Mobil Business Resources Corporation

OFFICE OF LEGAL COUNSEL

ANN F. GILLOOLY
MANAGING COUNSEL

3225 GALLOWS ROAD
FAIRFAX, VIRGINIA 22037

TELEPHONE: (703) 846-3308
FACSIMILE: (703) 846-2792

VIA UPS OVERNIGHT MAIL

May 27, 1997

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

Re: Comments of Mobil Oil Corporation on "Proposed Rules Establishing Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil," 62. F.R. 3742, January 24, 1997

Dear Mr. Guzy:

Enclosed are comments by Mobil Oil Corporation on the Notice of Proposed Rulemaking published January 24, 1997, by the Department of Interior's Minerals Management Service ("MMS"). Mobil has a direct and substantial interest in this crude oil valuation Rulemaking.

Thank you for the opportunity to present these comments.

Very truly yours,

Ann F. Gillooly (bk)

Ann F. Gillooly

AFG/bk
Enclosure

COMMENTS OF MOBIL OIL CORPORATION
May 28, 1997

"Proposed Rules
Establishing Oil Value for Royalty Due on Federal Leases,
and on Sale of Federal Royalty Oil"
Department of the Interior
MINERALS MANAGEMENT SERVICE
62 Fed. Reg. 3742, January 24, 1997

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Mobil Oil Corporation and its subsidiaries and affiliates (collectively "Mobil") comprise an integrated petroleum firm operating worldwide at all levels of the industry — from exploration and production of crude oil to refining, marketing, and distribution of a wide variety of finished petroleum products. In 1996, Mobil's 100% equity share of crude oil production in the U.S. was approximately 230,000 barrels per day. This volume includes barrels applicable to private, state, Indian, and federal leases. In fact, in 1996 Mobil provided royalties on crude oil to the federal government on approximately 9,300 barrels per day representing a total value, both in cash and in-kind delivery, of approximately 63 million dollars. Mobil's U.S. refinery needs exceed its U.S. production. Yet only a small portion (approximately 10 percent) of Mobil's owned domestic production goes to its domestic refineries. Mobil acquires additional domestic and foreign crude oil to meet its refinery demand. At the same time, Mobil acquires crude oil at the lease and elsewhere for purposes of trading and marketing crude oil as a separate profit-making enterprise. As part of its U.S. operations downstream of the lease, Mobil also owns and/or operates common carrier crude oil pipelines and other crude oil transportation facilities.

Mobil has a direct and substantial interest in the Notice of Proposed Rulemaking ("NOPR") published January 24, 1997, by the Department of the Interior's Minerals Management Service ("MMS").

I. INTRODUCTION.

MMS has proposed a radical new royalty valuation regime that selectively, but widely, substitutes agency pricing for the lease market in violation of sound economics, sound policy, and the Department of the Interior's statutory authority. The program represented by the January 24, 1997, NOPR has, in summary, at least the following fundamental problems:

The MMS concept of a single reference price based on NYMEX or ANS spot market quotes is flawed and unworkable. Those reference markets respond to different supply and demand factors than do lease markets. Reference market factors are not synchronized with lease market factors that, in turn, vary widely from region to region, as well as from field to field and lease to lease.

Lease markets are the proper reference for establishing royalty value from a legal, economic, and policy perspective. MMS has neither provided support for its assertions that there is insufficient lease market activity to measure value accurately nor otherwise justified the proposed rule's departure from historic focus on the lease. Vigorous lease markets exist and generate many arm's-length transactions or "comparables" that are the appropriate, primary references for royalty valuation. MMS also does not support its assertion that lease markets have changed in relevant respects since the current regulations became effective in 1988. There is no acceptable reason to move away from the 1988 regulations, which properly tie royalty valuation to actual lease market activity where possible.

The proposed rule is tantamount to formula price regulation; MMS is not legally authorized to engage in the price and tariff-style netback regulation proposed here. Congress has not delegated the power to set rates, tariffs, or prices to the Department of the Interior, nor does MMS have authority to regulate downstream marketing operations. Detailed and activist involvement by MMS in calculating the proposed netback values will inevitably multiply potential points of dispute between firms and the agency; the proposal is thus reminiscent of the cumbersome and costly mechanism of 1970's petroleum price regulation. For this reason, among others, the proposed rule will not provide the "certainty" that MMS expects.

MMS errs in asserting a new duty to market crude oil at no cost to the federal government. This alleged duty is not a viable basis for imposing royalties on value added by downstream marketing investments and risk-taking. MMS further errs, legally and logically, in proposing payment on downstream marketing value even when the producer has realized a lesser amount on selling the crude oil in an arm's-length lease market transaction or in a transaction within the range of "comparable" lease market transactions.

MMS' improper effort to capture downstream value is unfairly discriminatory. MMS attempts to draw a line between "true independents" and integrated firms engaged in "reciprocal" transactions and to require only the latter to pay the higher reference netback in all circumstances. No viable market rationale for this discrimination against vertically integrated firms is offered or exists. The proposal also results in anomalous and unreasonably discriminatory situations in which identical sales are treated differently. Nor is it proper to calculate different prices depending on what a firm in MMS' disfavored category of firms does with crude oil <u>after</u> it leaves the lease.

MMS offers no market theory or rationale for disqualification of all buy/sells, exchanges, or other "reciprocal" dealings. For decades, exchanges and buy/sells have been widely used by many firms, not simply the integrated majors. These transactions serve competitive market functions and are properly viewed as arm's-length transactions. MMS' statements that "multiple dealings" between two firms are suspect, justifying disqualification of all such firms' transactions, have no support, nor does MMS support its view that any purchase of crude oil by a producer, or any contractual "call," is suspicious. Moreover, no market theory explains why engaging in a buy/sell or other MMS-defined "reciprocal" transaction should disqualify every <u>other</u> one of a firm's transactions.

MMS' reaction to perceived posted price problems is illogical. MMS offers nothing to indicate that transactions based on posted prices do not continue to reflect market value at the lease. One of the principal bases for the proposed rule is MMS' claim that there are now more lease sales at prices that specify a fixed increment over some posting than transactions at posted prices. Even if this unverified observation is true, a reasoned reaction requires only ensuring that actual transaction prices, rather than any unused or unverifiable postings, remain the basis of royalty valuation. The existing regulations accomplish this, but any doubts on this score can be dealt with by modest updating of the existing posted price benchmarks.

Defects large and small in the proposed rule demonstrate that MMS lacks expertise in downstream marketing activities. MMS' charter is to collect royalties at the lease by careful monitoring and auditing to identify lease market value by measuring <u>that</u> market. Its expertise is properly at the lease. MMS is entitled to enter the downstream crude marketing arena as a player, by taking oil in kind, but it is neither entitled nor presently wellequipped to regulate downstream marketing endeavors. Errors that "demonstrat[e] a lack of market awareness by the MMS," Transcript of Denver Hearings on Proposed Rule (Apr. 15, 1997) (hereinafter "Denver Tr.") at 74 (comments of Jack Bloomstrom, Eighty-Eight Oil Company), abound in this ambitious proposal and will generate continuing friction and disputes if implemented. In such circumstances, the proposed interim rule approach will not work and will impose substantial unnecessary costs on both the agency and the industry through regulatory burden and market distortion.

MMS' Proposed Form 4415 is ill-conceived, is illegal, and unnecessarily and discriminatorily burdens private industry and government. Mobil supports and adopts the well-considered report of the Barents Group dated March 25, 1997. Wholly apart from its failure to meet the requirements of the Paperwork Reduction Act, MMS proposes information-gathering that is not authorized by its governing statutes.

MMS does not and cannot support the undercurrent of the NOPR implying that lease markets cannot be trusted because of collusion or other "suspect" activity." MMS should articulate its views on collusion and misconduct, and, if it believes such allegations to be plausible, then pursue them through adjudicative procedures, not informal rulemaking. MMS' present approach consists of unsupported and vague implications of problems, of "suspect" activity, and of the bare possibility that certain transactions "could" be collusively arranged. Such remarks in the NOPR poison the rulemaking atmosphere while avoiding clarity or reasoned analysis of lease markets, and deny due process to the firms apparently suspected of misconduct. Unproven misconduct is not a viable rationale for this proposed rule.

The proposed rule has procedural defects that would not survive judicial scrutiny. The proposal fails to meet the legal requirements of the Administrative Procedures Act, of other executive and procedural mandates, or of due process, and it attempts to impose regulation unauthorized by the agency's governing statutes. It is not supported by the kind of market research, data collection, empirical study, and technical analysis necessary in order to justify its viability or its rationale. The interim rule proposal is improper in light of the above deficiencies. Moreover, MMS has proceeded on a biased record; among other things, it has retained and heavily relied on consultants with questionable expertise and motives who were already committed to one side of a vigorous debate over lease market pricing. After substantial scrutiny, no courts have adopted the pricing theories advanced by such consultants, and several have rejected them; MMS appears to have adopted their mere allegations, without balanced study or a proper record addressing current market conditions.

The MMS record reveals no analysis of whether implementation of the proposed rule would work as intended or would provide a net benefit to the public. Supporting materials suggest that MMS has made no study of likely market adjustments to its proposal or whether the alleged benefits of the proposed rule would outweigh the costly regulatory apparatus it would create. For example, the expected increase in effective royalty payments may discourage some production from marginal properties. The discrimination among firms and as to post-production marketing and refining dispositions of crude oil may induce market inefficiencies by firms legitimately seeking to minimize regulatory impact. Thus, MMS cannot demonstrate that implementation of such a scheme would even yield a net increase in royalty revenue to the public.

MMS' best course is to withdraw the NOPR and satisfy its concerns by taking all its federal royalty oil in kind. By entering fully into the lease markets, MMS can assure the public that it is obtaining the lease market value to which it is entitled without the substantial number of employees and costly monitoring associated with both current and proposed royalty valuation regulations. As a guide, MMS should consider the royalty-in-kind ("RIK") approach taken by the government of Alberta, Canada, more streamlined than current agency RIK approaches. Alternatively, or while developing such RIK systems, MMS should consider updating the current posted price benchmarks to ensure that benchmark priorities continue to capture lease market value as established by actual lease market transaction prices.

II. THE PROPOSED RULE IS FUNDAMENTALLY FLAWED.

The proposed rule rests on unsound economic principles and an apparent lack of full understanding of real-world crude oil business practices and imperatives downstream of the lease. The notion that MMS can accurately calculate crude oil market values at the lease from a single national price derived from a distant and different commodities (or spot) market price is highly controversial at best, unsupported by any empirical study by MMS, and lacking sound basis. Indeed, it does not appear that MMS intends to net back to the lease at all, for it knowingly limits its deductions to specifically enumerated transportation costs and quality adjustments, ignoring many other costs and risks incurred in bringing lease crude to downstream markets and avoiding the issue of added value in bringing crude closer to points of consumption.

The result is not royalty valuation at all but either: (1) a disguised price regulation program, (2) unauthorized movement of the point of royalty determination off the lease for most lessees, or (3) a hidden increase in royalty rates. Given inherent conceptual shortcomings, the proposed rule is not subject to reformation by tinkering with the details of the netback formulations, or by redrawing the line between "true independents" and others.

A. Contrary to the NOPR, Comparables at the Lease are the Proper Primary Determinant of Royalty Value.

The clearest misstep in the NOPR is MMS' abandonment of actual lease transaction prices as the principal determinant of crude oil values for royalty purposes. While paying lip service to the concept, the NOPR acknowledges that, under the proposed rule, "MMS expects that a relatively small volume of Federal oil production would be valued using the arm's-length gross proceeds method." 62 Fed. Reg. 3742, 3744 (1997). As currently written, only a handful of companies would be entitled to use arm's-length gross proceeds at the lease. Transcript of Houston Hearings on Proposed Rule (Apr. 17, 1997) (hereinafter "Houston Tr.") at 44 (comments of David Blackman, Burlington Resources/IPAA).

Basic economic theory and years of prior MMS practice teach that the proper method for valuing a good is to review the price at which it is bought and sold in arm's-length comparable transactions between parties with opposing economic interests. Plaintiffs in the pending Engwall case, 1/ private royalty lessors in New Mexico, rely on a netback methodology developed by one of MMS'

1/ Engwall, et al. v. Amerada Hess Corp., et al., No. CV-95-322 (5th Dist., Chaves County, New Mexico) (filed Sept. 1, 1995).

retained consultants and conceptually similar to MMS' netback methodology. 2/ In response, Professor Joseph Kalt of Harvard University demonstrated that there are active lease markets for the purchase and sale of oil, and testified that the use of comparables from lease markets is the best measure of lease market value. Testimony of Joseph P. Kalt, Ph.D., in Engwall v. Amerada Hess Corp. (hereinafter "Kalt Test.") at 1116-17, 1125-26, 1177 (attached in the Appendix hereto as part of Exhibit 1). 3/ Only "by looking at outright transactions at arm's-length for the comparable level of commerce and under comparable supply and demand conditions [can] one see what the market says" about the interplay of those forces. Id. at 1117. The Engwall court rejected the netback proposal of MMS' expert, which it deemed "novel" in the sense that it lacked "precedent," and relied on the "comparables" approach in denying class certification. 4/ By its nature, the quest for comparable transactions is a localized, lease-specific inquiry because it seeks similar transactions, that is, transactions subject to similar supply and demand factors. 5/

2/ Plaintiffs in Engwall relied on the non-economist expert Benjamin Johnson of Summit Resources who was retained by MMS in developing the proposed rule.

3/ All exhibits cited herein are attached in a separate Appendix filed concurrently with these comments.

4/ Decision Denying Class Certification ¶ 10, Engwall v. Amerada Hess Corp., No. CV-95-322 (5th Dist., Chaves County, New Mexico) (March 26, 1997) (attached in the Appendix hereto as Exhibit 2).

5/ Accord Heritage Resources, Inc. v. NationsBank, 939 S.W.2d 118, 122 (Tex. 1996) ("Market value is the price a willing seller obtains from a willing buyer. . . . The most desirable method [for determining market value of oil] is to use comparable sales. . . . A comparable sale is one that is comparable in time, quality, quantity, and availability of marketing outlets.") (citations omitted); Piney Woods Country Life Sch. v. Shell Oil Co., 726 F.2d 225, 240 (5th Cir. 1984) (the "best means of determining the market value at the well . . . would be to examine comparable sales"), cert. denied, 471 U.S. 1005 (1985); Shamrock Oil & Gas Corp. v. Coffee, 140 F.2d 409, 410 (5th Cir.) (to determine "market price" the court must look to "the price that is actually paid by buyers for the same commodity in the same market"), cert. denied, 323 U.S. 737 (1944); Exxon Corp. v. Middleton, 613 S.W.2d 240, 246-47 (Tex. 1981) (same).

The current regulations, issued in 1988, rested on Interior's reasoned affirmation of comparables and its determination that lessee proceeds under an arm's-length sales contract at the lease are "the best measure of market value." 53 Fed. Reg. 1184, 1186 (1988).

> Prices received for the sale of products from Federal and Indian leases pursuant to "arm's length contracts," in many instances, are accepted as value for royalty purposes. However, even for some arm's length contracts, contract prices may not be used for value purposes if the lease terms provide for other measures of value . . . or when there is a reason to suspect the bona fide nature of a particular transaction. <u>Even the alternative valuation methods, however, are determined by reference to prices received by individuals buying or selling like-quality products in the same general area who have opposing economic interests</u>.

<u>Id</u>. at 1187 (emphasis added).

Within the agency, this concept is reflected in an established body of law. In <u>Getty Oil Co.</u>, 51 I.B.L.A. 47 (1980), Getty received the same price for gas from the same lease both from an affiliate and from a third party, but the agency assessed additional royalty payments because of the affiliate relationship. I.B.L.A. ruled that it was "error, in the absence of even a suggestion of impropriety, for [the agency] to disregard the validity of Getty's agreement" with its subsidiary. <u>Id</u>. at 51.

> [Non-arm's-length affiliate contracts] may result in a fair market price. If a transaction is not at arm's length, some other manifestation that the price is nonetheless an accurate portrayal of the article's worth is required. It must be a price [that] independent buyers in arm's length transactions would be willing to pay.

<u>Id</u>. I.B.L.A. found the third party contract Getty had at the same lease to be an appropriate comparable reflecting the lease market value. In that case, Getty's

affiliate kept the production. Subsequent cases applied the same principles when the affiliate sold the production. 6/

The current proposal effectively rejects reliance on lease market comparables as a measure of lease market value. This represents a significant about-face by MMS. See Memorandum from Associate Director for Royalty Management to Director, Minerals Management Service (Feb. 12, 1987) (rejecting use of spot or futures prices for valuing crude oil at the lease) (attached in the Appendix hereto as Exhibit 3). Such a departure from a settled principle places a heavy burden of justification on MMS to explain its rationale. 7/ The NOPR is inadequate in this regard, again failing to offer a market rationale or reasoned basis for abandoning the lease markets, referring only to unspecified work by unnamed "consultants" and "experts." 62 Fed. Reg. 3742. The supporting materials recently received in response to requests under the Freedom of Information Act ("FOIA"), 5 U.S.C. § 552, offer no appropriate empirical studies, market analyses, or data to support assertions that lease markets are not useful references. Moreover, none of these materials support MMS' assertion that there are insufficient lease market transactions from which to ascertain value.

The sound theory and substantial legal precedent that requires first resort by MMS to comparables at the lease also expressly reject netbacks as useful benchmarks. Kalt Test. at 1177. Indeed, courts have generally recognized that netbacks are legally impermissible for valuing oil at the lease in the face of comparable sales. Piney Woods, 726 F.2d at 239-40 (netback valuation methods are " 'the least desirable method of determining market price,' " and can be used only when comparable sales in the field are not available) (quoting Montana Power

6/ See Mobil Corp., 112 I.B.L.A. 56 (1989) (Mobil might have difficulty identifying comparables from other companies, due to antitrust and proprietary considerations, but MMS has the information and can publish it); Transco Exploration Co. & TXP Operating Co., 110 I.B.L.A. 282 (1989); Amax Lead Co., 84 I.B.L.A. 102 (1984), modified, 99 I.B.L.A. 313 (1987).

7/ See infra at Part V.D.1.

Co. v. Kravik, 586 P.2d, 298, 303-04 (Mont. 1978)); Heritage Resources, 939 S.W.2d at 122; see also Wall v. United Gas Pub. Serv. Co., 152 So. 561, 563 (La. 1934) (when a lease is silent, market price means price at the well, not "the price the gas would bring in a market remote from the well"); compare Marathon Oil Co. v. United States, 604 F. Supp. 1374, 1386 (D. Alaska 1985) (upholding an actual transaction-based netback in order to calculate royalty value in a "special, unique situation" where there was neither a lease market nor reliable comparable transaction at the lease), aff'd, 807 F.2d 759 (9th Cir. 1986); see also Denver Tr. at 40 (comments of Hugh Schaeffer, Chairman, Royalties Committee of the Independent Petroleum Association of Mountain States) ("[N]et-back methods to determine royalty have been approved only where other methods cannot be used to calculate a wellhead or a leasehold value.").

B. Transactions at the Lease and Transactions on the NYMEX or in the ANS Spot Markets Take Place in Different Markets.

The NOPR offers conclusory assertions that "many of the experts MMS consulted" regarded NYMEX prices "to be the best available measure of oil market value." 62 Fed. Reg. 3745. Notably however, the NOPR does not state that NYMEX is the best measure of lease market value, the relevant value to be measured for royalty purposes. The proposed rule operates on the implicit but erroneous assumption that transactions on the NYMEX and in ANS spot markets in California are comparable to transactions in the lease market and reflect the same supply and demand factors. At best, transaction prices at the lease, such as crude oil postings, may relate broadly to prices on the NYMEX or on world markets, but there is no precise correlation, and MMS offers no explanation for why there should be. See Kalt Test. at 1116-17, 1121-26. Lease transactions take place in wholly different markets from transactions on the NYMEX or in the ANS spot markets.

At the threshold, the NYMEX and ANS spot markets each establish a single price scale for a reference crude oil -- West Texas Intermediate ("WTI") on the NYMEX and ANS in California. Federal leases, however, produce a wide variety of crude oils from many fields and with vastly different physical properties. See e.g., Denver Tr. at 27 (comments of Dan Martinez, Monterey Resources) (comparing Alaskan North Slope crude to San Joaquin Valley crude and noting that "the two grades of crude oil have completely different sets of refining values and a different set of fundamentals that influence the price"). In California, for example, typical crude oil assays report information on a large number of crude characteristics, such as distillation yields, vanadium, nickel, pour point, nitrogen, Reid vapor pressure, smoke point, freeze point, cloud point, asphaltenes, paraffins, and the like, all of which vary in crudes from different fields. 8/ Lease market prices account for such variances in quality because they are crude-specific. See generally Kalt Test. at 1143. The MMS ignores or masks such important factors governing supply and demand at the lease by using WTI or ANS as surrogates for all crudes. This will inevitably introduce error into any effort to measure indirectly the market value of widely varying crude oils. Id. at 1177, 1190-92.

The proposed rule does purport to adjust for quality differences but, to the extent Mobil understands the effort, it appears completely inadequate. Quality adjustments are lumped together with so-called "location" factors and measured solely by the difference between prices for the specific crude in spot markets at MMS-identified "market centers" and prices for single reference crudes at the index pricing point (NYMEX or ANS). 62 Fed. Reg. 3747. Since neither location is at the lease, there is no indication that the quality differences are accounted for by these prices. This problem is compounded by the use of a measure that MMS readily concedes reflects, in whole or in part, something else entirely, i.e., factors related to differences in location of crude oil between the index pricing point and the identified "market center." Moreover, there is no evidence that all crudes are traded on a relevant spot market or any spot market, or any evidence that significant numbers

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8/ See also Ex. 3 at 2 (citing "the chemical composition and refining characteristics of the crude oil" among a number of "[f]actors important to the establishment of value of a particular crude").

of such transactions in a specific crude take place at these "market centers." Finally, the reporting of spot market transactions is not reliable. 9/ Using actual lease transaction prices avoids all of these pitfalls, and is free of the elaborately cumbersome reporting and administrative mechanism contemplated by MMS. 10/ Lease market prices by definition address the myriad of quality variances in federal lease crudes and are the logical place to identify crude oil value at the lease.

Similarly, using actual lease market transactions to measure crude oil value eliminates the need for the elaborate efforts to adjust for location. Whatever locational factors are addressed by MMS' attempt to measure the difference between the spot prices at certain market centers and the NYMEX or ANS reference point prices, they would not address the relevant location factor, which is the lease location itself. Again, Mobil would be aided in commenting further on location issues and proposed location adjustments if it had an explanation for MMS' rationale for the location calculation.

9/ Prices reported by the trade press are problematic for at least three reasons: (1) the number of transactions reported to the trade press may be too small to provide any statistical certainty; (2) there is no uniform method for calculating spot market averages; and (3) the accuracy of any report in the trade press depends heavily on the skills of the individual journalists covering the market on a given day. Affidavit of Marshall Thomas, PVM Oil Consultants, Inc. (hereinafter "Thomas Aff.") ¶¶ 59-62 (submitted in support of comments filed by American Petroleum Institute). Moreover, spot transactions are only part of a set of larger market transactions that include many unreported term sales; thus focus on spot market prices will not accurately measure market center value. The thin reporting makes these spot publications subject to manipulation; yet there is no regulation to protect against such matters.

10/ MMS itself expects private sector reporting costs to increase approximately $800,000 per year. 62 Fed. Reg. 3750. A preliminary analysis by Barents Group LLC indicates that this estimate is grossly inadequate. Barents Group LLC, Preliminary Analysis of the Department of Interior, Minerals Management Service Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases and on Sales of Federal Royalty Oil 14-15 (Mar. 25, 1997) (attached in the Appendix hereto as Exhibit 4).

The proposed rule also fails to account for the fact that purchasers on the NYMEX and in the ANS spot markets often operate at a different functional level from purchasers at the lease. Generally, lease purchasers intend either to process their crude acquisitions into valuable products at a refinery, or to pursue profit though arbitraging the differences between lease prices and prices they can obtain from other consumers usually at other locations. Both seek to profit from the investments they make in marketing, moving, and/or refining the crude. Purchasers on the NYMEX or in the ANS spot markets include many participants with entirely different functions. Many are speculators who have no need or use for actual crude oil but are playing a high risk game based on factors not present at the lease. Some participants in the NYMEX are buying and selling commodities as a hedging device, another supply/demand factor that is unrelated to the lease. 11/ Only some are crude users who have specific crude needs or delivery obligations to meet. 12/ In short, the proposed rule fails to recognize that the lease market and the commodities markets serve essentially different classes of customers. The purported adjustments make no allowances for these differences, nor could accurate adjustments be calculated.

The proposed NYMEX reference also has timing problems. MMS has selected a futures reference that does not reflect current market value for crude oil as required by historic practice and the governing statutes. In the past MMS has consistently recognized that royalty valuation is to be based on the current value of the crude oil and that futures prices "would be inapplicable." See Ex. 3 at 1-2.

11/ Hedging devices are means by which investors may reduce the risk of price fluctuations in the marketplace by making a carefully controlled series of sales and purchases of futures contracts -- some with the obligation to deliver and some with the obligation to receive. "The key to successful hedging is accurate forecasting of price movements." John L. Wilson, To Hedge or Not to Hedge, 13 Pub. Utils. Fort. 21, 22 (1990). This difficulty makes hedging devices risky and miscalculations costly.

12/ It is estimated that as much as 70% of the NYMEX market is dominated by speculators. Thomas Aff. at ¶ 22.

Accordingly, a change in the valuation methodology to that adopted by the proposed rule would necessitate "a change in statutory, as well as regulatory, language." Id. at 2.

C. MMS Concerns About Posted Prices Do Not Justify the New Valuation Methodology of the Proposed Rule.

The NOPR is filled with bottom line assertions that posted prices do not reflect market value, but the materials relied upon to support the proposed rule contain neither appropriate data nor other empirical studies supporting those claims. Well designed market studies would confirm that posted prices represent market value at the lease. Indeed, MMS acknowledges that "many contract prices are tied to postings . . ." 62 Fed. Reg. 3744. Stakeholders in the proposal, however, do not have the burden to disprove unsupported agency bases for rulemaking. E.g., Connecticut Light & Power Co. v. NRC, 673 F.2d 525 (D.C. Cir.), cert. denied, 459 U.S. 835 (1982).

Most of the NOPR statements about posted prices imprecisely assert that such prices do not reflect "market value." The phrase "market value" is used so loosely, however, that it appears to mean only that posted prices do not comport with MMS' NYMEX netback notions of value, or with ANS and other spot markets or with other irrelevant downstream market center prices. 13/ Thus, the NOPR never actually states that lease postings do not represent the relevant lease market value. In short, MMS bases an entirely new method of royalty valuation on vague statements and innuendo without demonstrating that the current regulations result in improper or inaccurate crude oil valuation at the lease.

13/ The NOPR states that the proposed rule aims to decrease reliance on oil posted prices and assign a value to crude oil that better reflects market value" 62 Fed. Reg. 3742 (twice); see also id. at 3744 ("Given the mounting evidence that posted prices frequently do not reflect value in today's marketplace. . . .") When aligned with such statements as "NYMEX prices were regarded by many of the experts MMS consulted to be the best available measure of oil market value," id. at 3745, it is clear that loose references to market and value in the NOPR do not necessarily, if ever, refer to relevant lease markets or lease market value.

MMS sometimes suggests that its concern is that postings do not always match the highest prices observed in lease or nearby markets, such as special auctions or the California sell-offs addressed by the City of Long Beach in comments at the Houston public hearing. 14/ But basic economics does not define market value as the highest possible value. 15/ When willing buyers and willing sellers at arm's-length negotiate different prices for essentially similar items, all such prices reflect the competitive market, as even consumers can recognize from automobile sales. MMS has previously understood that certain auction or sell-off prices represented special situations that are not comparable to lease market sales, not proper measures for royalty valuation, and not proper standards against which to assess the validity of postings in the field because they represent only a small and specialized segment of a competitive market.

> A common thread from much of our research is the concept of marginal prices/supply in the California market. That is, refiners sometimes face limited sources of supply to satisfy specific short-term and/or emergency crude oil feedstock needs. In these cases the independents often bid prices higher than those posted for oil in the same or nearby fields . . . . For oil sold in the Elk Hills and Wilmington sell-offs, a premium over the posted prices for associated fields generally exists. We believe that the marginal supply concept accounts, at least in part, for these differences.

Memorandum from Chief, Valuation and Standards Division to Deputy Associate Director for Compliance, Att. 1 at 5 (Mar. 2, 1994) (attached to the Appendix hereto as Exhibit 16); see also Letter from Jerry D. Hill, Associate Director for Royalty Management, MMS, to Richard Hopkins, Chief, Subvention Audit Branch, Office of

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14/ Houston Tr. at 176 (comments of Brian McMahon, City of Long Beach); see also Comments on Proposed Rules on Valuation of Oil from Federal and Indian Leases at 12 (March 18, 1996) (filed by Western States Land Commissioners Association).

15/ See generally E. Thomas Sullivan & Herbert Hovenkamp, Antitrust Law: Policy and Procedure 49-64 (Michie 1989).

the Controller of the State of California (Dec. 9, 1986) (attached in the Appendix hereto as Exhibit 5) (based on analysis of sell-offs by the City of Long Beach in 1986, "MMS concluded that the market forces represented by posted prices reinforced by the market forces represented in a competitive bidding process [sell-off] verified that value received for royalty purposes in California satisfied the requirement of the regulations").

Similarly, spot sales can be part of market activity but are not representative. Ignoring the substantial volumes of crude oil that are transacted on a term basis will provide a misleading picture of the market, whether looking at lease market transactions or, as in the MMS proposal, attempting to calculate price factors from published spot prices at certain market centers. See supra note 9.

The most likely basis for statements that posted prices do not reflect market value is nothing more than the observation that, in contrast to past periods when the vast majority of arm's-length lease transactions were at postings, there are now more transactions in which the negotiated arm's-length price at the lease is expressed as, for example, buyer's posting plus 25 cents, or Koch's posting plus 40 cents. See Houston Tr. at 9 (comments of Director of Royalty Management) ("[Posted prices] are a starting point that forms the basis for further negotiations where oftentimes premiums are paid above posted price."); Questions & Answers California Crude Oil Underpayments and Proposed Oil Valuation Regulations (Jan. 30, 1997) ("MMS believes that posted prices may now represent the beginning point for price negotiation or something similar, but no longer generally represent market value.") (attached in the Appendix hereto as Exhibit 6). Neither the NOPR nor the FOIA materials verify this observation, however; no studies indicate whether transactions at these posted-plus prices represent any significant volume, or whether the resulting prices are above the average or median for postings, since postings themselves are not uniform. Even if there are an increased number of such contracts, the observation neither establishes that postings do not reflect lease market value, nor justifies throwing out the 1988 regulations. For example, Koch, a non-producer, posts so low that an actual transaction at its posting plus $1.00 may still equal or be less than some other company's posting for the same crude. Mobil believes that empirical study would demonstrate that Koch's low posting represents the marginal clearing price for many Texas and Gulf area crudes at the lease, because competitive clearing prices should generally fall to the price level of competing foreign imports into Gulf ports. Basic principles of economics define that clearing price as the competitive market price. Such analysis is not evident in the NOPR or its supporting materials.

A reasoned reaction to this possible, but undocumented, trend identified by MMS would require only ensuring that (1) actual transaction prices remain the basis of royalty payments and (2) valuation be based on postings that are used in actual transactions or, if used in affiliate transfers or non-arm's length transactions, that can be verified by reference to comparable lease market transactions. The existing regulations accomplish this, but, any doubts on this score can be dealt with by modest updating of the existing posted price benchmark.

Finally, if MMS believes that companies are paying royalties on postings when their actual contract prices are above those postings, that is an audit enforcement matter adequately covered by the existing regulations. None of MMS' vague statements, unsupported assertions, or other discussions of posted price justify declaring lease markets to be nonexistent or untrustworthy or abandoning the current lease market benchmarks.

D. The Proposed Rule Improperly Attempts to Ascribe Value Added to Crude Oil by Downstream Marketing Efforts to the Value of the Crude at the Lease.

Even if it were possible to derive differences in "market value" between two points by analyzing certain costs, the proposed indexing method does not account for all costs between the lease and the arbitrary reference. Further, it does not attempt to measure value added to crude oil as a result of downstream marketing efforts made by crude sellers such as risk, return on investment, and the like.

Persons or entities that trade, transport, and/or refine crude oil are not doing so as lessees. The proposed rule mistakenly treats these downstream functions as part of production. The demarcation between production and downstream crude oil marketing is established, inter alia, by the existence of a thriving class of independent resellers who buy crude oil at the lease and resell to others, usually downstream of the lease. Kalt Test. at 1121-26, 1129-35. **16/** Whether operating independently, or within a larger integrated firm like Mobil, resellers operate on the hope that they will be able to purchase crude oil at competitive lease prices, transport or otherwise relocate it to trading centers or consumption points, and then sell it for prices sufficiently high overall both to recover costs and to reap some return on their investments of capital and time and on their assumption of risk. Whether they succeed or fail in a particular transaction does not control either their overall success or the market price at the lease. See generally Sullivan & Hovenkamp, supra note 15, at 49-64. Nor does the reseller's purchase price at the lease and other costs in marketing crude have a controlling effect on the price at which the crude is resold at a trading center or on the NYMEX.

As a matter of economic analysis, it makes no difference whether a third party or the lessee/producer performs the downstream marketing function; this function remains separate from production. The trading and transportation arms of companies that are lessee producers, no less than independent resellers, also invest substantially in the downstream marketing of crude oil. At a minimum, such marketers may aggregate crude oil produced from one or more leases and use their expertise and experience to select the best transportation option, up to and including building storage or new transportation facilities. They arrange to deliver crude in sufficient quantities to meet pipeline or other transportation specifications.

16/ The existence of independent resellers further establishes that transactions at the lease and transactions on the NYMEX or in the ANS spot markets occur in different markets. See supra Part II.B.; Kalt Test. at 1190-92.

Once crude is ready for transportation, marketing employees must, for example, schedule the crude onto a specific pipeline, arrange to take delivery of the crude at the pipeline terminus or trade away the right to receive the crude at the pipeline terminus for other consideration. Performance of these functions requires an investment in capable employees and, in some instances, transportation facilities or services. By repositioning the crude oil from the lease to a point closer to ultimate consumption, the reseller/marketer functionaries perform valuable services that necessarily add value to the oil, none of which inheres in the oil at the lease.

The proposed rule also fails to account for the risk assumed by the trader, whether an independent entity or an integrated division or affiliate of the lessee, in these endeavors. Trading generally involves risk, whether one meets customers' needs for real barrels at or on the way to real points of consumption or trades on an exchange such as NYMEX. Trading on NYMEX itself can be a high-risk endeavor. Sophisticated commodities traders command high salaries but concomitantly must incur high research costs and assume substantial risk. Assumption of risk, while not readily quantifiable, has value to purchasers in downstream or commodities markets. The trader who assumes the risk of market fluctuations is entitled to compensation for that function as well. The proposed rule completely ignores a variety of risk factors in making adjustments from the index price. See generally Kalt Test. at 1177; Thomas Aff. ¶¶ 55-56.

The NOPR also assumes that the price of crude oil on the NYMEX or in the ANS spot markets is equal to the price at the lease plus some definable cost that merely needs to be subtracted to "net back" to the lease. This error flows directly from a failure to recognize that lease markets are different markets than the NYMEX and ANS spot markets. See supra Part II.B. Since prices at the lease are, not surprisingly, often below that partial-cost netback level, the proposed rule implicitly but erroneously concludes that oil at the lease is "underpriced." But prices are not simply the sum of accounting costs. Firms engage in trading and transportation functions precisely because they believe that the value of those services to purchasers of crude, i.e., what purchasers are willing to pay for the oil after performance of the services, will tend to exceed the cost of the oil plus the cost of providing the marketing service. Embedded within this economic concept is a rate of return on the marketing function. If the rate of return on that function is insufficient, crude oil marketers will no longer perform the marketing service and will invest their capital and skill elsewhere. By failing to consider such matters, the required indexing provisions extract a portion of downstream profits to which the lessor is not entitled. This distorts the concept of royalty, which is the lessor's share of production free of production costs. See infra Part V.A.

Precisely the same principles apply to the lessee/producer who also refines some or all of its royalty crude. The off-lease functions of transportation and refining, often also including trading to improve refinery positions, are different from the production function. It is illogical to attribute the value added as crude moves downstream toward one's own refinery to the production function, whether the crude oil is eventually refined by third parties or by the same entity that produced it at the lease.

E. The Proposed Netback of Costs Omits Many Actual Costs and Fails to Account for Various Risks Unrelated to Production of Crude Oil.

As discussed above, costs are not the same as value; costs allow one to measure the success or failure of a business but do not control market price. See Sullivan & Hovenkamp, supra note 15, at 49-64. But even as an exercise in capturing costs in order to netback to the lease, the proposed rule falls short. While purporting to netback "costs" from the lease, the proposal considers only transportation costs — treating them inadequately — and excludes costs such as the following:

- aggregation of volumes;
- blending of different quality crudes to meet customer or pipeline specifications;
- storage and inventory costs;
- scheduling costs;

- overhead related to downstream functions, including salaries for crude marketers, research costs, and the infrastructure (i.e., computers, etc.) necessary to run a successful trading operation; and
- costs of assumption of risk.

While the assumption of risk by downstream marketers is difficult to quantify, especially for self-insured firms, it cannot simply be ignored. The price of crude at the index pricing point will differ from the lease price, at least in part because there are different risks that must be assumed and managed in the two different markets. 17/ Examples include:

- risk of inventory loss (e.g., line loss, pipeline misallocations, physical pipeline breaks or trucking spillage);
- environmental and safety risk;
- risks associated with facilities investment (e.g., underutilization of pipelines costing millions of dollars);
- price risks (e.g., spot market versus term contract; NYMEX versus spot market; price fluctuations);
- risk of purchaser's credit worthiness; and
- performance risks (e.g., force majeure; capacity problems; failure of delivery).

The proposed rule makes no effort to adjust for any of these costs associated with the trading and transportation functions. Moreover, it is quite clear that any effort by MMS to do so would involve it in regulation analogous to that performed by public service commissions and other ratemaking bodies. At the public hearings, several groups lamented the parallel between MMS' proposed rule and the oil price regulations of the 1970's. Far from creating the "certainty" that MMS projects, **18/** such government undertakings multiply points of controversy with the industry, increase auditing and dispute resolution exponentially, and destroy the trust relationship that should control a lessee-lessor contract. **19/** This is simply not a

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17/ Kalt Test. at 1182.

18/ 62 Fed Reg. 3742.

19/ Houston Tr. at 135-136 (comments of Tom White, Walter Oil & Gas Corporation) (noting that proposed rules would force MMS and industry to revert to proper function for MMS and is not committed to its discretion by statute. See infra Part V.

F. The Proposed Rule Draws an Improper Distinction Between Vertically Integrated Firms and Other Federal Lessees.

The proposed rule draws a distinction between vertically integrated firms and other federal lessees, particularly small independent producers. Denver Tr. at 12 (comments of Debbie Gibbs Tschudy, MMS); see also 62 Fed. Reg. 3744 (noting prevalence of "exchange agreements and frequency of reciprocal sales among companies — particularly major integrated firms" as one of the bases for the proposed rule). Under the proposed rule, the "pure producer" is to use actual transaction prices to value crude oil for royalty purposes. A vertically integrated firm such as Mobil, that not only produces crude oil but transports, markets, and/or refines it as well, must value oil for royalty purposes using one of the prescribed index pricing mechanisms. Denver Tr. at 12-13 (comments of Debbie Gibbs Tschudy, MMS). This classification serves no legitimate regulatory interest and lacks a reasoned economic basis.

The NOPR provides no economic rationale for such a distinction. MMS leases oil-producing properties to firms with varying degrees of integration. Its articulated goal is to obtain proper royalty payments on oil produced from federal leases. That interest remains constant regardless of the identity of the federal lessee or its involvement in other activities beyond the production of crude oil. Nor does the distinction foster MMS' goal of "certainty" in the royalty calculation process.

MMS cites an alleged difficulty in ascertaining the value of crude oil produced by lessees who may also refine that crude. Houston Tr. at 9 (comments of Debbie Gibbs Tschudy, MMS); Denver Tr. at 10 (comments of Debbie Gibbs

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their "adversarial positions" from "the days of price controls"); id. at 152 (comments of David Blackman, Burlington Resources) (noting that "the further [MMS] move[s] valuation away from the lease, the more areas of potential conflict [will arise]").

Tschudy, MMS). Regardless of whether disposition of specific crude oil results from an arm's-length transaction between a lessee and an unaffiliated, independent third-party or an internal transfer between divisions or affiliates of an integrated company, MMS' sole interest remains the collection of the proper crude oil royalties from oil produced from federal leases. Difficulty in ascertaining lease market value does not justify differential treatment between lessees based on their status as integrated or non-integrated companies. Indeed, as discussed above, there are ample market benchmarks at the lease from which to ascertain lease market value for royalty purposes. <u>See</u> <u>supra</u> Part II.A. That is the economically rational means for addressing issues arising from non-arm's-length transfers between an integrated lessee and its downstream divisions or affiliates. There is no statutory authority for making royalty valuation turn on the status of the lessee as opposed to the lease market value of the crude oil, and thus no legitimate regulatory goal is served by the distinction.

As an economic matter, MMS' distinction amounts to an attack on vertical integration in the oil industry. Vertical integration is nothing more than the use of an internal administrative directive rather than a market transaction for some business activity because the former is believed to be more efficient in a given context. Robert H. Bork, <u>The Antitrust Paradox</u> 227 (1978). If vertical integration is, in fact, more costly than market transactions, one can expect that the market will discipline the firm that mistakenly relies on vertical integration. In fact, the whole concept of outsourcing now prevalent across both the manufacturing and service sectors is ample evidence that businesses will shed inefficient vertical integration when third-party transactions are less costly. Accordingly, the persistence of vertical integration within a given firm or firms is an indication of efficiency that should be encouraged, not impeded, through rulemaking.

MMS apparently believes that vertical integration permits a firm to alter its pricing decisions by allowing the firm to sell or transfer crude oil to its own affiliate or subsidiary at a price below the price that it would obtain in arm's-length transactions. Houston Tr. at 9 (comments of Debbie Gibbs Tschudy, MMS); Denver Tr. at 10 (comments of Debbie Gibbs Tschudy, MMS). That notion has been discredited, see Bork, supra at 228, largely because it ignores the economic concept of opportunity costs. 20/ The real cost to an integrated firm of transferring crude oil from its producing arm to its refining and marketing arm will always be the price that the producing arm could have obtained by a sale of the crude in the lease market — in other words, the cost of the opportunity foregone. Again, that cost can accurately be measured by looking at arm's-length comparable lease transaction prices.

A rational integrated firm will not permit its lessee to subsidize its affiliated downstream operations by recording transfer prices at below the price the oil would fetch in an arm's-length transaction in the lease market. To do so might sacrifice returns at the refining level, for instance, by causing the refinery to operate at an uneconomical rate. If the marginal costs of refining crude oil are rising, recording an artificially low crude transfer price may result in increased refining output at higher costs. The integrated firm will be paying more for the performance of the refining function than it would if it recognized the opportunity cost of refining the crude oil and operated its refinery on an optimal scale in accordance with those opportunity costs. See Bork, supra at 228. Since the market punishes firms engaging in such behavior by according them lower accounting profits, there is no reason to believe that, absent other factors, integrated firms will behave in that fashion. MMS does not appear to have explored these possibilities or attempted to show how the relevant facts eliminate efficiency rationales for vertical integration in the oil industry. Without such explanation, the discrimination between vertically integrated firms and other lessees lacks rational economic mooring.

20/ Opportunity cost is the proper way to measure economic costs. Richard A. Posner, Economic Analysis of Law § 1.1 (1992). Opportunity cost is the benefit foregone by employing a resource in a way that denies its use to someone else. Id.

One can also quibble with MMS' success in tailoring the proposed rule to the classification it is attempting to draw. The principal classification device is the provision requiring those who have purchased any crude oil within the preceding two years to use the indexing method. 62 Fed. Reg. 3753, 206.102(a)(6). Thus one purchase, exchange, buy/sell or even crude call or farm-out agreement eliminates all a firm's other transactions from the definition of "arm's-length," no matter how unrelated those transactions may be, and requires that all of a lessee's production be valued for royalty purposes on an index pricing method. Based on the comments at the Denver and Houston hearings, the scope of that provision, in practice, apparently sweeps far broader than MMS intended. E.g., Houston Tr. at 44 (comments of David Blackman, Burlington Resources) (noting that "virtually everyone" will have to use the NYMEX netback method if the proposed rules are approved). Even if MMS adjusts its proposal to achieve a more precise "fit," however, its underlying goal remains improper.

G. The Proposed Rule Discriminates Between Similarly Situated Firms.

The distinction between vertically integrated firms and other lessees also results in discriminatory treatment between similarly situated lessees — which could result in similarly situated lessees producing the same volumes at the same time from the same field but required to make different federal royalty payments. Suppose, for example, a lessee sells 10,000 barrels of crude oil to an unaffiliated, arm's-length buyer at the buyer's posted price. The lessee receives no other consideration for the sale. The lessee does not engage in exchanges and has made no purchases from unaffiliated third parties in the preceding two years. Under the proposed rule, the lessee is entitled to use the gross proceeds method for valuing the crude for royalty purposes, i.e., to treat the posted price as the value of the crude oil for royalty purposes. On the same day, a second lessee operating yards away in the same field makes an identical, arm's-length contract with the same purchaser. The second lessee, however, engages in some activity — purchasing crude, for example — that disqualifies it from using gross proceeds. The proposed rule arbitrarily requires the second lessee to use an indexing net-back method for valuing the crude oil for royalty purposes. Because price and accounting costs are different, any equivalence between the royalty payments made on these two identical sales of crude would be pure happenstance — even if MMS sought to fully net back to the lease. Such a valuation scheme is neither economically rational nor legally defensible.

Discrimination may also result when both sellers are required to use the indexing method. For example, if one lessee sells oil at Cushing and another takes oil from the same field to its refinery, the royalty values under the proposed rule may be entirely different. This exposes the proposed rule as an effort to attach a royalty obligation to downstream activities that are not part of the production function. Further, depending on the various transportation allowances and location/quality adjustments applicable, the same barrel of crude oil is subject to different valuation for royalty purposes based solely on the path it takes after production. As a result of these disparities, which are inherent in the proposed rule, some firms are required to donate more of their marketing efforts to the federal government than others.

Second, the proposed rule discriminates against entities vertically integrated into transportation. When adjusting for transportation costs under the proposed rule, those lessees who must value their oil under the indexing method may only deduct "[a]ctual transportation costs." See 62 Fed. Reg. 3754, § 206.105(c)(1)(iv)-(v). This imposes additional costs on those lessees who may be affiliates of an entity having some equity interest in pipelines. They may only deduct actual costs as defined by MMS while other companies whose crude takes the same path can deduct the FERC-approved tariff for the same movement. The opportunity cost incurred by each is the same. It is not logical to have different royalty valuations based solely on the ownership interests of the lessee in downstream assets.

Moreover, since 1994, FERC has relied extensively on market-based rates and permitted tariff adjustments on the basis of established ceiling prices rather than on a cost basis. 18 C.F.R. § 341 et seq. The effect of these FERC rules is to alleviate the need for a number of pipeline companies to maintain the type of cost data necessary to make allowable deductions under the indexing method prescribed in the NOPR. Accordingly, the proposed rule operates to reimpose upon lessees who may have an equity interest in a pipeline the necessity of reconstructing actual costs. This is an expensive process, often requiring employment of outside consultants and legal experts. See generally Barents Report (Ex. 4) at 27. Under the guise of calculating royalty values for crude oil, the proposed rule essentially undermines the streamlined regulatory process adopted by FERC. 21/

H. The Proposed Rule Improperly Disqualifies Exchanges and Buy/Sell Agreements.

MMS admits that crude oil exchanges and buy/sell agreements are typically arm's-length transactions and is willing to accept the "location differentials" negotiated in such transactions as a transportation deduction when an index method for valuing crude oil is required under the proposed rule. 62 Fed. Reg. 3754, § 206.105(c)(ii). At the same time, MMS declares crude oil price terms negotiated in these same agreements to be suspect. 22/ These suspicions are neither fully explained nor supported by evidence.

21/ Aside from resulting in discriminatory royalty valuations, the proposed rule impermissibly encroaches upon a regulatory matter within the jurisdiction and competence of the FERC. Nothing in the Mineral Leasing Act, the Outer Continental Shelf Lands Act, the Federal Oil & Gas Royalty Management Act, or the newly enacted Federal Oil & Gas Royalty Simplification & Fairness Act entitles MMS or the Department of the Interior to regulate pipelines. See Chapman v. El Paso Natural Gas Co., 204 F.2d 46 (D.C. Cir. 1953).

22/ E.g., 62 Fed. Reg. 3742 ("Because of the frequency of oil exchange agreements, reciprocal deals between crude oil buyers and sellers, and other factors where the real consideration for the transaction could be hidden, arm's-length

Crude oil exchanges are a long-standing petroleum industry practice. They have been used at every level of the domestic petroleum industry for a century or so. Exchanges have well-recognized efficiencies and are uniformly recognized as procompetitive. Blue Bell Co. v. Frontier Refining Co., 213 F.2d 354 (10th Cir. 1954) (upholding product exchanges against claim that they are part of a scheme to divide and allocate markets in violation of section 1 of the Sherman Act, 15 U.S.C. § 1); Thomas v. Amerada Hess Corp., 393 F. Supp. 58 (M.D. Pa. 1975) (obvious that petroleum product exchanges enhance competition rather than suppress it); cf. City of Long Beach v. Standard Oil Co. of Cal., 872 F.2d 1401 (9th Cir. 1989) (Long Beach I) (three-cut exchanges have potential procompetitive benefits and thus cannot be condemned as per se illegal under section 1 of the Sherman Act), modified, 886 F.2d 246 (9th Cir. 1989), cert. denied, 493 U.S. 1076 (1990).

Crude oil exchanges and buy/sells can achieve several legitimate business goals either alone or in tandem. First, they substitute for transportation by relocating the ownership of crude oil without the need for physical movement of the oil. By passing title to crude, exchanges and buy/sells effectively allow crude oil owners to relocate crude inventory without additional pipeline facilities or the need to engage in expensive trucking, shipping, or rail movements of oil. In fact, exchanges and buy/sells can relocate ownership of crude oil between two points wholly unconnected by pipelines or any other transportation facilities. In essence, exchanges and buy/sells can perform a service that would otherwise be physically

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contract prices would be used as royalty value only by producers who do not also purchase crude oil."); id. at 3744 ("The reason MMS would not accept the contract price for oil subject to an exchange agreement is that the prices stated in an exchange agreement may not reflect actual value."); id. ("[T]he widespread use of exchange agreements and reciprocal sales as well as difficulties with relying on posted price, cast additional doubt on the usefulness of many apparent arm's-length sales prices as a good measure of market value."); compare id. ("As with multiple dealings between two parties, MMS would presume that the price of oil sold under arm's-length contracts subject to crude oil calls is suspect . . . because the sale terms may be liberal to the property buyer in return for a favorable product purchase price by the property seller.").

impossible or excessively expensive. Second, crude oil exchanges and buy/sells permit parties to alter the time of crude ownership without making additional investments in storage facilities. Third, exchanges and buy/sells may permit crude oil owners to alter the quality of crude inventory while reducing the risk of overall loss of supply volume. One who may be better off with a lower gravity crude, or a crude with special lube characteristics, can trade its existing supply of non-conforming crude for crude that meets its, or its trading client's, precise needs. The proposed rule recognizes none of the efficiencies resulting from exchanges and buy/sell agreements. Further, MMS appears to have given no consideration to the extent to which its proposal might discourage exchanges by producers or otherwise introduce inefficiencies into lease trading and downstream trading of crude oil.

The NOPR appears to assume unrealistically that reciprocal transactions such as exchanges are a perfect match — identical volumes and identical crude quality characteristics, traded at identical times. But real world discrepancies are inevitable and would discourage the manipulation that MMS theorizes could occur. Moreover, the manipulated relationship between reciprocally traded crude oils that MMS posits would last only a short time due to the continuous and non-synchronous changes in supply and demand factors from lease to lease and market to market. See supra Part II.B. These dynamics would cause the relationship between the crudes traded to shift unpredictably to the benefit of one and to the detriment of the other trading partner. Thus a collusive arrangement, whether depending on no prices or on artificially low fixed prices, would break down within weeks, making the hypothesized collusion too risky in the real world. Most exchanges and buy/sells are long-term transactions.

The proposed rule also ignores demonstrable economic and legal effects of the price terms included in exchange and buy/sell agreements, whether there is close identity in the crude oils traded or not. It does so apparently because such price terms might be used to mask the real consideration for crude oil. The NOPR contains no explanation of how this might occur, whether it has occurred, and to what extent, and whether it is likely or even feasible under real world constraints.

So far as appears from the NOPR, mere hypothetical misuse of exchanges is the basis for disqualifying these admitted arm's length transactions. See e.g., 62 Fed. Reg. 3742 (claiming that "real consideration for the transaction could be hidden" in exchange agreements and reciprocal deals (emphasis added)).

Exchanges of property are economically indistinguishable from sales and purchases, and are recognized as such by the Uniform Commercial Code. See generally U.C.C. § 1-201(9) ("Buying may be for cash or by exchange of other property or on secured or unsecured credit and includes receiving goods . . .") (emphasis added). Explicit legal provisions encourage exchanges of property rather than cash sales. See, e.g., 26 U.S.C. § 1031 (making like-kind exchanges of property free from federal income taxation); in the specific context of crude oil exchanges and buy/sell agreements, the stated crude oil price terms serve real-world purposes that provide incentive for accurate, competitive market price terms. The pricing term, for example, has binding legal effect in the event of loss of crude or the nonperformance or insolvency of the other party to the agreement. Accordingly, because of the risk of loss or nonperformance, neither party to the exchange has an incentive to use any price term other than the market value in its exchange and buy/sell agreement. 23/

Here again, the economic concept of opportunity cost should be included in the analysis. See supra note 20 and accompanying text. As a practical matter, a party cannot enter into a crude oil exchange or buy/sell agreement without first acquiring crude oil from some place. The economic cost of that acquisition, and thus the exchange or buy/sell, is precisely the amount that the

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23/ MMS presumably relies on its consultants for its conclusion that exchanges and buy/sells are suspect and used to manipulate lease markets. At least some of these consultants once supported the view that posted price exchanges and other exchanges with specified prices were procompetitive, non-collusive transactions. Certainly those who were retained by plaintiffs in the Long Beach litigation, see infra at Part IV., took that position, opining that the existence of certain crude oil exchanges, no longer in use, that did not specify a price term constituted evidence of a conspiracy to fix crude oil prices. Long Beach I, 872 F.2d at 1405-06.

parties to the transaction could have made by selling their respective crudes outright. In such a situation, the parties to the exchange or buy/sell lack incentive to accept any consideration or price term (given the risk of loss or nonperformance) that differs from the price that could have been obtained in an arm's-length cash sale under the same supply and demand conditions existing at the point of delivery on the exchange. If the exchange itself lacks price terms, comparables at the lease should be consulted to establish this opportunity cost or royalty value.

The proposed rule also errs by treating "location differentials" contained in the exchange agreements as actual transportation costs. MMS fundamentally misperceives the function of most exchanges or buy/sells, which is to avoid the physical movement of crude oil. Instead of reflecting the actual costs of crude movements, location differentials often are nothing more than a negotiated amount paid by one party to the exchange to the other for the convenience of the exchange service. 24/ Thus the suggestion that crude oil transferred at the lease on a buy/sell may properly be valued by taking the price of crude oil on the other half of the transaction at some downstream marketing center and subtracting a negotiated differential would not accurately value the crude disposed of at the lease. Kalt Tr. at 1122-26. It could have the effect of erroneously ascribing to the price of production at the lease, the profit made by the marketer's skilled relocation of crude oil supply. Id.

I. MMS has not Established that its Proposal Would Serve the Objective of the Agency.

Nothing in the proposed rule suggests that MMS has considered the full effect that its new approach to royalty valuation will have on crude production

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24/ This point was established in prior litigation between Mobil and the State of California and the City of Long Beach. See Amended and Revised Statement of Decision and Judgment Re: Mobil, Conclusions of Law 10-11, People of the State of California v. Chevron Corp., No. C587912 (Cal. Sup. Ct. Aug. 6, 1993) (attached in the Appendix hereto as Exhibit 7).

levels, distribution, or refined product prices. Consumers inevitably will be affected by MMS' myopic focus on increasing federal royalty payments at the expense of other considerations. Indeed, to the extent that the new royalty valuation method increases overall royalty payments, it could make marginal oil wells uneconomic. Houston Tr. at 104 (comments of Richard Rorschach, National Association of Royalty Owners).

Even if the proposed rule will not cause complete abandonment of certain leases, by regulating crude oil values through an index pricing and partial cost adjustment scheme, the proposed rule creates perverse incentives for lessees to dispose of their crude oil in a fashion that legitimately minimizes the regulatory extraction of profits from their downstream marketing efforts. One effect may be that integrated companies will substitute more foreign crude in their refineries in place of production from federal leases. Id. at 104-05 (noting that "every time [the U.S. loses] domestic production in marginal wells [it has] to import [ ] more foreign crudes"). By favoring one class of producer, the proposed rule may, like the petroleum pricing regulations of the 1970's, distort investment and other market behavior, introducing inefficiencies that are detrimental to the public overall. The proposed rule makes no effort to explore fully such market adjustments and the potential consequences on the use and distribution of crude oil and refined products throughout the United States.

III. THE PROPOSED RULE HAS SIGNIFICANT PROCEDURAL FLAWS.

A. The Proposal Depends on a Burdensome New Form MMS-4415 That Meets Neither the Standards of the Paperwork Reduction Act or Interior's Authorizing Statutes.

Mobil has adopted and here incorporates by reference, the March 25, 1997, report prepared by the Barents Group LLC and submitted to the Office of

Management and Budget ("OMB"). 25/ The Barents Report (Ex. 4) preliminarily demonstrated that the information-collection device that is integral to the proposed rule — the proposed new Form MMS-4415 — is excessively burdensome, costly, and does not meet MMS' own objectives. It further demonstrates that the proposed new form fails to meet the standards of the Paperwork Reduction Act, 44 U.S.C. § 3501, et seq. ("PRA").

The PRA provides that the OMB Director can disapprove proposed information collection if the Director finds that the agency has not complied or responded effectively to comments made. The implementing regulations further state that, to obtain OMB approval, the agency must demonstrate "that it has taken every reasonable step to ensure that the proposed collection . . . [i]s the least burdensome necessary . . . and [h]as practical utility." 5 C.F.R. § 1320.5(d)(1). The Barents Report, as well as problems discussed above, establish that MMS has not and cannot meet these general PRA standards for OMB approval. Indeed, OMB recently withheld its approval of the MMS form, Notice of Office of Management and Budget Action (Apr. 15, 1997), and MMS has not revised or repromulgated the form or the related proposed rules to meet OMB concerns. This suggests that the rulemaking cannot proceed in its present form but must be withdrawn or substantially revised and repromulgated with notice and an opportunity to comment. Modest changes to the proposed form will not suffice.

More specifically, MMS must be able to certify that its proposed form and information collection:

> (a) Is necessary for the proper performance of the functions of the agency, including that the information to be collected will have practical utility;
>
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25/ A group of industry associations, including the Mid-Continent Oil and Gas Association of which Mobil is a member, submitted the Barents Report with a letter to OMB ("MCOGA") dated March 27, 1997. Mobil separately commented and adopted MCOGA's comments, including the Barents Report, by letter to OMB dated March 25, 1997. The Barents Group LLC is a wholly-owned subsidiary of KPMG Peat Marwick LLP.

(e) Is to be implemented in ways consistent and compatible, to the maximum extent practicable, with the existing reporting and recordkeeping practices of those who are to respond; [and]

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(i) Uses effective and efficient statistical survey methodology appropriate to the purpose for which the information is to be collected.

5 C.F.R. § 1320.9 These certifications cannot fairly or accurately be made with respect to the proposed rule, as OMB has indicated.

Among the many problems with the NOPR's information collection proposal, addressed at length in the Barents Report, and with modifications suggested subsequently by MMS, are the following:

- MMS' estimate of the cost of complying with the proposed information collection is (a) unsupported and (b) too low;
- Most of the information to be collected would be unusable for and would not achieve the intended purpose of obtaining reliable market price adjustments for oil quality and delivery location;
- The proposed Form MMS-4415 would be excessively burdensome, requiring far greater industry compliance costs than is anticipated by MMS;
- The proposed information collection would impose major systems costs on firms, most of whom would have to change internal company administrative, accounting, and record-keeping systems to capture and integrate the requested information;
- The new filing requirement would be inequitable in that it would impose burdens on individual lessees and their affiliates that would bear no clear relationship to the number of federal leases held or the volume of federal royalty oil sold;
- The use of average spot price differences for establishing locational price differentials is problematic, inter alia, because of low volume in some markets and the unevenness of transactions over time;
- The "location/quality adjustments" based on the information collected on the new Form MMS-4415 will not be accurate or statistically valid;
- The use of "stale" price differentials based on the information collected on the new Form MMS-4415 will lead to inaccurate valuations;

- Changes in the treatment of transportation allowances will result in substantial compliance and administrative costs, and will create inequities;
- By assuming a single crude oil price rather than a range of market prices that reflect actual arm's-length transactions, the valuation methodology will have distributional impacts that have not been considered by MMS;
- Obtaining contract information from and providing it to separate affiliated companies, as required by the proposed rule, will be difficult at best and present issues of confidentiality and competition; and
- The complex compliance considerations regarding what constitutes "like quality oil" will lead to uncertainty that increases the cost of the proposed rule for both lessees and MMS.

Moreover, MMS lacks the statutory authority to expand its information collection as proposed. Under the Federal Oil and Gas Royalty management Act ("FOGRMA") 30 U.S.C. § 1713, lessees, operators, and other persons "directly involved in developing, producing, transporting, purchasing, or selling oil or gas subject to this chapter" are required to keep records and make reports reasonably required by rules regarding such oil or gas, and only "through the point of first sale or the point of royalty computation, whichever is later." See also infra Part V.A. Consider particularly the unfairness of imposing on a lessee who sells at the lease a requirement to collect and report information on costs to nearby "aggregation points" or relating to market centers to which it has neither access nor need. MMS appears unaware of antitrust concerns that prevent such a lessee from obtaining such information from third parties. E.g., Mobil Oil Corp., 112 I.B.L.A. at 63-64 n.8. Giving such lessees the "option" to forego the deduction is neither appropriate nor fair. There simply is no statutory basis for MMS' proposal to require federal lessees to report information regarding nonfederal production or non-production functions performed downstream of the lease whether by lessees, their affiliates, or companies with no connection to federal crude oil royalty production.

MMS must satisfy its obligations under the Paperwork Reduction Act before proceeding to promulgate a final rule, and must, in any event stay within the limits of the Mineral Leasing Act, FOGRMA and other governing statutes. The deficiencies in the proposed Form MMS-4415 are so great, and so integral to the overall proposed rule, that MMS must withdraw the current proposal. If MMS is still inclined to drastically alter current royalty valuation approaches, it must devise an alternate proposal that is consistent with both OMB's requirements and MMS' statutory authorizations and that imposes reasonable information collection requirements that are based on accurate estimates of the burden of compliance. Properly revised and confined, MMS must make new certifications to OMB. In any event, a meaningful opportunity must be allowed for public comment on any new material that MMS submits to OMB.

B. The Proposed Interim Rule Would Be Unlawful and Unwise.

MMS states that it "may publish an Interim Final Rule while it further evaluates the methodology in this proposed rule." 62 Fed. Reg. 3743. MMS' rationale is that an interim rule "would provide the flexibility to do a revision after the first year without a new rulemaking." Id. Such an interim rule would be (1) legally unauthorized, (2) impractical, and (3) unreasonably costly. MMS misperceives the rulemaking process as permitting radically new, untested procedures to be imposed on a trial and error basis, with industry participants bearing the substantial burden of MMS experimentation.

> The assumed flexibility that MMS would get in testing and changing the rule would come at a cost that MMS does not recognize in its analysis of the proposed rule. If the rule is initially issued on an interim basis, lessees will incur all of the costs [detailed in the report] of installing and adjusting their administrative operations and systems to comply with the Interim Rule and then, after one year, will have to incur some of the same kinds of costs again to comply with any changes MMS decides to implement when issuing its Final Rule. <u>The option of issuing an Interim Final Rule would be costly and disruptive and would not serve MMS' stated objective of</u>

adding "more certainty to the valuation of oil produced from Federal lands."

Barents Report (Ex. 4) at 32 (emphasis added).

The fundamental problems with the proposed rule, the burdens it would impose, and the profound effects on the industry, all discussed above, make it peculiarly unsuited for interim implementation. The rush to judgment implied by MMS' conclusory assertions about suspicious market circumstances, see infra Part IV, and its unwillingness to provide a reasonable amount of time for stakeholders to respond to the NOPR, raise additional concerns about the interim proposal.

MMS does not advise under what exception to the Administrative Procedure Act it justifies its proposed Interim Rule. Under that Act, informal notice-and-comment rulemaking may be bypassed only for interpretative rules, general statements of policy, agency administrative matters, or where the agency finds both "good cause" and that notice and comment procedures are "impracticable, unnecessary, or contrary to the public interest." 5 U.S.C. § 553(b)(3)(B). These statutory exceptions are narrowly construed. **26/** Implementation of the proposed rule on an interim basis cannot be justified under any of these standards.

In comparable contexts, MMS has not used interim rules. Regarding royalty-in-kind ("RIK") matters, the agency recently has proceeded with pilot projects to examine empirically its hypotheses; a pilot program, like the RIK project, to test MMS' NYMEX and ANS spot determinations would be a more reasoned and defensible approach here. When oil valuation rules were less

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26/ E.g., Alcaraz v. Block, 746 F.2d 593, 612 (9th Cir. 1984) (agency may not use "good cause" exception to manipulate procedures to its own use); United States Steel Corp. v. EPA, 595 F.2d 207, 213 (5th Cir. 1979) ("mere existence of deadlines for agency action, whether set by statute or court order, does not in itself constitute good cause."), reh'g granted and opinion clarified, 598 F.2d 915 (5th Cir. 1979); South Carolina ex rel. Patrick v. Block, 558 F. Supp. 1004, 1016 (D.S.C. 1983) ("Unnecessary" exception confined to situations where an administrative rule is routine, insignificant in nature and impact, and inconsequential to the public).

significantly revised in 1988, several years of rulemaking preceded the final, formal implementation of those rules. Given the revolutionary nature of the proposed rule, the notion that it could be imposed on a trial basis and refined without further rulemaking is particularly misguided.

C. The NOPR Violates Certain Executive Orders.

The agency's statement that "the rule does not represent a governmental action capable of interference with constitutionally protected property rights" is incorrect, and a Takings Implication Assessment should have been prepared under Executive Order 12630. See 62 Fed. Reg. 3750. The proposed rule would deprive royalty payors of their constitutionally protected property rights in situations where royalties will have to be paid based on a price that is impossible to obtain for the sale of the federal government's oil. Moreover, the gist of the government proposal is to assess royalties on non-production, non-lease investments and value; to this extent, the proposal represents an unconstitutional taking of a portion of investments and profits from downstream activities that are not part of the value of production saved, removed, or sold from the federal lease. See generally infra Part V.A.

Additionally, the agency's estimate of the cost of the proposed rule is demonstrably flawed. See generally supra Part III.A.; Barents Report (Ex. 4) at 13-32. Thus, the agency statement that the proposed rule "will not have a significant economic effect" within the meaning of Section 3(f)(4) of Executive Order 12866 is erroneous. 62 Fed. Reg. 3750.

Mobil also disputes the agency's certification for purposes of the Unfunded Mandates Reform Act of 1995 that "this rule will not impose a cost of $100 million or more in any given year on local, Tribal, or State governments, or the private sector." Id. At a minimum, MMS must reevaluate its estimate of the burden and economic impact of the proposal, and it also must reconsider its certification under the Unfunded Mandates Reform Act in light of the Barents Reports and other comments.

D. The MMS Has Unduly Curtailed the Time For Comment on the NOPR.

The NOPR is singularly uninformative about the bases, rationale, and data supporting its significant and startling conclusions about current markets and practices and its proposed radical revision of oil valuation regulations. From review of materials recently produced in response to FOIA requests that were necessitated by this lack of information, it appears that the NOPR represents the culmination of several years work by MMS, including the work of an inter-agency task force, audit efforts, and reports commissioned from various consultants or experts who were not identified in the NOPR. Given the staggering scope of the NOPR and the withholding of customary supporting material, the original 60 days provided for notice and comment was insufficient, and the additional extension, doled out piecemeal in a last-minute, 30-day increment, has not cured the problem. MMS has been cavalier about the complaints of insufficient time, wrongly suggesting that mere awareness of general "issues" about posted pricing are a substitute for adequate time to study the intricacies of a detailed, complex, and novel proposal. 27/ MMS is similarly cavalier about the real world limits placed on industry members like Mobil who are subject to pending litigation raising overlapping issues and thus could not participate fully in the Advanced Notice of Proposed Rulemaking issued December 20, 1995. 28/

27/ Letter from Cynthia Quarterman, Director, Minerals Management Service, to American Petroleum Institute (Mar. 18, 1997) (attached in the Appendix hereto as Exhibit 8).

28/ Response to the open-ended nature of the ANOPR, which sought alternatives to current lease pricing, seemed designed to compromise those defending current lease pricing in litigation brought by private royalty interests. Letter from Ron G. Kissick, Mobil Exploration & Producing U.S. Inc., to David S. Guzy, Minerals Management Service (March 14, 1996) (on file with the Minerals Management

An interested party should not be forced to file FOIA requests in order to obtain access to basic information on which an agency relies for such proposed rules. MMS should have granted a proper amount of time measured from the mid-April receipt of the final and most substantive FOIA responses. 29/ Only the surprising lack of the expected data and technical analysis in these FOIA materials ameliorates this situation. So long as the burden of establishing the conclusions and bases for the proposed rule remains with MMS, MMS' failure to support the proposed rule appropriately may offset the problem of insufficient time. Mobil reserves the right to object to the short time for preparing comments, if subsequent events place on it, or the industry, the burden of demonstrating deficiencies in the NOPR or in the conclusions on which the proposed rule purports to rest.

IV. MMS IS PROCEEDING ON AN INSUFFICIENT AND ONE-SIDED RECORD.

Promulgation of the current proposed rule is premised on unproved allegations and theories of crude oil underpricing that MMS previously had examined carefully and rejected. Internal MMS documents on this about-face show that it was precipitated by little more than the settlement of California crude oil pricing litigation, which led MMS to accept conclusions in out-dated studies by plaintiffs from that litigation — conclusions that MMS previously had viewed as insufficient. Moreover, such a premise is clearly subject to debate, yet MMS has effectively shut out one side of that debate. MMS relied only on consultants already

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Service and available in webcite www.rmp.mms.gov/oilvalu/oilvalu.HTM) (attached in the Appendix hereto as Exhibit 9).

29/ Following initial study of the NOPR, FOIA requests by Mobil and for Mobil via industry associations were presented in the last days of February. MMS' final and most substantive response was dated April 8, 1997, but not received by relevant persons for Mobil until the following week; additional time was needed to collect significant responsive materials identified by MMS but not copied and sent out with the material. Copies of certain items provided by MMS were defective, with many missing pages.