IPAMS

Independent Petroleum Association of Mountain States

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August 4, 1997

Mr. David S. Guzy
Chief, Rules and Publications Staff
Minerals Management Service
Royalty Management Program
P. O. Box 25165, MS 3101
Denver, CO 80225-0165

RE: Establishing Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil
62 Federal Register 36030, July 3, 1997

Dear Mr. Guzy:

On behalf of the Independent Petroleum Association of Mountain States (IPAMS) I am submitting comments on the above-referenced supplementary proposed rule.

IPAMS very much appreciates MMS' willingness to amend the earlier proposed rule (62 F.R. 3742, 1/24/97) based on the comments of independents presented at the public meetings and in written comments on the proposed rule. The proposed amendments are purportedly designed to address the concerns of independents. The proposed amendments, by broadening the definition of arm's-length sales, will, in fact, protect many of IPAMS' members from having to pay royalties on a NYMEX or ANS value.

However, MMS appears to have missed the substance of IPAMS' comments. While we felt it was incumbent upon commentors to address in some detail the reasons we believe the proposed rule is flawed, this was in no way intended to imply that IPAMS advocates the concept embraced by the proposed rule. Nor were our comments intended to suggest that if MMS were to amend the proposed rule to address *some* of our concerns that IPAMS would be able to support the rest of the rule.

This is remarkable in that IPAMS' comments on the proposed rule were absolutely crystalline. IPAMS was, is now, and will continue to be, opposed to any rulemaking regarding valuation of oil and gas for royalty purposes which moves the point of valuation away from the lease in contravention of lease terms and statutory mandates.

IPAMS still believes the proposed rule is unnecessary, and that it should be withdrawn.

The supplementary proposed rule fails to address the key points discussed in our comments dated May 28, 1997:

- **The Rocky Mountain crude oil market is isolated from other markets.** Oil is typically sold at the lease between willing buyers and sellers in a dynamic market. Prices for Rocky Mountain crudes do not track with, nor are they influenced or controlled by, outside economic forces like the NYMEX; they are determined based on the price refiners can get for their products. Rocky Mountain production does not leave the region.

- **The proposed rule violates two fundamental principles of royalty valuation.** First, that gross proceeds received under arm's-length contracts determines market value is a long-held principle; one which this and other recent MMS rulemakings attempts to ignore. Royalty is to be based on the value of production removed or sold from the lease. Value is defined as "that price which a product will bring in an open market between a willing seller and a willing buyer". The Mineral Leasing Act defines the point at which value is determined at the lease or wellhead or some other point within the lease boundaries. The best measure of market value is the price reflected in an arm's-length contract.

  Second, MMS itself has rejected netback methods to determine royalty and has approved them only in instances where other methods cannot be used to calculate a wellhead value or leasehold value. MMS fails to acknowledge other, more reliable, valuation methods, and exacerbates the situation by going far beyond the accepted reach of netback calculations in proposing a method which disregards the downstream value of the oil actually produced from the leases as the starting point for the calculation. Even the courts have rejected netback methods as the "least desirable method of determining market price". MMS' proposal to use a netback approach is not warranted because arm's-length contracts exist that establish the value of oil at or near the lease.

- **MMS' proposed change in valuation methodology lacks rationale or justification.** MMS has failed to provide any explanation for the assumptions it has relied on in developing the proposed regulations, violating extensive case law which requires the regulatory agency to make an affirmative case for its actions, particularly when proposing regulations that deviate substantially from the agency's longstanding construction of a statute.

- **The NTL-5 Gas Royalty Act bolsters valuation based on arm's-length contracts.** The Congress, through passage of the NTL-5 Act in 1987, found it was inequitable to adjust the method of calculating royalty payments as a result of changes in market conditions. Congressional intent is clear that prices received under contracts that reflect values in the field or area of production are the best determinant of value, regardless of whether those prices are lower than other prices which could be obtained elsewhere, under different circumstances. Forcing lessees to pay on a NYMEX value violates the intent of Congress because NYMEX prices bear no relationship to the actual value of crude oil in fields where there is an established market. MMS has a very short memory. IPAMS recalls it was the use of NGPA ceiling prices that had no bearing in the marketplace which led to enactment of the NTL-5 Act.

MMS has failed to address IPAMS' concern that so-called "plain English" revisions to its regulations have imposed an onerous new duty to market on lessees. As stated in previous comments, IPAMS is concerned that this subtle revision to the language in the regulations will result in independents having to pay royalties on higher values than those received. This will occur because of a perception by MMS or its auditors that the lessee has somehow breached his lease terms by failing to market his production in such a manner as to earn the highest price possible, however far downstream of the lease. IPAMS reiterates its recommendation that the language be removed from this and future regulations.

MMS has also failed to address IPAMS' opposition to promulgation of an interim final rule.

With regard to the proposed amendment concerning crude oil calls, MMS has stated it has concerns about a lessee's ability to know, and MMS' ability to timely obtain, the pricing information needed to monitor adequately whether the prices lessees receive 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. In addition, MMS has requested comments to address situations 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.

The only way for MMS to verify pricing information with any certainty is through audit. MMS' stated goal of implementing a three-year audit period may assist in this effort. It must be acknowledged by MMS that, even though a call exists, a sale to a non-affiliated purchaser is still an arm's-length transaction, and not subject to a non-arm's-length valuation methodology. The fact that no additional offers to purchase the crude are received does not taint the sale.

An arm's-length transaction could be considered "suspect" only where a breach of the lease terms had occurred or in instances of other misconduct by the lessee. There are already adequate safeguards in existing lease terms and regulations to address those situations. MMS cannot use the call process to later determine that a lessee could have or should have received a higher price. This goes directly to the heart of IPAMS' concern with the "duty to market" language. (Please see IPAMS' comments on the NTL-5 Act and the duty to market, both above and in our May 28, 1997, letter for further discussion.)

IPAMS recommends MMS eliminate the phrase "Most Favored Nations clause" from the regulations. The term has not been defined by MMS. Moreover, MMS' use of the phrase is inappropriate and its application somewhat misconstrued. The "Most Favored Nations" clause is commonly used in the valuation of natural gas, but rarely, if at all, used in the valuation of crude oil. It is not found in oil exchanges. The clause deals with when a purchaser must increase a contract price because there are other, higher prices in the field or area. It would not be applicable to crude oil exchanges when defined in this manner. Where a lessee receives a bona fide offer to purchase crude oil from a third party and the holder of the call either releases the call or matches the offer, the transaction should be eligible for gross proceeds valuation.

Also regarding crude oil exchanges, MMS requests comments on whether it should require lessees who value their production using gross proceeds received under an arm's-length contract to certify that they are not maintaining an "overall balance" with their purchaser. IPAMS believes that a one-time or periodic certification would be the simplest and easiest way to address this issue.

MMS also requests comments on whether it should amend §206.102(a)(6) to specify purchase levels below which a lessee would not be required to value their production using an index value. Establishing a threshold does not alleviate IPAMS' concerns. If a producer is not selling to an affiliate, he should not be subject to any valuation methodology besides gross proceeds. If a lessee certifies that his production was sold at the lease, he should have satisfied regulatory requirements.

IPAMS would like to request clarification on two points. First, would the two-year period still apply? Second, would all a lessee's production have to be valued on NYMEX if only one lease was subject to NYMEX?

IPAMS' fundamental objection to using NYMEX or other indexed prices to value crude oil still exists. MMS' proposed amendments do not address this objection. Royalties are supposed to be based on the value of <u>production</u>. To require lessees to pay on a NYMEX value renders production a <u>commodity</u>. Crude oil must be valued as production at the wellhead.

In short, regardless of what changes MMS may suggest to modify the earlier proposed regulations, the fact remains that you can't take a bad idea and make it better. MMS' proposed amendments do not address IPAMS' primary concern with the proposed rule. The very questions MMS has raised in the supplemental proposed rule effectively demonstrate how complicated the proposed regulations are. Nothing in the statutes or in the terms of the lease mandates such a complex process. Simplicity and certainty is what works best for industry and government. Much effort in the past several years has gone into developing more simplified and streamlined regulations and processes. However, MMS' recently proposed valuation regulations run directly counter to that concept.

For true arm's-length sales, value should be the price the lessee received for his production. For non-arm's-length sales, value should be established through benchmarks which are based on comparable transactions in the same field or area. Further complication is neither necessary nor warranted.

In conclusion, IPAMS is opposed to the proposed rule, even as amended. IPAMS recommends MMS withdraw the proposed rule and revert to the 1988 crude oil valuation regulations utilizing gross proceeds for arm's-length transactions and a benchmark system for non-arm's-length transactions that relies on comparable transactions in the field or area as the basis for valuation.

August 4, 1997

Mr. David Guzy
Chief, Rules and Publications Staff
Royalty Management Program
Minerals Management Service

As always, IPAMS appreciates the opportunity to provide you with our comments. Please do not hesitate to contact me if you have any questions, or if you would like to discuss our comments in greater detail.

Sincerely,

Carla J. Wilson
Tax and Royalty Director