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OWNERSHIP

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Exxon Company, U.S.A. Comments on MMS Supplementary Proposal on Valuation of Crude Oil Produced on Federal Leases 30 CFR 206, 63 FR 6113 (February 6, 1998)

Dear Mr. Guzy:

Exxon Company, U.S.A. [Exxon] has actively participated in the ongoing oil valuation rulemaking. Exxon filed comments on the MMS' initial proposal published in January 1997. In addition, Exxon filed comments on the MMS' supplemental proposals in July 1997 and November 1997. Exxon incorporates its earlier comments by reference. The following comments focus on the MMS' latest supplementary proposed rule published on February 6, 1998 at 63 Fed. Reg. 6113 [Proposal].

The MMS' stated goal is to "decrease reliance on oil posted prices, develop valuation rules that better reflect market value, and add more certainty to valuing oil produced from Federal lands." 63 Fed. Reg. 6113. Furthermore, the MMS stated in its February 5, 1998 New Release that "Royalty must be based on the value of production at the lease." The proposed rulemaking falls far short of the MMS' stated objectives of better reflecting market value at the lease and adding more certainty to valuation of crude oil.

A. The MMS Proposal Fails to Reflect Market Value at the Lease.

The MMS' unlawful attempt to expand the duty to market seeks to impose royalty on something other than the value of production saved, removed or sold from the lease. In addition, while the latest

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MMS proposal has taken a step in the right direction by retaining gross proceeds for arm's-length sales, the MMS Proposal maintains an index based methodology for valuation of crude oil that is not sold at arm's-length. The index-based methodology, along with the proposed adjustments to the index, fails to reflect market value at the lease accurately.

1. The MMS is Unlawfully Attempting to Expand the Duty to Market

Despite objections by Exxon, other industry members and trade associations, the MMS has not modified its overreaching and unsupported proposal on an expansion of the duty to market. Proposed 30 C.F.R. § 206.106 provides as follows:

> You must place oil in marketable condition and *market the oil for the mutual benefit of the lessee and the lessor at no cost to the federal government* unless otherwise provided in the lease agreement....

The MMS erroneously describes the unlawful expansion of the duty to market as a mere clarification:

> We did modify the paragraph of your *obligation to place oil in marketable condition at no cost* to the Federal Government *to clarify that it includes a duty to market the oil.*

62 Fed. Reg. 3746 (emphasis added). While the MMS now describes its recent expansion as a "long-standing policy," there is no existing statutory, regulatory, administrative, or other legal support for the MMS' attempt to expand the duty to market. The MMS' new construction is illogical; marketing <u>oil at no cost to the government is not mutually beneficial.</u> While clearly beneficial to the government, it lacks "mutual benefit to the lessee."

In its attempt to unlawfully expand the duty to market, the MMS is attempting to impose royalties on a value different than the value of production at the well. By attempting to expand the marketing obligation and impose royalties on the value of downstream marketing, the MMS is exceeding its statutory and contractual authority to do so.

The governing statutes limit the MMS' regulatory authority. Section 8(a) of the Outer Continental Shelf lands Act requires the payment of royalty at a specified percentage "in amount or value of production saved, removed, or sold from the lease." 43 U.S.C. § 1337(a). The Mineral Lands Leasing Act requires the payment of royalty on a percentage "in amount or value of the production removed or sold from the lease." 30 U.S.C. § 226(b). Where the MMS has attempted to impose royalties on something other than the value of the production saved, removed or sold from the lease premises, the courts have declared the agency's action to be in excess of its statutory authority. *See Diamond Shamrock Exploration Co. v. Hodel*, 853 F.2d 1159 (5th Cir. 1988) (Fifth Circuit rejected the

Department of Interior's attempt to impose royalties on take-or-pay payments holding that royalties are due only on the value of minerals actually produced). The MMS' attempt to impose royalties on the value that may be added to the oil by the lessee's downstream marketing efforts is beyond the MMS' statutory authority as it is clearly not the value of production saved, removed or sold from the lease.

The MMS' attempt to expand the duty to market is contrary to existing contract terms. While the MMS' February 5, 1998 Press Release states that federal lease terms "require the lessee to market production at no cost to the lessor," the Press Release fails to identify such a provision. This is because no such provision exists. A typical Outer Continental Shelf lease form provides for royalties on the "amount or value of production saved, removed, or sold from the leased area."[1] A typical onshore lease form provides for royalties on the "production removed or sold from the leased lands."[2] Just as is required of parties to a private contract, when the government enters into contractual relations such as oil and gas leases, "its rights and duties therein are governed generally by the law applicable to contracts between private individuals." *Lynch v. United States*, 292 U.S. 571, 579 (1934). The MMS cannot unilaterally amend the lease terms and impose royalty on something other than the value of production at the lease. In the proposed rule, the MMS is attempting to do just that by unlawfully expanding the duty to market and imposing royalty on a lessee's marketing services.

2. The Use of Index Prices

While the MMS has substantially reduced its reliance on NYMEX futures prices, the MMS maintains a valuation based on NYMEX for the Rocky Mountain Region and relies on ANS spot prices as well as other spot prices for royalty valuation. MMS should eliminate all reliance on NYMEX-based valuation. In addition, the MMS Proposal continues to rely on ANS spot prices as well as other spot prices for royalty valuation. The problems associated with spot prices in all market regions are discussed in detail in Exxon's prior comments. Crude oil spot prices, which are far removed from the lease, are an inaccurate assessment of market value at the lease, even with the MMS' proposed adjustments. By utilizing the downstream spot prices, the MMS seeks to impose royalty on something other than the value of the production saved, removed or sold from the lease. The MMS has failed to achieve its stated goal of better reflecting "market value."

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[1] Form 3300-1 (February 1971).

[2] Form 3120-9 (September 1985).

B. The MMS Proposal Lacks Certainty.

The MMS Proposal, which includes three different geographic approaches, and requires numerous adjustments, fails to provide certainty and in fact, adds uncertainty to the oil valuation process. Many sections of the Proposal are unclear or ambiguous. Some examples illustrating the lack of certainty in the Proposal are as follows:

Lack of Quality Adjustments

In an attempt to determine market value at the lease in non-arm's length contract valuation, the Proposal generally starts with a downstream market value, then allows adjustments for applicable location and quality differentials as discussed throughout the Proposal. The mechanism for adjusting for location differentials is discussed at length but very little substantive detail is provided on how to make quality adjustments. In Section 206.112 (3) (e), adjustments based on pipeline quality banks are discussed but what if the crude does not go through a pipeline with a quality bank? In addition, the Proposal fails to provide for quality adjustments between the lease and aggregation point where the lease quality differs from the aggregation point quality. The absence of such an adjustment could negatively impact either the lessee or the U.S. For example, where the pipeline quality at the aggregation point is 35 degrees API and two leases flow into the pipeline, one at 30 degree gravity and one at 40 degree gravity, appropriate quality adjustments for the purpose of determining value at the lease are not provided. The lessee with the 30 degree gravity lease production would be required to pay royalty as though the crude oil was 35 degree gravity. The lessee producing the 40 degree gravity crude oil would also pay royalty as if the production were 35 degree gravity. Clearly, without appropriate quality adjustments, there is no mechanism to accurately determine value at the lease.

Even when a pipeline quality bank exists, it may not be comprehensive enough to handle necessary quality adjustments on various crude oils beyond sulfur and gravity. The MMS definition of "quality differential" recognizes that factors beyond sulfur and gravity may affect value but the Proposal fails to appropriately account for those factors.

Section 206.122 eliminates any reference to the point of settlement approved by the MMS for offshore leases and focus only on onshore leases. Certainly, as with onshore leases, lessees must be allowed to make appropriate adjustments when the quality and quantity varies from the quality and/or quantity at the approved settlement point. For example, if a higher grade crude oil is blended with federal lease production for pipeline transportation purposes, the lessee must be allowed to adjust for the value and volume added by the higher grade crude oil. To the extent that the MMS is disallowing such adjustments, the MMS is imposing royalty on something other than the "value of production."

Areas of Subjectivity

There are many areas where the guidelines are not clearcut and the decisions that will be required by the MMS will be subjective in nature. Examples illustrating the inherent subjectivity of the Proposal include, but are not limited to, the following:

- What are the procedures for having a tendering program approved?
- How is "reasonable value" determined?
- What reflects "total consideration"?
- How will the "MMS determine that any of the index prices referenced ... no longer represent reasonable royalty value...?"

Request for Valuation Guidance

Perhaps the most disingenuous part of the Proposal is Section 206.107. It leads a lessee to believe that it can request guidance from the MMS so that it can comply with the valuation regulations in a manner providing certainty. After providing that the lessee must "submit all available data related to your proposal and any additional information MMS deems necessary", the MMS negates any certainty by stating that the determination it provides will be "non-binding." If the MMS cannot provide binding valuation guidance under its own regulations, how will the lessee or MMS ever have certainty? This section only highlights that a lessee, no matter how diligent, will be second-guessed.

MMS 4415

There still is insufficient clarity in how to comply with the requested data on the MMS 4415. If federal and non-federal production are commingled, what must a lessee report? Are 4415's subject to audit? If the MMS determines that it has inaccurately calculated the differentials it publishes, will there be retroactive adjustments and subsequent penalties?

Additional references to areas of uncertainty are outlined in Exxon's earlier comments dated May 27, 1997 and in the American Petroleum Institute's current and earlier comments and are not repeated in these comments.

C. The MMS Proposal is Administratively Burdensome.

The Proposal is administratively burdensome because of the three geographic methodologies and the inherent uncertainty. In addition, the collection and retention of data to support the payments under three varying methodologies will require additional systems and staff. Instead of creating simplicity, the MMS has increased the complexity of reporting and added another reporting form, the MMS 4415. Although not addressed in the Proposal, the MMS 2014 may require changes in payor codes and AID number relationships to accommodate the geographical valuation schemes presented in the Proposal.

The Proposal imposes tracing requirements that are complex, burdensome and costly. For example, Section 206.102 requires tracing where multiple exchange transactions occur before the "ultimate purchases." For the three geographic methodologies, the Proposal generally requires tracing to arrive at transportation allowances. In some cases, the tracing requirement is impossible to satisfy due to a variety of factors that include antitrust considerations and the inability to trace after commingling and/or sale to a third party.

The audit burden will be immense for both the lessee and the MMS. Given the geographic methods, the lack of guidelines, and inherent subjectivity in many decision areas, it will be difficult, if not impossible, for the payor to follow the rule and for the MMS to develop meaningful audit procedures that conform to the rule.

D. Conclusion

To date, the MMS has failed to address fundamental flaws inherent in this Proposal. The Proposal fails to assess royalties on the value of production, as required by the governing statutes and leases, and to add certainty. In fact, it adds uncertainty to the oil valuation process and imposes additional, costly burdens on the MMS and lessees. Exxon urges the MMS to consider valuation alternatives, including a realistic royalty-in-kind or tendering program that meet the overall objectives of simplicity and certainty for valuing crude oil and condensate produced from federal leases. Exxon also urges the MMS to consider and address all the issues raised by Exxon and other commentors concerning this Proposal.

Sincerely,

William L. Stone