be presumed.

Having reviewed the case law of different jurisdictions on the duty to market, SCO recommends the following alternative language:

(ii) Breach of your duty to market the oil for the mutual benefit of yourself and the lessor. MMS will not use this provision to simply substitute its judgment on the true market value of the oil for the proceeds received by the lessee or its affiliate under an arm's length sales contract. Examples of when the duty to market will apply include: when a lessee or its affiliate acts unreasonably, negligently, or in bad faith in the sale of oil from the lease; when the lessee or affiliate takes acts that subordinate the royalty interests of the lessor to the broader business interests of the lessee and/or its affiliates; or when the arm's length contract price is substantially below market value and no legitimate explanation for the result is shown by the lessee or affiliate.

#### 4. Gathering in Deep Water

MMS has asked for comments on industry's assertion that it should be permitted a transportation allowance for movement of oil from a subsea completion point to a central accumulation or treatment point. This issue does not directly affect California's current federal royalty revenue interests. However, any modification of the gathering definition that would confuse the gathering/transportation distinction does affect California. SCO has serious concerns that carving exceptions to the gathering rule will become a slippery slope for further industry arguments in favor of broader transportation deductions. Thus, SCO opposes modifying the definition of gathering for deepwater projects or for any other reason.

In reviewing industry's request for an exception for deepwater gathering, SCO believes that MMS should consider the following:

(a) Under the Deepwater Royalty Relief Act, industry is already entitled to a royalty holiday on the production of 87.5 million barrels. It is SCO's understanding that the scope of this holiday was designed to permit deepwater lessees to recover their investment costs.

(b) Companies are currently arguing before FERC that the same segments of pipe are, in fact, gathering.

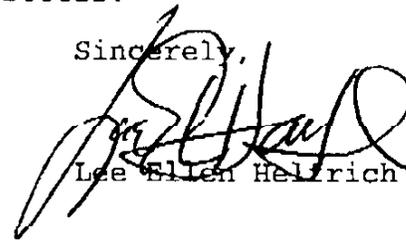
(c) Currently it is FERC's policy to presume that facilities that collect gas at 200 meters or greater depths are gathering facilities. SCO has serious doubts that any offshore oil movement upstream of an aggregation or treatment point could be factually characterized as not involving gathering.

(d) Given FERC's current policy and MMS's current definition of gathering (and contrary to suggestions made by industry in the July 9 Senate meeting), there are no legitimate investment backed

expectations that these deepwater lines would be treated as transportation and subject to FERC tariffs, or, for that matter, that gathering costs would be deductible from federal royalties.

In closing, SCO commends MMS's efforts to assure that this rulemaking remains an open, public process.

Sincerely,

A handwritten signature in black ink, appearing to read "Lee Ellen Helrich", written over the typed name.

Lee Ellen Helrich