Independent Petroleum Association of America
Domestic Petroleum Council

August 1, 1997

Mr. David S. Guzy
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Minerals Management Service
Royalty Management Program
Building 85
Denver Federal Center
Denver, CO 80225

Re: Supplementary Proposed Rule on Crude Oil Valuation, 62 Fed. Reg. 36030 (July 3, 1997)

Dear Mr. Guzy:

The Domestic Petroleum Council ("DPC") and the Independent Petroleum Association of America ("IPAA") welcome the opportunity to offer additional comments to the Minerals Management Service ("MMS") on valuing royalties on crude oil from federal leases. On behalf of our more than 5,500 members, we thank MMS for its decision not to pursue an interim final rule, but instead to solicit further comment on this important subject.

However, while process is important, it is no substitute for substance. We of course support the changes MMS has made to the original proposed rule, for they represent the first steps in the right direction. These changes would allow more independent producers selling crude oil at arm's length at the lease not to use the NYMEX-netback scheme when paying royalties. These changes, which MMS calls "minor," 62 Fed. Reg. 36031, actually have significant implications. Through them MMS recognizes that there are far more valid arm's-length transactions in the lease market than recognized in the original proposal. As IPAA and DPC explained in our May 1997 comments, these transactions can be used to set values for non-arm's-length transactions under appropriately crafted benchmarks.

However, even those of our members benefitting from the supplement's changes remain opposed to the rule, because the proposal continues to encroach on the principle on which independents conduct their businesses: that production is best valued by sales at the lease and not by downstream transactions. Once a party decides to participate in markets beyond the lease, it does so recognizing that it is entering a new arena of risks, costs, and rewards -- ones significantly different from those it undertook to discover and

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produce the oil. Yet MMS is proposing to push all producers into undertaking those risks, free of risk or cost to the lessor, through the proposed duty to market, and in essence to punish independents who engage in certain exchange agreements or are subject to certain calls on production by forcing them into the NYMEX-netback scheme. At bottom, then, the supplementary proposal reveals that MMS has yet to examine seriously a number of IPAA's and DPC's comments going to the heart of the problems with MMS's initial proposal.

At the core of those problems is MMS's reluctance to continue relying on arm's-length prices for oil sold at the lease market as the touchstones of royalty valuation, despite the clear dictates of Congress and sound public policy. That reluctance is revealed in several contexts in the proposed rule. In each of these contexts the agency also inappropriately attempts to share in the benefits of activities in the midstream market for crude oil without sharing in the risks and costs of those activities.

First, the supplemental notice has not abandoned MMS's attempt to codify a new "duty to market" federal lease production free of cost to the lessor. Our May 1997 comments explained in detail why this attempt is unlawful, but we must re-emphasize the most important point. The proposed duty to market would apply even to small independent producers who would otherwise be entitled to pay royalties on the gross proceeds they receive from the sale of the oil. In other words, the proposed duty undermines the very changes in the proposal set out in the supplementary notice and would create an unlawful subsidy of the royalty interest. Whatever else MMS may do to ameliorate the effects of its proposal on small producers, its adoption of the proposed duty to market would assure that the final rule will be litigated.

Second, the supplemental notice continues to propose as an alternative valuation method the use of the proceeds a lessee's affiliate receives from reselling crude oil downstream from the lease, with the lessor sharing *at most* only in the cost of transportation. This position is inconsistent with MMS's statutory duty to value production at the lease, for it claims royalty on value added to the oil by mid-stream marketing activities. This position is unlawful, is already the subject of litigation, *see Xeno, Inc. v. Babbitt,* No. 97-35517 (9th Cir.), and should not be codified in regulations.

Third, the supplemental notice continues to deny royalty parity to producers who ship oil through pipelines owned wholly or even in part by affiliates. The proposal would bar an affiliated producer from deducting the full pipeline tariff in calculating the value of the royalty when a similarly situated, but unaffiliated producer may deduct that tariff. By limiting the producing affiliate's allowance to the pipeline affiliate's so-called "actual costs," MMS is simply attempting to claim royalties on the profits from a non-royalty-bearing transaction: transportation. The Department has already ruled that discrimination against affiliated transactions in transportation is unlawful, *Shell Western E & P Inc.*, 112 IBLA 394 (1990), and *Mobil Producing Texas & New Mexico, Inc.*, 115 IBLA 164 (1990), and MMS has disclosed no reason to reverse those rulings here.

Fourth, the supplemental notice continues to rely on NYMEX prices to value crude oil outside California and Alaska. But the NYMEX's futures price for oil in terminals at Cushing, Oklahoma, is influenced by different supply and demand factors than those influencing the prices agreed to in sales at thousands of federal leases around the nation. As our May 1997 comments showed, those differences virtually guarantee that the NYMEX-netback scheme MMS is proposing will arrive at the **wrong value** for oil at the lease, never reflecting the value set in real, arm's-length sales. The NYMEX-netback value will be high one month, low the next, and unpredictable throughout. (See Exhibit 1.) Conceptually, however, MMS is wrongly attempting to value royalties on lease production by starting with a downstream price reflecting none of the operational risks and costs lessees face.

If MMS wants to derive value from participating in downstream markets, it has the means readily at hand: royalty-in-kind. All of the agency's concerns and perceived problems, as identified in the supplementary proposal, are fully addressed if the agency markets its oil royalty. As long as MMS continues to take royalty in value, those concerns can never be fully resolved. Yet the supplementary proposal completely fails to explore royalty-in-kind. (Please see Exhibit 2.)

In sum, MMS began this process in 1995 with a simple inquiry: whether it was appropriate to continue to let companies use their own posted prices as the proper means of valuing oil they do not sell at arm's length. Though reasonable people can disagree over the answer to that inquiry, DPC and IPAA agree with the agency that the question is a fair one to debate. And in our May 1997 comments, both organizations proposed changes to the regulations that resolve the debate in MMS's favor. Indeed, our comments today offer, at an even greater level of detail, further recommendations on how to make our May recommendations work most efficiently for MMS and producers. But this process cannot work well with MMS remaining silent. The supplementary proposal ignores our detailed proposal to fix MMS's perceived problem with its current valuation benchmarks for non-arm's-length sales. It ignores our offers to work with the agency to address its concerns about benchmarks. In light of these detailed comments and offer, producers can take no comfort from MMS's request for "comments on alternatives based on lease market indicators...." *Id.* at 36032.

ADDITIONAL CONCERNS ABOUT NYMEX

In our prior comments, DPC and IPAA explained in detail why the proposed NYMEX-netback method is an irrational proxy for arm's-length sales prices in the lease market. Here we would like to make sure MMS understands why our members' opposition to the NYMEX scheme is more than merely theoretical.

As MMS is well aware, crude oil production in the United States is characterized by thousands of wells with limited rates of flow and high costs of operation, a counterpoint to foreign regions, like Saudi Arabia, with prolific wells and low operating costs. It is harder for independent producers to make a dollar in domestic production. To try to make the extra dollar, many of our members have created affiliated companies to participate in the midstream market for crude oil. But many have not. The latter simply produce the oil and sell it, at the lease market when they can, beyond when they have to. Yet both groups oppose the NYMEX method. Why?

For those members already participating in the midstream market, we have already explained their objections at length. The NYMEX price is not just a futures price, it is essentially a downstream price, free of most of the risks of the lease market. Though the relationship of the NYMEX price to the wellhead price is unpredictable, one would expect (and MMS admits it expects) the NYMEX netback to yield values higher than wellhead prices. Members in the midstream market object to MMS's claims to royalties on value added by their midstream marketing activities, claims it makes without offering to share in the risks or costs. To those members, MMS's proposal is simply an attempted tax on a separate line of business.

For those generally not in the midstream market, several features of the rule may force them into the NYMEX method anyway: certain calls on production, multiple exchange agreements, the purchase of oil if MMS institutes a purchase-volume threshold (see pages 6 to 15 below), and, even if these three do not apply to a given producer, the duty to market. On balance, these producers expect to have MMS value the royalty share at a price higher than what the producers actually receive from their sales whenever they are subject to the NYMEX method.

If the lease market is valuing a particular grade of crude oil in the range of \$15.50 to \$16 per barrel, but MMS is using a downstream price to value the royalty share for that oil at \$17 per barrel, the producer is forced to find a way to obtain \$17 for the non-royalty barrels to avoid paying royalty on proceeds it never received. When the producer's value is less than the royalty value, the producer's royalty rate is in effect raised.

To avoid that result, there is only one way the producer can reasonably assure that his proceeds are close to the price at which MMS is valuing the royalty. That way is for the producer to enter the midstream market and try to replicate the exchanges at market centers and aggregation points on which MMS is basing its NYMEX-netback calculations. Using NYMEX as a basis for royalty valuation, in other words, will encourage companies to integrate the production function with the midstream marketing function in the oil industry.

Of course, no producer can be assured that it will receive the same value as MMS is calculating under its NYMEX netback. But its alternative is to accept shrinking profit margins from higher royalty costs, eventually squeezing itself out of business. This should be of great concern to MMS, because increased royalty costs and declining competition for new leases will dramatically reduce the bonus bids the agency would otherwise receive on new OCS leases. But in any event, this dilemma is of great concern to our members. Either alternative portends the reduction, and perhaps the end, of arm's-length sales at the wellhead. It is this prospect that keeps our members united in their opposition to a NYMEX-based valuation rule.

COMMENTS ON BENCHMARKS

The supplemental notice "requests comments on alternatives for valuing production not sold under arm's-length contracts -- § 206.102(c). Specifically, MMS requests comments on alternatives based on lease market indicators that are readily available contemporaneously." 62 Fed. Reg. 36032. In our May 1997 comments, DPC and IPAA proposed revisions to the benchmarks currently found in section 206.102(c) to eliminate any reference to posted prices. We emphasized the numerous sources of arm's-length transactions in the lease market: outright sales, lessees' sales to small refiners under the 20 percent set-aside clause, sales by companies under competitive sales programs, sales by the MMS of oil taken in kind, and so forth. We noted that MMS's Auditing and Financial System already holds the data on tens of thousands of arm's-length transactions, and that the Interior Board of Land Appeals has assigned MMS the duty of using that information in implementing the existing benchmarks. We therefore suggested that MMS undertake the practice of making price information available routinely to provide what the supplemental notice calls "lease market indicators that are readily available contemporaneously."[1]

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[1] For your ready reference, we attach a copy of MMS's Midway-Sunset field lease market analysis referred to in our prior comments. (Exhibit 3.)

Although the brief reopening of the comment period has made the effort difficult, IPAA and DPC have prepared additional recommendations on how to implement an improved system of lease market benchmarks. The only significant change in the thrust of the recommendations is that we are proposing to have producers undertake more of the burden of confirming that data from arm's-length sales supports the values determined under the benchmarks. Our recommendations are attached as a separate paper. (See Exhibit 4.)

COMMENTS ON REQUESTED TOPICS

1. PURCHASE THRESHOLD LEVELS WOULD BE IRRATIONAL.

We are greatly concerned by MMS's request for comment on whether it should "specify purchase levels below which a lessee would not be required to value their production using index value." 62 Fed. Reg. 36031. Put more directly, the question is whether a producer should be forced to value production under the NYMEX scheme if it purchases more than a certain number of barrels in a given period of time, such as a year or two years.

A specified purchase level is a dual invitation: to ridicule for the agency and to a valuation nightmare for producers. To understand the nature of this request more completely, let us attempt to place it in a context that is "closer to home" to persons not working in the oil and gas production industry. Suppose the Internal Revenue Service proposed to place you in a higher income tax bracket if you purchase more than 10 gallons of milk a year. Anyone's reaction would naturally be to ask what business is it of the IRS's how much milk one buys. We trust you understand our members' concern.

The rulemaking record is full of illustrations of why producers need to buy crude oil, and we incorporate them without repeating them. Setting a purchase level would produce irrational results. Suppose the level were set at 2,000 barrels. In a given year, a producer could easily use that much oil in "frac" operations. Suppose the level were set at 20,000 barrels. A producer could easily buy that much oil back from a pipeline in order to provide oil to an MMS-designated small or independent refiner at an onshore point as required under the 20 percent set-aside obligation in its OCS leases. Whatever level is set, a producer is likely to have legitimate needs to buy more than that much oil for reasons irrelevant to royalty valuation; yet the producer would then have to convert its royalty accounting system to the NYMEX scheme, with the likelihood that it would have to convert back to the gross proceeds approach the following year. Given that the only concern ever mentioned regarding the purchase of oil is the "overall balance," a specified purchase level would be completely unsupportable.

To its credit, MMS has recognized this and has accepted our earlier recommendation that, if its problem with purchasing oil is the overall balance, it should say so. A purchase level is completely ill-suited to the task of determining whether a given transaction is truly at arm's length, and our proposed improvements to the benchmark system give MMS the data it needs to assure no overall balance has been created. A purchase level produces false conclusions. With a purchase level, a producer could be selling oil at arm's-length to a buyer, but the sale would be treated as non-arm's-length because the producer had bought more than the purchase level of oil for frac operations from some unrelated third party. The sole explanation for such a result would be the agency's unfettered exercise of whimsy.

The effect of a purchase threshold level on an independent producer's business decisions could be pernicious. Take, for example, the producer who wishes to sell private producing leases in one region to raise money to develop federal leases in another. Included in the assets to be sold are crude oil purchase contracts, under which the producer is obliged to purchase the crude of other working interest owners in the field and resells that crude, along with his own production, into the midstream market. In negotiating the sale, that producer is likely to find otherwise interested purchasers unwilling to buy the assets offered, because the crude oil purchase obligations under the contracts would cause the buyer to exceed MMS's purchase threshold level. The effect of inhibiting these otherwise interested purchasers is to artificially devalue the producer's assets and to constrain the development of the federal leases.

2. THE CHANGES ADDRESSING CRUDE OIL CALLS ARE IMPROVEMENTS, BUT THE PROPOSAL STILL LEAVES UNWARRANTED BURDENS ON SMALL PRODUCERS.

In our opening comments, IPAA and DPC urged MMS to abandon the idea that sales of oil were suspect transactions if the oil was "subject to crude oil calls." Proposed § 206.102(a)(4), 62 Fed. Reg. 3752 (restricting sales of oil subject to calls from being treated as arm's-length sales). We observed five main flaws in that part of the proposal.

First, the restriction irrationally applied even if the call was not exercised. Second, the restriction irrationally applied to sales under calls requiring the callor to pay the prevailing market price or to meet or beat an offer from an independent party. Third, the restriction irrationally applied to sales under calls when the price was to be negotiated *after* the right of call had been created. Fourth, the restriction irrationally applied to calls requiring sales at the callor's posted price when there was no evidence that the producer could have negotiated a higher price. Fifth, the restriction created inordinate compliance costs for producers, requiring exhaustive title searches and searches of non-record documents referenced in title documents to determine whether the production was subject to a call. In short, given the MMS's lack of evidence that crude oil calls had caused undervaluation of crude oil sales, we recommended that the agency review sales under calls on a transaction-specific basis and, if it found the parties to the call had deliberately negotiated a below-market price as part of the consideration for the call, value the sale under the benchmarks.

MMS has attempted to accommodate our concerns that calls on production should not subject a producer to the NYMEX valuation scheme. The supplemental notice changes the restriction to apply only to "oil disposed of under ... [t]he exercise of a non-competitive crude oil call." Proposed § 206.102(a)(4)(iii); 62 Fed. Reg. 36032. The supplement defines "non-competitive crude oil call" to mean

> a purchase sale agreement [*sic*] or farm out in which the buyer of the property agrees to be subject to a call on their production that does not contain 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.

Proposed § 206.101; 62 Fed. Reg. 36032. We appreciate MMS's effort to address the problems with its initial proposal, but regret that the effort has fallen short.

We begin with what is right with the supplemental notice. The change meets our first objection listed above. The restriction would no longer affect sales when calls are unexercised. For this reason, the change also meets our fifth objection. Because unexercised calls are no longer covered, the proposal would no longer compel lessees to conduct records searches to determine whether their property may be "subject to" a call.

But the supplemental notice fails to solve the other problems with the original proposal. The change attempts to meet our second objection, concerning competitive calls, without complete success. To avoid the NYMEX scheme under the supplemental proposal, the producer's sale must be under "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." *Id.*

MMS's approach is unworkable for three reasons. First, the reference to a "Most Favored Nations clause" is unhelpful. A Most Favored Nations clause is ordinarily found in natural gas contracts and requires that the price paid be the highest paid in the area for similar gas. It would be extraordinary if a call on crude oil production ever contained such a provision. Normally, calls on production are, as we explained in our opening comments, preferential rights of purchase. They require the holder of the call to match the price being offered by third parties in order to exercise the call. The matched price may or may not be the highest pricc paid in the area, but is nevertheless an arm's-length transaction wholly appropriate for royalty valuation. These calls are created not to lower royalty value but to assure supply of oil in times of scarcity, just like the crude oil call held by the United States on every federal and Indian lease. That is why these calls generally go unexercised.

Second, the change is unworkable because it places producers into the NYMEX scheme every time the callor's opening price is high enough to discourage competing bids from independent parties. The callor's price may be high enough so that no other parties would respond to the producer's request for competing bids.[2] If others do not bid, then the price is not "based on what other parties are willing to competitively bid to purchase the production" within the meaning of the rule. Yet that is the very situation in which MMS should be happiest with the callor's price.

Third, the change does not address our third and fourth objections. The agency's concern about crude oil calls is that, when the callor granted the producer the property right, the callor sold the property for less than it was worth in exchange for the producer's promise to provide oil in the future at less than the market price. This concern is irrational when the price is to be agreed to after the call is created: the callor has lost his bargaining power to compel a below-market price. Even when the price is set at the time the call is created, the price is not automatically suspect. Consider the following example. Small producer A has a lease not subject to a call. It sells its production to Chevron at Chevron's posted price. On the adjacent lease, small producer B's oil -- of a quality identical to A's -- is subject to Chevron's call, and the call requires the sale at Chevron's posted price. A and B sell identical oil, essentially identically located, at the same price. Producer A is allowed to value royalty at the price it actually receives, yet B must use the NYMEX scheme. No sound reason of public policy supports this distinction.

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[2] As MMS knows, producers sometimes cannot find alternative buyers. To illustrate this point, we attach a royalty valuation letter MMS issued in the 1980s to Petro-Lewis Corporation allowing it to value royalties on production at an arm's-length price **below** the posted price after Petro-Lewis had sought offers from 12 potential purchasers but received no bids. (Exhibit 5.)

If MMS wishes to restrict the use of valuation based on gross proceeds where "non-competitive crude oil calls" are exercised, it needs to adjust the proposed definition. A "non-competitive crude oil call" should be defined to mean "an agreement in which the buyer of the property agrees to be subject to a call on its crude oil production and in which the parties intend the price to be paid for the oil to be less than that under an arm's-length sale of comparable oil in the field or area in exchange for other consideration to the buyer in the sale of the property." Sales under non-competitive crude oil calls should be evaluated under the benchmarks for non-arm's-length transactions.

In sum, while the change concerning crude oil calls is an improvement, it still creates irrational valuation results and draws irrational distinctions. We urge MMS to adopt the recommendation in our May 1997 comments. If MMS has evidence that a producer received consideration when the call was created in exchange for a sales price below market value, then it should value the sale using the benchmarks proposed by IPAA and DPC. This approach protects the public from collusive dealing and honors arm's-length market information and values.

3. MMS'S CONCERNS ABOUT LESSEE IMPLEMENTATION OF CRUDE OIL CALLS CAN BE BEST ADDRESSED BY ADOPTING DPC'S AND IPAA'S COMMENTS ON BENCHMARKS.

MMS has specifically sought comments on the ease of enforcing its proposal regarding crude oil calls.

> MMS does have some concerns about whether this proposal to allow valuation based on gross proceeds in a competitive call circumstance may result in undervaluation situations. For instance, we have concerns about a lessee's ability to know, and MMS's ability to obtain timely the pricing information needed to monitor adequately, whether the prices lessees are receiving are the highest prices under the Most Favored Nations clause and whether such prices are subject to discounts below true market prices and index values because of exchanges and other complex marketing arrangements.

62 Fed. Reg. 36031. Because this passage is not entirely clear, there are three ways to read this statement of concern. First, if the concern is that a particular lessee may be hiding consideration from the MMS to reduce its royalty obligation, that situation presents a question of individual compliance and enforcement. We share that concern. That practice

not only is unethical, but also places honest lessees at a competitive disadvantage. The appropriate course of action is for MMS to periodically review price information received on the monthly royalty reports in a given field or area. It then should timely investigate any pricing anomalies found to determine if a lessee is paying improperly. If improper conduct is discovered, MMS should employ the appropriate enforcement weapon from the arsenal of remedies it has under federal law.

Second, MMS's concern may be that a producer in good faith may not have access to the information needed to know whether its callor is paying the prevailing market price. A producer would welcome MMS's timely help in that case, because the producer has a five-to-seven-times greater interest than MMS does in receiving the full amount it is entitled to under the terms of its call. If MMS's database reveals a discrepancy, and to the extent MMS is authorized to disclose the price information, a producer would appreciate knowing it.

Third, MMS's concern may be that the crude oil market is essentially corrupt and nearly all participants are concealing "true market prices" behind "exchanges and other complex marketing arrangements." 62 Fed. Reg. 36031. If this is the concern, one must ask how MMS could have spent hundreds of millions of dollars and millions of hours in auditing lessees' records over the last 15 years without uncovering so vast a conspiracy. It is important that federal regulations remain reality-based. If MMS has this as its concern, it must make its evidence available and allow an opportunity for meaningful public comment.

Finally, MMS has requested comment on a point we find obscure. "MMS also would like comments to address the situation where the holder of the call may transfer the right to take the production to a third party and whether that might affect the gross proceeds paid to the lessee." *Id.* As we read this, MMS is envisioning a situation in which a small independent, such as Basin Exploration, has taken a farmout from Exxon which reserved a call on Basin's production to be sold at Exxon's posted price. Exxon then sells its call right to Chevron. The specific question asked is "whether that might affect the gross proceeds paid to the lessee." The answer would depend on how the call is worded. (MMS should be aware that several dozen representatives of IPAA and DPC member companies have read this particular inquiry. None has been able to understand what concern underlies the question. We regret that we cannot be more responsive to your inquiry.)

4. MMS HAS PRUDENTLY ABANDONED THE VIEW THAT THE PURCHASE OF OIL IS A SUSPECT TRANSACTION.

In its initial proposal, MMS would have refused to treat a lessee's sales to third parties as arm's-length sales if the lessee had purchased any oil in the prior two years. Proposed § 206.102(a)(6); 62 Fed. Reg. 3753. Both DPC and IPAA explained at length why that proposed position was irrational, would have treated millions of legitimate purchases of crude oil as suspicious, and would have forced virtually all independent producers to treat their sales as non-arm's-length sales subject to the NYMEX scheme. We noted that the only evidence in the rulemaking record remotely suggesting that oil purchases might raise a royalty concern was the theory of Mr. Benjamin Johnson that some major oil companies secretly keep an "overall balance" of purchases and sales with another company so that each can deliberately undervalue crude oil prices, a theory alleged on two sheets of overhead transparencies used in an internal MMS briefing.

We are gratified by MMS's response, recognizing that the proposal was "potentially too restrictive" and that producers have many legitimate reasons for purchasing crude oil. Instead, MMS proposes to disregard an arm's-length sale if "the contract price does not represent market value in the field or area because an overall balance between volumes bought and sold is maintained between that buyer and seller...." Proposed § 206.102(a)(4)(ii); 62 Fed. Reg. 36032. In connection with this change, MMS asks whether "we should require lessees ... to certify that they are not maintaining an 'overall balance' with their purchaser." 62 Fed. Reg. 36031.

If MMS is convinced by Mr. Benjamin Johnson's theory, then the agency must be faulted for being untrue to its beliefs; for it has failed to begin taking all oil royalties in kind from the suspected offenders. Only royalty in kind can leave the agency completely assured that it will not be deprived of its full royalties by an overall balancing arrangement, if in fact such an agreement exists.

However, a less partisan observer than Mr. Johnson would find no evidence to support Mr. Johnson's theory. Nonetheless, if the term "overall balance" is reasonably defined, IPAA and DPC object neither to this provision nor to the suggested certification. If two parties have agreed to value their sales to one another at below market prices and to keep one another whole by mutually buying and selling equal amounts of oil, the MMS should not accept their rigged sales prices. And if a certification would increase MMS's comfort on this issue, our members will gladly sign one.

Our concern is that the term be reasonably defined, because an overzealous auditor or plaintiff's lawyer will "cherry-pick" transactions to create the illusion of a balance, thus driving up a lessee's auditing and administrative costs without warrant in responding to orders and litigation. While protecting lessees from an auditor's chimera, the following definition would be faithful to MMS's concerns.

> "Overall balance" refers to a circumstance in which the total quantities of oil which two parties buy from and sell to one another (in transactions that are not exchange agreements as defined in this section) are approximately equal, the parties intend that the quantities be approximately equal, and parties intentionally sell the oil at less than the price in any comparable arm's-length sale in each of the fields in which the oil is produced. Quantities are considered approximately equal if the total volumes bought and sold differ by less than one percent. If the total volumes bought and sold remain approximately equal for more than six consecutive months, the parties are rebuttably presumed to have intended their mutual purchases and sales to be approximately equal. If volumes are approximately equal for six or fewer consecutive months, the parties are rebuttably presumed not to have intended their mutual purchases and sales to be approximately equal.

5. MMS'S PROPOSAL TO VALUE EXCHANGE AGREEMENTS IS APPROPRIATE ONLY IF LEASE MARKET BENCHMARKS ARE USED.

In its initial proposal MMS would have required that all oil disposed of under an exchange agreement be valued under the NYMEX scheme. Proposed § 206.102(a)(4); 62 Fed. Reg. 3752. IPAA and DPC opposed this approach, noting that there was no reason to abandon the current approach of comparing the exchange with an arm's-length sale under the benchmark.

The supplemental proposal would change this approach in a limited context. If the lessee traded its production "under an exchange agreement with a person who is not affiliated with" it, the lessee could choose to pay royalties under the NYMEX scheme or under what MMS calls "gross proceeds."

> If you elect to use gross proceeds, you would use the gross proceeds from your arm's-length sale of the oil after the exchange, adjusted for any location or quality differences paid or received under the arm's-length exchange agreement.

62 Fed. Reg. 36031.

We strongly support the concept of giving the lessee a choice, but we object to the Hobson's choice offered here. Ordinarily, a lessee does not exchange oil at the lease for other oil at the lease in order to resell the other oil at the lease, as suggested in MMS's example. *See* 62 Fed. Reg. 36031 (describing exchange with 25-cent differential for quality followed by resale for $20 per barrel). Instead, exchanges usually reposition crude oil and are a standard midstream market activity. MMS's proposed approach to gross proceeds on exchanges is essentially similar to its attempt to use the proceeds that an affiliate of the producer receives from marketing oil downstream. Both inappropriately seek to attribute to the value of production at the lease the value added by midstream marketing activities. A better choice to give a producer is the option of valuing exchanged oil either by using lease-market benchmarks or by using its resale price minus exchange differential. The lessee may find it reduces accounting costs to use the resale price rather than the benchmarks and may appropriately be given that choice.

Nor is the use of the NYMEX scheme any more warranted simply because a producer exchanges oil with an affiliate or uses multiple exchanges to move the oil to the ultimate purchaser. The complexity and expense of the NYMEX method creates a disincentive for independent producers. If multiple exchanges or exchanges with affiliates require a producer to use NYMEX for royalty value, then producers can be dissuaded from using these otherwise convenient means of repositioning oil. That will have an unfortunate effect, for some purchasers are not as willing to buy oil outright as they are to exchange oil they have in oversupply at a different location away from the lease or other point of exchange.

The appropriate way to value oil disposed of at the lease under an exchange agreement is to give the lessee a choice between valuing the transaction under the benchmarks or using the price it receives from the sale of the oil received under the exchange (or series of exchanges) adjusted by the differential (or differentials) in the exchange (or exchanges), as discussed in our prior comments. An independent producer typically needs more than one exchange to reposition OCS crude oil for sale. Our members strongly oppose a restriction that would place that producer under the NYMEX scheme.

6. Making Exceptions Applicable only to Specific Transactions Is Prudent.

The supplemental notice attempts to provide greater focus to MMS's proposed exceptions from the gross proceeds approach to valuation.

> MMS also is amending § 206.102(a)(1) to clarify that the exceptions to valuing oil sold under arm's-length contracts based on gross proceeds are transaction or contract specific. That is, if you have one arm's-length contract that is subject to a non-competitive crude oil call, then that does not necessarily mean that all of your Federal production must be valued under § 206.102(c).

62 Fed. Reg. 36032. If the exceptions are properly crafted, we agree, provided that section 206.102(c) contains benchmarks based on lease market transactions.

CONCLUSION

MMS has now received two rounds of comments on its proposal. Voluminous comments from oil producers -- and some from states -- have identified fundamental problems with all the key features of the proposed rule. If the agency is to move forward, it would be best to stay further action on a final rule while MMS analyzes the comments in full and issues a revised proposal with a preamble thoroughly addressing the comments raised. It is not idle rhetoric to describe the current proposal as the most radical change in royalty valuation concepts in 75 years. So sweeping a change requires more than two rounds of public comment.

Before reproposing the rule, MMS should hold several joint meetings with representatives of affected States and of federal lessees to discuss MMS's concerns over the existing and proposed benchmark system. Though our recommendations on benchmarks are detailed -- considering the brevity of the second comment period -- we recognize that they provide only a framework for discussion. Many issues remain to be worked through to obtain consensus among all the stakeholders in the federal royalty program. Nonetheless, we have placed a serious and thorough proposal on the table which addresses the concerns MMS identified at the outset of this rulemaking, and it does so more cheaply and rationally than the NYMEX scheme. IPAA and DPC stand ready to work with you and with affected States to assure its serious consideration.

The Congress is currently considering yet another MMS request for an increased appropriation to hire still more auditors. Ultimately, however, MMS needs to recognize that 14 years of auditing and enforcement under FOGRMA have not achieved the necessary twin goals of federal royalty management: increased public revenues with reduced public expenditures. To meet these goals, RIK is the only way.

Sincerely,

J. Larry Nichols
Chairman
Domestic Petroleum Council

Roy W. Willis
Acting President
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