COMMENTS ON BEHALF OF THE CALIFORNIA STATE CONTROLLER'S OFFICE
MMS Proposed Oil Valuation Rules Workshop
Washington, D.C.
April 6, 1999

This workshop is being held today because the "industry" - writ large - has complained that Interior has not been open to listening to its concerns. As someone who has represented a client:

- o that sued the Department of the Interior to stop the honor system for royalty payments;

- o that opposed the 1988 regulations for being too industry oriented because the rules did not overtly address the problems of posted prices, exchanges, overall balancing arrangements, and inflated transportation costs; and

- o that has had its efforts to implement Interior's own policies repeatedly stymied or delayed by Interior itself because of concerns about industry reaction,

I find the accusation that Interior doesn't listen to industry remarkable. In fact, if it were true, it would be an historical first. But its simply not true.

This rulemaking began in 1995 -- at which point industry refused to participate because, according to them, the 1988 rules "ain't broke, so don't fix 'em." This attitude permeated the early comments on MMS's proposal in 1997. But, we're still here today because of Interior's willingness to listen to industry, who after four years finally purports to be ready with "new" alternatives.

The fact is that Interior has listened and responded to industry throughout the rulemaking. Attached to my testimony is a non-exhaustive list of compromises that MMS has already made at industry's request. In fact, some changes were made and undone because industry changed its mind. Right now, I'd like to focus on two of those changes to demonstrate the length to which MMS has been willing to go to accommodate the concerns of industry.

First, let's look at NYMEX or commodity pricing, which has all but disappeared from the MMS proposal. Industry's attack on NYMEX was vehement, emotional, even petty -- "New York City prices." This rhetoric was hard for some of us to understand since this allegedly "irrelevant" price was being touted as received to oil company shareholders in annual report after annual report; it is a price that is the result of industry's own buying and selling. In fact, industry's attacks were so faulty that NYMEX officials (which had no dog in the fight) had to submit comments and testimony to correct the record. More recently, an industry relief measure attached to the Senate's supplemental appropriations bill, and presumably reflecting industry's wishes, oddly references NYMEX as a value benchmark for relief. Apparently, NYMEX is good enough for royalty relief, but not good enough for MMS to use for royalty value. Nonetheless, at industry's request, NYMEX is for practical purposes gone from the proposed oil rules.

My second example involves overall balancing arrangements. Initially MMS proposed to exclude from arm's length contracts any sales that were tied or subject to other product trades. It proposed a 2 year rule or litmus test for the existence of these transactions, which California actually thought was too generous. Industry's initial response was to deny the very existence of these overall balancing arrangements. After all, the existence of such arrangements challenges the very notion that oil is bought, sold and traded in separate, individualized field transactions -- like milk at the mini mart.

That denial was echoed in a New Mexico court, where a major oil company executive testified, under oath and on behalf of the industry, that overall balancing arrangements didn't exist. Last October, however, in a Texas court, both correspondence reflecting those arrangements and a manual on how they operate were publicly revealed. This manual, by the way, was from the same company whose executive testified in the New Mexico court. Testimony of Interior employees, offered during the Texas hearing, indicated that the companies had never disclosed the existence of those arrangements during audits or valuation disputes. Those arrangements affect hundreds upon hundreds of crude oil sales, particularly by major companies. Yet, at the behest of industry, MMS modified its rules to put on government auditors the burden of proving, on a case by case basis, that a particular sales contract is subject to an overall balancing arrangement.

These two examples alone show that MMS listens to industry and that, indeed, it listens to industry even when the evidence demonstrates that it should not. In fact, to the extent that MMS's most current proposal, with the modifications noted in the most recent notice, are complicated, less certain and more costly and burdensome -- at least to federal and state governments -- it is because MMS made changes requested by industry. And, if the past is truly prologue, complexity, uncertainty and burden redound to the benefit of industry by making it more likely that royalty losses will not be detected.

So lets move to the "new" issues that industry wants MMS to consider. According to its own outline:

- industry wants a looser definition of affiliate, which would increase the number of contracts subject to an arm's length gross proceeds analysis, despite the fact that the current definition, in the 1988 rules, was proposed by industry, which definition, by the way, California opposed as too restrictive.

- industry wants to return to a comparable sales approach for non-arm's length contracts;

- industry wants another benchmark system under which spot sales are looked to last;

- o industry wants to increase use of FERC tariffs for purposes of calculating transportation allowances and differentials;

- o industry wants to limit the protection afforded to the public under the long recognized duty to market principle;

- o industry wants advance, appealable and binding valuation determinations based on unaudited information submitted by lessees;

- o industry wants MMS to recognize deductions for marketing expenses, which have never been allowed.

Very little time needs to be spent with the voluminous public record compiled during this rulemaking to show that none of these issues is new. If the horse isn't dead, it is begging to be put out of its misery. What might be new is industry's assertion, in its pre-workshop issues outline given to MMS, that these proposals must be viewed as a "package" -- an all or nothing approach that seems contrary to industry's expressed desire to negotiate. And, for reasons already detailed in 1986, 1987, 1997, and 1998, SCO opposes both the whole and each part. In fact, taken as a whole these proposals merely tinker around the edges of the 1988 rules in a manner that decreases the royalty obligations of major payors. Rather, according to the minutes of the previous workshops, industry wants to roll back the administrative application of the 1988 regulations to coincide with their expectations as to those regulations. Industry's request to adopt the policy positions it has taken in administrative litigation cannot be viewed as bringing new ideas to the table. Industry's proposals, in essence, transform a system designed to protect the public's royalty interests into a royalty relief package.

Rather than repeating California's prior comments, I would like to direct my comments on these issues to the independent sector; California's position with regard to the major's pricing practices is, I believe, relatively well known.

At the outset, I note that SCO has always supported a separate rule for independents based on arm's length gross proceeds, although we also support extending you the option of paying on a simpler basis, such as spot, if you so choose. Our reasons for supporting this approach are simple:

(1) California's independents are dying out or being gobbled up by major companies;

(2) Low crude oil prices impact California as a royalty beneficiary to the same extent that they impact independents; we are both victims.

(3) Our evidence shows that this is not solely a function of the recent downturn in prices; that downturn only exacerbates a pattern of underpricing "at the lease" that has existed for decades.

SCO sincerely believes that it has interests in common with the independent sector. So it would like to share with them its perspective on the MMS and industry proposals, which is guided by the benchmark of "who benefits."

o Who benefits from a return to the benchmark system?

According to the comments submitted by independents, most sell oil under arm's length contracts. This would not change under MMS's proposal. The non-arm's length benchmark system benefits major oil companies who sell to themselves. In SCO's view, forcing these companies to pay royalties on the basis of truer values will provide independents a data base to negotiate better higher prices for their own production. Independents have already been successful in doing this in litigated cases. Allowing majors to pay royalties on deflated field prices (e.g., a comparable field sales approach) allows them to continue their undervaluation practices.

o Who benefits from expanded use of FERC tariffs?

Under MMS's proposal, independents would be allowed to deduct their actual arm's length costs of transportation, which may be the maximum FERC tariff rate. Not one independent has argued that it should be entitled to deduct more than its actual costs of transportation. Again, those that benefit from this proposal are the major integrated companies, who own and operate pipelines. The idea that these integrated companies are "similarly situated" to independent producers has no basis in logic or law. The reason this benefits the majors is because the real debate over use of FERC tariffs is in regard to non-arm's length transportation arrangements. California's evidence shows that maximum FERC rates are inflated, that they are used as a means of maintaining underpricing at the wellhead and reaping further profits on the oil the majors buy, and that the tariffs are adjusted, negotiated down, or ignored by majors in intra-company transfers or in trades among themselves. Will allowing these companies to continue to deduct FERC tariffs benefit independents? In SCO's view, the only answer to that question is no; it solidifies the majors ability to force independents to pay the maximum rate for transportation. It locks in the majors competitive advantage and makes independents captive to the integrated companies. Many independents have recognized this themselves in their comments and public statements. Again, in SCO's view, the MMS proposals empower independents to negotiate fairer transportation arrangements.

o Who benefits by limiting the duty to market?

The entire duty to market debate -- the new euphemism for which is "second guessing" -- is being driven by a misconception of what the duty is. Scare tactics are being used by someone to cause independents to fear that the duty to market will push them to index pricing. This is incorrect both as a matter of law and as a matter of MMS's historical practice. The duty to market has never been interpreted to permit a lessor to second guess a lessee's price simply because another producer got a higher price in a comparable sale in the same field. The assumption -- and one affirmed by MMS in its rulemaking -- is that in arm's length contracts a lessee has made its best efforts to obtain the highest price it can for the benefit of both the lessee and the lessor. What the duty to market protects against is imprudent, negligent or bad faith actions of a lessee, and the burden is on the government to prove a breach of duty. This is not an easy burden nor can it be met by pointing to higher field prices obtained by others.

Let's look at MMS's practice under the duty to market. Has SCO, as MMS's delegate, or MMS itself, once gone to an independent, selling under an arm's length contract, and, under a duty to market rationale, demanded a higher royalty payment because the independent's neighbor received a premium over posting or because posted prices are a sham. The answer is absolutely not. And the reason is simple: independents don't post the prices; independents are captive shippers and independents are equally victims of undervalued field pricing. Again, independents are not similarly situated in fact or in law. The very recognition by MMS of arm's length contract prices in its proposed regulation assures that the government can't go beyond that price in the absence of proof of imprudence or negligence. In fact, other than cases dealing with unlawful deduction of marketing expenses, there are only a few cases, all of which deal with regulated prices, where MMS has asserted a breach of a duty to market and MMS's success in these cases has been mixed because the burden is great.

So who benefits from a stricter duty to market? Well, we only have to look to who California, Texas, Alaska, Louisiana, New Mexico and the Federal government have pursued on the posted price and similar issues to find out who. While difficult, the duty to market does not impose on the government the burden of proving fraud and if news reports, publicly revealed evidence, and settlement endeavors provide any signal, it is that the majors are having difficultly defending against even a fraud standard. Because the arm's length gross proceeds standard would also be available to major oil companies under MMS's rule, the evidence suggests that the beneficiaries of deleting or limiting the duty to market will be these integrated companies.

o Who benefits by advance, binding valuation decisions?

Probably no one. First, a binding decision is only as good as the information that supports it. If that information proves to be inaccurate, incomplete, or false, the government can ignore the decision on those grounds, under statutes, rules and even the False Claims Act. In fact, the government would be entitled to penalties under FOGRMA. Second, industry's proposal for appealable valuation decisions will simply delay the audit process, which in turn simply increases industry's interest liability. Third, in today's climate, the only entities that have the resources to tie up audits and the appeals process with a two bites at the apple appeals system, i.e., appeal of a valuation decision, appeal of an audit finding, are major companies. In fact, it is remarkable that the same industry that pushed for the RFSA reforms of an expedited, streamlined, and less bureaucratic appeals process would now propose what is, in essence, a second valuation bureaucracy and a greater appeals burden for both industry and the government.

o Who benefits by recognition of marketing allowances?

Again, to state the obvious, major oil companies who by and large are the royalty payors that would be required to pay under MMS's non-arm's length valuation proposals. Certain independents, those with marketing affiliates, may also receive some benefit, but certainly not enough to save them from current market forces. Given that MMS has never permitted these deductions whether marketing is performed by the lessee or assumed by a purchaser, this industry proposal is the clearest example of a flat request for royalty relief in this rulemaking. If royalty rate reductions for stripper and heavy oil, and tax benefits that translate into $0 federal income tax liability for at least 75% of the independent sector have not saved the independent sector, a few pennies more in terms of marketing allowances will simply not do the trick. Moreover the audit burden associated with even minimal monitoring of these new allowances will likely eclipse any benefit to the independent sector. For these reasons and those stated in other comments, SCO continues to oppose any recognition of a marketing allowance.

The independent sector is not the only entity in California facing a crisis. California's public education system is also in crisis. Every spare dollar in California is being dedicated to shoring up its public education system. Under these circumstances, the State simply cannot afford to accept a reduction in its existing revenue stream. But that is exactly what it faces because of the moratorium and other appropriations riders. And it is what it would face under industry's oil valuation proposals.

As noted, California has made its recommendations and supported proposals that assure that the independent sector's preferred valuation method will be maintained. The State cannot afford to lose more of its education dollars to provide relief that: (1) will simply not save its independents from the effects of the current price downturn, and (2) will, in its opinion, only benefit the major oil companies. SCO's recommendations support its twin goals: do not harm to the independents; save our education dollars.

For the reasons I've stated and those in our previous comments, SCO offers three "new" recommendations to MMS:

(1) reconsider its proposal to allow major oil companies to pay on any gross proceeds methodology, except as a minimum acceptable value, and after making this modification, go forward with the rule;

(2) to the extent that the independents have identified concrete and specific problems with the MMS proposal that do not involve modifying current lease and legal principles, SCO recommends that MMS go forward solely to apply a new and modified rule to major integrated companies; and finally

(3) to go forward with a final rule for California only, modified in a manner that takes into account SCO's prior recommendations.

Non-Exhaustive List of MMS Compromises With Industry[1]

o Compromised with industry by repeatedly re-opening the public comment process and inviting comments on industry proposals.

o Compromised with industry by expanding the use of the gross proceeds methodology.

o Compromised with industry by amending the rule to permit sales subject to crude oil calls to be considered Arm's Length.

o Compromised with industry by deleting the two year rule, which was designed to protect against royalty losses attributable to overall balancing arrangements.

o Compromised with industry by expanding the use of tracing particular production through exchanges and other non-arm's length transactions.

o Compromised with industry by agreeing to accept transportation cost data as relevant to the calculation of location differentials.

o Compromised with industry by excluding NYMEX prices as an index price.

o Compromised with industry by expanding the federal royalty in kind program.

o Compromised with industry by accepting limited use of tendering for valuation.

o Compromised with industry by opening the door to offshore gathering deductions.

o Compromised with industry by reducing the reporting of needed information about location and quality differentials.

o Compromised with the majors by providing them an opportunity to propose valuation methods other than spot prices.

o Compromised with industry by allowing advance, binding valuation determinations.

o Compromised with industry by affirming that the duty to market would not permit the federal government to "second guess" a lessee's arm's length contract absent proof of imprudence, negligence or bad faith.

---

[1] NOTE: Industry's position on many of these issues has fluctuated during this rulemaking in at least two ways. First, industry has attacked MMS for amending its proposals to reflect industry's own proposals. Second, having compromised its position to accommodate industry, industry is now asking for more accommodation.

from: SCO Comments on 7/16/98 Proposal

(ii) Breach of your duty to market the oil for the mutual benefit of yourself and the lessor. MMS will not use this provision to simply substitute its judgment on the true market value of the oil for the proceeds received by the lessee or its affiliate under an arm's length sales contract. Examples of when the duty to market will apply include: when a lessee or its affiliate acts unreasonably, negligently, or in bad faith in the sale of oil from the lease; when the lessee or affiliate takes acts that subordinate the royalty interests of the lessor to the broader business interests of the lessee and/or its affiliates; or when the arm's length contract price is substantially below market value and no legitimate explanation for the result is shown by the lessee or affiliate.

4. Gathering in Deep Water

MMS has asked for comments on industry's assertion that it should be permitted a transportation allowance for movement of oil from a subsea completion point to a central accumulation or treatment point. This issue does not directly affect California's current federal royalty revenue interests. However, any modification of the gathering definition that would confuse the gathering/transportation distinction does affect California. SCO has serious concerns that carving exceptions to the gathering rule will become a slippery slope for further industry arguments in favor of broader transportation deductions. Thus, SCO opposes modifying the definition of gathering for deepwater projects or for any other reason.

In reviewing industry's request for an exception for deepwater gathering, SCO believes that MMS should consider the following:

(a) Under the Deepwater Royalty Relief Act, industry is already entitled to a royalty holiday on the production of 87.5 million barrels. It is SCO's understanding that the scope of this holiday was designed to permit deepwater lessees to recover their investment costs.

(b) Companies are currently arguing before FERC that the same segments of pipe are, in fact, gathering.

(c) Currently it is FERC's policy to presume that facilities that collect gas at 200 meters or greater depths are gathering facilities. SCO has serious doubts that any offshore oil movement upstream of an aggregation or treatment point could be factually characterized as not involving gathering.

(d) Given FERC's current policy and MMS's current definition of gathering (and contrary to suggestions made by industry in the July 9 Senate meeting), there are no legitimate investment backed

11TH STORY of Level 1 printed in FULL format.

Oil & Gas Journal

April 6, 1998

SECTION: LETTERS; Pg. 8

LENGTH: 619 words

HEADLINE: Politics and royalties?

BYLINE: Harrold E. (Gene) Wright, Tyler, Tex.

BODY:

With all due respect as a longtime reader and admirer, I think your (OGJ, Mar. 23, 1998, P. 27) editorial on politics and the federal oil royalty under-payment case fails to address the real issue.

You ask, "Does Rep. Maloney (KNY) support leasing off New York?" That is not the real issue. (But if you really want to know the answer, ask her, not us; and if you don't really want to know, why ask?).

The real issue is: Has the industry lived up to the terms of its contracts with the U.S. government, the Indians, the American taxpayers, the producing states, and the other public beneficiaries of federal royalty revenues? The government leasing arrangements have specific requirements not contained in the so-called "Producers 88" lease forms widely used for private leasing by our industry.

OCS leases, the statutes, and the regulations require that federal oil royalties be calculated at "no less than fair market value." Everyone in the industry knows, if they have watched the oil spot markets, the "P-Plus" (posting-plus) markets, and the Nymex markets, that for more than a decade, posted prices for oil royalties have been lower than market values.

The federal leases and regulations also require royalties to be calculated on the basis of "gross proceeds," not "net proceeds after deduction of transportation charges."

Furthermore, as everyone in the industry knows, no costs of "production" can ever be charged against the royalty owner. In light of this, please allow me to ask your readership two relevant questions:

* How many company CEOs and other executives have been actually warned by their lawyers that the controlling federal statutes expressly and specifically define "production" to include "transfer of (oil or gas) to shore" and any "transfer of oil or gas off the lease site?" All federal leases are expressly made subject to the federal statutes.

* How many executives have been warned that these statutes have control over contrary DOI-MMS regulations allowing transportation deductions from oil royalty payments on OCS leases? My guess is that far too few executives have been so properly warned.

My personal belief is that our industry has been badly served by its lawyers and bookkeepers whose efforts seemingly may not have kept the industry properly advised of all its obligations and huge potential liabilities to the U.S. government.

You wonder why the government refuses to lease the ANWR in Alaska, the Lewis & Clark National Forest and the OCS outside the Gulf of Mexico. But why should the industry expect any government to issue new leases anywhere if the industry has not lived up to the terms of its existing leases?

Perhaps even more important, how can our industry expect any help at tax-writing time, or any support from the U.S. government against any foreign governments that renege on, or does not live up to the terms of, oil and gas concessions to U.S. companies, if the companies themselves have not lived up to the terms of their own lease agreements with their own government?

I am among many industry leaders who think that the industry's lawyers and bookkeepers have much to answer for, much more so than the executives who rightfully have concentrated all their efforts and attentions on finding more oil at lower costs and properly operating sizeable corporations.

Having been a member of the industry for more than 50 years, and being one of the individual plaintiffs in the case discussed in your editorial, I hope you will see fit to share my viewpoint with your readers. It simply is a matter of living up to formal agreements made to lease government lands. That certainly should not be involved in politics at any level.

LANGUAGE: ENGLISH

LOAD-DATE: April 17, 1998