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RULES PROCESSING TEAM

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January 9, 2001

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US Department of the Interior
Mail Stop 4024
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Attention: Rules Processing Team

RE: Minerals Management Service Proposed Rule, Relief or Reduction in Royalty Rates -- Deep Water Royalty Relief for OCS Oil and Gas Leases Issued After 2000. Federal Register Vol. 65, No. 222, Pages 69259-69275, November 16, 2000.

Dear Walt:

The National Ocean Industries Association, American Petroleum Institute, Domestic Petroleum Council, Independent Petroleum Association of America, the US Oil & Gas Association, and the International Association of Geophysical Contractors appreciate the opportunity to provide comments on the above referenced Minerals Management Service proposed regulation.

Since passage of the Deep Water Royalty Relief Act in 1995, our associations and member companies have participated in a cooperative effort with MMS focused on future royalty relief policies resulting from the Deepwater Royalty Relief Act. We believe this effort has been productive and anticipate continuation of this dialog will be necessary and mutually beneficial as MMS develops and implements royalty relief policies.

This latest rulemaking addressing the discretionary royalty relief program is especially of interest to industry because it provides lessees an additional option when evaluating the feasibility of developing a marginal discovery in deepwater. By providing comments to MMS on proposed rulemakings similar to this one, your agency will be in a better position to implement a comprehensive royalty relief program that accomplishes its objectives and provides industry with a more efficient and effective program.

Our comments in this letter are a compilation of a general industry analysis of the proposed rule. We anticipate individual companies will provide additional and detailed comments directly to the agency and that this trade association response should not prejudice differing views expressed by any member company.

The following comments have been divided into three parts. Part one discusses our very general concerns in the context of other simultaneous changes being made to the deep water royalty relief program. Part two addresses the various questions asked by MMS in the background narrative included in the proposed rulemaking along with some general comments addressing some of the issues stated in the MMS summary of the rulemaking. The third part of our comments addresses the specific proposed regulations themselves as published.

Part I. General Concerns

The changes in the discretionary program addressed here should not be addressed independently of other changes in the deep water royalty relief program which are occurring simultaneously. In particular, the sharp reduction in the level of automatic suspension volumes at all depths, and the complete elimination of such automatic volumes in the 200-800 meter depths, represents a major shift in policy approach. Accomplishing this shift without a major adverse effect on supply, as we have argued in comments on prior elements of the program, shifts an increasing administrative burden to the discretionary program. Insofar as discretionary elements of the previous deep water royalty relief program have been cumbersome, shifting a growing burden to the discretionary program gives industry cause for concern. Until a satisfactory track record for receipt and timely processing of applications for discretionary relief has been established, industry will by necessity heavily discount the prospect of such relief at the time of its investment decisions. Until this track record can be established, there is a likelihood of a significant loss of supply incentives to post 2000 leases at all depths.

Thus far, there has been no indication in either the proposed rules or the subsequent workshops held by MMS that the agency appreciates this increased burden or has taken steps to address it. Without such a commitment, the overall effect of the shift will be to increase the royalty burden on deep water oil and gas production. At a time when we are growing increasingly dependent on imported oil, and when dramatic gas demand growth is outstripping our capacity to supply from traditional sources, the role of the deep water is becoming increasingly important. It seems a particularly inopportune time to reduce the royalty incentives associated with that production.

Part II. Specific MMS Questions

The modifications MMS has proposed in its rulemaking show that some comments previously made by industry have been considered. MMS' proposal to apply discretionary relief to specific projects on a lease basis in lieu of a field basis is an progressive improvement over the current regulations. Lease based relief tied to specific projects will alleviate some of the issues that have arisen as a result of the field based relief position the MMS has taken in the past and ensures that an individual eligible lease does not lose entitlement due to activity on adjacent leases.

We also are pleased MMS decided to propose the adoption of a minimum royalty suspension amount for applications it approves on post November 2000 deepwater leases.

Knowing in advance the minimum discretionary relief the MMS may approve will help applicants to plan development of their projects as MMS completes its evaluation of an application.

However, there are a few areas of the proposed regulations with which we are concerned. One such example is the treatment of sunk costs in relief applications on development and expansion projects. MMS has proposed allowing only documented costs of the discovery well, both for development projects on post-2000 deepwater leases and for expansion projects on pre-Act or on post-2000 deepwater leases, and disregarding prior and post discovery well costs in the sunk cost calculation. It is troubling MMS is of the opinion "only future costs, not historic costs, influence decisions on whether to proceed on a specific project." Especially puzzling is the MMS opinion "activities and costs other than the discovery well, such as acquiring seismic data, completing engineering studies, or drilling additional wells, are conducted at the applicant's discretion before filing an application for royalty relief." Making a deepwater development investment decision is not something industry or any individual company takes lightly. Information and data collected before and after the discovery well is drilled is critical to a lessees ability to make an informed and prudent decision whether or not to develop a project. Dismissing these costs as discretionary is troublesome, especially when considering that any application submitted for discretionary royalty relief must to be based on the fact a project has to be viable and potentially profitable to even be considered a candidate for discretionary royalty relief.

In addition, MMS dictates the accuracy of an applicant's cost estimate for a project. The provision that relief will be reduced or withdrawn if less than 80% of proposed pre-production costs are not spent prior to first production will require applicants to gather additional geological and reservoir information to increase confidence in their cost estimates. Therefore, the 80% accuracy threshold essentially requires adequate appraisal expenditures be made to confirm the proposed development system and ensure cost estimate accuracy. In previous communications, MMS replied to an industry request to reduce the 80% accuracy threshold to 70% by saying, "Because the grant of royalty relief is irrevocable, MMS believes it should be based on well-defined data." This statement and the 80% threshold provision runs contrary to the argument delineation activities are discretionary.

Therefore, post-discovery sunk costs, and the rules of how they are to be treated have an important influence on the investment decision to continue with a potentially marginal field. MMS is requested to reconsider its position of only allowing the discovery well costs in the sunk cost calculation for development and expansion projects. We are encouraged MMS has decided to at least include a component of royalty relief in the qualification determination for establishing how much relief will be granted an applicant for a specific project. This, however, still does not adequately address the use of post-discovery sunk costs in the evaluation process.

It is recommended MMS consider allowing for the inclusion of the discovery well cost as well as all delineation and appraisal costs (*e.g.*, additional wells, acquiring seismic data,

and engineering studies) incurred post-discovery on a pre-tax adjusted for inflation basis in the royalty relief application process. These are "future" costs at the time the decision is made to continue evaluating a project. Including these inflation adjusted pre-tax costs will better reflect the process each lessee follows internally when making a decision to develop or not.

We further recommend MMS make the decision process for discretionary royalty relief as transparent as possible. The less uncertainty surrounding the discretionary royalty relief process, the greater the possibility the process will have a positive impact on the decision to continue evaluating a project.

MMS has requested respondents to the proposed rulemaking answer the following questions on sunk costs:

(a) How does a credit for sunk costs change your incentive to explore a risky prospect and to apply for royalty relief?

Answer: The treatment of pre-discovery sunk costs in a potential royalty relief application on an undrilled prospect has little or no effect on a lessee's decision to drill a risky prospect. Lessees will not pursue the drilling of an initial exploratory well on a deepwater prospect based on pre-drill economics dependent upon discretionary royalty relief to be profitable. Taking into account the automatic suspension volumes in a pre-drill economic analysis is one matter, but counting on a discretionary suspension volume in the analysis is another. Drilling an initial exploratory well on a marginally economic deepwater project is ill advised and normally does not happen.

(b) What other treatments of sunk costs promote exploration without resulting in excessive volume suspension for many projects?

Answer: As stated earlier, additional costs and expenses are incurred by a lessee when attempting to make an investment decision once sufficient and adequate data and information has been obtained which gives the lessee reasonable confidence in prudently deciding to move forward with developing a new prospect. Knowing delineation and appraisal costs will be allowed to be included in a royalty relief application, potentially would encourage lessees to drill delineation or appraisal wells to help evaluate the extent of a discovery made with the initial exploratory well, especially when the results from the initial well are ambiguous.

A company is most likely to request discretionary relief on a project if after the discovery well it appears the project might be marginal. In this case, the company requires additional data to confirm a commercially viable development exists. The potential for discretionary relief is therefore a type of "last resort" factored into the project economics to

justify incremental exploration expenditures. In this scenario, post-discovery (delineation) costs are prudent because otherwise a company abandons a potentially developable prospect.

The additional information gained from the activity would allow companies to make better decisions regarding development of a project. Not counting post-discovery exploration expenses would encourage companies to proceed with too little information, compelling them to apply for royalty relief before the discovery is properly delineated. Therefore, the improved project delineation information also reduces the likelihood MMS would grant "excessive" royalty relief or a development would be abandoned prematurely.

Due to the cost of drilling wells in deep water, lessees as a general rule want to drill as few of wells as necessary before making a decision to move forward with development. Very rarely will a lessee decide to drill a delineation or appraisal well knowing, that, if the project is approved for royalty relief, recoupment of their incremental investment for the additional well(s) will be tied to additional royalty suspension volumes granted on an approved project. Investing unnecessary funds today, without some expectation of the likelihood credit will be given on approved applications, is not economically rational considering the time value of money and the uncertainty MMS will grant any relief to allow lessees to recoup these additional sunk costs.

MMS proposes continuing its current policy to evaluate and approve or disapprove an application within 180 days of being deemed complete. We continue to believe six months to approve or disapprove an application is excessive. Under the current royalty relief application process, applicants are required to submit comprehensive data and information concerning the project they propose to develop. Verifying this data and information, evaluating the merits of the project and securing MMS' final decision, is believed could be accomplished in 90 to 120 days.

In the notice MMS requested respondents to "suggest forms of royalty reduction that we are not now using that might encourage increased production in the special circumstances proposed in Section 203.80" of the proposed regulations. Individual companies responding to this rulemaking will respond specifically to this request.

As part of MMS' continuing effort to reduce paperwork and industry burdens in complying with various regulations, MMS requested respondents comment on the following questions:

(a) Is the proposed collection of information necessary for MMS to properly perform its functions, and will it be useful?

Answer: Under the current process MMS has established to solicit and evaluate royalty relief applications, the majority of the information requested by MMS is necessary to allow for a comprehensive review of a proposed project.

(b) Are the estimates of the burden of the hours of the proposed collection reasonable?

Answer: It is suggested MMS contact those companies who have submitted an application to MMS requesting royalty relief. These few companies will be the best source of information on estimating the time it takes to collect the required data and information for an application.

(c) Do you have any suggestions that would enhance the quality, clarity or usefulness of the information to be collected?

Answer: Standardization of the various reports required for an application would be helpful, but probably is not practical. With the anticipated number of applications, standardizing the reports would not be cost effective. However, because MMS has received and reviewed several applications, it should be possible to generate a set of generic example reports as guides for future applicants. Example reports would clarify many unit, tax status, inflation and discounting questions arising from the regulation or application guidelines. The time saved by not having to answer the same procedural questions from several applicants would justify the time spent developing the example reports.

(d) Is there a way to minimize the information collection burden on those who are to respond, including the use of appropriate automated electronic, mechanical, or other forms of information technology?

Answer: Utilizing computer diskettes or compact disks to store and transmit reports, data and information to MMS would be helpful as would information and data submitted via e-mail and secure internet sites. Subject to appropriate security and confidentiality measures, when at all possible, required reports, along with the necessary data and information to support an application, should be submitted to MMS electronically. At this time transmitting all the reports and data via the internet may not be practical. The MMS mail server limits the size of a data file that can be received. In some cases, files transmitted to MMS on other matters must be separated into multiple files and transmitted under separate messages. Submitting an original royalty relief application with supporting data and information should be hand carried to MMS. Subsequent information and data MMS may request regarding the application could be submitted via e-mail as long as the data file was not too big.

Part III. Suggested Modifications to the Rules

The following comments and recommended modifications are listed in order as they are found under Title 30 CFR 203.

1. On page 69268 of the Federal Register Notice under the "*Development project*" definition found in section 203.0, subsection (2) (ii) which reads "Are located in the Gulf of Mexico west of 87 degrees, 30 minutes West longitude;" should be replaced with "Is in a location or planning area specified in the Notice of Sale offering that lease". This modification is consistent with the "*Royalty suspension*" definition and does not unduly limit the MMS' ability to offer deepwater royalty relief.

2. On page 69268 of the Federal Register Notice under the "*Expansion project*" definition found in section 203.0, the word "significant" in the seventh line of the definition should be deleted. The word is simply too subjective when left to the discretion of the application review and approval process.

3. On page 69268 of the Federal Register Notice under the "*Fabrication*" definition found in section 203.0, eliminate the phrase "a letter from a fabricator certifying that continuous construction has begun," and replace with "a letter from you stating construction has begun." Pursuant to the Fabrication definition, MMS is already requiring applicants to provide copies of binding contracts between the applicant and the fabrication yard along with a copy of the receipt showing the customary down payment. It is an unnecessary burden to require the applicant to request the fabricator prepare and either send to MMS, or give to the applicant to send to MMS, a letter certifying construction has begun. If an applicant has received discretionary royalty relief, he is the one that is at risk of losing that relief if he fails to abide by the regulations applicable to the relief granted. Giving a third party (the fabricator) the ability to place an applicant's discretionary relief at risk for failure to comply with an MMS requirement for certification notice is unreasonable.

4. On page 69268 and 69269 of the Federal Register Notice under the "*New production*" definition found in section 203.0, the word "significant" in the last line of the definition should be deleted. As stated above, the word is simply too subjective when left to the discretion of the application review and approval process.

5. On page 69269 of the Federal Register Notice under the "*Sunk costs*" definition found in section 203.0, delete the definition in its entirety and replace with the following:

"*Sunk costs* on an authorized lease, expansion project or development project means the inflation adjusted before-tax costs (as specified in section 203.89(a)) of exploration, development, and production costs incurred by a company after the date of first discovery on the lease and before the date MMS receives a complete application for royalty relief. Sunk costs shall include the costs of the discovery well qualified as producible under 30 CFR part 250, subpart A, and such costs associated with any delineation or appraisal wells drilled to evaluate the extent of the resources found in the discovery well, but do

not include any lease acquisition and holding costs such as cash bonus and rental payments."

6. On page 69269 of the Federal Register Notice under Section 203.3, in the table in subsections (a), (b) and (e), the word "significantly" should be deleted from all columns in the table. As stated above, the word is simply too subjective when left to the discretion of the application review and approval process.

7. On page 69270 of the Federal Register Notice under Section 203.4 (b), the table entitled "(b) Confirmation elements required to retain royalty relief in Sections 203.70, 203.81 and 203.90 through 203.91", the first item in the table which reads "(1) Fabricator's confirmation report" should be replaced with "(1) Applicants confirmation report". As stated above, it is believed the applicant should have the responsibility to ensure fabrication begins timely and report commencement of fabrication to MMS. Adding a third party letter to the post approval relief process is unnecessary and burdensome.

8. On page 69270 of the Federal Register Notice under the table dealing with "Provisions for discontinuing relief in Sections 203.54 and 203.78" under Section 203.4 (f), item (3) should be modified by adding after the word "in" the phrase "the Notice of Sale and". This change is consistent with what is believed to be the intent of MMS.

9. On page 69271 of the Federal Register Notice under Section 203.60 (a), replace the phrase "lying wholly west of 87 degrees, 30 minutes West longitude," with "which lease is in a location or planning area specified in the Notice of Sale offering that lease." This modification is consistent with the "*Royalty suspension*" definition and does not unduly limit the MMS' ability to offer deepwater royalty relief.

10. On page 69271 of the Federal Register Notice under Section 203.62 (c), add the following phrase after the words "required reports" at the end of the section, "and you are encouraged to contact this office prior to preparing your application for this guidance."

11. On page 69271 of the Federal Register Notice under Section 203.63 (b), after the word "only" add "development project or expansion". This is suggested for clarification.

12. On page 69271 of the Federal Register Notice under Section 203.65 (b), replace "180" with "120" for first applications and replace "120" with "90" for redeterminations. As stated above we continue to believe six months to approve or disapprove an application is excessive considering MMS is provided with most, if not all, of the information and data it needs to evaluate an application. Verifying the applicant's data and information, evaluating the merits of the project, and securing MMS' final decision should be able to be completed in significantly less than 6 months.

13. On page 69272 of the Federal Register Notice under Section 203.68 (b), under (4) in the Table, replace "(4) Include sunk costs for the discovery well only.", with "(4) Include sunk costs for the discovery well and any subsequent delineation or appraisal

wells." This modification tracks the suggested changes to the "*Sunk costs*" definition as stated above.

14. On page 69272 of the Federal Register Notice under Section 203.69 the term "most likely resource size" is used in subsections (b) (1) and (b) (2). It is believed MMS is suggesting this term means, "the most likely known recoverable reserves from all reservoirs under a single project." It is suggested MMS consider defining this term to help eliminate any confusion that may arise.

15. On page 69272 of the Federal Register Notice under Section 203.70, the first item in the table that reads "(a) Fabricator's confirmation report" should be replaced with "(a) Applicant's confirmation report". As stated above, it is believed the applicant should have the responsibility to ensure fabrication begins timely and report commencement of fabrication to MMS. Adding a third party letter to the post approval relief process is unnecessary and burdensome.

16. On page 69273 of the Federal Register Notice under Section 203.74 (b), it appears there is a phrase missing from this subsection after the word "application." If something is missing, it is requested MMS correct this subsection.

17. On page 69274 of the Federal Register Notice under Section 203.80(a), in the third line of this subsection, delete the word "significant." As stated above, the word is simply too subjective when left to the discretion of the application review and approval process.

18. On page 69274 of the Federal Register Notice under Section 203.81, the eighth item in the table that reads "(a) Fabricator's confirmation report" should be replaced with "(a) Applicant's confirmation report". The same rational as stated above also applies to this requested modification.

19. On page 69275 of the Federal Register Notice under Section 203.89 (a), the second sentence of this subsection should be modified as follows: "On an expansion project or a development project, sunk costs are just the eligible costs of the discovery well *and any subsequent delineation or appraisal wells* for the project." This modification tracks the suggested changes to the "*Sunk costs*" definition as stated above.

It is important for MMS to continue the process involving industry discussion, examination, and consideration of future royalty relief policies. We appreciate being given the opportunity to provide comments on the subject rulemaking. We continue to encourage MMS to incorporate the fundamental principles of stability, and predictability into any future royalty relief policies or policy changes. Stability is critical, as companies would hesitate to trust the discretionary relief process if defined inputs to the application continuously change during the time period required for evaluating and submitting an application. Royalty relief policies also must be predictable, so companies considering making an application for supplemental deepwater royalty relief can complete their own analysis and predict with fair accuracy whether MMS would approve the application.

We thank you for your consideration of our views.

Sincerely,

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