July 26, 2011

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MS61013C
Office of Natural Resources Revenue
U.S. Department of the Interior
P.O. Box 25165
Denver, Colorado 80225

SUBJECT: Docket Number ONRR-2-11-0005
RIN 1012-AA01
Advance Notice of Proposed Rulemaking
Federal Oil and Gas Valuation
Joint Industry Comments

The American Petroleum Institute (API), the U.S. Oil and Gas Association (USOGA), and the Council of Petroleum Accountants Societies (COPAS) offer the following comments on the Office of Natural Resources Revenue's (ONRR) advance notice of proposed rulemaking on federal oil and gas valuation. The U.S. oil and natural gas industry supports 9.2 million U.S. jobs and more than 7.5 percent of the U.S. economy. The industry has paid more than 150 billion dollars in royalty revenues to the federal treasury. The membership of the submitting organizations represents operators – both large and small, and both integrated and independent – who are responsible for the payment and reporting of royalties on substantial volumes of production of oil and gas resources on federal lands. Also represented are the industry accounting professionals who are dedicated to the reasonable resolution of issues related to production volume and revenue accounting, and financial reporting and tax matters, so that companies operating in all parts of the U.S. can effectively and efficiently comply with the valuation and payment of Federal oil and gas royalties.

The API is a national trade association that represents over 470 members involved in all aspects of the oil and natural gas industry. API represents operators involved in the exploration and production of both onshore and offshore federal resources.

The USOGA is a national trade association for the oil and gas industry established in 1917 in Tulsa, OK. USOGA currently has about 4,500 members and in addition to its Washington, DC headquarters has Divisions in Alabama/Mississippi, Louisiana, Oklahoma and Texas.

The Council of Petroleum Accountants Societies, Inc. (COPAS) is a professional organization comprised of the oil and gas industry's most knowledgeable and influential accounting professionals. COPAS has operated as a non-profit entity for 50 years and has over 3,500 members with 24 societies in the United States and Canada. COPAS was established in 1961 by representatives from various independent local societies throughout the U.S. and Western Canada. These societies recognized the need for standardized procedures and guidelines as the oil and gas industry expanded across the country so that common issues and problems could be addressed in a central forum. The societies have developed standardized documents in areas such as joint interest accounting, auditing, production volume and revenue accounting, and financial reporting and tax matters so that companies operating in all parts of the U.S. and Canada can effectively and efficiently use the same standards and guidelines.

The industry appreciates the stated intent of the ONRR to create regulations that offer greater simplicity, certainty, clarity and consistency in royalty valuation. However, any efforts toward simplicity should also be geared toward revenue neutrality. We offer the following comments to address the specific questions raised in your May 27 advance notice of proposed rulemaking.

Index Pricing

Question: *The ONRR is seeking comment on the existing use of index pricing to determine the value of production for oil royalty purposes and whether the use of index pricing should be expanded or altered. Additionally, the ONRR is considering the use of index pricing in valuing Federal gas for royalty purposes.*

Comment: We support the expanded use of index pricing to determine the value of production for oil royalty purposes, and we support the use of index pricing in valuing Federal gas for royalty purposes, as long as the specific regulations drafted provide administrative simplicity and the use of index pricing remains revenue neutral. If ONRR moves forward with expanded use of index pricing for oil valuation and/or with the use of index price for gas valuation, lessees should have the option to select index valuation in all circumstances, including both arm's-length and non arm's-length dispositions for oil, gas and all other royalty-bearing products including natural gas liquids (NGLs) and other liquids recovered. The regulations should provide that the use of index pricing is optional for lessees, allowing companies to elect to utilize gross proceeds as the valuation method or to utilize index pricing. Optionality allows companies to determine which valuation method actually provides the least administrative burden. It will also simplify the handling of those situations (if any) in which no reliable index exists. Because the index valuation methodology should be designed to be revenue neutral, allowing the lessee the option to use either index or gross proceeds will merely provide a selection between two different but revenue-equal valuation methodologies, and will not affect total royalty revenue to the federal government. The specific index pricing regulations should be drafted in a way to minimize any potential need for revisions to royalty payments and prior period adjustments. We also oppose the inclusion of any safety net calculations as are currently required for Indian Gas Valuation, as these calculations increase administrative burden and experience with Indian safety net calculations has shown that the gas indices used closely track gross proceeds over time.

Companies should still have the option to request a value determination for all production from any federal lease.

Question: *We seek input on how well index prices currently represent the value for oil and gas produced in different regions or areas of the country, such as states on the Gulf of Mexico coast (including Texas, Louisiana, Mississippi, and Alabama, as well as onshore areas within those states), the Midwest (including Oklahoma and North Dakota), the Southwest (including New Mexico and the Permian and San Juan Basin areas), the Rocky Mountain area (including Wyoming, Montana, and Colorado and Utah outside the San Juan Basin), the West Coast states (primarily California), and Alaska. Please identify what index publications you believe apply to what parts of these areas and the relative advantages and disadvantages, and strengths and weaknesses, of using each of the identified published index prices.*

Comment: For the majority of the country there are adequate indices for oil, gas and NGLs. Any index pricing system must be kept current to keep it valid and feasible for use by industry. The government and industry should collaborate to ensure that indices approved for royalty valuation are applicable, available for use, deemed feasible for use by industry and can be validated. For example, ONRR should consider a process in which lessees can submit a recommended list of indices that are appropriate for their dispositions. ONRR should also have a system in place to actively review the approved indices so that timely adjustments are made to maintain the adequacy and applicability of the list of approved indices and so that additional indices can be added as appropriate. Furthermore, there should be a mechanism in place for individual companies to work with the ONRR to address any problems that may arise, in order to ensure adequate resolution and accuracy in the indices used.

Question: *We also seek input on whether value should be based on first-of-month prices, daily spot prices, or some mixture of the two when considering the use of index prices.*

Comment: For natural gas, first-of-month pricing makes the most sense because it is available in a timely fashion and provides greater simplification. For oil, index pricing should be adjusted for actual location and quality associated with the pipeline quality banks (i.e., use the actual quality bank).

Question: *In addition, we seek input on how to best value this gas for royalty purposes in situations where gas from Federal leases is produced in areas not covered by index pricing, or where limited reported spot market activity exists.*

Comment: Industry does not see this as being a significant issue. However, in the event such a situation arises, the lessee could utilize gross proceeds, work with ONRR to develop or determine the applicable index, or could propose an alternative valuation method.

Question: *Does the concentration of Federal production in some areas of the country create any potential problems with relying on index prices in those areas, now or in the future?*

Comment: Industry does not foresee this as a problem.

Question: *Finally, we request comment on whether ONRR should use published index prices to value Federal oil and gas sold under non-arm's-length contracts as well as arm's-length contracts.*

Comment: If index valuation is implemented, industry supports use of index prices to value oil, gas, NGLs and other liquids sold under both arm's length and non-arm's length contracts so long as it is optional, remains revenue neutral and results in reduced burden as compared to other methods of valuation.

Transportation Allowances

Question: *The ONRR is examining possible alternatives to the requirement to track actual costs for determining transportation and to address the bundling issue. Please consider the following:*

If ONRR were to adopt index-based valuation, the point at which the index prices are compiled and published may or may not be the point of actual sale for particular gas, and the costs of transportation to the actual point of sale may not be relevant. However, the index pricing point would be remote from the lease or unit in virtually all circumstances, and value at the index pricing point may not reflect value at or near the lease or unit. If ONRR employed index prices to value Federal oil and gas for royalty purposes, what methods should be considered that would adjust for location differences between the lease or unit and the index pricing and publication point?

Comment: In order to most accurately reflect value, there should be a location differential with an escalation factor, and a separate component for fuel (a fixed percentage of the produced volume). The government must also provide a mechanism for review such that differentials and escalation factors are periodically revised to maintain validity. Provisions for extraordinary transportation allowances also need to continue, as found in the current regulation at 30 C.F.R. § 1206.156(c)(3).

Question: *In the interest of simplifying the determination and verification of location adjustments, should ONRR consider prescribing either a fixed differential amount per unit volume (thousand cubic feet (Mcf) or million British thermal units (MMBtu)) or a fixed percentage to be deducted from the index value to account for location differences?*

Comment: To best achieve revenue neutrality, a fixed amount per MMBtu for the infrastructure costs or transportation fee (with an escalation factor) plus a fixed percentage of the volume for fuel should be used.

Question: *Should ONRR apply a fixed differential amount per unit volume to all production in a particular area or that is transported through a particular pipeline?*

Comment: At a minimum, a location differential/fuel component adjustment needs to be calculated for each index point, including offshore. The regulation should include different rates for conventional gas development, coalbed methane development and other unconventional gas development, and the rates must be kept on an MMBtu basis to maintain simplicity and effectiveness with existing systems.

Question: *Would a flat percentage of the index value (perhaps with a cap) be preferable, either on a regional or nationwide basis?*

Comment: A flat percentage would likely not provide revenue neutrality and is not preferred. Using a flat percentage would introduce substantial complexities due to the variabilities, transportation distances, differences in offshore development, differences in coalbed methane development, etc. It would more accurately reflect actual transportation costs to use a fixed cost with an escalation factor and a separate component for fuel.

<u>Process Gas and Processing Allowances</u>

Question: *The ONRR is considering accounting for the value of liquid hydrocarbons contained in the gas stream by applying an adjustment or ''bump'' to the index price, applicable to residue gas when gas is processed, in lieu of valuing residue gas and extracted liquid products separately, calculating the actual processing costs, and deducting those costs from the value of the extracted liquids (the procedure required under 30 CFR 1206.153(a) and 1206.158 through 1206.159). This adjustment could be based on, or could incorporate, a number of components, including the following:*

Gas quality (either Btu content or gallons per Mcf (GPM)).

Comment: An adjustment or bump should utilize btu content and should not apply to keep-whole contracts where there is no "plus" or "uplift". Generally, industry supports the use of a bump.

The differential between the gas price and the oil or natural gas liquids (NGL) price similar to a ''frac spread'' or a ''processing margin.''

Comment: This method would present significant complexities and the differentials would have to be published in a very timely and ongoing manner. This differential truly changes over time and the adjustment would have to continuously take into account this variability.

Revenue neutrality must be maintained if this type of differential is used to adjust for processing costs.

Certain plant operation factors, such as shrinkage, producer processing costs, and plant operations costs.

Comment: In order to maintain revenue neutrality, the adjustment should take these factors into account, because the consideration of these factors would result in closer approximation of the actual cost of processing. This type of an adjustment must take into account both processing fees and plant fuel charges. The regulations must also maintain the existing provisions for extraordinary processing allowances as found in the current regulation 30 C.F.R. § 1206.158(d)(2)(i) & (ii).

Question: *We also seek input regarding whether such an approach could eliminate the burden of accounting for allowable costs to process gas and reduce or eliminate the potential for disputes over unbundling of gas plant charges, without reduction in royalty value. The ONRR could calculate this adjustment on a monthly basis and make it available on our website expressed in the form of a price per unit volume (MMBtu or Mcf).*

Comment: If done timely, accurately and effectively, this adjustment has the potential to reduce the burden on industry. The ultimate goals should be revenue neutrality and the reduction of burden. Under this approach MMBtu content is preferable to Mcf. Posting the rate on the website on a monthly basis should help reduce disputes, but this raises several questions that must be addressed up front in order to avoid further complications in the future. For example, retroactive corrections could significantly add to the burden and should be considered in developing such an approach. Our recommended solution to these concerns would be that any identified corrections and/or adjustments to the ONRR prescribed rates be rolled forward into the following month or year, instead of requiring prior period adjustments for all the affected properties. Furthermore, any potential approach should address all gas liquid products, including condensate and others that do not fall under the NGL category.

Question: *ONRR could maintain current reporting requirements for processed gas and NGLs but establish a fixed processing allowance. This fixed allowance could be either on a nationwide basis for all Federal gas or on a narrower basis, such as offshore and onshore leases; offshore regions and onshore basins; or gas-plant-specific.*

Comment: If ONRR maintains reporting of value with a fixed processing allowance, and index pricing is used for residue gas valuation, then index pricing should also be used to value NGLs and any other liquids derived from the gas. Under this approach, the fixed allowance should not be nationwide – a narrower basis is preferred because the narrower the basis, the more revenue neutral the allowance will be. At a minimum, any fixed allowance should be on an offshore region and onshore basin basis, as well as on a plant type basis. The type of plant (e.g., cryogenic, lean oil, adsorption, absorption) and the plant efficiency should also be considered.

Questions: *We seek input regarding the advantages and disadvantages of simplifying processed gas royalty reporting and payment by either of the aforementioned methods. We also are interested in other methodologies that would simplify the reporting associated with gas processing allowances or, if possible, eliminate the allowances by substituting a market-based proxy to reflect the value of liquid hydrocarbons contained in the gas stream.*

AND

In addition, ONRR requests your input on how the various methodologies would affect your business practices, bookkeeping, etc.

Comment: The initial transition will take considerable effort and resources, and will likely be expensive and demanding on company and government resources. Appropriate transition time will be necessary for industry to make appropriate system adjustments. The government should provide at least 12 months of transition time in advance of implementation. If the ONRR proceeds with an efficient and effective system with adequate transition time, then the revised regulations could result in increased efficiencies in the future. If not, however, the rule could add complexities upon complexities for the foreseeable future. As long as there are no true-ups, safety nets, dual accounting, keep-whole accounting issues, and the like, then the transition should be relatively simple. Conforming changes may also be necessary throughout the ONRR, BOEMRE and BLM regulations to ensure consistency and certainty.

<u>Other Issues</u>

Question: *The ONRR also is interested in receiving comments on any other alternative methodologies. If you propose a methodology different from those discussed above, please explain how the suggested methodology would meet the goals outlined above and why you believe your methodology is the best alternative.*

Comment: The industry has no other alternative methodology to propose.

In closing, the assembled trade associations appreciate the opportunity to comment on the advance notice of proposed rulemaking for federal oil and gas valuation. The oil and natural gas industry stands ready to continue to invest in safe exploration and development of federal oil and natural gas resources, and we look forward to working with ONRR to ensure that the federal royalty system strikes a balance that includes assurances of simplicity, certainty, auditability, revenue neutrality and fairness.

Please contact Erik Milito (682-8273, militoe@api.org) or Emily Kennedy (202-682-8260, kennedye@api.org) with the American Petroleum Institute if you would like additional information on the comments provided above.

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