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Via Facsimile: (303) 231-3194
and First Class Mail

Mr. David S. Guzy, Chief
Rules & Procedures Staff
Royalty Management Program
Minerals Management Service
Building 85, Denver Federal Center
Denver, Colorado 80225

Re: Establishing Oil Value for Royalty Due on Federal Leases
(62 FR 49460, September 22, 1997)

Dear Mr. Guzy:

Marathon appreciates the opportunity to participate in the MMS' recent workshops on the proposed rule and to submit the enclosed comments on the MMS' recently proposed alternatives for establishing oil value for royalty due on federal leases.

As evidenced by the proposed alternatives and the comments submitted earlier by the states and industry, the MMS has begun to recognize the many complexities and uncertainties of its proposed rule. Accordingly, Marathon continues to support and recommend the development and implementation of a federal royalty in-kind program. Such a program would alleviate these complexities and uncertainties, and reduce the administrative burden for both the lessee and the MMS.

If you have any questions please contact me.

Sincerely,

Dow L Campbell

Dow L. Campbell

Enclosure

cc: The Office of Information and Regulatory Affairs
Office of Management and Budget
Attention Desk Officer for the Department of the Interior
725 17th Street, N.W.
Washington, D.C. 20503

[83972]

Marathon Oil Company
Comments on MMS Proposed Alternatives for Oil Valuation
62 FR 49460 - September 22, 1997

INTRODUCTION

In the **Federal Register** on September 22, 1997 (62 FR 49460), the Minerals Management Service ("MMS") published a notice of reopening the public comment period under the proposed rule published in the **Federal Register** on January 24, 1997 (62 FR 3742), and supplementary notice published in the **Federal Register** on July 3, 1997 (62 FR 36030). Therein the MMS outlined alternatives for proceeding with further rulemaking and requested public comment on those alternatives. The public was given until October 22, 1997, to submit such comments; this deadline was subsequently extended until November 5, 1997. Marathon Oil Company ("Marathon") welcomes the opportunity to comment on these alternatives.

BENCHMARKS

Alternative 1 - Bid-out or Tendering Program

As Marathon understands this proposed alternative, Marathon supports the concept of a voluntary tendering program, which results in a true market value at the lease, as an integral part of a revised benchmark system. Marathon has sold crude oil at arm's-length at the lease under a bid-out program; however, Marathon has no direct experience with a formal tendering program. Therefore, before Marathon can endorse such a program, the MMS must first publish the methodology and requirements that it proposes and clearly indicate how such a tendering program would fit into the benchmark system.

MMS requests comments on whether a certain minimum amount of production should be sold pursuant to a tendering program before such a price would be acceptable for valuing the remainder of a lessee's production not sold at arm's-length. Pricing theory suggests it is the marginal barrel which tends to influence the market price in the field or area. Therefore, it is arbitrary to require a specific amount of production be tendered. Any volume greater than a de minimis volume can be representative of market value at the lease. However, recognizing the MMS' concern regarding "significant quantity," Marathon suggests an alternative acceptable to all parties would be a volume equal to the federal royalty interest.

Alternative 2 - Benchmarks

Marathon supports the use of the benchmarks detailed in this alternative as a workable method of determining a royalty price for crude oil produced from federal lands which is not sold pursuant to an arm's-length contract. The federal lessee would be required to review each transaction to determine whether or not it meets the criteria of an arm's-length transaction. If so, royalty would be paid on the gross proceeds accruing to the lessee. If not, the lessee would use other arm's-length transactions under the benchmark system to determine the price for royalty purposes.

The first benchmark would be outright sales of like-quality crude in the field or area, including a tendering program. However, Marathon does not believe these sales must be the result of a tendering program as described in Alternative 1. Many producers sell crude oil outright through their normal marketing procedures. These producers should not be required to implement a formal tendering program in order to use this benchmark for royalty valuation purposes. Outright sales should be used as a benchmark whether or not they result from a tendering program.

The second benchmark is a lessee's or its affiliate's arm's-length purchases of crude in the field or area. Marathon supports the use of this benchmark, and considers arm's-length purchases when valuing equity crude under the current regulations. Marathon actively purchases crude oil at the lease and uses the market price information obtained to value Marathon's equity production. Marathon's practice of reviewing market value and paying premiums was described more fully in the company's comments submitted on May 27, 1997.

The third and fourth benchmarks, outright arm's-length sales by third parties and prices published by the MMS based on its RIK sales, respectively, are valid indicators of market value at the lease. However, Marathon questions whether they are as likely to be available on a timely basis as the other benchmarks. To the extent this information is available, it could be used to value production for royalty purposes.

Marathon suggests the fifth benchmark be revised to include a netback from either an index or the resale of crude by the lessee's affiliate. An acceptable netback methodology would recognize and account for the many costs and risks incurred in moving crude from the lease to a market center. These costs include, but are not limited to, transportation, gravity/quality adjustments, administrative costs, marketing costs, storage costs, in-transit costs, and carrying costs. See Marathon's comments dated May 27, 1997 and August 1, 1997 for a detailed discussion of the problems with the MMS' netback methodology as proposed.

Marathon supports the use of the benchmarks in the order they are listed. The lessee would start with the first benchmark and use it if applicable. If not, the lessee would proceed down through the list and use the first benchmark applicable to its operations. However, an alternative would be for the lessee to elect which benchmark to use. The election would be made for a prescribed period of time, subject to change with the MMS' approval if changes in the market or the lessee's operations so dictated. Marathon would also support this alternative approach.

The MMS asks for comments as to whether a minimum amount of production should be required to be purchased by a lessee or its affiliate or by third parties before such a price would be acceptable for valuing the lessee's production not sold at arm's-length. Marathon's position on representative volumes is explained under Alternative 1.

The MMS also requests comments regarding gross proceeds and a requirement to use the higher of the benchmark value or gross proceeds. Marathon firmly contends the benchmarks should be a proxy for gross proceeds. Assuming benchmarks based on arm's-length transactions are used to value non-arm's-length transactions, a true-up requirement is not applicable. The true-up concept is inherent in the benchmark valuation.

Finally, the MMS requests comments on how it can verify that contracts are indeed arm's-length sales and that they reflect the total consideration for the value of production other than through audit. Unfortunately, there is no way for the MMS to ascertain whether a contract is arm's-length except through an audit. The implementation of a benchmark system would require the MMS to continue to audit lessees. However, the MMS' auditing effort would be reduced as it would be able to perform desk audits for reasonableness on a more timely basis.

Marathon contends any valuation proposal must comply with lease terms and value production at or near the lease. While simplicity and certainty are worthwhile goals, lease provisions should not be sacrificed for their sake. Likewise, audit issues should not supersede valuation issues. The only way for the MMS to eliminate reliance on audits is to implement a comprehensive royalty-in-kind program.

Alternative 3 - Geographic Indexing

Marathon believes that geographic indexing using the MMS' system data is an unworkable alternative. It was also apparent at the various MMS workshops that many, if not all, in attendance agreed that this is an unworkable alternative.

This alternative is unworkable primarily because of the short time frame within which the MMS would be required to publish the data that it receives. Accurateness of the data also could present a problem. To turn the reported data around within such a short time frame would unacceptably increase the chance of errors for both the payor and the MMS. If the data reported is inaccurate, it could require numerous revisions by the MMS and corrections by the payor. Furthermore, to require lessees to pay on some other value until the MMS publishes the values contained in its database would only lead to an increased reporting burden for the lessee and an increase in verification and audit time and expense for the MMS.

Alternatives 1 - 3 - Rocky Mountain Exception

Marathon is interested in simplifying the valuation process rather than complicating it. Any valuation theory and methodology should be applied to all federal production. Exceptions should be made only on a case by case, fact-situation by fact-situation basis. All federal production should be valued according to its fair market value at or near the lease.

As discussed in many companies prior written comments and during the recent workshops, lessees buy and sell crude oil in transactions at or near the lease throughout the United States. These transactions occur not only in the Rocky Mountain Region, but also in the Mid-Continent and OCS regions. In accordance with lease terms and the MMS' long history of valuing production at or near the lease, the MMS must look to these transactions for valuation purposes before using a netback methodology to impute royalty value. There is no basis in fact for using a benchmark system only in the Rocky Mountain Region. The market dynamics which make benchmarks feasible in the Rockies also make them feasible nationwide.

Any exception for a specific geographic area should only be made on a factual basis pursuant to a netback type valuation methodology. And then, only when such netback methodology is the last benchmark in a benchmark system. In that limited circumstance, the beginning point for a netback methodology could vary by geographic area.

DIFFERENTIALS

Alternative 4 - Fixed Differentials

Marathon renews its argument, as discussed in detail in its earlier comments, that the proposed Form MMS-4415 is indeed too burdensome on lessees. However, Marathon cannot support the theory of fixed differentials. A fixed differential cannot adequately reflect the actual costs and risks associated with transporting and marketing crude oil in the market place. The objective of a valuation methodology is to establish a contemporaneous value at the lease. Individual lease value cannot be mechanically derived by adjusting index prices by standard or fixed differentials for a zone or area. Transportation cannot be mechanically reduced to a fixed cent per barrel or a fixed cent per mile rate, nor can quality and transportation be mechanically reduced to a percentage of NYMEX value. A fixed differential can neither mirror the physical flow of the crude oil, nor reflect the constraints of transporting and marketing oil in the domestic crude oil market; actual costs must be allowed.

Fixed differentials create a welfare situation whereby producers of low quality, low volume production in a remote area are subsidized by higher quality, high volume producers strategically located in close proximity to a market center. If the MMS has a standard royalty percentage in a given zone or area, such as the OCS, the MMS is indifferent as to whether the value is accurate on an individual lease basis, as long as the overall pot is correct. However, this concept is not acceptable to producers. Federal lessees should not be subject to a welfare distribution of value.

The MMS has requested comments on three methods to calculate and publish location differentials from the lease to the market centers; however, the proposed methods lack any description of how the MMS intends to calculate these differentials. Are the methods based on the actual costs of transportation, the actual quality differences experienced in the market place, and the actual costs and risks associated with the transporting and marketing of oil? None of these methods alleviate the problems which Marathon identified in its earlier comments to the MMS on its January 24, 1997, proposed rule.

Any quality differentials adopted by the MMS should be timely based on those available in the local market place, and thus dictated by market supply and demand. Otherwise they are arbitrary. Gravity adjustment scales are tailored for specific grades of crude in localized markets, and pipeline quality banks adjust for gravity and/or sulfur. A netback methodology must allow federal lessees to deduct the actual gravity/quality adjustments incurred.

Alternative 5 - Index (Published Spot v. NYMEX)

Marathon maintains a netback methodology should be the last benchmark, not the primary method for determining the royalty price. The MMS' proposed methodology starts with the NYMEX price, but immediately uses published spot prices to derive a NYMEX price at the market center by adjusting the NYMEX price at the index pricing point to the general quality of crude typically traded at the market center, and otherwise to reflect location/quality value differences at the appropriate market center. As discussed in detail in Marathon's comments dated May 27, 1997, the proposed methodology does not account for gravity/quality differences as intended by the MMS.

Marathon is not as concerned whether a netback calculation starts with NYMEX or spot prices as with the adjustments allowed to netback to the value at the lease. The MMS has failed to address many of the concerns expressed in previous comments regarding the costs associated with midstream activities such as transportation, marketing, risk management, and administration. These are actual costs which must be captured and included in any netback methodology regardless of its starting point.

The MMS also requested comments on allowable transportation costs. The MMS should allow actual transportation costs when production actually flows to the market center where the spot price is published. However, the MMS should also allow the actual cost of transportation to an alternate disposal point (i.e. a refinery) when the production does not flow to a market center.

CONCLUSION

Marathon is pleased with the MMS' recent efforts to work with industry to develop a workable oil valuation policy. Through the workshops the MMS, the states, and industry have been able to make progress toward a policy which will determine the market value of crude oil at the lease in accordance with lease terms. As stated herein, Marathon believes the adoption of a benchmark system is a workable method of determining a royalty price for crude oil which is not sold at arm's-length. A netback methodology should be an exception to the rule rather than the rule itself, and should be used only when a contemporaneous value at the lease cannot be determined through another benchmark. Once again, Marathon recommends the MMS withdraw the proposed rule and consider the valuation alternatives discussed during the workshops and in written comments. Marathon strongly believes that valuation procedures can be developed to satisfy lease provisions and the concerns raised by the MMS. Marathon supports the use of a benchmark system to determine market value at the lease. However, no valuation policy will totally eliminate valuation disputes. Therefore, Marathon urges the MMS to work with industry to develop and implement a comprehensive royalty-in-kind program.

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