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By E-Mail/Original by Mail
David S. Guzy, Chief
Rules & Publications Staff
Royalty Management Program
Minerals Management Service
P.O. Box 25165
Denver, Colorado 80225-0165

RE: Further Supplementary Proposed Rule, "Establishing Oil Value for Royalty Due on Federal Leases," 64 Fed. Reg. 73820 (December 30, 1999)

Dear Mr. Guzy:

The following comments to the Minerals Management Service's (MMS) "Further Supplementary Proposed Rule" on oil valuation are submitted on behalf of the California State Controller's Office (SCO).

Three years have passed since MMS first published its royalty reform rules for public comment. During that three years, the comment period has been extended and re-opened numerous times, mostly at the request of the industry or members of Congress. Thousands of pages of written comments were submitted and reviewed, and MMS has held numerous public hearings around the country.

Yet, MMS is still being criticized, mostly by industry, for being non-responsive to the concerns of federal lessees. Indeed, at the last public hearing on January 20, an industry representative went so far as to suggest that the days of an amiable, cooperative relationship between industry and the agency were put to an end through this rulemaking. Any change that has resulted, however, stems from a better understanding by MMS of both industry practices and its true administrative role. In short, to the extent that MMS is now less responsive to industry, it is more responsive to its public trust obligations. A long overdue and better balance of interests is evident and the Department should be commended for its efforts.

SCO also believes, however, that the political and rhetorical criticism of MMS is simply inconsistent with the rulemaking record. The result of three years of public comment has resulted in repeated accommodations to industry. Numerous amendments and modifications have been made to the rules as initially published, many of which have been over the opposition of royalty beneficiaries. In fact, in SCO's view, many of these accommodations (e.g., crude oil calls, overall balancing arrangements) have been *at the expense* of creating a more certain, less complicated rule. MMS also has been, with SCO's support, particularly solicitous of the concerns of small independent producers who have been equal victims of the major oil companies' two tier pricing practices.

It is certainly true that MMS has rejected many of industry's recommendations (e.g., comparable sales). Yet, taken together, what industry has been advocating for nearly three years was tantamount to no change. In fact, some of their proposals (e.g., no duty to market) would essentially modify their contractual duties to the government and reduce federal royalty income.

What industry critics overlook is that MMS is addressing some very real problems in the market and with the current regulations that were depriving taxpayers of their full and fair share for private industry's use of publicly owned lands. Regulatory loopholes were being exploited to the financial detriment of royalty beneficiaries. The evidence is overwhelming.

While it has been generally supportive of MMS's overall efforts during this rulemaking, SCO has opposed and continues to oppose many of the changes MMS has made to its originally proposed rule. SCO's prior comments are incorporated by reference herein, and we urge MMS to reconsider our views on tracing, the gross proceeds floor, a NYMEX safety net, and overall balancing agreements. With many of these changes, in conceding to industry MMS has placed the burden of proof on itself, when it should be placed on those with ready access to information and a duty to disclose it.

SCO, of course, recognizes the pressure that has been put on MMS and its need, as a result, to make reasonable compromises. SCO believes, however, that a distinction must be made between reasonable compromise and simple appeasement. In other words, it is one thing to make changes based on substantial factual showings or which simply juggle the relative administrative burdens. It is another to make concessions that are simply aimed at making the regulations more palatable to industry. Unfortunately, it is SCO's view that MMS's latest round of proposed changes, especially those relating to allowances and differentials, fall within the latter category.

Our detailed objections to MMS's latest proposals are set out in an Attachment. And, as stated, SCO incorporates its prior comments and those of the City of Long Beach by reference. In proceeding to a final rule, SCO asks MMS to review all of the industry concessions it has made in light of the following questions:

(1) do the proposals respond to the market and administrative based flaws of the current regulations, and, to the maximum extent possible, foreclose opportunities for future royalty gamesmanship;

(2) do the proposed regulations, as a whole, represent economically, legally sound valuation alternatives, and, if so, what is the minimum amount of information MMS needs in advance to make them work;

(3) where concessions to industry have been made, are they based on industry documentation that establishes a clear and credible factual basis for change;

(4) where concessions result in added audit burden (e.g., deletion of the 'two year' rule on overall balancing arrangements, tracing) is the burden realistic and manageable, and has MMS clarified administratively its full document access rights; and

(5) are the concessions consistent with the factual findings set out in the preamble.

SCO believes that if MMS can answer yes to these questions, it has achieved a reasonable balance between its public trust obligations and any legitimate concerns of industry.

Sincerely,

Lee Ellen Helfrich
Lobel, Novins & Lamont

On Behalf of the
California State Controller's Office

Enclosure

ATTACHMENT

SUPPLEMENTAL COMMENTS OF THE STATE CONTROLLER'S OFFICE
64 Fed. Reg. 73820 (December 30, 1999).

I. TRANSPORTATION

A. Location Differentials [Proposed Sec. 206.112]. SCO opposes MMS's proposal to use transportation costs to a refinery in calculating value from the index price. The purpose of a location differential is to capture the value differences in crude oil between two points -- the index pricing point and the field. Capturing the difference associated with the oil's location results in a value "at the lease," which is the point where industry believes value should be determined.

When specific oil is not exchanged, but will valued at index, MMS proposes to allow transportation costs to an "alternate disposal point" to be deducted from index. MMS appears to assume that major companies will not have access to location differential information when, for example, they transport oil produced from federal land directly to their refineries. Based on industry practices in California, SCO disagrees with that assumption.

From prior workshops and publications, SCO understands that MMS's concern stems largely from the lack of location differential information for use in the Rocky Mountain region, and with industry objections with regard to advance reporting of location differential data (Form 4415).

SCO notes that for the Rocky Mountain region, use of index based values is the last in a series of benchmarks. As MMS recognized at the Denver workshop, use of an index value will not often be triggered for the Rocky Mountain region. Under those circumstances, an "alternate disposal point" transportation calculation may be the only feasible alternative, at least in the absence of other location differential data. Unique factors associated with the Rocky Mountain region, however, hardly justify use of an "alternate disposal point" methodology in those areas, like California, where better, more accurate information is in fact available.[1]

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[1]SCO notes that the "alternate disposal point" is also inconsistent with MMS's current practice with regard to transportation allowances. Lessees are not entitled to a deduction for transport beyond the valuation point (e.g. majors valuing at posted price are not entitled to deduct transport to their refineries). Similarly, lessees should not be entitled to allowances beyond the index point.

For similar reasons, SCO opposes MMS's proposal to dispense with collecting location differential information through Form 4415. If collecting such information is the only way to avoid application of an "alternate disposal point" transportation calculation, that fact, in and of itself, provides justification for retaining the reporting requirement. Through re-engineering, MMS may reach a point in the future where reporting will be unnecessary. MMS is not there yet, and indeed, re-engineering's success depends on development of an adequate information base. It is unfair to both the public and federal lessees to use economically inaccurate proxies for adjusting index-based values when actual location differential information does, in fact, exist.

SCO again urges MMS to include an anti-circumvention provision in its regulations on location differentials. This is particularly important given MMS's proposal to permit lessees in "multiple exchange" situations to add up the differentials stated in each exchange to determine the location adjustment to an index-based value. A general anti-circumvention rule would protect against situations where the "multiple exchanges" are, in reality, simply paper transactions.

B. Actual Cost Calculation [Proposed Sec. 206.111]. SCO opposes, in part, MMS's proposals to amend the current regulations regarding the calculation of actual costs of transportation.

We note at the outset that the preamble did not contain any factual explanation justifying MMS's proposed amendments to current practice. Indeed, it appears that these proposals have been made simply to appease industry's objections to using actual costs rather than "value of service" to determine a transportation allowance.[2]

Nonetheless SCO does not oppose MMS's proposal to allow a new depreciation schedule to a new and wholly independent owner of a transportation system purchased at arm's length. Our position, however, is based on MMS's recognition of two caveats.

First, the proposal would not apply to sales of transportation systems to joint ventures, partnerships or limited partnerships in which the original owner participates. While SCO believes that this is consistent with MMS's proposed definitions of affiliate and arm's length transactions, clarity would be advanced if MMS addressed these types of "affiliations" more directly either in the regulations or preamble.

Second, the proposal should be amended to make it consistent with the gross proceeds rule. This would require, where applicable, recapture of an appropriate percentage of the purchase price from the original owner/payor. Recapture would provide an equitable balance between the interests of the royalty owners/beneficiaries and the federal lessees.

[2] Industry's complaint that it did not focus on the current regulations during the 1987 rulemaking, because it intended to circumvent them through application of FERC tariffs, is, in our view, both an inaccurate characterization of industry's very active role in all aspects of the 1987 rulemaking and irrelevant.

SCO opposes MMS proposed Sec. 206.111(g)(3), which would allow an owner of a transportation system to continue to depreciate what is in essence a fully depreciated asset by 10 percent of the owner's initial capital investment solely for purposes of its transportation allowance calculation. Given typical depreciation schedules -- life of equipment or reserves -- the proposal is overly generous and inconsistent with typical accounting and business practices. SCO again notes that MMS has not put forward in its preamble any rational factual basis for this proposal, let alone explained why it believes this to be consistent with an allowance calculation based upon "actual costs."

As MMS is aware, during the rulemaking leading up to the 1988 regulations, many States and Tribes, including SCO, opposed the bureau's adoption of the BBB rate as too generous. The BBB rate is, after all, one step above the junk bond rate, and most certainly is higher than the borrowing rate available to major pipeline owners. The "risk" of pipeline construction is virtually non-existent onshore. In our view, industry commenters have also over-stated the risk offshore, which arises at the front end, i.e., exploration and development, rather than in the transportation investment.

However, as we understood it, MMS adopted the BBB -- at industry's urging -- because (1) it would be simple to administer, and (2) over time, it would be an economic wash to both the government and the system owner.

For three years industry has been claiming that the BBB does not reflect the true cost of capital -- that the BBB is too low. Yet, for an equally long period, industry has refused to submit for the record any actual data that would support its position. Rulemaking in an industry imposed factual vacuum is what was largely responsible for the flaws in the 1988 regulations. No amendments to the current regulations are warranted if they cannot be factually supported. SCO hopes that the days when industry could deny MMS access to the data necessary to evaluate industry's own proposals and practices are over.

II. BINDING DECISIONS [Proposed Sec. 206.107].

SCO does not oppose advance, binding valuation determinations subject to appropriate limitations. SCO supports the limitations that MMS has put in place, but recommends the following additional modifications.

A. Advance determinations should be limited to sanctioning a lessee's use of a method that is applicable under the rules. In other words, a lessee may come to MMS in advance with the appropriate data and seek a determination that it is using a proper valuation method under the rules. We urge MMS to make it particularly clear that it will not, under proposed Sec. 206.107, entertain new valuation methodologies. New methods proposed by industry should be subject to publication and comment, or, at the very least, be subject to state review and consent.

B. Whether the decision is rendered by the Assistant Secretary or the MMS, an impacted state should be given an opportunity to provide input on whether a binding decision is appropriate under the circumstances.

C. While we believe that this is MMS's intent, it should be made clearer that the determination has no precedential value beyond *both* the factual situation set forth and the particular lease(s) or lessee.

D. While under delegation contracts, state delegates are bound to apply Interior's approved policy, SCO recommends that MMS clarify that an advance determination does not impact the scope of an audit or the type of documentation that can be accessed. During the DC workshop, representatives from MMS and the Solicitor's Office agreed. A binding determination should not inhibit an auditor from developing the facts that support rescission or even regulatory changes.

E. We agree with the suggestion of the MMS representative at the January 20 DC workshop that any advance determination should "sunset" after two years. SCO further recommends, however, that MMS recognize explicitly that it is the lessee's obligation to bring to the bureau's attention any changed circumstances that would alter the advance determination. For example, a sales contract must be arm's length at the outset and at the time of royalty payment under the current and proposed regulations. If the contract ceased to be arm's length during the two year period, the lessee should be required to notify MMS. In any event, MMS should not be bound by an advanced determination under such circumstances.

III. DEPARTURES FROM INDEX PRICING [206.103(d)]

As MMS is aware, SCO agrees that the bureau should retain the authority to depart from index pricing when the market or other evidence demonstrates that a particular index has ceased to be transparent or otherwise does not represent true open market prices. In fact, in prior comments SCO proposed a safety net method that could be used to cross check ANS prices. Assuming MMS has rejected SCO's suggestion that such a method be specifically set forth in the rules, SCO recommends, alternatively, that MMS provide greater detail as to what it will consider in terms of other "relevant matters." In this regard, SCO suggests that MMS incorporate the characteristics that led it to propose index pricing and which are reflected in the preamble, e.g., transparency. Also, SCO suggests that MMS incorporate examples of acceptable alternatives; for example market basket, WTI, Brent, Dubai.

Finally, SCO recommends that the regulation be amended to provide that delegated States may initiate a decision under 206.103(d) by requesting that an alternative method replace index when the latter no longer represents true market value. Oftentimes, States are in a better position to detect changes in the viability of local market value indicators.

IV. "AFFILIATION"

During prior workshops, some industry representatives took the position that transactions between lessees and joint ventures or partnerships, in which they participate, should be considered "arm's length." Through prior comments, SCO opposed this notion as inconsistent with the body of existing case and statutory authority defining joint venture and partnership relationships. In short, concepts of percentage ownership, which industry wants to be the controlling factor in an arm's length determination, are less meaningful in the joint venture or partnership context. This is essentially due to the mutual agent/principal relationship of partners, and the fiduciary duty to act to the mutual benefit of the partners.[3]

In SCO's view, the general legal principles that define a joint venture relationship would support a presumption that transactions between a lessee and a joint venture in which it participates are non-arm's length. A joint venture is a mutual profit making enterprise that in and of itself destroys notions of independence. Once a joint venture is found to exist -- which is a question of fact -- transactions between the venture and any venturer should be deemed non-arm's length. *National Mining Association v. DOI,* 177 F.3d 1 (DC Cir. 1999) supports this view.

As regards joint ventures, SCO strenuously objects to MMS's proposed definition of "person" under which a "person" includes a joint venture "when established as a separate entity." This language suggests that MMS would not recognize a joint venture unless it was reduced to writing or in some way formally constituted. Joint ventures, however, like standard partnerships, have been found to exist based on oral understandings or operating practices. As noted, whether a joint venture exists is a question of fact, not formality.

SCO understands that MMS inserted this language to clarify that some seeming "joint" relationships are not necessarily joint ventures (for example working interest relationships). Under existing law, it is highly unlikely that the existence of a working interest alone would give rise to a joint venture relationship. With all respect, SCO suggests that MMS is confusing principles of tenancy, etc, with joint ventures.

The *National Mining Association* decision[4] may not support a similar presumption with regard *all* transactions of a limited partnership (LP).[5] LPs, a creature of statute, have been characterized as "hybrids" that share both corporate and partnership traits. This is largely due to the fact that some LPs do serve as passive investment vehicles for otherwise independent investors.

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[3] While a joint venture is technically not a partnership, the same fiduciary principles have consistently been applied to and among joint venture participants.

[4] Given MMS's proposal to amend the 10 to 50% presumption of control in light of *National Mining Association*, SCO is, of course, assuming that the bureau has been advised that the case should be treated as controlling authority.

[5] Historically, corporations could not enter into standard partnerships. Whether this continues to be true nationwide is a matter of state law. However, like joint ventures, once a standard partnership has been found to exist, a non-arm's length presumption should follow.

However, it does not follow from this that ownership percentages or concepts of operational control are necessarily more meaningful in determining the arm's length nature of a transaction between an LP and one of its partners, either general or limited.

Typically operational control of an LP is delegated to the general partner(s), who owe the traditional fiduciary duties to limited partners. General partners, however, do not necessarily have ownership "control." In fact, a general partner may be little more than a manager with a small percentage. Under *National Mining Association*, the relative ownership percentage of a general partner is immaterial; it is acceptable to deem a transaction between a lessee/general partner of an LP as non-arm's length.

Under *National Mining Association*, whether transactions between a lessee/limited partner and an LP are arm's length or not would likely be viewed as a factual question, under which ownership percentage may be one, but not necessarily the controlling, factor. Again, this is because an LP may include passive investors. Where a limited partner owns less than 50%, a transaction may still be non-arms length depending on the number and identity of the limited partners, the nature and purpose of the LP's business, the relationship between the LPs business and that of the limited partners, and other factors akin, but not wholly identical, to those reviewed in order to "pierce a corporate veil." In this mix, it should also be recognized that the general partner owes a duty to act to the mutual benefit of the limited partners and that, whether one is a limited or general partner, self dealing is subject to particular scrutiny. In short, the question is whether, under all the circumstances, the LP provides more than a passive investment opportunity for the limited partner.

Given the history of MMS's rulemaking, it is obvious that the overall purpose of investigating business relationships is to foreclose "transfer pricing" opportunities. In this regard, joint ventures and LPs can be used in the same manner as corporate affiliates. SCO understands that it is MMS's intention to deal with non-corporate affiliations through the "opposing economic interests" factor of the arm's length definition. SCO does not dispute that the above discussion fits comfortably within that component of the arm's length definition. However, SCO also believes that the *National Mining Association* decision supports introducing other presumptions into the definition, which will increase regulatory certainty overall. At the very, least, SCO suggests that MMS confirm that joint ventures and LPs will be reviewed under the "opposing economic interests" factor, and that the corporate control factors listed in its proposed regulation are not determinative of different types of business relationships or exhaustive.

V. REFINERY VALUE [Proposed Sec. 206.103(e)]

From the discussions at the workshops, SCO understands that MMS does not intend to permit lessee/refiners to use a refinery value in lieu of index unless the lessee/refiners prove that use of an index value is not a reasonable estimate of the federal oil's fair market value. The burden should be placed on the lessee/refiner to establish by credible evidence that the index value is invalid as to particular production. However, this is not required under the plain language of MMS's proposed rule, which states only that the lessee/refiner must "believe" index values are unreasonable. SCO notes that its concern stems from the fact that industry has consistently stated its "belief" during this rulemaking and before Congress that using index prices is unreasonable.

The list of documentation required under Sec. 206.103(e) should be amended to include the lessee/refiner's internal analyses of the value of particular crude oils to its refinery. SCO urges MMS to assure that it can acquire such information by specifically referencing it in the rule. Replication of such analyses would also provide MMS with an important means of cross-checking other indicia of value.

VI. MISCELLANEOUS ISSUES

A. Expansion of Index Option/Gross Proceeds Minimum.

Through this rulemaking MMS has attempted to retain to the maximum extent possible -- and at industry's urging -- the concept that royalties will be based on arm's length gross proceeds. Options to depart from the gross proceeds minimum were extended only where it would be necessary to trace through several transactions to determine the arm's length sales price.

As MMS is aware SCO objected to the decision to dispense with the general requirement that royalties be remitted at the gross proceeds floor. As we understood it, however, the options were extended in order to reduce the administrative burden of tracing to smaller independents. As industry itself has long stated, that burden does not exist when there is a first arm's length sale. Indeed, such calculations have been made, without complaint, for decades.

SCO notes that, at least for California, ANS spot prices were selected for valuing oil in non-arm's length situations because, in part, of evidence that ANS was being used by major oil companies in trades among themselves and for internal purposes. ANS, thus, can be viewed as a legitimate proxy for "gross proceeds" to these companies. When these same companies are selling at arm's length, there is less reason to depart from the traditional gross proceeds concept. The industry's argument in favor of expanding the option does not withstand analysis.[6] SCO has no objection however to allowing these companies to pay royalties on the higher of index

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[6]As we understand the major oil companies' concerns, as expressed during the DC workshop, they now oppose the arm's length gross proceeds concept because: (1) arm's length is defined as requiring a contract between parties who have "opposing economic interests," and (2) weighted averages may have to be computed. Opposing economic interests, however, are the sine qua non of any arm's length agreement. Requiring such opposition is not new; it in fact is a long recognized part of the definition of true arm's length transaction. It is at least curious that this long standing test became controversial after the evidence of overall balancing agreements became public. Determining weighted averages is neither difficult nor unusual. Both the recommendation and the available facts suggest that, after three years, the majors have already figured out ways of royalty avoidance.

or gross proceeds.

B. ANS Validity

During the most recent workshops, a representative from Exxon-Mobil made the surprising claim that the jury verdict in *Long Beach* should somehow preclude MMS from using ANS spot prices as a measure of value. It was not clear how the company's representative reached this conclusion.

Whatever the jury decided, it is impossible to read the verdict as a rejection of the use of adjusted ANS spot prices as a reasonable means for determining oil value. The jury made no determination that ANS was not a transparent or open market price. The jury did not decide that fair market that value cannot not be determined by reference to a marker crude. The jury made no determination that ANS prices could not be used as a basis for valuing oil produced in California. Moreover, the jury made no determination that is binding on the United States. Indeed, it is absurd to suggest that Interior delegate its statutory and decision making responsibilities to twelve randomly selected citizens in Los Angeles county.

The claim to the contrary is disingenuous, especially coming from Exxon-Mobil. California sued Exxon for breach of contract. Exxon argued, and put on evidence purporting to show, that the City and State in entering into the contract gave up market value in the hope of getting a higher net profits return. The jury found that the City and State could not go beyond the terms of the contract.