THE UNITED STATES DEPARTMENT OF THE INTERIOR (DOI)
MINERALS MANAGEMENT SERVICE (MMS)

IN THE MATTER OF	§	
	§	
The Further Supplementary Proposed Rule For Establishing Oil Value for Royalty Due on Federal Leases	§ § §	JAN 2000 RECEIVED
	§	
64 *Fed Reg* 73820, et seq., December 30, 1999	§	

COMMENTS OF
THE COASTAL CORPORATION

Attention: Mr. David S. Guzy, Chief
Rules and Publications Staff
Royalty Management Program
Minerals Management Service
P.O. Box 25165, M.S. 3021
Denver, Colorado 80225-0165

Via E-Mail
(David_Guzy@mms.gov)

and

Overnight Delivery
Building 85, Room A-613
Denver Federal Center
Denver, Colorado 80225-0165

Dear Mr. Guzy:

The Coastal Corporation is pleased to respond to the request of the MMS for comments on the Further Supplementary Proposed Rules For Establishing Oil Value for Royalty Due on Federal Leases, 64 *Fed Reg* 73820, et seq., December 30, 1999 (the **Proposed Rules**).

I. COASTAL

The Coastal Corporation (**Coastal**) is a Houston-based energy holding company with consolidated assets of over $14 Billion. Acting through its numerous subsidiaries and affiliates, Coastal has domestic and international operations in natural gas transmission, storage, gathering, processing, and marketing; oil and gas exploration and production; petroleum refining, marketing, and distribution; chemicals; power production; and coal. Coastal is a federal and

Indian lands oil and gas lessee, and has oil and gas transportation and marketing affiliates, and, therefore, has an interest in the Proposed Rules.

II. COASTAL'S POSITION

A. In the past, Coastal has been opposed to the Proposed Rules on the grounds that they will not simplify the royalty value determination process, they will not reduce the administrative and audit burden associated with royalty valuation, they will value royalty oil at a point far downstream of the lease in a market that is very different from the market at the lease, and most importantly, they will impose a new, unfair, and burdensome obligation on the lessee to become the free marketing agent of the government. Although almost everyone acknowledges that this latest version of the Proposed Rules are an improvement over the original version, Coastal remains opposed for the same reasons it opposed the original Proposed Rules.

B. Coastal has previously filed written comments on each of the various and several versions of the Proposed Rules, attended and participated in various of the Public Hearings and Workshops held by the MMS, and actively supported the efforts of industry trade organizations, including the American Petroleum Institute (**API**) and the Independent Petroleum Association of America (**IPAA**). Coastal hereby endorses, renews, and incorporates herein as part of these comments, the written and oral comments previously submitted in this matter by itself, the API, the IPAA, the Domestic Petroleum Counsel (**DPC**), and the United States Oil & Gas Association (**USOGA**).

C. In addition, Coastal hereby endorses and incorporates herein as part of its own comments, the joint written comments filed in reference to this, the most recent version of the Proposed Rules, by the API, the IPAA, the DPC, and the USOGA.

III. DISCUSSION

In Coastal's opinion, the Proposed Rules have almost nothing to do with royalty valuation - they have only to do with marketing. Like the infamous and often quoted post-it note reportedly used during President Clinton's first election campaign, "It's the Economy, Stupid," all federal lessees should have a similar post-it note on the Proposed Rules, "**IT'S MARKETING, STUPID.**"

HISTORICAL OVERVIEW

Unless otherwise expressly provided in the oil & gas lease, a royalty owner (the **lessor**) is entitled to its royalty share of oil produced from a lease, either in kind or in value, only at or near the lease. Coastal acknowledges that the operator/working interest owner of the lease (the **lessee**) generally has a duty to do those things reasonably necessary to place the produced crude oil in marketable condition at the lease at no cost to the lessor. For example, the lessee will usually separate water, sediment, and other contaminants from the oil, and in some instances, treat the oil to remove excess sulphur, if there is no lease market for high sulphur oil. Once the oil is in marketable condition, a lessor is generally entitled to elect to take its royalty share of the oil in kind or in value.

If the lessor elects to take its royalty share in kind, the lessee is obligated to deliver the royalty share of the oil to the lessor at the lease, either into storage tanks provided by the lessor, or for the account of the lessor into the pipeline to which the well may be connected. In either event, all cost, risk, and expense to transport and market the royalty share of oil downstream from the lease is borne by the lessor, not the lessee.

If the lessor elects to receive its royalty share of the oil in value, the lessee markets the royalty oil along with its own share of the oil, and pays the lessor. If the oil is sold on or at the lease, this payment is a share of the gross sales price from the sale (so far we are in agreement with the Proposed Rules). However, if the oil is sold off the lease (and this is the point at which Coastal's position differs from the Proposed Rules) the payment to the lessor is a share of the net sales price, adjusted for the royalty owner's proportionate share of all expenses incurred by the lessee downstream of the lease (also referred to as "market value at the lease").

FIRST, IT IS IMPORTANT TO NOTE from the above overview that in both cases, royalty in kind and royalty in value, the lessor bears its proportionate share of all downstream expenses of transporting and marketing the oil, including any activities of the lessee that add additional value to the oil.

SECOND, IT IS IMPORTANT TO NOTE the fact that the crude oil market at the lease is a very different type of a market than the crude oil market downstream of the lease at a market center. For example, oil sold at the lease is sold without any warranties or guarantees of type or quality of oil (so long as it is reasonably free of impurities and is in marketable condition), and without any warranties or guarantees of an exact delivery date or an exact delivery volume. It is sold if, as, and when produced in fluctuating volumes dependent upon such variables as the condition of the well, physical characteristics of the reservoir, weather, and production operation activities. The only warranty the lessee makes in such sales is that it has the right to sell the oil, free of any adverse claims for royalties or taxes, and it is only liable to the purchaser for breach of this single warranty. On the other hand, oil sold at a market center, as proposed by the MMS, is warranted and guaranteed by the seller to be: (i) a certain type, (ii) a certain quality, (iii) delivered on an exact date, and (iv) delivered in an exact volume, and the seller is liable to the purchaser for any differences between the specifications, dates, and volumes stated in the sales contract and the actual oil delivered.

FINALLY, IT IS IMPORTANT TO NOTE that the marketing of crude oil is a distinct business function, separate and apart from exploration and production activities - the usual business of the lessee. If a lessee or a lessor chooses to hire a third party marketing agent to market its oil downstream of the lease, it would reasonably expect to be charged a fee for that service - either a percentage of the gross sales price or a flat fee per barrel. As real world examples, (i) the Canadian government pays its marketing agents 50¢/barrel for marketing services, and (ii) in the Mobil Oil Company settlement, the class of lessors/plaintiffs agreed to pay Mobil a marketing fee in calculating future oil royalties - a fact often ignored or overlooked by the MMS and other proponents of the Proposed Rules.

Expenses related to the marketing function and the need for reasonable marketing fees have been discussed at length in prior MMS Workshops and Public Hearings on this matter. Various experts commented, both orally and in written comments, that the expenses incurred in the marketing of crude oil, including, but not limited to, professional, sales, and support staff, office space, computers, telephone, and electronic communication, insurance, bank guarantees, financing, etc., are substantial. In Coastal's case, the lease crude oil marketing function has an annual budget in excess of $1 Million.

THE MMS, HOWEVER, CHOOSES TO IGNORE ALL OF THE ABOVE, and via the Proposed Rules, seeks not to simplify the Rules, nor to properly value royalty oil at the lease, but to unilaterally and arbitrarily impose upon the federal lessee the potentially burdensome obligation to be the marketing agent for the government's royalty share of oil - all at no cost, risk, or expense to the government. The $66 Million per year that the MMS says it will collect in additional revenue when the Proposed Rules become effective is not the result of underpaid royalties, as claimed by the MMS and other proponents of the Proposed Rules, it is simply the result of mandatory free marketing, to which the government it is not contractually or legally entitled.

IV. SPECIFIC COMMENTS

1. The Proposed Rules Impose a New Duty to Market Obligation.

In the preamble to the Proposed Rules, the MMS tells us that §206.106 -the duty to market oil for the mutual benefit of the lessee and the lessor at no cost to the government - is simply a restatement of the lessee's presently existing obligations. The MMS is wrong!

The Proposed Rules create and unilaterally impose a brand new obligation on the lessee. This is not simply a restatement of the present law! There is a big difference between the presently existing duty to place production in marketable condition at no cost to the government, as discussed in Section III, above, and the new §106 duty to market that oil downstream of the lease at no cost to the government. As the MMS is well aware, this exact same language is currently the subject of two lawsuits in the Federal District Court in Washington, D.C. - *IPAA v. Armstrong,* and *API v. Babbitt* - and will no doubt become the subject of additional litigation after the final Proposed Rules become effective.

COASTAL RECOMMENDS retaining the 1988 Rules which correctly and lawfully only impose a duty on the lessee to place oil produced from federal lands in marketable condition at no cost to the federal government. In the alternative, if the government desires to have the lessee market its royalty oil downstream of the lease, the government should at least be honest enough to pay the lessee a reasonable and fair fee for performing the subject marketing services, rather than inventing a new implied obligation and imposing it on lessees as justification for free marketing.

2. The Proposed Rules Assume That There Is No Market at the Lease.

The MMS is wrong again! In general, there is a viable active market for crude oil at the lease. There was no showing on the record that the present regulations are no longer workable, and, therefore, there is no justification for the radical changes set forth in the Proposed Rules. Rather than simplifying the valuation process, and thus reducing the audit burden, the Proposed Rules make the whole oil valuation process more complex, more costly, and more burdensome, thus increasing the audit burden. Without justification or express authority, the Proposed Rules move the valuation point for many lessees far downstream of the lease.

COASTAL RECOMMENDS retaining the 1988 Rules which correctly and lawfully value royalty oil at or near the lease.

3. For Non-Arm's Length Sales, The Proposed Rules Value Royalty Oil at a Distant Sales Point or Market Center, Rather than at the Lease.

It is Coastal's position that the MMS is entitled to its royalty share, as is any other royalty owner, either in kind or in value, at the election of the government, only at or near the lease.

The 1988 Rules valued royalty oil at or near the lease regardless of whether the sale was arm's-length or non-arm's length, but the Proposed Rules will change the valuation point for non-arm's length sales either to the actual point of sale to a third party, regardless of how far downstream and remote that sales point is from the lease, or to a market center index price, regardless of the fact that the market center is a completely different kind of market from the lease market, as discussed above, or whether the lessee actually sells its oil there or not.

COASTAL RECOMMENDS retaining the 1988 Rules which correctly and lawfully value royalty oil at or near the lease.

4. The Proposed Rules Do Not Adequately Provide for Quality and Location Differentials.

Although Coastal is very happy to see the demise of yet another burdensome federal reporting form - MMS 4415 (proposed in the original version of the Rules) - the Proposed Rules now make no allowances for quality and location differentials between the oil at the lease and the oil at the market center unless the seller actually enters into arm's-length exchange agreements. This may have the result of negating the quality and location differences between oil produced on the lease, to which the government is contractually and lawfully entitled to its royalty share, and more valuable oil sold in the market center - to the financial advantage of the government and the financial disadvantage of the lessee. In addition, this may have the effect of voiding the lessee's election to value royalty oil on either a gross proceeds basis or on a market center index basis when oil is transported without benefit of arm's-length exchange agreements and sold at a point other than the market center, thus forcing the lessee to trace - generally acknowledged by those who know to be a burdensome and sometimes impossible task in the real world of current oil marketing .

COASTAL RECOMMENDS retaining the 1988 Rules which correctly and lawfully value royalty oil at or near the lease. In the alternative, the MMS should provide for adjustments for quality and location differentials between the value of oil at the lease and the gross sales price of oil sold downstream of the lease in every situation, even if the lessee or seller did not actually enter into an arm's-length exchange agreement.

5. The 1988 Rules and the Proposed Rules Do Not Provide a Reasonably Fair Rate of Return for Pipeline Investments.

§206.111 (h) presently provides for a rate of return for pipeline investments based upon the industrial bond yield index for Standard and Poor's BBB rating. I am informed that this rate is presently about 7%. Coastal's management would not approve the construction, acquisition, or investment in any pipeline project with an expected rate of return of only 7%.

COASTAL RECOMMENDS a rate of return equal to two (2) times the BBB bond rate, a far more realistic rate of return for pipeline investments, and a rate in conformity with the rate of return that is generally permitted by other governmental regulatory agencies, such as, the Federal Energy Regulatory Commission.

6. The Proposed Rules Should Use More Specific Examples in Formulas.

COASTAL RECOMMENDS that if the Proposed Rules are published as final rules, despite the unanimous opposition of the oil industry and other knowledgeable experts, as reflected in the volumes of written comments submitted in this matter to the contrary, the Rules should at least include specific examples of royalty calculations in §206.103 (b) (3) and §206.103 (c) (1) & (2) to help avoid different interpretations and future audit problems.

V. CONCLUSION

1. The Proposed Rules should be withdrawn, and federal royalty oil should continue to be valued under the 1988 Rules.

2. If the MMS desires to establish an oil valuation scheme different from the 1988 Rules, the MMS should commence a negotiated rule making process, working with industry representatives, to write practical and workable rules based on real world experience - not

hyperbole, politics, speculation, innuendo, or the advice of consultants who are either motivated by a financial interest in the outcome of pending royalty litigation, or are paid by special interest groups who have a financial interest in the outcome of pending royalty litigation.

3. Any royalty valuation rules should value oil at or near the lease, preferably through a series of benchmarks similar to the 1988 Rules, as previously proposed by Coastal, oil industry trade organizations, and other oil companies.

4. The best long-term solution to the oil and gas royalty valuation problem is Royalty In Kind (RIK), thus eliminating the need for royalty audits altogether, and their correspondingly large expenditures of staff time and money by both the government and the oil companies. Coastal and industry trade organizations are ready to meet with MMS staff to discuss and negotiate the details of a practical and workable RIK program.

RESPECTFULLY SUBMITTED this 28th day of January 2000.

THE COASTAL CORPORATION

Robert G. Teeter by [illegible]

By: Robert G. Teeter
Senior Staff Attorney
Natural Resources Law Department, Legal Division

Coastal Tower, Suite 886
Nine Greenway Plaza
Houston, Texas 77046-0995

Telephone: (713) 877-1400 (main)
(713) 877-7019 (direct)

Fax: (713) 877-3869
E-Mail: bob.teeter@coastalcorp.com