ipaa
America's Oil & Gas Producers

US Oil & Gas Association

ADVOCATE FOR THE OIL & GAS INDUSTRY

March 4, 1999

Mr. Tom Kitsos
Acting Director
Minerals Management Services
Department of the Interior
1849 C Street NW
Washington, DC 20240

Dear Mr. Kitsos:

This is a response to the letter dated February 10, 1999, from Cynthia Quarterman. Our members have asked that we communicate their continuing concerns regarding the Minerals Management Services' (MMS) efforts to implement new crude oil value regulations. The Director's letter indicates that independent producers continue to misapprehend how these proposed rules would affect their interests. Our members, who are Independents, disagree as they consider how the rule would affect their businesses.

The Director's letter repeats earlier points in her April 7, 1998, letter to the *Oil Daily* and in testimony given and correspondence sent to committees of the Congress. You are, by now, well aware of our responses. But, in the hope that continued discussion can break through the logjam, we will restate our concerns over MMS's three points as directly as we can.

1. Second-Guessing. We appreciate MMS's attempt to allay concerns over agency second-guessing of an independent's marketing decisions. Please understand, however, that the proposed rule attempts to codify a practice of second-guessing which our members, larger and smaller, have vigorously contested under the current rule. It is no comfort to all producers that the proposed rule would make explicit MMS's interpretation of the current rule, when our members believe that the current interpretation is in error.

For example, consider an independent selling gas at the lease for \$1.60/MMBtu. In an effort to increase sales revenue, the independent decides to sell *at arm's length* to a different buyer at the lease, but instead of a set price, the parties agree that the independent will receive 95% of the buyer's downstream resale price. As it happens, the buyer is able to resell the gas for \$1.80/MMBtu (after adjusting for transportation costs) and pays the independent \$1.71/MMBtu at the lease. Your lawyers have admitted in federal court that the independent would not breach his (alleged) duty to market if he continued to sell the gas to the original purchaser for \$1.60. Yet, because the independent has chosen to market the gas using a percentage-of-resale price clause, MMS asserts that the independent breaches the duty to market by paying royalty on the \$1.71 he actually receives. MMS demands that he pay royalty on the \$1.80 received by the reseller.

Here, MMS would have accepted royalty at \$1.60, the independent increases the royalty value to \$1.71, and MMS cries "foul" and demands \$1.80. This is second-guessing an independent's arm's-length sale. This is no hypothetical. It is the *Taylor Energy* case, and it is egregious. The solution to this issue is to state explicitly in regulatory language that arm's-length sales will not be second-guessed and contain no caveats such as comparisons to average prices.

2. Affiliate Resales. The Director's letter advises that "[u]nder current regulations, MMS looks to your affiliate's arm's-length sales price to determine [the] gross proceeds minimum." MMS's proposed rule would expressly codify MMS's interpretation of the current rule. That is why we have not supported it and have worked hard to resolve this issue with the Department. We oppose this interpretation of the current rule. The Interior Board of Land Appeals and many of MMS's own auditors are not of the view that the "lessee" who must pay royalty on his "gross proceeds" is both the lessee and all of the lessee's affiliates. IBLA is on record that the "term lessee, however, is specific and cannot be expanded to include an affiliate of the lessee." *Shell Oil Co. (On Reconsideration)* 132 IBLA 354, 357 (1995). The Department's proposed rule is clearly a significant change in the text and meaning of the current regulations, even if it is no change in how MMS is trying to enforce them.

3. The Implied Duty to Market. The Department's position on this point is in litigation. *IPAA v. Armstrong*, Civ. No. 98-00531 (RCL) (D.D.C.). The Director's letter has not alleviated the fundamental concerns of producers.

Our associations would like to work with the Department to solve outstanding valuation issues. We are pleased that the Director's letter welcomes "an open discussion of issues," and we are grateful for that invitation.

We remain committed to finding a workable solution to concerns over crude oil valuation. If you have questions, please call Ben Dillon with IPAA (857-4722) or Alby Modiano with U.S. Oil and Gas Association (638-4400).

Sincerely,

Lee O. Fuller

Lee Fuller
Vice President of Government Relations
Independent Petroleum
Association of America

Alby Modiano

Alby Modiano
Vice President
US Oil & Gas
Association

Letter to the Editor: IPAA Reasserts Belief That Royalty Changes Will Affect Business

Dear Editor:

The Independent Petroleum Association of America (IPAA) believes the following letter signed by 272 independent oil producers lays to rest once and for all the fallacy that producers will not be affected by the Minerals Management Service's (MMS) plan to change the way in which oil royalty payments should be calculated.

As the letter to members of Congress clearly states, the rulemaking would harm independent producers because the government would be able to "second-guess" the proceeds a producer receives from a third party, which could ultimately mean the producer actually pays royalties on more than he or she receives.

MMS's own letter to Sen. Frank Murkowski (R-Alaska), dated Aug. 31, states that if MMS determines that proceeds from a third party are "not reasonable" due to misconduct, a breach of its duty to market, or due to an exercised noncompetitive call, the value of this independent's oil production will be based on Alaska North Slope crude for California and Alaska, on benchmarks for the Rockies, and spot prices for the rest of the country.

It certainly sounds like independents are affected by this new proposal. Despite MMS Director Cynthia Quarterman's assertion in *The Oil Daily (10-2-98, p.3)*, the plan applies to independent producers with marketing affiliates and is not limited to producers who refine. These are the plain facts!

Ultimately, no independent producer can be confident that his or her price is reasonable, given MMS's history of proposing regulations that offer auditors too many opportunities to determine what is reasonable. Independents believe they receive the best possible price. A price they consider reasonable to run their business surely should be reasonable to the government for royalty purposes.

Quarterman's letter to *The Oil Daily* provides an interesting insight into the problem that MMS is having in creating a new oil valuation rule. That insight is that the MMS staff working on this rule have a fundamental misunderstanding of the industry they are attempting to regulate.

She says she is "baffled" by independents' insistence that they will be affected by the proposed regulations. Independents are baffled by the inability of MMS to understand how we do business and how their proposed regulations create an uncertain business environment for us. We have tried to explain our concerns to MMS, but they don't seem to be listening.

Yours faithfully,
Gil Thurm,
IPAA President

Independents' letter to Congress:

Oct. 5, 1998
Dear U.S. Senate and House of Representatives:

During the Senate floor debate on the fiscal year 1999 Interior Department spending bill Sept. 16, Sen. Barbara Boxer (D-Calif.) stated plainly that independent oil producers would not be affected by a government proposal to change the way in which oil royalty payments should be calculated. The Minerals Management Service bolstered Boxer's position by stating in a flier to Congress that, "The rule would have no impact on independents who sell on the open market to unaffiliated third parties — approximately 95% of all companies. ..."

As an independent producer, I want to assure you that nothing could be further from the truth. The rulemaking will cripple independent producers because the government can "second-guess" the proceeds I receive from a third party. If a government auditor decides my proceeds aren't reasonable or I've breached newly delivered duties, they will subject me to their complex and costly bureaucratic formulas.

These formulas could mean I have to pay royalties on more than I receive. This is wrong and the effect on marginal wells could be devastating.

It doesn't end there. If I decide to form a marketing affiliate, I will encounter an entirely new set of rules. There are different sets of procedures for Wyoming production, California production and New Mexico and offshore production. This doesn't make sense.

I urge you to back an IPAA-supported one-year moratorium on the proposed rulemaking that would give industry and the federal government more time in which to craft an oil royalty plan that is both fair and administratively efficient.

Independents have a plan that captures actual values at the lease and is efficient. I urge MMS to adopt it.

Should you believe MMS and Boxer? No! I'm the regulated party and these rules could have a disastrous effect on my business. The claim that I'm writing to you as a spokesman for major oil and gas producers is ludicrous. To survive in this business climate when oil prices are disastrously low, I must dedicate my scarce resources to matters that affect my bottom line. That's not speaking on behalf of majors; it's stopping arbitrary regulations that will harm my business.

The letter was signed by 272 independent oil companies.

The Oil Daily *welcomes letters to the editor. To express an opinion, send a letter to The Oil Daily, 1401 New York Ave., N.W., Suite 500, Washington, D.C. 20005-2150, or fax (202) 783 8230; e-mail, jcollin@energyintel.com.*

Earnings . . .

(Continued from 1)

a significant dent in independents' output. But Morris said he expects third-quarter production to be 0.8% lower than in the second, implying that low prices may finally be having a slight impact on volumes.

CIBC Oppenheimer analyst Victor Hughes said production shut-ins brought about by a particularly troublesome tropical storm season in the Gulf of Mexico could hurt third-quarter earnings, too.

"Lost days of production will drop profits for some Gulf producers," he said.

Unocal Corp. and Noble Affiliates Inc. have warned shareholders that hurricane-related shut-ins will hurt third-quarter results *(see story, p.7)*.

Other companies deriving most of their revenue from the Gulf that analysts cite as vulnerable include Oryx Energy Co., Newfield Exploration Co., Ocean Energy and Forcenergy Corp.

Nonetheless, Hughes said lots of independents should be thankful for the storms because of the support they provided commodity prices — particularly natural gas.

Had gas prices closed the quarter at end-of-August levels, he said, many producers would have had to take noncash ceiling test writedowns to reflect the declining value of their reserves.

"We haven't had a quarter end with low gas prices yet. Without the storms, it would have happened and caused another round of big asset write-downs," Hughes said.

(T Paul Merolli

low of 39.35¢/gallon. At the close of the session, front-month heating oil was down 1.40¢ at 39.45¢/gallon.

Spot prices for liquefied petroleum gas (LPG) were little changed on the week, but the prospects remain grim for propane, according to data from the Energy Information Administration (EIA).

In its monthly propane report, EIA said propane stockholders added 3.9 million bbl to primary storage last month to bring U.S. inventories to 78.6 million bbl at the end of September. According to EIA, that figure — some 17.8 million bbl higher than in the year-ago period — is the highest that propane stocks have been at the beginning of the heating season since 1986. Separately, in its *Short-Term Energy Outlook*, the agency said stocks are their highest since 1981 *(see story, p.5)*.

Stocks increased in all major regions last month and remained significantly above their normal ranges in the Midwest and Gulf Coast.

Spot prices of methyl tertiary butyl ether (MTBE) remained static in Houston but slipped in New York Harbor following declines in the broader markets.

As for natural gas, spot prices gave up more ground, sinking 5¢ in Louisiana and south Texas. With cooler weather around the region and the continuing gas storage surplus, traders said there's just too much supply and not enough demand.

The November Nymex Henry Hub gas contract tumbled hard, dropping 13.9¢ to close at $2.254/MMBtu.

Eric Kronenwetter, Steve Parezo

Spot Prices: Specialty Products

(cents / gallon)

LPG

Mont Belvieu, Texas	Change	Oct. 8	Oct. 1
Propane	-0.25	25.00	25.25
Butane	-0.25	30.00	30.25
Isobutane	0.00	30.25	30.25
Natural Gasoline	-0.75	33.25	34.00
Ethane	-0.50	16.50	17.00
Conway, Kan.			
Propane	-0.25	24.50	24.75
Butane	0.25	27.50	27.25
Isobutane	0.00	31.25	31.25
Natural Gasoline	0.50	34.75	34.25
Ethane	0.00	15.75	15.75
Sarnia, Ontario			
Propane	1.00	27.50	26.50
Butane	0.00	26.00	26.00
Isobutane	0.50	27.50	27.00
MTBE			
Houston	0.00	62.00	62.00
New York Harbor	-1.00	66.50	67.50

Source: Reuters

Letter to the Editor: MMS Chief Expresses Bewilderment At Independents' Concern About Rules

Dear Editor:

We're still baffled. In Gil Thurm's letter to the editor published in *The Oil Daily* on Oct. 7, he references language from a Minerals Management Service (MMS) letter to Sen. Frank Murkowski (R-Alaska) and suggests that, because of this language, the new rule will affect independent producers. The following response should lay this issue to rest, once and for all.

Mr. Thurm states, "... if MMS determines that gross proceeds from a third party are 'not reasonable' due to misconduct, a breach of its duty to market, or due to an exercised noncompetitive call ..." oil production will be valued as non-arm's length. From there he concludes that MMS will use this provision to "second-guess" the third-party proceeds received by independent producers, and that the proposed regulations "... create an uncertain business environment ...."

This particular provision of the proposed regulations is *not* new. A quick look at our existing regulations reveals that the crucial language is almost identical. Section 206.102(b)(1)(iii) states, "... if MMS determines that the gross proceeds accruing to the lessee pursuant to an arm's-length contract do not reflect the reasonable value of the production because of misconduct by or between two contracting parties, or because the lessee has otherwise breached its duty to the lessor to market the production for the mutual benefit of the lessee and the lessor, then MMS shall require that the oil production be valued ..." as non-arm's length.

We question why the independent producers are focusing opposition to our new rule on a provision that has been in effect for over 10 years. Not only is this provision in effect for oil, but also for unprocessed gas, processed gas and coal, as well. Mr. Thurm states, "[i]ndependents are baffled by the inability of MMS to understand how we do business ...." We are equally concerned by the independents' failure to acknowledge that this is not a new requirement. For over 10 years royalty payments have been based on regulations that contain essentially the same language.

As we have stated repeatedly, this provision has not been and will not be used to second-guess a producer's marketing decisions. In fact, at the request of independents, we modified our proposal on July 16, 1998, to clarify this intent. However, after reviewing the modification, the independents recommended we not include the modified language in the rule. So, we told them we wouldn't. Now they once again express concern about second-guessing.

The letter signed by 272 independent oil companies contains a number of troubling misapprehensions about the proposed rule. For example, it states, "If I decide to form a marketing affiliate, I will encounter an entirely new set of rules."

Not true. In our February 1998 proposal, we maintained our current policy of accepting gross proceeds under arm's-length contracts by specifying that arm's-length sales by marketing affiliates would be valued on gross proceeds. Independents with marketing affiliates would not have paid on "... a new set of rules."

However, once again, some independents cried foul complaining that only the refining companies could use the new rules. So we announced in our paper, "Outline for Federal Oil Valuation Final Rulemaking," that we would allow an option for companies with a marketing affiliate to pay on the affiliate's arm's-length resales or spot prices/benchmarks. That is, those companies could *choose* to come under that set of new rules. The paper was attached to Assistant Secretary Bob Armstrong's Aug. 31 letters to Sens. Breaux, Domenici, Nickles, Murkowski and Hutchison, outlining the status of oil valuation issues in the final rule. The letters and the paper were published and remain under "What's New" on the MMS website at www.mms.gov.

Again, if any independent company thinks it would be forced to pay more royalties under the new rule, we would be happy to talk to them directly at (303) 275-7200. As of this writing, we have received only one call in response to the offer in my letter of Oct. 2 *[TOD, 10-2-98, p.3]*.

Sincerely,
Cynthia Quarterman
Director,
Minerals Management Service

The Oil Daily *welcomes letters to the editor. To express an opinion, send a letter to The Oil Daily, 1401 New York Ave., N.W., Suite 500, Washington, D.C. 20005-2150, or fax (202) 783 8230; e-mail, jcollin@energyintel.com.*

JPAA's Modified Valuation Proposal - Attachment

MIDSTREAM ACTIVITIES

7-15t/661.

Marketing

- Aggregating Volumes for Barrel Availability
- Satisfying Specialized Customer Quality Preferences
- Scheduling Monthly Crude Business through Contracted Companies and Pipelines
- Crude Movement Flow Schedule for Accounting
- Review Financial Analysis of Trades
- Review of Contracts and Other Marketing Arrangements vs. Current Markets
- Development of Monthly Market Differentials
- Obtain and Analyze Crude Oil Samples

Operations

- Contracting for or Providing Transportation
- Scheduling of Volumes
- Providing Pipeline Fill
- Tracking Volumes Delivered
- Providing Credit Services
- Constructing or Leasing Storage Facilities
- Scheduling Storage Volumes
- Maintaining Inventory
- Environmental and Safety Compliance

Risk Management

- Dealing with Price Fluctuations at or Upstream of Market Centers
- Risk or Loss of Pipeline Volumes
- Environmental Liabilities for Spills
- Risk of Purchasers' Default

Administration

- Contract Preparation and Follow through with Outside Company
- Contract Maintenance
- Royalty Bonus Development and Application
- MMS and Royalty Compliance
- Oil Price Development
- Inventory Reconciliation
- Disbursement Activities (Division Order, Tax, Legal)

dc 6373