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August 4, 1997

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

Re: Establishing Oil Value for Royalty Due on Federal Lease, and on Sale of Federal Royalty Oil: Control No. RIN 1010-AC09

Dear Mr. Guzy:

In accordance with the Supplementary Notice of Proposed Rulemaking which appeared in the Federal Register on July 3, 1997, please find enclosed an original and one copy of the "Comments of the New York Mercantile Exchange on Proposed Rulemaking," for filing in the referenced proceeding. A copy of this letter and comments is also being faxed to you today.

In addition, please time-stamp the additional two copies of this pleading in the self-addressed, postage-paid envelope enclosed.

Please do not hesitate to call me should you have any questions concerning these comments.

Sincerely,

Douglas F. John

Douglas F. John
Counsel for The New York Mercantile Exchange

Enclosures

BEFORE THE DEPARTMENT OF THE INTERIOR
Minerals Management Service

Establishing Oil Value for Royalty) Due on Federal Leases, and on Sale) of Federal Royalty Oil)	**Control No. RIN 1010-AC09**

COMMENTS OF THE NEW YORK MERCANTILE EXCHANGE ON PROPOSED RULEMAKING

These comments are submitted by the New York Mercantile Exchange (NYMEX or the Exchange) in response to the proposal of the Mineral Management Service (MMS) to revise Parts 206 and 208 of its regulations [30 CFR Parts 206 and 208], dealing with valuation of oil produced from federal leases for royalty purposes.[1]

1.0 Introduction.

NYMEX is the world's largest physical commodity market and energy marketplace. Futures and options contracts for crude oil, natural gas, unleaded gasoline, heating oil, and electricity are traded there, as are futures for propane. In addition, futures and options contracts for precious metals (gold, silver, and platinum group metals), futures contracts for copper, and futures contracts for the <u>Eurotop 100sm</u> are also traded there. NYMEX is regulated by the US Commodity Futures Trading Commission (CFTC) and provides a forum for price discovery, risk shifting, and price transparency used by thousands of commercial participants in the everyday operations of their businesses. NYMEX prices are

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1 Notice of RMP's originally-proposed rule changes appeared in the January 24, 1997 Federal Register at 61 Fed Reg. 16, pp. 3741-3763. Notice of RMP's amended proposal appeared in the July 3, 1997 Federal Register at 62 Fed Reg. 128, at pp. 36030-36037. The latter Notice established a comment date of August 4, 1997.

disseminated widely on a real time basis, available to the public-at-large through dozens of different major media outlets, and serve as a critical reference for thousands of non-Exchange commercial transactions on a daily basis.

2.0 Summary of NYMEX Comments.

Under the subject proposal, as amended, MMS would establish a form of index-based valuation for royalty purposes on oil produced from federal leases and sold or transferred in other than arms' length contexts. Specifically, MMS proposes to embody in Section 206.102(c)(2)(i) the following valuation basis for such oil:

> (i) For production from leases not in California or Alaska, value is the average of the daily NYMEX futures settle prices (Cushing, Oklahoma) for the Domestic Sweet crude oil contract for the prompt month. The prompt month is the earliest month for which futures are traded on the first day of the month of production. You must adjust the NYMEX price for applicable location and quality differentials and you may adjust it for transportation costs under Section 206.105(c) of this subpart.

In general, NYMEX has no specific views on the appropriateness of MMS's proposal, i.e. NYMEX is neither a proponent nor an opponent of the proposal. However, NYMEX believes it can be of assistance to MMS in clarifying some issues that have been previously raised in this proceeding and offers its comments in that capacity. These issues pertain to NYMEX, its operations, and the role it serves in the oil industry, and our primary intent is to correct inaccuracies. Specific areas where corrections are necessary are 1) the relative participation in the NYMEX market of commercial oil entities versus non-commercial entities; and 2) the role served by NYMEX in the oil market.[2] Greater detail is provided with respect to both of these areas in the next two sections.

3.0 Commercial Versus Non-Commercial Participation in NYMEX Oil Trading

The American Petroleum Institute (API) has previously provided comments to MMS, including a report from a consultant--Marshall Thomas (Thomas Report). The Thomas Report indicates that trading at NYMEX is dominated by speculators who account for more than 70 percent of market participation. Using the CFTC as the authoritative basis, the facts indicate the reverse of the Thomas report's conclusions, a rather glaring difference.

The CFTC provides definitions as to what constitutes <u>hedging</u>. By implication, that which does not qualify as "hedging" constitutes "speculation." The CFTC's definitions were adopted pursuant to CFTC's statutory authority, and CFTC's regulations are structured to insure that speculators are not allowed to dominate trading (by, *e.g.* the establishment of speculative trading limits, which may be relaxed for *bona fide* hedging).

The CFTC maintains statistics on participation in commodity markets such as the NYMEX Crude Oil Futures market that differentiate between <u>hedging</u> and <u>speculation</u>. The categories of differentiation are, respectively, "commercial participation" for

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[2] There are, in NYMEX's judgement, other, less significant areas where inaccuracies have been reported to MMS, but NYMEX is not interested in pursuing clarification *ad nauseam*.

hedging and "non-commercial participation" for speculation. This statistical summary is referred to as the "Commitment of Futures Traders Report" and covers all customer participation that is required by regulation to be reported to the CFTC by the customers' brokers. Historically speaking, Crude Oil Futures reportable positions have tended to constitute approximately 75 to 80 percent of total open positions. (For example, reportable positions as contained in the July 15, 1997 Commitment of Futures Traders Report constituted 78 percent of total open crude oil positions.)

According to the CFTC's Commitment of Futures Traders Report, Commercial positions have tended to constitute above 80 percent of open reportable positions in crude oil contracts for all months,[3] which is the reverse--and then some--of the Thomas Report's contention.

Moreover, since the MMS proposal focuses on the first month forward contract (sometimes referred to as the spot month), to the extent anyone believes that these statistics are relevant, they might wonder if the spot month exhibits any material differences from all months. In fact, the CFTC does not maintain a separate report for the first month forward. However, based on NYMEX's observation over many years, the concentration of Commercial positions to Non-Commercial positions has consistently been greatest in the spot month. The reason for this is that as

3 The July 15, 1997 report identified over 85 percent of open reportable positions in crude oil as Commercial.

the first month forward contract gets closer to termination, participants with open positions must decide if they intend to liquidate their positions or not do so and assume delivery obligations. Clearly, only Commercial participants are in a position to assume delivery obligations.

The Exchange deliberately manages upcoming terminations of first month forward contracts by substantially increasing the required performance deposit for open positions (margins) throughout the month to encourage market participants with no delivery intentions to liquidate any open positions they may hold. This is considered prudent oversight. One of the results of this prudence is that Non-Commercial open positions in the spot month are relatively smaller than in any other months.

4.0 NYMEX's Role in the Oil Market.

NYMEX does not intend to use its comments to inform on the broad and deep role it plays in the oil industry, of which it is an integral part. However, the aforementioned Thomas Report asserts in numerous instances that NYMEX-determined prices reflect "speculative" interests rather than, by implication, the real oil industry. Whatever view one may hold on the relationship between oil bought and sold at the lease and that bought and sold for delivery in the pipeline system at Cushing, Oklahoma, an unmistakable theme throughout the Thomas Report is the suggestion that NYMEX prices are somehow not reflective of the oil market. Any such suggestion is not only false; it is nonsense.

There have been and continue to be countless instances where NYMEX's role of providing a useful and unambiguous price reference for the oil industry has been recognized. Such recognition originates from a broad range of sources, including public testimonials from industry (*i.e.* references in annual reports); scholarly reports; and trade publications serving the oil industry (references and headlines on a daily basis).

Interestingly, a fairly typical endorsement of NYMEX's role in price determination for the oil market was provided by the author of the Thomas Report in a complimentary periodical published by NYMEX--Energy In the News, Winter 1996-97 Edition, p. 15-19. (A copy of this article was, evidently, included with API's original submission.) Indeed, the Thomas Report references this article, but somewhat selectively, understating considerably the level of endorsement contained in the article. If MMS has not taken the time to read the article, consider the following quotations:

> In terms of liquidity and scope of participation, the NYMEX Division contract is the primary *de facto* global benchmark.

(Article at p.16).

> WTI is the undeniable benchmark crude in the U.S. market, a position that is enhanced by the futures contract, which the oil trade considers to be WTI for all practical purposes...

(Article at p.17).

Perhaps the most serious false implication of the Thomas Report, however, is in reference to the role NYMEX served during the Persian Gulf hostilities of 1990-1. The Thomas Report states:

> During the more recent Gulf war oil upheaval, skyrocketing spot and NYMEX crude oil prices were widely criticized in Congress.

(Report at p. 25). Though the context of this statement within the Thomas report suggests that it is intended to discredit <u>spot</u> oil prices as unsuitable for applying to production at the lease, the implications of the statement seem broader and more severe. They are also tremendously misleading. NYMEX was publicly lauded by the U.S. Government for the role it served during the Persian Gulf hostilities--by, in particular, the Energy Information Administration of the U.S. Department of Energy (EIA) and the U.S. General Accounting Office (GAO). EIA was established to provide, among other things, an independent source of analysis and information on energy issues and markets to the U.S. government. The GAO reports directly and exclusively reports to the U.S. Congress. A review of relevant EIA[4] and GAO[5] reports should remove any doubt about the respect which the U.S. government accorded NYMEX for its handling of the Persian Gulf crisis.

5.0 Conclusion.

NYMEX trusts the foregoing comments will help clarify the points addressed, and would be pleased to offer further comment

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4 "Petroleum Prices and Profits in the Ninety Days Following the Invasion of Kuwait," EIA Report No. SR/OA/90-01 (Nov. 1990).

5 The relevant GAO reports are entitled "OIL PRICES, Analysis of Oil Futures Market Prices Since Iraq's Invasion of Kuwait," GAO No. GGD-91-73BR (May 19, 1991), and "ENERGY SECURITY AND POLICY, Analysis of the Pricing of Crude Oil and Petroleum Products," GAO No. B-249628 (March 19, 1993).

about its operations upon request, should the MMS consider such information helpful.

Respectfully submitted,

Robert A. Levin / DFJ.

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