American Petroleum Institute
1220 L Street, Northwest
Washington, DC 20005-4070
202-682-8000

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David S. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P.O. Box 25165
MS 3101
Denver, CO 80225-0165

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Comments of the American Petroleum Institute on MMS Proposal for Amendments to the Transportation Allowance Regulations for Federal and Indian Leases; 30 CFR Part 206, 61 FR 39931 (July 31, 1996)

Dear Mr. Guzy:

API welcomes the opportunity to file written comments on the MMS' July 31, 1996 transportation allowance proposal. API's members are involved in all aspects of the petroleum industry: exploration, production, transportation, refining and marketing. Many of API's members operate Federal or Indian leases with significant royalty obligations and would be directly affected by this important regulation.

As our attached detailed comments make clear, API strongly disagrees with the MMS characterization of the rulemaking as a mere clarification. If adopted, the MMS proposal would plainly create new obligations which depart radically from existing regulations and in many respects exceed the MMS' statutory authority. In addition, there is no basis whatsoever for applying such fundamental changes retrospectively.

We urge the MMS to weigh these comments carefully and modify its transportation allowance proposal accordingly.

Sincerely,

David T. Deal
Managing Attorney
(202) 682-8261
(202) 682 8033 FAX

Comments of the American Petroleum Institute on

Amendments to Transportation Allowance Regulations

for Federal and Indian Leases to Specify Allowable Costs

and Related Amendments to Gas Regulations

30 CFR PART 206

61 FR 39931 (July 31, 1996) and 61 FR 48872 (September 17, 1996)

INTRODUCTION

The Minerals Management Service (MMS) proposes to amend its 30 CFR Part 206 regulations governing valuation for royalty purposes of gas produced from federal and Indian leases. The proposed rule primarily addresses allowances for transportation of gas. Although the MMS contends that the amendments would clarify the methods by which gas royalties and deductions for gas transportation are calculated, the proposal in fact would radically alter and unlawfully expand federal and Indian lessees' obligations.

I. PRODUCT VALUATION 30 CFR §§ 206.152(i), 206.153(i), 206.172(i) and 206.173(i)

MMS proposes to amend its product valuation regulations to provide that federal and Indian lessees are obligated to market natural gas and gas plant products at no cost to their federal and Indian lessors. This newly created obligation is then cited as the basis for the proposed disallowance of "nonallowable costs" in determining transportation allowances under proposed 30 CFR §§ 206.157(g) and 206.177(g). Although the specific costs that MMS proposes to disallow are discussed in greater detail below, the purpose of this section is to comment more generally on the proposed creation of a new obligation on the part of federal and Indian lessees to market gas and gas plant products at no cost to their federal and Indian lessors. In a nutshell, API believes creation of such a new obligation is unlawful.

A. <u>The proposed regulation would create a new obligation.</u>

Under existing regulations, federal and Indian lessees have an obligation "to market the production for the mutual benefit of the lessee and the lessor" and they have an obligation "to place [production] in marketable condition at no cost to the Federal Government or Indian lessor unless otherwise provided in the lease agreement." 30 CFR §§ 206.152(b)(1)(iii); 206.152(i); 206.153(b)(1)(iii) and 206.152(i). They do not, however, have an obligation <u>to market</u> production <u>at no cost</u> to their lessors.

MMS masks the creation of this new obligation in two ways. First, MMS tries to equate the obligation to place production in marketable condition with the obligation to market. According to MMS, since the former must be done at no cost to the lessor, the latter must be done for free as well. The preamble to the proposed regulations states:

> For decades, the regulations required that the lessee place production <u>in marketable condition</u> at no cost to the lessor. Thus, if the purchaser incurs costs <u>to market</u> the production, the lessee may not reduce the royalty value (either directly or through the transportation allowance) to compensate the purchaser for those marketing costs.

61 FR 39934 (emphasis added). To put production in marketable condition, however, is only one small part of the overall process of marketing that production. It does not follow that all marketing

costs must be borne by the lessee just because a small portion of those marketing costs are recognized as being the lessee's responsibility.

Second, MMS asserts that the obligation to market federal and Indian lease production at no cost to the lessor is simply a corollary of the lessee's existing implied obligation to market the lease production for the mutual benefit of both itself and its lessor. The preamble explains:

> MMS believes that the added language contains the concept embodied in the implied covenant to market for the mutual benefit of Federal and Indian oil and gas leases.

61 FR 39935. The proposed regulation, however, is actually inconsistent with the implied covenant on which MMS relies, since "for the mutual benefit" of both parties does not mean that one party gets a free ride while the other party bears all the expense.

Even if the obligation to market for free is not new, the obligation to market away from the lease clearly is. Under existing law, a lessee is obligated to market only at or near the lease.

Finally, all of the unbundled transportation changes that MMS is proposing to disallow have been allowable deductions for decades. Disallowance of these charges now unquestionably creates a new obligation.

1. The obligation to place production in marketable condition at no cost to the lessor cannot be expanded to encompass all marketing costs.

The limited obligation to put production in marketable condition at no cost to the lessor has never before been equated with a broad, all encompassing obligation to market for free, at least not in the agency's duly promulgated regulations. MMS' current regulations, for example, define the phrase "marketable condition" 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 CFR § 206.151. Notably, this definition focuses on the physical condition that the production must be in so that it can be marketed under contracts typical for the field or area in which the production occurs.

Thus, under the current "marketable condition" regulation, the only thing that a lessee is required to do at no cost to the lessor is to place the production in the physical condition necessary to market it under contracts typical for the field or area. The cost of marketing efforts beyond placing the production in marketable condition at or near the lease, especially the cost of marketing efforts incurred in order to obtain higher prices for the lease production many hundreds of miles away from the field or area where it was produced, is not even remotely contemplated by the marketable condition rule, either in its present form or as it has evolved throughout its history.

The obligation to put gas into marketable condition originally was found in two Department of the Interior regulations. The first provision, 30 CFR § 221.31, effective June 1, 1942, was originally published at 7 FR 4132, 4137. That provision, which governed federal onshore leases, stated:

> Emulsion and dehydration. The lessee shall complete and maintain his wells in such mechanical condition and operate them in such manner as to prevent, as far as possible, the formation of emulsion, or so-called B.S., and the infiltration of water. If the formation

> of emulsion, or B.S., or the infiltration of water, cannot be prevented or <u>if all or any part of the product is unmarketable by reason thereof or on account of any impurity or foreign substance, the lessee shall put into marketable condition, if commercially feasible, all products produced from the leased land and pay royalty thereon without recourse to the lessor for deductions on account of costs of treatment or of costs of shipping.</u> To avoid excessive losses from evaporation, oil shall not be heated to temperatures above the minimum required to put the oil into marketable condition. If excessive temperatures are required to break down any emulsion, then other means of dehydration must be utilized. Under such circumstances the supervisor must be consulted, and his approval obtained.

(Emphasis added.) This provision remained in effect until October 27, 1982, when part 221 was "revised and modernized." 47 FR 47758 (October 27, 1982). The revision and modernization process essentially removed the old 221.31. Then, on August 12, 1983, section 221.31 was redesignated as 43 CFR § 3162.5-3. 48 FR 36583 (August 12, 1983). Today it is found in 43 CFR § 3162.7-1(a), which provides: "The operator shall put into marketable condition, if economically feasible, all oil, other hydrocarbons, gas, and sulphur produced from the leased land."

The offshore counterpart of this regulation was promulgated in 1954 as part of the regulations adopted to implement the Outer Continental Shelf Lands Act. As originally promulgated, the regulation provided:

> <u>Emulsion and dehydration</u>.
>
> (a)The lessee shall complete and maintain all oil wells in such mechanical condition and operate them in such manner as to prevent, so far as possible, the formation of emulsion and basic sediment.
>
> (b)The lessee shall put in marketable condition, if commercially feasible, all products produced from the leased land and pay royalty thereon without recourse to the lessor for deductions on account of costs of treatment.

30 CFR § 250.41 (1954). This regulation, except for being redesignated as 30 CFR § 205.42 in 1968, remained largely unchanged until the late 1970's. Then, without explanation, in either the proposed rule, 44 FR 13527 (March 12, 1979), or the final rule, 44 FR 61892 (October 26, 1979), corrected, 45 FR 20465 (March 28, 1980), the provision was revised to read:

> The lessee shall put into marketable condition, if commercially feasible, all products produced from the leased land. In calculating the royalty payment, the lessee may not deduct the cost of treatment.

30 CFR § 205.42 (1980).[1]

The second Department of the Interior regulation that contained an obligation to put gas in marketable condition was the regulation governing royalties due on processed gas. The original onshore provision, 30 CFR § 221.51(b), effective June 1, 1942, was originally published at 7 FR 4132, 4138. It provided:

> (b) The present policy is to allow the use of a reasonable amount of dry gas for operation of the gasoline plant, the amount allowed being determined or approved by the supervisor, but no allowance shall be made for boosting residue gas, or other expenses incidental to marketing.

30 CFR § 221.51(b) (1942). This provision was modified slightly and renumbered as 30 CFR § 221.114 on October 27, 1982, when part 221 was "revised and modernized." 47 FR 47775 (October 27, 1982). Then, on August 5, 1983, section 221.114 was redesignated as 206.106. 48 FR 35641 (August 5, 1983).

[1] The preamble generally explained that all of the changes were intended to "eliminate unnecessary and redundant provisions" and to improve organization and clarity. 44 FR 13528 (March 12, 1979); 44 FR 61886 (October 26, 1979).

> (d) No allowance shall be made for boosting residue gas or other expenses incidental to marketing.

30 CFR § 250.67(d) (1954). The provision was redesignated as section 206.152(d) on August 5, 1983. 48 FR 35641 (August 5, 1983). Under the ejusdem generis rule, "other expenses incidental to marketing" must be limited to "other expenses" similar to boosting expenses, i.e., expenses incidental to marketing that are necessary to place the production in marketable condition.

Effective March 1, 1988, the onshore and offshore provisions were both incorporated in a new section 202.151(b), which currently provides:

> A reasonable amount of residue gas shall be allowed royalty free for operation of the processing plant, but no allowance shall be made for boosting residue gas or other expenses incidental to marketing, . . .

53 FR 1271 (January 15, 1988). While the term "marketing" is used in this regulation, the preamble to the 1988 rulemaking shows clearly that MMS' intent was not to encompass any and all marketing costs associated with the sale of residue gas, but only those "marketing" costs incidental to putting the residue gas in marketable condition. The preamble explained:

> Several industry commenters stated that an allowance for boosting residue gas should be allowed under paragraph (b) for operation of the processing plant. The rationale was that costs associated with this process are incurred as a result of processing and should not be regarded as costs necessary to place the gas in marketable condition.
>
> MMS Response: The regulations specify the MMS's policy that the lessee is required to condition the production for market. The cost for boosting residue gas is considered as a cost necessary to place the gas in marketable condition, and will not be an allowable deduction.

53 FR 1236 (January 15, 1988).

In sum, there is no pre-existing regulatory support in the so-called "marketable condition" rule for imposing an obligation on federal and Indian lessees to provide free services over and above placing the production in marketable condition. Under existing regulations, once production is in marketable condition, a federal or Indian lessee's obligation to provide free "marketing" services is at an end.

2. The obligation to market for the mutual benefit of the lessor and lessee does not carry with it an obligation to market for the lessor for free.

Federal and Indian lessees, like private lessees, unquestionably have an implied obligation to market lease production for the mutual benefit of both parties. Nevertheless, the implied obligation of a lessee to market for the mutual benefit of both itself and its lessor has never before been viewed as embodying the concept that this marketing must be done by the lessee for free. As one distinguished commentator observed:

> The duty of the lessee to deliver royalty gas to the market or to market the gas in the sense of making a sale does not dispose of the question of which party should bear the cost incident thereto.

Kuntz, E., A Treatise on the Law of Oil and Gas, Vol. 5, sec. 60.1, p. 122 (1978). According to Professor Kuntz, the determination of who should bear a particular cost is governed by whether the cost is properly identified as a production cost or whether it is properly identified as a marketing cost, since the lessee traditionally bears production costs but shares marketing costs proportionately with the lessor. Id.

MMS may take the position that general oil and gas principles such as these do not apply to federal and Indian leases. Nevertheless, there must be some pre-existing source for the implied obligation that MMS claims to exist. An obligation is not "implied" simply because the agency says it is. And while MMS purports to rely on pre-existing jurisprudential authority for its assertion that there is an implied obligation on the part of federal and Indian lessees to market lease production for free, the only authority it cites is a decision by the agency itself, i.e., the decision of the Interior Board of Land Appeals in Walter Oil and Gas Corp., 111 IBLA 265 (1989).[2] Of course, the Department of the Interior cannot create lease obligations by adjudication any more than it can "imply" them by administrative fiat.[3]

Finally, the alleged existence of an implied obligation on the part of federal and Indian lessees to market lease production for free actually is inconsistent with the agency's duly promulgated regulations. Under the agency's published regulations, federal and Indian lessees are obligated to market lease production for the mutual benefit of both parties. See 30 CFR §§ 206.152(b)(1)(iii) and 206.153(b)(1)(iii). "Mutual" does not mean that one party gets a free ride while the other party bears all the expense.

3. Federal and Indian lessees currently have an obligation to market only at or near the lease.

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[2]Gratuitous dicta in some cases notwithstanding, existing judicial authority stands only for the proposition that federal and Indian lessees are obligated to put production in marketable condition at no cost. See California Co. v. Udall 296 F.2d 384 (D.C. Cir. 1961) (costs for compression, dehydration, and conditioning to meet pipeline specifications); Mesa Operating, Ltd. v. U. S. Department of Interior, 931 F.2d 318 (5th Cir. 1991) (costs of compressing, gathering, processing, treating, liquefying or transporting); Shoshone Indian Tribe v. Hodel, 903 F.2d 784 (10th Cir. 1990) (compression and administrative costs associated with processing).

[3]The agency also cannot create new lease obligations by regulation, an issue discussed more fully below.

The "marketable condition" rule requires lessees to put production in marketable condition for free. The "market" for which the production must be conditioned, however, is the market at or near the lease. See 30 CFR § 206.151 ("marketable condition" means lease products 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.) By requiring lessees to market downstream of the lease (or to pay royalties as if they had), the proposed regulations are creating new obligations. They clearly are changing, not merely "clarifying", federal and Indian lessees' obligations.

4. The proposed disallowance of non-deductible costs constitutes a radical departure from existing regulations.

MMS recognizes that the costs it is now proposing to disallow have been deductible for years. While it asserts that it is only now able to determine which parts of a pipeline tariff historically were for transportation and which were for "marketing", this is incorrect. While it may now be easier for MMS to go behind pipeline tariffs, it always had the ability to do so. See, e.g., 30 CFR 206.157(b)(5). The proposed disallowance of the deductions therefore constitutes a radical departure from the existing regulations, thereby creating new obligations.

In sum, there is no existing obligation on the part of federal and Indian lessees to market lease production for free that goes beyond placing the production in marketable condition or to bear transportation costs that have been deductible for years.

B. MMS cannot, by regulation, impose a new obligation on federal and Indian lessees to market lease production for free.

MMS' regulatory authority to determine the value of production on which royalties are due is limited by the governing statutes. Section 8(a) of the Outer Continental Shelf Lands Act requires the payment of royalty at a percentage "in amount or value of the production saved, removed, or sold from the lease." 43 USC § 1337(a). Likewise, the Mineral Lands Leasing Act requires the payment of royalty at a percentage "in amount or value of the production removed or sold from the lease." 30 USC § 226(b). Where the MMS has attempted to impose royalties on something other than the value of the production saved, removed or sold from the leased premises, the courts have declared the agency's action to be in excess of its statutory authority. See, e.g., Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159 (5th Cir. 1988).

Under the proposed regulations here, MMS is attempting to impose royalties on the value of marketing services provided by lessees long after production is removed from the leased premises, whether these services are performed by the lessee or by a third party who has purchased the gas. For example, if a lessee sells its production at the well and some unrelated third party performs marketing services that results in that third party receiving a higher price, the value of the marketing services arguably must be added to the value of the production on which royalties are due under the proposed regulations. The lessee necessarily is receiving a lower price because the purchaser, rather than the lessee, is marketing the gas and incurring the costs associated with performing those marketing services. See, e.g., proposed 30 CFR § 206.152(i) ("Where the value established under this section is determined by a lessee's gross proceeds, that value shall be increased to the extent that the gross proceeds have been reduced because the purchaser, or some other person, is providing certain services the cost of which ordinarily is the responsibility of the lessee to place the gas in marketable condition or to market the gas.") (emphasis added). This is clearly beyond the agency's statutory authority, which is limited to valuing the production when it is saved, removed, or sold from the lease.

Even if the addition of a new obligation to pay royalty on the value of services provided by a lessee (or third parties) after federal lease production has been placed in marketable condition and after it has been removed from the leased premises is not precluded by statute, it is not contractually authorized. Under most federal leases, the Department of the Interior does not have the contractual authority to unilaterally amend the royalty payment obligations established in the lease.[4] Unless the lease expressly provides otherwise, the "property rights of the lessee are determined only by those rules in effect when the lease is executed." Union Oil Co. of California v. Morton, 512 F.2d 743, 748 (9th Cir. 1975); see Pauley Petroleum, Inc. v. United States, 591 F.2d 1308, 1325-26 (Ct. Cl. 1979), cert. denied, 444 U.S. 898 (1979). Moreover, the Fifth Amendment and fundamental due process also prohibit the United States from annulling previously created contractual rights. See, e.g., Perry v. United States, 294 U.S. 330, 353-54 (1935); United States Trust Co. of New york v. New Jersey, 431 U.S. 1, 26 n.25 (1977); National Railroad Passenger Corp. v. Atchison, Topeka & Santa Fe Railway Co., 470 U.S. 451, 471-72 n.24 (1985).

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[4]Some federal leases provide that they are subject to all valid regulations promulgated by the Department of the Interior in the future. Many, however, do not.

C. <u>The proposed regulation is bad policy.</u>

Even if the agency could lawfully promulgate a new regulation to create an obligation on the part of federal and Indian lessees to market lease production for free, it should not adopt such bad public policy. First, since the extent of a lessee's new "marketing" obligation is not defined, auditors will be given virtually carte blanche to second guess whether the price obtained in any particular case was adequate, leading to uncertainty and confusion. Even more importantly, the policy underlying the agency's existing regulations, reliance on arm's-length prices in the marketplace to determine fair market value, is being abandoned and replaced with a new standard, the highest obtainable price, with no apparent explanation. The following example illustrates.

Under current regulations, the gross proceeds received by Lessee A from its wellhead sale of federal lease production is acceptable for royalty purposes, absent proof by the agency that the lessee has engaged in misconduct. Under the proposed regulation, however, if Lessee B sold comparable gas further downstream for a higher price, it might be said that the price received by Lessee A was reduced because its purchaser was providing services that Lessee A was obligated to provide for free, i.e., the services that Lessee B provided in order to collect a higher price. Indeed, any arm's-length wellhead sale to a pipeline or marketer arguably will be subject to challenge because these purchasers are in the business of incurring additional marketing costs in order to resell the gas at a profit. Thus, the price a lessee receives from a pipeline or marketer almost always will be reduced because these purchasers are providing marketing services that enable them to receive a higher price when they resell the gas. That's why they are in business.

This, however, has nothing to do with the value of federal and Indian production at the lease.

Under the proposed regulation, the highest obtainable price for comparable gas, whether received in a comparable sale of gas at or near the lease or in a downstream resale of gas at the burnertip, will become the royalty determinant, replacing the current standard of the lessee's arm's-length gross proceeds. Similarly, the agency's current acceptance of non-arm's-length sales prices if they are within the range of comparable arm's-length sales prices will have to be abandoned. So long as comparable gas is sold anywhere to anyone at a higher price, an argument might be made that the lessee received a lower price because the purchaser (affiliated or not) provided "marketing" services that the lessor was entitled to receive for free.

Even if the agency had the statutory and contractual authority to move the royalty valuation point for federal and Indian leases downstream of the lease, these are major changes to the existing regulatory scheme that should not be adopted without careful consideration. Moreover, the regulated community is entitled to a reasoned explanation of why the agency is now choosing to abandon the fundamental basis for the valuation regulations that have been in effect since 1988 and that were adopted only after years of careful thought. See Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co., 463 U.S. 29, 103 S. Ct. 2856 (1983). MMS' characterization of such a fundamental change as being merely a "clarification" of existing obligations does not satisfy that obligation.

II. Firm Demand Charges and Capacity Release Program 30 CFR §§ 206.157(f)(1) and

206.177(f)(1)

MMS proposes allowing firm demand charges as allowable costs in computing the transportation allowance but would limit the allowance to the applicable rate per MMBtu multiplied by the actual volumes transported. MMS also proposes that any credits received from the pipeline for releasing firm capacity not be included in computing the transportation allowance. API urges that the entire demand charge actually paid by a lessee be allowed as a deduction. Only if a lessee's actual cost for the demand charge has been reduced by a credit under a capacity release program should the allowance be reduced accordingly.

Limiting the transportation allowance for the demand charge based on actual use of reserved capacity unfairly penalizes a lessee who selects firm transportation in good faith. Gas production cannot take place without a means by which to transport produced volumes away from the lease. Before production occurs, the lessee must determine the type of transportation services to schedule depending on such factors as available markets, transportation rates, and pipeline capacity constraints. Since it is in the mutual interest of both lessor and lessee to obtain the highest price for the gas and to minimize transportation costs, the interests of lessee and lessor are not in conflict. In the event the lessee determines that firm transportation is required or desirable so as to obtain a higher price for the gas, the demand charge cannot be avoided. However when production eventually occurs, any number of reasons beyond a lessee's control may prevent it from using all the reserved capacity, even when it is acting in utmost good faith in selecting transportation arrangements and in producing the lease. By disallowing the portion of the demand charge associated with unused reserved capacity, MMS incorrectly assumes that a lessee has acted unreasonably or in bad faith, or has incurred unnecessary costs which could have been avoided, or has failed to market production for the mutual benefit of lessee and lessor. Thus, MMS would impose a penalty without a determination that the lessee has failed to act prudently.

MMS' assumption that the demand charge is allocable between used and unused capacity is incorrect. Firm transportation contracts never allocate the demand charge in such a manner. They clearly specify that the entire demand charge is consideration for firm transportation irrespective of how much capacity is used. Inasmuch as gas produced from the lease may not be shipped under a firm transportation contract without payment for all reserved capacity, the entire firm demand charge is a direct cost associated with the produced volumes. Thus, the entire demand charge is allocable to produced volumes, and it is unreasonable to limit the portion of the charge which may be included in an allowance based on a purely artificial, after the fact allocation between used and unused reserved capacity. Because the entire demand charge is a direct actual cost associated with the produced volumes, any reduction in the charge which occurs as a result of a capacity release program must also be considered in calculating the allowance.

API believes that it is incorrect to characterize a demand charge for <u>reserving</u> transportation <u>capacity</u> as being a cost of transportation, just as it would be incorrect to characterize a payment for an option to buy a house as being part of the purchase price for the house. Nevertheless, a demand charge for firm transportation is a legitimate cost that is often incurred in order to enable the gas to be sold at a higher price. This is a cost that is properly deductible in and of itself, without regard to whether or not it is characterized as a cost of transportation with respect to any particular volumes. If the government wants royalty on the enhanced value obtained as a result of demand charges incurred by the lessee to reserve transportation capacity, which costs are over and above the cost of placing the production in marketable condition, it must share in those costs. Otherwise, the lessee is being required to market federal and Indian lease production so as to obtain the highest obtainable price for the exclusive benefit of the lessor.

Although API does not agree with MMS' position, if MMS is correct in characterizing the demand charge as being a transportation cost, and if MMS is also correct in analogizing demand charges for firm transportation with gas purchase reservation charges, it should reach the same result for both. See Murphy Exploration & Production Company, MMS-93-0889-OCS (July 11, 1996) (appeal pending) (a demand charge in a gas sales contract was a payment for the sale of gas just as demand charges in the gas transmission industry purportedly are payments for transportation; the entire demand charge was held to be royalty bearing gross proceeds from the sale of gas, not just the pro rata charge based on the volume of gas actually produced and sold).

In sum, regardless of how the demand charge is characterized, it is a legitimate cost that should be deductible in its entirety, subject only to being reduced for credits received under a capacity release program.[5]

[5]MMS' comment that it does not want to be involved in the profit or loss of capacity brokering reflects a misunderstanding of the program. Transportation capacity cannot be resold at a profit. Capacity brokering is not a profit-making business enterprise for the lessee. Firm

III. <u>Cash-out, Scheduling, Imbalance and Operational Penalties</u> 30 CFR §§ 206.157(g)(3) and 206.177(g)(3)

MMS proposes disallowing cash-out, scheduling, imbalance, operational and any other penalties incurred by the lessee as shipper in computing the transportation allowance, even when such costs are incurred pursuant to an arm's-length transportation agreement. MMS incorrectly assumes that such costs are incurred solely as a result of the lessee's breaching its duty to market production for the mutual benefit of lessee and lessor. Because such costs may result from reasons beyond the lessee's control, even when the lessee has acted prudently and in utmost good faith, API urges that cash-out, scheduling, imbalance and operational penalties actually paid be allowed in computing the transportation allowance. Only if a lessee has failed to act as a prudent operator of the lease should a penalty be disallowed in computing the allowance. MMS should not disallow an actual cost incurred pursuant to a transportation agreement based on an assumption of a breach of duty, rather than upon an actual determination that the lessee has failed to act as a prudent operator or shipper.

Cash-out, scheduling, imbalance and operational penalties are not per se determinations that the lessee has failed to act as a prudent shipper or that it has failed to market production for the mutual benefit of lessee and lessor. Rather, they are means by which pipeline companies and

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transportation costs may be mitigated by the release and resale of excess capacity, but there is always a cost (not a profit) associated with purchasing firm transportation in order to obtain a higher price for the gas. If the government wants to share in the benefit of the higher price, it shippers manage pipeline imbalances in order to maintain adequate line pressure to ensure pipeline integrity.

Before Federal Energy Regulatory Commission (FERC) Order 636, pipelines exercised broad day-to-day control over the volumes of gas flowing through their systems. They were able to maintain pipeline integrity despite the fact that not every shipper's nominations vs. actuals or receipts vs. deliveries were in balance. After FERC Order 636, maintaining regular flows of gas through pipelines began to present considerable operational and commercial difficulties for pipelines. Shippers sold gas directly to end-users and LDC's, and they assumed responsibilities traditionally performed by pipelines, including coordinating nominations between shippers and purchasers, and monitoring production to ensure physical flow matches nominations. Because pipelines no longer performed these functions, contractual techniques evolved to manage imbalances, i.e., cash-out, scheduling, imbalance, and operational penalties. These financial incentives evolved to pass "line pressure risk" to shippers who now controlled the merchant function. Thus, a lessee cannot market production downstream of the lease in the hope of finding a better market without assuming these new transportation responsibilities and being subject to these contractual provisions.

However, in the real world, nominations never match actuals, and receipts never match deliveries. Tolerances were developed to recognize this fact. Penalties are incurred as a result of exceeding tolerances, not as a result of breaching any duty to market production for the mutual

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must share in the cost as well.

benefit of lessee and lessor. It is in the mutual interest of lessee and lessor to avoid imbalances and penalties. It is unreasonable, arbitrary and capricious to assume that a lessee who incurs such costs has breached its duty to market or that it has somehow benefited to the detriment of the lessor. Such penalties should be disallowed only upon an actual determination that the lessee has acted imprudently.

In 30 CFR § 206.152(b)(1)(iv), MMS proposes two new exceptions to the gross proceeds rule. MMS would value all over-delivered volumes purchased by a pipeline under a cash-out provision at the price the pipeline is required to pay for volumes within the tolerances for over-delivery. In addition, upon a determination by MMS that the price specified for over-deliveries is unreasonably low, the lessee would be required to value all over-delivered volumes according to the non-arm's-length benchmarks. API strongly objects to these proposed exceptions to the gross proceeds rule. First, MMS fails to recognize situations where an over-delivery occurs for reasons beyond a lessee's control and where the lessee has acted in utmost good faith as a prudent shipper. Second, the provision would allow MMS to ignore an arm's-length sale price without establishing objective standards for determining that the cash-out price is unreasonably low.

MMS incorrectly assumes that a reduced price received for over-delivered volumes outside the tolerance is a penalty for breach of the lessee's duty to market. Based on this incorrect assumption, MMS concludes that, at a minimum, any such penalty should not be deducted from the gross proceeds for the sale of gas. However, because the reduced price is merely the gross proceeds of volumes which would not otherwise have been produced and sold, the reduced price is not per se the result of a penalty. Once again, MMS should not disallow the lessee's gross proceeds from an arm's-length sale at a reduced price in the absence of actual imprudent conduct by the lessee as an operator or shipper.

Since MMS has no basis to assume that a lessee who incurred an over-delivery in excess of a tolerance has breached its duty to market, it is even more egregious to establish a provision whereby volumes sold within the over-delivery tolerances have been unreasonably undervalued. This provision ignores the fact that imbalances are inevitable and that a transportation contract with a cash-out provision may be the best means by which to sell gas in the best market. Allowing the revaluation of gas sold under a cash-out provision without a determination of imprudent conduct by the lessee/shipper would be arbitrary and capricious. MMS would in effect be requiring the lessee to operate the lease according to an unreasonably high standard of conduct set by MMS. It is the lessee, not the lessor, who owns the right to operate the lease.

IV. Pipeline Rate Adjustments 30 CFR §§ 206.157(f)(1) and 206.157(f)(1)

MMS proposes that if a lessee receives a payment or credit from the pipeline for penalty refunds, rate case refunds, or other reasons, the lessee must reduce the firm demand charge used to calculate its transportation allowance. The lessee must adjust the allowance by the amount of the refund or other credit for the affected reporting period.

With respect to penalty refunds, API believes that the transportation allowance should be adjusted only for those costs which are being allowed by MMS in computing the transportation allowance. Thus, it is inconsistent for MMS to propose disallowing penalty charges as a deduction, but requiring the lessee to pass through reimbursements of penalty costs. Because API urges that penalty costs be included in calculating the transportation allowance, any subsequent penalty refunds should be passed through only to the extent they have been shared by the lessor.

API agrees with MMS that requiring lessees to adjust prior month royalty reporting is administratively burdensome and would not satisfy MMS' objective to simplify and streamline royalty reporting. API recommends that for federal leases, the lessee be allowed to report the adjustment in the month received. For Indian leases, because of the major portion analysis requirement, a simplified reporting method is not possible.

V. <u>Gas Supply Realignment Costs</u> 30 CFR §§ 206.157(f)(2) and 206.177(f)(2)

API agrees with the MMS's proposed treatment of gas supply realignment costs as allowable transportation costs. However, API disagrees with statements in the preamble that attempt to tie the treatment of gas supply realignment costs to gas contract settlements. The deductibility of gas supply realignment costs should not be tied to the royalty consequences of gas contract settlements or the outcome of any pending litigation on this issue. The appropriate basis for allowing gas supply realignment costs as allowable transportation costs is that they are costs of transporting gas charged to all pipeline customers.

VI. Actual or Theoretical Losses 30 CFR §§ 206.157(f)(7) and 206.177(f)(7)

API believes this proposal needs to be clarified to state that this is not intended to disallow a transportation deduction for the gas that the transporter uses for fuel. Additionally, the discriminatory treatment of non-arm's-length transportation is without any apparent basis. A rational explanation must be provided if the proposed regulation is to withstand judicial scrutiny.

VII. Supplemental Services Necessary for Transportation 30 CFR §§ 206.157(f)(8) and 206.17(f)(8)

MMS proposes allowing certain supplemental costs for compression, dehydration, and treatment of gas only if the transporter requires such services as part of the transportation process. The use of the word "supplemental" is inappropriate in this context. The indicated services, compression, dehydration, and treatment of gas are not, in most cases, supplemental to the transportation of gas. These services are an integral part of the transportation process and not an activity to put the gas in marketable condition. If necessary to distinguish these services from other marketable condition services, the word "other" not "supplemental", would be more appropriate. Once gas is in marketable condition, all subsequent services should be deductible.

VIII. Banking and Parking Fees 30 CFR §§ 206.157(g)(1)(ii) and 206.177(g)(1)(ii)

Banking and parking are necessary services to ensure balancing at market centers and hubs. There is no justification to disallow these fees, especially fees incurred in the same month as a sale. There is usually no physical cessation of the movement of gas; even MMS admits banking and parking are often only "paper" occurrences.

IX. <u>Aggregator/Marketer Fees</u> CFR §§ 206.157(g)(2) and 206.177(g)(2)

MMS proposes to disallow aggregator/marketer fees a producer pays to another person or company (including affiliates) to market its gas. API urges MMS to reconsider. As discussed above, federal and Indian lessees have no duty to market downstream of the lease, and certainly no obligation to do so for free once the production has been placed in marketable condition. If the government wants to enjoy the benefits of higher prices obtainable because aggregator/marketer fees are incurred, it must share in the costs.

X. <u>Intra-Hub Title Transfer Fees</u> 30 CFR §§ 206.157(g)(4) and 206.177(g)(4)

Under the proposed rule, MMS would disallow pipeline intra-hub transfer fees (title transfer tracking) because it considers these fees to be part of the sales transaction. These fees are clearly a necessary part of the transportation process and should not be deemed to be a sales component. The intra-hub title transfer fees are not marketing costs but rather are costs necessary to transport gas through a hub to any one of several potential pipelines in order to maximize the revenue from a sale of gas. The disallowance of the intra-hub title transferee fees unjustly punishes aggressive marketers who are seeking to get the highest price by moving gas through a hub to a better market. It is essential that the hub operator tract the title transfer of the gas as it moves through the hub for an efficient transportation system. API believes that these fees are essential to the efficient management of the transportation process and should be an allowable cost in determining the transportation allowance.

XI. <u>Other Nonallowable Costs</u> 30 CFR §§ 206.157(g)(5) and 206.177(g)(5)

MMS' concern about lessees relabelling or restructuring nondeductible costs as transportation costs is unfounded. All costs incurred to market production after the production has been placed in marketable condition should be allowed. This line should not be difficult to draw. The electronic bulletin board (EBB) example given by MMS illustrates the problems discussed above with respect to MMS' position in this rulemaking.

MMS erroneously assumes that the cost of computer software to access EBB's is not an allowable cost. MMS' assumption is based on the premise that federal and Indian lessees are obligated to provide this "marketing" tool at no cost to the lessor. This, in turn, means that a lessee selling arm's-length at the well who does not incur this expense, and thus is able to sell only at a lower price, must pay royalty on <u>both</u> its arm's-length gross proceeds <u>and</u> the "phantom proceeds" attributable to the value of the computer software that MMS now says the lessee was obligated to provide at no cost to the lessor. This result is not statutorily or contractually authorized, and even if it were, it would constitute a radical departure from the agency's existing regulations that deserves a more reasoned explanation than is contained in the current rulemaking record.

EBB's are used to avoid pipeline penalties, to locate capacity on pipelines, to make nominations and confirmations, and otherwise to obtain the highest possible prices. Certainly, the lessor benefits if the lessee incurs this cost and, as a result, obtains a higher price than otherwise would be obtainable. There currently is no obligation, however, on the part of federal and Indian lessees to obtain the highest possible price obtainable anywhere at any expense, much less for the lessee to do so entirely at its own cost. For the reasons discussed above, MMS' attempt to impose such an obligation through this proposed rulemaking is not only unlawful, it is bad public policy.

In sum, API urges the agency to allow the deduction of all costs formerly deductible as part of a pipeline's bundled transportation charge, since these are costs above and beyond the cost of placing production in marketable condition and, as such, they should be shared by both the lessor and the lessee. Any other result requires the payment of royalties on a value in excess of the value of the production saved, removed or sold from the leased premises, and is therefore in excess of the agency's statutory and contractual authority.

XII. <u>Retroactive Effective Date</u>

MMS proposes to make the changes effective May 18, 1992, the effective date of FERC Order 636. Retroactive application of these changes would be unlawful and API strongly opposes it.

Notwithstanding the MMS' characterization of the proposed rule as a clarification, it is plainly a substantive, legislative rule. By its very title, "Amendments to Transportation Allowance Regulations for Federal and Indian Leases to Specify Allowable Costs and Related Amendments to Gas Valuation Regulations", the MMS' proposed rule contemplates changes to existing rules. And, in fact, the proposed rule contemplates a host of specific, fundamental changes to 30 CFR §§ 206.173(i), 206.153(i), 206.177(i) and 206.173(i) which define new obligations and assert the MMS' authority to enforce them.

The leading case on the subject of retroactive application of a substantive rule is Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 102 L. Ed. 2d 493 (1988). In Bowen, the Supreme Court clearly enunciated its position: It is axiomatic that an administrative agency's power to promulgate legislative regulations is limited to the authority delegated by Congress. Bowen at 208.

The Court further stated:

> Retroactivity is not favored in the law. Thus, congressional enactments and administrative rules will not be construed to have retroactive effect unless their language requires this result. [Citations omitted.] By the same principle, a statutory grant of legislative rulemaking authority will not, as a general matter, be understood to encompass the power to promulgate retroactive rules unless that power is conveyed by Congress in express terms.

Bowen at 488 U.S. 208, 209.

Justice Scalia in his concurring opinion in Bowen further opined that the Administrative Procedure Act rulemaking requirements for substantive rules was controlling and dispositive in this case:

> Given the traditional attitude towards retroactive legislation, the regime established by the APA is an entirely reasonable one: Where quasi-legislative action is required, an agency cannot act with retroactive effect without some special congressional authorization. That is what the APA says, and there is no reason to think Congress did not mean it.

Bowen at 488 U.S. 224.

In sum, MMS' authority to promulgate the proposed rulemaking must be done in accordance with the applicable statutes defining its authority and the Administrative Procedure Act. Under these statutes, the rule cannot be retroactive; accordingly any final rulemaking on this matter must be applied prospectively only.