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By Fax (303) 231-3194; Original by Mail
David S. Guzy
Chief Rules and Procedures Staff
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Building 85, Denver Federal Center
Denver, CO 80225

Dear Mr. Guzy:

The following comments are submitted on behalf of the California State Controller's Office (SCO) to the amended proposal of the Minerals Management Service (MMS) on crude oil valuation. 62 Fed. Reg. 36030 (July 3, 1997).

As indicated in SCO's prior comments on MMS' original proposal, SCO is largely supportive of the Service's efforts to modify its oil valuation regulations. SCO believes the original proposal reflects important steps in the direction of assuring that the government collects the true "value" of production for royalty purposes, the Secretary's statutory mandate.

I. PRELIMINARY REMARKS

SCO is aware that MMS is under considerable pressure from industry to back track on its original proposals and that it is difficult for any agency to maintain its resolve in the face of a steady and well financed barrage of negative comments, briefings, conferences and press releases. It is understandable under such circumstances for an agency to consider dousing some of the flames through accommodation. But responding to pressure cannot justify an agency acting precipitously, which unfortunately is what, in SCO's view, happened with regard to MMS' amended proposal.

As SCO understands it, this amended proposal results from private "off the record" meetings between MMS and two industries associations. This process was particularly dismaying to SCO because it is clear that afterwards MMS chose to solidify and expand the use of the gross proceeds methodology prior to reviewing all of the public comments on its original proposal; indeed prior to the deadline for comments on its original proposal. Thus, SCO's comments, which were in part directed at the gross proceeds methodology, cannot be given equal consideration. As explained below, while SCO is also sympathetic to the plight of small producers, it cannot passively accept the MMS proposals on gross proceeds as they now stand.

II. INDEPENDENT PRODUCERS

Given MMS' recent action, SCO believes it necessary to reiterate the basis for its opposition to the gross proceeds rule. In fact, the comments submitted by many industry representatives simply serve to strengthen SCO's opposition.

Based on SCO's experience, use of the "gross proceeds" methodology in California will result in the payment of royalties on the basis of posted prices. Industry itself, along with other commenters and consultants, have confirmed that most out right sales of crude oil in the field are made on a basis related to posted prices. And, in the preamble to its original proposal, MMS recognized that most outright sales contracts are tied to posted prices.

At the same time, Interior, through its Interagency Task Force, has found that posted prices in California do not reflect the value of the production. The Task Force report was based on reviews by both independent consultants and MMS. Those analyses included review of the documentation obtained by California in the Long Beach cases. Not one commenter has leveled a serious challenge to the actual evidence underlying and conclusions of the Task Force report.[1]

Thus, at least as it regards California, posted prices do not represent value -- Interior has made that determination. And, it is value, not "gross proceeds," "price received," or any other standard, that the Secretary is obligated under statute to collect as royalty. Calling it "gross proceeds" or "comparable sales" or anything else will not change the fact that it is a royalty computed on the basis of posted prices -- a royalty computed on the basis of something less than true value. See e.g., Continental Oil Co. v. United States, 184 F.2d 802, 815 818 (9th Cir. 1950)

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[1]SCO notes that the Task Force report, and all of its appendices, have now been made public. To those commenters who have complained that there is "no evidence" sustaining MMS' conclusion that posted prices in California do not reflect value (and to other matters such as the existence of over-balance agreements, real exchange values, and the like), SCO suggests that they can easily obtain additional confirmation by moving the California courts for public access to the Long Beach documents, which MMS reviewed under confidentiality agreements.

(independent producers assertion that they were entitled to pay on gross proceeds rejected when proceeds were based on posted price found not to reflect true value). As a matter of law, MMS could value all production in California through application of the adjusted ANS value. In short, posted price by any other name is still not value.

While there may be equitable considerations for recognizing an exception for small producers in California who have been "victims" of the discredited posted price system, there are no rational grounds for accepting royalty based on posted price and calling it "value." As SCO pointed out in its initial comments, any acceptance of posted prices -- even under the guise of gross proceeds -- as "value" opens the door to attacks on use of index based valuation. This is indeed a theme that runs through the comments submitted by industry. Major companies have complained overtly of discrimination and others have pointed to MMS' acceptance of gross proceeds as validation that prices in the so-called "lease market" represent "value." The issue of course is how separate treatment of independent producers and other lessees can be justified within the framework of an inquiry concerning the value of production.

Unlike industry, SCO believes that there is a nonarbitrary rationale that provides some support for the acceptance of less than full value in a narrow category of situations. Some of the evidence supporting such a rationale can be found in the reports of other government agencies. Thus, for example, the Federal Trade Commission recognized the existence of a "two tier" market for crude oil in California. 49 Fed. Reg. 8550 (March 7, 1984). Similarly, the Department of Commerce issued findings concerning the marketing problems facing independent producers in California; problems that Department explicitly noted were not shared by integrated firms. Report to Congress on U.S. Crude Oil Exports, Department of Commerce, Bureau of Export Administration (August 1989). Interior's Task Force also took note of the "captive prices" being offered for production in California fields.

There is indeed further support for this view in some of industry's own comments. Thus the California Independent Petroleum Association candidly admits that "Independent operators are price takers, not price setters." Similar sentiments were expressed in other industry comments. See e.g., Comments of ARCO Western Energy ("Currently, California pipeline barrels are being price by the market below the value determined by the methodology prescribed by the proposed rulemaking. This is a condition that the producers of crude oil in the state of California cannot control; we do not establish the price for our oil"). While this evidence would equally support a finding that sales at the lease are less than arm's length (that the producers are not willing sellers, but captive sellers), it also provides some factual basis for MMS' distinctions. In short, independent producers in California may not be receiving true value, but it may be "their value," i.e. the only price available to them for the crude oil they produce in light of their marketing options.

In summary, it is clear that MMS wants to go forward with a rule that permits independent producers to calculate royalties on gross proceeds. Both the process leading up to and the text of its new amended proposals simply confirms this. Yet, MMS still lacks a reasoned justification for its chosen course. This very serious problem with MMS' proposed rules results from its insistence on dealing with a core issue -- the treatment of independent producers -- indirectly, rather than directly. MMS' implicit favoritism of independents through narrowing of the gross proceeds rule does not resolve the problem; indeed it exacerbates the problem because many "price setters" will remain eligible to use gross proceeds. As it stands now, MMS' proposed gross proceeds rule effectively, but wrongfully, serves to validate as "value" the very posted prices that were the impetus for this rulemaking.

There is simply too much at stake for California for SCO to passively accept the MMS' gross proceeds proposals on the record as it now stands. Still, as indicated in its initial comments, SCO is not without sympathy for those independents that have been locked into the posted price system. But, SCO believes that MMS must acknowledge that the relative equities vary among independents. Thus, for example, as noted in Mobil's comments, some independents have profited through the arbitrage opportunities associated with the disparity between posted price and true market value. In SCO's view, the fact that these opportunities exist stand as added evidence of the undervaluation of posted prices. The fact that certain independents can take advantage of these opportunities place them on a different footing than other, smaller, independents. Their broader opportunities do not, as some have suggested, permit them to pocket the difference between postings and true value to the detriment of the public. See e.g. Klein v. Arkoma Production Co., 73 F.3d 779 (8th Cir. 1996); Wegman v. Central Transmission, Inc., 499 So. 2d 436 (La. App. 1986), writ denied, 503 So. 2nd 478 (La. 1987); Texas Oil & Gas Corp. v. Hagen, 683 S.W. 2d 24 (Tex. App. 1984).

It was for these types of reasons that SCO recommended in its initial comments that MMS confine use of the gross proceeds methodology to truly small independents. SCO recommended that MMS' recognize the gross proceeds methodology as an exception to indexed based value for independent producers, defined as those who produce 20,000 bbl, who demonstrated an inability to obtain true value, e.g. those with transportation constraints or a remote lease location. SCO continues to believe that such an approach is the best in terms of assuring that MMS has the fullest record supporting any acceptance of royalties on the basis of postings-related contract prices.

We note that at least one other State agency, the Oklahoma State Lands Commission, advocated a similar approach, but recommended defining independents as those that produced 10,000 bbls in any given State. The discrepancy between SCO's and OSLC's proposals has led us to reevaluate the merits of defining independents on a production level basis. SCO now recommends that MMS consider defining independents as (1) producers with no affiliation to a refinery (non-integrated companies) and (2) producers with no marketing/resale affiliates. Such an approach is analogous to that followed by the Internal Revenue Service. See e.g., Mobel Exploration v. U.S., 71 AFTR 2d ¶ 198,029 (Jan. 19, 1993) ("A producer... is independent so long as it is not, directly or by relation, a retailer or refiner.") It is also consistent with MMS' current approach to valuation of affiliate sales. Finally it gives recognition to the relative abilities of different sectors of the industry to avoid trading crude oil on the basis of posted prices.

Absent such a modification to MMS' proposed gross proceeds methodology and an accompanying reasoned justification for use of the gross proceeds methodology by independent producers, SCO continues to vigorously oppose the MMS proposal. The following comments on MMS' new amended proposals on calls, overall balance arrangements, and exchange agreements should not be construed as an acceptance by SCO of MMS' gross proceeds methodology. Rather, SCO offers the following comments and recommended modifications to MMS' amended proposals with the caveat that even those proposals are objectionable if their use is not confined, with justification, to true independent producers.

III. CRUDE OIL CALLS

MMS proposes to accept the gross proceeds under a contract creating a call when that contract contains "a Most Favored Nations clause or a similar clause in which the price is based on what other parties are willing to competitively bid to purchase the production." For the reasons stated below, in SCO's view MMS' amended proposal unnecessarily disadvantages the federal government and will cost money that the government should be collecting. SCO believes that the concerns of the independents can be addressed in a manner that better protects the interests of the government.

Before outlining the problems with how MMS has defined what it terms as a "competitive crude oil call," SCO believes it important to underscore that MMS is right to exclude calls from the gross proceeds methodology. SCO did not understand any commenter to argue that a call provision did not have "value," and there is no credible argument that it does not. SCO knows, through its own audits and information shared by others, that there are situations where a reduction in the price of a property is connected to the grant of a call to the seller. Indeed, in some situations the value of the call may actually be calculable. Even where it would be difficult or problematic to calculate, however, it still maintains a value -- something given up by the buyer of the property -- that is tied directly to later production from the lease. MMS is thus correct to view sales of production under call provisions as falling short of being truly "arm's length" even if the underlying contract creating the call was otherwise between unaffiliated parties. In agreeing to the call, the buyer of the property has contracted away a significant part of its independence.

Acceptance of gross proceeds as royalty has been viewed by MMS as minimally acceptable because it derives from a contract between independent parties in a marketplace. MMS' amended proposal to carve out unexercised calls from its original proposal is, at least, logically consistent with this rationale. SCO would note, however, that it does ignore the shadow that the existence of the call might have on potential purchasers looking towards a more continued supply source.

The consistency underlying the proposal to carve out unexercised calls, however, is significantly less apparent in MMS' proposal to accept the call price if the contract contains a Most Favored Nation (MFN) or similar clause. And, there are important policy reasons why MMS, at the very least, should modify this amended proposal.

The first problem with MMS' proposal is that it assumes that the mere existence of an MFN or like provision validates the price received by the seller from the holder of the call. MMS' proposed regulatory language is not confined to <u>enforced</u> MFNs.[2] There may be many reasons why a seller/lessee chooses not to enforce a contractual provision.

For example, suppose the contract creating the call contains a third party MFN provision. Under a third party MFN provision, the seller may be entitled to insist that the holder of the call pay for the production on the basis of the highest price being paid for comparable production in the field or area. Assuming that the holder of the call agrees to pay that price rather than releasing its preference (a consideration that in and of itself may cause the seller to forgo enforcing the MFN), the MFN price may not apply until after the call holder receives notice from the seller. <u>See e.g.</u>, Sample Third Party MFN set out at 4 Williams & Meyer, Oil and Gas Law §726 at p. 756.

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[2] In this regard, SCO notes that MMS' proposed regulatory language is inconsistent with the Service's expressed purpose for this amendment. In the preamble, MMS states that it proposes to accept the price under an exercised call when it "<u>is</u> valued based upon the price other parties are willing to competitively bid to purchase the production ...."

All of the industry commenters that have addressed the subject have agreed that sellers cannot obtain the type of comparable sales information that would be needed to trigger a third party MFN provision. Thus under MMS' proposal, a price under an exercised call will be accepted for royalty purposes on the basis of the "protection" provided by a contractual provision that industry represents it cannot enforce. Even assuming a given lessee could pursue its rights under a third party MFN provision, it would not -- and thus the federal government would not -- be entitled to the higher "competitive" price until after it provided notice to the call holder. In short, the simple existence of an MFN or like provision is a hollow protection of the federal government's royalty interests.

The second problem with MMS' amended proposal is that it is both overinclusive and underinclusive in the types of "prices" it would accept for royalty purposes under even enforced MFNs or like provisions. MMS' operating assumption appears to be that prices received under (or validated by the existence of) MFNs and the like are more "acceptable" for royalty purposes because they better reflect the prices received in a particular field. MMS is assuming that it is some kind of arm's length third party activity that invariably triggers these provisions. This assumption is faulty.

MFNs and similar provisions -- like Bona Fide Offer Provisions[3] -- are simply forms of price escalation provisions. They derive from private contracts that are not necessarily tied to federal notions of "arm's length" or "non-arm's length." For example, suppose the contract creating the call contains a Two Party MFN provision. Under a Two Party MFN, the seller is entitled to be paid by the call holder at the highest price the call holder uses for purchases of other comparable production in the field or area. Whether the call holder must notify the seller of this price or the seller must discover it itself will vary from contract to contract. <u>See</u> Sample Two Party MFNs set out at 4 Williams & Meyers, Oil and Gas Law §726 at pp. 754 -755. In any event, there is nothing that requires that the price triggering the Two Party

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[3] SCO assumes that it is a Bona Fide Offer Provision that MMS is attempting to capture in its phrase "or a similar clause in which the price is based on what other parties are willing to competitively bid to purchase the production." A Bona Fide Offer Provision is one in which the seller, after giving the call holder notice, is entitled to receive from the call holder the price in a written offer from a third party for the production. Several variations of a Bona Fide Offer Provision were attached to the comments submitted by IPAA. If MMS opts to retain this feature of its amended proposal, SCO believes that certainty would be better served if MMS would define with more specificity the types of provisions that would allow lessees to be excepted from the rule on calls.

MFN be an "arm's length" price. Indeed, if a call holder's non-arm's length price is higher, the Two Party MFN could be triggered. Assuming enforcement of a Two Party MFN by a seller/lessee, under the MMS amended proposal the federal government would be protecting itself through accepting a price as royalty that it would not otherwise accept under its regulations. MMS' amended proposal is thus overinclusive.

MMS' proposal could also prove to be underinclusive. For example, in Hall v. Arkansas-Louisiana Gas Co., 359 So.2d 255 (La. App. 1978), the court determined that an MFN clause was triggered upon showing that the buyer had been paying royalties to the lessor of other property on a value higher than the price being paid to the seller. Interestingly, the lessor receiving the higher value in that case was the United States. Yet, under its amended proposal, MMS is specifically attempting to avoid that result -- it is attempting to carve out situations where certain lessees could avoid paying royalties on an index value.[4]

The third problem with the MMS' amended proposal is that it places the federal government in the awkward position of being dependent for its royalties on the interpretations that private parties put on provisions in their contracts. As suggested above the terms of any MFN or like clause can vary. Even those escalation clauses submitted by IPAA in its comments demonstrate this -- each was a variation of a Bona Fide Offer Provision. There can also be variations in the particulars of both Two Party and Third Party MFNs. IPAA admitted in its comments that it could not submit for MMS review all the different types of MFN clauses it felt warranted exception from the originally proposed rule on calls. The variations in these provisions increase exponentially when it is remembered that the contract will be interpreted as a whole. Some of these issues will be the very type of issues that plague the royalty management program under the current regulations, e.g., what is a "comparable sale," a "field," an "area," "like quantity," "like quality," etc. Other issues will be new to MMS, e.g., what is a "bona fide offer," "ample notice" etc. It is not surprising that there has been a substantial amount of litigation over what triggers an MFN. See e.g., 4 Williams & Meyers, Oil and Gas Law § 726.

But there is one thing that is clear about an MFN or similar clause: in whatever litigation that ensues, the issue will be the intent of the parties in agreeing to that provision -- not the intent or interpretation of the federal government. Moreover,

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[4]It is interesting to note that MMS' proposal could prove to ultimately harm the interests of any lessee that might want to rely on cases like Hall to argue that its MFN clause was triggered by the federal royalty payments (for example, adjusted NYMEX) made by a call holder.

those issues will be resolved under applicable State law principles, which may vary -- not uniform federal principles.

The fourth problem is that suggested by MMS itself in the preamble to its amended proposal: the compliance problems associated with monitoring the parties' performance under an MFN or similar clause. Clearly, monitoring whether a lessee has received all it could under many types, if not all, of these MFN and other provisions will require an audit beyond the books and records of the lessee. For example, to monitor a Third Party MFN will require MMS to look to all the sales contracts (involving federal and non-federal production) in a given field or area and to monitor a Two Party MFN will require audit of the call holders' other purchases in the area. Even assuming that these tasks can realistically and reliably be completed, the difficult legal issues mentioned above will remain, along with others revolving around the reasons for any lessee's failure to obtain the price under an MFN or other clause. Audit will need to be conducted under varied state legal principles. These complications exist even without considering those that would accompany "other complex marketing arrangements," although MMS is right to be concerned about the impact of such arrangements. There is simply no reason to believe that crude oil sold under a call provision is immune from being discounted, balanced, or exchanged by the parties to the contract in light of other transactions between them.[5]

The fifth problem, of course, is that discussed by SCO more fully above. By accepting prices under MFNs and other escalation clauses, MMS has simply increased the potential for "value" to be based on posting-related prices. It has also opened the door to further arguments by industry in support of a comparable sales methodology, which, as detailed more fully below SCO vigorously opposes.

Recommendation

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[5] MMS has asked for comments on the impact to "gross proceeds" where the call holder assigns his interest under the contract. SCO fails to see why MMS would believe that there would be any impact on "gross proceeds" in this situation since the assignee would have the same preference rights under the same pricing provisions of the original call holder. (The contract between the assignee and the original call holder, however, could shed light on the value of the call provision.) The only impact SCO can envision under an assignment would be where the contract creating the call has a Two Party MFN provision. Under such a provision, it is arguable that it would be triggered by the higher prices of the assignee, rather than the original call holder. However, there is some authority to the contrary. See Warren Petroleum Corp. v. Federal Power Comm'n, 282 F.2d 312 (10th Cir. 1960).

For the foregoing reasons, SCO believes that the best course is for MMS to confine any exception to the originally proposed rule on calls to unexercised calls.

However if MMS opts to expand the exception to the rule on calls to encompass certain types of price escalation provisions, SCO would recommend that, at the very least, MMS modify the amended proposal with regard to MFNs and similar clauses to:

1. Apply only after the lessee has triggered the escalation provision;

2. Apply only where the price received by the lessee under a triggered escalation provision is:

   a) based on arm's length sales prices or bids for such sales by third parties to the contract creating the call; or

   b) based on the value acceptable under 206.102(c)(2).

3. Recognize that the lessee's ability to pay royalty on the price obtained under a triggered escalation provision is dependent upon its meeting the other provisions of §206.102(a).

Finally, SCO notes that there is little to be gained in certainty or clarity by the creation of new terminology, i.e. "non-competitive crude oil calls." SCO believes that while it may take more words, it is better in the long run for MMS to set forth with specifity the scope of the exclusions from the originally proposed call rule. Such an approach would also be more consistent with principles of "plain English."

IV. TWO YEAR RULE

In its amended proposed rule, MMS proposes to eliminate the provision that disallowed use of the gross proceeds method if the lessee had purchased oil from the buyer of the federal production within the previous two years. SCO had supported MMS' original proposal and had, in fact, recommended expanding it to a) transactions beyond the mere purchase and sale of crude oil, and b) purchases occurring within one year <u>after</u> the lessee's sale of production from a federal lease.

SCO opposes MMS' new amended proposal. The language that MMS has offered in lieu of the two year rule will cause difficult compliance problems by forcing MMS to prove on a case by case basis through audit the existence of overall balance arrangements. Given the informality of many of these arrangements and the burden of tracing through all of two parties' transactions to determine how they are related, SCO has serious concerns about whether MMS' approach is workable or realistic. SCO believes that the concerns of the independents can be addressed directly as exceptions to the application of the two year rule.

SCO's more serious concern with MMS' amended proposal is that it would accept a contract price in the face of an overall balance arrangement if the price "represents market value in the field or area." MMS does not explain what it means by "market value in the field or area" for purposes of this provision. Yet, it is the very purpose of this rulemaking to set out the standards to be used to determine "market value in the field or area." If MMS is referring to ANS by using this phrase, SCO has no objection. Unfortunately however, SCO fears that MMS is opening the door to use of a comparable sales methodology.

SCO vigorously opposes any use of a comparable sales methodology.

A. Overall Balance Arrangements

SCO's support of the two year rule was based on that fact that it was a realistic way to deal with the very difficult compliance problems associated with reciprocal trades. SCO also, of course, supported any narrowing of the gross proceeds methodology.

MMS is right to exclude contracts subject to overall balancing arrangements from the gross proceeds rule. The existence of an overall balancing arrangement indicates that there is something more occurring than a simple sale of production under a single contract; rather there are multiple and related purchases and sales between the parties. Clearly the four corners of one contract will not reveal the "total consideration" flowing to the seller. The difficulties of unraveling overall balance arrangements justify excluding all contracts subject to them from the gross proceeds rule.

Yet these difficulties also underscore the wisdom of MMS' original proposal for a two year rule. SCO understands that the marketers MMS interviewed during its investigation confirmed that such reciprocal dealings are often conducted on an informal, unwritten basis. This in and of itself will decrease the likelihood that such dealings will be detected. It will also force MMS and State delegates to expand the scope of their audits -- information will not only be required of a lessee's accounting division, but also from its marketing personnel and perhaps others. Thus, for example, the existence of a balancing arrangement among those companies that traded California crude oil under the three cut exchange was first revealed in intra-company memoranda, not from accounting documentation. MMS and State delegates will also need to review the books and records of the lessee's trading partner.

SCO would note that overall balance arrangements are not always informal. Some companies will enter into "net-out" agreements, which are in essence umbrella agreements that apply to some or all of the sales or trades between the companies. While the existence of a net-out certainly would assist any compliance effort, it only saves one step in the overall review. MMS will still need to then review all of the two companies' transactions to determine which fall under any net-out agreement. Further complications arise where multi-party trades fall within an overall balance arrangement.

Thus, the originally proposed two year rule avoided costly and burdensome audits[6] and, given the unique problems associated with detecting reciprocal deals, would have provided better protection of the federal government's royalty interests.

However, as noted, MMS now proposes to eliminate the two year rule. Its amended proposal is based upon two specifically set forth concerns of the independents. First, the two year rule would have barred the use of the gross proceeds methodology by independents that "purchase oil to make up for production shortfalls." Second, the two year rule precluded payment of royalties on gross proceeds where companies "purchase crude oil to operate their lease." These were the only two factual scenarios that MMS refers to in finding that the two year rule "is potentially too restrictive."

Rather than dealing with those concerns directly, however, MMS proposes to exclude from gross proceeds only those contracts that are demonstrably part of an overall balance arrangement. MMS recognizes that it cannot enforce this provision prior to audit (it is considering certification). As SCO has shown, it is also unlikely that MMS will be able to enforce this provision after audit.

B. Comparable Sales

For SCO, there is even a more fundamental problem with MMS' amended proposal. Under its plain terms, even where there is an overall balancing arrangement, the "contract price" will be acceptable for royalty purposes if it represents "market value in the field or area."

It is the purpose of this rulemaking to set out the methodologies for determining "market value in the field or area." MMS has specifically proposed only two methodologies: gross

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[6] Compliance with the two year rule would remain, of course, subject to audit. However, it is less burdensome to the extent that the federal government would be relieved of the burden of proving actual reciprocal impact between or among transactions.

proceeds and adjusted index. But neither of these specifically proposed methodologies fit within MMS' amended proposal on overall balancing arrangements. Since MMS' intent under its amended proposal is to decrease the number of situations that might force independent producers to use an index based value, we doubt that MMS intended §206.102(a)(4)(ii) to read:

> (4) You must use paragraph (c)(2) -- NYMEX or ANS -- of this section to value oil disposed of under
>
> (ii) An arm's length contract between a buyer and seller in which the contract price does not represent NYMEX or ANS (market value in the field or area) because an overall balance ....

Subsection (a)(4)(ii) makes even less sense if "gross proceeds" is substituted for the phrase "market value in the field or area." Either MMS has made a drafting error or it intends to cross check contract prices in overall balance situations against an as yet unidentified standard for determining "market value in the field or area." We would hope that §206.102(a)(4)(ii) is simply the product of a drafting error.

Given that MMS has attempted under this amended proposal to accommodate the interests of IPAA and IPAMS, however, SCO must assume for purposes of these comments that MMS will make the comparison required by proposed §206.102(a)(4)(ii) through use of some other methodology, like comparable sales. SCO is also unfortunately forced to make this assumption because of trade press articles reporting that MMS has "signaled" its willingness to consider use of a comparable sales methodology. SCO opposes any use of the comparable sales methodology and it particularly opposes the insertion in these rules of back door benchmarks.

The first problem with the comparable sales approach is one that is uniquely relevant to overall balancing agreements. In California, for example, a need for overall balancing arose under the three cut exchange. Overall balancing facilitated trading on a basis other than the prices quoted for purchase of production in the field -- the trading companies recognized that the production had greater value than was being paid in the field and used the three cut and balancing to avoid trading on the basis of "comparable field sales". In such a situation, acceptance of a contract price if it compares with other field prices provides no protection to the federal government's royalty interest. Indeed, it ignores one of the core reasons for not permitting use of the gross proceeds method in overall balancing situations.

The second and related problem is that use of the comparable sales methodology, at least in California, is a charade. Comparable sales is simply a euphemism for multiple posting related prices. Since posted prices do not reflect the true value of production in California; comparable sales cannot reflect the true value of production in California. A rose is a rose is a rose.

The third problem is that comparable sales is not workable. Industry has conceded that it cannot apply a comparable sales method, i.e., industry's argument that "antitrust" constraints and other competitive considerations disable it from access to information about prices obtained by others in the field or area. Contrary to industry's assertions, MMS' computer systems are simply not designed to determine comparable sales. And, given the type of analysis needed for comparable sales, it is doubtful that such an analysis could ever be made through a computer system with any degree of reliability or accuracy. Even if it could, a computer generated comparable sales figure would be an unaudited figure. Comparable sales is also a difficult, costly and burdensome standard to administer through audit.[7]

<u>Recommendation</u>

For the foregoing reasons, SCO recommends that MMS retain the two year rule as originally proposed. The types of purchases set out by MMS could easily be excepted from the scope of the two year rule. Such an approach would grant relief to small independent producers, which is MMS' stated intent, while providing better protection of the government's royalty interest.

At the very least, SCO urges MMS to delete the phrase "market value at the field or lease" from its amended proposal. If MMS decides to go forward with a rule that specifies overall balance arrangements, the existence of such arrangements should alone trigger valuation under the non-arm's length rules. MMS has not justified the basis for application of any back door benchmarks.

In addition, MMS might want to consider a compromise approach, which could ameliorate some of the audit burden associated with overall balance arrangements. The following language represents such a compromise:

> (ii) An arm's length contract subject to a formal or informal overall balance arrangement that applies to two or more transactions between the buyer and the seller. A rebuttable presumption that an overall balance arrangement exists where you or your affiliate purchased crude oil, gas, NGLs, or finished or unfinished products, within the two years prior to the royalty payment due date, from the same party that purchased your production from the federal lease. This subsection does not apply to purchases made by you to make up for production

[7] SCO adopts by reference the comments submitted by the State and Tribal Royalty Audit Committee on the issue of the comparable sales methodology.

shortfalls or to operate the federal lease.

V. EXCHANGE AGREEMENTS

In its original proposal, MMS excluded all transfers of production under exchange agreements from the gross proceeds methodology, requiring instead that California production be valued by reference to ANS. SCO supported this proposal. Under MMS' amended proposal, lessees will have the option to calculate their royalties on production transferred under certain exchange agreements by either ANS or a form of "gross proceeds." This option will apply only where the exchange is arm's length and the lessee enters into an arm's length sale of the production received under the exchange. In such a situation, a lessee may calculate royalties based upon the gross proceeds resulting from the sale of the exchange production.

MMS does not provide any explanation for this departure from its original proposal, although of course SCO assumes generally that MMS was attempting to accommodate concerns expressed by independent producers. SCO appreciates that MMS' proposed modification does not involve a departure from the original rationale for excluding exchange agreements from the gross proceeds rule, i.e., that such trades are not conducted on a price basis. SCO also supports MMS' apparent rejection of the independents' request to have production transferred under exchanges valued by reference to "comparable sales."

SCO does however maintain some concerns over the workability of the MMS' amended proposal. It will entail a certain degree of tracing of production through transactions, which is a costly exercise that can be burdensome to both the government and the lessee. And, we do believe that MMS' amended proposal opens a door to gaming that did not exist under its original proposal. Daisy chains could and have included transactions that, when viewed in isolation, looked like arm's length transactions. Without continuous litigation over document access and the subjective "intent" of the parties to the "sale" (and attendant delay in royalty payment), there is no practical and assured way for MMS to safeguard against this very realistic prospect. SCO notes that it took years for DOE to unravel analogous problems during the price control years. MMS does not have years to conduct such inquiries.

For these reasons, SCO must withhold any support for MMS' amended proposal on exchange agreements.

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In conclusion, SCO understands MMS concern over independent producers and, indeed, is sympathetic itself to the price disadvantages such producers face. However any expansion of the gross proceeds method promotes gaming, allows those who set and take advantage of cheap oil to pay royalty on low prices and, even more importantly, weakens the defendability of the proposed rule as a whole. MMS must provide a reasoned justification for the distinctions it wants to make. As discussed above, SCO believes that MMS can reasonably address this serious problem, but it must start by clearly defining who is eligible for calculating royalties on what is in reality a basis less than true value. If MMS proceeds on such a basis, SCO can see room for reasonable compromise as to MMS' new amended proposals. California, however, cannot afford to support any gross proceeds methodology otherwise.

Sincerely,

Lee Ellen Helfrich