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January 31, 2000

Via Facsimile: (303) 231-3385
& Overnight Mail

Mr. David S. Guzy, Chief
Rules & Procedures Staff
Royalty Management Program
Minerals Management Service
Building 85, Denver Federal Center
Denver, Colorado 80225

Re: Establishing Oil Value for Royalty Due on Federal Leases
Further Supplementary Proposed Rule
(64 FR 73820, December 30, 1999)

Dear Mr. Guzy:

Marathon appreciates the opportunity to submit the enclosed comments on MMS' recently published further supplementary proposed rule for establishing oil value for royalty due on federal leases.

If you have any questions, please contact me.

Sincerely,

Dow L Campbell

Dow L. Campbell

Enclosure

[118734]

cc: The Office of Information and Regulatory Affairs
Office of Management and Budget
Attention: Desk Officer for the Department of the Interior
725 17th Street, NW
Washington, D C. 20503

Marathon Oil Company
Comments on MMS' Further Supplementary Proposed Rule
Establishing Oil Value for Royalty Due on Federal Leases
64 FR 73820 - December 30, 1999

INTRODUCTION

In the Federal Register of December 30, 1999 (64 FR 73820), the Minerals Management Service ("MMS") proposed further changes to its proposed rule amending the regulations governing the royalty valuation of crude oil produced from federal leases. MMS' original proposal was published in the Federal Register on January 24, 1997 (62 FR 3742); a supplementary notice was published in the Federal Register on July 3, 1997 (62 FR 36030); the comment period was reopened by notice published in the Federal Register on September 22, 1997 (62 FR 49460); a supplementary notice was published in the Federal Register on February 6, 1998 (63 FR 6113); and a supplementary notice was published in the Federal Register on July 16, 1998 (63 FR 38355). Marathon Oil Company ("Marathon") has committed substantial resources to provide constructive comments at each stage of this process and welcomes the opportunity to comment on the latest proposed regulations.

Marathon reaffirms and incorporates by reference its comments submitted in response to each of the MMS proposals and notices referenced above. Marathon also supports and incorporates by reference the comments being filed jointly by the American Petroleum Institute, the Independent Petroleum Association of America, the Domestic Petroleum Council, and the United States Oil & Gas Association in response to the MMS' most recent proposal. In addition, Marathon offers the following comments:

WYOMING PROBLEM

Marathon is extremely concerned with the proposed process of valuing Federal oil production in Wyoming. One of the MMS' basic premises for proposing new regulations for valuing oil royalties was to provide more simplicity and certainty to the process and to reduce disputes and litigation between the MMS and lessees. Under the latest proposal, if a lessee has production in Wyoming which must be valued under section 206.103(b), but which does not or cannot meet the stringent and burdensome requirements of either of the first two methods in the valuation hierarchy, the lessee defaults to an index for WTI crude at Cushing, Oklahoma. Much of the crude oil produced in Wyoming is not of a quality similar to the oil traded at Cushing, and it certainly is not from the same field or area. Under this valuation scenario, the result is a completely artificial value with completely contrived location and quality adjustments, since Wyoming production cannot be physically transported by pipeline to Cushing. For example, at page 73836, MMS engages in a discussion respecting valuation of Rocky Mountain oil that is delivered to a refinery. However, MMS' proposal to use the Cushing WTI spot price as a surrogate for a price that might be paid in Salt Lake City could result in serious errors in valuing oil produced in the Rockies. In cases such as this, the lessee is left with defaulting to talking to the MMS to attempt to resolve the quality differentials. This process will increase uncertainty and greatly expand the number of value determination requests filed by lessees.

This position has been strongly echoed by the State of Wyoming in its verbal statements at each of the three recent Federal Oil Valuation Rulemaking Workshops held in Denver, Houston, and Washington:

"The calculations required to arrive at a netback value from Cushing, Oklahoma may have two opposite effects, neither one yielding a fair value."

"... there are still questions regarding the Rocky Mountain Region value in terms of having to make adjustments for applicable location and quality differentials, and for transportation costs. These concerns are particularly well-founded given the fact that it is rare for Wyoming oil to ever actually be physically transported to Cushing, Oklahoma. This begs the question, what will transportation be based on? These uncertainties cannot help but increase the administrative burden and costs for industry, as well as, State and federal auditors."

The MMS needs a workable alternative for the Wyoming situation, and, to that end, Marathon proposes two changes. First, the MMS should loosen its arbitrary 50 percent standard in the second Rocky Mountain benchmark, Section 206.103(b)(2), and adopt a more realistic and viable, yet still significant, 30 percent standard. Second, the MMS should take all volumes that would otherwise be valued under Section 206.103(b)(3) as royalty-in-kind, which should prove feasible in light of the success of MMS' Wyoming Royalty-In-Kind Pilot program.

PROPOSED CORRECTION - VALUATION UNDER AN ARM'S-LENGTH CONTRACT

The proposed rule creates a possible concern in the valuation of royalties from arm's-length transactions based upon the question and answer session at the Houston workshop. If a lessee enters into a non-arm's-length exchange and the lessee subsequently sells the oil in an arm's-length transaction, then Marathon believes the royalty should be valued under Section 206.102(a)(1). However, per the MMS' response to questions at the Houston workshop, the royalty would have to be based on Section 206.103 rather than gross proceeds because such a transaction would not literally fall under Section 206.102(a)(2) (which excludes situations in which the ultimate sale is by the lessee). In contrast, under Section 206.102(d)(1), if a lessee enters into an arm's-length exchange and <u>you or your affiliate</u> subsequently sells the oil in an arm's-length transaction, then the royalty could be based on gross proceeds. Unless the lessee makes the election under Section 206.102(d)(1) to value royalties under Section 206.103, royalties should be valued on gross proceeds from any arm's-length transaction. To fix this glitch, Marathon proposes that Section 206.102(a)(2) be rewritten as follows:

> (2) You sell or transfer to your affiliate or another person under a non-arm's-length contract and <u>you, or</u> that affiliate or <u>that</u> person, or another affiliate of <u>any</u> ~~either~~ of them, then sells the oil under an arm's-length contract.

QUALITY & LOCATION DIFFERENTIALS

Marathon has several comments and suggestions regarding the proposed rule's mechanisms for calculating quality and location adjustments.

The MMS claims that posted prices have become a progressively less reliable indicator of market value of crude oil since the late 1980's, and intends to discount their use completely in the new rule. However, the MMS needs to recognize that posted prices are often the best indicator of quality differentials between grades of crude oil and that gravity scales are widely used throughout the industry to adjust for quality differences within a specific grade. Comparable sales and purchases of like quality crude from the same field or area, whether they are based on posted prices or spot market prices, still represent the best indicator of market value at the lease. Comparable sales and purchases reflect actual transactions and should be an acceptable benchmark prior to requiring the use of theoretical spot prices with theoretical adjustments for location, quality and transportation.

The MMS has designated ANS as the only index price for California and Alaska, and has designated WTI as the only index price for the Rocky Mountain Region. California indices include Line 63, THUMS and Kern River. Rocky Mountain Region indices include Wyoming Sweet, Edmonton Light Sweet (PAR), Edmonton Mixed Light Sweet and Hardisty Bow River. If MMS continues to insist on using spot prices, then, at a minimum, lessees that are forced to use index prices should be allowed to use spot prices for crude oil similar in quality to that of the lessee's oil production regardless of whether the market center for those spot prices is located in the same Region, as long as appropriate location, quality and transportation adjustments are made.

The definition of location differential should be expanded to include transportation between the first onshore point and the market center, and transportation downstream from onshore leases. Exchange differentials and published tariffs should be accepted as viable location differentials.

The MMS still needs to recognize that time spreads between NYMEX contract months are widely used to calculate premiums and discounts to index prices. These premiums and discounts are often added to or subtracted from WTI indices such as Koch's WTI posting to establish daily prices during the production month. The time spread relationship between the prompt month, second month and third month NYMEX contracts is referred to in the industry as the "roll" or "calendar month average". The roll is added to or subtracted from the prompt month indices (depending on whether NYMEX prices are rising or falling) to determine calendar month prices.

If a lessee believes that applying the index price nearest the lease yields an unreasonable value, a lessee can meet with MMS to determine reasonable value. There are many federal leases that are connected to pipelines that do not go to a major market center or become part of a stream that has a published price. Examples include the production connected to the High Island Pipeline System, production on Gulf Coast pipelines that terminate at barge terminals, production in the Rocky Mountain Region and production in California. MMS should propose a procedure for making gravity and sulfur adjustments that does not require a formal value determination process. A market based quality bank system has been developed by an independent consultant that could serve as a basis for making gravity and sulfur adjustments between similar crude types. This quality bank process could be used to resolve these issues where a quality bank does not exist.

Publications like Platt's often include gravity and sulfur values in their stream designations. The MMS must recognize that quality specifications that are reported by Platt's and other such publications are not based on actual composite analysis. The gravity and sulfur values are not intended to serve as a basis for determining quality adjustments between lease crude and the published prices.

TRANSPORTATION

In its proposal, the MMS has improperly and arbitrarily eliminated the use of tariffs as the basis of transportation deductions for onshore and offshore properties. However, the non-jurisdictional determinations which gave rise to recent disallowances of FERC tariffs relate exclusively to certain offshore pipelines. In all other respects, FERC and the various state agencies have maintained the same jurisdiction over onshore pipelines and other offshore pipelines as in 1988.

With respect to the determination of the cost of transportation services provided in non-arm's-length situations, MMS states, on page 73834, "Industry commenters asserted that they only agreed to the MMS actual-cost method under the 1988 rules because of the provision to use FERC tariffs." However, in the preamble to the final rule that was published on January 15, 1988 (53 FR 1213), the MMS specifically said, "MMS will issue a notice of proposed rulemaking to reconsider the applicable rate of return for purposes of these regulations." Indeed, the assurance of revisiting the rate of return issue helps explain why industry did not oppose the "actual cost" method at the time, yet MMS has failed to make good on that promise. MMS also says in its latest proposal, on page 73835, "We believe that FERC tariffs often exceed the transporter's actual costs." However, Congress, under the Interstate Commerce Act, has entrusted to the FERC, not the Department of the Interior, the determination of proper oil pipeline rates.

Finally, the MMS has also arbitrarily dismissed repeated concerns by lessees that obtaining access to the necessary records of affiliated transportation entities may prove to be discriminatory and thus impossible. In proposed sections 206.110(a)(1) and 206.110(a)(2)(ii), MMS provides that certain transportation allowances would be determined under section 206.111. However, in both instances cited, the lessee would be required to obtain "actual cost" data from a third party in order to comply. Presumably that third party would not voluntarily provide the data and, hence, the lessee could be denied any transportation allowance. The likelihood of such an unjust result strongly suggests that MMS should reconsider its abhorrence of rates set up by independent regulatory bodies like FERC.

The MMS has specifically requested comments regarding whether modification of the rate of return on investment under 206.111(h) is appropriate, and if so, comments relating to the modification of that rate of return in terms of a multiple of Standard and Poor's BBB bond rate. For purposes of return on investment computations, Marathon believes a return based on the weighted average cost of capital (WACC) utilizing both debt and equity components is the appropriate benchmark to use. With respect to a rate used in computing transportation allowances, Marathon believes that the use of an industry average WACC published by a widely recognized source such as Ibbotoson Associates, Cost of Capital Quarterly is a fair proxy to use in any rate of return computation. Marathon utilizes Ibbotoson as a reliable external source when reviewing cost of capital issues and fully endorses its use in the position paper on rate of return methodology submitted to the MMS by the Swanson Energy Group Inc. Of course, any industry average WACC must be adjusted to reflect a before tax rate in order to be consistent with the MMS approach. For ease of administration, we also endorse the recommendation in the Swanson paper to use two times the BBB bond rate as the appropriate rate of return. Marathon also believes the analysis set out in the Swanson paper effectively demonstrates that other benchmarks, such as the cost of debt or the after tax Return on Capital Employed, are inappropriate as a proxy for the cost of capital.

ADMINISTRATIVE BURDEN

There is a significant amount of unrecognized administrative burden associated with the latest proposal. This redesign of the valuation process will be especially complicated by the fact that valuation methodologies vary depending on the region of production.

The MMS must realize that the proposal in its current form leaves many questions unanswered. How to value oil in the Wyoming market, how to know if a transaction will be considered arm's-length by the MMS, whether or not an entity will be considered an affiliate under the regulations, and how to calculate transportation costs when industry has not generally had to calculate "actual costs" for many pipelines are among the most vexing concerns. Each of these conditions will create circumstances that will require lessees to request valuation determinations where the need did not previously exist. The MMS must be ready to quickly respond to these requests, preferably before the effective date of the final rule.

In the recent workshops the MMS stated that it intends to issue a final rule in March with an anticipated effective date of June 1, 2000. This is simply not feasible. Marathon has complicated computer systems which will have to be redesigned and reprogrammed. It is anticipated that the redesign of the system alone will take at least two months after the final rule is published. Then the reprogramming will need to take place. Marathon recommends that the effective date of the final rule be no earlier than October 1, 2000, in order to permit all parties to make the necessary changes to their existing systems.

MARKET AT THE LEASE

The MMS asserts in the preamble at 73820 that "None of the comments submitted throughout this nearly four-year rulemaking effort demonstrated that as a general rule a competitive market exists at the lease." Marathon disagrees with this assertion. In our comments submitted in response to MMS' January 24, 1997 proposed oil valuation rule, Marathon cited a study conducted by Professor Joseph P. Kalt of the Harvard University Kennedy School of Government. As a result of his study, Professor Kalt was able to compile a database representing over 850,000 arm's-length transactions at lease markets during 1990-1996 in just New Mexico, Texas, and Oklahoma. This study is further supported by the Declaration of Professor Kalt and Kenneth W. Grant which is attached to the joint industry comments as an exhibit. In addition, Marathon currently sells the majority of its federal production in arm's-length transactions. About 80% of Marathon's production is sold under arm's-length contracts, much of it at or near the lease. MMS, however, has yet to offer conclusive evidence which supports its claim that very little Federal oil is currently sold at arm's length. In fact, the success of the MMS' own royalty-in-kind program supports the contention that there is indeed a viable market at the lease.

More importantly, on page 73829, MMS declares, "It is longstanding MMS policy to rely on arm's-length prices as the best measure of value, and we have no intention of changing this." However, despite this purported faith in the market, MMS refuses to allow arm's-length prices to be used to value production not sold at arm's-length (with the sole exception of Rocky Mountain production).

MMS contends that "there are regional differences in the domestic crude oil market, particularly on the West Coast and in the Rocky Mountain Region, owing to differences in market concentration and availability of transportation options." However, this does not change the fact that arm's-length prices represent the best indicator of market value at the lease regardless of the region. Benchmarks (including those relying on comparable arm's-length contract prices) should be accepted for every region, not just the Rocky Mountain *Region*.

DUTY TO MARKET AT NO COST TO THE FEDERAL LESSOR

The current MMS proposal continues to improperly assert that there is a duty to market at no cost to the Federal lessor and references several cases and theories in the preamble. The MMS is incorrect in citing, on page 73823, the example of <u>Marathon Oil Co. v. United States</u>, 604 F.Supp. 1375 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 480 U.S. 940 (1987), as holding that sales downstream do not result in a lessee being permitted to deduct marketing costs. In that litigation, MMS specifically argued that Marathon's marketing costs were deductible in determining Marathon's royalty obligations.

Additionally, the MMS is inconsistent again when it says on page 73823, "Lessees may market at the lease without breaching the duty to market. However, if a lessee chooses to market downstream, the choice to do so is for the mutual benefit of itself and the lessor, and does not affect the lessee's relationship to the lessor. The choice to market downstream does not make marketing costs deductible..." And then MMS says, on page 73831, that "an overriding general premise of this rulemaking is that where oil ultimately is sold at arm's length before refining, it should be valued based on the gross proceeds accruing to the seller under the arm's-length sale (with the option to use index or benchmark values under some circumstances as discussed earlier)." In essence, MMS claims there is a duty to market downstream of the lease because it seeks to look through multiple downstream transactions to determine royalty value.

As comments by others in this proceeding demonstrate, any duty to market ends at the lease line. Marathon firmly believes it has no obligation to bear all the costs and risks of marketing MMS' royalty share of production downstream of the lease. If MMS wants to share in the benefits of the downstream market, it must also share the costs and risks of marketing downstream of the lease.

CONCLUSION

Although several previous areas of concern have been addressed by the MMS in this most recent proposal, the MMS continues to base its proposed methodologies on the false assumptions that a significant market at the lease does not exist, but that a duty to market downstream of the lease at no cost to the lessor does exist. Marathon and industry have offered substantial evidence to rebut these assumptions, but the MMS has failed to support its position with evidence of its own. Therefore, Marathon supports a comprehensive expansion of the current royalty-in-kind initiative as the most viable alternative to resolving the issue of federal royalty oil valuation. Royalty-in-kind offers the best long-term solution to satisfying the federal lessee's royalty obligation while assuring that the federal government receives fair market value for its royalty oil.

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