July 26, 2011

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Office of Natural Resources Revenue
U.S. Department of the Interior
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SUBJECT: Docket Number ONRR-2-11-0005
RIN 1012-AA01
Advance Notice of Proposed Rulemaking
Federal Oil and Gas Valuation
Marathon Oil Corporation Comments

Marathon Oil Corporation (MRO) is responsible for the valuation and payment of royalties on substantial volumes of oil and gas produced from Federal leases. MRO appreciates ONRR's stated intent of this rulemaking process to provide regulations that would 1) offer greater simplicity and certainty and clarity and consistency in production valuation for mineral lessees and mineral revenue recipients; 2) be easy to understand; 3) decrease industry's cost of compliance; and 4) provide early certainty to industry and ONRR that companies have paid every dollar due. We further appreciate ONRR's affirmation that the final regulations must be revenue neutral. MRO supports the joint industry comments filed by API and COPAS and USOGA, and MRO submits the following supplemental comments in response to specific questions posed in your May 27 advance notice of proposed rulemaking.

Index Pricing

Question: The ONRR is seeking comment on the existing use of index pricing to determine the value of production for oil royalty purposes and whether the use of index pricing should be expanded or altered. Additionally, the ONRR is considering the use of index pricing in valuing Federal gas for royalty purposes.

Comments: The existing use of index pricing to determine the value of production for oil royalty purposes is limited to four types of disposition: 1) non arm's-length disposition outside of Alaska, California and the Rocky Mountain area; 2) a sales contract that does not reflect the

total consideration for the value of production; 3) a breach of the lessee's duty to market for the mutual benefit of the lessee and the lessor; and 4) at lessees option, after one or more arm's-length exchanges, or after one or more inter-affiliate transfers, even when the oil is then sold at arm's-length. MRO supports expanding the use of oil index pricing to provide lessees the option of using index values for all Federal oil that is sold at arm's-length, rather than limiting it to arm's-length sales that occur after one or more arm's-length exchange, or after one or more inter-affiliate transfer. If the use of oil index pricing is expanded, actual location and quality differentials (including actual pipeline quality bank adjustments) should continue to be applied. Additionally, we support the use of index pricing, at lessees option, in valuing Federal gas for royalty purposes, regardless of whether gas is disposed of under an arm's-length contract or under a non arm's-length contract. Any such gas index price methodology must apply to all gas products contained in the produced gas stream, including but not limited to retrograde condensate and drip condensate and scrubber condensate and NGL's. The first index point that lessees gas production actually flows to (or through) should define value, with adjustments for location and quality between the Facility Measurement Point (FMP) and the first market point applied to establish value at the FMP. Lessees should not be subjected to the additional burden of a safety net provision as contained in the Indian Gas Valuation Regulations.

Question: We seek input on how well index prices currently represent the value for oil and gas produced in different regions or areas of the country, such as states on the Gulf of Mexico coast (including Texas, Louisiana, Mississippi, and Alabama, as well as onshore areas within those states), the Midwest (including Oklahoma and North Dakota), the Southwest (including New Mexico and the Permian and San Juan Basin areas), the Rocky Mountain area (including Wyoming, Montana, and Colorado and Utah outside the San Juan Basin), the West Coast states (primarily California), and Alaska. Please identify what index publications you believe apply to what parts of these areas and the relative advantages and disadvantages, and strengths and weaknesses, of using each of the identified published index prices.

Comments: Oil index prices adequately represent the value for oil produced from states on the Gulf of Mexico coast (including Texas, Louisiana, Mississippi, and Alabama, as well as onshore areas within those states), the Midwest (including Oklahoma and North Dakota), the Southwest (including New Mexico and the Permian and San Juan Basin areas). NYMEX calendar month average is the dominant WTI basis in these areas, and Petroleum Argus is the dominant basis differential (grade differential) in these areas. Oil index prices are not adequate for oil produced from states in the Rocky Mountain area (including Wyoming, Montana and Colorado and Utah outside the San Juan Basin), the West Coast States (primarily California) and Alaska. NYMEX calendar month average (CMA) is an adequate price basis for these areas, but establishing value at or near the lease is problematic due to a lack of published grade differentials. Gas index prices adequately represent the value for gas produced from all regions or areas of the country except Alaska. The dominant gas index price publications are Platts Inside FERC's Gas Market Report and Platts Gas Daily.

Question: We also seek input on whether value should be based on first-of-month prices, daily spot prices, or some mixture of the two when considering the use of index prices.

Comments: First-of-month prices and daily spot prices are comparable indications of value. The difference between the two is negligible, fluctuating from positive to negative as market conditions change, with no particular bias toward one or the other over time. First-of-month prices are the dominant price basis for gas sales contracts at or near the Facility Measurement Point. First-of-month prices are prescribed in the Indian Gas Valuation Rule. First-of-month prices are recommended as the prescribed index for Federal gas valuation.

Question: In addition, we seek input on how to best value this gas for royalty purposes in situations where gas from Federal leases is produced in areas not covered by index pricing, or where limited reported spot market activity exists.

Comments: Gross proceeds is an accurate measure of value and should be the default valuation in situations where gas produced from Federal leases is not covered by index pricing, or where limited reported spot market activity exists. In the absence of an arm's-length sales contract by lessee or lessee's affiliate, then lessee should submit a request for valuation determination or propose an alternative valuation methodology.

Question: Does the concentration of Federal production in some areas of the country create any potential problems with relying on index prices in those areas, now or in the future?

Comments: The concentration of Federal production in some areas of the country has no impact on the transparency or liquidity of index prices in those areas.

Question: Finally, we request comment on whether ONRR should use published index prices to value Federal oil and gas sold under non-arm's-length contracts as well as arm's-length contracts.

Comments: Published index prices adequately represent the value for oil and gas that is produced in most regions or areas of the country, and should be an option for lessees to use to value Federal oil and gas sold under non arm's-length contracts as well as arm's-length contracts.

<u>Transportation Allowances</u>

Question: The ONRR is examining possible alternatives to the requirement to track actual costs for determining transportation and to address the bundling issue. Please consider the following:

If ONRR were to adopt index-based valuation, the point at which the index prices are compiled and published may or may not be the point of actual sale for particular gas, and the costs of transportation to the actual point of sale may not be relevant. However, the index pricing point would be remote from the lease or unit in virtually all circumstances, and value at the index

pricing point may not reflect value at or near the lease or unit. If ONRR employed index prices to value Federal oil and gas for royalty purposes, what methods should be considered that would adjust for location differences between the lease or unit and the index pricing and publication point?

Comments: If ONRR expands the use of index prices to value Federal oil for royalty purposes, ONRR should preserve the use of actual adjustments for location and quality differences between the lease or unit and the index pricing and publication point. If ONRR employs index prices to value Federal gas for royalty purposes, a location differential consisting of a flat transportation component (escalated annually) and a variable fuel component (fixed percentage of inlet volume or MMBtu) which is comparable to the actual arm's-length transportation costs in the field or area, should be calculated and published by ONRR similar to the monthly gas prices that ONRR publishes for Indian Index Zones.

Question: In the interest of simplifying the determination and verification of location adjustments, should ONRR consider prescribing either a fixed differential amount per unit volume (thousand cubic feet (Mcf) or million British thermal units (MMBtu)) or a fixed percentage to be deducted from the index value to account for location differences?

Comments: Revenue neutrality can best be achieved by calculating a location adjustment that consists of a fixed transportation component (escalated annually) and a variable fuel component (fixed percentage of inlet volume or MMBtu) that is comparable to actual arm's-length transportation costs in the field or area.

Question: Should ONRR apply a fixed differential amount per unit volume to all production in a particular area or that is transported through a particular pipeline?

Comments: Applying a fixed differential amount per unit volume to all production that is transported through a particular pipeline would more accurately reflect lessees actual cost of transportation, but would require voluntary disclosure of specific transportation system cost data by service providers that do not have a royalty obligation to the Federal Government, and would be administratively burdensome for lessor and lessee to implement.

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

Comments: A flat percentage of the index value, applied on a regional basis, would certainly provide simplicity, but a flat percentage of index value would not likely achieve revenue neutrality. A cap and a floor would increase the chance of achieving near term revenue neutrality, but the cap and floor should be escalated annually in order to maintain revenue neutrality over time.

<u>Processed Gas and Processing Allowances</u>

Question: The ONRR is considering accounting for the value of liquid hydrocarbons contained in the gas stream by applying an adjustment or ''bump'' to the index price, applicable to residue gas when gas is processed, in lieu of valuing residue gas and extracted liquid products separately, calculating the actual processing costs, and deducting those costs from the value of the extracted liquids (the procedure required under 30 CFR 1206.153(a) and 1206.158 through 1206.159). This adjustment could be based on, or could incorporate, a number of components, including the following:

Gas quality (either Btu content or gallons per Mcf (GPM)).

Comments: MRO supports accounting for the value of liquid hydrocarbons contained in the gas stream by applying an adjustment or "bump" to the index price, applicable to residue gas when gas is processed, in lieu of valuing residue gas and extracted liquid products separately, calculating the actual processing costs, and deducting those costs from the value of the extracted liquids, except however, when gas is processed under a keep-whole contract whereby a lessee is kept whole on inlet MMBtu's but the lessee does not receive any value or "uplift" for entrained liquids.

Question: The differential between the gas price and the oil or natural gas liquids (NGL) price similar to a ''frac spread'' or a ''processing margin.''

Comments: The differential between relevant gas index prices and corresponding NGL prices similar to a "frac spread" should be taken into consideration when establishing the LHC adjustment or "bump". This differential should be reviewed annually and the LHC adjustment or "bump" should be adjusted accordingly to ensure revenue neutrality.

Question: Certain plant operation factors, such as shrinkage, producer processing costs, and plant operations costs.

Comments: Plant operation factors, such as shrinkage, producer processing costs, and plant operations costs should be taken into consideration when establishing the LHC adjustment or "bump". These operating factors should be reviewed annually and the LHC adjustment or "bump" should be adjusted accordingly to ensure revenue neutrality.

Question: We also seek input regarding whether such an approach could eliminate the burden of accounting for allowable costs to process gas and reduce or eliminate the potential for disputes over unbundling of gas plant charges, without reduction in royalty value. The ONRR could calculate this adjustment on a monthly basis and make it available on our website expressed in the form of a price per unit volume (MMBtu or Mcf).

Comments: Accounting for the value of liquid hydrocarbons contained in the gas stream by applying an adjustment or "bump" to the index price, applicable to residue gas when gas is processed could eliminate the burden of accounting for allowable costs to process gas and

reduce or eliminate the potential for disputes over unbundling of gas plant charges, without reduction in royalty value.

Question: ONRR could maintain current reporting requirements for processed gas and NGLs but establish a fixed processing allowance. This fixed allowance could be either on a nationwide basis for all Federal gas or on a narrower basis, such as offshore and onshore leases; offshore regions and onshore basins; or gas-plant-specific.

Comments: if ONRR maintains current reporting requirements for processed gas and NGLs but establishes a fixed processing allowance, the fixed allowance should be on a plant specific basis and should be at lessee's option. This would be similar to the IRS allowing taxpayers to choose between itemizing deductions or taking a standard deduction on a Federal Income Tax return.

Questions: We seek input regarding the advantages and disadvantages of simplifying processed gas royalty reporting and payment by either of the aforementioned methods. We also are interested in other methodologies that would simplify the reporting associated with gas processing allowances or, if possible, eliminate the allowances by substituting a market-based proxy to reflect the value of liquid hydrocarbons contained in the gas stream.

AND

In addition, ONRR requests your input on how the various methodologies would affect your business practices, bookkeeping, etc.

Comments: The advantages of simplifying processed gas royalty reporting and payment include 1) reducing the administrative burden associated with audits, and 2) eliminating the potential for disputes. The disadvantages of simplifying processed gas royalty reporting and payment include 1) time-consuming and costly system changes to accommodate revised valuation procedures, and 2) an increase in lessees administrative effort associated with manually downloading and keying the index price values from ONRR's website. This manual override would create settlement diversity between the Federal Government and other owner types (State royalty interest, private royalty interest and working interest) which would require special handling.

<u>Other Issues</u>

Question: The ONRR also is interested in receiving comments on any other alternative methodologies. If you propose a methodology different from those discussed above, please explain how the suggested methodology would meet the goals outlined above and why you believe your methodology is the best alternative.

Comments: Marathon has no other alternative methodology to propose.

In closing, MRO stands ready to continue to invest in safe exploration and development of federal oil and natural gas resources, and we look forward to participating in public workshops to discuss possible changes to the oil and gas valuation regulations after the written comment period closes and ONRR has had a reasonable time to review and analyze the comments.

Dan Riemer, Marathon Oil Corporation