



Congressional Testimony

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Prepared for the Energy and Mineral Resources Subcommittee, Resources
Committee

House of Representatives

July 31, 1997

Madam Chairman and Members of the Subcommittee, I appreciate the opportunity to appear today to present testimony on the Minerals Management Service's (MMS) ongoing examination of the feasibility of taking oil and gas royalties "in kind." We are undertaking this study as part of our continuing efforts to improve services to the public at reduced cost. We are also responding to a congressional directive to consider additional royalty in kind scenarios. Before discussing details of our current study, I would like to provide you with some background information.

Background

The Department of the Interior has historically based oil and gas royalty valuation on fair market value, typically defined as the gross proceeds realized by its lessees under arm's-length sales. For many years, this served as an equitable valuation standard and continues to work well today in cases of wellhead or producing area arm's-length sales. However, the energy industry has changed dramatically over the past 10 years.

With respect to crude oil, the world events of the 1970's produced new price volatilities and an active spot market. Spot trading at producing area market centers by middlemen, such as brokers and re-sellers, has increased compared to the traditional long-term contracts between producers and refiners. Further, many sellers now use the futures market for risk management and market information. Product exchanges are now a common method of disposing of production.

With respect to natural gas, the Federal Energy Regulatory Commission's (FERC) deregulation of the natural gas transportation industry, the widespread emergence of producer affiliates and joint venture marketers, and the evolving deregulation of retail natural gas and electric markets have complicated royalty valuation.

The once-dominant wellhead sale has been replaced by more frequent "downstream" sales by affiliated energy marketers, especially for natural gas. A series of downstream transportation, processing, marketing, and risk management activities (e.g. price hedging) -- even inter-commodity exchanges (e.g., from gas to electricity) -- frequently occur before a first sale is made, thereby complicating the tracing and calculation of a lessee's gross proceeds. In some instances, for example, a gas producer's first sale may not occur until the burner tip in a residential consumer's home.

The changing nature of the current energy market has, unfortunately, fostered disputes between MMS and producers over the appropriate royalty valuation for oil and gas. For example, we have had disputes over how much of the downstream revenues should be included in gross proceeds, what deductions are appropriately made from gross proceeds for downstream services, and to what extent is the lessee's duty to market for the lessor at locations remote from the lease. Administrative appeals and litigation have proliferated as MMS and the energy industry have struggled to resolve these issues.

Changes in the energy market have presented great challenges for MMS to provide simpler and more certain royalty valuation regulations and guidance. MMS has attempted to meet the challenge through a series of regulatory and policy actions, using negotiated and revised valuation rulemakings. Regulatory

and policy solutions developed to date have often been controversial. However, we believe that progress towards solutions to royalty valuation disputes is tangible and that we are on the right path to successfully addressing these issues.

Part of this "right path" may include implementation of a royalty in kind (RIK) program or programs. The complexity and divisiveness surrounding existing royalty valuation have prompted us and many in the oil and gas industry and Congress to consider the potential benefits of RIK programs. In the best case RIK scenario, valuation disputes could be eliminated or at least reduced. Auditing lessees' production could consist of straightforward volume reconciliations completed soon after the production month. Administrative savings could accrue to both the Federal government and industry through decreased royalty reporting and verification. The potential may exist to enhance Federal revenues through significant aggregation and sophisticated marketing. The extent of such benefits, however require more examination and analysis. While the RIK program offers possibilities for the marketing of Federal production, it also places the government into a new role similar to that of a working interest owner sharing in benefits and risks.

MMS recognizes the potential for these benefits and, accordingly, we are seriously examining the feasibility of adopting RIK programs. Before discussing the early results of our examination, I would like to speak briefly of MMS' 1995 Royalty Gas Marketing Pilot during which MMS took a percentage of its offshore gas production in kind.

1995 Royalty Gas Marketing Pilot

During calendar year 1995, MMS took and sold by competitive bid at the lease approximately 45.6 billion cubic feet of gas from 14 lessees covering 79 leases in the Gulf of Mexico, accounting for approximately 6 percent of the U.S. royalty share of Gulf of Mexico natural gas production. The pilot was an operational success, proving that RIK sales are feasible, however, royalties were some 9 cents per MMBtu less than would have been realized under the in value system. Extrapolated to all Gulf of Mexico Federal leases, this loss would have been approximately \$82 million annually. MMS learned a substantial amount about RIK concepts from the pilot and from subsequent interaction with gas producers and marketers, including:

- 1) The voluntary nature of the program put MMS at a disadvantage that likely contributed to revenue losses, the most obvious disadvantage being that volunteered leases were scattered throughout the Gulf, reducing opportunities to aggregate volumes and enhance values.
- 2) Sales at the lease resulted in MMS not realizing value enhancements from downstream marketing services, natural gas liquids uplifts, and aggregation.
- 3) Administrative relief to MMS and industry did not occur because only a few leases were included and audits of the producers' shares were still conducted.

1997 RIK Feasibility Study

The primary objective of our current study is to determine if implementation of an RIK program or programs for Federal oil and gas is in the best interests of the United States, and, if so, under what circumstances. We use the phrase "best interests of the United States" to refer to a program that would:

- 1) Offer potential revenue neutrality or enhancements to the U.S. Treasury; and
- 2) Provide extensive administrative relief for MMS and industry.

The study considers both small-scale pilots and across-the-board, "steady-state" programs involving substantial volumes of Federal production. In the study, we are assuming that the following conditions would have to prevail for the U.S. to successfully implement an RIK program or programs, namely:

- 1) Federal lease rights to take in kind would be exercised at our option.

- 2) Regulations would be promulgated.
- 3) Market value benchmarks would measure program success.
- 4) MMS would not audit the lessee's production share to measure value.

During the study, we have conducted several types of research, including:

- 1) interviewing governmental entities to learn from their RIK experiences;
- 2) convening public workshops to obtain public input on a spectrum of potential RIK options under consideration; and
- 3) surveying energy marketers to learn more about how energy commodities are marketed and sold downstream of the lease.

Other RIK Experiences. The Texas General Land Office (GLO) takes oil and gas in kind from State leases. The GLO's oil is sold by competitive bid at the royalty measurement point. GLO staff stated that RIK revenues are some 5% more than in value revenues. The GLO is currently in dispute, just as the MMS is, with many producers over the value the GLO receives in royalties. Generally, the in value royalty payments were based on postings. GLO has recently reached settlement with at least one integrated producer to pay royalties on a NYMEX adjusted price, rather than postings. Our understanding is that the advantage of the oil RIK competitive bid price compared to the negotiated royalty valuation has disappeared.

The GLO's gas RIK program provides gas to State facilities as an alternative to services provided by local utilities. Excess gas is sold on the spot market. The program has two primary goals: 1) to enhance the School Fund, and 2) to streamline the GLO royalty program. The GLO sells approximately 1 Bcf per month from 100 state leases in the Gulf. The GLO reported that the program has resulted in about \$1 million, annually, in additional revenues and about \$10 million, annually, in savings from decreased gas prices for State facilities by cutting out the local utilities. Our understanding from GLO, is that the local distribution companies are now becoming more competitive to try to gain the State facilities back as customers. The schools are receiving more competitive prices, however, the State is reducing its margin to remain a competitive supplier. Later, I will discuss our findings on gas from the OCS.

During the past 3 months, we have spent some time learning about the experiences of other governments in RIK, especially the Province of Alberta's RIK oil program. Under this program, the entire Province's Crown (royalty) share is delivered at the oil tank battery. The Province's marketing agents combine Crown production with their own equity production, and move the crude oil significant distances to refineries where sales occur. The agents are paid a per barrel marketing fee. The Alberta crude oil RIK program is reported to be slightly revenue positive compared to refinery postings. We understand that the Alberta benchmark prices are comparable to U.S. market center prices, for example, the Empire and St. James market centers. Alberta has told MMS that their small revenue enhancement primarily results from movement of the Crown's production away from remote areas with little refining capacity and demand to areas of many refineries with greater demand for crude volumes.

The Alberta RIK program provides an interesting model for us to consider as we move forward in assessing RIK programs. I will speak further to this model later today.

The State of Wyoming has formally expressed interest about creating a pilot RIK program. We have met with them several times to explore that possibility. We remain open to work with the State and industry in formulating a pilot program in Wyoming. Our offer to the State that we develop a joint implementation team remains open.

Public Comment. MMS conducted six public workshops to obtain public comment on RIK feasibility. The primary public reaction to MMS' RIK options was widespread support for MMS to take oil or gas production in kind. This sentiment was expressed by large and small producers, marketers, field service companies, pipeline companies, and State governments. Comments from marketers and some producers indicated that gas RIK has more potential for revenue enhancement than does oil RIK. Their rationale is

that the Federal government's royalty strength is in its ability to aggregate large volumes of production. That characteristic is not as important in the oil market because it consists of refiners that typically look for incremental barrels to fill excess capacity rather than for large volumes to fuel ongoing industries as is the case in the gas market. Further, some commenters indicated that a large-scale RIK program would work better for offshore leases in the Gulf of Mexico because of the concentration of volumes in a relatively small area with mature pipeline/market infrastructures.

Public comment supported delivery of U.S. royalty production at the lease, followed by either lease sales or downstream sales by a contracted marketing agent as the best options. Both producers and marketers urged MMS to adopt bold programs (rather than "pilot projects") involving substantial volumes and long time periods. Producers cited significant administrative savings and marketers asserted revenue enhancements as the basis for their opinions.

Market Survey. MMS conducted a survey of natural gas marketing companies to understand this aspect of the business and to determine the implications and potentials for marketing of U.S. royalty gas production. The energy marketers appear to possess three attributes that they could provide to MMS that have positive implications for marketing of U.S. royalty gas:

- 1) Knowledge and experience gained in swapping/trading multiple commodities;
- 2) Efficiencies from moving large volumes; and
- 3) The full spectrum of marketing services (e.g. storage, transportation service portfolios, commodity swapping/arbitrage, risk management, trading on location differentials, and knowledge of and relationships with pipelines, gathering systems, processors, and customers).

Each of these attributes could potentially increase the revenues the government would receive from gas production. The gas marketers each contend that MMS can enhance offshore gas revenues by strategic alliances with energy marketers. The primary reason offered by marketers is that MMS could provide market leverage for an agent by virtue of the large magnitude of supply from a single source. The same reasoning apparently underlies the recent private joint ventures between major producers and gas marketers.

Preliminary Findings. Our examination and deliberations on potential future RIK programs are still ongoing, and, as such, the findings I discuss here today are still quite preliminary. However, we offer some of our tentative findings to generate discussion and to let you know the status of our analysis at this point in time. An overall finding of the study will likely be that, under favorable circumstances, RIK programs could be workable, revenue neutral or positive, and administratively more efficient for MMS and industry. Favorable circumstances include:

- 1) **Downstream Marketing and Sales:** An MMS RIK program that can strategically participate in downstream services and value enhancements could improve Federal royalty revenue.
- 2) **Aggregation:** The ability to aggregate and supply substantial volumes to end-user markets could provide MMS and its agent with market leverage primarily through assurance of supply.
- 3) **Administrative Relief:** Decreased reporting to MMS, and the reduction of audits of the producers' shares would benefit both the U.S. and the royalty payors.

However, RIK programs would have reduced chances for success if implemented under unfavorable conditions, including:

- 1) Continuation of audits of the producers' shares;
- 2) Statutory language reversing our current RIK authorities by:

- a) requiring MMS to take royalty in kind only at the lessees' discretion;
- b) limiting our ability to have RIK volumes transported by the lessee at cost or requiring us to pay above market transportation rates on non-jurisdictional gathering lines to move royalty production; or
- c) requiring MMS to accept RIK volumes at less than marketable condition.

3) Taking in kind Federal production scattered throughout many basins in a relatively large geographic area, which would decrease the potential for aggregation of volumes and increase the MMS learning curve for implementing RIK programs.

With respect to crude oil, we caution against assuming that the Alberta program is directly relevant to U.S. crude oil RIK potential. First, the Alberta revenue information covers only one 6-month period and is only marginally positive. Second, the stated reason for the small revenue enhancement in Alberta--movement of crude oil substantial distances to areas of greater refining demand--would likely not occur in the Gulf of Mexico. This is because the U.S. Government should already be receiving royalties under the current in value scheme based on relatively high demand in the Gulf which results from a high concentration of refineries. Further movement downstream under an RIK system would likely not result in higher prices.

For onshore, implementation of a new crude oil RIK system would be large and complex because of the scattered nature of the production. This would make such an RIK program a difficult undertaking that should be attempted only if revenue and administrative impacts for all parties are decidedly positive.

MMS believes that our proposed crude oil valuation rule promises to provide for certainty in oil valuation partly by utilizing transparent market indicators tied to producing area market centers. Under an oil RIK program, it is likely that the Government would realize proceeds similar to those quoted at the market centers, which is the basis for our proposed valuation rule. Considering that lessees cannot deduct marketing costs under the Federal in value system, we believe that implementation of an oil RIK program would actually lose revenue because MMS would need to pay these costs under an RIK program without the potential for volume aggregation or downstream value enhancements of a gas RIK.

In summary, we are not convinced that crude oil RIK is in the best interests of the United States. However, we have not yet quantified the relationship between direct revenue implications and potential administrative savings for oil RIK. We are, therefore, willing to work together with industry, States and the Congress to develop and conduct a pilot program that might help provide these answers.

With respect to natural gas, we believe that a gas RIK that uses one or more marketers has the potential to enhance revenues because:

- 1) MMS could receive more benefits from downstream sales of gas and associated liquids than currently received at the lease;
- 2) the potential to aggregate production would increase under RIK if existing lessees of offshore royalty gas are replaced by one or a few marketers;
- 3) downstream value additions may be more quickly captured by RIK programs than under in value royalties that are currently in litigation; and
- 4) gas marketers generally have a more diverse portfolio of transportation options than many producers, and can thus use the most appropriate service to exploit lucrative yet often short-lived marketing opportunities.

In sum, we are encouraged by the prospects for gas RIK from both revenue and administrative perspectives. We intend to proceed cautiously to develop specific program models consistent with the favorable conditions I previously mentioned, and to assess their feasibility before we make any firm decisions on whether or how to implement a new RIK pilot.

Next Steps

I reiterate that the findings I have outlined here today are preliminary, and that, upon further detailed economic and program analysis, different conclusions may be reached. We will not make any decisions before such analysis is completed. We further believe that it is not wise to make legislative decisions before comprehensive analyses are conducted. Any statutory or regulatory assistance that may be necessary will depend on the specific nature of any RIK program that is developed. At this point, it is premature to guess what type of legislative assistance, if any, may be needed.

Specifically, our course of action will be the following. We will first complete our conceptual assessment of potential future RIK programs. We then intend to work together with Congress, interested States and the industry to identify specific areas of interest in RIK. If indications remain positive that certain RIK scenarios should be pursued, we will develop detailed program specifications that can then be assessed for their likely fiscal and administrative impacts. Decisions will follow.

In closing, let me state that the Department of the Interior is quite open to alternative and innovative ways to manage the revenues generated from the Nation's public resources. We understand that the energy markets have changed dramatically from those in existence when our valuation regulations were published in 1988, and that these still evolving changes require us to be agile and flexible in our approach so that both government and industry have workable systems to manage royalty revenues. It is precisely that need for agility and flexibility that leads us to believe that a legislatively constructed program might lock in elements of an RIK program that would later turn out to be counter to the operations of the marketplace. We continue to work on two fronts to meet this challenge, namely to develop clear and certain valuation regulations for in value royalties, and to explore and implement RIK programs where they are workable and beneficial to all parties.

Madam Chair, this concludes my prepared remarks. I would be pleased to answer any questions you or the Members of the

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