IPAMS

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February 5, 1996

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RECEIVED

Mr. David S. Guzy, Chief
Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P.O. Box 25165, MS 3101
Denver, Colorado 80225-0165

Re: Independent Petroleum Association of Mountain States
Comments--Proposed Rulemaking
Amendments to Gas Valuation Regulations for
Federal Leases, 60 Fed. Reg. 56007, et seq.

Dear Mr. Guzy:

The Independent Petroleum Association of Mountain States (IPAMS) is submitting, concurrently with this letter, joint comments with the Independent Petroleum Association of America in the above-referenced rulemaking. In addition, IPAMS would like to submit the following separate comments. and incorporate the remarks made by Hugh V. Schaefer at the public hearing held January 22, 1996 in Houston into these written comments.

IPAMS is committed to improving royalty valuation and accounting. Thus, IPAMS is particularly concerned that the final rule for gas valuation be workable and fair to all producers.

As written, the proposed regulations are incomplete, confusing and will lead only to conflicting interpretations and applications. With this deficiency, mistakes are bound to occur which in turn will lead to excessive auditing and administrative appeals along with the concomitant costs to the lessee.

Because of the problems which will be caused by the complexity and radical departure from the previous system, these proposals should be tested in a pilot program before final implementation. The pilot program should be limited to five years and limited to geographical areas, such as the Gulf OCS, where there is an active, competitive market dealing with substantial quantities of gas on a regular basis. The regulations should not be implemented as a whole until the pilot program has proven their effectiveness and utility.

IPAMS appreciates the opportunity to make these additional comments.

Very truly yours,

Barbara L Widick

Barbara L. Widick
Director of Regulatory Affairs

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Mr. David S. Guzy, Chief
Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P.O. Box 25165, MS 3101
Denver, Colorado 80225-0165

Re: Independent Petroleum Association of America
Independent Petroleum Association of Mountain States
Comments - Proposed Rulemaking - Amendments to Gas Valuation Regulations for Federal Leases, 60 Fed. Reg. 56007 et. seq.

Dear Mr. Guzy:

The Independent Petroleum Association of Mountain States (IPAMS) is a non-profit, non-partisan trade association representing the interests of independent oil and natural gas producers, royalty owners, industry consultants and service/supply companies operating in a ten-state Rocky Mountain area: New Mexico, Wyoming, Colorado, Montana, Nebraska, North Dakota, Utah, South Dakota, Nevada and Arizona

The Independent Petroleum Association of America (IPAA) is the national trade association of approximately 5500 members that represents the interests of independent domestic natural gas and crude oil producers. IPAA's members are engaged in the exploration for, and production and sale of, natural gas, and are keenly interested in the methodology pursuant to which royalties will be calculated and paid.

IPAMS and IPAA (referred to jointly as the Trade Associations) submit the following comments in the above-referenced rulemaking proceeding.

I. Introduction

IPAA and IPAMS appreciate the opportunity to participate in the work of the Federal Gas Valuation Negotiated Rulemaking Committee (NRC) and to provide these comments during this formal rulemaking process. The Trade Associations believe that the proposals to eliminate allowance forms, eliminate dual accounting for non-arm's-length sales of processed gas, redefine the term gathering, permit deduction of downstream compression expense and permit valuation of natural gas liquids on a wellhead MMBtu basis are helpful steps in the right direction and will assist in improving royalty accounting and payment procedures. During the deliberations of the NRC, the Trade Associations expressed their concern about many of the proposals and voted "sideways" in order to allow the work of the NRC to proceed The proposed rules have not alleviated many of our concerns and therefore we are renewing our concerns and objections in this letter on those issues subject to our sideways vote.

While we recognize that the NRC members worked many hours to develop a valuation system which would benefit all parties, we believe the index system is far too complex for independent oil and gas operators to use. **Although independents will be allowed to continue using the gross proceeds methodology, the complexity of the proposed valuation methodology in its entirety is contrary to the basic mission of the NRC.** Such a complex system coupled with the requirement that producers pay on entitlements, whether the producer takes or not, will discriminate against independents and leave them at a competitive disadvantage.

To illustrate this issue, our members in the Rocky Mountain region must operate in a large region served by relatively few pipelines. The efficient movement of gas in this area is restricted by the lack of pipeline interconnects which in turn provide access to only a few gas markets in the United States. Many of the pipelines serving this area traverse great distances to gather gas and charge rates which vary greatly depending upon the subarea served and the distance to the market. These factors preclude the development of a valid index system. A proper market value through the index system will not be obtainable and is not workable for the Rocky Mountain region. It may only work in an area which is free of the special constraints facing producers in this area.

The Trade Associations dispute the finding of the Department with respect to the Regulatory Flexibility Act (60 Fed.

Reg. 56015). **We strongly disagree with the certification of the Department that this rule will not have significant economic effect on a substantial number of small entities under the Act.** The statement that "these changes would add several alternative valuation methods to the existing regulations" is hardly a basis to conclude that the rule will not have significant economic effect. The rule fails, contrary to the pronouncements in the preamble to the rulemaking, to simplify, clarify, and improve royalty accounting for Federal gas We believe that a more in-depth analysis of the economic effect of this regulation on the small entities needs to be done. We seriously doubt that any meaningful economic analysis will support the Department s certification under the Regulatory Flexibility Act.

The Trade Associations also dispute the certification of the Department that a takings implication assessment need not be prepared under Executive Order 12630, Government Action and Interference with Constitutionally Protected Property Rights. We submit that it is unfair to require a payor to true-up to the safety net, but not allow a credit for payments above the median price. If a safety net is to be used, it should cut both ways. As proposed, the safety net regulation is arbitrary and capricious and may be an unwarranted taking of constitutionally protected property rights.. If the Department is committed to values for royalties based upon interacting market forces, then it is improper and unlawful to collect royalty which is based upon values which do not reflect actual value especially where it can be established that no gas is actually being sold in a given zone at the median price. A takings implication assessment should be prepared where a regulation seeks to extract a value which is contrary to market value especially where the Department has made the commitment to market forces being the best measure of value. See, p. 8.

The rulemaking is also deficient in its failure to address valuation of high cost natural gas including coalbed methane and high sulphur gas. New technology has enabled the industry to tap these resources. The proposed regulations are inadequate to address this unique circumstance.

II. Entitlements

The original purpose of the NRC was to address two issues: (1) reporting royalties on entitlements versus takes of gas produced under federal agreements and (2) the benchmark pricing methodology for non-arm's length contracts. Since the inception of the NRC, the Trade Associations have expressed strong concerns about the payment of federal royalties when federal gas is underproduced. See: Committee Report, p. 69. The trade associations voted sideways in an effort to go forward with the Committee's work. However, that vote should not be construed as a sign of support for the entitlements proposal.

The Trade Associations oppose the entitlements proposal because it will severely penalize independents in certain areas by forcing them to pay royalties out of pocket. On the other hand, producers on the Outer-Continental Shelf will not be subjected to this hardship because of the common federal interest which will permit them to report and pay on a 100% takes basis regardless of any production imbalances.

However, with respect to proposed regulation 211.18(c)(3) - Who is required to report and pay royalties?, the Trade Associations support this regulation so that lessees have an exception to report and pay royalties on their entitled share of production where all operating rights owners in an agreement can agree on common reporting and payment responsibilities among themselves.

III. Gross Proceeds v. Index Pricing

The Trade Associations are opposed to any royalty valuation system which does not recognize gross proceeds received under arm's-length contracts as the final and incontestable determinant of value. Subjecting lessee's to possible challenges to arm's-length values for two years after the year of production through the index system is arbitrary, capricious and unfair. **We strongly oppose any royalty valuation system which forces a lessee to pay royalties on any value which is in excess of the price it received for its gas.** While we recognize that the MMS' proposed rule does not require such a system, we are concerned that the MMS will require producers to pay royalties on a value higher than the price received.

The better rule is that if gas is sold in the spot market under an arm's-length contract which complies with other MMS valuation regulations, then there should be no comparison of other prices in the field or area. Of course MMS has the statutory duty to audit royalties, but it should not reject a price paid under an arm's-length contract unless there is evidence of misconduct or a breach of the marketing covenant as presently required by current regulation. It appears to the Trade Associations that the development of the index and the safety net regulations is a thinly veiled attempt to require all undedicated arm's-length gas sales agreements to be valued as if they were non-arm's-length contracts, if the producer elects to value the gas according to index.

IV. The Safety Net Calculation

The MMS requested comment on what should occur if MMS is unable to make the final two-year safety net median price determination. Two years is more than adequate time for MMS to make this determination and if it fails to do so, then it should not publish a final safety net median price at all. Lengthening the time in which this determination will be made is particularly burdensome and onerous on independent producers. To drag this determination out forcing the lessee to continue to provide for this contingency in future years is onerous and burdensome. Also, it appears to extend the audit period unnecessarily. If MMS is unable to make the final safety net determination, then the books should be closed and prices received by a lessee for the production year involved should be accepted subject to audit.

The statement that the NRC did not address this issue is inaccurate when the record of NRC proceedings is examined. Industry agreed to a two-year maximum period to calculate the safety net because any longer delay would militate against the certainty which the Committee was striving to achieve. The Committee received firm assurances from a senior MMS official that the necessary calculations could be made within two years. Based on these assurances, consensus was reached on the two-year limit. See: Committee Report, pp.34-35. MMS should live up to its commitment.

The safety net will compare prices received according to the index methodology (spot prices) with prices received under arm's-length contracts which are not limited to spot prices. Since the index is based only upon spot prices, it is patently unfair to use prices received under non-spot contracts as the basis with which to compare spot prices. This is comparing apples with oranges. Several producers do make arm's-length long-term arrangements for the sale of gas outside the spot market. Many producers are selling gas in present sales for one year or longer and basing the price on indices other than spot pricing. The purpose is to ensure price stability so that the producer can go forward with planning its exploration and development projects without being subject to the vagaries of the market. Spot contracts should not be compared with any other type of contract except other spot prices in the same field or area.

The proposed regulations are a radical departure from the manner in which the Department of the Interior has valued federal royalties in the past. In the preamble to the 1988 regulations, MMS made the following statement:

> ... MMS maintains that gross proceeds to which a lessee is legally entitled under arm's-length contracts are determined by market forces and thus represent the best measure of market value ...
> 53 Fed. Reg. 1186 (January 15, 1988).

It is evident that gross proceeds received under arm's-length contracts will no longer be acceptable if initial values are based on index. MMS should return to the principles as quoted above from the 1988 regulations and not force a lessee to comply with complicated and arcane index and safety net regulations.

V. Onshore Beneficial Use

. Over the years some of our members have experienced MMS and State delegated audits which have confused the deductibility of expenses for such matters as compression, dehydrating and gathering with beneficial use of gas. It would be advisable for the final regulations to clear up this confusion by restating the following comment by MMS which appeared in the final rule for revision of gas royalty valuation regulations.

> The determination of whether or not gas has been unavoidably or avoidably lost and whether or not gas used as royalty-free (whether used off lease or on lease) are

> operational matters covered by the appropriate regulations of the Bureau of Land Management (BLM) and MMS for onshore and offshore operations respectively. The BLM's requirements are governed by the provisions of 43 C.F.R. Part 3160 and Notice to Lessees and Operators Number 4A. The MMS's requirements are governed by the provisions of 30 C.F.R. Part 250. ...
> 53 Fed. Reg. 1230 (January 15, 1988)

The proposed regulations appear to perpetuate this confusion. In proposed 30 C.F.R. 202.450(b), MMS restated the 1988 rule but then added the following sentence to the proposed rule:

> However, except as provided in Section 202.451(b), in no instances will any gas be approved for use royalty-free downstream of the facility measurement point approved for the gas.

The sentence quoted above appears to conflict with the MMS' prior acknowledgment that only the BLM has jurisdiction to determine "whether or not gas has been unavoidably or avoidably lost and whether or not gas used" is royalty-free. Under Notice to Lessees No. 4-A (NTL-4A), the BLM has jurisdiction to determine if gas is being put to a beneficial use on or <u>off</u> the lease for onshore operations, not the MMS. Frequently the BLM has approved royalty-free gas beyond the facility measurement point. The sentence quoted above from the proposed rule will interfere with the jurisdiction of the BLM to make this determination. The last sentence of Section 202.450(b)(1) of the proposed rule should be changed to read as follows: However, except as provided above in this section as well as in Section 202.451(b) and under Notice to Lessees No. 4-A, in no instances will any gas, etc. As stated earlier, MMS should make it clear that it does not have jurisdiction for onshore beneficial use determinations.

VI. Benchmarks

With respect to the request for comments on improving benchmarks to be applicable when there is a non-arm's-length contract, the Trade Associations believe that value for royalty purposes in this situation should be based on comparable arm's-length contracts in the same field or area as presently provided in the existing benchmarks. **We are opposed to any attempt to use an affiliate's gross proceeds as the basis for royalty valuation.** This approach will lead to protracted litigation and will be counter-productive to the maintenance of an efficient royalty management system.

The proposal to conduct rulemaking on improved benchmarks is a thinly veiled attempt to capture downstream values on a product that has been enhanced solely by the efforts of the lessee and not the Federal government. With the regulatory prohibition against deduction of compression, gathering, dehydration and other gas conditioning costs by a Federal lessee, the Federal lessor is sharing in the enhanced value of a product which is contrary to fundamental principles of a royalty. Essentially a royalty is a share of production in kind (or value) at the wellhead, See: Law of Federal Oil and Gas Leases Section 13.01[1] p. 13-3 (Rocky Mountain Mineral Law Foundation 1994), and is based upon wellhead values in the same field or area and not higher values which are created downstream of the lease and away from the wellhead. It is particularly inappropriate to seek royalty on a product which has been transformed downstream from the royalty product which existed at the time of its production at the wellhead. In many instances, particularly in the Rocky Mountain states, gas sometimes has no value at the wellhead because of the unmarketable condition of the gas at that point due to impurities and other substances in the gas stream which are not acceptable for pipeline delivery. When the lessee assumes the entire cost of conditioning the gas into a marketable product, it is unfair for the Federal lessor to seek a royalty on a product which has been enhanced by the Federal lessee. Therefore, MMS should not promulgate regulations which try to extend a right to a royalty beyond the point where it is appropriate.

With respect to proposed regulation 202.450(d)(iv)(C)(3), where the operating rights owner takes none of its entitled share of production and the production cannot be valued using an index-based method as if it had been taken, five benchmarks are proposed. We suggest changing benchmark number (3) - the weighted average of the operating rights owner s gross proceeds under arm's-length contracts for that month in the field or area - to number (1) and renumbering the remaining benchmarks accordingly. Using the current month's value in the field or area is much less complicated than having to average the last three months. Using the current month's value will lessen the administrative burden for both MMS and industry. If there are no sales for the immediate previous three months, what is the alternative? This issue was not addressed. Without it, confusion is likely to occur.

VII. Gas Contract Settlements

The MMS also requested comments on seeking royalties on settlements resulting from contract disputes between gas producers and gas purchasers. The statement by MMS that the NRC didn't consider this issue is inaccurate. In the NRC's deliberations abandonment of gross proceeds valuation was agreed to by MMS and the States subject to industry agreeing to the safety net median value which would be based on prices received under arm's-length contracts in the same zone and other criteria Gas contract settlements were not included in the list of criteria. The Committee specifically agreed that buyout/buydown settlements would not be used in calculating the safety net. In fact, the NRC agreed not to discuss the issue during committee meetings. Therefore, there is no justification to propose a regulation which is not based on consensus of the committee when the charter of the committee is considered. The Trade Associations are deeply disturbed that MMS would interject this issue into this proposal thereby jeopardizing the entire rulemaking proceeding. We strongly urge MMS to remove the proposal from the rule. We oppose the collection of royalties on gas contract settlements.

VIII. Zones

The Trade Associations believe that determination of zones which will be appropriate for index pricing should not be published by MMS without prior notice and invitation for public comment. It is imperative that the MMS hold public hearings to determine if the index methodology is appropriate for a given zone. There are many areas in the Rocky Mountain states which were not recognized as potential zones. For example, the States of Montana and North Dakota have not been identified as a zone although those States do produce substantial quantities of gas. Industry and the States should have an opportunity to comment on the formation of zones and also on the viability of zones. The index pricing systems will be particularly difficult for independents to administer because it will require the tracing of gas to the appropriate index pricing point within a zone on a well to well basis. Generally, most of our members lack the capability to perform the analysis.

IX. Additional Comments

As to proposed regulation 202.452(b)(3) - Standards for reporting and paying royalties on gas. This section requires reporting NGLs in standard U.S. gallons, <u>except for</u> zones with an active spot market and valid published indices. This seems to be an unnecessary complication of the rule. Although NGLs are sold in gallons, nevertheless reporting can be done very simply on an MMBtu's basis. To do so better meets MMS and industry's objective of reporting consistency. Moreover, reporting all gas and gas products on an MMBtu basis will eliminate confusion on the part of payers as well as the increased likelihood of reporting errors.

As to proposed regulation 206.454(e)(7), there are questions which should be addressed regarding the convening of a technical procedural review (TPR) where the final safety net median value is disputed. How will notification to all affected parties be made? What happens if a company does not or cannot participate in the review and the value is later modified? Will all companies within a zone be notified of any modification to the safety net median value? These issues need to be addressed. Most importantly, we strongly object to the TPR decision as nonappealable. Since it would have the same binding final effect as other administrative orders and would have a significant impact on the valuation of royalties, fairness and administrative due process requires it be subject to further review, if a lessee so elects.

With respect to proposed regulation 206.456 - Transportation allowances - general. As discussed in the preamble, the NRC employed the term "location differential." However, in the proposed rule, the term transportation allowance is used for the same purpose without giving any reason for the change. The term "location differential" was used to distinguish between a company's actual costs for transportation and amounts that reflect a reasonable cost for transporting gas to the Index Pricing Point (IPP). The Trade Associations recommend, consistent with the Committee consensus, the term "location differential" be reinstated in the final rule and defined as approved by the Committee.

With respect to proposed regulation 206.457(c)(2)(iv)(A) and 206.459(b)(2)(iv)(A) - Determination of transportation allowances, and Determination of processing allowances. These sections prohibit an allowance for transportation systems and processing plants in instances where the lessee or the lessee's affiliate has previously claimed allowances. If new capital is invested which would extend the economic life of producing Federal leases, then a new depreciation schedule should be approved for the new capital.

With respect to proposed regulations 206.457 and 206.459 - General. The proposed rule does not distinguish between arm's-length and non-arm's-length transactions in reporting processing allowances and it is unclear whether allowance forms are eliminated for non-arm's-length transactions. We strongly support the Committee recommendation (Committee Report, page 73) that all transportation and processing allowance forms be eliminated for both gross proceeds and index-based payers. Therefore, the Trade Associations recommend that, in keeping with its commitment to eliminate allowance forms, MMS must eliminate <u>all</u> transportation and allowance forms for <u>both</u> arm's-length and non-arm's-length sales in the final rule.

Also in the preamble to the proposed rule, at page 56015, MMS requests comments on how best to accommodate supplementary reporting. We recommend that <u>all</u> issues arising from these regulations that may require modification to reporting requirements, including supplementary reporting as well as reporting of NGLs be referred to the Royalty Policy Committee's Subcommittee on Royalty Reporting and Production Accounting. Clearly, this Subcommittee is the most appropriate venue for determining the most efficient, streamlined, accurate reporting methodology under the amended regulations.

Finally, the Trade Associations recommend that MMS reconvene the NRC should it become evident that the final gas valuation rule may differ substantially from the proposed rule, since a significant revision of the negotiated rulemaking would require reproposal of the regulations in draft form for additional comment by the public. The NRC must make the determination whether the rule should be changed. Moreover, failure by MMS to publish the final rule essentially as it was negotiated will result in a further erosion of the credibility of the Department regarding negotiated rulemaking.

Again, the Trade Associations thank the MMS for this opportunity to comment on the proposed gas valuation regulations. We request that the entire record of the NRC meetings be incorporated into these rulemaking proceedings.

Sincerely,

Barbara L. Widick

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