ERCIAL RESOURCES
(505)-827-5724

SURFACE RESOURCES
(505)-827-5793

MINERAL RESOURCES
(505)-827-5744

ROYALTY
(505)-827-5772

State of New Mexico
Commissioner of Public Lands
Ray Powell, M.S., D.V.M.
310 Old Santa Fe Trail, P. O. Box 1148
Santa Fe, New Mexico 87504-1148
Phone (505)-827-5760, Fax (505)-827-5766

PUBLIC AFFAIRS
(505)-827-5765

ADMINISTRATIVE MGMT.
(505)-827-5700

LEGAL
(505)-827-5715

PLANNING
(505)-827-5752

MAY 1997
RECEIVED

May 23, 1997

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

Re: **Comments on Proposed MMS Rules RE Valuation of Federal Royalty Oil**

Dear Mr. Guzy:

Enclosed are SLO's comments on the above proposed rules on valuation of Federal Royalty Oil.

The New Mexico State Land Office (SLO) appreciates MMS' attempt to update these rules to capture the full value of federal crude oil for federal royalty purposes, both for past time periods through the audit process and for the future. We can assure you that the State Land Office is actively involved with the Oil Industry in pursuing past under reported crude oil royalties and looking to future pricing methodologies of the same. Therefore, we have similar objectives and goals in these matters.

In New Mexico, SLO works primarily for education through our various beneficiaries and your federal crude oil royalties, which are shared with our state government, helps our state's annual general fund budget, of which about one half of the funds are dedicated to Education. Therefore, any increases in crude oil royalty revenues from our office and from your federal royalties help to further fund education in our state.

We understand that comments can be made until May 28, 1997 on this proposed rule. In addition, a possible future comment period may occur after MMS has reviewed all comments todate and considered any revisions to the proposed rule. As a result, we are submitting our comments so that they may be considered in any current review and possible redrafting by MMS.

We may want to submit further comments after we have seen any redrafted rule.

Sincerely,

Ray Powell

RAY POWELL, M.S., D.V.M.
COMMISSIONER OF PUBLIC LANDS

Comments on Proposed MMS Rules RE Valuation of Federal Royalty Oil, Dated May 23, 1997

The New Mexico State Land Office (SLO) hereby responds to the MMS Notice of Proposed Rulemaking, dated January 24, 1997, which would modify the valuation procedures for both arm's-length and non-arm's-length federal crude oil royalty transactions.

I.

General Comments

MMS is to be commended for its new proposed pricing regulations. Specifically, we agree with MMS's proposed index pricing using the average of the daily NYMEX futures settle prices for the Domestic Sweet Crude Oil Contract for the prompt month for federal leases, outside of California.

We also agree with MMS's discontinuation of posted prices to value federal royalty crude oil.

SLO is concerned about the use of the Gross Proceeds methodology for valuing federal royalty crude oil in certain types of possible arm's-length transactions.

SLO is further concerned that the definition of "exchange agreements" is defined too narrowly.

We agree that differentials, such as quality and location adjustments, must be made for federal royalty crude oil to arrive at an accurate lease value.

II.

The Valuation of Federal Royalty Oil Outside of California

Not Sold Under Arm's-Length Transactions, Sect. 201.102(c)

A. The NYMEX Price is a Valid Indicator of the Market Price of United States Crude Oil Outside of California.

The NYMEX price is an excellent indicator of the market value of crude oil. Unlike posted prices, which are the result of decisions made by individual oil companies with no public accounting as to how they are determined, the NYMEX crude transactions constitute a huge volume of crude oil in a market that is public and has a very large number of the oil company participants. Millions of barrels of crude oil are bought and sold each business day. The number of barrels traded on NYMEX is substantial to the total world production of crude oil. The NYMEX price is established by trading in an open market, which cannot be controlled by any one oil company or small group of oil companies. The closing price on the NYMEX reflects a fair market value since it represents the consensus of a large number of willing buyers and sellers regarding the value of a standard quality of crude oil at a given point in time at a specified location. Because there are many different and diverse participants in the market with differing interests, it cannot be controlled by one company or a few companies.

The price quoted on NYMEX has become a market benchmark for the pricing of all domestic crude oil, except possibly California crude oil. In addition, the P-Plus market at Cushing, Oklahoma, which can be adjusted to Midland, Texas, is an alternate market price and is quoted through the Platts Oilgram.

SLO understands that the WTI value is tied to the market center at Cushing, Oklahoma and the WTS value is tied to the market center at Midland, Texas. These two markets accurately reflect oil values for New Mexico, which include the Permian and San Juan Basins.

As indicated at the Houston meeting on April 17, 1997 by Bob Levin of NYMEX, the NYMEX market is a valid indicator of crude oil market value. The mechanics of arbitrage also reduces the spread between the different markets.

B. Non-California Posted Crude Oil Prices Do Not Reflect Market Value.

There are a number of indicators that posted prices for crude oil outside of California do not reflect the market value of crude oil. The evidence includes the following:

* The posting-plus (P- Plus) market, as reported in Platts Oilgram, shows that the West Texas Intermediate(and adjustments to Sour) crude oil have commanded a premium over posted prices in most periods.
* As indicated by the Texas General Land Office and the University of Texas Land Accounting, the public bidding of crude oil sales in recent years have resulted in increased royalty oil receipts.
* Phillips changed its posting practices in early 1992, as reported in Platts Oilgram, since its posted prices did not reflect its actual prices and to eliminate the practice of paying bonuses above posting (to be more equal to the NYMEX price less the cost to transport crudes from the lease to Cushing, Oklahoma), but all available evidence indicates that it has not happened on a

long term basis.

* ARCO, in 1993, made additional crude oil royalty settlements for the period of 1986 to early 1992 with various states, including the New Mexico State Land Office, and other royalty holders East of the Rockies by making voluntary payments reflecting oil valuation prices above posted prices.

III.

The Gross Proceeds Method of Valuing Crude Oil

Sections 206.102 (a) and (c)

We propose that the gross proceeds method should be limited to sales of federal royalty crude oil, as follows:

1. To sales of federal royalty crude oil by independent producers, who are selling to third parties with no repurchase arrangements, including buy/sell agreements.
2. To sales of federal royalty crude oil by independent producers to major producers, who are purchasing this oil from these parties in properties, in which they do not have an economic interest, and for which there are no repurchase arrangements or buy/sell agreements regarding this crude oil.

Based on our knowledge, the gross proceeds method is difficult and expensive for MMS to properly monitor and enforce. The commingling of crude oil and the accounting records of oil companies make it impossible in many instances to determine what gross proceeds are received for federal royalty crude oil.

Exchange Agreements Are Defined Too Narrowly

Exchanges are defined too narrowly under the proposed regulations (Section 206.101), with the result that the gross proceeds method would apply to many more crude oil transactions than MMS intends.

Federal royalty crude oil is frequently transferred from an oil company that produces the crude oil to its internal group or to its affiliated company in the corporate group that either transfers it to another affiliated group or company for refinery needs or sells the crude oil. After it is transferred to its affiliated group or company, it is commingled with other crude oil. As a result, it is almost impossible to trace crude oil produced from specific leases when it is commingled with other crude oils.

The Interagency Task Force concluded correctly that accounting procedures in oil companies made it near or if not impossible to trace the prices received for specific federal royalty crude oil when such oil was transferred from the company producing the oil to its affiliate.

The definition of "exchange agreement" is too narrow which has the effect of increasing the transactions to which the gross proceeds method applies. The definition of "exchange agreement" is too narrow for five reasons: (1) it excludes exchanges in which the receipt and delivery take place at the same location; (2) it excludes multi-party exchanges; (3) it excludes transportation agreements; (4) it excludes net-out agreements; and (5) it excludes involving crude oil for any other products. The result of the narrow definition of exchanges is that the gross proceeds method may have a far broader application than that intended by MMS.

IV.

Differentials

The concept of value differentials is a very problematic portion of the proposed rule as it relates to the calculation of appropriate location and quality adjustments. SLO agrees that MMS is moving in the right direction in its consideration of location and quality differentials.

The basic concept of "index point to market center to aggregation center to lease" is not readily evident in our markets in the Permian and San Juan Basins. Essentially, our research tends to show that these market places show the movement of oil directly from the leases in the Permian or San Juan Basins to either Midland, Texas or Cushing, Oklahoma market centers or for use by local refiners.

A location and/or quality differentials will yield a value at the lease for federal production, as compared to an adjacent market center, which will include the effects of transportation, supply and demand, risk, crude type, etc. Therefore, a lessee would not be entitled to a separate transportation allowance and the actual transportation costs incurred by lessees are of limited relevance.

It is our understanding that the location and/or quality differentials can have real market relevance, since the "buy/sell" agreements result in a negotiated differential. As a result, the negotiated differential will consider the various market forces, as stated above.

V.

Conclusion

We appreciate the opportunity to present comments on MMS's proposed rules. SLO is pleased with MMS's decision to move to market based indicia for the future valuation of federal royalty crude oil. We hope that our comments are useful in MMS's formulation of its federal crude oil valuation rules.

We also look forward to reviewing an updated set of these proposed crude oil valuation rules and the possible submission of further comments thereon at a future date.