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By E-Mail (without attachments); By Express Mail (with attachments)

Sharron Gebhardt, Regulatory Specialist
Minerals Management Service
Minerals Revenue Management
Building 85, Room A-614
Denver Federal Center
Denver, Colorado 80225

Re: Preliminary Comments of California State Controller Steve Westly

Dear Ms. Gebhardt:

The following preliminary comments to the August 20, 2003 proposed rule on federal oil valuation, 68 Fed. Reg. 50087, are submitted on behalf of Steve Westly, the Controller of the State of California.

Under the guise of making "technical" corrections based upon its undisclosed and improbable "experience" with the 2000 federal oil valuation rules, MMS is proposing major changes to provisions of those rules, which it acknowledges will reduce federal royalty oil income. Most, if not all of these changes, relate to issues that were studied and rejected by MMS in prior valuation rulemakings. Yet nowhere in the background statement does the agency point to a single change in market conditions that support its proposals.

The Controller does not oppose change when the evidence supports it. But a change to an Administration more willing to simply accept bald assertions of the oil industry is not evidence.

For the reasons that follow, the Controller requests that MMS withdraw its proposed rule pending full disclosure to the public of all records that relate to the genesis of MMS's proposed

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rulemaking.

Introduction

It is becoming routine to pick up a newspaper and read another story about the Interior Department's breach of the public trust. In the most recent revelation, Interior accepted a price of $40.00 per rod for rights-of-way across Indian trust lands, when neighboring landowners were receiving 10 times that amount. "Report Finds Oil Firms Paid Indians Less For Land", Washington Post (August 21, 2003). Not surprisingly, Interior simply accepted the appraisal of the oil company that asked for the permit, rather than undertaking even a minimal review of fair market value. "Site Visit Report of the Special Master", *Cobell v. Norton*, Civ. No. 96CV01285 (August 2003)[excerpt attached] This episode joins a long list of similar ones, including for example:

- Interior's withholding from Congress information about the true value of a land exchange, which showed a loss to the public of tens of millions of dollars. "Norton Admits Interior Hid Facts From Congress", Indianz.com (July 24, 2003)[attached].

- Interior's basing of a decision on water rights on the Klamath River on a polling data presentation by a White House official; an approach to policy making that even "chilled" experienced political appointees and "killed" the salmon market. "Oregon Water Saga Illuminates Rove's Methods With Agencies, Wall Street Journal (July 30, 2003)[attached].

- Interior's request for the resignation of an official who refused to sanitize his congressional testimony. *See* "Plaintiffs' Opposition to Interior Defendants' Motion And Memorandum To Require Plaintiffs' Compliance With Court's Orders Concerning 'Attachment C'", *Cobell v. Norton*, Case No. 96CV1285 (filed August 18, 2003)[attached]. *See also e.g.*, "Top Interior official ousted," Associated Press (July 30, 2002) [attached].

- Interior's issuance of proposed regulations to overturn a judicial decision the Department won in a lawsuit that had been brought on behalf of an entity represented by the Interior Solicitor when he was in private practice. "Sale of the Wild", Vanity Fair (September 2003) [attached].

- Interior's cash "creativity" award to an auditor who "fabricated" a mineral audit, while putting the employee who revealed the fraud to investigators on administrative leave. See "Probe: Feds fabricated documents in Navajo Trust Case", Farmington Daily Times (June 18, 2003) [attached]. *See also* IG Audit Report 2003-I-0023 (available at www.oig.doi.gov and incorporated by reference herein).

- Interior's conduct of what a federal judge found was a "sham" proceeding in order

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to make a decision adopted in secret appear as if it had been subject to public scrutiny. *Cobell v. Norton*, 226 F. Supp. 2d 1, 113-114 (D.D.C. 2002) [excerpt attached].

- Interior's interference in an EPA environmental review to expedite the issuance of leases to former clients of the Deputy Secretary, who was still receiving income from those clients. Transcript, NOW with Bill Moyers (May 30, 2003) [excerpt attached].

It is not difficult to conclude that the MMS's proposed rule on oil valuation fits comfortably within this pattern. This is particularly true for California, which under MMS's own revenue impact analysis, could lose the most federal royalty revenue if its proposal is adopted as a final rule. MMS does not explain its wholesale rejection of its own studies supporting use of ANS pricing in California and it admits it has no contract or other transactional data supporting its proposed alternative. *E.g.*, 68 Fed. Reg. at 50091.

What is known, of course, is that California has long been one of the most vociferous and active of the state and tribal critics of Interior's disregard of the public's royalty revenue interests. It is also, of course, noteworthy that the company with the largest interest in leases on- and offshore California is a former client of the Deputy Secretary. "Interior deputy participated in meetings on oil and gas leases," Contra Costa Times (April 4, 2003). When he was in the private sector, the Deputy Secretary also testified for that company as an industry "expert" in the False Claims Act cases, which involved undervaluation of federal and Indian crude oil. *Id.* Interior's response to critics of its recent royalty activities has been to respond by suggesting that their royalty interest "can be changed by statutory amendment at the discretion of Congress." February 27, 2003 letter from MMS Director to the Chairman, State and Tribal Royalty Audit Committee [attached].[1]

Interior's Rulemaking Is A Procedural "Sham"[2]

Interior misled the public at the outset by saying it was considering only "technical" amendments to the 2000 oil rules. *See* Notice of public workshops, 68 Fed. Reg. 7086 (February 12, 2003). *Compare* Technical Amendment, Minerals Management Service, 67 Fed. Reg. 19109 (April 18, 2001); Technical Amendment, Bureau of Indian Affairs, 66 Fed. Reg. 8768 (February 2, 2001); Correcting Amendments, Minerals Management Service, 57 Fed. Reg. 26996 (June 17, 1992) [attached]. The specifics were not revealed in its notice or press release, but were only made available to the "public" at workshops, for which the "public" had less than 3 weeks to prepare.

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[1] MMS does not appear to recall that federal mineral revenues compensate states for substantial amounts of "tax free" property located in the states. Over 40% of California, for example, is tax free federal property. MMS also ignores that federal royalty revenue is used to fund public education. And, finally, MMS has forgotten that the reason that states are more involved in the federal royalty program is because of Interior's history of incompetence and industry bias.

[2] *Cobell*, 226 F. Supp. 3d at 113-114.

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MMS would not disclose for public inspection any material supporting its claim that its own "experience" indicated "a potential for improving those rules in some respects." 68 Fed. Reg. at 50088. Because of MMS's RIK/SPR initiative, the main impact of its proposal will be on production from leases under which states receive revenue. Yet, MMS did not contact any of its own delegated state audit offices, land offices, or other energy agencies to obtain their "experience" regarding crude oil pricing, production, marketing or transportation.

Instead, the "technical" amendments disclosed at the workshops were nothing more than a well worn industry wish list of expanded deductions from royalty. In 1988, industry called many of the items on the list "post production" costs – which MMS determined were not deductible. In 2000, industry called this items "midstream marketing" costs – which MMS determined were not deductible. Since 2000, however, all of these costs are now proposed as deductions because they have been labeled "transportation related."

Industry's re-labeled list now makes its appearance as a proposed rule, which Interior – despite its knowledge of active congressional interest in valuation issues and the probable opposition – issued shortly after the congressional recess. Although it took Interior five years to promulgate the 2000 oil rules, which were changed and re-published for comment three times, it is granting the public 30 days to comment on 21 pages of densely packed "technical" amendments that even under its overly rosy estimates will result in revenue losses to the public. And, the same Department that took over six years to make up its mind on royalties owed from coal waste piles, has yet to issue civil penalty regulations under a law enacted in 1996, and has done nothing to respond to 2000 audit findings of its own Inspector General regarding the costly flaws of its royalty rate reduction programs[3], expects to review all of the comments and publish new oil valuation rules within a month after the close of the comment period.

A representative of the American Petroleum Institute (API) conceded at the D.C. workshop in March 2003 that industry made a "strategic" error in focusing its considerable resources on the "duty to market" issue. But, standing alone, industry's "strategic" errors do not justify "running" those same issues "up the flagpole again", which is how the API representative described Interior's current initiative. Nor is reconsideration of these matters justified by the fact that political appointees in the current Administration concurred with industry's judicially rejected "duty to market" claims. "MMS Head Vows to Look Into Controversial Oil Valuation Rule," Oil Daily (April 5, 2002) [attached]. In this regard, it is noteworthy that MMS's first public notice that it was considering changing the 2000 oil valuation rules was published within a month of the Supreme Court's refusal to hear industry's petition to review the duty to market decision. *IPAA v. DeWitt*, 279 F.3d 1039 (D.C. Cir. 2002), *cert. denied sub nom, IPAA v. Watson*, 123 S.Ct. 869 (January 13, 2003).

Interior Has No Experience Under The 2000 Oil Rules

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[3] See IG Audit Report No. 00-I-300; IG Audit Report 01-I-297; IG Audit Report 99-I-297. Inspector General Reports are available to the public at www.oig.doi.gov.

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Undoubtedly, the biggest affront to the public trust related to this proposed rule is MMS's bald assertion that the amendments evolved from its "experience" under the 2000 oil rules, and the "expertise" that it has gained from its royalty in kind projects.

The only "experience" MMS has under the 2000 oil rules is its receipt for processing of industry generated royalty reports. Whether industry has reported its royalty debts accurately in these reports is unknown. No audits of royalties owed under the 2000 rules have been conducted. The three year audit cycle that would review those royalty payments is just beginning, and is being hampered by systemic problems with MMS's new "re-engineered" computer system. Other than reliance on industry statements, MMS cannot credibly claim to know what is or is not "common" or "current industry practice" – a phrase that it repeats throughout its proposed rule as some kind of justification for its proposals. *E.g.*, 68 Fed. Reg. at 50089, 50090, 50103. As audits, Interior Inspector General reports, and the False Claims Act suits have demonstrated, time and again, reliance on data reported by industry does not further the public's royalty revenue interests.

Nor, to SCO's knowledge, has MMS ever during its 20 years of administrative existence completed a transportation audit. It candidly acknowledges that it "does not routinely collect detailed allowance information, such as affiliation between the payor and transporter or the cost components used to calculate a non-arm's length allowance rate." 68 Fed. Reg. at 50098-9. This "information gap", however, does not deter the agency from stating that it can draw rational, non-arbitrary distinctions between whether a particular cost should be characterized as "transportation" or "marketing." The fact that the agency does not even attempt to set forth the standard it used in categorizing these costs as "transportation" or "marketing" is, in itself, telling.

Moreover, the integrity of the information MMS is required to collect and process on a timely basis is open to serious question. Over the past three years, MMS has also experienced serious computer and contractor problems with its automated royalty system, which it has disingenuously blamed on court orders in the Indian trust fund case. *See e.g.*, Letter of July 21, 2003 from STRAC to Senator Jeff Bingaman [attached]. MMS cannot make accurate payments to States and Tribes from this data, or calculate the interest owed on its own late payments, but nonetheless the public is expected to trust in its "experience" evaluating these incomplete and unaudited company reports.

Even the experience MMS actually cites to in the proposed rule is suspect. For example, on page 50089 MMS states that it "studied the correlation between several public indicia of crude oil prices ... *and the values actually used in paying royalties to MMS on crude oil sold at arm's length*" (emphasis supplied). What MMS fails to disclose to the public is that it does NOT collect information that would enable it to determine whether any royalty paid was based on an arm's length or non-arm's length contract. There is not even a box on the 2014 royalty report where a lessee is required to check off whether its disposition of production was at arm's length or not. Indeed, its own revenue impact analyses are based upon 50-50 "assumptions" about the percentage of non-arm's length transactions in different and diverse regions of the country. MMS itself did not even bother to use its own reported data to conduct its economic analysis, which is clearly demonstrated by its

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overstatement of onshore royalty rates and its failure to use reported data to make transportation rate and quality adjustments.

MMS also suggests that it has gained further information from industry's judicial challenge to the 2000 oil rules. However, that challenge is based upon the administrative record compiled during the rulemaking leading up to those rules. There should be no new data in that record; nor should any of industry's "legal" arguments be surprising.

MMS's claim of expertise as a result of it royalty in kind projects is equally faulty. As the General Accounting Office concluded:

> "To date, MMS has not developed clear strategic objectives linked to statutory requirements nor collected the necessary information to effectively monitor and evaluate the Royalty-in Kind Program. Without clear objectives linked to statutory requirements and the collection of necessary information, MMS cannot systematically assess whether Royalty-in-Kind sales are administratively less costly, [and] whether they generate fair market value or at least as much revenue as traditional cash royalty payments ...."

"A More Systematic Evaluation of the Royalty-In-Kind Pilots Is Needed," U.S. General Accounting Office, GAO-03-296 (January 2003) [excerpt attached]. Presumably GAO reached these conclusions based upon full access to MMS's RIK sales contracts and transportation arrangements. During the workshops, however, MMS refused to put the documents underlying its claim of RIK expertise in the record.

In short, it cannot or will not support its claim of expertise, and the available documentation belies its representations to the public.

MMS's NYMEX Proposal Is A'Head Fake'.

In its public relations statements on its proposed rulemaking, Interior has emphasized the success of the 2000 rules and its proposal to "tweak" those rules through the adoption of NYMEX prices as the criteria for valuation of crude oil. These statements are akin to the Administration's "Clear Skies" programs.

> "'Clear Skies' states stirring goals for reducing smokestack emissions; left unstated is that these goals are lower than those the administration inherited."

"Sale of the Wild", Vanity Fair (September 2003).

Despite the considerable evidence of industry's routine use of NYMEX prices in crude oil transactions east of the Rockies, the oil industry leveled an expensive, time-consuming and unsupported administrative and legislative attack on MMS's 1998 proposal to adopt NYMEX. Under congressional pressure, MMS adopted WTI for valuation east of the Rockies. Of course,

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during the long rulemaking interlude, industry saved considerable sums by continuing to pay royalties on inadequate criteria.

Neither NYMEX nor WTI were ever considered as criteria for valuation of crude oil in California. Instead, MMS adopted ANS spot prices for California based upon the results of its own investigations and studies, which included its recognition of certain structural differences in the California crude oil market (*e.g.*, its isolation).

Industry now embraces use of NYMEX for valuing royalty crude oil. It continues to oppose use of ANS pricing for California, making the same arguments it made during the rulemaking leading up to the 2000 rules. Instead, it advocates using NYMEX as the sole basis for valuing California crude oil (in non-arm's length situations), and – without so much as an "honorable mention" of its prior investigations – MMS proposes to use NYMEX to value California crude oil too.

The reality is that neither industry nor MMS are proposing to value California crude oil by reference to the NYMEX. Instead, they are proposing to value California crude oil by reference to Line 63 spot prices – a criteria advocated by industry during the 2000 rulemaking and rejected by MMS for reasons that have not changed. This result is reached through a backdoor mathematical calculation, under which MMS would simply subtract under-valued Line 63 prices from WTI prices and label the result a "grade differential." This is, of course, about as convincing as subtracting under-valued posted prices in California from ANS spot prices and calling that result a "grade differential" – a proposition rejected in MMS's own investigations of California under-pricing.

Interior's policy reversals don't end with the proposals directed at California. For purposes of the Controller's preliminary comments, the following examples will suffice:

- MMS proposes to allow industry to increase the rate of return for determining transportation allowances from BBB to 1.5 times the BBB. Industry's efforts to increase the rate of return were rejected during the 1988 rulemaking and rejected again during the 2000 rulemaking. As MMS explained, this junk bond rate "is higher than these companies' actual borrowing rates would be." 65 Fed. Reg. at 14051. At the March 2003 workshop in D.C., industry explained that the reason that the rate of return was on the agenda was not because of any changes in the industry or transportation economics. Instead, they just wanted to "run it up the flag pole" again.

- MMS proposes to allow industry to make "volumetric adjustments for actual lines losses" – a clear departure from historic practice. In fact, it is contrary to the long held proposition that the volume of production for royalty purposes is determined at the lease. Obviously subtracting those same volumes on the transportation side of the equation violates this historic principle: it reduces the public's royalty share of production. It is also inconsistent with industry's assertion during the 2000 rulemaking that these types of losses are part of the "risks" lessees take in

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downstream marketing – risks that the courts have again confirmed are not deductible from royalty. MMS's effort to reduce royalty bearing volumes through creative expansion of transportation deductions also appears in its proposals regarding line fill, short term storage, and shrinkage.

- In a striking departure from its stated goal of increased "certainty," MMS proposes to treat the disposition of production by operators on behalf of other lessees under joint operating arrangements as arm's length transactions. Operators under such arrangements typically sell all the production on behalf of co-lessees. At the DC workshop, MMS explained that this proposal made the agenda because some operators and co-lessees began entering into alternative sales agreements in an attempt to circumvent the 2000 rules. Under the 2000 rules, according to MMS and industry, lessees were being "forced" to change their business relationships in order to avoid paying true value for federal production. Other than that, MMS does not explain its reasoning for assuming that these new agreements may be "arm's length". The complexity and uncertainty that accompanies this proposal, of course, stem from the fact that most non-operating co-lessees are working interest owners, not royalty interest owners. Working interest owners agree to share the costs of production and post-production activities, which are cost free to a royalty owner. The difference between what the "arm's length" price of a co-lessee and the operator's sales value will be accounted for as a lump sum. Given that MMS has announced (over the objection of States and Tribes) that it intends to reduce its audit activities (IG Report 2003-I-0023), this will result in reducing royalty revenues by costs that otherwise would not be deductible from royalty.

Conclusion

The bottom line is this: if Interior was doing something other than simply catering to industry's wishes, it would provide a rational explanation for its proposals and open the records justifying its "experience" for public inspection. It would not mislead the public by labeling its proposals "technical" changes, and it would not try to speed through a rulemaking while Congress is out of town.

One of the most telling statements in MMS's proposal is its assertion that the amendments "better reflect the way industry accounts internally for its oil valuation." 68 Fed. Reg. at 50103. This is not simply contrary to the recommendation of the 1982 independent commission report on how Interior should approach royalty valuation and accounting. Report of the Commission, Fiscal Accountability of the Nation's Energy Resources (January 1982). It is also contrary to the lessons of the False Claims Act suit and the Enron debacle. Relying on industry's internal accounting practices is not a plan consistent with Interior's public trust obligation.

The California State Controller reserves the right to supplement these comments. The Controller also incorporates by reference all comments submitted by his Office in connection with

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the rulemaking leading up to the 2000 oil valuation rules, which are available at www.mms.gov.

Sincerely,

Lee Ellen Helfrich

Attachments

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