Amended July 30, 1998

Notes--mtg. sponsored by Rep's Miller and Maloney--proposed MMS oil royalty valuation rule

Meeting held Tuesday, July 21, Capitol Building. Participants at table included:

Courtney Cuff, Green Scissors (Friends of the Earth)
Ralph DeGennaro, Taxpayers for Common Sense
Danielle Brian, Project on Government Oversight
Brian McMahon, City of Long Beach
Anna Amillio, U.S. PIRG
Hank Banta, California Comptroller's Office
George Miller, U. S. Congress (CA-07)
Carolyn Maloney, U. S. Congress (NY-14)
Perry Shirley, Navajo Nation
Alan Taradash, Jicarilla Apache Tribe
Cynthia Quarterman, Director, MMS
Bob Armstrong, Assistant Secretary for Land and Minerals Management
Debbie Gibbs Tschudy, MMS
Claire Milner, California Department of Education
Andrew Rotherham, American Association of School Administrators

A number of other individuals were in the audience.

Ms. Maloney opened the meeting at 2:05 p.m. She stated that the meeting was open to the public and then requested everyone at the table to introduce themselves. She then requested a statement from Mr. Miller.

Mr. Miller noted that others had been excluded from a recent meeting on the same topic sponsored by Senator Breaux. He stated that the oil valuation rule is very important and would be a great step forward for the public. He is opposed to deals preventing the rule from becoming effective and wants the proper benefits for the taxpayers. He wants it to be known that there is a substantial constituency supporting finalization of the rule.

Ms. Maloney stated that the issue of oil royalty undervaluation has been known for years, and that this was the first Administration to take steps to correct the problem. She complimented the many individuals and related reports addressing this issue, including the California report showing potential losses of over $800 million due to oil royalty undervaluation. She noted she has proposed a bill that would tie royalties to market prices.

Ms. Maloney is concerned that "backdoor" negotiations are occurring regarding the rule. She referenced an insider memorandum that discussed oil company meetings where industry representatives discussed strategies for delaying the rule, such as employing tactics similar to those used by the tobacco industry to block unfavorable legislation. She stated that she hopes the Department will put a strong rule in place. She then asked Mr. Armstrong to provide a statement.

Mr. Armstrong said the Department concluded long ago that the current rule and associated royalty payments were not adequate, so the Department launched the current effort to revise the rule. The Department has held 14 hearings and received over 4,000 pages of comments on the proposed rule over the last 2 ½ years. He believes a good rule will result.

At the same time Mr. Armstrong referenced the current rider preventing MMS from publishing a final rule. He stated that while he opposed the rider, he agreed to attend Senator Breaux's meeting to explain the content and status of the proposed rule. He expressed his appreciation for the opportunity to attend today's meeting and stated that his intent was to get the rule published. He also stated that the Department was taking notes on the meeting and would put them in the public record. He then asked if there were any issues the attendees would like to explore or questions they would like answered.

Ms. Maloney then requested general statements from the attendees.

Mr. DeGennaro stated that he was concerned with the direction of the rulemaking and that the taxpayer should get the best return possible. There should be no "backdoor" meetings. He encouraged the Department not to back away from its position and even suggested strengthening the current proposed rule. He referenced a June 6, 1998, letter to Secretary Babbitt in which his group provided a survey showing the public believes the Department's position, relative to industry's, is correct in the oil royalty dispute. His job is to build political support, which he will continue to try to do.

Ms. Maloney asked for other comments.

Mr. Miller asked Mr. Armstrong where he stood on timing of the rule.

Mr. Armstrong replied that he intends for an October 1, 1998, publication. The rider, however, impacts that date. He is willing to meet with industry and Congressional groups on their concerns. He indicated he would look closely at issues related to transportation and gathering on deepwater leases. He noted that when the California oil undervaluation case developed several years ago, it convinced him a new rule was needed. He noted that he will meet with Senators Breaux, Domenici, and others again tomorrow and will try to convince them that the MMS rule is correct and should proceed. He further believes the proposed rule would limit some audit requirements.

Ms. Quarterman noted that the current comment period on the proposed rule is open until July 24. MMS also recently published a Federal Register notice summarizing a few minor changes to the proposed rule. She said MMS intended an October 1 publication date for the rule.

Ms. Amillio then stated that it is time to stop the oil royalty ripoff. She stated that her organization had helped to cut many wasteful programs, and that the current situation was not fair to the public. She was outraged that Congress is seeking a further delay and is concerned that the

Department is under great pressure. She encouraged the Department to go in the **opposite** direction because the oil belongs to the public and has huge associated environmental consequences. These environmental costs require oil companies to "pay up." She stated that 280 million barrels of oil are spilled, leaked, or lost due to inefficiencies by the oil companies each year. She added that because all oil production has associated environmental costs, no companies--even small ones--should be let off the hook.

Ms. Cuff congratulated Representatives Miller and Maloney, as well as Senator Boxer, for their stands on this issue. She said oil companies have been astoundingly inefficient regarding the environment, that they had no regard for it and had left it scarred. Now Congress was poised to give oil companies another break. She stated that royalties help to fund land acquisition, address consequences of pollution, and help fund the Land and Water Conservation fund. She stressed that proper royalty payments are needed to address associated cleanup costs, which amount to at least $790 million per year. She emphasized that oil industry actions resulted in big costs and health concerns to taxpayers, yet the current rider would subsidize this damaging industry. She said the industry caused the equivalent of 1,000 Exxon Valdez spills per year in pollution. She said industry should not continue to get the "red carpet" treatment through the rider. She thanked those members of Congress who supported the oil rule.

Mr. Miller then asked about the issue of rebuttable presumption of control when deciding whether companies are affiliated. He asked whether such language might lead to endless litigation.

Ms. Gibbs Tschudy replied that MMS was simply proposing to return to the affiliate definition in the current rule--that ownership between 10 and 50 percent presumes affiliation, with lessees offered the opportunity to rebut that presumption. She noted that MMS has received few requests to rebut the presumption, and that it hasn't been a problem so far.

Mr. Miller noted that the IRS uses a 10 percent cutoff on affiliation and wondered why MMS couldn't do the same.

Ms. Gibbs Tschudy replied that she thought the IRS uses that cutoff for foreign applications, but that other provisions of the IRS code reference 50 percent or even as much as 80 percent as the threshold for defining affiliation.

Mr. Armstrong noted again that MMS was simply returning to the provisions of the existing rule; Mr. Miller asked, if requests to rebut are rare, why return to such a provision? Mr. Armstrong replied that it at least gives industry an opportunity to present its case.

Mr. Miller then stated that oil is second only to money in fungibility, and that we are dealing with companies who deal with each other continuously. He used the merger of Shell and Texaco refining/marketing interests as an example. He doesn't want endless litigation on the issue of affiliation; the issue is not easily segregated by ownership. He believes the issue needs "sunshine" and that the public interest must be served.

Mr. McMahon said nothing in the rule requires companies to report concerning their affiliations. He asked what rebuttable means, and what proves that the presumption has been rebutted?

Mr. Banta said that if the rebuttable presumption of control/affiliation hasn't been a problem to date, then it probably hasn't been a problem for industry. If it provides an opportunity for "gaming," however, it may become a problem. He referenced his oil pipeline experience as an example.

Ms. Quarterman then asked Ms. Gibbs Tschudy to explain how MMS currently handles affiliation.

Ms. Gibbs Tschudy said that to date MMS has never approved a company in the 10 to 50 percent ownership range as being non-affiliated. Further, under the proposed rule, in the case of an arm's-length contract, if the proceeds received don't reflect total consideration received or if a company breached its duty to market to the mutual benefit of the lessee and lessor, the lessee would be required to pay based on spot prices.

Mr. McMahon noted that in the January 1997 version of the proposed rule, a statement about MMS's right to audit appears, but that it appears to be missing in the latest version. Ms. Gibbs Tschudy said that if it is not there, it was an oversight or it is located in another section of the rule.

Ms. Brian said that maybe a simpler way to measure affiliation is that <u>any</u> ownership interest represents affiliation.

Mr. Shirley thanked Ms. Maloney and Mr. Miller for the opportunity to represent the Navajo Nation. He also wished that New Mexico Senator Domenici could hear his comments. He noted that the Federal regulations are critical to the ongoing Indian oil valuation regulations. He also believed the premise of moving away from posted prices was critical, because they don't represent value. Mr. Shirley said one of his main interests was whether the rider applies to Indian leases as well as Federal. He stressed the importance of mineral revenues to the Navajo Nation.

Mr. Shirley noted that posted prices have been proven fictitious in many lawsuits, and that oil valuation is a Federal, State, and Indian issue. Audits show that the current valuation methods aren't working, that companies are "in bed" with one another, and are taking advantage of the regulations regarding transportation to minimize their royalty payments. Auditors are limited by the current regulations due to the current valuation benchmarks. The burden then is shifted to auditors to prove royalties are incorrect. Companies also block access to records, rendering audit efforts largely fruitless. He believes NYMEX pricing is necessary and overdue. He encouraged the Department not to back down on the rule and to consider the spillover effects on Indian leases. He added that he was surprised the comment period had been extended.

Ms. Quarterman responded that the rider prohibits MMS from using its budgeted funds for publishing oil valuation rules, and that includes both Federal and Indian.

Ms. Maloney then asked Mr. Armstrong what he meant by "they" supported NYMEX, but he supported spot prices--who is "they?" Mr. Armstrong replied that there is little difference between spot and NYMEX prices. Ms. Maloney then asked for a spot price definition. Mr. Armstrong replied that they are prices published at terminals, such as Cushing--there may be about a half-dozen spot prices published.

Ms. Maloney said MMS should use NYMEX because NYMEX prices are market rates, and postings and spot prices aren't. She asked why should any rate other than a market rate be used? She repeated that spot prices aren't market prices and that we should treat ourselves like oil companies treat each other.

Ms. Gibbs Tschudy explained that spot prices are market prices.

Ms. Maloney asked again, why go to other prices such as spot? She said spot prices can be manipulated and that market rates should be used. She said Alaska North Slope (ANS) prices should be used, but not spot or other prices.

Ms. Gibbs Tschudy replied that spot prices represent actual transactions between willing buyers and willing sellers in the market as opposed to posted prices that are set by the oil companies themselves. She also stated that, over time, NYMEX and spot prices yield the same value.

Ms. Maloney then asked whether spot prices include transportation.

Ms. Gibbs Tschudy noted that NYMEX prices are assessed at Cushing, Oklahoma. She explained that NYMEX and spot prices, after appropriate location adjustments, are essentially equal. She further explained that by using the spot price, one part of the necessary adjustments was eliminated.

Ms. Maloney referred back to Mr. Shirley's comments concerning manipulation of transportation. She said that NYMEX prices should be used, and transportation should be kept separate, thereby eliminating companies' ability to manipulate transportation deductions to their benefit. The rule should clearly apply a market price and separate out any refining and transportation costs to avoid manipulation--she wants simplicity.

Ms. Brian was concerned about "big oil's" access to the Senate. She commended Mr. Armstrong, Ms. Quarterman, and Ms. Gibbs Tschudy on their efforts. She was concerned, however, with the rule's direction. She believed the current version was a leap backward--that small apparent concessions in total amount to such a large overall concession as to bring the entire rule into question. She stated that "big oil" has gotten nearly everything they wanted and that the proposed version is worse than the current rule. She believed concessions had gone too far on:

1) liberalization of the gross proceeds concept;

2) changes to the affiliate definition, meaning companies could sell low to affiliates and participate in downstream profits;

3) language added to the proposed rule saying MMS wouldn't second-guess a company's marketing decisions (she believed MMS must second-guess company decisions in order to properly determine value); and

4) not requiring certification that overall balancing agreements don't take place between companies.

Ms. Brian said the overall effect was to make MMS appear to be the "three monkeys": see no evil, hear no evil, speak no evil. Her closing recommendations were:

1) don't define value by type of transaction, but by type of seller; majors should pay on index and not on gross proceeds, thereby eliminating the affiliate question;

2) any ownership should define affiliation;

3) require companies to open their books concerning reciprocal relationships and all related data; and

4) require companies to disclose/certify all balancing relationships.

Mr. Armstrong asked Ms. Brian whether she had made all of these recommendations initially. She replied that they were cumulative throughout the rulemaking process. She said she thought some of the changes MMS made along the way were ill advised and wondered how such changes could have happened.

Mr. McMahon stated that he has access to lots of oil sales records. He noted that lots of bonuses have been paid and that he continuously has been opposed to use of gross proceeds for royalty valuation. He seconded Ms. Brian's position that independents shouldn't be expected to pay on prices they don't receive. He knows that gross proceeds in California won't be market value--"nobody gets ANS price." He left open the question of whether independents should be allowed to use gross proceeds. However, if a major sells at less than the market price, royalties should be paid on the market price. He also stated that he is continuously disappointed that the documents he possesses aren't reviewed by MMS.

Ms. Quarterman noted that on the major/independent issue, MMS earlier had proposed a refiner/non-refiner split for valuation purposes. The Department's legal counsel were concerned about equal protection/discrimination, so that approach was not used. Both Ms. Brian and Mr. Banta thought a discrimination argument was absurd.

Mr. Peter Schaumberg of the Department's Solicitor's Office noted that unequal treatment could result if two companies operating under substantially identical circumstances could be forced to pay royalties differently because of their status as major/independent or refiner/non-refiner. Mr. Banta stated that he talked to the Deputy Solicitor, and Mr. Banta represented that the Deputy Solicitor did not agree with Mr. Schaumberg's position (amended from earlier posting of minutes).

Ms. Quarterman stated that companies had informed MMS that they should be able to use their gross proceeds where applicable, and that they should also be able to apply such proceeds to value their non-arm's-length transactions. She requested comments from the attendees.

Mr. McMahon said he didn't want to appear to attack MMS, and he thanked Mr. Miller, Ms. Maloney, and Senator Boxer for their support. He also thinks MMS is doing the right thing by applying ANS prices in California. But he thinks MMS's exchange agreement definition is not broad enough. He referenced three types of exchanges not covered by MMS's definition: time trades, where oil of the same type may be traded at the same location but at different times; crude-for-products exchanges; and multi-party exchanges, or "daisy chains." He said the effect of each is to hide the true value, but MMS's definition wouldn't necessarily require such transactions to be valued at an index price. He said that such transactions would be prohibitively difficult to monitor and that MMS should modify its exchange agreement definition to include the types of transactions he described.

Mr. McMahon also said a provision is needed for companies to say when they have overall balance agreements. Further, he thought MMS's initial two-year rule regarding use of gross proceeds when companies buy from one another was good. Trades are not necessarily at the same time; while the two-year span may have been a bit too broad, some period between trades may be a good requirement for use of gross proceeds.

Mr. McMahon said MMS shouldn't give away market prices via too-large transportation deductions. Under the proposed rule, companies could deduct long-distance transportation to sales points or refineries not restricted to the market area. There may be no incentive for more efficient transportation. He also believes there is a quality deduction problem by using differentials in arm's-length agreements between companies, because such differentials are suspect and can be manipulated. He recommends looking to pipeline gravity and sulfur bank data--situations where opposing economic interests exist.

Ms. Maloney asked Mr. McMahon to put his comments in writing. She said his comments about transportation were "chilling."

Ms. Maloney also asked who has to release Mr. McMahon's records, and why is there confidentiality? Mr. McMahon said the Departmental Solicitor's office should have assured releasability in advance. Ms. Maloney noted that she and Mr. Miller hadn't been able to look at the records either. Mr. Schaumberg responded that the documents at question were under court seal.

Ms. Maloney noted that Mr. McMahon pointed out potential manipulation by the oil companies. She said the regulations should be tightened up to prevent such possibilities. She said her research indicates a resulting loss of $66 million per year. She then asked what the Department's estimate was. Ms. Quarterman replied it was the same.

Ms. Gibbs Tschudy said that changes to the rule regarding overall balances, multiple exchanges, and quality adjustments would be addressed in the final version. She believed that this would address some of Ms. Brian's concerns.

Ms. Maloney was concerned that a lot of good work was going for naught due to the rider. She thinks her proposed legislation requiring oil valuation at NYMEX for non-independents is the answer.

Ms. Amillio suggested we define majors and independents the way IRS does. She also said the transportation provisions of the rule increased the potential for environmental disaster. She also referenced deepwater leases and the issue of transportation versus gathering. She believes industry already got a subsidy there when they got royalty relief. She doesn't believe they should get anything else. The deepwater environment is an important ecosystem. The Department should look at the big picture and not "chip away" at the rule.

Ms. Deborah Lanzone, staff assistant to Ms. Maloney, asked if there were further comments.

Mr. Taradash said he would follow up on the deepwater comments. He said that on the Indian gas rule, industry surfaced the royalty holiday concept. Industry subsidies would be enormous. He also said that although dual accounting is required on Jicarilla Apache leases, necessary records are difficult to get. Further, under the 1988 valuation regulations, Indian royalties were reduced from the "highest value" concept to an arithmetic mean value basis. He indicated that 98 percent of the tribal budget came from mineral lease revenues.

Mr. Taradash said the minimum underreporting of <u>volumes</u> on Jicarilla leases, which is overseen by BLM, was 15 percent and ranged up to 60 percent. He said companies typically refuse to do dual accounting and thinks underreporting of royalties is 40-50 percent overall. He believes the effect of the Royalty Simplification and Fairness Act is to not push industry to report and pay any more than they have to. He stated that oil and gas accounting is complex and doesn't lend itself to simplistic approaches--detailed accounting and examination of records is necessary. He stated that companies use broad and varied methods of keeping the real information out of their books. From the royalty owner's perspective, there is a responsibility to maximize revenues, but companies will do all they can to minimize their payments.

Mr. Taradash said the budgets of agencies responsible for minerals oversight have been significantly reduced, if not eliminated. There will not be a second chance to collect what is due, from a practical standpoint. Reduced funding manifests itself in lower royalty collections.

Mr. Taradash said allowance reductions should be strenuously monitored regardless of the beginning value basis. Indian leases have no provision for transportation allowances. FERC tariffs are overstated compared to actual transportation costs. Overall, Mr. Taradash encourages close attention to detail and oversight.

Ms. Milner summarized the importance of royalty receipts. They go straight to California school funds. Books, teacher salaries, and related obligations are funded from these receipts. She encouraged the Department to maintain its position.

Mr. Rotherham indicated acquiring the money needed for public schools is an ongoing hassle. Some smaller states are substantially affected by monies lost to royalty underpayments.

Mr. McMahon said this was the first time he had heard that the Department couldn’t distinguish between small and large companies for royalty purposes. He said previous trade legislation showed bias toward smaller companies and that currently-proposed RIK legislation distinguishes small refiners. Further, entitlements programs in the mid-1970's to early 1980's showed bias toward small companies. Ms. Brian also referenced the IRS Code at 613A(c).

Regarding the affiliate definition, Mr. Banta said the rule should clearly spell out required access to documents; companies argue that auditors can’t have access because affiliate companies’ records are unavailable. He also recommended that the affiliate definition be removed from the arm’s length definition for clarity. He noted that the real stakeholder is the American public--it’s the public’s oil and <u>they</u> have the primary interest, not the oil companies.

Mr. Armstrong noted that he and Ms. Quarterman indeed represent the public. He takes very seriously the effect of what he does. He is trying his best to follow through with this rule.

Mr. DeGennaro asked if it was accurate to say that the Department of Justice with the concurrence of the Department of the Interior intervened in a lawsuit because they thought oil companies have underpaid royalties and manipulated the process? Ms. Quarterman said yes.

Mr. DeGennaro followed up by noting that rewriting the regulations can prevent future abuses. He said the Department shouldn’t give breaks to those who previously have ripped off the public. He noted he has written the entire Senate membership urging support for the Senator Boxer amendment to strike the rider. He acknowledged it would be a public fight and requested the Department’s support. He said his group would show stamina on this issue.

Mr. Shirley then asked Ms. Brian if her previous statements meant she advocated not using gross proceeds in the regulation. She responded that independents are rightfully concerned about having a gross proceeds option, but that majors shouldn’t have that option.

Mr. Shirley noted that gross proceeds could result in the highest value, so he doesn’t want to eliminate that provision. He also expressed concern about affiliation--anytime industry is allowed to shift burdens to MMS, it makes the overall situation more difficult. Where affiliates are involved, records access is a major problem. Regarding exchange agreements, MMS needs language to enable pursuit of true value of the oil. He sees many of the same exchanges referenced by Mr. McMahon. MMS's rule should address these different types of exchanges.

Mr. McMahon noted that the New Mexico State Lands staff couldn't attend, but that they agreed with his comments.

Mr. Armstrong added, in response to earlier comments, that he thinks the Department has a good record on Gulf of Mexico oil spills and that safety and environmentally sound operations is one of the Department's best results.

Ms. Lanzone thanked everyone on behalf of Representatives Maloney and Miller and adjourned the meeting at 2:55 p.m.

NEWS FROM

CONGRESSMAN GEORGE MILLER

7th District, Calif. Committee on Resources.
Committee on Education and the Workforce.
2205 Rayburn Building, Washington, D.C. 20515

FOR IMMEDIATE RELEASE
Tuesday, July 21, 1998

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STATEMENT OF CONGRESSMAN GEORGE MILLER ON CRUDE OIL ROYALTY VALUATION

I am pleased to welcome our guests, Assistant Secretary Armstrong, MMS Director Cynthia Quarterman, Danielle Brian, Executive Director of the Project on Government Oversight, along with representatives of the states, tribes and other groups fighting the extension of the Hutchison rider in the FY 1999 DOI appropriations bill

We are holding this meeting in response to Mr. Armstrong's decision to reopen the public comment period on the proposed rule so that the Department could comply with certain Senators' interest in brokering some sort of compromise on behalf of the oil companies.

The purpose of our meeting is to allow proponents of a new rule -- who were explicitly excluded from the Senate meetings -- the opportunity to speak face-to-face with the Assistant Secretary on the proposed rule. This meeting will be "on the record" as part of the public comment process, and MMS will post "notes from the meeting" on their Internet site.

Let me state at the outset that we appreciate the great lengths to which the MMS has gone to accommodate the perspectives of all affected parties. We are not, unlike some of our Senate counterparts, asking for delay, negotiation or compromise. Nor do we believe that MMS had been unresponsive to industry concerns. To the contrary, we are concerned that MMS and the Department have been overly accommodating of industry issues, at the expense of the public schoolchildren who directly benefit from the federal oil and gas leasing program.

Industry and Senatorial accusations notwithstanding, a new draft GAO report, commissioned by Senator Boxer and Rep. Maloney, exonerates the MMS efforts to solicit, consider and respond to industry concerns on the proposal.

(more)

In addition, the report concludes that the industry's preferred alternative to the MMS rule --- royalty-in-kind — is not feasible for a nationwide program involving all federal oil and gas leases. The report validates the need for new rules.

Our guests have a full agenda of issues to discuss today, so I will limit my comments to one issue, deferring to our invited guests to discuss the rule in greater detail.

The MMS also asked for comments on the concern raised by industry on the costs associated with gathering versus transportation, especially in deep water development.

According to MMS, industry has argued that since development, especially of deep water leases, often involves a sub-sea completion with no platform, that bulk, unseparated production is moved sometimes in excess of 50 miles to a platform where it first surfaces and is treated. Therefore, industry argues, in these situations the movement of production from sub-sea production over long distances should be deductible as a transportation allowance.

I would remind the Department that under the very generous provisions of the Deep Water Royalty Relief Act, oil and gas companies can produce quantities of oil worth $1.4 billion [the royalty value of this amount of oil at $13.00 per barrel is $142 million; at $16.00 per barrel the royalty value is $172 million] before paying any royalties to the taxpayer.

Now, according to comments made by Shell's CEO, Jack Little, during the Senate meeting on July 9, industry believes they are entitled to more discounts. They would like to deduct the costs of gathering the oil, which is not deductible under current rules, in order to pay even lower royalties.

For deep water operations these "gathering" deductions would be significant, because most companies now use lower cost sub-sea production facilities that require long distance movement of the oil or gas through a pipeline to a separation facility.

In this way, the producer saves himself a great deal of money. The use of this "new technology" results in significant savings for the producer at each location. Therefore, the argument that gathering costs should be deductible for the producer at the taxpayer's expense is not persuasive.

Also, the Department should be aware that the issue of defining gathering versus transportation is also under consideration by the Federal Energy Regulatory Commission. Ironically, in that venue, producers are arguing just the opposite – that transmission lines used to transport oil and gas from remote sub-sea facilities offshore and transported to central accumulation points, *should* be considered as "gathering" lines so that FERC cannot regulate them. The contradiction is, not surprisingly, driven by the companies' desire to keep costs down and profits up.

We believe the MMS has been heading in the right direction and are hopeful that pressure from the oil industry will not result in further delay or weakening of a much needed rule.