Copies of Correspondence and Testimony
referenced in
Comments of the California State Controllers' Office
November 5, 1997

Written Statement
of Danielle Brian
Executive Director
Project On Government Oversight
before the Committee on Resources
Subcommittee on Energy and Mineral Resources
U.S. House of Representatives
September 18, 1997

I appreciate the opportunity to present my views on the Committee's inquiry concerning the proposals to require the Department of the Interior's Minerals Management Service (MMS) to take royalties in kind, rather than in value, which is the current norm. I am the Executive Director of the Project On Government Oversight, since 1981, a non-profit, non-partisan government watchdog group. Our mission is to investigate, expose and remedy fraud, mismanagement and subservience to corporate interests by the federal government.

For the past four years, I have been examining the current federal oil royalty collection program and its astounding failures. I have not had experience looking into gas royalty collections, but I do know enough to know that the oil and gas markets are different enough that one cannot transpose knowledge of oil to the gas market. Over these past few years, it has become crystal clear that the American public, along with all other landowners with oil leases, have been losing out on literally billions of dollars owed to all of us, simply because we were relying on the arbitrary and archaic system of posted prices which undervalues crude oil.

BACKGROUND ON WHY RIK IS BEING PROPOSED:

Since the 1960s in California, there has existed a differential between what the major refiners were posting as a value and what that oil was actually worth on an open market. Since the NYMEX began trading crude oil contracts, it has been clear that a problem exists outside California as well. The problem is that all land owners, including the federal government, have been paid royalties on the lower posted price, rather than on the value of the oil as determined by the open market. Let me emphasize that I am talking about the actual value of unrefined crude oil, the reported prices actually paid for crude oil, and not downstream values.

We believe the companies should be required to pay royalties based on value. The companies should not be required to pay one nickel more than what the crude is worth, but they should pay every penny they owe. The amount owed is set by the open market, which determines the prices, not the phoney posted price system. The NYMEX reports the prices that are paid -- it does not project prices nor is it an index -- it is a reporting of the actual prices companies are paying and receiving. Why shouldn't landowners receive royalties on the values corporate lessees actually received or acknowledged for the crude oil?

While POGO was working to expose this discrepancy, MMS was working, too. In a move that has not been given the accolades it deserves, MMS concluded that relying on the posted price is unworkable, inefficient and most importantly it was allowing billions of dollars to go uncollected across the country.

They came to this decision after the release of their Interagency Task Force that was charged with investigating the existence of the postings/market discrepancy in California. I apologize for the length of this quote from their report, but I believe it is critically important:

> The records discussed below, show California refiners generally preferred purchases or exchanges of California crude oil because, **at prevailing posted**

> **prices, profit margins were much higher than for the ANS (Alaska North Slope) alternative.**
>
> **Therefore, the documents exhibit the extent to which the California oil pricing system, i.e., refiners' posted prices, undervalued California crudes' values to the refiners.** Since these refiners also produced California Federal crude, and to the extent they paid royalty on posted prices, **the royalties they paid did not reflect the value of the crude oil to the company**. In most cases, its real value is never seen in the contract transactions because the crude is either transferred to the refining arm of the company, or it is exchanged with another refiner for replacement crude oil. (emphasis added)

In other words, the companies were not paying the royalties they knew they owed the government. In addition to the use of postings to deliberately underpay royalties, integrated companies often use buy/sell exchanges to hide the true value of crude oil. This is not as complicated a concept as it sounds.

Let's take, for the sake of argument, the production arm of a company called Texxon. They "sell" a barrel of their crude to Shellaco for $10, even though the barrel was worth $12 on the open market. At the other end of the pipeline, the refining arm of Texxon "buys" a barrel of crude from Shellaco for $10. Neither company has lost any money, even though they "bought" and "sold" barrels for $2 below the market price. What they have established, however, is a paper trail for MMS auditors that states that in an arm's length transaction, the price on these barrels was $2 below the market price. These are the kinds of games that these companies play in order to avoid paying the government, and other landowners, what they owe.

So MMS decided to make some changes. This, as you know, is not easy for a bureaucracy to do. They recognized the need to streamline and make more efficient the royalty collection process, so they recommended moving to the market-based valuation system as reported by the NYMEX for East of the Rockies, and Alaska North Slope for California. This is the system the integrated major oil companies use to value their own oil internally, and of course, these are the prices being paid on the market. Not surprisingly, Big Oil raised its head. Until then, these majors had been quite silent through this debate.

Now they realized these improvements to the system -- which I note have not yet been finalized or implemented -- will result in their having to pay the federal government more in royalties. Not surprisingly, they did not like what they saw.

Law firms and economists were suddenly paid to deluge MMS with criticisms of their proposed new rule. It should not come as a surprise to us that industry does not want to have to pay what it owes for producing on public land -- it has been getting away with cheating the public for decades.

These efforts have produced two baseless lies which have, unfortunately, shaped this debate: The first lie is that RIK would be better for smaller independents, because MMS' proposed Rule is too burdensome for them, or that they would have to pay royalties on prices they did not receive. MMS' recent revision to its proposed Rule makes this argument baseless. That is, the revised rule allows them to pay royalties on their receipts, not a value derived from NYMEX prices. Simply put, the trade associations that purport to represent the interests of small independent oil producers are doing their members a great disservice by creating this aura of fear around the new Rule.

The second lie is that paying royalties on the value of the crude imposes an unfair "duty to market." This is a sham. They have always had a duty to market. For example, the existing rules, put into effect in 1988, state that a lessee has a ". . . duty to the lessor to market the production for the mutual benefit of the lessee and the lessor. . ." and provides that MMS may take over the valuation computation if this is not done. The new Rule allows for the deduction of location and quality differentials. The myth of additional "value" added by marketers to the crude, over and above these differentials, is a fig leaf industry is hiding behind so as not to admit they should have been paying royalty owners higher royalties all along.

The methodology used by MMS to determine location differentials, i.e. the differentials used by the companies in making exchange agreements, would subsume all other costs if they existed. Of course, we don't believe they do exist.

To demonstrate this point, before 1986 spot and posted prices East of the Rockies tracked each other quite closely, once one accounted for transportation. Therefore, obviously there was no added value between the wellhead crude and the crude at the market. Now, with a persistent differential between spot and posted prices, there is no reason to attribute it to a purported marketing cost. Rather, it is an indication of the undervaluation of the crude.

The point is also demonstrated by the fact that a number of large independent producers are getting prices that are tied to the NYMEX.

WHY A NATIONWIDE RIK PLAN IS NOT IN AMERICA'S BEST INTEREST:

Ironically, industry's proposed RIK plan in some ways would not be very different from what we currently have. We are already relying on private marketers to get the best price available for the crude produced on federal land. We simply have not been sharing in that value. This system has not been good for the federal government, or any other land owners.

One reason industry's RIK plan is not in America's best interest is that it will most likely result in royalties based on posted prices. The marketers of the government's oil would make their profit by collecting the difference between postings and market prices -- they would buy the government's oil at postings, and sell it at the market price. On the other hand, under the proposed Rule, this difference would all go to the government, except in arm's length contracts involving small independent producers, who themselves, may not be receiving full value.

Independents have suffered under the posted price system along with the federal government, and other landowners. As characterized by one industry association, independents are "price takers" not "price setters." Like independents, MMS would be trying to sell even smaller quantities of crude. MMS' feasibility study notes that even the marketers do not see any benefit from aggregation of federal oil, assuming aggregation is possible. The lack of access to transportation to the market drains all of us our bargaining position at the wellhead.

But instead of improving the situation for independent producers, the RIK program locks the federal government into the same powerless condition where we must accept whatever price is offered to us by the companies that control or own local pipelines. And guess where we end up? Back at posted prices.

According to Louisiana's testimony, the potential savings we may see by reducing administrative costs, are likely to be largely offset by the marketing experts who would need to be hired by the government to handle the RIK oil.

More significantly, the potential administrative savings would likely amount to only a fraction of the royalties we would collect if we implement the new Rule. The total operating expense of MMS is $60 million annually. The proposed Rule is estimated to increase MMS' revenue by at least $100 million annually. Even if the RIK plan allowed us to completely eliminate MMS (which it couldn't as MMS is responsible for much more than just crude oil royalty collection), the government would <u>still</u> have to collect increased revenue of more than $40 million annually to be as effective as a NYMEX value system.

In MMS' feasibility study, however, they stated "...despite direct inquiries, marketers were not able to provide convincing arguments or evidence that oil RIK would be revenue positive."(p.16) If even the people who would stand to make a profit off the RIK plan cannot show that the government would be any better off with it, why on Earth should we do it?

We have heard today how effective the RIK program is in Alberta. There are enough fundamental differences in the relationship between government and industry in Alberta that their system could not be transposed to the United States. I submit that our industry would not be as enthusiastic about RIK if it were subject to such restrictions as exist in Alberta.

THE PLIGHT OF INDEPENDENTS:

I understand from your earlier hearing on this subject that Rep. Dooley is particularly concerned about the impact of MMS' new rule on the independents. I am also concerned about the impact on small independents, and it is quite clear that MMS has been too. In response to the IPAA's concerns, MMS revised the Rule to more than compensate for their unique situation. If the independents do not have access to transportation to the market, as is true in California; if they are captive sellers, the MMS has proposed that these companies may pay royalties based on what they received for the crude.

WE SHOULD NOT REINVENT THE WHEEL:

Other land owners across the country — States, private land owners and Native American tribes — are rising up, in some cases filing law suits, and demanding payment based on value — the full value owed to the land owners. The State of Texas, which testified at your recent hearing, has completed a settlement with Chevron. Private royalty owners in Alabama are currently settling with Mobil. ARCO is paying New Mexico. All of these States are being paid royalties based on the NYMEX. The State of Louisiana is being paid by all leaseholders based on the spot prices at St. James. These States have testified that given the choice, they have rejected RIK programs in favor of being paid on the value of the oil. The Federal government should learn from the decisions being made by States across the country not to use RIK.

There may very well be unique circumstances where RIK could work. This does not mean, however, that MMS should accept a voluntary plan, where companies can dump on us their poor quality, small quantity or difficult to transport crude, they would rather not have to deal with.

I am sure it is not lost on you that industry is in favor of RIK. Of course they are. They are interested in their bottom line, not ours. You can't blame them for trying, but we certainly shouldn't let them get away with it.

FOLLOW-UP ADDRESS

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Written Statement
of
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before the
Committee on Resources
Subcommittee on Energy and Mineral Resources
U.S. House of Representatives
September 18, 1997

Dear Madam Chairwoman and Members of the Committee:

My name is Edwin S. Rothschild, Energy Policy Director of Citizen Action, a nationwide consumer organization with members in 31 states. Citizen Action has been involved in energy issues since its founding in 1978. I have worked as a consumer advocate on energy issues since 1972.

We are here today to discuss proposals for the federal government to take its oil and gas royalties in kind. Before examining such proposals in detail, we would like to make several observations that bear directly on this issue.

We note, first, that oil and gas industry efforts promoting royalty in kind began in earnest only after the Minerals Management Service ("MMS") proposed changing the valuation method for the collection of royalties on oil and gas produced from federal onshore and offshore lands. It is strange, to say the least, that for 75 years oil and gas leaseholders had no burning desire for a royalty in kind system and were content with a system of posted prices. When questions began to be raised about the posted price system and when proposals were advanced to go to a system using prices based on the competitive marketplace, then royalty-in-kind suddenly had some appeal. Moreover, having spent a great deal of time and effort in opposing the federal government's sale of the prolific Elk Hills oil field, we are struck by the irony of the industry now wanting to get the government into the oil business, after arguing vociferously about the need to get the government out of the oil business.

As a consumer organization, we are really not wedded to any one system of collecting federal oil and gas royalties as long as those methods or systems chosen ensure that the public, which own the resources, receive the maximum revenues to which they are legally entitled under existing economic conditions. Moreover, as Members of Congress you have the very important duty of examining and reviewing such proposals very closely because, as elected government officials, you have a fiduciary responsibility to ensure that the public, that is the U.S. Treasury, obtains full value for their property.

We also would like to note that significant structural changes in the oil and natural gas marketplace must be recognized when considering various royalty proposals. For example, over the past 25 years the oil industry has undergone enormous consolidation. A veritable handful of companies produce most of the oil on federal lands. Those same producers are also the nation's largest oil refiners. In these companies, oil and gas production almost always goes through one or more transfers within the companies before it is sold, exchanged, or refined by the companies. There is no such thing as an arms-length transaction between affiliates or subsidiaries of the same parent company. Furthermore, the large companies rarely sell oil outright; they almost always exchange away what they do not keep for their own use. Since most of the oil produced on federal lands is produced by large, vertically integrated oil companies and since there are now only a small number (and likely soon to be even fewer) of those companies in the marketplace, a real market price transaction does not exist on which to base federal royalties, or state royalties for that matter. Therefore, MMS's proposal to use NYMEX as the base upon which market prices can be determined not only makes economic sense, but is highly appropriate.

This is not to say that royalty in kind should never be used. On the contrary, it may make sense in a number of instances -- selling offshore volumes of natural gas, for example. However, we would strongly urge the Committee not to accept the clearly self-serving comments of oil and gas industry executives that royalty in kind should be applicable to any and all leases, especially not on a voluntary basis, as a few have suggested. Rather, we urge the Committee to examine the industry's views under a clear and powerful microscope keeping in mind that it is highly unlikely that oil and gas producers would promote a policy that would actually increase government revenues at their expense.

In your letter of invitation, Madam Chairwoman, you asked about the connection between structural changes in the oil and gas industry and the implementation of a royalty in kind collection program. We believe that there is sufficient evidence to conclude that consolidation in the oil and gas industry and the lack of effective competition in some key markets could undercut a royalty in kind program.

Tables 1 and 2 below indicate how the ten largest oil producers in the nation have remained remarkably stable over time, despite the sharp decline in the overall number of producers and the overall decline in domestic petroleum output. In 1982, the *Oil & Gas Journal* proudly remarked, "The mere compilation of the OGJ 400 demonstrates the immense size and diversity of the petroleum industry." Yet, in a few short years, this number would be whittled down, in part because of changing economic conditions and in part because of a spate of mergers and acquisitions. Gulf was devoured by Chevron; Mobil acquired Superior; Texaco bought out Getty; Sohio was captured by British Petroleum. There were many others, but these were some of the largest consolidations during the 1980s. By 1991, the *Oil & Gas Journal* had to report that it's once proud OGJ 400 had become the OGJ 300, because "industry consolidation has slashed the number of public companies." And, again in 1995, the *Oil & Gas Journal* reported that the OGJ 300 had shrunk down to the OGJ 200. "Mergers, acquisitions, and other forms of consolidation have again shrunk the Oil & Gas Journal list of publicly-traded oil and gas producers in the U.S." Today, the consolidation of oil producers continues. The production units of Shell and Mobil, for example, have joined forces in California,[1] and Texaco recently purchased Monterrey Resources for $1.4 billion.[2]

Industry consolidation also has taken place at the oil refining and marketing levels of the industry. The disappearance of independent refiners and marketers and the combination of some of the nation's largest integrated oil companies has sharply reduced the number of domestic oil purchasers. With fewer domestic crude oil purchasers, there is less overall competition, that is, fewer bidders for the remaining supplies that are sold into the open market. Similarly, there is also growing consolidation in natural gas and electricity markets. Such combinations include pipelines buying pipelines; gas companies buying electric companies; electric companies buying gas companies; and electric companies buying electric companies -- all with an eye to controlling delivery of Btus and kilowatts from production or generation to the burner tip. The growing concern by the remaining small and some large independent oil and natural gas producers about wellhead prices for oil and natural gas has a lot to do with this growing consolidation in the oil and natural gas markets. In some regions, independent producers have been forced to sell at much lower prices because purchasers control the only means of moving the product from the field to market.

Table 1 traces the changes in oil (liquids) production as reported in the industry trade publication, *Oil & Gas Journal*, for the years 1982-1996. It clearly demonstrates that Exxon, BP, Arco, Shell, Texaco, Chevron, Mobil and Amoco have dominated U.S. oil production. Not surprisingly, these are the same eight companies which are among the ten largest payors of oil and gas royalties (Table 3) to the U.S. Government paying 61% of all onshore and offshore royalties paid for oil. Moreover, as Table 3 also shows, these same companies pay a much smaller part of the royalties on natural gas production (42%) suggesting that production is dispersed among more companies, including many independents.

Table 1

United States Liquids Production (000 bbls)

Year	Exxon	BP/ Sohio	Arco	Shell	Amoco	Texaco (Getty)	Chevron (Gulf)	Gulf	Mobil (Supr)	Getty	Sun/ Oryx	Phillips	USX	Unocal	Top 10	Top 400 300, 200
1982	270000	253200	222000	190000	151000	127000	121000	104000	103000	102000					1643200	NA
1983	285000	223800	238000	191000	149000	124000	116000	100000	102000	104000					1632800	2357300
1984	285000	232000	240000	195000	149000	210000	115000		113000		71000	62000			1539000	2239378
1985	281000	262300	237000	193000	144000	233000	214000		120000		71000	68000			1684300	2417010
1986	278000	263100	240000	209000	142000	215000	199000		114000				63740	63000	1660100	2360400
1987	276000	309000	243000	204000	142000	197000	185000		112000		59000			63000	1668000	2343500
1988	278000	314000	246000	193000	149000	192000	177000		111000		57000			64000	1660000	2312600
1989	253000	286000	241000	180000	142000	175000	176000		107000		53000			63000	1560000	2145100
1990	234000	269000	233000	168000	127000	167000	167000		102000		51000			52000	1467000	2029000
1991	266000	269400	244000	167000	116000	166000	166000		121000			47000		57000	1515400	2094000
1992	216000	251800	242000	163000	107000	158000	158000		114000			50000		47000	1409800	1967000
1993	202000	228900	221000	147000	100000	155000	144000		111000			47000		48000	1308900	1877000
1994	206000	220800	216000	151000	93000	148000	134000		110000			45000		50000	1278800	1854000
1995	219000	209000	213000	161000	88000	139000	129000		103000				48180	46000	1261000	1828000
1996	214000	206000	205000	165000	92000	142000	125000		96000			37000	45000		1245000	1820000

Source: *Oil & Gas Journal*, various issues.

Table 2

Liquids Production By Top 10 Companies And As A Percent of Top 400, 300, and 200 1982-1996 (000 bbls)			
Year	Top 10 Companies	Top Companies	Percent Top 10
Top 400			
1982	1643200	NA	NM
1983	1632800	2357300	69%
1984	1539000	2239378	69%
1985	1684300	2417010	70%
1986	1660100	2360400	70%
1987	1668000	2343500	71%
1988	1660000	2312600	72%
1989	1560000	2145100	73%
Top 300			
1990	1467000	2029000	72%
1991	1515400	2094000	72%
1992	1409800	1967000	72%
1993	1308900	1877000	70%
1994	1278800	1854000	69%
Top 200			
1995	1261000	1828000	69%
1996	1245000	1820000	68%
Source: *Oil & Gas Journal*, various issues.			

Table 3

Top Ten Royalty Payors - 1996			
Company	*Oil*	*Gas*	*Total*
Shell	$193,043,793	$168,662,408	**$361,706,201**
Chevron	$158,395,170	$158,965,381	**$317,360,551**
Exxon	$156,756,227	$91,998,760	**$248,754,987**
Texaco	$88,826,287	$122,995,288	**$211,821,575**
Mobil	$63,808,900	$78,760,205	**$142,569,105**
Amoco	$41,649,258	$96,934,509	**$138,583,767**
Union	$39,437,517	$93,051,833	**$132,489,350**
Arco (Vastar)	$42,204,665	$63,248,893	**$105,453,558**
Marathon	$57,008,595	$34,782,074	**$91,790,669**
BP	$42,826,430	$9,721,547	**$52,547,977**
Top Ten Total	$883,956,842	$919,120,898	**$1,803,077,740**
U.S. Total	$1,452,092,920	$2,175,636,703	**$3,627,729,623**
Percent Top Ten	61%	42%	**50%**
Source: Minerals Management Service.			

Before analyzing and assessing the applicability and feasibility of a royalty in kind program for use on federal oil and gas leases, it is important to ask why, suddenly, the industry is making such an intense effort to persuade you and the Interior Department to move to such a program? First, we think it is important to recognize recent state and federal efforts to collect underpayments of royalties from previous production, the value of which was tied to posted prices. As recently reported by *Business Week*, "The current wave of oil royalty litigation was prompted, in large part, by eye-popping judgments against the industry. In 1992, for example, the state of California received a settlement of $350 million from seven large oil companies after a two-decade struggle. And in 1994, Alaska recovered $3.7 billion."[3] Furthermore, on behalf of the state of Texas and private royalty owners, Texas filed a lawsuit in 1995 against eight oil companies. The first company to settle the suit was Chevron which agreed to reimburse the State and the other royalty owners $17.5 million for payments going back to 1986. In addition, Chevron also agreed to a new valuation formula based on prices for West Texas Intermediate crude oil as reflected on NYMEX for all production after January 1, 1997. On December 20, 1995, the MMS published an Advance Notice of Proposed Rulemaking about possible changes to the rules for royalty valuation from Federal and Indian leases. As explained by MMS, "The intent was to decrease reliance on oil posted prices and to develop valuation rules that better reflect market value."

The decision to move away from artificial, non-market based posted prices set off volcanic tremors and tectonic movement from Houston to Casper. This shift from posted prices to market-based prices would clearly enhance federal and state revenues and sharply reduce the need for complex audits of intricate intra-company and other transactions. We also note that both large integrated and large independent companies tend to refuse MMS auditors access to trading affiliates' records. Clearly, without appropriate records, it becomes difficult, if not impossible, to track pricing transactions.

Ironically, even though NYMEX is being proposed by MMS as the base on which to calculate the price at the lease (after adjusting for location and quality), some in the oil industry are claiming that NYMEX prices do not accurately reflect the market. A reading of oil company 10-K filings to the Securities and Exchange Commission, however, clearly shows that most large companies, integrated and independent alike, report that they use NYMEX to hedge their own oil and gas sales. By doing so they show utmost confidence that changes in NYMEX prices go right along with changes in local prices directionally and in absolute terms. Otherwise, why would they use NYMEX? On this critical point, what should the Committee believe: what the companies tell their shareholders on their 10-Ks, or what they tell the government about a change that will help to correct royalty underpayment.

Clearly, from the point of view of the public trust, MMS was moving in the right direction, especially with regard to dealing with the problem of non-arms length transactions. Because most of the transactions on federal oil leases are not arms-length, there is no competition. The transaction is between affiliates or subsidiaries of the same company, usually the production arm selling to the trading arm or to the refining arm. Thus, if there is no competitive market price, how can the public obtain fair market value without engaging the government in long-term, complex audits? Substituting an RIK program on offshore oil sales for the collection of royalties based on NYMEX is of dubious value. Who else, for example, other than Shell, is going to purchase oil from Shell's billion dollar Cognac field in the deep waters of the Gulf? Shell clearly expects to obtain all the oil produced on that lease to feed its refinery in Louisiana. Thus, implementing an RIK program on such leases is very likely to cost the government money -- money to pay for hiring a knowledgeable marketing firm as well as other experts and because there is little evidence to suggest other buyers would come a calling. Of course, the government could refuse to sell to Shell until Shell paid what the government thought was fair, but then Shell would probably complain that the government is taking unfair advantage and should be prohibited from such activity. Based on the structure of the market and the fact that the bulk of royalty oil production is in areas where competitive arms-length transactions are limited at best, we believe that an RIK program would not yield as much revenue to the Treasury as basing the royalty on NYMEX prices adjusted for location and quality.

With regard to natural gas, however, an RIK program might be worthwhile. Certainly, it is worth conducting additional pilot programs to test this hypothesis. Following the deregulation of natural gas markets and with the beginning of deregulation in electricity markets, there is some reason to believe that large volumes of natural gas from the Gulf of Mexico could command market prices sufficiently higher than current levels. Of course, in order to work, an RIK program cannot be operated on a voluntary basis as some in the industry have argued. The government must have the authority to take as much of its royalty gas as it deems necessary to obtain fair market value.

While there may be some reasons to consider RIK programs in onshore areas, it is impossible for the federal government to move forward unless the states do so as well. At this point in time, while we understand Wyoming is moving forward and Texas has made some efforts in the area, neither California, nor Louisiana seem to be interested in such a program.

We'd also like to comment on several issues that have been raised by the companies promoting RIK. Many of their spokesmen make a big issue out of the costs of government oversight and auditing. According to the MMS, the annual costs of administering the entire royalty system is $66 million, of which approximately $20 million is used for audits. The audits, at least since 1982, have generated approximately $125 million a year in revenue. Thus, for every dollar spent, the government gets about six. Secondly, industry spokespeople ignore the fact that there are costs associated with implementing an RIK program, not the least of which, is paying and overseeing marketers hired to sell the government's royalty oil or gas.

We also think it is curious that smaller independent oil and gas producers are complaining loudly about the proposed royalty system when they are likely to do far better financially under such a system than they do now. The fact is that, at least with respect to oil, smaller independents receive the posted price for all their production, rather than the higher NYMEX-based price. Such a system primarily benefits the major integrated oil and large independent companies at the expense of smaller independent producers. Instead of criticizing MMS, we believe the smaller independents ought to be thanking the agency. According to the MMS's supplementary proposed rule, smaller independent producers will, for the most part, not be even subject to NYMEX-based prices, assuming they engage in arms-length competitive transactions. For such transactions, they would be allowed to use gross proceeds paid.

Finally, we believe it is important to point out that a number of oil and gas industry spokespeople have criticized the concept of "Duty to Market," claiming that there are some vaguely defined "costs," beyond legitimate location and quality adjustments, associated with moving oil or gas from the lease. Historically, producers have always marketed royalty production. They have an impled common law duty which has been legally upheld. Any attempt to alter this relationship could result in a breech of contract. Since contractual relationships undergird all of the government's oil and gas leasing arrangements, such a breech of contract, even if legislatively mandated, could result in extensive litigation.

In summary, we believe that whatever royalty program is adopted or used by the MMS, it must result in prices determined by competitive market forces and in fair market value. We believe with respect to transactions regarding oil leases which are not competitive and not arms-length, that prices be determined on the basis of NYMEX adjusted for location and quality. We believe it is reasonable to proceed with additional RIK pilots, especially with respect to natural gas, since it appears that market conditions may be more favorable, especially in the Gulf of Mexico, for such a program. Finally, we also think it makes sense to carry out additional pilot programs for oil and gas onshore, but recognize it can only work in states that are also willing to implement such a program.

NOTES

1. "Shell Affiliate CalResources and Mobil Complete Definitive Agreements on California E&P Company," Shell Press Release, June 2, 1997.

2. "Texaco to Buy Monterey Resources for $1.4 Billion in Stock and Debt," *Los Angeles Times*, August 19, 1997.

3. "A Royalty Pain for the Big Oil Companies," *Business Week*, September 1, 1997.

Supplemental Sheet

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