320 PARK AVENUE
NEW YORK, NY 10022-6815
(212) 508-3200
TELECOPIER: (212) 508-3230

811 NORTH OLIVE AVENUE
WEST PALM BEACH, FL 33401
(407) 832-6966

LANE & MITTENDORF LLP

919 18TH STREET, N.W.
WASHINGTON, D.C. 20006

(202) 785-4949

TELECOPIER: (202) 466-5289

CITY TOWER, LEVEL 4
40 BASINGHALL STREET
LONDON EC2V 5DE
(171) 628-4020
TELECOPIER: (171) 628-4070

499 THORNALL STREET
EDISON, NJ 08837
(908) 494-5100
TELECOPIER: (908) 494-7271

May 27, 1997

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

RE: Establishing Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil, Notice of Proposed Rulemaking, 62 Fed. Reg. 3742 (January 24, 1997)

Dear Mr. Guzy:

I. Introduction

We are submitting these comments on Establishing Oil Value for Royalty Due on Federal Leases, and on Sale of Federal Royalty Oil, 62 Fed. Reg. 3742 (proposed January 24, 1997) ("NOPR"), on behalf of Taylor Energy Company of New Orleans, Louisiana ("Taylor"). Taylor is an independent producer of oil and gas on the Outer Continental Shelf. Taylor's production from three Federal leases is subject to a right of first refusal held by a major oil company which is not affiliated in any way with Taylor. Given the proposed treatment of that crude sale, Taylor will be directly affected by the proposed changes to the valuation methodology proposed in the NOPR published by the Minerals Management Service ("MMS") of the Department of the Interior, particularly that section of the NOPR addressing oil production subject to a crude oil call.

Our comments focus particularly on that section of the NOPR that alters the treatment of Federal royalty oil subject to a crude oil call. In the interest of brevity and economy, Taylor has not discussed issues already addressed by other commenters. Taylor, however, endorses the views of the Independent Petroleum Association of America and incorporates those comments herein by reference. Taylor supports fully those comments.

II. The NOPR

For sales that fit within the criteria of "arm's length" sales, the NOPR retains gross proceeds as the royalty value. However, the NOPR significantly changes the current regulations by redefining what sales are considered to be not at arm's length and by imposing artificial crude oil valuations on those sales.

The NOPR assumes that all call provisions result in royalty payments below the market price at the wellhead. The new rule, therefore, will treat all sales under contracts subject to a crude oil call as non-arm's length sales. For these sales, the MMS has concluded that posted prices do not accurately reflect market value. The MMS is proposing elimination of posted prices as a valuation standard in favor of a complex index pricing methodology based, for leases not in California or Alaska, on certain New York Mercantile Exchange ("NYMEX") futures settle prices adjusted for location/quality differentials and transportation costs.

If the proposed rule becomes final, most sales of federal royalty oil will be deemed to be not at arm's length regardless whether the sale was, in reality, an arm's length sale. Such a result, increasing the financial burden on federal lessees without adequate justification, would be arbitrary, capricious and an abuse of agency discretion.

III. Current Law and Regulations

The Mineral Leasing Act provides for the lease of land in exchange for a royalty to be paid in amount or value of the production. 30 U.S.C.A. § 223 (1986). The current MMS regulations addressing valuation of Federal royalty oil provide that (i) the value of Federal royalty oil sold at arm's length is the gross proceeds accruing to the lessee and (ii) the value of such oil not sold in an arm's length transaction is the lessee's contemporaneous posted prices or oil sales contract prices. 30 C.F.R. § 206.02 (1996). The current regulations comply with the requirements of the Notice to Lessees Numbered 5 Gas Royalty Act of 1987 (the "Act"). The Act specifies that reasonable value for oil and gas production shall be calculated by taking into consideration "the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters." Notice to Lessees Numbered 5 Gas Royalty Act of 1987, Pub. L. No. 100-234, 101 Stat. 1719, 1720 (1988). The current regulations accomplish that purpose.

In contrast, the NOPR ignores the market for crude at the wellhead. The NYMEX price for futures is driven by factors apart from the price a willing buyer and willing seller will agree to at the lease. *See* Comments of Independent Petroleum Association of America 32-36 (May 15, 1997) (filed with the MMS). As such, it is not a relevant criteria upon which to base value. The

MMS should continue to be mindful of the appropriate standards for value expressed by Congress.

IV. Taylor's Comments

A crude oil call is defined in the proposed rule as "the right of one person to buy, at its option, all or a part of the second person's oil production from an oil and gas property." 62 Fed. Reg. at 3751. The NOPR states, "if your oil production is subject to a crude oil call, even if you sell it under an arm's-length sales contract, you must value it under the index pricing provisions." *Id.* at 3744. This provision was added because all transactions in which a crude oil call is involved are "suspect." The MMS's suspicions arise because "the sale terms may be liberal to the property buyer in return for a favorable product purchase price by the property seller." *Id.*

A. The NOPR Improperly Classifies the Sale of Oil Subject to a Crude Oil Call as a Non-Arm's Length Sale

The treatment of every call contract as non-arm's length is ill-advised and inappropriate. The NOPR cites no facts or evidence to support the MMS's presumption that sales pursuant to the exercise of crude oil calls result in loss of revenue to the MMS. Nor do statements in the record evidence support such a supposition. The anecdotal evidence upon which the MMS may be relying is inconsistent with Taylor's experience and with Taylor's understanding of the use of crude oil calls in the industry.

The proposed rule presumes that a seller of crude oil would not try to maximize its own profits. In fact, many agreements that include such calls require that the call be exercised at a premium above the posted price. Taylor's crude sales contract gives its lessor the right to exercise its option to purchase crude only if the lessor meets or exceeds a competing arm's length third party offer. If the lessor does not exercise its right of first refusal, Taylor sells the crude at the same price, namely the best possible price. There are times when the lessor's call price exceeds the price which Taylor can receive from third parties. Obviously, the call <u>benefits</u> MMS in those situations. Still, the new rule, as proposed, would presume that Taylor and its lessor colluded to drive down the price that Taylor would receive for its production in order to deprive the MMS of royalty revenue. This is not a logical position for the MMS to adopt given the lack of evidence in the record upon which to base such an assumption.

B. The NOPR Improperly Applies Index Pricing to Sales at and above Market Value

The index valuation methodology is required under the NOPR not only where calls are exercised for a price below market value, but even where the exercise price of the call equals or exceeds the wellhead market value. A lessee selling oil upon the exercise of a call is provided no opportunity to rebut the MMS presumption that the sale is for less than market value. The proposed rule goes well beyond protecting the Federal government's interest in the amount of royalties received. It denies producers due process by not allowing challenges to the MMS presumption.

The proposed rule also applies the index valuation methodology where no call is exercised, simply because the production was subject to a call. As a result, an arm's length sale for market value, which otherwise would be subject to the gross proceeds rule, must utilize the index methodology simply because the call could have been exercised. There is no logical basis for such a requirement. If a call is not exercised or a purchaser pays the wellhead market price for the crude, the sale is exactly like all other arm's length transactions. The current regulations should be applied to both types of sales. Agencies must treat similarly situated parties the same unless there is a valid reason for failing to do so. *Independent Petroleum Ass'n v. Babbitt*, 92 F.3d 1248, 1258 (D.C. Cir. 1996). Failure to treat similarly situated parties similarly is arbitrary and capricious, and any such decision of MMS would be subject to reversal by a court. The MMS has demonstrated no valid reason for treating one arm's length sale differently from another simply because an entity not party to the sale could have exercised a call. This requirement would, therefore, inevitably be overturned in subsequent litigation as arbitrary and capricious action by the agency.

C. Classifying the Sale of Oil Subject to a Crude Oil Call as a Non-Arm's Length Transaction Will Have a Chilling Effect on Farmouts and Assignments of Federal Leases

Farmouts and assignments of leases provide an invaluable mechanism for the continued and/or expanded production of oil when the original lessee chooses not to incur the expense of further developing the lease. Continued and/or additional production results in greater royalties for the MMS. Obviously such transactions benefit MMS and should be encouraged.

Taylor acquired its interest in the Leases by assignment. As part of the assignment to Taylor, the lessor received the right of first refusal to purchase crude oil production <u>but only if the lessor paid the same or higher price as bona fide third party purchasers</u>.

If MMS arbitrarily assumes that such a right of first refusal requires producer to value crude on unrealistic NYMEX prices, it will inhibit future lease assignments and farm-outs. Rather than benefitting MMS through presumed greater royalties such treatment will stifle full development and enhanced production from leases. Less production means less royalty payment to MMS.

As proposed, the new rule would arbitrarily reduce or eliminate the incentive for a lessee to enter into such a lease arrangement, because the treatment of sales of oil as non-arm's length would unnecessarily impose a complex valuation arrangement and increase costs for the lessee. This would discourage parties from entering into such arrangements, with the result that potential gas and oil reserves may go undeveloped, thus depriving the MMS of royalties on that production.

D. Current MMS Regulations Provide Adequate Protection against Abuses

The MMS's broad approach to all call provisions is unwarranted as MMS has ample protection if the contract price is below market or posted prices. The MMS may audit its lessee to determine whether an arm's length contract for the sale of production reflects the total consideration received by the lessee. 30 C.F.R. § 206.102 (1996). If the MMS finds that the contract does not adequately reflect consideration, it may require that the oil be valued as if not sold at arm's length. *Id.* The MMS has not claimed that it is losing royalties as a result of the exercise of calls, nor has it demonstrated that the remedial procedures currently in place are inadequate. In fact, the MMS has given no reasonable explanation for the implementation of this provision of the proposed rule. The theoretical possibility which MMS cites in its NOPR is simply an insufficient basis for imposing such a burdensome obligation on lessees.

V. Conclusion

Taylor supports the efforts of the Department of the Interior to collect royalties based upon the fair and accurate production of oil from Federal lands. Taylor, however, respectfully requests that the MMS remove the provision in the proposed rule requiring the index valuation methodology for Federal royalty oil subject to a crude oil call. The alleged benefits that may result do not outweigh the burdens that will be imposed on lessees because, at least under Taylor's contract with the lessor, few calls are exercised and those that are exercised often require the lessor to pay a premium over the posted price. The collusive arrangements envisioned by the MMS rarely occur, and when they do occur they may be addressed through existing regulations designed for that purpose.

Taylor appreciates the opportunity to comment on this proposed rule and looks forward to working with the MMS further to develop rules that are equitable to all parties.

Very truly yours,

LANE & MITTENDORF LLP,
Attorneys for Taylor Energy Company

By: Richard G. Morgan

Richard G. Morgan
Patricia S. Mugavero
919 18th Street, N.W.
Suite 800
Washington, D.C. 20006
202/785-4949