STATE OF WYOMING
OFFICE OF THE GOVERNOR

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STATE CAPITOL
CHEYENNE, WY 82002

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May 27, 1997

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

Re: Proposed Rules Establishing Oil Value for Royalty Due on Federal Leases.
Federal Register, Vol. 62, No. 16 (January 24, 1997)

Dear Mr. Guzy:

Thank you for providing the State of Wyoming an opportunity to comment on this extremely important change in valuation methodology for federal royalty purposes.

The proposed change would only affect valuation for royalties on federal leases. Obviously, it has the potential of affecting not only revenue to the US Treasury but also to the State's treasury. Furthermore, if the valuation methodology proposed in the new rules is a valid, defensible method, it might be difficult for the state to justify adopting a different valuation method for royalties on state leases and maybe even for taxation purposes. This is why it is not lightly that we comment on the proposed rule.

We understand the concerns of the Minerals Management Service regarding valuation of oil when the transactions have become so complex in our global market. We applaud the efforts to simplify the administration of the valuation function. However, we must take great care not to paint with too broad a brush for fear of creating another set of complexities which might be tainted with unfair results.

The state can support the addition of an index basis as the starting point of valuation, but only in the case of true non-arms length transactions. Given the volatility of the oil market, we would

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like to express some reservations regarding the choice of NYMEX as the index of choice. Although care was taken to pick a time as close to production month as possible, it still remains that the valuation will be based on a futures price rather than the actual trading price during the month of production. Indexing, done on the broad scale advocated by the revised methodology, may keep the revenue neutral on a global scale but not on the state level. We fear that Wyoming will end up being a net loser. The calculations required to arrive at a netback value from Cushing, Oklahoma may have two opposite effects, neither one yielding a fair value. An independent's gross proceeds at the lease may actually be higher, based on the local supply and demand forces for his quality of crude, than NYMEX adjusted for transportation. Both US and State treasuries would lose royalty revenue. On the opposite side, and for the same reasons, adjusted NYMEX may be higher than gross proceeds. In this case the lessee would pay royalties on phantom income. Neither situation is fair. This is a serious concern.

The second, and more vigorous, objection we would like to make concerns the very restricted application of an arms-length transaction. Wyoming has a large population of independent producers. The majority of them sell their oil at the lease. When there is no market at the lease, MMS has accepted valuation for royalty purpose established by the first sale adjusted by a transportation allowance from the lease to the point of first sale. This is a clear recognition that the lease is the point of valuation. The proposed rule would deny the existence of an arms-length sale at the lease if the lessee has purchased crude oil from an unaffiliated third party in the United States in the two year period preceding the month of production. The assumption here is that the lessee had entered into a deal whereby complicated exchanges over a two year period would allow the parties to stay in overall balance and report below market values. All this, without checking whether or not there were contractual documents in place. Independent producers often buy oil for use on and operation of the lease. Oil or condensate are often the fluids of choice for fracturing formations and improving the rate of production of the lease. These transactions have nothing to do with sweetheart deals and yet they would penalize the lessee by forcing him to report valuation based on an index established hundreds of miles from the lease, making it more problematic to arrive at true market range on the lease. Gross proceeds is still the simplest and fairest way to value.

The database compiled by MMS should allow it to have access to regional market ranges that can quickly show significant divergence in reported valuation which would trigger immediate investigation and audit. Better yet, MMS should take all its royalty in kind and have first hand knowledge of the market. Presently, MMS is marketing, through agents, a substantial amount of its share of royalty crude. Surely, it trusts its agents to get the best possible price for its oil and can then compare to value reported by the lessees in the same field. Comparable sales are invaluable information when analyzing non arm-length transactions.

We understand and support MMS's decision to stop relying on posted prices, but monitoring of the market in which MMS is a front line player should yield enough information on market value so that reliance on a futures index would become the exception rather than the norm.

Independent producers should not be at a disadvantage when they sell their production in arms-length transactions. For this reason the definition of arms-length should not be made so restrictive by the exceptions in 206-102 (a). Finally, we think this issue is so important that we cannot support the strategy of issuing an interim rule which may or may not be amended later. We would support a longer comment period, further discussion and research before promulgation of a final rule.

Sincerely,

Jim Geringer

Jim Geringer
Governor