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CERTIFIED MAIL – RETURN RECEIPT REQUESTED

JANUARY 31, 2000

Mr. David S. Guzy, Chief  
Rules and Publications Staff  
Royalty Management Program  
Minerals Management Service  
P.O. Box 25165, MS 3021  
Denver, Colorado 80225-0165

JAN 2000  
RECEIVED

Dear Mr. Guzy:

The New Mexico Taxation and Revenue Department with this letter is formally responding to the Notice of Supplementary Proposed Rule identified in the Federal Register dated Thursday, December 30, 1999. This proposed rule would modify the valuation procedures for crude oil transactions on federal lands.

The following are the New Mexico Taxation and Revenue Department comments as it relates to the position MMS is taking on certain situations and areas where changes were made and or comments were requested.

#### General Comments

The Department continues to support the Minerals Management Service (MMS) efforts to come up with revised valuation criteria to use in crude oil valuation which do away with reliance on posted prices in less than arm's-length situations in the Permian and San Juan basins of New Mexico. We support the use of appropriate index pricing for valuation and agree that differentials for quality and location adjustments must be made, where applicable, to arrive at an accurate lease level price. We support the exclusion of both the Permian and San Juan basins in New Mexico from the Rocky Mountain area and its inclusion in the "rest of the country" area as it pertains to the proposal for separate valuation methodologies.

The Department feels that the issues identified by the independent producers have been generally dealt with within the proposal and the arguments that remain related to valuation downstream of the lease are without merit. This valuation proposal puts an end

to a valuation methodology that was ripe with problems and moves back to the historic application that the best determination for value is the actual proceeds received regardless of how the corporate hierarchy of a lessee transferred the product.

With few exceptions, the New Mexico Taxation and Revenue Department strongly believes that the proposed rule, in its present form, provides for a fair, simple and certain valuation methodology that captures the true market value of oil produced from federal lands where federal lessees market the production under non arm's-length conditions. The Department, at the same time, does not believe that this proposal puts an undue hardship on federal independent lessees that market their production in arm's length transactions. No specific facts have been presented in any hearings, workshops or written comments that would support an equity issue or un-fairness application of this proposal.

#### Specific Comments

**Duty to market:** The Department continues to support the position that MMS is taking on this issue. Long standing court cases including one in New Mexico support the fact that the duty to market at no cost to the lessor is not unique to federal leases. The choice of a federal lessee to market downstream does not make marketing costs deductible or permit the lessee to disregard part of the sales price obtained at a downstream market. Industry and politicians continue to cloud the issue and MMS has specifically identified in workshops that costs associated to managing the transportation of the product would be deductible as transportation from the value of the product if it is moved to downstream market centers. The Department supports the fact that marketing arrangements may or may not enhance the lessee's ability to obtain a higher price in downstream markets and therefor the argument that marketing costs are deductible because they support only the receipt of additional values is without cause.

**Definition – "Person" (Section 206.101):** the definition includes "joint venture" but adds, "when established as a separate entity". The Department does not consider the additional language to add anything to the definition, we consider it to be irrelevant and recommend that it be removed.

**Option Selection and 2 year election (Section 206.102):** The Department supports the election requirement of two years. Anything less than what is identified would put the federal royalties at risk to potential game playing.

**Gross Proceeds with Option to Index( Section 206.102):** The Department supports the proposed concept that federal royalties should be paid on the actual receipts received negotiated between opposing economic interests, less actual transportation, if the initial price recognized is recognized at a point downstream from the lease. This concept is not new, as this is the basis surrounding how a tax or royalty is applied against a "value". The option proposal to value using an "index price", also is fully supported by the Department as it provided flexibility to the federal lessees; it simplifies the effort required to

recognize the appropriate value; and it supports the lessees that use the oil production as their refinery stock where no value can be established.

**Transport Oil To Refinery:** The MMS in Section 206.103 identifies the valuation application where a lessee transports or indirectly moves their federal production to their refinery. MMS identifies that a lessee may apply to the MMS for approval to use a value representing the market at the refinery. The Department can not support any effort by either the MMS or federal lessees to establish a theoretical value at a refinery and then to allow actual transportation costs from the point of production to the refinery. MMS in their effort to recognize spot prices as value can not support this value application. Every effort should be made to value the production at a market center nearest to the point of production and to recognize either actual transportation costs if the production moves through the market center or a negotiated rate based on non federal production, other transportation costs to that market center or third party information.

**Binding Value Determination:** MMS in the preamble of Section 206.107 states that a value determination by MMS staff is binding on MMS and delegated states with respect to the specific situation addressed in the determination unless the MMS Director or the Assistant Secretary modifies or rescinds it. The Department has concerns as it relates to this binding application and the bureaucratic process that must be taken to get it modified or overturned. Our office has seen multiple cases in which pertinent facts in specific situations were not identified or asked for, and had they been considered, a different determination would have been made. We are also concerned that to get a determination overturned that only the MMS Director or the Assistant Secretary can do it. We feel that Royalty Management Personnel who work directly in establishing value determinations should have the direct authority to rescind if relevant facts are identified after the fact. We see no reasoning that top management at MMS has to deal with what should be lower level decision making. We also recommend that if a value determination request is specific to a state, that the state be allowed to fully participate in the decision making process. States that maintain audit contracts with the MMS are usually more knowledgeable about the facts and the situation and can fully support the MMS in the decision making process.

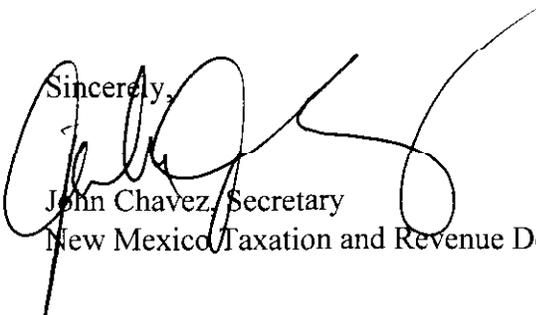
**Transportation Allowance – ROI:** MMS in Section 206.111 allows an ROI allowance against 10 percent of the original capital investment even after transportation system has been depreciated below that amount. This change is not acceptable to New Mexico. We see no basis for continuing to allow a “return on investment” allowance when a transportation system has been depreciated below its salvage value. This proposal, if finalized, may not significantly impact directly any oil transportation systems in New Mexico but the change could have a snow ball effect on current gas valuation regulations. If introduced there, a significant impact on New Mexico royalties would occur. If this has to be adopted, the Department recommends that it be applied only to offshore transportation systems and not onshore. The basis for this is that offshore transportation system investments are riskier than onshore.

**Transportation Allowance – Rate of Return:** MMS in the preamble to Sections 206.110 and 206.111 requested comments on whether they should modify the rate of return and, if so, what that rate should be. The Department can not support any change to what is currently used. Industry in their discussions stated that the rate should be higher to reflect the risks related to the Gulf of Mexico and particularly deepwater. This argument does not support a higher rate for onshore transportation systems. It also is not supported by the fact that there should be relatively low risk on a new transportation system where production has been identified. While the actual search for oil may be with high risk, the pipeline is only constructed after sufficient reserves have been identified to warrant the investment. If reserves actually produced are lower than estimates used to justify construction of the pipeline, then the federal government will also suffer, as a higher allowance rate will exist. This argument also does not take into consideration that significant royalty breaks currently exist when producing from “deep water” classified production. New Mexico also would be deeply concerned if a different rate was used for oil vs. natural gas and the effect it may have on any future gas value regulations.

**Transportation Allowance – Actual Cost Concept:** The Department fully supports the MMS proposal to recognize actual costs associated to transportation systems as defined by Section 206.111. The Department does not agree with any method that deviates from this concept such as “value of service”, tariffs and other non-jurisdictional controlled concepts. The Department believes that the recognition of actual costs with a rate of return, consistently follows the royalty valuation and allowance principle and historic application.

In concluding, the New Mexico Taxation and Revenue Department commends the efforts that MMS has undertaken to ensure that everyone has had an opportunity to participate. We feel this rule goes a long way to ensure that federal oil production is fairly valued for everyone that produces oil and shares in its revenues. We continue to urge MMS to move forward on the proposed regulation.

Sincerely,



John Chavez, Secretary  
New Mexico Taxation and Revenue Department