

MARTIN LOBEL
LEE ELLEN HELFRICH
HENRY M. BANTA

LAW OFFICES OF
LOBEL, NOVINS & LAMONT, LLP

888 17TH STREET, N.W., SUITE 810
WASHINGTON, D.C. 20006

(202) 371-6626
TELECOPIER: (202) 371-6643
LNLaw.com

OF COUNSEL
ARTHUR L. FOX II
ALAN S. NOVINS
(1937 - 2006)
WILLIAM JOHN LAMONT
(1916 - 1994)

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By eRulemaking: <http://www.regulations.gov>

Hyla Hurst, Regulatory Specialist
Office of Natural Resources Revenue
P.O. Box 25165, MS 61013C
Denver, Colorado 80225

Re: Advanced Notice of Proposed Rulemaking,
76 Fed. Reg. 30878 (May 27, 2011),
Federal Oil and Gas Valuation

Dear Ms. Hurst:

On behalf of the California State Controller's Office (SCO), the following comments are submitted in response to the Office of Natural Resources Revenue (ONRR) Advanced Notice of Proposed Rulemaking, 76 Fed. Reg. 30878 (May 27, 2011). These comments relate to ONRR's request for input on new methodologies for the valuation of federal crude oil. Modification of the rules for valuation of oil produced from federal leases on and offshore California is premature and unnecessary.

California shares in the revenues received on oil production from federal leases in and offshore the State. For 29 years, SCO has served as the Interior Secretary's delegate under the Federal Oil and Gas Royalty Management Act, as amended, responsible for auditing such federal leases. It was SCO that first raised the problem of undervaluation of posted prices with ONRR's predecessor agency, the Minerals Management Service (MMS); a problem ignored by the federal government until it ballooned nationwide. SCO continues to have as much, if not greater, expertise in the California oil market than either ONRR or MMS.

Thus SCO is dismayed that ONRR would proceed with any rulemaking effort without first consulting with its own delegated experts. Neither ONRR/MMS' experience with the federal Royalty In Kind (RIK) program, a much criticized project¹, nor the Indian Gas Rule is remotely relevant to the valuation of crude oil produced in and

¹ The General Accountability Office repeatedly has reported that MMS had no ability to confirm the effectiveness of the RIK program and could not reliably account for the costs and benefits of the program. See e.g., GAO-03-296, Report to Congressional Requesters on Mineral Revenues (January 2003); GAO-07-682T, Testimony before Committee on Natural Resources (March 28, 2007). See also Innovation & Information Consultants, Inc. "Memorandum: MMS Report in RIK Pilot Program in Wyoming" (April 2001) [available at <http://www.pogoarchives.org/m/ep/ep-rikmemo.pdf>]. Thus, ONRR's reliance on MMS' RIK experience for purposes of the ANPR is somewhat curious. 76 Fed. Reg. at 30879.

offshore California. As ONRR recognizes, the 2007 Royalty Policy Committee report recommendations were confined to valuation of natural gas.² 76 Fed. Reg. at 30879.

SCO understands that ONRR has concerns about the burdens of monthly valuation analysis. *Id.* However, as ONRR surely must acknowledge, much of ONRR's current problem stems from MMS' premature decision to move forward on implementing its "re-engineered" reporting systems in 2001; a move that was opposed by the State and Tribal Royalty Audit Committee. This MMS decision was coupled, intentionally or not, with a marked deterioration in company reporting. While positive steps have been taken, these problems have yet to be resolved retroactively or prospectively. As a result, even if an administrative desire for "one size fits all" methodologies was sound public policy, ONRR currently lacks credible information and data to evaluate alternative value markers, standardized (*e.g.*, flat) allowances, let alone revenue neutrality on a regional or nationwide basis. Given industry's claims to confidentiality of detailed royalty information, whether *bona fide* or not, it is doubtful that ONRR will be receiving verifiable information from industry stakeholders in response to an ANPR.

SCO comments as follows to ONRR's specific issues to the extent that they relate to crude oil valuation.

A. Use of Index Prices To Value Oil (76 Fed. Reg. at 30880).

1. SCO continues to support use of ANS spot prices as the valuation marker for production transferred in Non-Arm's Length (NAL) arrangements. ANS tracks world oil prices and, thus, remains a viable index in California. While use of any index needs to be routinely monitored for viability and to assure revenue neutrality, SCO has seen no changes in the California crude oil market, which would support use of alternative indices, as was proposed by MMS in 2003, but ultimately rejected in 2004. 69 Fed. Reg. 24959, 24960-1 (May 5, 2004). Indeed, then MMS conceded that use of ANS was simpler than use of other indices. *Id.* at 24960. SCO continues to agree; use of ANS in NAL situations does not cause the type of administrative burdens that seem to be ONRR's primary motivation for its ANPR. 76 Fed. Reg. at 30879. Moreover, SCO has seen increased compliance by industry with audit document requests since the 2000 change transformed ANS to the default value for crude oil produced in or offshore California.

2. SCO does not support use of ANS spot prices to value production transferred under Arm's Length (AL) contracts. Hypothetically, use of ANS to value AL crude oil might result in an uptick of royalty revenues owed under some leases, depending, of course, on the allowance component and other factors. However, use of ANS in AL situations would also deprive ONRR and SCO of data (*e.g.*, monthly reports, contracts, exchanges) to monitor the viability of any index and the market generally. It was, after all, access to contracts and related internal company documentation that exposed the inadequacy of posted price as a valuation marker. To assume that the market for crude oil in California or elsewhere has evolved to the point where it is immune to manipulation is, SCO suggests, not in the public's interest.

B. Transportation Allowances (76 Fed. Reg. at 30880-1).

1. SCO is sympathetic to ONRR's concerns on bundling. Nonetheless, SCO's experience in the geothermal area indicates that fixed differentials or flat percentages for setting royalties and allowances reduce royalty income. The establishment of the percentage for geothermal was the product of a lack of information on the part of the federal government that would enable it to determine a method or formula that credibly tracked actual

² SCO notes that true revenue neutrality evaluation of alternative methodologies for federal gas valuation is hampered by: (1) MMS' refusal to amend current regulations regarding the "marketing affiliate" definition, despite its recognition in 1999 that "no company" falls within the definition (Indian Gas Rule, 64 Fed. Reg. at 43508); (2) its failure to take advantage of its substantial authority to obtain industry information to investigate the unbundling issue, and (3) the absence, to SCO's knowledge, of any review of the revenue neutrality of the Indian Gas Rule.

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costs in the market. ONRR's data base for oil transportation is no better than for geothermal, which is a much smaller universe. Thus, SCO opposes fixed differentials and flat percentages for determining allowances and respectfully suggests that ONRR's suggestions in this regard are premature, given the unreliability of its database, the infancy of its efforts to improve it and its failure to utilize the expertise of its delegates before initiating a rulemaking effort. As an aside, SCO notes that ONRR should evaluate whether the notion that market value must be determined "at the lease" is an anachronism, inconsistent with the statutory language. *See e.g., Amoco Production Co. v. Watson*, 410 F.3d 722, 727-728 (D.C. Cir. 2005), *aff'd*, 549 U.S. 84 (2006).

Thank you for the opportunity to submit comments.

Respectfully,

A handwritten signature in black ink, appearing to read "Lee Ellen Helfrich". The signature is fluid and cursive, with a large initial "L" and "H".

Lee Ellen Helfrich

Counsel to the California State Controller's Office