Congress of the United States
Washington, DC 20515

July 30, 1998

Honorable Bruce Babbitt, Secretary
U.S. Department of the Interior
Washington, D.C. 20240

Dear Mr. Secretary:

Under the current regulations governing crude oil royalty valuation for federal leases, a mountain of evidence has emerged demonstrating that federal oil and gas lessees, primarily the large, integrated corporations, have been cheating the American people out of hundreds of millions, if not billions, of dollars in royalties on federal oil and gas production.

This evidence can be found in Congressional investigations, the Department of Justice *Qui Tam* litigation, the Department of Energy's Alaska North Slope Export study, the Federal Trade Commission's study, and your own Interagency Task Force findings, as well as several oil-producing States' and Indian Tribes' litigation. The evidence of this widespread, consistent and costly undervaluation correctly led to the Department's ongoing rulemaking on crude oil valuation.

The valuation problem exists because major companies produce oil and "sell" it to themselves, or purchase crude oil through an exchange at a bonus but pay only the posted price or purchase crude oil downstream at spot prices but report only posted prices. They base their royalty payments on "posted prices" --- offers to purchase --- which we now know were artificially deflated in relation to market value. Royalties, calculated as a percentage of the value of the oil or gas produced, are, therefore, based on the price calculated to industry's advantage and not necessarily in line with market prices or in the best interests of the American taxpayer.

The proposed rule would reduce the use of posted prices and would instead generally require the use of higher, spot market prices to value crude oil for royalty purposes. Under the proposed revision, MMS would continue to allow use of the "gross proceeds" --- actual sales --- methodology for "arm's length" transactions, however, "non-arm's length" transfers would be required to use spot market prices adjusted for location and quality of the crude oil.

States that receive a share of the federal royalties are generally supportive of the MMS proposal, although the State of California Controller and City of Long Beach have advocated elimination of the "gross proceeds" option except for independent producers victimized by posted prices. They advocate near universal reliance on the spot market less adjustments for quality and location of the crude oil. Many states have implemented similar changes in their own programs and now rely on published market center prices instead of "postings" or gross proceeds. As evidence that your efforts serve the public interest, a number of States and Native American Tribes have spoken in favor of the speedy implementation of the proposed rule. Attached please find excerpts from their comments.

The oil industry is opposed to the new rules. While it does not come as a surprise, the industry has been using every possible avenue to prevent Interior from issuing the final rule. In addition to promoting a bogus "royalty-in-kind" program and appropriations riders, with every revision to the proposal, industry has come up a new set of "problems" — actually red herrings — that obscure the fact that the new rule is necessary because the oil industry has cheated the American people out of billions of dollars.

Because of industry's actions to subvert the government's right to collect fair market value, it is imperative that the new royalty program relies on independent, easily verifiable information not directly supplied by or dependent upon the lessees. The use of spot market indices, as proposed by MMS, is not a new or radical idea. The industry itself relies on and uses spot market indices all the time.

A number of States, taxpayer, education and environmental groups have expressed serious concerns that the proposed rule is overly accommodating to the oil industry in a number of ways. For example, as the Project on Government Oversight has asserted, the rule would adversely expand the opportunity for the major integrated companies to pay royalties on "gross proceeds" and not spot market prices. These groups have also expressed concern about the proposed definition of "affiliate" which allows a rebuttable presumption of control for lessees that own between 10 and 50 percent of other lessees' businesses. Finally, the questions concerning a lessee's "duty to market" continue to be problematic.

Taken together--- if not accompanied by other strengthening provisions---these changes from earlier proposals would undercut the ability of the government to assure fair returns on federal oil production. We, therefore, offer a series of suggestions, attached as technical comments, derived from these comments as well as our own research.

In addition, we enclose the July 23, 1998, comments of Mr. Brian McMahon, attorney for the City of Long Beach, on the subject of transportation and quality adjustments, which we believe have merit and should be carefully considered by the MMS. We concur with Mr. McMahon's comment that transportation allowances and location differentials should be limited to the least expensive alternative to transport the oil to the nearest market center. Further, we concur with Mr. McMahon's recommendation that the "quality" adjustments should be based on published rates of gravity and sulfur banks near common carrier pipelines rather than on information supplied by the producers, i.e., through "arm's length" exchange agreements that are easily subject to manipulation.

We recognize the enormous pressure the Department has received from the industry and we commend your staff, particularly the management and employees of the Minerals Management Service, for their efforts to carefully consider all comments on the proposed rule, while taking seriously their responsibility to protect the public interest. It is important to remember that this is not the industry's oil, but instead a public resource which belongs to the taxpayers and benefits not only state education funds, but also conservation and preservation funds as well. The oil industry will not perish if required to pay federal royalties based on spot market prices.

Please consider this correspondence as our comments on the proposed rule. We believe the MMS has been heading in the right direction and are hopeful that pressure from the oil industry will not result in further delay or weakening of a much needed rule. We, therefore, urge the MMS to stand tough on the substance of the rule and move to implement it as of October 1, 1998.

Sincerely,

George Miller

GEORGE MILLER
Senior Democrat
Resources Committee

Barbara Boxer

BARBARA BOXER
United States Senator

Attachments
CC: Assistant Secretary for Land and Minerals
Minerals Management Service Director

Technical Comments

Gross Proceeds

Under the existing rules, promulgated in 1988, the price of oil sold under an *arm's length* transaction is defined as *all financial compensation accruing to the seller*. This compensation, referred to as the *gross proceeds*, includes the quoted sales price and any premium, or any bonus, the buyer received. The gross proceeds as reported by producers historically closely tracked the posted prices for a given field. But, since 1988, gross proceeds *actually received* have generally been above posted prices.

The latest version of the proposed rule would greatly expand from the January 1997 proposal the number of lessees able to base royalty payments on "gross proceeds" instead of spot market prices. This is problematic and runs counter to the rule's original intent.

Methods that cannot be regularly verified and enforced --- and applied broadly and systematically -- will result in monetary loss. But under the proposed rule (section 206.102), by increasing the opportunity for more lessees to base their royalty payments on gross proceeds sales instead of spot market prices, MMS will provide an incentive to hide value through paper transactions. As recommended by the California Comptroller, MMS should return to its original proposal, and confine gross proceeds to the first sale made at an arm's length. All other production royalties should be based on spot market center pricing.

Arm's Length Transaction

Within the oil industry, it is difficult to separate the "parties with competing economic interests," especially when the market is so clearly controlled by the majors. However, some provision should be made for independent producers with little or no market power. They should not have to pay royalties based on spot market prices (minus transportation and quality deductions) that they cannot hope to receive from buyers in the field. This group of producers should be allowed to pay royalties based on what they actually receive --- including premia as currently required.

But this option must be strictly limited and monitored because lessees have proven that, given the opportunity, they will avoid paying royalties based on true value of the oil. Lessees who use "gross proceeds" to value the crude oil should be prohibited from using gross proceeds in crude oil exchanges, or other balancing agreements, *(which by definition <u>are not</u> arm's length)* that could conceal the true value of the oil produced from that lease.

Had industry not been dishonest about royalties, perhaps a more trusting approach, i.e., tendering, as suggested by industry, would have merit. Unfortunately, this is not the case. Lessees have discredited themselves by hiding the real value of crude oil through balancing agreements and other types of exchange agreements or through unwillingness to report the real value of crude sold to third parties --- instead reporting report intra-company sales instead. As noted below, the reference to *affiliate* should be deleted from this section as its inclusion is misleading. Transactions between affiliates are by definition not arm's length.

Non-Arm's Length transaction

Under current rules, for non-arm's length transactions, the value of oil is defined as the higher of either the gross proceeds or the amount arrived at by the first applicable valuation method from the following options: a lessee's contract or posted prices; other posted prices; other arm's length contract prices; arm's length spot sales; or netback .

The proposed rule would require all non-arm's length transactions to be based on spot prices, or contracts under which the buyer and seller agree to the delivery of a specific quantity of oil in the following month. These "spot prices" change daily but are easily accessible and verifiable.

Clearly, using spot market prices or NYMEX futures contracts to establish the market value of crude oil is a reasonable approach. By allowing deduction of location and quality allowances, the value of the crude oil at the market is adjusted so that the royalty will be taken on the value of the crude oil "at the lease."

Definition of Affiliate

Under the February 1998 proposed definition of *affiliate*, 10 percent ownership would require royalties to be calculated as non-arm's-length valuation for transactions between persons with such a degree of affiliation. Industry has argued that10 percent is too low because affiliates with this small amount of ownership, would actually have no control over the affiliated entity. They asserted that too many lessees would be excluded from using their gross proceeds to set value in arm's-length transactions.

They advocate retention of the current definition of *affiliate,* where ownership of 10 percent through 50 percent creates a presumption of control. In the July 8, 1998 *Federal Register* notice, MMS said that it understands the concern raised in the industry comments regarding presumption of control.

We were disconcerted by the decision to retain the current definition of *affiliate*, i.e., less than 10 percent ownership would create a presumption of non-control; ownership of between 10 and 50 percent would create a presumption of control that the lessee could rebut; ownership in excess of 50 percent would establish control.

MMS asserts that there have been few requests to rebut the presumption of control in the past decade, and that, therefore, this change should have little or no effect. There is no guaranty, however, that such a situation will continue in the future. Or, for that matter, that MMS has a clear picture of affiliations in the 10 to 50 percent range. At a minimum, MMS must place the burden of proof squarely on the lessee and must provide specific guidance on what would constitute a valid rebuttal. The proposed rule will complicate audits and invite disputes.

The discussion of "affiliate" revolves around the question of "control" as defined in the proposed rule. However, this misses the point. Given the structure of the industry, it is clear that the majors, or integrated producers, have *controlled* the "posted price" of crude oil, regardless of the amount of ownership an affiliate, particularly an independent producer, has enjoyed with a purchaser or other producer. The amount of control an affiliate has over another is not significant in this matter, as the California Controller has noted.

The actual percentage of ownership is irrelevant if lessees are able to use "gross proceeds" -- or reported sales prices that are less than fair market value --- in "arm's length transactions" and then make up the difference between or amongst themselves. Indeed, the existence of an affiliated "exchange" should immediately disqualify the use of gross proceeds, since an exchange between affiliates is by definition not an arm's length transaction.

Since it would, in all probability, not be practical or legal to negotiate the "set" or "fixed" deductions seen in recent settlements such as the Chevron-Texas settlement, and, further, some protection for independent producers seems appropriate, we suggest incorporation of the Internal Revenue Code's definition of "independent producer" found in the section 613 into the rule to further limit the transactions that could use "gross proceeds" to those lessees seeking to rebut the presumption of control in order to use gross proceeds as the basis for their royalty payments.

"Independents" – or those producing less than 50,000 barrels of oil per day and who do not own or are affiliated with a refinery --- do not have either the market power or access to pipelines and refineries to give them much, if any, control over the prices the major, integrated producers will pay for their crude oil. Surely, some independent producers may have negotiated "posted-price-plus-premia" agreements with the purchasers of their crude oil and they should pay royalties on the value of the whole "arm's length" transaction, not just posted price or gross proceeds if they are receiving added value through such subsequent exchanges.

The central question is whether or not a producer has the ability to form a business relationship with another producer or entity in the oil business that enables them to hide the true value of production. We concur with the California Controller on this issue generally, and advise MMS to remove the reference to *affiliate* in the definition of *arm's length* and to delete the term *control.*

Duty to Market

Industry's protestation notwithstanding, the duty to market crude oil produced on federal lands at no cost to the government is one of several lease obligations that the courts have uniformly recognized. The courts have said this obligation stems from the duty -- implied in every contract -- of good faith performance.

During the rulemaking process, industry has approached the question of "duty to market" from several different directions. At the heart of their concern is the fact that they have been hiding marketing costs within transportation deductions in order to increase their operating costs in order to increase their deductions.

Recently, independent producers have actually denied <u>any</u> duty to market, while continuing to assert an entitlement to pay royalties based on gross proceeds. The reasons given publicly by the independents have been based on fear -- fear that the government will "second-guess" their sales judgement. This is not fear based in law or reality. Only those who operate imprudently or negligently have anything to fear from MMS. It is not a test that can be met simply by showing that a lessee used a different marketing option than the MMS would have.

In California, for the most part, there has been no evidence of imprudent performance among the independents. Most independents in California have been prevented by the major, integrated corporations from realizing true value for their production. This is because the crude oil market in California is dominated by a handful of major integrated companies. These companies not only control the bulk of all production but also the transportation and refining facilities in the states. One example of this control is the continued operation of three heated pipelines in the State as private carriers. Without other access to transportation, producers must accept what they can get from the majors who are rarely willing to pay more than their own undervalued posted prices.

Industry's arguments for transferring their marketing costs to the government are simply indefensible. The marketing costs that industry lists are not new, nor are their marketing practices. For decades, whether lessees sold in local markets or distant ones, they did not deduct and did not attempt (until recently) to deduct their marketing expenses. Further, industry has been unable to support its claim that marketing costs enhance the value of oil.

Finally, there is no reason to accept "gross proceeds" as a legitimate measure of royalty value over a market center index if lessees reject any obligation to make a good faith effort to sell the production. We support the MMS position on this matter and concur with their current position to delete the "breach of duty to market" language from the rule and return to the historically held policy that a lessee has a duty to market the oil at no cost to the government.

<u>Overall Balancing Agreements and Exchanges</u>

As noted by the State of California, there is substantial evidence that overall balancing arrangements exist and reduce the royalties paid by the major payors of federal royalties. The oil industry uses *posted-plus-premia*, subsequent exchanges or overall balancing arrangements, to bridge the difference between the posted price and the spot market price. In this way, they have reduced their royalty payments and still kept themselves "whole" at the taxpayers' expense.

However, even recognizing that these arrangements are used to hide value, MMS has not taken into account the fungibility of crude oil--- –and the subsequent ease with which its ownership can be transferred and exchanged. And, naively, MMS has placed the burden on itself to prove that such an arrangement exists on a lease-by-lease basis, that a given contract is subject to such an arrangement, and that a specific amount within the agreement is subject to each purchase and sale subject to the agreement. This approach would involve complex tracking and auditing for every lease and should be avoided.

It would be neither feasible nor cost-effective to attempt to trace the infinite number of exchanges that could occur to hide the true value of federal crude oil. MMS must rely, to the maximum extent, on an independent, easily verifiable standard and not on information supplied by the very groups that have been short-changing the taxpayers.

We concur with the MMS proposal to limit the number of exchange transactions to be traced under "gross proceeds" transactions, however, we would also recommend that MMS require all lessees who employ the "gross proceeds" method (instead of index pricing) to report all balancing arrangements related to a lease. Further, in light of industry's bad faith performance in this area, any such lessee should be required to so certify subject to penalties in the event of fraud. Assuming that MMS auditors will "catch" all such agreements is not sufficient.

Quality Differentials

The proposed rule provides that deductions from gross proceeds will be allowed for "quality," i.e., gravity and sulfur content of the crude. The rule suggests that adjustments will be based on "arm's length exchange agreements." This is not the appropriate direction to take.

Quality adjustments in exchanges between oil producers and buyers are just as easily manipulated as the absolute price terms for crude oil. Instead, the rule should use published gravity and sulfur banks in common carrier pipelines near the federal leases to index crudes. These banks are the result of competition among a number of companies and represent objective criteria for making appropriate quality adjustments.

Transportation Deductions or Locational Differentials

The value of the oil sold from a federal lease is determined by the price paid in a sale "at the lease" which is how independent producers traditionally sold their oil. Since the mid-1980's, however, independent producers have employed marketers and traders to transport their oil from the leases to market centers and refineries where the oil is sold at higher prices. MMS regulations allow the producer to deduct the cost of transportation to the point of actual sale from the gross proceeds.

As explained by Mr. McMahon, the rule should be revised to clarify that transportation costs must be limited to the least expensive available transportation alternative to the nearest market center.

Transportation versus Gathering Costs

In the July 8, 1998, *Federal Register* notice, MMS asked for comments on the concern raised by industry on the costs associated with gathering versus transportation, especially in deep water development. According to MMS, industry has argued that since development of deep water leases often involves a sub-sea completion with no platform, bulk, unseparated production is moved sometimes in excess of 50 miles to a platform where it first surfaces and is treated. Therefore, industry argues, in these situations the movement of production from sub-sea production to the platform should be deductible as a transportation allowance which is generally and specifically by rule now considered to be gathering and therefore not deductible.

We remind the Department that under the very generous provisions of the Deep Water Royalty Relief Act, oil and gas companies can produce quantities of oil worth $1.4 billion (at today's prices) before paying any royalties to the taxpayer. We disagree, therefore, that industry is entitled to more discounts, by allowing them to deduct the costs of gathering in order to pay even lower royalties.

For deep water operations these "gathering" deductions would be significant, because most companies now use lower cost sub-sea production facilities that require long distance movement of the oil or gas through a pipeline to a separation facility. The use of this "new technology" results in significant savings for the producer at each location. The argument that gathering costs should be deductible for the producer at the taxpayer's expense is not persuasive.

The Department should be aware that the issue of defining gathering versus transportation is also under consideration by the Federal Energy Regulatory Commission. Ironically, in that venue, producers are arguing just the opposite – that transmission lines used to transport oil and gas from remote sub-sea facilities offshore and transported to central accumulation points, *should* be considered as "gathering" lines so that FERC cannot regulate them.

States and Native American Comments

The State of Alaska Department of Natural Resources wrote: *"**We do 'have a dog in this fight.'** . . . **The proposed rules would establish royalty value using widely published crude oil prices instead of relying on the posted prices set by the lessees themselves**. . . . **MMS has attempted to set the value of its royalty against the prices in an independent market where oil is traded competitively** . . . **The approach taken by MMS** to simplify the calculation of royalty value under its proposed rulemaking under the FRSA* [Federal Oil and Gas Royalty Simplification and Fairness Act] ***will better protect Alaska's interests.*** *"*[1]

The California State Controller's Office (SCO) wrote: *"**Throughout this rulemaking, SCO has supported MMS** . . . SCO cannot, however, support MMS's current proposal. It is of vastly different character and, indeed, takes a different direction by tipping the balance away from protection of the public's royalty interest in favor of private interests. **The beneficiaries of MMS's current proposal are the very companies whose conduct precipitated the need for this rulemaking.**"*[2]

The City of Long Beach, as Trustee for the State of California testified: *" The major oil companies have created the crisis in crude oil valuation today. The crisis is caused by the failure of the major oil companies to post prices at the market value of crude oil . . . The current crisis was not created by MMS."*[3]

The Louisiana Department of Natural Resources (DNR) wrote: *"To sum up, **DNR is supportive of MMS's attempt to value NAL [non-arms-length] production in a more certain, timely, and accurate manner than provided in the current regulations.**"*[4]

The Navajo Nation Minerals Department wrote: *"The Navajo Nation requests you to take into highest regard, your **moral obligation** to protect the mineral resources of Indian nations by **eliminating any language which bars the MMS from finalizing any proposed crude oil valuation regulations on Indian lands** and to prevent any similar language that would bar the MMS from finalizing regulations in the future."*[5]

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[1] John Shively, Commissioner of the Department of Natural Resources, Memorandum to the Office of the Governor, State of Alaska, April 27, 1998.

[2] Lee Ellen Helfrich and Henry M. Banta, Law Offices of Lobel, Novins & Lamont on behalf of the California State Controller's Office, Letter to Minerals Management Service, March 23, 1998, 11.

[3] M. Brian McMahon, Testimony on behalf of the City of Long Beach as Trustee for the State of California before the Subcommittee on Energy Research, Development, Production and Regulation, U.S. Senate Committee on Energy and Natural Resources, June 11, 1998, 1-2.

[4] Jack C. Caldwell, Secretary of the Department of Natural Resources of the State of Louisiana, Letter to Minerals Management Service, May 28, 1997, 3.

[5] Perry Shirley, Assistant Director of the Navajo Nation Minerals Department, Letter to the Honorable Ralph Regula, Chairman of the U.S. House Interior Subcommittee on Appropriations, June 8, 1998, 2.

The State of New Mexico Taxation and Revenue Department wrote: *"First and foremost, the* ***Minerals Management Service (MMS) should be commended*** *for the effort they have made in* ***developing oil valuation rules that are fair to all interested parties****. They also should be commended for recognizing an issue and following through with it to resolution, in an environment where litigation abounds, unfounded criticism is made public and* ***political mechanisms are used to mandate positions*** *. . . In concluding, the Department* ***requests that the MMS move forward in promulgating this proposal****."*[6]

The New Mexico State Land Office (SLO) wrote: *". . .any increases in crude oil revenues that would result from revised valuation methodologies* ***would directly benefit education funding*** *in this state . . . The New Mexico Land Office* ***continues to support the MMS in pursuing its proposed valuation regulations*** *for oil and* ***adamantly supports the discontinuation of posted prices*** *to value federal royalty crude oil . . . In short, the New Mexico SLO* ***urges the MMS to reconsider regulated use of NYMEX indexing****, with appropriate adjustments.'"*[7]

The Texas Land Commissioner wrote: *"If Senator Hutchison wants to use Texas as the model for this type of policy, then* ***she should support the Mineral Management Service in getting the real market value of the oil*** *and charging royalty rates like we do in Texas."*[8]

The State of Wyoming Office of the Governor wrote: *"* ***The Minerals Management Service must be complimented on its obvious efforts at arriving at a fair and practical solution for this difficult problem.****"*[9]

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[6] John Chavez, Secretary of the State of New Mexico Taxation and Revenue Department, Letter to the Minerals Management Service, March 19, 1998.

[7] Ray Powell, State of New Mexico Commissioner of Public Lands, Letter to Senator Don Nickles, Chairman of the Subcommittee on Energy Research, Development, Production and Regulation of the Senate Energy and Natural Resources Committee, June 10, 1998.

[8] Garry Mauro, Texas Land Commissioner, Letter to the Editor, The Austin American-Statesman, May 12, 1998, A8.

[9] Jim Geringer, Governor of the State of Wyoming, Letter to the Minerals Management Service, October 28, 1997.