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May 28, 1997

VIA FAX AND COURIER

Mr. David S. Guzy
Chief, Rules and Procedures Staff
U.S. Department of the Interior
Minerals Management Service
Royalty Management Program
Rules and Publications Staff, MS3101
Building 85, Denver Federal Center, Room A-212
Denver, CO 80225-0165

BY HAND

U.S. Department of the Interior
Mail Stop 4230
Minerals Management Service
1849 C Street, N.W.
Washington, D.C. 20240

Re: *Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases*

Dear Mr. Guzy:

Texaco Inc., on behalf of itself and its affiliates, Texaco Exploration and Production Inc. ("TEPI") and Texaco Trading and Transportation Inc. ("TTTI"), appreciates the opportunity to submit these preliminary comments on the Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases, 62 Fed. Reg. 3742 (1997). These comments are necessarily preliminary because the published Notice and public record supporting the proposed rule have virtually no explanation or basis for its promulgation. Consequently we have not had the opportunity to evaluate fully the basis for and impact of the proposal, which would radically alter valuation methods for about one quarter of the nation's total crude oil production. At this stage, however, one matter is clear -- the proposed rule, if implemented, would harm Texaco's and its affiliates' business and the efficiencies we create as an integrated federal lessee. We urge MMS to withdraw the proposed rule, and not to abandon the long-standing principle of valuing crude oil at the lease using arm's-length sales prices in the field of production.

Texaco and its affiliates have worked closely with MMS in past rulemaking efforts and very much hope to continue to do so. We stand ready to assist MMS in clarifying and improving methods to continue to ascertain that prices in the field are arm's-length and, thus, fairly reflect supply and demand conditions in the field.

For integrated companies and most other firms paying royalties, the proposed rule abandons the use of arm's-length sales prices in the producing field. It would create artificial federal royalty values based on prices away from the lease that are not tied to fair market values in the field. Indeed, as discussed herein, the proposed formulas would create a wide disparity of potential crude oil values at the lease. Crude oil of the same type produced in the same field on the same day could have innumerable different, artificial values at the lease depending on where and how it is transported and whether or not the lessee is integrated. Despite the difficulties of discussing these issues due to pending litigation, Texaco has in the recent past initiated open discussions with MMS regarding our valuation practices. We are ready to continue these discussions and work with MMS to develop a proposal that is fair and workable for MMS and *all* of its lessees. However, we will strongly oppose any proposal that unfairly and unlawfully moves valuation away from the lease and discriminates against the integrated producer.

The proposed rule effectively raises the royalty rate in Texaco's federal leases. The proposal would simply boost federal royalty receipts by valuing crude oil as if it were already located in markets away from the lease, and would then severely limit the cost adjustments allowed back to the lease. Current lease terms, based on years of consistent interpretation and case law, require crude oil to be valued at the lease for royalty purposes. Application of the proposed rule would unilaterally change the royalty terms in existing crude oil leases, and, thus, violate the government's basic contractual obligations. In similar instances where the government has sought to abrogate the essential bargain of its contracts, the Supreme Court has declared such abrogations to be impermissible.

Attached hereto and incorporated into these comments are reports of four experts addressing issues that appear to have been raised by consultants interviewed by MMS in formulating the proposed rule. Again, we are prejudiced in not having access to details of the MMS consultants' conclusions or data backing them up. The experts whose reports are attached are as follows:

1) Dr. Philip K. Verleger, Jr., an economist and former Director, Office of Domestic Energy Policy, U.S. Treasury Dept., comments that the proposed New York Mercantile Exchange (NYMEX) index is a flawed and unreliable indicator of all types of crude oil prices at the time and place of production and would lead to substantial valuation errors (Tab 1);

2) Dr. Benjamin Klein, Professor of Economics at UCLA, comments that the net-back formulas under the proposed rule are a "convoluted and arbitrary procedure which is certain to produce large errors." Professor Klein presents, for example, a number of illustrations of the impact of the proposed rule in the California market (Tab 2);

3) Samuel A. Van Vactor, President of Economic Insight, Inc., comments that use of Alaska North Slope crude oil prices to value crude oil produced in California is unworkable and similarly would create arbitrary and unfair values at the lease (Tab 3); and

4) Robert B. Bossung, of Solomon Associates, Inc., presents an illustration of the high level of arm's-length crude oil transactions in the producing fields in Texas as an example (Tab 4).

In contrast to the comments of these experts, the public record lacks evidence supporting the proposed rule or demonstrating that the proposed formulas could possibly work.

I. AS A MATTER OF LAW, FEDERAL LEASE CRUDE OIL PRODUCTION MUST BE VALUED AT THE LEASE

When Texaco's midstream operations affiliate, TTTI, moves crude oil from a federal lease to an "aggregation point," "market center" or refinery, the value of the crude oil increases beyond the so-called "actual cost" of transportation services. Such increase in value is the result of many types of services of its midstream operations as well as the assumption of substantial risks. This increase in value is not reimbursable under the proposed rule. The proposed rule would deny integrated companies even the full market value of their transportation services.

As set forth below, the attempt to take increased crude values arising from midstream services and add them to the royalty base violates existing lease terms and exceeds the Secretary's statutory authority. The discrimination against integrated firms is equally unlawful.

A. Federal Leases Require Crude Oil To Be Valued At the Lease For Royalty Purposes

The proposed rule would unilaterally change essential terms of Texaco's federal leases. Federal crude oil leases are *contracts* and the parties thereto are entitled to rely on their terms. When the federal government chooses to enter into a contract, "its rights and duties therein are governed generally by the law applicable to contracts between private individuals." *Lynch v. United States*, 292 U.S. 571, 579 (1934). The government is just as bound by the terms of a crude oil lease as is any private lessor. *See, e.g., Rosebud Coal Sales Co. v. Andrus*, 667 F.2d 949 (10th Cir. 1982) (applying standard contract law to federal oil and gas lease transactions).

The proposed rule states, at section 206.100(b)(3), that it will not apply if it is inconsistent with "[a]n express provision of an oil and gas lease subject to this subpart." Texaco has over 600 producing federal oil and gas leases, some of which have been in effect for over seventy-five years. The leases typically provide for payment of royalties on a stated percentage of the "amount or value of production removed or sold from the lease," or, for OCS Lands Act leases, the "amount or value of production saved, removed or sold" from the leased area. The leases also typically provide that the Secretary may establish the minimum value of production, due consideration being given to the highest price paid for a part or for a majority of production of like quality *in the same field or area*, to the price received by the lessee, to posted prices, and to other relevant matters. As discussed above, the proposed rule does not measure the value of production removed or sold from the lease. Neither does it give any consideration to prices paid for production in the same field or area, the price received by the lessee, or to posted prices. Accordingly, the proposed rule is inconsistent with the express terms of Texaco's existing federal leases.

Texaco has vested contractual rights in its oil and gas leases. *See e.g., Enron Oil & Gas Co. v. Lujan*, 978 F.2d 212, 214 n.2 (5th Cir. 1992) ("Oil and gas leases are 'both conveyances and contracts.' . . . The method by which royalty is to be calculated is a contractual provision.") *cert. denied*, 510 U.S. 813 (1993); *see also Standard Oil Co. v. Hickel*, 317 F. Supp. 1192, 1197 (D. Alaska 1970) ("The Government's rights and obligations as lessor of public lands are no different from those of any other lessor."), *aff'd.*, 450 F.2d 493 (9th Cir. 1971). Any attempt by MMS to apply the proposed rule to determine royalty valuation would be a material breach of the lease provisions.

Thus, MMS lacks authority to amend unilaterally the terms of federal crude oil leases. Where the government seeks to abrogate the essential bargain of its contracts, the Supreme Court has declared such abrogation be an impermissible repudiation. *See, e.g., United States v. Winstar Corp.*, 116 S.Ct. 2432, 2479 (1996) (Scalia, J., concurring); *Lynch v. United States*, 292 U.S. at 578-80 (1934); *Perry v. United States*, 294 U.S. 330 (1935). The price/royalty terms are an essential part of any lease and, unless a lease expressly provides otherwise, the property rights of the lessee are determined only by those rules in effect when the lease is executed. *See, e.g., Union Oil Co. v. Morton*, 512 F.2d 743, 748-49 (9th Cir. 1975); *Pauley Petroleum Inc. v. United States*, 591 F.2d 1308, 1325-26 (Ct. Cl. 1979), *cert. denied*, 444 U.S. 898 (1979). MMS' proposed rule would unilaterally change the point of royalty valuation and increase the royalty base at the lease, thus abrogating the essential bargain of Texaco's federal leases.

Application of the new rule to existing oil and gas leases would likewise violate the government's contractual obligations. The Supreme Court has held that, because "retroactivity is not favored in the law," statutes will be "construed to have retroactive effect" only if the statutory language expressly requires that result. *Landgraf v. USI Film Prods.*, 511 U.S. 244, 264 (1994). The presumption against retroactivity is particularly compelling here, because application of the new rule to existing leases would upset the contractual rights of the parties. As the Court in *Landgraf* explained:

> Since the early days of this Court, we have declined to give retroactive effect to statutes burdening private rights unless Congress had made clear its intent.
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> The largest category of cases in which we have applied the presumption against statutory retroactivity has involved new provisions affecting contractual or property rights, matters in which predictability and stability are of prime importance.

Landgraf v. USI Film Prods., 511 U.S. at 270-71.

Nothing in either the Minerals Leasing Act, the OCS Lands Act, or the Federal Oil and Gas Royalty Management Act gives the Secretary authority to promulgate regulations that unilaterally change the terms of existing leases. Indeed, the clear Congressional intent is to *not* upset the settled contractual expectations of the parties. Texaco has paid the federal government approximately $1.5 billion in bonuses for just its currently active federal leases in reliance on settled contract terms and the enabling legislation. For example, the lease forfeiture provisions of the Minerals Leasing Act are limited to instances in which the lessee fails to comply with provisions of the Minerals Leasing Act, of the lease, and "of the general regulations promulgated under this chapter and in force at the date of the lease . . . ." 30 U.S.C. § 188(a) (1994). Although FOGMRA expressly applies to existing leases, section 305 of the Act provides that "no provision of this Act or any rule or regulation prescribed under this Act shall alter the express and specific provisions of such a lease." Pub. L. 97-451, Title III, § 305, 96 Stat. 2447, 2461-62 (1983). Similarly, Texaco's leases that incorporate regulations of the Secretary typically provide that the lease is subject "to all reasonable regulations of the Secretary of the Interior now or hereafter in force *when not inconsistent with any express and specific provisions herein* . . . ." *E.g.*, Lease Form 4-213 (Sept. 1961)(emphasis added).

In addition to these basic contract principles applicable to federal leases, the Fifth Amendment prohibits the government from unilaterally repudiating contract rights.[1] Three factors are relevant to whether a Fifth Amendment taking has occurred: (1) the economic impact on the claimant; (2) the extent to which the rule interferes with the parties' investment-backed expectations; and (3) the character of the government action. *Connolly v. Pension Benefit Guar. Corp.*, 475 U.S. 211, 225 (1986). The proposed rule would have an adverse economic impact on federal lessees because it would capture any increase in value to lease production after its removal from the lease. Again, Texaco made a huge investment in bonus payments to the government and capital improvements to its leases and did so in reliance on the lease terms. Taking the increase in value to lease production after its removal from the lease interferes with Texaco's investment-backed expectations related to the royalty burden of the leases. For example, Texaco might not have bid, or might have bid less, on a lease if this new royalty valuation methodology had been specified. Finally, the character of the government action is that of a permanent appropriation of the increase in value to lease production. Based on Fifth Amendment standards, the proposed rule would create an unlawful taking.

B. The Proposed Rule Exceeds the Statutory Authority of the Secretary of the Interior

The proposed rule exceeds the statutory authority of the Secretary, because it does not measure the "value of production removed or sold from the lease."

Regulations can have the force and effect of law only if they are promulgated pursuant to a statutory grant of authority. *See Chrysler Corp. v. Brown*, 441 U.S. 281, 308 (1979); *accord, Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988) ("It is axiomatic that an administrative agency's power to promulgate legislative regulations is limited to the authority delegated by Congress."). The statutory basis for the collection of royalties is contained in the Minerals Leasing Act of 1920 and the Outer Continental Shelf (OCS) Lands Act. The Minerals Leasing Act gives the Secretary authority to lease public lands, and requires that any such "lease shall be conditioned upon the payment of a royalty at a rate of not less than 12.5 percent in *amount or value of the production removed or sold from the lease.*" 30 U.S.C. § 226(b)(1)(A) (1994) (emphasis added). Similarly, the OCS Lands Act requires that royalties be obtained based on the "amount or value of the production saved, removed, or sold." 43 U.S.C. § 1337(a)(1)(A) (1994). The plain language of both Acts requires that royalties be based on the value of the

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1 The just compensation clause of the Fifth Amendment states "nor shall private property be taken for public use, without just compensation."

production *at the lease*. This statutory interpretation is well settled. *See, e.g., United States v. General Petroleum Corp.*, 73 F. Supp. 225, 235 (S.D. Cal. 1947) ("royalties are payable on the gas as it is produced at the well"), *aff'd. sub nom. Continental Oil Co. v. United States*, 184 F.2d 802 (9th Cir. 1950); *Mobil Producing Texas & New Mexico, Inc.*, 115 IBLA 164, 171 (1990) ("[n]ormally gas is sold and valued for royalty purposes at the wellhead"); *Shell Oil Co.*, 52 IBLA 15, 20 (1981) (transportation allowance to the nearest open market only needed "where no market exists at the wellhead" for crude oil). A course of dealing over many years reflects an intent of both the government and its lessees that production is to be valued at the lease.

Indeed, MMS has for over seventy-five years consistently interpreted the statutes to require the valuation of lease production at the lease. In a closely analogous case, a federal court rejected the Secretary's attempt to change a royalty valuation rule that had been subject to long-standing interpretation. *Marathon Oil Co. v. Andrus*, 452 F. Supp. 548 (D. Wyo. 1978). In that case, the court noted that for over fifty years, both the Secretary and lessees understood that oil and gas used in lease production or unavoidably lost were not subject to royalty, and the court therefore concluded that it was arbitrary and capricious for the Secretary to change this settled valuation rule. As the court in *Marathon* explained:

> This Court cannot lose sight of the general rule that, when the executive department charged with the execution of a statute gives a construction to it and acts upon that construction for many years, the Court looks with disfavor upon a change whereby parties who have contracted in good faith under the old construction may be injured by a different interpretation.
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> A review of the legislative history of the Mineral Leasing Act, together with its many enactments and re-enactments, each leaving intact the wording that a royalty is to be paid on "value of the production removed or sold from the lease," plus the interpretation placed thereon by the Secretary of the Interior for a long period of time holding that royalties are not to be collected on oil and gas that was unavoidably lost or used in lease operations, are entitled to great weight.

452 F. Supp. at 551, 552-53; *accord Amoco Prod. Co. v. Andrus*, 527 F. Supp. 790, 792 (E.D. La. 1981)(reaching same result under the OCS Lands Act). The courts in *Marathon* and *Amoco* also carefully examined the legislative history of the Minerals Leasing Act and OCS Lands Act, and, in both cases, concluded Congress intended to ratify the Secretary's long-standing interpretation by not altering the statutes in subsequent re-enactments. *Amoco Prod. Co.*, 527 F. Supp. at 794 ("[t]he law is clear that Congressional

re-enactment of a statutory provision which has been consistently interpreted by an administrative agency signifies congressional approval and adoption of that interpretation."); *Marathon Oil Co.*, 452 F. Supp. at 551 (noting that Congress amended the Mineral Leasing Act seventeen times since its original enactment and seven times since the August 8, 1946 amendment which added the language "removed or sold from the lease," but consistently left unchanged the royalty valuation requirement, thus evincing its approval of the Secretary's long-standing interpretation).

The MMS proposed rule does not measure the value of production removed or sold from the lease. On the contrary, the proposed rule (1) uses unrelated values away from the lease for crude oil production in the field, (2) fails to account for the full increase in value to crude oil after its removal from the field, (3) uses a prior year's data to adjust for certain location differentials, and (4) produces widely varying, unpredictable and artificial "values" within each field (sometimes for the same crude depending on where, how and by whom it is transported).

Even as a "proxy" for measurement of the value of production at the lease, the proposed rule is fatally flawed. The proposed rule, as noted, imposes multiple different "value[s] of the production" within the meaning of the statute for the same quality oil produced from the same well on the same day. In addition, the "value of the production" would vary depending on whether the lessee was an integrated company or a non-integrated company which qualifies for a different valuation formula under the proposed rule.[2] In similar circumstances, courts have rejected as arbitrary and capricious such disparate treatment by the Secretary. *See e.g., Independent Petroleum Ass'n of Am. v. Babbitt*, 92 F.3d 1248, 1258, 1260 (D.C. Cir. 1996) ("An agency must treat similar cases in a similar manner unless it can provide a legitimate reason for failing to do so. . . . The treatment of cases A and B, where the two cases are functionally indistinguishable, must be consistent. That is the very meaning of the arbitrary and capricious standard.").

C. The Proposed Formulas Would Unilaterally Increase MMS Receipts By Basing Royalties On Higher Values Derived From Services Not In The Field

By limiting net-back adjustments for transportation services to certain "actual costs" in many circumstances, integrated companies would be denied the opportunity

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2 In fact, the qualifying non-integrated lessee would only be required to apply NYMEX or ANS index pricing – which is required of all integrated lessees – if it were guilty of misconduct or malfeasance. 62 Fed. Reg. at 3743. The proposed rule fails to explain why the punitive index pricing rules are automatically applied to integrated companies.

to recover the price normally charged in arm's -length transactions for those services.[3] (Non-integrated competitors, on the other hand, could deduct the full price of transportation services provided by third parties under the proposed rule.) The differences, often substantial, between "actual costs" and the full market value of transportation services will vary from place to place, pipeline to pipeline, and company to company.[4]

In addition to limiting the adjustment for transportation services, the proposed formulas would provide no allowance for any other valuable services provided by transportation and marketing companies. For example, the proposed rule would fail to account for such midstream services as the aggregation of small, diverse lease volumes into pools of oil suitable for a distant sales point.[5] To market crude oil away from the lease, such companies must maintain costly storage facilities and an inventory of crude oil in many locations, both in tanks and in the substantial pipeline fill needed to ship crude oil via pipelines. Such companies also provide substantial off-lease marketing services, as distinguished from marketing services at the lease level.[6] Marketing personnel must be experts in analyzing supply and demand conditions. Other personnel must manage inventories, plan deliveries, assess storage availability and

3 The circumstances under which transportation adjustments would be limited to "actual costs" for an integrated company appear arbitrarily chosen. For example, movements from the lease to a refinery would be limited to a deduction of the "actual cost" of transportation. So would movements from a lease directly to a "market center." However, movements to a "market center" through an "aggregation point" would begin with actual costs to the aggregation point and then would have a much different type of adjustment applied (e.g., sometimes based on exchange agreement location differentials, and other times based on published differentials). In addition, contrary to MMS comments at its public hearing in Houston, Texas on April 17, 1997, the "actual cost" adjustment is not simply a carry-over from the 1988 product valuation regulations. (*See* Hearing Tr. at p. 69.) Instead, this transportation adjustment would apply to all integrated lessees and all of their lease production, not just to lessees choosing to sell certain production "off the lease." *See* 30 C.F.R. § 206.104 (1996). In addition, the "actual cost" concept would apply to much greater transportation distances than envisioned under the existing regulation.

4 Remarkably, efficient companies would tend to be penalized under the proposed rule vis-à-vis less efficient competitors. Other things being equal, an efficient company with lower "actual costs" than their less efficient competitors would have a lower transportation cost adjustment and, thus, would be forced to pay *higher* royalty amounts. Such penalties against efficient companies, and discrimination against integrated companies, is unfair, illogical and unlawful.

5 The value added by aggregating large volumes of crude oil is obvious. A buyer is usually willing to pay more if it can avoid the cost of contracting with many different suppliers for a desired volume of oil.

6 MMS appears to assume that lessees have a "duty" to provide such marketing services. As discussed herein, this assumption directly contradicts lease provisions and is contrary to law. It is a unilateral taking of the increase in value derived from the many services provided off the lease.

costs, and provide accounting and administrative back-up. Administrative services alone include scheduling the movement of crude, measuring and determining the quality of the oil, providing various accounting services, managing accounts receivable and managing the credit risks and commercial exposure in holding inventories. Not only are the costs of such services ignored by the MMS proposal, but the service provider is not permitted an economic return on the required investment, or compensation for the exposure to risks. The value of these services is completely ignored by the proposed rule and would thus be added to crude oil values *at the lease*.

In addition, crude oil values away from the lease reflect substantial risks incurred in moving crude to various markets. No cost adjustment would be allowed for such risks under the proposed rule. Texaco assumes environmental risks including risks of oil spills in transit and at storage facilities, risks of delays resulting from such factors as equipment failure or weather, the risk of price volatility between the date of production and date of resale, risks of line loss (*i.e.*, unaccounted for volume shrinkage), credit risks inherent in reselling oil to third parties, unforeseen delivery bottlenecks and breakdowns in planning, and numerous other economic risks.

The proposal effectively grabs values added by commercial participants as the oil moves from the lease to the end-user. Under the MMS rationale, the lease buyer, the gatherer, the trader, the market analyst, the broker and every other midstream commercial player should not recoup the value of their services. The MMS proposed approach effectively means there is no localized lease level value for crude oil, and no difference between spot and long term contract prices. Actual transactions in the field have no merit as a valuation benchmark under MMS' proposal, while the standard becomes the distant commodity trading in the NYMEX pit or spot sales of Alaska North Slope oil delivered to Los Angeles. MMS ignores countless arm's-length transactions in the producing fields that create a viable and working cash market, involving a broad array of industry participants. These transactions necessarily reflect local conditions at the lease.[7]

In addition, many smaller producers who rely on buyers in the field to perform the service of making royalty payments on their behalf would incur new obligations to calculate payments, fulfill reporting requirements, and deal with audits. They might conclude that federal leases are not worth the added expense and risk. The added costs

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7 MMS' proposal to take the increase in value off the lease is reminiscent of an attempt by MMS to seek royalties based on the profits attributable to a cogeneration facility located on a lease that used federal lease crude oil. The IBLA rejected this attempt noting that the MMS netback formula allowed a deduction only for processing costs and failed to account for the fact that the remaining royalty base included profits on the increased value of the oil. *See Petro-Lewis Corp.*, 108 IBLA 20 (1989).

and risks imposed by the proposed rule would also likely cause marginal producing wells to be plugged and abandoned, thereby increasing reliance on foreign imports of crude oil. Such increased costs and risks would likely curtail investment in marginal wells, as well as in relatively high risk exploratory wells.

D. The Proposed Rule Unlawfully Discriminates Against Integrated Companies

Integrated companies would be unfairly disadvantaged under the proposed rule. Although arm's-length transactions are clearly the best indicators of crude oil value, integrated companies would be denied use of these transactions in establishing value, even when nonintegrated competitors continue to do so. An integrated company such as Texaco would *always* be required to use the NYMEX or ANS indices for valuing crude oil production at the lease, which, as noted above, artificially increase the royalty base. In contrast, a qualifying nonintegrated competitor would be able to rely on its arm's-length transactions at the lease to establish royalty value, and would thereby be able to circumvent the MMS' netback formulas. No reasonable basis exists for such discrimination against integrated companies.

The unsupported premise for discriminating against integrated companies is that affiliated transfers, and many arm's-length buy/sell and exchange transfers, cannot be valued based on comparable arm's-length transactions in the producing field. Without even considering the shortcomings of the proposed formulas as a basis for valuation, this presumption contradicts well-established Interior Department practice. In *Shell Western E&P, Inc.*, 112 IBLA 394 (1990), for example, the Interior Board of Land Appeals held that it was unlawful for the MMS to deny a tariff-based transportation allowance to a lessee solely on the basis of its affiliated relationship with the transporting pipeline, while at the same time approving a tariff-based allowance for lessees not affiliated with the transporting pipeline. The basis for the Board's decision was that MMS could not discriminate against a lessee that was affiliated with its pipeline transporter, solely on the basis of that affiliate relationship. This very type of discrimination is the central theme of MMS' proposed rule.

Based upon ill-defined data gathered by MMS through interviews with "private consultants," which data has not been placed in the public record, MMS proposes to ignore well-established precedent and adopt a rule that, without justification, treats as "suspect" (this is MMS' term) *all* transactions involving integrated companies. Indeed, the proposed rule goes so far as to treat as "suspect" actual arm's-length values paid for crude oil in the field where it is produced. This approach of condemning arm's-length transactions of integrated companies contradicts an entire body of oil and gas law developed over the course of a century. Under fundamental principles of oil and gas law, production is to be valued for royalty purposes on the basis of *actual* transactions in the field or area where the production occurs.

In short, the discrimination against integrated companies is not only unreasoned, it violates the Department's longstanding practices and legal precedent.

II. THE BEST INDICATORS OF MARKET VALUE OF PRODUCTION AT THE LEASE ARE ARM'S-LENGTH PURCHASES AND SALES OF CRUDE OIL IN THE PRODUCING FIELD

Each producing field has unique characteristics. They range from crude quality to logistical factors. Crude oil fields are subject to widely divergent economic influences depending on such factors as the quality of the crude, the supply and demand for different types of crude and the capabilities of local refiners in each region, the distance from the field to potential buyers, and the transportation alternatives available from each field. (*See* Report of Dr. Benjamin Klein, attached, at p. 5.) For example, if delivered by truck, road conditions and hauling distances to an intermediate storage point must be considered. If pipeline gathered, factors of physical line conditions and overall capacities at both intermediate and final sales points must be considered. Some crudes, such as relatively light, low sulfur crudes, can be processed economically by a large number of different refiners. Others, such as very heavy crudes or crudes with high sulfur levels, are most economically processed by refineries with specialized refining equipment such as cokers, catalytic crackers, and hydrotreating facilities that can upgrade the crude into light products such as gasoline. (*Id.* at p. 6 (referencing California crudes).)

The value of crude oil at a specific lease is established by arm's-length negotiations. Indeed, the MMS comments accompanying the proposed rule acknowledge that fair market value is determined by "the agreed-upon cash price between willing and knowledgeable buyers and sellers if neither were under undue pressure." 62 Fed. Reg. at 3746. The negotiated price for a specific lease reflects a wide variety of supply and demand factors relevant to the marketing conditions at the time of negotiations. Factors such as the presence of hydrogen sulfide gas, which requires additional manpower to handle the crude oil due to safety regulations, must be taken into account.

Values for different crude types (not just sweet and sour grades) do not move in tandem with each other. The spread between values of various grades changes frequently depending on a vast range of factors. (*See* Report of Samuel A. Van Vactor, attached, Figures 1-4.)

A substantial bidding market exists at the lease level. TEPI is only one of many companies selling crude oil to third parties in the producing fields. In addition, TTTI purchased 200,000 barrels per day of crude oil from third parties at the lease in 1996. Leading crude oil marketers such as Scurlock Permian Corporation introduced evidence into the administrative record that fierce competition for the purchase of crude oil exists in virtually every major field in the United States. (Transcript of MMS Hearing in Houston, Tx., April 17, 1997, Attachment 1.) Of course, any time MMS might be concerned that competition is lacking at any particular lease, MMS could take its royalties in kind and enhance the competition.

By way of example, since the State of Texas maintains such records, we asked the firm of Soloman Associates, Inc. to review "First Purchaser" forms filled out by Texas crude oil lessees. These records show a "highly active, competitive market for crude oil at the lease." (Bossung Report at p.1) For just one representative month, December 1995, a conservative estimate showed 11,236 out of 12,227 entries (91.9%) involved arm's-length transactions at the lease level in Texas. (*Id.* at p. 5.)[8]

In its public hearing on the proposed rule in Houston, Texas on April 17, 1997, MMS was asked to state the basis for its rejection of prices charged in the producing field as a royalty basis. Mr. Donald Sant of MMS responded that MMS had conducted "special audits" (through an Interagency Task Force) in California and found "premiums" received above the royalty basis price. (Hearing Tr. at p. 160.) Mr. Sant noted that bills were issued to companies subject to the special audits. In fact, it was Texaco that was audited by MMS and the claim that so-called premiums were found that increase the royalty base is nonsense. This "evidence" supporting the proposed rule is nothing more than a "discovery" by MMS auditors that crude oil sold at a market center is more valuable than crude oil sold in the field. For example, MMS "found" location differentials and called them "premiums." MMS simply subtracted the price in the field from the resale price in various market centers, which were sometimes hundreds of miles away from the field, and ordered Texaco to pay the difference, with interest. This *reductio ad absurdum* is in no way a basis for gutting seventy-five years of royalty policy using field prices to value field production.

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8 In addition to these many private company arm's-length transactions, the State of Texas, both through its General Land Office as well as the University of Texas Lands System, separately sells huge volumes of crude oil as part of its royalty in-kind program.

A. The Proposed Rule Would Create Multiple, Wholly Unpredictable "Values" For The Same Quality Crude Produced At The Same Time From The Same Well

Arm's-length purchases and sales of crude oil in the field may realize a range of prices that represent market value at the lease. However, because the proposed rule moves valuation off the lease, and ties formula adjustments to such factors as the status of the lessee, the proposal creates a vast array of unpredictable values beyond the true range of market value at the lease. Wellhead values of crude oil under the proposed rule would be unpredictable, making even short term planning by producers very difficult. The proposed rule requires use of different valuation formulas depending, for example, on whether the crude oil is moved to an "aggregation point," directly to a "market center," or directly to a refinery. In addition, within each of these various proposed formulas, the royalty value of crude oil would vary depending not only on where the crude oil is moved, but also on how it is moved and how far it is moved. For any given lease, the ultimate destination points and transportation methods and costs for a particular barrel vary widely. Under the proposed rule, crude oil values "at the lease" would be as unpredictable and varied as the number of potential destination points, transportation modes and transportation costs associated with them.

For example, the value of crude oil *in the field* that is moved twenty-five miles to an aggregation point would be significantly different from the value *in the field* if it were moved fifty miles to a refinery. Texaco's production affiliate, TEPI, produces crude oil in California, for example, that on any given day can be moved to San Francisco, Los Angeles, Bakersfield, or even in certain cases Texas (via the All America Pipeline). The proposed net-back formulas for each of these destination points would yield wholly different crude oil values in the producing field because the price adjustments would differ for each of these destinations. Such values would have no relationship to actual market prices in the field. Similarly, in New Mexico, TEPI produces both New Mexico Intermediate and New Mexico Sour crude from federal leases. On any given day, either of these two crude grades could be commingled in separate pipeline (sweet and sour) common streams. These separate common streams might be transported to a number of disbursed refineries located in at least seven states: (1) New Mexico (Artesia and Lovington); (2) Texas (El Paso, Houston, Beaumont/Pt. Arthur, Longview); (3) Oklahoma (Ardmore, Wynnewood, Ponca City, Tulsa); (4) Kansas (El Dorado, Coffeyville, McPherson); (5) Illinois (Chicago, Wood River, Robinson); (6) Indiana (Whiting, Indianapolis); and (7) Ohio (Toledo, Lima).

The proposed rule also applies different formulas depending on whether or not the crude oil flows through an MMS-defined "aggregation point," thus further complicating the analysis. For example, certain of TEPI's crude oil production from the Gulf of Mexico could flow to many different locations identified in the MMS proposal.

Under the proposal, different valuations would be obtained for the same lease production depending on which location is chosen. This result directly contradicts the stated reason for the rulemaking -- "[t]he proposed rulemaking would add more *certainty* to valuation of oil produced from Federal lands." (62 Fed. Reg. at 3742) (emphasis added). TEPI's Gulf of Mexico crude oil production that is not sold to third parties at the lease is resold by TTTI at such points as Texas City, Markham, Burns, Erath, Gibbstown, Johnson Bayou, Patterson, Pecan Island, and Krotz Springs, none of which are identified as market centers in the proposed rule. Instead, the proposed rule indicates that some of these points would be designated as "aggregation points," even though they are usually TTTI's final sales point. Using the "alternate market center concept" set out in the proposed rule, one undoubtedly would encounter many times more "alternate market centers" than actual "market centers." Producers would need to file requests for MMS calculated differentials under such circumstances in order to assure that proper royalties are paid. Yet MMS' calculation of such differentials would require assessments of each producers' sales and would likely generate multiple differentials for the same "alternate market center." Again, this concept directly contradicts the purpose of the proposed rule of adding "certainty" to valuation of federal lease production.

Of course, when TEPI sells crude oil to a third party in the field, TEPI has no means of knowing which aggregation points the crude oil flows through, which market centers or alternate market centers would be involved, or the cost of shipping the crude. Calculation of the required net-back royalty values would be pure speculation and could not possibly add "certainty" to the valuation of the federal lease crude.

So bizarre are the valuation formulas that the proposed rule would result in a wide disparity of royalty values for the *same crude oil sold under the same contract at the same price* when different co-owners of a lease exist. Hypothetically, if Texaco, ABC Integrated Company, and an independent company were co-owners of a lease East of the Rockies, and all of the production was sold to ABC's refining unit at a single price and flowed from the lease through an ABC pipeline to ABC's refinery, each of the three lessees would be required to value its share of production differently for royalty purposes. Texaco would use the NYMEX settlement price adjusted by location/quality differentials to the nearest market center, and subtract the price charged by ABC to move the crude oil. ABC, on the other hand, would use the "actual" transportation cost to its refinery (the "alternate market center"), and a location/quality differential between the nearest market center and NYMEX. The independent company, if it purchased no oil during the past two years, would use the price received in the arm's-length sale to ABC at the lease. The stated notion that the proposed rule adds "certainty" is nonsense. The uncertainties associated with the varying crude oil values under the proposed rule would disrupt planning and promote inefficiency.

B. Oil Sold At The Lease Would Be Valued As If Already Located Midstream, Which Omission Cannot Be Fixed In the Context of the Proposal

The proposed rule omits any way of reasonably valuing crude oil sold arm's-length at the lease to third parties. Instead, crude oil sold at the lease would be valued as if it were already located at a midstream "aggregation point." No adjustment for transportation or other value added from the lease to the aggregation point is provided in this circumstance. Yet, this omission in the proposed rule for valuing crude oil sold at the lease cannot reasonably be fixed within the context of the current proposal without substantially increasing the discrimination against integrated lessees.

As a matter of basic free market principle, and the realities of the crude oil marketplace, the only rational and fair way to value crude oil sold arm's-length to third parties at the lease is by using the contract price. Indeed, a net-back formula would be unworkable to value oil sold in the field to third parties. The seller would have no reasonable way of knowing or verifying where the oil would be moved by the buyer or the cost of moving it, which information is needed to determine value under the proposed net-back formulas. However, if MMS uses arm's-length sales prices to value crude oil sold to third parties in the producing field (which is the only fair or practical method available), then such prices should also be used to value non-arm's-length sales in the same producing fields. Otherwise, the discrimination against integrated companies under the proposed rule would increase. (Integrated companies alone would have the burden of paying higher royalties using the artificial net-back formulas reflecting values away from the lease).

Again, arm's-length prices in the field set market value. Texaco is a major arm's-length buyer and seller of crude oil at the lease. It should be treated no differently from its nonintegrated competitors.

III. THE NYMEX FUTURES MARKET IS NOT AN APPROPRIATE BENCHMARK TO VALUE CRUDE OIL IN A PRODUCING FIELD

MMS' proposed formulas East of the Rockies are based on a NYMEX settlement price for delivery of future barrels of West Texas Intermediate crude oil at Cushing, Oklahoma. The proposed rule uses the NYMEX futures value of WTI in the trading pit to value every type of crude oil in every oil field East of the Rockies. This *future* NYMEX price is used as the *current* value for crude production at the lease despite major gaps in timing, location and quality between the NYMEX trading floor and the point of primary supply at or near the wellhead location.[9] In fact, supply and demand factors are usually substantially different between these points.

The NYMEX futures market is very different from the lease markets. A NYMEX official testifying at MMS's hearing in Houston acknowledged that NYMEX has never researched correlations between "the lease and *our market*." (Hearing Tr. at 192.) The NYMEX is a paper market, not a "wet barrel" market. Participants in the NYMEX buy and sell futures contracts rather than actual barrels of oil -- almost exclusively to hedge or speculate. NYMEX is a market for "risk trading" and not oil trading. NYMEX transactions neither measure prices "at the lease" nor prices at the time of production.

As set forth in the attached report of Dr. Philip K. Verleger, Jr., the daily closing price on the NYMEX, which reflects the last two minutes of a trading day, is not a reasonable proxy for the value at the lease at the time of production of even WTI, let alone the numerous other crude oil grades throughout the United States. On average, there are less than .003% physical deliveries in any one month on a NYMEX contract, as compared to 75,000-150,000 contracts traded daily (an equivalent of 75-150 million barrels per day). Trading in such paper barrels relates exclusively to bulk markets, whereas production at the lease is often in small quantities, with unique quality, logistical and local market considerations that can be very different from the NYMEX paper barrel. Seventy-five percent of U.S. crude oil wells are stripper wells, which produce on average only 2.1 barrels per day.

MMS ignores price fluctuations in intra-day trading on the NYMEX. MMS proposes using the close/settlement value, which is a miniscule snapshot of time during the 24-hour trading period. (Verleger Report at pp. 1-3, 12-13.) Trading in NYMEX contracts regularly occurs during 104.08 hours of a standard week. (*Id.*). MMS proposes to use trades for royalty valuation purposes that occur in only ten minutes out of the 104.08 hours, or 0.16% of the time in which the market is open. (*Id.*) Viewed differently, a spot contract trading for twenty days out of a month would trade for 424.32 hours. (*Id.*) Yet, under the MMS proposed formula, only 1.13 hours of this trading period (0.3% of total trading time) would be sampled in the determination of settlement prices. (*Id.*) No consideration would be given to the weighted average sales

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9 MMS proposes to use the prompt NYMEX month in effect on the first day of the production month and would track those prices for a twenty-eight to thirty-one day period prior to expiration around the 21st of the month. For example, values for crude oil to be physically delivered in April 1997 would be pegged to the average value of the NYMEX May delivery contract as traded between March 21st and April 20th. Regardless of seasonal variations and numerous other factors, the proposal applies a futures price to the current value of oil.

price in the NYMEX trading pit, which reflects volumes traded as well as price fluctuations during the trading day. (*Id.*)

NYMEX values are also influenced by speculation about future price conditions that may have no relationship to a particular lease. (*Id.* at 3-9.) Dr. Verleger emphasizes that speculation contributes to a "risk premium" in NYMEX trading that appears especially prevalent in crude futures trading. (*Id.*). In addition, NYMEX values are necessarily influenced by pipeline delivery constraints at Cushing, Oklahoma. "Squeeze" situations by traders, and participation by commodity hedge funds and other non-commercial entities, create unique supply and demand conditions. For example, a bottleneck in certain pipeline deliveries to Cushing would create high prices at the Cushing end of the pipeline and correspondingly low prices at the opposite end of the pipeline, i.e., the field. (*See id.* at 9-10.) The influences of such a bottleneck on the Cushing price would necessarily have an opposite effect on valuation at the leases served by the pipeline. (*Id.*) (Of course, most fields are in no way connected to pipelines serving Cushing and would not be affected by such periodic pipeline constraints that influence Cushing prices.)

NYMEX closing values, particularly in the last few days of the expiration of the prompt contract month, are susceptible to manipulation due to options strike prices and the opportunity for options traders to benefit from premiums on the strike prices. (*Id.* at 10-12.)

The MMS proposed rule rests on many assumptions, some expressed and some implied, for which much of the underlying factual information has not been disclosed to the public. For example, the Notice to the proposed rule alludes to "a number of presentations by: crude oil brokers and refiners, commercial oil pricing reporting services, companies that market crude oil directly, and private consultants knowledgeable in crude oil marketing." 62 Fed. Reg. at 3742. MMS has not made this information available, other than providing cursory overviews of the consultants' opinions. Virtually no evidence has been inserted into the public record backing up these opinions. As best we can tell, MMS is basically relying on the biased opinions of consultants working for plaintiffs' lawyers that have been and remain involved in litigation against Texaco and other producers and buyers.

The consultants' opinions relied upon by MMS in preparation of its NYMEX index proposal have been consistently discredited in litigation against Texaco and others. Most recently, a New Mexico state court heard the testimony of Benjamin Johnson of Summit Resources in support of plaintiffs' motion to certify a class of royalty owners, which the court rejected. *Engwall v. Amerada Hess*, No. CV-95-322 (N.M. 5th Jud. Dist. Mar. 26, 1997). MMS has identified Mr. Johnson as a consultant, but has not cited his qualifications or expertise. In fact, in the *Engwall* case, Mr. Johnson testified that he had recommended to MMS that only as a *last resort* should market values of crude oil in the producing fields be calculated using a net-back formula based on NYMEX prices. (Tr. at 347-48, attached at Tab 5.) Mr. Johnson testified that he had recommended to MMS that if oil companies sell crude oil either "outright in an arm's-length final sale with no other consideration," or if the companies enter into a "buy-sell transaction" where "oil was exchanged for oil at another location," then such transactions should be used for royalty valuation purposes. (*Id.*) Mr. Johnson testified that his recommendation to MMS was that "[i]f we didn't have *any* of those actual transactions . . . then we can *use a comparable analysis* to look at other *nearby locations* whereby we look at buy-sell transactions that were employed by the defendants or by other companies of similar sophistication." (*Id.* at 348 (emphasis added).) According to Mr. Johnson, his recommendation to MMS was that only if *none* of these arm's-length transactions exist, then as a last resort, should a net-back methodology be attempted:

> Then the final method is, if there are none of those, if there are *no [outright sales or] buy-sell transactions available*, then *the last* would be a methodology, a net-back type methodology to be administered by the Minerals Management Service.

(*Id.* (emphasis added).)

The court heard contrary testimony of a widely-noted Harvard University economist, Dr. Joseph P. Kalt, who had compiled a vast database of arm's-length crude oil transactions in the producing fields in a number of states. Dr. Kalt demonstrated that a substantial variability exists among specific supply and demand factors from lease-to-lease and transaction-to-transaction. (Tr. Vol. 5 at 1143, attached at Tab 6)("[I]f you look at data on actual arm's-length comparable transactions, you do indeed find that those transactions at the lease demonstrate the influence of *highly-localized supply and demand factors, and in a quite substantial way*.") Dr. Kalt concluded that "[w]hen you look at how the market speaks at the field level, market valuation of actual transactions varies significantly with supply and demand factors specific to particular leases, crude oils, and transactions." (Id. at 1144.) Dr. Kalt specifically rejected Mr. Johnson's net-back theories noting that they cannot account for variability at the lease. (Id. at 1180-94.) Buyers at the lease level must account for such factors as transportation costs, storage availability, and costs of developing information regarding customer demand for various types of crude oil, and assumption and management of risk. Dr. Kalt noted that moving crude oil from the field to a market center is a "highly risky business." (*Id.* at 1183.) Dr. Kalt described the supply and demand factors involved in the NYMEX trading pit as "noncomparable to those in the field." (*Id.* at 1188.) Even comparing major trade centers such as Midland, Texas and Cushing, Oklahoma, Dr. Kalt determined that "the reasonable conclusion to be drawn is that even at trade centers, one sees different localized supply and demand factors that are specific to that trade center and make it different from the [other] trade center, and based on my evidence, also different from the supply and demand factors that one sees operative at the lease." (*Id.* at 1192.) Thus, Dr. Kalt testified that the NYMEX "demonstratively reflect[s] different supply and demand forces." (*Id.* at 1194.) Dr. Kalt concluded that "[t]hose forces are not present in the lease, they are not the same ones that are present at the lease in their totality, and as a result, there is an arbitrariness in the selection of these values." (*Id.*)

IV. THE ADJUSTMENTS TO NYMEX SET FORTH IN THE PROPOSED RULE DO NOT CORRECT THE DEFICIENCIES

A. Spot Price Adjustments Cannot Be Used To Equate Crude Oil Lease Production To The NYMEX Value

MMS has consistently condemned the use of either spot or futures price benchmarks netted back to the lease as a reliable indicator of production values. For example, MMS' Associate Director was highly critical of using such benchmarks in a memorandum concerning adoption of the current regulations:

> Application of spot prices in valuing non-arm's-length disposals of lease production would not be specific. Spot prices are available only for a limited number of "benchmark" domestic crudes delivered at specific points; e.g., West Texas Intermediate at Cushing, Oklahoma. It is not clear how spot prices would be adjusted for differences in quality or necessary transportation between that of the "benchmark" crude and that of the crude to be valued. An adjustment for differences in API gravity alone, for example, while a reasonable price adjustment mechanism for oil produced in the same field or area, does not necessarily reflect true value differences when comparing crudes from distant areas. The price differences in crude oil nationwide depend upon a host of factors not limited solely to gravity and transportation adjustments. Factors important to the establishment of value of a particular crude include the need for an availability of crude oil supply, the cost of transportation to the refinery, the chemical compositioning characteristics of the crude oil, the cost to refine the particular crude, the mix of refined products derivable from the crude and their values, prices currently paid or offered for the same or comparable crudes, and other economic criteria. Posted prices, which exist in all the important producing areas, reflect all these considerations; "benchmark" spot prices on the other hand, cannot

> relate these factors specifically to each producing area. The same is true for futures prices, which also relate to a few "benchmark" crudes only.

(Memorandum from Associate Director for Royalty Management to Director, MMS, Feb. 12, 1987.) Nevertheless, MMS proposes to adjust the flawed NYMEX *futures* index using *spot prices*.

Published crude oil spot prices, such as Platts assessments East of the Rockies cover only the following grades: WTI at Cushing, Oklahoma and Midland, Texas; West Texas Sour at Midland; Light Louisiana Sweet at St. James, Louisiana; Eugene Island Sour at St. James; Louisiana Heavy Sweet at Empire; and Wyoming Sweet at Guernsey, Wyoming. Yet, unlike circumstances, for example, in natural gas markets, there are dozens of other grades of crude oil produced East of the Rockies. Many of these crude oil grades have substantially different physical and market characteristics from the Platts spot price assessments, and cannot equitably be equated to those spot price values. Crude oil spot markets are less mature than, for example, natural gas spot markets, and a much smaller percentage of crude production is traded in spot markets as compared to natural gas.

Petroleum Intelligence Weekly recently reported (February 17, 1997) that for a crude grade to be used as a valid "benchmark," at least 300,000 barrels of the designated crude must be traded on a daily basis. Platts, of course, does not report volumes on the various spot assessments, and strong doubt exists about many of the reported grades. For example, in Texaco's experience arm's-length spot market transactions in Guernsey of Wyoming Sweet crude oil more often than not bear no relationship whatever to Platts reported spot prices.

Platts, for example, does not divulge its method of obtaining market assessments other than to state they are for one-hour time windows in the afternoon using telephone polling of selected people in the "industry." Of course, such people might be selective in the data they provide. Therefore, assessment values are subject to distortion and, perhaps, manipulation. In addition, since transactions occur between parties over a 24-hour period, the one-hour window of time used by Platts may not be a reasonable indicator, particularly if a crude grade is thinly traded and market prices are changing.

In addition, as discussed in greater detail below, any attempt by MMS to collect information and publish its own differentials to account for the inadequacy of the spot price publications could not provide sufficiently current data to account for changing market conditions. Again, the relative spreads among different grades/qualities of crude oil and among different production areas can change rapidly. MMS' data collection methods would yield obsolete data before they could be processed and published.

Take, for example, the very scenario used by MMS in its Notice of Proposed Rulemaking (62 Fed. Reg. at 3748) to describe how the spot market adjustments would work. Wyoming Sour is a crude grade with significantly different physical and market characteristics compared to West Texas Sour. Yet MMS equates Wyoming Sour, for which no spot price data exists, with West Texas Sour, for which spot price data is published. According to U.S. Bureau of Mines (now Department of Energy) crude oil assays, the following represents just some of those differences:

	West Texas Sour	Wyoming Sour
Field Country/State	Cowden South Ector, Texas	Elk Basin Park, Wyoming
Gravity API Deg.	34.6	30.8
Sulfur %	1.77	1.95
Light Gasoline %	11.0	8.1
Naptha %	21.6	18.7
Resid %	26.8	30.1

The assays clearly demonstrate unique physical differences between the two grade types that may create different values for buyers. Yet MMS presumably selected Wyoming Sour and West Texas Sour as optimal examples for its published Notice of how its proposed quality adjustment methodology would work. In addition to these distinct physical characteristics, however, the market conditions at the lease for West Texas Sour and Wyoming Sour are very different because of different logistical and demand considerations (discussed below).

The fact that contracting parties might sometimes use a price "benchmark" such as a Platts spot price or a NYMEX futures price in crude oil sales contracts at the lease is not evidence that such benchmarks could or should be mandated as values for all federal lease crude oil production, or for the same lease production regardless of changing circumstances. Parties who use a price benchmark for specific sales understand the risks and circumstances involved at the time they are doing so. The same parties contracting a month later at the same lease might choose a much different price mechanism. But in either case, the current arm's-length price should be accepted for royalty value regardless of how that price may be derived.

In addition, MMS purports to introduce "certainty" to royalty valuation through a process that, in part, involves simple averaging of spot prices at Cushing, Oklahoma across each month. Such an arithmetic averaging method could distort actual market conditions in the valuation process. For example, the proposed valuation assumes equal weighting of spot prices for each day of the month. However, transaction volumes across any given month are uneven and prices observed on different days may not have the same meaning. For example, if a spot transaction were to occur at a particular location for a particular quality of crude only one day per week on average, the spot price observed on that day could only reflect the supply and demand conditions at that location on that day. Yet, prices on days when no spot transactions occur may be substantially different from those on the day of the recorded transaction. The MMS methodology thus would not reflect any changes in market conditions that have occurred since the last transaction. Averaging spot prices across all days (*i.e.*, giving equal weight to days when many transactions occur and days when only one occurs) would distort the market value of crude. This becomes particularly problematic given that spot market activity, especially near Cushing, during any given month may be most concentrated in days leading up to the expiration of futures contracts. Of course, averaging spot prices over a month under the MMS methodology would do nothing to reduce the distortion induced by low or uneven transaction volumes. In addition, the spot prices would not be volume weighted. Thus, prices for very low volume contracts would have the same impact on the MMS value as prices for large volume contracts.[10] The MMS methodology also fails to account for the fact that spot prices listed in one publication may be different from spot prices in another publication.

At any given time, buyers might have unique needs for incremental spot supplies of crude oil having certain characteristics. For example, a refinery whose water-born cargo is delayed several days might enter the spot market and pay a premium significantly in excess of the average price of crude oil. MMS' averaging concept ignores the distributional consequences resulting from such unique supply and demand needs among buyers and sellers. In addition, under MMS' proposal, the lessee who enjoys an above-average price would pay a lower royalty, whereas a competing lessee who sells oil below the average market price must pay a higher royalty. Such a result not only distorts market efficiencies but is inequitable.

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[10] MMS could not use a weighted average under its methodology because transaction volumes are not available from published sources.

B. MMS' Other Location/Quality Adjustments Would Be Based On Irrelevant Information

Incredibly, MMS would also use year old, irrelevant information to adjust NYMEX futures prices to account for vast distinctions among qualities and locations of crude oil production throughout the country. Understandably, MMS presents no evidence that such adjustments would properly capture the location/quality differentials in the marketplace at the time of production. The proposed rule states that MMS would publish on an annual basis a set of location/quality differentials between major aggregation points and major market centers based on information provided by lessees in proposed Form MMS 4415, "Oil Location Differential Report." First, MMS lacks authority to require federal lessees to fill out forms in connection with transactions involving non-federal leases. Yet even if such authority existed, the proposed information would immediately be obsolete and meaningless by the time it could be processed and published. It would certainly become obsolete and irrelevant over the course of a year. The concept of using historic buy/sell or exchange contract data ignores completely the dynamics of the marketplace, where the relative spread in prices among various crude grades as compared to WTI, for example, changes frequently. (See, e.g., Van Vactor Report at 7-9; Klein Report at 9-11.) The proposal ignores issues of supply and demand seasonality and changing logistical constraints applicable from one field to the next. Thus an increase or decrease in pipeline capacity, refining capacity, or production volumes, or even changes in the weather, could have a substantial impact on either location or quality differentials that would not be reflected in last year's differentials.

In addition, the variety of types of buy-sell and exchange transactions and the multiple competitive factors affecting any one such transaction would make it impossible for MMS to develop a meaningful differential, even if the information were current. Any adjustments MMS might allow to account for such factors as location, gravity, sulfur content, blending costs, transportation costs and other factors would necessarily be arbitrary. For example, quantities or qualities of crude oil being exchanged may not be equal. The timing may not be equal. An exchange may be a term transaction or a spot transaction. Yet, MMS proposes to combine somehow (apparently by ignoring these issues) the data derived from proposed Form 4415 in order to derive a single *annual* quality/location differential between an aggregation point and a market center.

In addition, many aggregation point locations may have very few buy/sell or exchange transactions. Such limited transactions would be used by MMS to reflect market differentials for an entire year. Given rapidly changing market conditions over the course of a year, such small samples of potentially varied transactions would be statistically invalid for purposes of providing any average differential.

In sum, requiring federal lessees to base royalty payments on a prior year's location/quality differentials, which would have no relationship to current market conditions, is unreasonable, unlawful and terrible policy, and would impose unnecessary substantial new risks on the lessees.

V. ANS IS NOT AN APPROPRIATE BENCHMARK TO VALUE CALIFORNIA CRUDE OIL PRODUCTION

The fact that apples and oranges are sold in the same place and used for similar purposes is no basis for valuing one based on the price of another. In the Interagency Task Force Report, MMS properly rejected using ANS to value California crudes. (Final Report at App. 4, fn.1 (May 16, 1996).) And although MMS rejects the use of spot prices in favor of NYMEX as a valuation benchmark East of the Rockies, MMS now proposes to use ANS spot prices in Los Angeles or San Francisco to value all West Coast production. As set forth in the attached report of Benjamin Klein, the State of California has one of the most diverse indigenous crude supplies of any region in the world. (Klein Report at 4.) California crudes range from heavy (e.g., 13 degrees API) crude oils, sometimes with high levels of sulfur and other impurities, to light crudes (e.g., 40 degrees API) with relatively few impurities. (*Id* .) Dr. Klein states that "different crude oil fields in California are also subject to widely divergent economic influences depending on such factors as the quality of the crude, the supply and demand for different types of crude and the capabilities of local refiners in each region, the distance from the field to potential buyers, and the transportation alternatives available from each field." (*Id.* at 5.)

As set forth in the attached report of Samuel A. Van Vactor of Economic Insight, Inc., ANS is a waterborne crude oil available in tanker quantities having much different quality characteristics compared to most California crudes. (Van Vactor Report at 10.) Since 1993, for example, ANS spot prices have averaged 82¢ per barrel higher than spot prices for Line 63, a blended stream of California crudes delivered to Los Angeles with similar API gravity and sulfur content to ANS. These arm's-length price differences reflect economic and quality differences between ANS and California pipeline-delivered crudes that would not be captured by the MMS proposed methodology. (*Id.* at 6-9.) Dr. Klein's report shows that the spread between arm's-length prices of ANS and California crudes changes frequently. (Klein Report at 9-11.) Dr. Klein also shows that "[i]n addition to the large changes in relative prices between ANS and California crudes there are also large changes in relative prices of different California crudes." (*Id.*) Dr. Klein demonstrates that "[t]hese price changes reflect changes in the forces of supply and demand for different types of crude and crudes in different locations." (*Id.*)

In addition, the spot market transactions for ANS crude oil sold in California and reported by Platts are relatively thin. Only three sellers of ANS exist on the West Coast, and probably less than a dozen buyers are active. Most sales of ANS are term transactions. For competitive reasons, many transactions involve contract terms that are private and confidential, whereby both the seller and buyer agree not to report prices to the reporting services. Consequently, the validity of reporting services' price assessments for ANS are often suspect.

Spot market assessments of ANS crude oil landed in California have no justification whatsoever as a mechanism for valuing California crude oil. Not only is ANS a crude grade with limited liquidity on the spot market, its physical characteristics are substantially different from most California crude oils. Even relatively higher gravity off-shore California crude oils are not only significantly higher in sulfur content and lower in gravity than ANS, but have much higher metals and nitrogen content that reduce their market value.

As discussed above, the methodology in the proposed rule for adjusting ANS spot prices by tracking exchange and buy/sell quality and location differentials in a prior year, and then applying those values to a current period, fails to recognize the volatility of California crude oil markets and would be wholly unworkable. (*See* Klein Report, Figures 3, 4, 5A, 5B, 5C showing monthly variations, for example, between ANS and Kern River spot prices and Line 63 spot prices, as well as monthly variations in posted prices among various grades in California.)

In addition, as with the NYMEX consultants, the MMS' consultants on ANS pricing are active in working for plaintiffs' lawyers against oil producers and have been discredited in their testimony. Commenting on what the "consultants" may have told MMS is, of course, very difficult given the lack of information in the public record concerning their recommendations or any evidence supporting their conclusions. We note that in a case involving the value of Santa Maria Valley crude oil (*Union v. Pioneer*), for example, Peter Ashton of IIC used an ANS methodology to estimate the value of such crude. Mr. Ashton began with spot prices for landed ANS crude oil published by Telerate and Platt's, and then adjusted the prices for gravity, sulfur, and transportation to arrive at a value for SMV crude (making his methodology in that case even more conservative than MMS' here). At his deposition, Mr. Ashton admitted he had little evidence of arm's-length SMV prices supporting the prices he calculated as reasonable market value. (Deposition of Peter K. Ashton, October 3, 1996, pp. 132:18-134:12, attached at Tab 7.) When confronted with specific price calculations, Mr. Ashton could not state if those prices were used in actual arm's-length transactions. (*Id.*, pp. 136:12-137:18.)

The administrative record contains no evidence that the ANS net-back methodology proposed by MMS would ever reflect supply and demand conditions in any California producing field, let alone reflect values over the course of an entire year for all California fields.

VI. MMS HAS NO AUTHORITY TO REQUIRE LESSEES TO MARKET FEDERAL LEASE PRODUCTION AT NO COST TO THE GOVERNMENT OR AT A LOCATION AWAY FROM THE LEASE

The proposed rule wrongfully attempts to require a federal lessee (1) to bear all costs of marketing crude oil, i.e., with the Government receiving that benefit cost-free, and (2) to bear such marketing duties and costs at locations away from the lease. *See* 62 Fed. Reg. at 3746. This change is a major departure from lessee obligations under existing leases. While federal lessees are currently required by MMS regulations to place crude oil in a "marketable condition" at the lease, they are not required to market the product at no cost to the government, let alone in market centers. "Marketable condition" is defined as "lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area." 30 C.F.R. § 206.101 (1996). Once production is in that described physical condition, the lessee's cost-free duty under the lease has been satisfied. Judicial decisions interpreting the "marketable condition" rule have focused on this placement of lease product in the physical condition in which it can be sold; they do not impose an additional duty to market the oil at no cost, which duty MMS attempts to create unilaterally through its proposal. *Mesa Operating Ltd. Partnership v. U.S. DOI*, 931 F.2d 318, 320 (5th Cir. 1991), *cert. denied*, 502 U.S. 1058 (1992); *California Co. v. Udall*, 296 F.2d 384, 387 (D.C. Cir. 1961).

Rather than requiring free marketing services, the extent of the duty to market under existing federal leases is stated as a "duty to the lessor to market the production for the *mutual benefit* of the lessee and the lessor." 30 C.F.R. § 206.102(b)(1)(iii) (1996) (emphasis added). This duty is not the same as stating that the lessee must market production for the *unilateral benefit* of the lessor, i.e., at no cost. Even one of the most liberal commentators with respect to oil and gas issues has acknowledged that, "[a]fter a marketable product has been obtained, then further costs in improving or transporting such product should be borne by both lessor and lessee." E. Kuntz, *A Treatise on the Law of Oil and Gas*, Vol. 5, § 39.4, at 299 (1989). In addition, no obligation exists, mutual or otherwise, that such marketing take place at a market center away from the lease. The law is well settled that costs incurred away from the lease are not includable in the royalty base on which the government's share is calculated. *California Co.*, 296 F.2d at 387 (transportation costs). Since MMS proposes to value crude oil away from the lease with no marketing cost adjustment, it necessarily would require lessees to market their production at that location. This unilateral change in existing contractual obligations under federal leases is both unlawful and inherently unfair. *See*

Conoco, Inc. v. United States, 35 Fed. Cl. 309, 324 (Fed. Cl. 1996) (government's unilateral changes in permitting requirements under federal leases held to violate existing lease agreements).

VII. THE ADMINISTRATIVE COSTS ALONE OF THE PROPOSED RULE WOULD BE ENORMOUS

The proposed rule would substantially increase administrative costs incurred by Texaco. Values of production for each federal lease would depend on numerous new monthly variables, including NYMEX settlement prices (or ANS spot prices), the adjustments by type of crude based upon spot index differences, and a wide variety of location differentials based on "actual" transportation costs from the lease. Most of these variables would change from month to month. Texaco's current accounting systems are not designed to handle such formulas, and substantial system changes would be needed. Much of the required data is not even recorded electronically. The cost of making necessary changes and the time to make them would be very high, and would be aggravated by the scarcity of computer programmers due to year 2000 capability requirements.

In addition, in cases where the federal government is only a partial owner of a producing field, TEPI as the operator typically disburses all oil revenues, including royalties, for the leased property. Under the proposed rule, the operator would not be able to value uniformly the oil for each co-owner. Therefore, where TEPI is an operator on jointly owned properties with federal leases, the ownership interests would need to be unbundled. Texaco surveyed TEPI's Land Department in Denver, Colorado that is responsible for its Western Region leases. Based on our limited surveys to date, we estimate that it would take over three person-years just to review and unbundle the ownership interests for the estimated 437 properties with federal leases in the Denver, Colorado and Bakersfield, California regions alone. All of these properties have at least one separate and distinct federal lease, and many have more than one.

Also, Texaco has retained a "call on production" on most of the 1,377 properties sold in the Denver and Bakersfield regions since 1987. Based on the proposed regulations, such calls on production may affect how the buyer of the property values federal royalties. We would need to review all 1,377 sales contracts and potentially amend assignments with call on production language involving federal leases. Our preliminary estimate is that such a review and amendment process would take approximately three person-years. In addition, most of Texaco's 573 active federal leases in the Denver and Bakersfield regions are burdened with overriding royalty interests. Each source document creating these overriding royalty interests would need to be reviewed to determine how the oil production should be valued. Each property that contains federal and non-federal leases would need at least two different oil royalty valuation methods. Royalty ownership would need to be aligned on a division of interest to the appropriate oil valuation method. We estimate this work would take an additional three-quarter person-year.

The above-described administrative costs associated with researching, amending and processing ownerships of properties to comply with the new proposed regulations are currently estimated to involve from six to seven and a half person-years on just the properties in the Denver and Bakersfield regions.

In addition, TTTI currently purchases crude oil from approximately 24,000 properties and makes payments directly to the working and royalty interest owners for purchases of crude oil from over 10,000 of these properties. Operators, working and royalty interest owners usually have marketing agreements for the disposition of their crude oil. Depending on the contractual arrangements, TTTI may pay 100% of the proceeds to the operators or may disburse payments for the purchase of crude oil directly to each of the working and royalty interest owners. TTTI may also disburse severance taxes to various government entities on behalf of these parties. With respect to federal lease properties, TTTI purchases crude oil not only from TEPI but also from more than 400 non-affiliated, third-party operators. On behalf of these third-party operators, TTTI pays MMS as designee on approximately 800 Minerals Management AID numbers representing over 1,100 separate properties.

Compliance with the proposed rule by TTTI on behalf of third party operators would require substantial revisions in existing specialized computer programs, as well as the development of complex new programs. These efforts by TTTI would require skilled computer programmers to perform analyses, design, construction and implementation activities that are currently estimated to encompass over five person years. TTTI might determine that it is no longer feasible to provide such royalty disbursement services for third party operators involved with federal leases. At the same time, however, such disbursement functions could not likely be assumed by many independent operators who do not have the required complex accounting and computer systems for paying royalty and taxes. Such functions have been customarily performed on their behalf by first purchasers. The location/quality differentials in the proposed rule would vary significantly from company to company. Because much of the needed information pertaining to transportation costs would be proprietary, it might no longer be possible (irrespective of cost considerations) for one company to remit royalty payments on behalf of an operator. The inability to remit payments for another company would impose an additional administrative burden not only on lessees, but also on the MMS, because the number of remitters would substantially increase.

A. Proposed Form MMS-4415 Would Be Highly Costly and Largely Useless

In complying with the requirements of proposed Form 4415, a midstream affiliate must have access to information such as MMS lease numbers, lease locations, production rates, gravity at the lease, and sulfur that would generally reside with an upstream production affiliate. Conversely, an upstream affiliate filling out the form would need to develop information on pricing and other contractual terms that resides with midstream affiliates. Integration of information systems between TEPI and TTTI to capture accounting information necessary to complete Form 4415 would be very costly. We understand that the Office of Management and Budget rejected proposed Form 4415 for a variety of reasons.

MMS provides no support for its assumptions underlying the estimated costs associated with the new proposed form. For example, MMS assumes that it would take 15 minutes on average per filing and $25 per hour of labor effort. From Texaco's viewpoint, the MMS estimate is far too low and its assumptions are invalid. MMS fails to account for the practical difficulties in obtaining the required information, which does not currently exist. Texaco, for example, does not normally compute "actual transportation costs" of its midstream operations within the meaning of 30 C.F.R. § 206.105. Such calculations would require substantial changes in TTTI's accounting system. MMS' implicit assumption that all of the information required to fill out Form 4415 is readily available and systematically maintained by lessees in the normal course of business is completely inaccurate as applied to Texaco. A procedure and data system would have to be developed to gather, analyze, and record this data. Within Texaco the lessee/payor, *e.g.*, TEPI, generally does not engage in buy/sell or exchange transactions. Rather, TEPI's affiliate, TTTI engages in such transactions. No practical means exists to link information relating to midstream operations with production information for a specific lease. Crude oil produced from specific leases is typically commingled with other production before reaching a destination point. The financial systems of TTTI would have to be linked with the royalty reporting systems of TEPI; midstream systems would have to be modified to interface with upstream systems; pricing systems would have to be modified to interface with aggregation systems. Such modifications would require a major investment in system design and programming time. Even if it were somehow possible to begin submitting information on Form 4415 in the proposed two month period, which we seriously doubt, the compliance effort would cause a serious economic dislocation within TEPI and TTTI.

We note that the hourly labor cost assumed by MMS to create the information in Form 4415 is significantly lower than the compensation MMS assumes for its own employees who would receive the information. In its "Supporting Statement for Paperwork Reduction Act Federal Rule" submitted to OMB, MMS assumed that GS-9 employees would collect, sort and file the documents at a cost of approximately $29 per hour and that GS-12 analysts would analyze and publish the data at a cost of approximately $43 per hour. Texaco would need to assign experienced analysts and train additional personnel to collect and report crude oil transportation and other costs in the context of exchange and buy/sell arrangements. The average salary, with benefits, of an appropriately experienced professional employed by Texaco would be substantially higher than the $25 per hour MMS estimate.

Much of the information required on Form 4415 would be useless. Although MMS purports to use the data for assessing location/quality differentials between aggregation points and market centers, MMS would require Texaco to fill out forms involving transactions having nothing to do with such differentials. Any given volume of crude oil flowing from a lease can be the subject of numerous buy/sell or exchange agreements either between market centers or prior to reaching any market center. Such irrelevant information is proposed to be collected not only for federal lease production but for non-federal leases as well. In addition, where buy/sell and exchange agreements involve multiple aggregation points, MMS would have no way to disentangle the costs of separate legs of the trip. For example, crude oil may be trucked to St. James, Louisiana from on-shore leases and stored in tanks together with offshore crude oil. Crude from the commingled tank could then be exchanged for crude at another location. At that location, it is impossible for the seller or purchaser to know where the crude oil came from, or whether it came from one or more federal leases.

Since MMS in the Notice of Proposed Rulemaking focused on Wyoming crude and sales in the Salt Lake refining area, it would be instructive to examine how Form 4415 data would affect the valuation of Wyoming crudes. The NYMEX index formulas would be used to value crudes as diverse as Wyoming Asphalt, which is a significant on-shore grade for federal leases. Wyoming Asphalt is valued based on factors of supply and demand relating to requirements principally for road pavers and roofing product manufacturers. Pipeline constraints are a substantial, and dynamic, factor in pricing Wyoming Asphalt crude. In the unlikely event that meaningful data from Form 4415 could be used to compare Wyoming Asphalt to WTI, such data would not be current. For example, had data been collected in 1996 from proposed Form 4415 for Wyoming crudes, factors such as the recent opening of the Express Pipeline in April 1997, delivering Canadian crude oil to Casper with subsequent delivery to the Salt Lake refining area, would have been ignored. Canadian crude movements on this pipeline have recently had a significant impact on the value of many Wyoming crude grades. Yet such logistical factors would not be reflected on any prior year's Form 4415 data. Although this is a dramatic example of a changing logistical condition, many more subtle, non-obvious conditions can impact location/quality differentials at any given time. The MMS proposal suggests that royalty payors could file for equitable relief when such conditions change. Yet conditions change as rapidly as the weather. The ensuing requests for administrative adjustments would create a virtual flood of filings and resulting chaos for MMS and royalty payors.[11]

VIII. THE PROPOSED RULE DOES NOT PROVIDE AN ADEQUATE BASIS FOR PUBLICATION OF EITHER AN INTERIM OR FINAL RULE

The proposed rule is so substantively flawed that its promulgation as an interim or final rule would likely be chaotic. Indeed, it would likely be impossible to implement the rule within sixty days because of the extensive and time-consuming accounting and record-keeping changes that would be required. In addition, MMS has, thus far, failed to observe the procedures required by law. For these reasons, MMS should not publish either an interim or final rule. If an interim rule were adopted, many of the costs of implementation would be wasted if, as undoubtedly would be the case, the rule were changed significantly when finally promulgated. Such changes would be inevitable given the irrational, unsupported premises of the proposed rule.

A. MMS has Failed to Provide the Requisite Notice and Opportunity for Comment

As noted, the preamble to the proposed rule explains that: "In addition to comments received on the Advance Notice of Proposed Rulemaking, MMS attended a number of presentations by: crude oil brokers and refiners, commercial oil price reporting services, companies that market oil directly, and private consultants knowledgeable in crude oil marketing. MMS deliberations were aided greatly by a wide range of expert advice." 62 Fed. Reg. at 3742. However, the proposed rule fails to identify the experts and consultants upon whom MMS relied or to describe the presentations that these individuals and others made.

Moreover, MMS has not been forthcoming in response to numerous Freedom of

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11 For the record, we wish to refer MMS to a March 27, 1997 report submitted in comments on the proposed rule by Barents Group, LLC, entitled "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." The report was based in part on a study of Texaco's operations. It concluded that "[m]ost of the information that would be collected on the proposed Form MMS-4415 will not be usable for MMS' intended purpose of estimating 'location/quality differentials' between 'market centers' and 'aggregation points.'" (Barents Report at p. iv.) In addition to finding huge, unnecessary administrative costs that would be imposed on both the private sector and MMS by the proposed reporting requirements, Barents found that the proposal would "yield no benefits in terms of its objective of developing more reliable estimates of the market value of the oil produced from federal lands." (*Id.*)

Information Act requests for the information necessary to analyze properly the proposed rule, and has not provided sufficient time to analyze the conclusory information that was provided. For example, MMS has refused to disclose information contained in the contracts, agreements, and correspondence relating to crude oil sales in California from the Long Beach litigation and a slide presentation and other materials provided by Vastar Resources, Inc., despite acknowledging that MMS relied on that information in promulgating the proposed rule. As a result, MMS has failed to give interested parties such as Texaco adequate notice and an opportunity to comment as required by the Administrative Procedures Act.

B. The Proposed Rule Fails to Provide a Sufficient Statement of Basis and Purpose or Explain Why MMS is Changing Settled Principles of Royalty Valuation

In promulgating a new rule, MMS is required by 5 U.S.C. § 553(c) (1994) to "consider[] the relevant matter presented," and "incorporate in the rules adopted a concise general statement of their basis and purpose." However, the proposed rule fails to provide an adequate basis or reasoned explanation for eschewing consideration of arm's-length sales prices in the production field. It would be arbitrary and capricious for MMS to change the existing regulations without providing an adequate basis or explanation. *See Motor Vehicle Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 52 (1983) (holding that an "agency must explain the evidence which is available, and must offer a 'rational connection between the facts found and the choice made'").

The proposed rule fails to articulate any factual basis for its conclusion that arm's-length transaction prices are no longer valid indicators of value. Indeed, the comments accompanying the proposed rule make clear that MMS began its analysis with the preconceived view that prices in the production field would not be used. The sole justification provided in the proposed rule is the unsupported premise that crude values in the field "could be" hidden in certain exchange agreements and that arm's-length sales prices "may" be suspect simply because companies deal with each other:

> Because of the frequency of oil exchange agreements, reciprocal deals between crude oil buyers and sellers, and other factors where the real consideration *could be hidden*, arm's-length contract prices would be used as royalty value only by producers who do not also produce crude oil. . . . MMS is proposing this limitation because of concerns that multiple dealings between the same participants, while apparently arm's-length, *may* be suspect concerning the contractual price terms.

62 Fed. Reg. at 3742 (emphasis added). A rulemaking should be based on fact, not suspicion.

By ignoring the market at the lease, the proposed rule utterly fails to meet the "most important" criteria stated for alternative proposals, because it does not "reflect the general concepts of fair market value -- the agreed-upon cash price between willing and knowledgeable buyers and sellers if neither were under undue pressure."

62 Fed. Reg. at 3746.

In similar circumstances, the Supreme Court has rejected an administrative record based on supposition as a basis for a new regulation:

> Recognizing that policymaking in a complex society must account for uncertainty, however, does not imply that it is sufficient for an agency to merely recite the terms "substantial uncertainty" as a justification for its actions. As previously noted, the agency must explain the evidence which is available, and must offer a "rational connection between the facts found and the choice made." . . . Generally, one aspect of that explanation would be a justification for rescinding the regulation before engaging in a search for further evidence.

Motor Vehicle Mfrs. Ass'n., 463 U.S. at 52 (citation omitted). The administrative record here provides *no evidence* that the existing crude oil valuation regulations are not working or should be rescinded.

The purpose of a comment period is to allow interested parties "to communicate information, concerns, and criticisms to the agency during the rulemaking process." *Connecticut Light & Power Co. v. NRC*, 673 F.2d 525, 530 (D.C. Cir. 1982), *cert. denied*, 459 U.S. 835 (1982). An agency has an especially high duty to disclose technical studies and data:

> In order to allow for useful criticism, it is especially important for the agency to identify and make available technical studies and data that it has employed in reaching the decisions to propose particular rules. . . . An agency commits serious procedural error when it fails to reveal portions of the technical basis for a proposed rule in time to allow for meaningful commentary.

Id. at 530-31. *Accord, Lloyd Noland Hosp. & Clinic v. Heckler*, 762 F.2d 1561, 1565 (11th Cir. 1985) ("The original notice cited only a 'study conducted by a HEW consultant.'"); *Portland Cement Ass'n v. Ruckelshaus*, 486 F.2d 375, 392 (D.C. Cir. 1973) (rejecting rulemaking based on testing identified only as having been "conducted by the

Environmental Protection Agency and/or contractors": "[w]e find a critical defect in the decision-making process in arriving at the standard under review in the initial inability of petitioners to obtain -- in timely fashion -- the test results and procedures used on existing plants which formed a partial basis for the emission control level adopted, and in the subsequent seeming refusal of the agency to respond to what seem to be legitimate problems with the methodology of these tests."), *cert. denied*, 417 U.S. 921 (1974).

Again, Texaco is unable to discern any evidence in the public record supporting the conclusions of MMS' consultants, which form the basis of the proposed rule.

C. MMS Has Not Complied with the Unfunded Mandates Reform Act of 1995

The proposed rule states that MMS is in compliance with the Unfunded Mandates Reform Act, because it determined that the proposed "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." 62 Fed. Reg. at 3750.[12] In Texaco's view, MMS' determination is

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12 The Unfunded Mandates Reform Act of 1995, 2 U.S.C. §§ 1501-1571 requires *inter alia* that:

> Unless otherwise prohibited by law, before promulgating any general notice of proposed rulemaking that is likely to result in promulgation of any rule that includes any Federal mandate that may result in the expenditure . . . by the private sector, of $100,000,000 or more (adjusted annually for inflation) in any 1 year, and before promulgating any final rule for which a general notice of proposed rulemaking was published, the agency shall prepare a written statement containing --
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> (1) an identification of the provision of Federal law under which the rule is being promulgated;
>
> (2) a qualitative and quantitative assessment of the anticipated costs and benefits of the Federal mandate, including the costs and benefits . . . ;
>
> (3) estimates by the agency, if and to the extent that the agency determines that accurate estimates are reasonably feasible, of --
>
> (A) the future compliance costs of the Federal mandate; and
>
> (B) any disproportionate budgetary effects of the Federal mandate upon . . . particular segments of the private sector;
>
> (4) estimates by the agency of the effect on the national economy, such as the effect on productivity, economic growth, full employment, creation of productive jobs, and international competitiveness of the United States goods and services, if and to the extent

faulty, and a cost benefit analysis should be performed. Even ignoring the huge administrative cost that would result from implementation of the proposed rule, the rule itself has been touted as a way to increase federal royalty revenues by "perhaps on the order of $50-100 million per year." (Questions & Answers, California Crude Oil Underpayments and Proposed Oil Valuation Regulations, MMS, Jan. 30, 1997.) In addition, absent publication of an explanation of why the least costly alternative was not chosen, 2 U.S.C. § 1535 requires MMS to "identify and consider a reasonable number of regulatory alternatives and from those alternatives select the least costly, most cost-effective or least burdensome alternative that achieves the objectives of the rule, for . . . the private sector, in the case of a rule containing a Federal private sector mandate." MMS has not identified nor apparently considered any regulatory alternatives to the proposed rule, notwithstanding its acknowledgment that the proposed rule will impose a heavy administrative burden.

D. MMS Has Not Complied with Executive Order 12630

Executive Order 12630 requires MMS and other executive departments and agencies to "review their actions carefully to prevent unnecessary takings" and to "account in decision-making for those takings that are necessitated by statutory mandate." 53 Fed. Reg. 8859 (1988). Specifically, the Executive Order requires MMS to "identify the takings implications" of the proposed rule and "address the merits of [the proposed rule] in light of the identified takings implications." *Id.* at 8862. The underlying purpose of the Executive Order is to ensure "[r]esponsible fiscal management and fundamental principles of good government" by requiring "government decision-makers [to] evaluate carefully the effect of their administrative, regulatory, and legislative actions on constitutionally protected property rights." *Id.* at 8859.

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that the agency in its sole discretion determines that accurate estimates are reasonably feasible and that such effect is relevant and material; and

(5) (A) a description of the extent of the agency's prior consultation with elected representatives (under section [1534 of this title]) of the affected State, local, and tribal governments;

(B) a summary of the comments and concerns that were presented by State, local, or tribal governments either orally or in writing to the agency; and

(C) a summary of the agency's evaluation of those comments and concerns.

2 U.S.C. § 1532(a).

MMS did not comply with Executive Order 12630, based on its certification that "the rule does not represent a governmental action capable of interference with constitutionally protected property rights." 62 Fed. Reg. at 3750. Given the fact that the proposed rule is contrary to the express provisions of existing federal oil and gas leases and flies in the face of seventy-five years of settled law and contract-backed expectations, MMS' certification is erroneous and unjustified. Accordingly, MMS should comply with the requirements of Executive Order 12630.

E. MMS Has Not Complied With Executive Order 12866

The Office of Management and Budget in December 1996 determined that the proposed rule was a "significant regulatory action" within the meaning of Section 3(f)(4) of Executive Order 12866. That section provides that a "'[s]ignificant regulatory action' means any regulatory action that is likely to result in a rule that may . . . [r]aise novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in this Executive order." 58 Fed. Reg. 51735, 51738 (1993). However, MMS concluded that the proposed rule would not have a significant *economic* effect, as defined by Section 3(f)(4) [sic][13] of the Executive Order. The Executive Order defines a "[s]ignificant regulatory action" as one that is likely to result in a rule that may:

> (1) Have an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities;
>
> (2) Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;
>
> (3) Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof; *or*
>
> (4) Raise novel legal or policy issues . . . .

58 Fed. Reg. at 51738.

Because the criteria are listed with the disjunctive "or," meeting *any* one of the four criteria is sufficient to render the proposed rule a "significant regulatory action," which triggers the requirement that a cost/benefit analysis be conducted. In addition, if

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13 The correct citation is Section 3(f)(1).

the first criteria of an "annual effect on the economy of $100 million or more" is present, then the required cost/benefit analysis must be much more rigorous. Yet, the public record released by MMS shows no evidence that it has conducted any cost/benefit analysis required by Executive Order 12866. In particular, MMS has not conducted an assessment of the costs and benefits of potentially effective and reasonably feasible alternatives. Nor has MMS made available any evidence that would support such a cost-benefit analysis.

F. MMS Has Not Complied With the Paperwork Reduction Act

The Paperwork Reduction Act, 44 U.S.C. § 3506 (1994), requires each federal agency to reduce information collection burdens on the public and to increase information program efficiency. 44 U.S.C. § 3506(b)(1)(A), (b)(1)(B). Proposed Form 4415 would achieve the opposite result. It would substantially increase the information collection burden on the public, and greatly decrease the efficiency of the royalty management program. MMS estimates that Form 4415 would create an additional reporting burden of 32,000 hours, requiring each royalty payor to examine each of its crude oil exchange contracts and to compile location differential information therefrom. As explained above, this estimate is a gross understatement of the burden that would be imposed on royalty payors.

MMS submitted its Form 4415 proposal to the Office of Management and Budget for review under Section 3507(d) of the Act. 62 Fed. Reg. at 3750. Pursuant to Section 3506(c)(3), MMS was required to certify that the information requirement would be implemented in a manner consistent so much as possible with the existing reporting and recordkeeping practices of those who are to respond. 44 U.S.C. § 3506(c)(3)(B),(E). Again, as explained above, the proposal would require federal royalty payors to compile information in an entirely new fashion, which would be extremely burdensome and costly to achieve. In sum, the Form 4415 proposal violates the Paperwork Reduction Act.

IX. TEXACO'S ALTERNATIVE PROPOSALS

Texaco recommends that MMS expand MMS' royalty-in-kind program in fields where MMS might have any concern that sales prices at the lease do not reflect market value. For example, MMS could contract with firms with production and marketing experience to sell MMS royalty barrels either at the lease or in market centers if conditions for a sale might be more favorable there. Such firms would sell the royalty barrels for the highest possible return and would pay MMS that price minus negotiated costs and a marketing fee. With such an expanded program, MMS might achieve dramatic administrative cost savings, as evidenced by a similar program used by the

Province of Alberta, Canada. We understand that the Province of Alberta currently employs only 30-35 people to run a royalty-in-kind program that sells about 146,000 barrels of crude oil per day. By contrast, MMS employs several hundred people to manage and audit cost royalty payments on about 205,000 barrels per day. Texaco stands ready to provide guidance and assistance should MMS so require.

As a second alternative, Texaco proposes a methodology to establish crude oil value in the field by utilizing transactions involving a representative amount of lessee crude oil production sold arm's-length to third parties at or near the lease, with such values used in determining royalty for comparable production. This methodology would be based on designing bid packages that include appropriate volumes of comparable quality crude oil in a respective area. These volumes would be offered to qualified, credit-worthy third party purchasers and sold at the highest competitive bid. Comparable production in the area would be valued for MMS royalty purposes on the same basis as the volumes sold, adjusted if necessary for transportation or appropriate quality differentials. The royalty value would therefore be based on documented purchase and sales transactions between arm's-length buyers and sellers at the lease. Again, Texaco offers its assistance to the MMS in developing and implementing such a program.

X. CONCLUSION

Texaco urges MMS to withdraw the "Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases" because it unfairly and unlawfully attempts to boost government revenues by improperly valuing crude oil for royalty purposes and taking increased value to crude oil after it leaves the lease. The proposal is based on fundamentally false assumptions about crude oil markets and blatantly discriminates against integrated firms. We hope to assist MMS in any effort to clarify or improve methods to ascertain values of crude oil at the lease. We believe that such methods must continue to use arm's-length sales prices at the lease as a matter of fairness, practicality and law.

Sincerely,

James C. Pruitt