

# **BP Amoco**



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Mr. David S. Guzy  
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Royalty Management Program  
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P. O. Box 25165, MS 3021  
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**RE: Supplementary Proposed Rule  
Establishing Oil Value for Royalty Due on Federal Leases  
64 Federal Register 73820, December 30, 1999**

Ladies and Gentlemen.

BP Exploration & Oil Inc., on behalf of itself and BP Exploration (Alaska) Inc., BP America Inc., and Amoco Production Company (collectively "BPA"), appreciates the opportunity to submit comments to the Minerals Management Service's ("MMS") December 30, 1999 notice ("Notice") supplementing its proposed rulemaking that would amend federal regulations governing the valuation for royalty purposes of crude oil produced from federal leases ("Proposed Rule").

BPA has previously provided comments in response to the MMS' initial proposed rulemaking of January 24, 1997 (62 FR 3742), the MMS' supplementary proposed rulemaking of July 3, 1997 (62 FR 36030) and the MMS' request for comments on various suggested alternatives of September 22, 1997 (62 FR 49460). BPA's comments appearing below are in response to the Notice, and supplement those that we have previously provided to the MMS.

BPA supports many of the changes the MMS has made in the Notice. In particular, we support the following:

- MMS allowing lessees the option of using either their arm's length gross proceeds or index/benchmark values for arms-length exchanges made by the lessee or for arm's length sales or exchanges made through affiliates. As the MMS has indicated, problems associated with "tracing" values to the final sale would, in many cases, be too burdensome for the lessee to calculate the gross proceeds.

- **Elimination of Form MMS-4415.** The MMS has correctly determined administrative burden to the industry created by this form was not justified given the limited frequency in which the data would be used by the MMS.
- **Inclusion of language that the MMS will not second guess industry marketing decisions, even if those decisions or actions result in prices that are lower than other measures of market price or costs which are higher than other measures of market cost, unless the lessee acted unreasonably or in bad faith.**
- **MMS' acknowledgment that a lessee should be allowed to deduct the actual costs and a reasonable rate of return on owned/controlled transportation systems, and its request for comment on how to amend the proposal to create a more reasonable method.**
- **Allowance of an alternative valuation method for production from leases in the Rocky Mountain Region and for production delivered to the lessee's own refinery when the index method results in an unreasonable value.**

While the MMS has addressed many of the concerns expressed by BPA in past comments, we still have a number of concerns related to the December 30, 1999 proposal. Our specific concerns are as follows:

- **While the MMS proposal commendably eliminates the presumption of control if a lessee owns between 10 and 50 percent of an entity, the MMS has provided a series of tests which will be used to make the affiliate determination, which tests are inherently subjective. The MMS stated at the January 19, 2000 Houston workshop and the January 20, 2000 Washington workshop, that the lessee would be required to request a value determination as described in Section 206.107 to assure that its affiliate determination was correct. BPA is concerned that this process will take significant time. This will be particularly true during the period immediately after the issuance of these rules. We expect a large number of lessees, including BPA, to request affiliate determinations and resolution of other issues relating to royalty valuation, which will result in numerous immediate lessee requests for value determinations. Unless the MMS can process this large number of requests in a timely manner, lessees will be in a position of uncertainty at the time of filing. We suggest the MMS provide for sufficient time from the date it issues the Final Rule to the date the Final Rule takes effect, to allow lessees time to prepare and submit their initial value determination requests, and for the MMS to review the requests and issue its value determination. Further, the MMS should issue guidelines to assist lessees in determining whether or not the MMS will view their transactions as arms length. In light of the anticipated number of requests for value determinations, BPA proposes that the intended March 15 date be extended for several months to permit a more orderly and efficient transition. Further, since the determination of the affiliate issue is by way of a value determination mechanism, the MMS stated at**

the Houston workshop, and it should clarify in the comments to the Proposed Rule, that no penalties will apply if the lessee chooses not to follow the MMS determination, unless and until an order has been issued.

- The MMS' current proposal for transportation allowances related to non-arm's-length transportation contracts does not enable the lessee who elects to invest in pipeline projects to recover a reasonable return on its investment. We recommend the MMS reconsider the use of arm's length contract data as a basis for determining the allowances. Specifically, if more than 20 percent of a pipeline volume is transported at arm's length, the volume-weighted average of the arm's length rates should be used. This proposal is consistent with what the MMS is attempting to achieve with its proposed cost plus return method. The MMS states in this proposal that it "...believe[s] that the principle of permitting only actual costs, including a reasonable rate of return, is consistent with the longstanding royalty valuation and allowance principles and fairly and reasonably protects the public interest." MMS has attempted to define a reasonable rate of return through a complex, audit intensive method, when the best indicator of a reasonable rate of return can be found in the market rates actually reflected in arm's length transactions or FERC tariffs. The market rates reflect actual costs and a reasonable rate of return, and should be the basis for allowable cost deductions.

The short period allowed prior to the due date of these comments was not sufficient to permit BPA time to prepare an alternative proposal for those situations in which less than 20 percent of a pipeline's volume is transported arm's length. We recommend that the MMS provide additional time for all interested parties to develop and discuss the merits of alternative proposals.

- The MMS has not provided for an alternative valuation method except in the case of production from the Rocky Mountain region and for production that is transported to an owned refinery. It is likely that the index method will result in an unreasonable value due to the circumstances found in the sales of production at other locations. For example, BPA transports and sells Alaskan North Slope (ANS) crude oil in Alaska, the U. S. West Coast and the Far East. The currently proposed index method will value ANS transported and sold in the Far East at a price equivalent to that of ANS sold thousands of miles away on the U. S. West Coast. The method may result in an unreasonable result. In this situation, BPA should have the option to present an alternative valuation method to the MMS, and the MMS should have the authority under the rule to approve an alternate royalty valuation on the basis of any other approved method of valuation under the rule, in the event circumstances dictate that the preferred method does not yield a reasonable value.
- The MMS has consistently taken the position that royalty is due on the value of production at the lease, but the current proposal maintains that lessees have a duty to market free of charge, even if the marketing takes place downstream of the

wellhead and enhances the value of the production. As a result, the MMS disallows reasonable costs associated with the transportation of production to a market center and compensation for activities that enhance the value of the oil. While the Proposed Rule provides for all out-of-pocket costs associated with transportation from the lease to the market center, it does not authorize inclusion of the costs associated with carrying inventory or a rate of return to compensate the lessee for the risks of being in the business of crude oil transport and for value enhancing activities such as blending and volume consolidation.

While the Proposed Rule does allow for all out-of-pocket costs associated with transportation from the lease to the market center, it has not acknowledged the difficulty of calculating and auditing these costs. Non-third party direct and overhead costs related to pipeline schedulers, inspectors, and personnel associated with such activities as loss control, blending activities, and inventory management, can be difficult to capture, requiring allocation methods and estimates. BPA recommends that the MMS consider an alternate formula or flat rate method in place of an actual cost method to determine the allowance for non-third party personnel and overhead.

- The MMS continues to disallow actual losses, unless those losses result from payment under an arm's length contract. This disallowance does not recognize the use of a lessee's production as a source of fuel to run transportation equipment in remote locations. MMS should allow losses which can be attributed to reasonable uses within the transportation system.
- The Proposed Rule states that value determinations will not be issued if the request deals with hypothetical situations, matters that are inherently factual in nature, and matters subject to pending litigation or administrative appeals. At the Houston workshop, the MMS staff indicated that its intent was that by "inherently factual", it meant matters requiring extensive investigation into facts by the staff, not value determinations which are fact-specific. The Proposed Rule should be clarified to reflect that intent.
- Paragraph 206.100(b)(2) provides that if the regulations in this subpart are inconsistent with "(2) A settlement agreement between the United States and a lessee resulting from administrative or judicial litigation; ...then the ...settlement agreement...will govern to the extent of the inconsistency." BPA would like the MMS to delete the phrase "resulting from administrative or judicial litigation", since that language implicitly precludes a settlement outside of any administrative or judicial litigation. The MMS should have the authority to enter into settlements with lessees without having to go through litigation.

In addition to the concerns listed above, there are a number of areas in the Proposed Rules that BPA believes are unclear. Each of these is summarized below:

- The preamble to the rules states that in calculating value using indexes "[t]here may be cases where the nearest market center may not be the appropriate one for

you to use because the quality of your production better matches that typically traded at another more distant market center. In such cases, you could use this more distant market center to value your production." (P. FR 73831) However, the Proposed Rules states that the lessee is to use "...the market center nearest your lease for crude oil similar in quality to that of your production..." (Par 206.103 (c)(1)). BPA is supportive of the wording in the preamble and recommends that the wording be clarified and incorporated into the rules. We further recommend that the choice of index crude oils be expanded to allow for the use of a crude oil further from the lease or of less similar quality if that crude oil is a "currency crude" such as WTI at Cushing for which there is sufficient arm's length exchange transaction data to allow for a market related quality and location differential.

- It is unclear whether the two year determination by a company to use the index method or gross proceeds is done on a lease by lease basis or on a company basis. We recommend that the MMS allow this on a lease by lease (or field by field, as applicable) basis since the circumstances of different markets may make gross proceeds a workable alternative in one area and not in another area. Since the MMS has recognized both methods as yielding a fair market value, either should be acceptable to the MMS.
- It is unclear whether a lessee who takes its production directly to its refinery, without going through a market center, is allowed to take the quality bank adjustment that he would have incurred if he had gone through the market center. The MMS should clarify that the lessee nonetheless may take the quality bank adjustment.
- The MMS has provided the lessee a mechanism to request that costs be allowed to exceed 50 percent of the value of the oil. In a situations where a lessee has exceptionally high transportation costs, it is unclear whether this request is required to be made once to cover all situations when the price of oil is below a certain value, or whether the exception must be requested on a monthly basis during periods of low oil prices
- Changes of the magnitude proposed in this rule will require sufficient time for companies to put in place reporting systems and procedures to accurately calculate pricing and non-third party transportation costs. Even once these systems are in place, some data required for accurate filings will not be available at the time of filing. BPA recommends that the Proposed Rule include some period of time within which companies can reasonably work toward putting in place the appropriate systems and procedures to comply with the requirements of the Proposed Rule, without exposure to any penalty for noncompliance.

BPA's comments to the Notice are intended to be constructive and helpful to the MMS in developing a final rule that strikes an equitable balance among the interests of all parties,

and we trust that this will be the spirit in which our comments are received and considered by the MMS. BPA representatives are available to clarify or provide further elaboration with regard to any of our comments should the MMS so desire.

Respectfully submitted,

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