DEPARTMENT OF THE INTERIOR

MINERALS MANAGEMENT SERVICE

PUBLIC MEETING

Public Meeting on Supplementary Proposed Rule -- Establishing Oil Value for Royalty Due on Federal Leases

Taken on the date of

Wednesday, February 25, 1998

Starting time: 10:10 o'clock, a.m.

UNITED STATES DEPARTMENT OF INTERIOR

1849 C Street, Northwest, Basement Floor

Washington, D.C. 20240

Before: Yuvondra Everett Fantroy, Registered

Professional Reporter

PANEL MEMBERS:

David Hubbard

Deborah Gibbs Tschudy

Dave Domagala

AUDIENCE MEMBERS:

Mike Samsock

James E. Ford

Lee Helfrich

Danielle Brian

Hank Bautch

Bill Whitsitt

Deborah Lanzone

John Monsch

Julie Topolesti

Ben Dillon

Jack Belcher

Kenneth Grant

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Jeff Fritzler

Michael Heny

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P-R-O-C-E-E-D-I-N-G-S

MS. TSCHUDY: Welcome to the second public meeting on MMS's second supplementary proposed rule for valuing crude oil produced from federal leases.

At the panel with me is Dave Domagala, a mineral economist with the Minerals Management Service. He was the primary author of the executive order 12866 analysis that was completed along with the rule.

To my right is Dave Hubbard, chief of our economic evaluation branch with MMS, and one of the primary authors of the rule.

Housekeeping items. Of course you can hear there is a cafeteria nearby for drinks. The restrooms. We have not been able to locate the men's room.

MR. HUBBARD: Yes, I did. Go out and turn left into the main hall.

MS. TSCHUDY: There are a number of handouts at the table you may want to help yourself with. We do ask that you sign in that you have attended today and also sign

up to speak. We'll go to those people who signed up first and then to anyone else following that.

When you do speak, if you could state your name

and the organization you represent before you give your public statement. That would be appreciated. As long as the court recorder can hear from you the audience, you up don't have to come to the mike. But if she has any trouble hearing you, she may ask that you go to the mike.

We will start with a very brief explanation of the second supplementary rule, answer any clarifying questions, and then open it up to statements by the public.

Transcripts of today's meeting are available by contacting the organization and phone number listed up on the flip chart.

So with that we'll just do a quick overview. I think most of you have seen this, but some of you may not have. We'll go through this rather quickly.

The proposed rule making is a result of dramatic changes that have occurred in the crude oil market in the last 20 years and also the MMS's objectives to decrease reliance on posted prices, develop rules that reflect

market value and to also reduce the administrative costs of royalty valuation and add certainty to the process as well.

We published a proposed rule well over a year

now. That proposed rule allowed that true arm's length sales would be based on gross proceeds. Non-arm's length sales, exchanges agreements, crude oil calls or reciprocal purchases, meaning if you had purchased oil from anybody in the last two years anywhere in the U.S. all of those situations would be value based on index. For California the proposal would have been ANS and for the rest of the country it would have been NYMEX. Both adjusted for location and quality.

We published a supplementary proposed rule last July which would do three things. It eliminated the two-year purchase provision that was contained in the January proposal. It required payers with crude oil calls to go to NYMEX only if that call was exercised and only if that call was non-competitive. And, number 3, it allowed payers with arm's length exchange agreements, a simple, single arm's length exchange agreement to pay on the gross proceeds occurring under an arm's length contract after the exchange agreement.

We reopened the comment period last September and requested comments on five alternatives arising out of the comments we received on the proposed rule and the

supplementary rule. Those five alternatives were first outright sales or so called tendering or bid-out programs.

The second was a new series of benchmarks that was proposed by a particular trade association. The third was an alternative suggested by a state commenter that MMS calculated prices by geographic regions based on information reported to us.

The fourth was to use fixed or flat differentials off of the index price. And the fifth was to go to spot prices rather than a NYMEX-based price. The comment period on that reopened comment period closed in November.

In addition to the two public hearings that we held last April we also held seven workshops across the country. One of those in here in late October. And we received written comments on those five alternatives from 28 different entities.

And based on those comments we published the second supplementary proposed rule-making on February 6

that does have a 45-day comment period, so it closes March 23. In addition to the public meeting held here today we held one in Houston last week. We'll be in Denver next

Monday, Bakersfield on March 11 and Casper on March 12.

The second supplementary proposed rule making is founded on five basic principals. One that royalty must be based on the value of production at the lease. 2. That for arm's length contracts royalty obligations should be based on gross proceeds.

3. That for other than arm's length contracts the MMS still believes that index prices are the best measure of value for most parts of the country.

The fourth basic principle is that the lessee does have a duty to market the production at no cost to the lessor. And the fifth is that customized regulations for unique producing areas are preferable to a one size fits all approach.

So the second supplementary proposed rule-making would allow gross proceeds under an arm's length contract unless four situations occur. And this is a situation where the oil is sold arm's length prior to being refined and is sold by either the lessee or the lessee's

affiliate. And those four exceptions are 1. The contract does not reflect the total consideration. That is the first exception to the current arm's length provisions in

the 1988 regulations.

The second is that the value is not reasonable due to misconduct. Again, that's the second exception that's contained in the current regulations. But the third is a new one, that's oil disposed of under an exchange agreement unless a lessee has one or more exchange agreements, in which case they can base value on the arm's length resale after those multiple exchanges.

And the fourth exception is oil disposed of under a non-competitive crude oil call.

For oil that is not sold arm's length before it's refined, value is determined differently for three different part of the company.

For the Rocky Mountain area, the second supplementary proposes four benchmarks. The first applicable is the one that the lessee or its affiliates would use. The first is an MMS approved tendering program. To meet MMS approval, the lessee most tender at least a third of its federal and non-federal production, and must

receive a minimum of three bids and value has to be based on the highest of those three bids.

The second is the weighted average of the

lessee or its affiliates arm's length sales and purchases in the field or area. And that's provided that those arm's length sales and purchases exceed 50 percent of the lessee's federal and non-federal production in the field or area.

And the third is a NYMEX adjusted for location and quality. And the fourth is if the lessee can demonstrate that the first three benchmarks do not yield a reasonable value, then MMS will establish an alternative method.

Again, for oil that's not sold arm's length before it's refined. In California and Alaska the proposal is to use ANS prices adjusted for location and quality and for the rest of the country the proposal is to use spot pricing for the market center that's nearest the lease with like quality oil. Again, adjusted for location and quality.

The location and quality adjustments are for spot prices on two segments from the market center to the

aggregation point it's the lessee's actual cost either under an arm's length transportation agreement or the differentials specified in an arm's length exchange

agreement. Or if the lessee does not have such a rate, it's an MMS published rate based on information that we collect from form 4415.

From aggregation points to leases again, it's the lessee's actual cost of transportation. And then a change we've made from January and July is to allow quality bank adjustments from the aggregation points to the lease.

And, finally, in what we think are very few situations where a lessee sells at a lease, arm's length but for some reason has to value base on spot price, MMS will determine the allowance for them from the lease to the aggregation point.

The form 4415 has been greatly simplified from earlier proposals. We are requesting information only on exchanges involving federal oil. Only on exchanges from aggregation points to market centers. There is much less data than on the earlier form, and one-third less MMS identified aggregation points.

A couple of the other changes in the second

supplementary proposed rule are the timing of the index prices. We have changed to coincide the production month to the delivery month. We've also eliminated the proposed

changes to 30 CFR 208. That's the provisions of the current regulations for valuing oil that we take in kind and make available to eligible refiners.

As the preamble indicates we are looking at setting the value for that oil in the actual contract rather than by regulation.

So just a few pieces of summary information about the rule and how it effects federal crude oil production. This is how federal crude oil production breaks out across the country.

Seventy-three percent of our oil comes from the Gulf. Another 15 percent from on-shore and off-shore California. Six from Wyoming, four percent from New Mexico and two percent for the remainder of the Rocky Mountain states other than Wyoming.

This chart is our estimate of what amount of production by area would be value-based on index versus value-based on gross proceeds. We did this estimate by

looking at which producers have refining capacity and assuming that those producers would actually consume their production and not sell at arm's length before it was refined, so they would be based on spot.

Those producers without refining capacity we assumed would stay on gross proceeds. And this is how it splits out by various parts of the country.

So with that we will open it up to the public to either any clarifying questions you would like to ask about the rule or to any public comments you'd like to present at this time.

(No response.)

MS. TSCHUDY: Hearing no questions or others, we will go to our first speaker who signed up. Ben Dillon, representing IPAA.

MR. DILLON: My name is Bill Dillon, I'm a vice president of public resources for the Independent Petroleum Association of America.

Debbie, before I start, could I ask you a question? Are your flip charts that you used today available as a handout or can we get copies?

MD. TSCHUDY: They are. I'll tell you, if you

intended the Rocky Mountain Mineral Law Foundation special institute, they're being mailed out as an addendum to the available materials.

MR. DILLON: Great. I think maybe the best

format today is I've got a, hopefully, a short statement to make and then I think that some of our folks have some questions to ask.

For those that don't know, IPAA is a national trade association representing over 5,000 of america's oil and gas producers. They drill about 85 percent of the nation's wells.

My message today from the independent community is very similar to the message we delivered to MMS last Wednesday in Houston at a similar public meeting. We just ask, for the record, that the comments made there by myself, David Blackman, Tom White, John Munch, David Simpson and other independent representatives be incorporated in today's record.

Unfortunately, independents still remain disappointed that about hundreds of hours of discussions and development of reasonable proposals for changing the regulations in a manner consistent with the lease may have

fell on deaf ears. For independents, we proposed a number of valuation methods which we believe capture arm's length value of the lease in a much more simplified and certain manner.

The goals in these proposals seem to be very consistent with MMS's own stated valuation principals which are royalty must be based on the value of production at the lease, and we agree. And we think we have methods that can do it in some regard, in some aspects much more efficiently. And, of course, for an arm's length contracts royalty obligations should be based on gross proceeds. And, again, we agree.

For those that don't know and are interested, we have a little handout which more summarizes our suggestions that have been submitted for the record. I have some here and I would, again, submit this for the record today, which would document the suggestions we have made.

We have concluded, independents, that the rule as just described is digressed to maybe a more arbitrary departmental desire to force everyone who has an eventual arm's length sale to use a netback method. A method that is most administratively burdensome and complex available

to the government today.

Yes, this was one of IPAA's suggested methods to capture arm's length volume or value at the lease. However, it was one that was probably given as an option to

those companies which have smaller volumes, that they would readily admit were traceable. We provided for other producers to have much larger volumes, other suggestions for capturing value added near the lease, methods we believe have been ignored by MMS for the independent producer.

Let's not forget how this process began. The MMS announced it was suspicious of posted prices. Independents came forward and supported MMS's position to decrease its reliance on posted prices.

We believe our payback has been a proposal that makes it harder for an independent to determine the appropriate royalty value with certainty. MMS has chosen to discriminate against those who establish separate lines of business for marketing its oil. Not only does MMS not provide independents with no options for valuing other than netbacking from sales which occur hundreds of miles away from the lease, MMS is refusing to acknowledge the costs

and risks associated with those activities, costs that were acknowledged by the states during MMS's roundtable discussion.

Additionally, MMS chose to add further

uncertainty to well head stellar by stating that if you breach your newly minted duty to market at no cost to the government, you cannot pay on gross proceeds but instead you must use the index scheme.

It appears, contrary to public statements, MMS still rejects the notion that there are legitimate arm's length sales in the marketplace. Last year MMS exemplified this by placing all producers, independents and majors on NYMEX.

This year, a year later or so, MMS has placed restrictions on all producers, with a number of exceptions, still leading you to an index scheme.

Why has MMS done this? It appears to independents that MMS has been pressured by lobbying interests with a financial stake in the litigation brought in Texas. These alleged third parties seem to believe that they can bolster their extreme scheme for royalty payments by encouraging MMS to promulgate similar regulations. If

they are successful, this may improve their chances by applying these theories retroactively in the lawsuit.

I challenge MMS and its third party interests to explain to us why our proposals, the proposals contained

in here, do not accurately and efficiently capture well head value at the lease.

What am I talking about? Proposals such as tendering. Now, as you saw on the flip chart that tendering is an option available possibly in Wyoming or in the Rockies as defined. But tendering is not available to independents who do not refine barrels.

We had suggested in some circumstances tendering may be a viable method to establish value. Why is that? In the fact it's recognized, certainly in MMS's eyes is something that does capture such value in the Rockies. Why can't an independent choose to use it as a method is one of our comments.

Now we do have comments about the thresholds that were set on the tendering in Wyoming. And you would have to, I believe, tender 33 and a third percent of your volume. We had agreed with MMS in this proposal that something needed to be offered in excess of your royalty

share to put your own equity volume into play, but we believe that this threshold further would probably, maybe not make it available even to the refined barrels.

But, again, keep in mind my most significant

point is that tendering is not available to any independent as far as we're concerned anywhere in the country.

Weighted volume average. Again, a method where if a producer actually has third-party transactions at the lease, which many of my members do, they sell, they buy, from third parties. We had suggested that that be done, that the producer be given an opportunity to use its weighted volume of those transaction.

Again, this appears in the MMS's proposal in the Rockies but, again, it's only available for refined barrels and it is not available for independents.

Of course we did suggest, as I stated earlier, that one could netback with costs. And we did see that MMS grabbed on to that one and, as I stated earlier, applied it everywhere as the only option.

And then we also stated that some independents may elect to use the index scheme. Depending on where they sit in their production there may be some that desire,

depending on their volume, if using the plats, the market center with some actual costs, that some independents may chose to do that.

Finally, MMS talks about the fact that you could

go talk to the director of MMS and seek an alternative value, one that I just not mentioned. That is not available to independents as far as our reading of the rule. Yet, if you refine your barrels you can go plead your case, but if you don't refine your barrels you cannot.

Again, we're not quite sure as to the logic as to why this occurred. Now keep in mind everything I just stated only applies to refined barrels in the Rockies, not in the New Mexico or California or the off short. So regardless of your producing scenario in the offshore you fall into one or two cases. You're either going to netback for nonrefined or you're gonna use the index market center with some adjustments if you have refined barrels.

Again, we don't understand that. If these methods work and are legitimate methods to capture value at the lease, why doesn't that theory also hold true for the offshore.

So as you can see things have become fairly

19 restricted to the point where we're not sure if, especially

20 for some independent that may be marketing, if we have

21 obtained certainty and simplicity. Now let's not forget

22 about mom and pop oil company. The question is are they

going to be truly allowed to pay on their gross proceeds. Netbacking as you can imagine, but it's not an issue for them. They're selling at the well. So that's what -- so there is no netback, if you will.

This part of my membership is concerned about some of the words that have been inserted into the definitions by MMS. That more uncertainty may have been placed on the table by inserting words such as market in the definition of gross proceeds. What does that mean? And then when you take that definition of market and apply it to the stated, your off duty to market on behalf of the government and that you may breach that, these members are wondering if the fact that they may be considered to be in breach if they have not marketed in MMS's eyes.

And if they have been placed in breach, then are they subject to the index scheme. So that whole area which there has been much debate about, and Paul Leggitt will add some comments to that when I'm completed here in a few

minutes, as to why we believe and agree with the states that first of all it shouldn't be used to second guess gross proceeds and, second, that costs need to be recognized in a downstream market.

Now, are there other exceptions if you're selling at the well, that MMS may come in and audit? Some of us, some of the members when they look at these exceptions say maybe this is the Audit Employment Act. Why you might ask? Well, let's look at the records.

Gross proceeds is acceptable, except one, it does not reflect total consideration. Now as a footnote I understand that some of these exceptions today exist in the '88 rules. But when we changed the terms and changed the ground rules they may now take on a new meaning. Before you went to comparable sales if some of these were applied. Remember today under this proposal you wouldn't go to comparable sales, you would go to index. It is quite a different impact.

2. If the contracts reflect reasonable value and you have not breached your duty to market, and I've talked about that already, or you have misconduct.

3. If your arm's length exchange agreement does

reflect reasonable location of quality differentials.

And 4. If you have a non-competitive crude call that's exercised. That's a lot of lingo. But you can see, all of those words, the only way you can enforce those

words is, how, through audit. And we believe that their audit is going to probably increase for them, the independent community, and they're going to have to understand the index method when the auditor chooses to put them on that when they believe they have violated one of these terms.

It also goes on to say in the rule that you must demonstrate that you have had an arm's length contract. You must certify that if you've had provisions that are, again, willing buying, willing seller, and that you base your value on the highest price a seller can receive through legally enforceable claims.

A lot of terminology, a lot of what equates to uncertainty, we believe, for our membership. Which means we are not sure how big gross proceeds is on those charts, one way or the other.

And a quick comment on the competitive calls, Debbie, you've heard that, we won't go through that again,

that we are concerned that given the restrictive definition that that may have more impact now on the independents and we still ask for MMS to give us an opportunity and a way to figure that out. For those that don't know, and for the

record, it's basically if it's a non-competitive as defined in the regulations, even though the producer may have went out and sought other prices, they would still have to go to NYMEX or index depending on where you're at. And that may apply to a lot of independents. And which then causes MMS to need to collect date to make theoretical adjustments because these folks are not going to have actual costs to the index point.

So there is a cause and effect here. And the effect is quite a large administrative burden. So we'll be making comments again in our -- a written comment on how maybe to accommodate the crude oil call.

To conclude, believe it or not, MMS claims that its recognizes an arm's length sale as an appropriate tool to value oil for royalty payment. However, we believe MMS is still trying to force industry to assume the costs associated with marketing the oil to be included in the royalty payment equation.

We believe this is in a direct conflict with the lease contract between the oil and gas producer and the federal government. By not recognizing these marketing costs, MMS mob is attempting to collect royalties on more

than the value of oil and gas at the lease. This provision gives MMS a what cost-free, risk-free ride on the backs of companies engaged in downstream marketing.

If MMS wants to enter into the downstream markets, it should take its royalty in kind. Not only would it simply the process, it would save the government money.

It costs MMS about $60 million a year to administer, approximately, its royalty program. IPAA still believes that RIK system is the best option for the federal government. With the royalty econ system, the oil industry gets some of its oil that it produces from federal lands as a royalty payment. This would replace the current system that requires an in cash system.

Some complain that there are no success stories in this area. This is not true. Model programs based on RIK systems exist. There are success stories in Texas and Alberta and they have demonstrated major cost savings for

those governments.

Quite frankly, we believe with MMS's consultant and the party to the lawsuit who said, quote, the only way to be absolutely certain that a fair market value is

received for royalty oil is to take the oil in kind for sale by the agency, close quote.

With that I'm going to, since there seems to be some confusion about our statement that we believe that this duty to market and lack of willingness to deduct these costs is in conflict with the law. And if I can I would like to turn the podium over to Poe Leggette from Jackson and Kelly, to shed some light on that.

MR. LEGGETTE: Thank you. I'm Poe Leggette. Debbie, since you've already had the distinct pleasure of listening to me in Houston, I will be considerably briefer than I was there.

I want to make two observations for your consideration on legal points about the duty to market.

In the current rule 102 B13, a 1988 rule, there is a provision that says the lessee's gross proceeds will be accepted for value unless those proceeds are less than the reasonable value of the oil due to the lessee's breach

of its duty to market for mutual benefit of the lessee and lessor.

So you may wonder why eight years later, ten years later IPAA and the domestic petroleum counsel are in

an uproar over your duty to market. The reason's this.

First of all, the language in the '88 regulations never said free of cost to the lessor. They said mutual benefit.

And, second, the consequence of being in breach of that duty was that you were placed in the lease market benchmarks valuation scheme, which is entirely appropriate from the point of view of both of those trade associations: IPAA and DPC. In fact, both have advocated refinements to the benchmarks and been has noted the handout that the royalty valuation procedures to be followed to simplify the task of coming up with a true lease value.

This has been changed in the proposal. First of all, the definition of gross proceeds now adds the act of marketing to the kinds of compensation one can get that are included in gross proceeds and proposed 206.106 clarifies that this duty to market for mutual benefit is to be expressly at no cost to the lessor.

Now IPAA and DPC both invested considerable time researching the point and reporting to you in their prior comments, indicating that they could find no basis for a duty to market. The IPAA said such duties are express or

they don't exist at all. Now, there has been no express duty to market oil in the regulations.

Indeed, going away with that, one can find a duty not to market oil in the regulations. This is significant for both the arm's length seller and the IPAA or DPC member who sells to an affiliate to play the midstream marketing game. Let's start with the well head sell.

First of all, the proposed language makes it entirely appropriate for an MMS auditor to come back in on audit and second guess an arm's length sale because the lessee did not get as high a price as the lessor thinks it should have gotten.

Now is this different from the current rule? Yes, it is different. Because what is being proposed is an opportunity to second guess a well head sale that is getting the same value as every other well-head sale in that particular field and yet the auditor can come on and

say, well, you know, if you carried it down stream you could have gotten more and we'll deduct your transportation, but, basically, we see some people selling here in the market center or an aggregation point and you

ought to have done the same. And if you think I'm making this up, and if you think this is contrary to MMS policy, I submit for the record the director's decision in the Amarack Energy Corporation case, if I may, Dave (tendering.)

In there MMS had a case where the lessee had sold at or near the lease at a posted price, but also had a supplemental contract with the purchaser under which the purchaser engaged in midstream marketing activities, which are described there in the second and third paragraphs. The company at the time called Wolverine objected saying it's an arm's length sale and we are paying you on gross proceeds not only from what we get for the initial transaction but the extra proceeds we get from the midstream market. The director said it's not enough, we're dispositive for Wolverine to show that one or more of the contracts are arm's length.

So because Wolverine entered into the

supplemental contract and even though Wolverine had paid based on those proceeds, the detective held that it should have paid on the profits retained by its buyer from these marketing activities. The theory being the duty to

market. So that is why independents who sell at the well head are scared to death about the duty to market language in the new rule. And it doesn't get any better at all to someone who sells to an affiliate participating in the midstream marketing game.

The regulation has addressed or the preamble has responded to the IPAA and DPC's comments simply by saying MMS is not altering it's longstanding policy, citing two IPAA cases: Walter Oil and Gas and Arco Oil and Gas, this on page 6120 of your preamble.

Those cases both involve natural gas. We are unaware of any case involving marketing oil where IPAA has said there's a duty to market. And these decisions, according to *** IBLA don't address uniquely downstream processing and risks. Quite at issue there were activities that a lessee was going to form whether it was selling at the lease or selling downstream.

Now, we have gone over in prior presentations in

great detail what some of these downstream risks are, but I wanted to call to your attention one thing that caught everyone's eye in the presentation in Houston on royalty in kind.

Assistant to director Von Macy noted that the active aggregating oil adds value. As a matter of fact, the phrase he used was it changes the product. Now, we realize he was speaking metaphorically and not chemically, but the metaphor underscores a very literal truth. The aggregation that goes on in the midstream market is not something you do with the lease and it does change the product. Ordinarily, dramatically improving the value you can get because you reduce transaction costs from the buyer. They're willing to pay more. That's not even mentioning the fact that it's in a different location closer to where the buyer wants to have it.

The duty to market contains a fundamental concern and we think the rules, the provisions here apply to oil and applied downstream are beyond the government's authority. Thanks.

MS. TSCHUDY: Thank you. Is there anyone else that cares to make a public statement?

MS. HELFRICH: I'm Lee Helfrich and accompanied by my partner Hank Bautch, I'm here today to discuss MMS's later proposal from the perspective of the State of California.

As MMS knows, California through entities such as state land commission, state comptroller's office and City of Long Beach has supported the services efforts to improve valuation regulation for oil.

California continues to support several aspects of the MMS's proposed rule. It supports MMS's acceptance of ANX spot prices as a true market based indicator of value. Supports MMS's recognition of a separate rule for valuing California crude oil is required.

It supports MMS's refusal to rely on other local spot market prices for valuation in California and its effort to rid from the valuation instances of gross price valuation. These also, which in California's view, are a step towards putting in place a system that insures that the federal government and California citizens receive what is truly owed in terms of royalties.

California also supports MMS's refusal to abandon its long-held policy on the duty to market which

includes, as a corollary, the non-accessibility of marketing to federal.

As a footnote I would note that California is a state and so the competence of, by a previous agreement,

that all states have agreed that certain marketing expenses can be deducted. Which is not correct, at least from the standpoint of the State of California. We also appreciate MMS's proposition that neither tendering nor royality in kind can serve as a realistic benchmark for fair valuation of crude oil produced in California. MMS's resolve on these issues, particularly, is truly commendable

Unfortunately, while California agrees with certain particulars of MMS's proposal, taken as a whole, it must oppose MMS's newly revised proposed rule.

California will submit written comments detailing its objections on a petition by petition basis. For purposes of today's hearing, California simply wants to highlight its broader conclusion regarding the currently proposed rules.

Every step forward that MMS has made or maintained through this long rule-making process is effectively neutralized by the huge steps backwards it now

proposes to take.

MMS's initial proposal for a clear and certain limit on the use of gross proceeds. A permitted use of gross proceeds to pay royalties only in true arm's length

sales situations, the demand of index based valuation in situations where the evidence demonstrated the reliance on a price stated in a contract was not reliable.

MMS's second proposal loosented the limits on gross proceeds but was aimed at permitting greater use of that methodology only by independents without avenues for obtaining fair market value.

While California had objections to several provisions in MMS's initial and second proposal, it was not unsympathetic to MMS's desire to find a balance between assuring the collection of true fair market value and providing some exquity for those independents that have been equally victimized by under valuation in the lease market.

Though California disagreed with certain technical details, it was willing to except the direction that MMS's was pursuing and, indeed, actively looked for and proposal alternatives to help move in that direction.

The current proposal is of a vastly different character, it takes a different direction by tipping the balance away from the protection of the public's royalty efforts if they were private.

MMS proposes to expand the use of gross proceeds in a manner that eclipses the need of small independent producers. It seems in this regard I am oddly in agreement with the IPAA.

In order to verify a value reported on the basis of gross proceeds, MMS will not look to clear certain rules, rather proposes to track the flow of federal oil through multiple transactions in order to find the downstream arm's length contract or contracts under which molecules the federal production or molecules of received production might have been sold.

When those contracts are found, MMS will then work back upstream to adjust bringing appropriate location and policy differentials and exchanges and any legitimate transportation costs occurred in other types of transfers. Even assuming such tracing be done reliably through the production from a single league in California's experience this is a doubtful proposition.

MMS's proposal is not an methodology that lends itself to determining value on the thousands of leases in the federal lease universe. MMS's regulatory incentives should be directed across from the receipt of true value at

the lease market, but rather it proposes to provide an incentive that, obviously, benefits the larger companies in this country, to hide value through paper transactions.

It has been California's experience that methods that cannot be regularly verified and enforced, methods that can not be applied broadly and systematically result in monetary loss.

Even where integrated companies may be forced to report royalties on the basis of index based value and this, under our reading of the proposal, is only where it is clear that they have transferred the production internally and directly to their refineries.

MMS proposes to open a back door to be used solely by those companies of the discredited comparable sales methodology. In fact, the MMS proposal is, unfortunately, worse than a true comparable sales approach.

Integrated companies have been advised by MMS to show the unreasonableness of index-based valueation by

presenting evidence of their purchases of other crude oil. In California, if not elsewhere, this allows companies to show unreasonableness by showing purchases at posted prices. In fact, the companies that are advantaged by this

back door are the same companies that currently post prices substantially below market value.

MMS has, in essence, provided integrated companies to wage a constant and repeated litigation battles over the very of this rulemaking that posted prices understate values in the lease market. These same integrated companies and, again, only them, will also be permitted under MMS's proposal to reduce ANS values by deducting transportation costs.

This is achieved because MMS mistakenly confuses transportation deductions with location differentials. There is nothing in the law and economics or even logic that supports the proposition advanced in the MMS proposal that the relative value of accrued at two distinct locations A. the index pricing point and B. the lease can be determined solely by reference to the actual cost of transportation -- of transporting lease production to point C over here, which MMS calls an alternative disposal

point.

The three examples I have referenced in those exhausts California problems with MMS's latest valuation proposal, but they do demonstrate California's conclusion

that MMS has effectively abandoned the uniform and certain proposals that will assure that the public receives real value, which we believe to be the ANS method.

Neither equity nor evidence or tipping the scales away from use of the ANS method in favor of an expanded gross proceed system that cannot be administered on a systematic basis, that will result in reach Pete ed litigation over the very purpose of the rule's change, that provides unjustifiable transportation deductions and that invites transactions with the sole purpose of avoiding royalties.

For California these flaws, among others, represent a huge step backwards, a step that simply overwhelms the step forward that MMS has decided to maintain. That concludes my remarks.

MS. TSCHUDY: Is there anyone else in the audience that would care to speak?

MS. BRIAN: I'm Danielle Brian, executive

director of a project on government oversight. We're a nonprofit, nonpartisan government watchdog group which for the past four years has been investigating, exposing and working with remedying the oil industry's underpayment of

royalties to the federal government.

As you know, last week the Department of Justice voted to intervene in the suit against four major oil companies and announced their investigation of 11 others for what they stated was, quote, knowingly undervaluing oil extracted from public and Indian lands. To reduce royalties they would have had to pay the United States and the Indian nation.

As a result of these practices, it has become necessary to make it harder for oil companies to conceal their underpayment of royalties.

I commend the Department of Interior's MMS's effort to make this wrongdoing by oil companies more easily detected.

While the regulations have always, always required the oil industry to pay royalties based on the market price of crude oil, we have learned that they have not been paying the government that price.

The proposed rule does not change the measure of value but simply reinforces the government's ability to catch culprits in the future.

This rule is a giant step for the taxpayer as it

will enhance accountability and transparentcy in the future payment of royalties. I recognize the thought and effort MMS has invested in this important matter. The oil industry has considerable sophistication and tremendous leverage. Designing a system to anticipate potential underpayment methods is a daunting task but necessary to protect the interests of the American public.

Having said that, I would like to make three recommendations regarding the proposed rule. I believe all of these issues are significant enough that they have the potential to seriously undermine MMS's intent.

The first is that the language of the current proposal would require MMS to trace the value of the federal oil downstream after multiple exchanges, possibly sending us back to the days when some companies used daisy chain schemes to hide the value of oil downstream. An easier solution to this potential problem would be to limit the number of transactions MMS auditors would be required

to track to a maximum of one or two exchanges. After which point, the company would be required to pay royalties based on index typing as is proposed in earlier drafts of the rule.

Secondly, the proposed rule understates the prevalence of overall balancing arrangements in the industry and places the burden on MMS to discover them. Experience has taught us that it has been difficult for MMS auditors to detect such arrangements.

MMS should include language that would specifically require companies to disclose the existence of offsetting purchases from the same party to whom the oil has been sold, subject to audit. Disclosure of the so-called overall balancing arrangement would then shift the burden from MMS back to the company, which was also the intent of an earlier draft of the rule.

The final point is that the current proposed language places no limits on the transportation allowances companies can deduct, as the State of California just testified. I agree with that. Creating a situation where total transportation costs could be deducted even if the oil is moved far downstream from where the spot price has

been quoted.

MMS should limit the transportation allowances to the cost of moving the oil from the well head to the closest practical market unless the company can show a

hardship that requires them to transport the oil farther.

I would also like to take this opportunity to point out that the implementation of this new rule, particularly with the above-recommended modification, makes it easier for the government to detect the very wrongdoing that has forced us all together in the first place. As a result, there is no reason to consider industry's suggestion for a nationwide mandatory royalty in kind program.

As Secretary Babbitt recently cautioned, quote, in light of the Justice Department's allegations, the administration recommends that everyone move very, very cautiously before considering any new legislation such as mandatory royalty in kind that would decrease the amount of money rightfully due the American people.

In fact, I believe it is patently obvious that industry's RIK plan is merely a diversionary tactic intended to derail this rulemaking.

I submit that the Department of Justice's ongoing investigation should cause policymakers to take a good hard look at any criticism of this final proposed rule eminately from industry and recognize that this new rule

has been made necessary to ease the detection of wrongdoing because of industry's history of unwillingness to pay what they owe. Thank you.

MS. TSCHUDY: Anyone else care to make a statement?

UNIDENTIFIED SPEAKER: May I ask a question?

MS. TSCHUDY: Certainly.

UNIDENTIFIED SPEAKER: Would it be possible for the department to identify any additional basis on which it is asserting the duty to market prior to the deadline for filing comments, meaning in addition to the Arco and Walter cases cited in prior preambles?

MS. TSCHUDY: Through what forum are you suggesting?

UNIDENTIFIED SPEAKER: Gosh, Federal Registry notice or, personally, I would be happy if you wrote a letter to me, but you're certainly entitled to disseminate it more broadly.

MS. TSCHUDY: I'll take that under consideration.

UNIDENTIFIED SPEAKER: Thank you.

MR. GRANT: I would like to ask a question.

MS. TSCHUDY: Could you identify yourself?

MR. GRANT: My name is Kenneth Grant, I'm with the economics resource group. Just so I understand the language that is used here tonight in the NOPRA. When someone says or MMS uses "sold under an arm's length transaction, is that simply to mean cash for oil? Is that the transaction that's being described as opposed to an exchange that is, presumably, not arm's length?

MS. TSCHUDY: An arm's length contract is defined in the regulations as a contract between unaffiliated parties with opposing economic interests. And the term sale is also defined, and you'll see that in the definition.

But a sale is distinguished from an exchange agreement. It is also a defined term, but we don't consider all exchange agreements to be non-arm's length. In fact, we, in the reg, talk about arm's length exchange agreement and non-arm's length exchange agreement. Again,

it has to do with the parties involved as to whether it's arm's length or not.

I guess I'll go back and look at the regs, but I was a little confused. I though I saw on page 6117 the

words nonaffiliated versus arm's length.

MS. TSCHUDY: Yes.

MR. GRANT: What I was not clear about is how is a nonaffiliated exchange, a non-arm's length exchange?

MS. TSCHUDY: What the rule talks about is that a contract is an arm's length contract if it is, again, between parties who are not affiliated. And it defines an affiliation as greater than ten percent ownership, but it also talks about that a contract could be non-arm's length between non-affiliates but it may be non-arm's length because the parties do not have opposing economic interests.

So that might be what causes that contract to be non-arm's length.

MR. GRANT: Thank you.

MS. TSCHUDY: Any other questions or anyone else caring to make a public statement?

MR. MONSCH: John Monsch, Sante Fe Energy

Resource. This is more -- it isn't a public statement, but on non-competitive calls that we discussed numerous times, this is a very small subject to me in this whole realm of pricing royalty, but it just so happens this week

I have one of these and I have not seen in ages, a non-competitive call from a major oil company. But the way you have the regulations here, I would not be able, again, to use my gross proceeds from that sale even though we have been able, with not much negotiation, get a better price in what we feel like is market value for that well head oil.

Even though the competitive call stated its that company's posted price, someone mentioned earlier, a posted price is just a start of negotiation. And I think a producer should be able to demonstrate to MMS that even though the wording of the non-competitive call appears not to be a market related price, they could easily demonstrate the price is a market -- a competitive price.

I just think pushing them straight to index is not a fair way when you can demonstrate the price is a market price.

MS. TSCHUDY: Could you, in your written comments, provide some guidance to us on how a payer could

demonstrate that it's competitive? And then some of the comments we got on the previous proposals it was not clear that -- the commenters thought there was a way that you could demonstrate it was competitive. So if you could help

us out.

MR. MONSCH: Contrary to everybody that's, maybe, outside the oil industry, the producer's sole responsibility as marketing people people are to get the best price. That's just our objective. It is not to get into all theses exchanges that we didn't feel like it was adding value.

MS. TSCHUDY: That would be very helpful if you could give us written comments on what a lessee could submit to demonstrate that their call was, indeed -- that the price received was, indeed, competitive.

UNIDENTIFIED SPEAKER: Can I ask you one or two more questions?

MS. TSCHUDY: Yes.

UNIDENTIFIED SPEAKER: I've got two more.

MS. TSCHUDY: Okay.

UNIDENTIFIED SPEAKER: We discussed the other day the 4415. And we are very much in favor of, if there

is a way to work without that would be very advantageous to us. It looks like we, due to your regulations, you're down to very few places it is necessary, and the amount of burden it would place on the people would not be

justifiable.

Also on the valuing of oil, and we discussed this the meeting, I restudied the use of the timing period for pricing. For the Rockies you're using NYMEX and then the other areas we're using a published spot price.

And I think the way I read it we are talking about the period when either the publication or the NYMEX word is prompt, meaning when that month is trade possibly could not -- the NYMEX not be used in a spot price published -- agreed upon published price to be substituted in the Rockies and still get to the same location on your index pricing.

MS. TSCHUDY: What spot price would you use? Would you recommend you use?

UNIDENTIFIED SPEAKER: Well, after, we talked about probably you're going to reword it, Blumberger Plask, they put out a Cushing's price.

MS. TSCHUDY: So you could use Cushing's spot

price instead of NYMEX?

UNIDENTIFIED SPEAKER: Yes. Since you keep your regulations in what I call in sync instead of on one area and used in the other.

MS. TSCHUDY: Okay. Anything else, John?

MR. MONSCH: No.

MS. TSCHUDY: Anyone else with questions or a public statement?

(No response.)

MS. TSCHUDY: Well, we hold the world record for the most public comments on any rule, so maybe we can have a new record for the shortest public meeting unless someone else has a question or comment?

UNIDENTIFIED SPEAKER: Motion to close.

MS. TSCHUDY: Any seconds?

UNIDENTIFIED SPEAKER: Second.

MS. TSCHUDY: All right. I thank you all very much for your time and your comments.

(Thereupon, at approximately 11:55 o'clock, a.m., the above public meeting was concluded.)

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CERTIFICATE OF REPORTER

I, Yuvondra Everett Fantroy, RPR, do hereby certify that the foregoing proceedings were reported by me in stenotype and thereafter reduced to typewritten form; and that the transcript is a true record of the proceedings reported in the above-captioned case.

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Yuvondra Everett Fantroy

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