IPAMS
Independent Petroleum Association of Mountain States

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May 28, 1997

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

RE: Establishing Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil
62 Federal Register 3742, January 24, 1997

Dear Mr. Guzy:

The Independent Petroleum Association of Mountain States (IPAMS) is pleased to have an opportunity to submit comments to the Minerals Management Service on the above-referenced Notice of Proposed Rulemaking. IPAMS is a non-profit, non-partisan trade association representing the interests of over 700 independent oil and natural gas producers, service/supply companies, royalty owners and energy consultants operating in the Rocky Mountain states of Wyoming, New Mexico, Colorado, Utah, Montana, North Dakota, South Dakota, Nebraska, Arizona, Nevada, Idaho, Oregon and Washington. Most IPAMS members are producers of crude oil from federal leases located within these states.

IPAMS believes the new proposed rule on oil valuation should be withdrawn because it is unnecessary and unwarranted. The current oil valuation regulations, promulgated in 1988, remain wholly sufficient to properly determine the value of crude oil produced and sold from federal leases. The new proposed regulations, on the other hand, first contemplate an average national price for oil and then set forth an extremely costly and burdensome "netback from Wall Street" valuation methodology which is directly counter to the principles espoused in the

1988 regulations. The proposed methodology further bears little, if any, relationship to the way crude oil is marketed by small, independent Rocky Mountain crude oil producers.

The Rocky Mountain crude oil market is isolated from other markets

In fact, there are vigorous wellhead markets of willing buyers and sellers at or near the lease throughout the country, and in the Rocky Mountain region particularly. Generally, Rocky Mountain crude oil is sold on a negotiated basis between a buyer -- often, a non-affiliated aggregator/reseller, not a refiner -- and the operator. There are a few independent operators with marketing departments/affiliate marketers which move company production off the lease for sale or trade. However, a recent IPAMS survey of Rocky Mountain crude oil purchasers who purchase more than 90% of the crude oil produced in the Rocky Mountains revealed that, of those independent operators who do not have marketing departments/affiliate marketers, only one operator moves his oil off the lease for sale at a downstream point, and this production amounts to approximately 400 BOD. MMS's assumption that there are no markets at the wellhead is simply incorrect.

It is significant that Rocky Mountain independent producers typically sell their oil at the lease. They do not regularly engage in substantial volume exchanges, nor do they participate in downstream markets. Most current Rocky Mountain production is produced by non-integrated independent producers who sell oil into a buyer's market where prices are established by regional refiners with no economic ties to Cushing prices. Furthermore, the prices for Rocky Mountain crudes are influenced primarily by regional product prices -- based on what refiners can get for refined products. Both Rocky Mountain crude and product prices move independently from prices in other regions. These prices are not controlled by outside economic forces like the NYMEX.

Moreover, it must be recognized by MMS that there is no transparent market price for any of the dozen Rocky Mountain crude oil grades. Platt's Oilgram publishes a price for Wyoming sweet crude at Guernsey, a price which is is set on the basis of phone calls to only one or two Rocky Mountain purchasers and which is never verified by Platt's. Moreover, this price is not entirely reflective of the Rocky Mountain market; there are no prices published anywhere for Wyoming or Rocky Mountain sour crude. While posted prices have been the Rocky Mountain independent producer's primary price reference, other information gathered from various surveys of producer sellers as well as price data obtained from statements of sales of interests in outside operated wells have also been used to negotiate crude oil prices in the Rocky Mountain region.

To further illustrate the fact that the NYMEX price bears little relationship to the Rocky Mountain market, Rocky Mountain crude oil production is locked in to Rocky Mountain refiners, except for an estimated 30,000 BOD that move east out of the Williston Basin and another 40,000-50,000 BOD which move east into the midwest. Virtually all other pipeline transportation in the area is dedicated to moving Canadian crude into the Rocky Mountains and to the midwest. All of the crude produced in the Four Corners area (San Juan Basin) is refined locally.

Rocky Mountain crudes are bought and sold in a market that is entirely separate from mid-continent crudes and which does not track either mid-continent prices or NYMEX prices. For some Rocky Mountain crudes, there is a light/heavy differential and a sulfur differential, but these also frequently move independently from NYMEX light sweet. Therefore, MMS's assumption that there is a single market price for crude oil is erroneous. In fact, there is a whole range of prices in different locations, on different crude oil types, between different buyers and sellers, on any given day.

Further distinguishing Rocky Mountain crude oil production are the facts that most Rocky Mountain wells are operated by independents with small staffs and limited downstream marketing expertise, and that a high volume of Rocky Mountain crude is produced from marginal or stripper wells, few of which produce more than 100 BOD. Moreover, Rocky Mountain crudes are not physically moved to the Cushing market, further isolating the two markets. It is critical, then, that MMS's valuation methodology recognize and reflect regional differences, particularly the unique characteristics of the Rocky Mountain Region market.

<u>The proposed rules violate two fundamental principles of royalty valuation</u>

First, since enactment of the Mineral Leasing Act over 75 years ago, royalty valuation on federal (as well as private) leases has been guided by the principle that gross proceeds received under arm's-length contracts determine market value, and, consequently, royalty payments. However, the proposed rules represent a radical departure from that principle. Second, "netback" methods to determine royalty have been approved only where other methods cannot be used to calculate a wellhead or leasehold value. The MMS's proposed netback method improperly ignores the availability of other, more reliable, valuation methods; it also goes far beyond the accepted reach of netback calculations.

According to the Mineral Leasing Act of 1920, royalty from onshore federal leases is a percentage of the "value of the production removed or sold from the lease" 30 USC § 226(b). The term, "value" as used in the Mineral Leasing Act means the "reasonable market value; that price which a product will bring in an open market, between a willing seller and a willing buyer". See United States vs. General Petroleum Corp., 73 F. Supp. 225, 235 (S.D. Cal. 1947), aff'd. sub nom. Continental Oil Co. vs. United States, 184 F.2d 202 (9th Cir. 1950). In addition, it should be emphasized the Act defines the point at which value is determined at the lease or wellhead or some other point within the lease boundaries. 73 F. Supp. at 235, 254.

In 1988, MMS adhered to and reaffirmed these long-standing principles in adopting comprehensive new royalty regulations. MMS specifically stated that the best measure of the value of oil produced from a lease is the sale price under an arm's-length contract. See 53 Fed. Reg. 1184, 1186 (Jan. 15, 1988). The preamble to the 1988 regulations states, "MMS maintains that gross proceeds to which a lessee is legally entitled under arm's-length contracts are determined by market forces and thus represent the best measure of market value". id. at 1201. The preamble goes on to state, "The MMS believes that, in the vast majority of cases, gross proceeds constitute market value".

Instead of relying on these arm's-length contract prices, MMS now proposes to rely on an "index" price that is the NYMEX "price" for oil east of California (and the ANS price for oil in California). However, NYMEX prices do not constitute arm's-length contract prices. The NYMEX price is an artificial futures market price for the month following production that reflects an estimate of what speculators and traders believe the price will be in the next month for oil delivered to Cushing, Oklahoma. In a contango market, futures prices can be higher than today's prices. Moreover, posted prices don't respond to NYMEX fluctuations as quickly when prices increase as when they decline.

In choosing to rely on NYMEX prices, MMS is ignoring the sound economic rule set forth in General Petroleum and followed in the 1988 regulations: that the best measure of market value is the price reflected in an arm's-length contract. Arm's-length contracts -- not NYMEX futures prices -- represent the value of production under the Mineral Leasing Act. MMS cannot simply ignore those arm's-length contracts in promulgating royalty valuation rules.

The basic thrust of MMS's proposed methodology is to impose a type of "netback from Wall Street" system. MMS starts with the NYMEX "price" for oil at Cushing, Oklahoma, and subtracts a location/quality differential to come up with a theoretical oil value at the lease.

The typical netback approach takes the value of the oil or gas at a point downstream, then subtracts the actual costs of getting the production to that location, as well as costs that enhance the value of the product. Because this method yields only an approximate value of the product at the lease -- it does not necessarily reflect what a purchaser would have been willing to pay for the product in the field -- courts have noted that the netback method is the "least desirable method of determining market price...". Piney Woods Country Life School vs. Shell Oil Co., 726 F.2d 225,239 (5th Cir. 1984), quoting Marathon Power Co. vs. Kravik, 586 P.2d 298, 303-04 (Mont. 1978). Indeed, MMS's 1988 regulations reflect this strong preference for other valuation methods (e.g., relying on comparable sales in the field) by listing the netback method as the last in the hierarchy of benchmarks to be applied in determining the value of oil transferred under non-arm's-length contracts. 30 CFR § 206.102(c) (1996).

IPAMS' review of the preamble to the 1988 final rule (30 CFR § 206) regarding valuation of crude oil and gas, highlighted the following excerpts regarding the importance of relying on the marketplace as the proper determinant of value. IPAMS will cite to the Federal Register for January 15, 1988 (53 Fed. Reg. 1883). At page 1886, and in response to comments on the acceptability of gross proceeds as the value for royalty purposes, MMS stated as follows:

> *MMS maintains that gross proceeds to which a lessee is legally entitled under arm's-length contracts are determined by market forces and thus represents the best measure of market value.*

MMS specifically responded to the suggestion of the states that gross proceeds values should be tested and validated by using the netback procedure as a cross check by stating the following:

> *The MMS believes that gross proceeds under arm's-length contracts are representative of market value. However, MMS will continue to monitor value determination under its regulations to ensure that those determinations yield reasonable values. To routinely perform labor intensive netback calculations is impractical.* (emphasis added)

Also at the same page in response to criticism that the benchmark hierarchy system may not effectively be applied because of the system's complexity, MMS responded as follows:

> *MMS supports the benchmark system. Most of industry, those who report under the system, believe it to be a workable system.*

IPAMS, too, supports the benchmark system. However, we are opposed to the use of a single benchmark -- a NYMEX price -- for valuing non-arm's-length sales. IPAMS endorses the concept that arm's-length sales be valued on the gross proceeds received for the production at or near the lease, and that valuation for non-arm's-length transactions be based on comparable true arm's-length transactions in the same field or area. Only as a last resort should any type of indexed or futures price be used. It should be noted IPAMS believes there are other, better published market price indicators for certain areas or regions than the NYMEX price. IPAMS would be pleased to work with MMS to develop a set of benchmarks based on these criteria.

At page 1187, state and Indian commentors challenged the MMS' statement that the proposed regulations would yield long-term benefits to royalty owners. MMS responded as follows:

> *MMS believes that the regulations provide valuation criteria that will result in reasonable values and will create an atmosphere of certainty in royalty payments and thereby correct some of the royalty deficiencies encountered in the past.*

At page 1196, there was considerable discussion about the netback methodology. MMS indicated that the netback method should be used for valuation only where the form of the lease product had changed and it was necessary to start with the sales price of the changed product and deduct transportation and other costs including processing. MMS used as an example, oil production used on lease to generate electricity which is then sold to a third party. Many commentors objected to this netback because it would result in MMS doing a netback from the farthest downstream product. MMS stated "it was not MMS' intent to netback from downstream products". It is apparent that MMS is now changing its position by going to NYMEX. MMS must draw a distinction between lease production on the one hand as being the product subject to royalty, and the NYMEX paper barrel, which is a commodity rather than a lease product. This transition is a legal transformation into a non-lease product which runs contrary to the statute, the terms of a federal lease and the applicable regulations.

At page 1198, MMS provided extensive responses in support of the arm's-length valuation proposal. The reasons cited by MMS for the use of the gross proceeds standard are as follows:

1. MMS typically accepts this value because it is well grounded in the realities of the marketplace where, in most cases, the 7/8ths or 5/6ths owner will be striving to obtain the highest obtainable price for the oil production for the benefit of itself, the royalty owner benefits from this incentive.

2. It also adds more certainty to the valuation process for payors and provides them with a clear and equitable value on which to base royalties.

3. Under the final regulations, in most instances the lessee will not need to be concerned that several years after the production has been sold MMS will establish royalty value in excess of the arm's-length contract proceeds, thereby imposing a potential hardship on the lessee.

4. The gross proceeds standard will give auditors an objective basis for measuring lessee compliance.

5. [The gross proceeds standard] will reduce audit workload and reduce the administrative appeal burden which results when valuation standards are too subjective, particularly when values are determined to be in excess of the lessee's arm's-length contract gross proceeds.

At page 1200, MMS made the following statement:

> *MMS believes that gross proceeds under an arm's-length contract generally constitutes the market value of a commodity. This does not preclude MMS from establishing a value where necessary, e.g., a contract does not meet MMS's standards for an arm's-length contract, the lease agreement requires a different value, or the lessee has engaged in misconduct.*

At page 1232, MMS made the following statement regarding the gas benchmark system, which is equally applicable to crude oil:

> *MMS does not agree that the benchmark system will be difficult to administer or that there will be a lack of cross checks. MMS realizes that it must become increasingly familiar with transactions occurring in the areas where federal and Indian leases are situated. By becoming more familiar and obtaining sales volume and price information, MMS will be able to identify anomalies that exist and review the circumstances involved in those transactions.*

At page 1247, MMS makes the following statement regarding multiple contracts:

> *MMS recognizes that some parties may have multiple contracts with one another. This fact alone would not cause a contract to be treated as non-arm's-length. Rather, there must be some indication that the contract in question does not reflect the full agreement between the parties.*

The proposed regulations represent a radical departure from the findings that MMS made at the time of the adoption of the 1988 regulations. At page 1249, the MMS makes the following statement with respect to the netback method:

> MMS agrees that the netback method will not be used frequently. The netback analysis should only be used where less complex procedures are not feasible. For purposes of this section, MMS does not consider a situation where either transportation or processing allowances are deducted from an arm's-length delivered sales price for gas as a netback.

It would appear MMS is ignoring the fundamental principle that royalty value is determined at the royalty point picked by the BLM on the lease and where the product changes hands for a valuable consideration. If the product exchange is an arm's-length transaction the gross proceeds become the applicable value for royalty purposes. If the product is exchanged through a non-arm's-length transaction, then the benchmark system is required. Many of the numbers used by MMS to calculate the netback seem to have been picked out of the air and lack any rational support.

One way for MMS to validate and verify prices in a given field or area would be for MMS to take some of its crude oil in-kind at the lease and sell it on the open market. This would give MMS the opportunity to see the real market rather than relying on calculations of a netback from the NYMEX. IPAMS is encouraged to see MMS' efforts to study the feasibility of taking its royalty in-kind and urges MMS to maximize the amount of production taken in-kind. IPAMS believes this is the most rational and reasonable approach to satisfying the royalty obligation and one which would benefit both industry and the American taxpayers.

MMS's proposal to use a netback approach is not warranted because there exist arm's-length contracts that establish the value of oil in the field. Moreover, MMS's proposed methdology deviates substantially from a true netback method. Rather than use the downstream value of the oil actually produced from the leases as the starting point for the calculation, MMS proposes to use a value for paper barrels traded on Wall Street. While a true netback approach is the least desirable royalty valuation method and should be use only as a last resort, MMS's proposed approach is far worse -- it is not a valid, accepted approach.

<u>Inclusion of crude oil purchases, exchanges and agreements with crude oil calls virtually eliminates arm's-length transactions</u>

Adding insult to injury, MMS proposes this netback methodology for all non-arm's-length transactions, then attempts to eliminate virtually all arm's-length transactions by excluding all agreements which retain a call on crude oil production -- whether the call has ever been exercised or not, as well as all producers who have bought crude oil within the last two years -- without regard to either the size or purpose of the crude oil purchase.

The "netback from Wall Street" approach to valuing oil sold under a non-arm's-length transaction is fundamentally and fatally flawed. Even if an acceptable non-arm's-length valuation method had been proposed, however, the rule would still be objectionable because it narrows the definition of an arm's-length transaction in an unfair and unnecessary way that will have a significant adverse impact on small independent producers. In particular, IPAMS strenuously objects to proposed §206.102(a)(6) which would require a lessee to net back from Wall Street, even though he sold oil at arm's-length, if the lessee or any of his affiliates purchased any crude oil from any third party anywhere in the country at any time in the two years preceeding the arm's-length sale.

The stated rationale for this two-year rule is that several MMS "consultants" had convinced the MMS that "multiple dealings between the same participants, while apparently at arm's-length, may be suspect concerning the contractual price terms" (62 Fed. Reg. 3743). MMS then concludes that buying crude oil from third parties is the functional equivalent of entering into an "exchange agreement". IPAMS takes serious issue with the MMS's market theory of exchange agreements, but even under the MMS's own theory, an exchange must involve a contemporaneous exchange of equivalent volumes to be suspect. The two-year rule, on the other hand, amounts to using cannons to kill flies.

The rule is grossly over-inclusive. Producers who have never seen an exchange agreement still buy oil for use as load oil and field fuel. Even if a producer purchases third-party oil, those volumes would have to be equivalent to and purchased from the same party the producer is selling to. Moreover, two years is an eternity in the oil market. There is no justification under the MMS's market theory to go back even one month, let alone 24 months, to disqualify an arm's-length contract. The rule is also uncertain in its application to a variety of daily occurrences in the field. For example, if an operator sells a non-operator's oil under the standard provisions of a joint operating agreement, has he purchased crude oil for the purposes of the rule? Has a lessee who pays his lessor in cash rather than in kind purchased crude oil for purposes of the rule?

The alternative proposal is narrower in one sense -- at least it limits disqualified arm's-length contracts to situations where the lessee has other dealings with the purchaser. But again, the proposal does not reflect the volume and equivalency that is critical to market theory cited by MMS as the reason for the rule. Moreover, the uncertainty of the alternative proposal is magnified by the use of the phrase "goods and services". Is a producer's arm's-length sale to a company disqualified because that company operates properties in which the producer has an interest? Is the sale disqualified because the producer bought drill pipe manufactured by the purchaser's affiliate?

IPAMS also objects to the treatment as non-arm's-length of oil produced subject to calls where the parties to the call agreement are not affiliated in any manner. Regardless of whether the call is exercised or not, § 206.102(a)(4) of the proposed regulations requires valuation of crude to be based on NYMEX prices under § 206.102(c)(2)(i). In making this requirement, MMS presumes that the price of oil sold under an arm's-length contract subject to crude oil calls is "suspect". (62 Fed. Reg. 3742, 3744). MMS states that calls are similar to "multiple dealings between the parties" and must bear a similar presumption. However, no data or other analysis is provided to support this presumption.

The presumption also applies to calls retained in farmout agreements. However, the proposed regulation makes no finding that farmouts are the result of "multiple dealings between the parties" nor that they are otherwise "suspect". The presumption indulged in by MMS ignores the reality of the role and function of a call in farmouts, particularly those involving IPAMS members. The typical farmout which the independent producer in the Rocky Mountain region enters into is not the result of "multiple dealings between the parties". Instead, the Rocky Mountain independent producer deals with unaffiliated parties in negotiating farmouts. These dealings are arm's-length, made on an isolated basis, and not always made with an integrated major oil company which is also in the business of refining crude oil. In fact, most of the time, the Rocky Mountain independent producer obtains farmouts from other independents or mid-size, non-major oil companies which do not have refining affiliates.

Clearly, under these circumstances, MMS's presumptions are unfounded. The valuation proposal for calls would apply regardless of whether the call is exercised. Frequently, however, calls are never exercised. If the call is not exercised, the typical Rocky Mountain independent producer will sell the crude at the wellhead/tank battery in an arm's-length transaction to someone other than the party giving the farmout. Most purchasers of crude oil in the Rocky Mountains are not also producers in that area. Clearly, in this situation, if the call is never exercised, the sale should be treated under an arm's-length valuation regulation.

In addition, the proposal for valuing crude oil subject to calls fails to identify the variety which exists in types of call provisions. In the Rocky Mountain area, a typical call will have a "favored nations" type of provision which requires the holder of the call to either match the price in a bona fide third party offer or release the call. Here again, the situation does not justify non-arm's-length treatment. The manner in which MMS would treat calls in agreements is misguided and will not withstand judicial scrutiny. Conway vs. Watt, 717 F.2d 512 (10th Cir. 1983).

MMS' proposed change in valuation methodology lacks rationale or justification

MMS bases its entire proposal on the evidently faulty assumptions provided by three so-called consultants, whose motives may very well be "suspect" themselves. In fact, we understand that at least some of MMS's consultants are expert witnesses for plaintiff royalty owners in pending state royalty cases, and who stand to receive a percentage of any recovery made by the royalty owners. It is disturbing that MMS would rely on such "bounty hunters" to provide advice in royalty matters. There is no data, evidence, nor sound analysis presented by MMS to substantiate its assumptions or to justify the need for such a radically different approach to crude oil valuation.

In fact, MMS fails to provide any explanation for the assumptions it relied on in developing these proposed regulations. Agency rules are considered arbitrary if the agency's explanation is "so implausible that it could not be ascribed to a difference in view or the product of agency expertise". Motor Vehicle Mfrs. Ass'n. vs. State Farm Mut. Auto. Ins. Co., 463 U.S. 29 (1983). Because of the lack of any explanation to establish the validity of the presumption, MMS has failed to make an affirmative case for its actions. Agencies are expected to "make their case". FPC vs. Transcontinental Gas Pipe Line Corp., 423 U.S. 326, 331 (1976). Courts reverse agency determinations when the agency's reasoning is obscure (FPC vs. Texaco, Inc., 417 U.S. 380, 395-97 (1974)) or when the agency has not demonstrated that serious thought was given to make its decision rational (Greater Boston Television Corp. vs. FCC, 444 F.2d 841, 851 (D.C. Cir. 1970) cert. denied, 403 U.S. 923 (1971). In the case of Santa Fe International Corp. vs. Watt, 591 F. Supp.929, 936 (D. Del. 1989), the court stated that if the agency's interpretation of the regulations or the statute is contrary to legislative history or purpose, the court will not hesitate to reject it. The U.S. Supreme Court, in Motor Vehicle Mfrs. Ass'n., supra, stated, "If an agency departs from its own longstanding construction of a statute, it must supply a reasoned analysis for its change of course".

Moreover, MMS's rationale for the proposed rule seems to be based chiefly on a decided lack of trust. Lessees have entered into a contractual relationship with the federal government -- one that requires fundamental fairness and trust. Since MMS has provided no further justification for the proposed regulations other than faulty assumptions based upon other faulty assumptions. IPAMS strongly urges MMS to withdraw the proposed rule and retain the 1988 oil valuation regulations. MMS has not satisfactorily demonstrated a real need to do otherwise.

NTL-5 Act bolsters valuation based on arm's-length contracts

In 1987, Congress passed the Notice to Lessees Numbered 5 Gas Royalty Act of 1987 ("NTL-5 Act"). This legislation was passed in order to modify existing Department of Interior regulations which required lessees to compute and pay royalties on the higher of gross proceeds or the highest applicable ceiling rate established by the Natural Gas Policy Act of 1978 (15 USC 3301, et seq.) ("NGPA"). Congress found that between 1982 and 1986 gas prices in many areas declined below maximum lawful prices established under the NGPA and the continued application of NTL-5 required some royalties to be paid on the basis of a ceiling rate higher than the market value of the gas. Also, Congress found that the failure to adjust the method of calculating royalty payments resulting from changes in the gas market created various problems in valuation, produced inequitable situations for many lessees and payors whose gas market price was well below NGPA ceiling prices, and created uncertainty associated with the collection of royalty revenues. Congress also found that the uniform application of NGPA ceiling prices was inequitable given market conditions during this period.

Because of these findings, Congress enacted the NTL-5 Act which permitted lessees and payors to account for federal royalties on the basis of prices received under arm's-length contracts even if the applicable ceiling rate established by the NGPA was higher.

IPAMS submits that Congressional policy as established by the NTL-5 Act makes it clear that prices received under contracts which are reflective of values in the field or area of production are the best determinant of value for royalty purposes. IPAMS further submits that Congress has spoken by the enactment of the NTL-5 Act. MMS must acknowledge that Congressional policy is paramount and must be observed in any rulemaking. Congress recognized that market conditions are the most reliable value for royalty purposes rather than some artificial construct which is not reflective of market values. Congress found that the NGPA and its hierarchy of ceiling prices no longer reflected values received in the real market place, i.e., the field or area where production occurs. IPAMS also submits that resorting to the NYMEX methodology violates Congressional policy as enunciated in the NTL-5 Act and should not be utilized because it will bear no relationship to the actual value of crude oil in fields where there is an established market.

Historically, the Department has accepted prices under arm's-length and non-arm's-length contracts. With respect to the latter type of contract, they have been acceptable for royalty purposes as long as prices received under such a contract are consistent with prices received under arm's-length contracts in the same field or area. *Getty Oil*, 51 IBLA 47 (1980). Courts have recognized that a longstanding policy of the Department can constitute a rule or covenant running with the land which cannot be altered. See. Marathon Oil Company vs. Andrus, 452 F. Supp. 548 (D. Wyo. 1978); Gulf Oil Corp. vs. Andrus, 460 F. Supp. 15 (D. Cal. 1978) (payment of royalty on oil or gas regardless of whether it was removed, saved or sold was unwarranted because longstanding practice of the Department was not to collect royalty on oil or gas loss in spills, blowouts, fires, or oil or gas which was vented or flared or used for lease purposes.) The Department of the Interior never appealed these decisions. IPAMS finally submits that acceptance of prices under contracts representative of arm's-length values in the field or area has been the consistent policy of the Department since the inception of the Mineral Leasing Act and is consistent with the provisions of the Mineral Leasing Act.

Plain English/Duty to Market

IPAMS supports MMS' efforts to write its regulations in plain English. However, we must repeat the caveat that, where unamended portions of the regulations require revising, MMS must take special care not to make any substantive changes to the regulations. A perfect example of "reconstructing" the regulations via plain English is MMS' continued attempt to impose on lessees a new duty to market. This onerous provision made its debut in the Amendments to Transportation Allowance Regulations for Federal and Indian Leases published in July 1996. IPAMS took exception to the provision in that proposed rule, and we take exception to it here. MMS is establishing an elaborate new marketing standard while moving the point of valuation all the way to Wall Street! This is a blatant attempt to increase government revenues at the expense of the lessee.

Notwithstanding any other comments IPAMS has made on the proposed rule, inclusion of a "duty to market" concept in the regulations is clearly the most oppressive. What concerns IPAMS members is the implication that failure by a producer to market production in such a manner as to earn the highest price possible, however far downstream of the lease, would constitute a breach of this new duty to market. Of paramount concern is that auditors will apply this new marketing standard long after the actual sale and require additional royalties -- and interest -- on a value higher than that received for the production because the auditor believed the producer should have marketed the production differently to obtain a higher price. IPAMS still holds that the creation of this new duty to market violates applicable statutes and lease terms. Moreover, MMS' retention of this concept will likely hobble the rule in litigation for many years to come. IPAMS believes this is an issue which should be decided outside the rulemaking process.

Interim Final Rule

MMS has suggested it will publish an interim final rule while it further evaluates the methodology in this proposed rule, to provide MMS with the flexibility to revise the regulations after the first year without the necessity of promulgating a new rule. IPAMS is adamantly opposed to the publication of an interim final rule. To adjust one's royalty accounting systems once is burdensome. To have to do it twice is unwarranted and unnecessary. MMS must have enough confidence in its regulations to finalize them without having to further evaluate them at the expense of producers. A limited and voluntary pilot program would be a more appropriate means for evaluating a new methodology.

Conclusion

MMS has gone too far in proposing a sweeping NYMEX-based valuation methodology. The rule as proposed so narrowly defines arm's-length transactions as to virtually eliminate them. To subject small independent producers in the Rocky Mountain region to a NYMEX-based valuation methodology is ludicrous. Moreover, the valuation methodology proposed by MMS fails to even approximate the value of production sold at or near the lease. Moreover, the collection of data via the proposed MMS Form-4415 is unworkable and will not provide MMS with accurate enough data on which to base reasonable location and quality differentials.

Historically, MMS has endorsed gross proceeds as the appropriate value for arm's-length transactions. Similarly, MMS has supported the benchmarking system to value non-arm's-length transactions -- one based on looking first to comparable arm's-length sales. Meanwhile, MMS has avoided any netback methods, deeming them the "least desirable" valuation methods. IPAMS can see no justifiable reason to depart from these longstanding and proven principles. Nor has MMS justified its perceived need to do so.

MMS is simply concerned with a limited number of transactions which it deems "suspect". Very well. Then MMS should make those transactions the exception to the rule and permit itself a closer examination of them. Don't alter the universe to capture comets. The 1988 regulations work well for crude oil valuation. In the vast majority of cases MMS has received proper payment on appropriate values under the 1988 regulations.

IPAMS recommends MMS withdraw the proposed regulations and concentrate its efforts on improving the 1988 benchmarks. Again, IPAMS would welcome an opportunity to discuss appropriate benchmarks with MMS.

We appreciate the opportunity to provide you with our comments and trust you will give them your serious consideration. As always, please do not hesitate to contact me if you have any questions, or if you would like to discuss IPAMS' comments in greater detail.

Sincerely,

Carla Wilson

Carla J. Wilson
Tax and Royalty Director