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DIRECTOR'S OFFICE

July 26, 2011

Hyla Hurst
Regulatory Specialist
Office of Natural Resources Revenue
P.O. Box 25165, MS 610C
Denver, Colorado 80225

Re: Regulation Identifier Number 1012-AA01Federal Oil and Gas Valuation

Dear Hyla Hurst:

Thank you for the opportunity to comment on the Office of Natural Resources Revenue's (ONRR) advance notice of proposed rulemaking proposing changes to the existing regulations governing the valuation of oil and gas produced from Federal onshore and offshore oil and gas leases, for royalty purposes. Please find listed below our comments on each issue.

Comments and recommendations on:

A. the use of Index Prices to value oil and gas

Should the use of Index Pricing to determine the value of oil be expanded or altered?

In a word, **No,** there is no need to expand or alter the use of index pricing to determine the value of oil. The NYMEX price is working. Extensive use of Index Prices in the CFR's is likely to intensify the manipulation of these indexes.

Should ONRR use index pricing in valuing Federal gas for royalty purposes?

Again, in a word, No, in general, using Indexes for all valuation would invite many more efforts to manipulate the Indexes. Gas Index pricing - Using one index cannot capture the value of gas for the situation where gas is sold at various locations to numerous third parties and the company is pooling these transactions to create a price.

If Index prices are to be used a composite of several indices should be used to minimize the risk of price manipulation.

Using an Index price to value oil or gas could eventually result in a situation similar to what occurred with NGPA pricing. The price of the product will no longer reflect the market value of the product.

<u>How well do index prices currently represent the value for oil and gas produced in different regions or areas of the Country?</u>

In the past, published index prices in "*Inside F.E.R.C*" for gas in Wyoming has been markedly lower than other geographical prices due to supposed pipeline constraints. The index prices used or selected to assign value may arguably be attributable to various extraneous factors when in reality; actual sales prices may be higher.

It does not appear that the proposed changes would be revenue neutral but would probably reduce royalty revenue to the Federal Government.

<u>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.</u>

For the Rocky mountain region first-of-the-month prices publication: ***Inside F.E.R.C.'s Gas Market Report*** use of CIG Rocky MTNs., Kern River WY, NWPL Rocky MTNs indexes are robust enough in terms of volume and deals, but Questar is too weak to use as reported to this publication. Questar, if reported at all often has very limited trades, sometimes a single deal and very low volumes in relation to the other indexes. Kern River WY and NWPL Rocky MTNs indexes strengths are the large volumes and lots of deals these two indices have them the advantage of being much more reflective of a true market price.

For the Rocky mountain region daily spot prices the recommended publications are: ***Platt's Gas Daily's*** use of CIG, Kern River/ Opal, Cheyenne hub, Northwest Wyoming, and Northwest South of Green River indexes; ***Natural Gas Intelligence Daily Gas Price Index's*** use of Cheyenne Hub, CIG, Kern River, Northwest domestic, Northwest SW of green River, Opal, and again the Questar index is far too weak to be a reliable indicator of fair market value.

<u>Should the use of index prices be based on first-of-month prices, daily spot prices, or some mixture of the two?</u>

We do not agree with the use of index prices for gas, or with expanding index price use with oil. If index prices are to be used, we do believe that a mixture of the first-of-the-month and daily spot prices is needed to reflect or capture fair value. What the appropriate percentage should be, in terms of use, is complicated and could be more costly and burdensome than reporting under current regulations. The index price would just be a starting point for calculating royalty revenues.

<u>How can ONRR best value gas for royalty purposes when produced in areas not covered by index pricing, or there is limited reported spot market activity?</u>

If production is sold under an arm's-length contract the Gross Proceeds is the best value for royalty purposes.

If production is sold under a non-arms-length contract then the royalty payor, ONRR and Wyoming should meet to discuss a value for this production. This has been done in the past and has worked really well for the payor and as well as protecting the public's interest.

<u>Does the concentration of Federal production in some areas of the country create problems with relying on index prices in those areas, either now or in the future?</u>

Once again, in the past, published index prices in "*Inside F.E.R.C*" for gas in Wyoming has been markedly lower than other geographical prices due to supposed pipeline constraints. The index prices used may be shown as a result of extraneous factors such as this when in reality, actual sales prices may be higher.

There is no certainty that the royalties paid to states will be revenue neutral relying on manipulated index prices.

<u>Should ONRR use published index prices to value Federal oil and gas sold under non-arm's-length contracts as well as arm's-length contracts?</u>

There is no reason to use an index price on Arm's-length transactions for either oil or gas when we would have 3rd party documentation. Again, using Indexes for all valuation would invite many more efforts to manipulate the Indexes.

Using index prices for the non-arm's-length transactions has worked well when used as a floor for the price.

<u>B. Transportation Allowances</u>

<u>If ONRR were to adopt index-based valuation what methods should be considered to adjust for location differences between the lease or unit and the index pricing and publication point?</u>

ONRR should use reasonable actual arm's length costs for location differences. The only way to ensure revenue neutrality is just to allow actual costs. So if actual costs need to be audited to ensure revenue neutrality we should just use actual costs.

This scenario could be more costly and burdensome than current regulations.

Should ONRR consider prescribing either a fixed differential amount per unit volume (MCF) or million British thermal units (MMBtu) or a fixed percentage to be deducted from the index value to account for location differences?

Transportation Allowances – Once again, using a fixed amount for transportation cannot equate to a fair allowance. The transportation scenarios are so different between companies and physical locations. It would be impossible to ensure revenue neutrality without looking at actual cost. So if reasonable actual arm's-length costs need to be audited to ensure revenue neutrality, we should just use actual costs.

This scenario could be more costly and burdensome than current regulations.

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?

Transportation Allowances – Once again, using a fixed amount for transportation cannot equate to a fair allowance. The transportation scenarios are so different between companies. It would be impossible to ensure revenue neutrality without looking at actual cost. So if reasonable actual arm's-length costs need to be audited to ensure revenue neutrality, we should just use actual costs.

This scenario could be more costly and burdensome than current regulations.

As to oil, many exchange agreements, buy/sells, or swaps are hybrid between an outright sale and a transportation agreement. It essentially "converts" crude oil at one location into crude at another location. To apply a fixed differential amount per volume to all production would provide a deduction when one is not incurred, warranted, entitled, or deserved.

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

If any index values percentages are going to be used, a cap must be used. Companies can easily manipulate the values to meet a cap, however.

It would be impossible to ensure revenue neutrality without looking at actual cost. So if reasonable actual arm's-length costs need to be audited to ensure revenue neutrality, we should just use actual costs.

This scenario could be more costly and burdensome than current regulations.

C. Processed Gas and Processing Allowances

Should ONRR apply an adjustment or "bump" to the index price based on gas quality (either Btu content or gallons per Mcf (GPM))?

The use of a "bump" to index prices based on gas quality would be costly and burdensome. The "bump' would constantly have to be recalculated based upon gas quality content. It would be less costly and burdensome to report and pay on actual liquid values.

Companies already have a close eye on actual liquid values; it is in their interest to do so. It is in the public's interest for us to audit the actual liquid values and not just do a compliance review of "bump" ONRR generated. Adding an additional layer of complexity by trying to approximate the actual liquid values with a "bump" that captures the dynamics of NGL markets, while not evoking controversy over being either under reflective or over reflective of the actual values and maintaining revenue neutrality is debate best avoided by requiring companies to report and pay on actual liquid values. The same actual liquid values they already closely track.

Should ONRR apply an adjustment or "bump" to the index price based on the differential between the gas price and the oil or natural gas liquids (NGL) price similar to a "frac spread" or a "processing margin?"

The use of a "bump" to index prices based on oil or NGL's price would be costly and burdensome. The "bump' would constantly have to be calculated based upon oil or liquid prices, particularly if it was to be revenue neutral.

It would be less costly and burdensome to report and pay on actual liquid values.

Should ONRR apply an adjustment or "bump" to the index price based on certain plant operations factors, such as shrinkage, producer processing costs, and plant operations costs?

There are too many different gas plants (size of plant, quality and quantity of gas processed) to apply a "bump" that would account for the value of the processed gas plant products with progressively newer and better equipment, dynamic industry and technology changes, in addition to ever changing regulatory and environmental considerations.

This would require looking at actual costs and plant operations to insure the public's interest is protected in order to determine the appropriate "bump" that is revenue neutral. This is an area of the regulations where simplest solution would be to fine tune the regulations that are already in place. To simplify our current regulations then limit the processing allowance deduction to the reasonable **actual** costs subject to a cap not to exceed the actual liquid values (or 66 2/3 for example). Companies track their actual costs not just because it is good business to do so, but because they have reporting requirements to other governmental organizations and their own management.

Would the application of an adjustment or "bump" to the index price based on above discussed approaches 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 a reduction in royalty value?

Industry has always grumbled about costly and burdensome reporting. This is something every business does. The concept of "less is best" will not ensure that every dollar due has been paid.

The only way to ensure revenue neutrality in any of these scenarios is by looking at actual cost. In order to protect the public's best interest actual cost will need to be looked to ensure revenue neutrality. Industry has legions of accountants, engineers and lawyers as well as numerous years of experience in transporting and processing gas so they are more than equipped to unbundle these costs. Industry is more than capable, of the un-bundling of costs on systems or gas plants, they may or may not own, based on their vast experience and expertise in transporting and processing gas. These companies are perpetually buying and building pipelines and gas plants. Additionally, the incentive must be for them to do so in order to get the deduction. It is in the public's interest to require appropriate support for any deductions that a payor may choose to claim. It is not in the public's interest to just allow a deduction for the sake of the deduction or to allow unsupported deductions. Remember deductions have been made available in certain situations, but are not required.

D. Other Alternatives

What other alternative methodologies would meet the goals outlined in this proposed rule change?

The best alternative would be to make corrections to the regulations as they currently exist. This offers the advantage of being better understood than a change in the regulations would be and the amount of issues that we could potentially litigate will continue to diminish as the court continues to hear many of the already outstanding issues identified to date. Any new changes to the regulations will be fertile grounds for new litigation no matter how simple it at first appears to be, or is intended to be.

For example: In rewriting the regulations, the definition of Lessee is different in the oil section, 30 CFR 206.101 than in the gas section, 30 CFR 206.151. This error should be corrected. The recommended wording for both oil and gas is the definition in 30 CFR 206.151: "*Lessee* means any person to whom the United States issues a lease, and any person who has been assigned an obligation to make royalty or other payments required by the lease. This includes any person who has an interest in a lease as well as an operator or payor who has no interest in the lease but who has assumed the royalty payment responsibility."

Another example of a correction to the gas regulations: is to add language to further clarify the definition of *Affiliate*. We would further recommend that the word “only” be removed, or changed to “any of” in the definition of *Marketing affiliate* in keeping with the United States Court of Appeals’ rational in *Fina Oil and Chemical Company v. Gale Norton* (Decided June 27, 2003) as to what is necessary to require valuations based on downstream resales. The language of §206.151(3) *Marketing affiliate* should have the word “only” removed from this definition. It was the presence of “only” in the definition of *Marketing affiliate* that the court in *Fina* addressed as a regulatory flaw that could (and should) be change in precisely this manner. We hope this opportunity to conform to the *Fina* decision is not missed.

One area for simplification would be to eliminate the extraordinary processing allowance. This is probably not needed and results in reduced revenue to the government.
NGL values are expected to increase. Gas plants do plant turnarounds to maintain their equipment for recovery efficiency. With technology and better plant efficiencies, it should not cost a lot to process gas anymore. In the past, companies have greatly benefitted from giving them 66 2/3% processing with an extraordinary allowance up to 99%. Even though these were fixed percentages, companies did not make the effort to pay on their actual costs, they just took the maximum allowed percent. This would not “provide certainty to industry and ONRR that companies have paid every dollar due.” The whole concept of extraordinary processing allowance should be done away with.

Another area ripe for simplification would be to eliminate the extraordinary transportation allowance. If the extraordinary processing and transportation allowances are not eliminated, then the two combined, meaning processing and transportation should not exceed 99% of the gross value of the product. If the company is taking a regular processing and regular transportation allowance the two combined should not exceed 75% of the gross value of the product.

In conclusion, we appreciate the opportunity to comment on the Office of Natural Resources Revenue’s advanced notice of proposed rulemaking governing the valuation of oil and gas produced from Federal onshore and offshore oil and gas leases.

Sincerely,

________/s/___________________
Michael Geesey, Director
Wyoming Department of Audit

______/s/______________________
Steve Dilsaver, Administrator
Wyoming Department of Audit
Mineral Audit Division