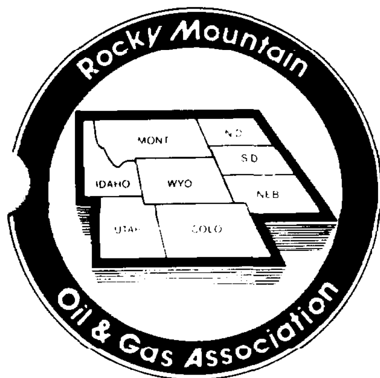

Carla J. Wilson
Director
Tax, Finance & Accounting

1775 Sherman Street, Suite 2501 • Denver, CO 80203-4313
Telephone 303/860-0099
FAX 303/860-0310

November 22, 1996

Mr. David S. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P. O. Box 25165, MS 3101
Denver, CO 80225-0165

RE: Amendments to Gas Valuation Regulations for Indian Leases
61 FR 49894, September 23, 1996

Dear Mr. Guzy:

The Rocky Mountain Oil & Gas Association (RMOGA) is pleased to have had the opportunity to participate on the Indian Gas Valuation Negotiated Rulemaking Committee (Committee). As you know, RMOGA is a regional trade association representing hundreds of members, large and small, who account for more than 90% of the oil and gas exploration, production and transportation activities in the Rocky Mountain states, as well as the majority of Indian lessees. As such, we maintain a vital interest in the valuation of production from Indian and federal leases. I am writing today to offer the Association's comments on the above-referenced proposed rule.

When RMOGA petitioned for representation on the Committee, it was because our members believed a less complicated and more certain process for valuing natural gas produced from Indian leases could be developed, and that RMOGA could make a meaningful contribution to such an effort. Indeed, at one point during the negotiation process, we believed these objectives had been accomplished. Even though it was generally acknowledged Indian lessees would be paying more royalty than before, in general, RMOGA members felt the simplified procedure, certainty of royalty valuation, assurance of closure, and the attendant administrative savings would offset any additional royalty they expected to pay.

Regrettably, however, it appears the attempt by MMS to satisfy the objectives of a single member of the Committee, as well as its own objectives, has all but destroyed any concensus on the part of industry. The "eleventh hour" modifications of the earlier concensus agreement for which RMOGA had voted seriously altered RMOGA's perception of the formula and has consequently eroded our support for the proposed rule.

The inclusion of a "safety net" requirement for non-dedicated sales; the requirement for separate major portion and dual accounting calculations for natural gas liquids; and the requirement to trace gross proceeds represent a serious aberration from the Committee's agreement which, for all practical purposes, obviates virtually any administrative savings for industry and will no doubt result in *increased* administrative costs. Even so, these exigent requirements will provide no discernable benefit to the tribal lessors.

It must be appreciated that industry was included in the process only after MMS and the tribal lessors had been deliberating a gas valuation rule for nearly a year. Industry was placed at an even greater disadvantage due to the composition of the Committee. With the addition of RMOGA, industry was allotted five out of nineteen positions on the Committee, a predicament which was further exacerbated by a two-thirds concensus rule which made it virtually impossible for industry to overcome any adverse or objectionable provisions proposed for the rule.

Despite these obstacles, RMOGA continues to support the use of independent published index prices for valuing gas produced from Indian leases. We can also support the concept of an alternative "percentage bump" to satisfy the dual accounting requirement contained in most Indian leases, to the extent its use is optional at the discretion of the lessee, because of the administrative advantages. Indeed, RMOGA voted in favor of these provisions during Committee negotiations.

However, RMOGA cannot support the rule as proposed for the reasons mentioned above, as well as the reasons outlined in our specific comments which follow.

Specific Comments

Section 202.550 - How to determine the royalty due on gas production

MMS requested comments on whether the Department should provide approval for allotted leases, rather than seek the approval of the many individual allottees who may share in a single lease, under those circumstances where a lessee who can demonstrate an economic hardship requests a royalty rate reduction. RMOGA believes MMS should continue to provide this approval because of the complexity involved in identifying and locating individual lessors in order to obtain their approval. MMS possesses the experience and expertise to make reasonable and equitable decisions on such requests for royalty rate reductions.

Section 260.170(c) - What this subpart applies to

This paragraph permits a lessee to calculate value of production by other, alternative methods to those described in the proposed rule, but only if the lessee, the tribal lessor, and MMS jointly agree to the valuation methodology. MMS's inclusion in these negotiations is contrary to the Committee's discussions on this issue. It was RMOGA's understanding these agreements were to be negotiated between the lessor and lessee. The tribes are perfectly capable of adequately representing their own interests. Indeed, several tribes have already successfully negotiated alternative valuation agreements with industry.

We can see no reason for MMS to involve itself in these negotiations. Adding another layer of bureaucracy will only impede the process and add to MMS's administrative burden. MMS should amend the final rule to state that agreements negotiated between the tribes and industry would automatically be deemed approved by MMS, thereby avoiding the need for MMS to review each agreement.

Section 206.171 - Definitions

In the preamble to the regulations, MMS states the definition of "marketing affiliate" has been removed from the existing regulations because it is "no longer relevant to valuation in today's market". RMOGA would argue that marketing

affiliates are, and will continue to be, relevant in the gas market; therefore, this definition should be reinstated in the final rule.

Section 206.172(b)(iii)(2)(ii) - How to value gas produced from leases in an index zone

Here, MMS requires a comparison of the lessee's index-based value to a value calculated pursuant to Section 206.174 (How to value gas production when an index-based method cannot be used) for gas which was not sold under a dedicated contract and which was subject to a previous contract contingent upon a gas contract settlement. MMS asserts it included this provision in order "to continue current policy". While RMOGA acknowledges this may be MMS's current policy, we question wisdom of perpetuating in a prospective rulemaking a policy which has recently been the subject of so many adverse court decisions.

Moreover, subjecting industry to a gross proceeds calculation requirement completely negates the benefit of utilizing the index-based formula method. RMOGA opposes the arbitrary inclusion of this provision by MMS in the proposed rulemaking and recommends it be removed in the final rule. The Committee deliberated at length and at will to craft a regulation that would satisfy the terms of the lease with the express intent to *avoid* gross proceeds and contract settlement issues.

Section 206.172(d)(6) - How to determine the index-based value for gas production

MMS should clarify in this section that individual index prices will be excluded if MMS determines the index price does not accurately reflect the value of production in that index zone *on a prospective basis only*.

Section 206.172(e) - How you determine the minimum value for royalty purposes

This section requires calculation of a "safety net", a concept to which RMOGA strenuously objects. RMOGA voted to approve the original index-based formula believing the formula would satisfy both the gross proceeds and major portion provisions contained in the Indian leases — except for gas sold under higher priced dedicated contracts. Furthermore, a review of the minutes of the meetings clearly evidences this was the intent of the Committee. Indeed, the concept of a safety net was not raised until many months after the vote on the formula had been taken.

In the preamble, MMS states the safety net provision was "a contentious issue with the industry representatives, as they object to tracing gas sales [and] believe that the index-based value is representative of market value". It is still a contentious issue with industry. Not only do RMOGA members object to tracing gas sales, but we also maintain that by doing so it will be impossible to determine the value of gas with any certainty. All of the benefits industry hoped to realize by using the index-based formula methodology have been obliterated by the inclusion of this safety net requirement. The safety net requirement will serve only to perpetuate valuation and audit disputes and lead to further litigation.

It must be conceded that the safety net was included despite the vehement objections of industry. Moreover, when industry representatives called for a vote on the modified index-based formula which included a safety net, they were essentially ignored and the request was carelessly dismissed. RMOGA believes the inclusion of a safety net provision is a profound violation of the original concensus on gross proceeds and major portion lease requirements.

The statement that industry believes index prices are indicative of market value is somewhat skewed because in this instance, industry believes index prices will result in a much higher value than actual market value, particularly when applied using the index-based formula which, at the outset, calls for an average of the highest index prices. There should be no need whatsoever to augment the index-based formula through the inclusion of a safety net procedure in these regulations.

It should also be made clear in the preamble that the safety net has nothing to do with testing the validity of the index, but that it is intended solely to capture downstream value in markets occurring beyond the field or area in which the lease is located.

Finally, it must be acknowledged by MMS that industry representatives on the Committee stated numerous times that downstream values are contrary to Indian lease terms which specify that value is to be determined "in the field or area", as well as the fact that industry representatives objected to establishing any valuation points, particularly ones downstream of the index point. RMOGA denounces this thinly disguised attempt to tie value to markets downstream of the index point through the use of a safety net.

RMOGA also objects to MMS's continuing efforts to bolster its arguments with respect to pending legal disputes through the rulemaking process. The references to gas contract settlements and the requirement in this section that lessees trace the proceeds of their marketing affiliates are but two of the most recent examples of this crusade.

Section 206.173(b)(4)(i) and (ii) - Alternative methodology for dual accounting

RMOGA questions the necessity for the phrases "and you must use the alternative method for all that gas production" and "and you may use the alternative methodology for these volumes" in these paragraphs. They are both extraneous and confusing, since they are contained in the section which addresses the alternative valuation methodology. We recommend they be deleted in the final rule.

Section 206.174(a)(4)(ii) - How to value gas production when an index-based method cannot be used

This section provides that MMS will calculate the major portion value for each designated area; however, there is no provision for industry to challenge MMS's calculation in situations where industry disputes the value. RMOGA recommends MMS stipulate in the final rule a process by which industry can contest MMS's major portion calculation.

In addition, RMOGA recommends insertion of the phrase "less applicable allowances" after the phrase "Form MMS-2014" in the first sentence in order to clarify that allowances will be deducted before the major portion price is calculated. We also recommend inserting the phrase "less applicable allowances" after the phrase "gas plant product" in the first sentence of Section 206.174(a)(4)(ii)(b)(1)(i) for the same reason.

Section 206.174(g)(2)

This section sets forth the methodology for valuing gas plant products using an actual dual accounting calculation. Unfortunately, as proposed, the effect of these provisions will be the imposition of a *separate* dual accounting calculation for natural gas liquids within the standard dual accounting calculation and a *separate* major

portion calculation for liquids within the standard major portion calculation. This is just an absurd requirement that is neither specified in nor contemplated by the terms of any Indian leases. Moreover, this requirement constitutes yet another violation of the concensus on the original gross proceeds and major portion formula.

The record clearly reflects when the vote was taken on the formula it was understood that the formula would satisfy the major portion requirement *for the entire gas stream*. Here again, the concept of a separate accounting for liquids was not raised until many months after the vote on the formula had been taken. In fact, this issue was not raised until the *final* meeting of the Committee, thereby frustrating any opportunity to fully analyze or discuss the concept.

These superfluous requirements also disregard lease language that specifies value determinations be made in the field or area, and instead contemplate markets far downstream of the lease. Further, these requirements seem to be based on the erroneous assumption that the lessor is somehow entitled to track its royalty to downstream markets, and worse, that the lessee has a duty to bypass markets in the field or area in favor of those downstream. Finally, MMS has itself concluded a netback methodology is the least desirable methodology for valuing gas production. It is irrational to assume there is any principled basis for netting back value from the point of *ultimate consumption*.

MMS also requested comments on the following questions:

1. **Is a minimum value needed when a lessee chooses the actual dual accounting methodology?**

RMOGA is wholly opposed to the notion of a minimum value. When the Committee developed the sliding scale of percentage "bumps" for the alternate dual accounting methodology, it conducted a data analysis which demonstrated that the value of liquids was not significant in determining the amount of an increase related to dual accounting. Whether the liquids market is high or low is irrelevant. Moreover, the administrative costs associated with performing and verifying a minimum value would undoubtedly surpass any discernable benefit to the lessor.

2. **Are there other better methods to use?**

Because the idea of a major portion calculation for liquids is contrary to the Committee's original concensus on the index-based formula, RMOGA recommends eliminating the concept in the final rule. Accordingly, RMOGA would not support *any* minimum value determination.

3. **Are Conway and Mont Belvieu the proper locations to look for prices for gas plant products?**

RMOGA believes the proper location to determine prices for gas plant products is at the tailgate of the plant. This would be consistent with lease language referencing the field or area.

4. **Are the 7.0 and 8.0 cents per gallon the right deductions for transportation and fractionation?**

RMOGA has recommended eliminating the concept of a major portion calculation for liquids; therefore, there is no need for a deduction for transportation or fractionation.

5. **Would a percentage of the price or actual rates paid be a better deduction?**

See RMOGA's comments on question number 4 above.

Section 206.174(l)(1)

MMS's effort to limit the issue of closure to only Montana and North Dakota is another explicit breach of the compromise reached by the Committee. In fact, the Committee agreed to two year closure *anywhere* the 25 percent major portion rule would apply, *not* just to Montana and North Dakota. Further, the requirement to report adjustments that would result in additional royalty — which was *not* part of the Committee agreement — undermines the closure that was the objective of the agreement and is an impossible provision to administer; therefore, it should be deleted.

Section 206.174(l)(2)(ii)

This section provides for an extension of the time periods in which to make adjustments if the lessee has a pending dispute with the person transporting or processing its gas production; however, the rule fails to provide a mechanism for granting such extensions. Because they should not be self-executing, MMS should require some notice of the existence of the pending dispute. RMOGA recommends MMS specify a method in the final rule governing how these extensions would be applied for and by what process they would be granted.

Section 206.176(a)(1)(i) and (ii) - How to do accounting for comparison

The use of the term "including...applicable allowances" (emphasis added) in these paragraphs is confusing and implies allowances will not be deductible. This seems to be just the opposite of what we believe is the paragraphs' intent. RMOGA recommends replacing the word "including" with the word "less" in each of these paragraphs to avoid that confusion.

Section 206.176(c)

This paragraph provides that accounting for comparison is not required for gas that is not processed until after it flows into a pipeline *with an index located in an index zone*. It should be noted the Committee agreed that no dual accounting would be required if the gas entered the *main line* prior to processing. Whether the pipeline has an index is irrelevant. This paragraph should be revised to accurately reflect the Committee's agreement. (The same reference should also be corrected in Section 206.172(b)(ii) and wherever discussed in the preamble.)

Section 206.178(g) - Actual or theoretical losses

This paragraph permits the lessee to deduct specifically identifiable actual or theoretical losses as part of its arm's-length transportation contract. The 1988 regulations contained an exception for Federal Energy Regulatory Commission (FERC) or state approved tariffs. However, this exception has been omitted from the regulations without Committee agreement and without explanation in the preamble. This exception should be reinstated in the final rule.

The Regulatory Flexibility Act

RMOGA disputes MMS's assertion that "this rule will not have a significant economic effect on a substantial number of small entities under the Regulatory Flexibility Act". As discussed above, it was acknowledged by industry the rule would undoubtedly result in higher royalty costs. The impact of a major portion calculation which initiates with a price that is artificially high and allowance deductions that are artificially low inflates the royalty value from the outset. The increased administrative burden required to comply with the safety net requirement, the additional major portion and dual accounting calculations for natural gas liquids, and the gross proceeds calculations amplifies the consequences of the rule, especially for small producers. Finally, the elimination of the option for small producers to value their production based on actual gross proceeds further exacerbates their dilemma.

The Paperwork Reduction Act

RMOGA also takes issue with MMS's declaration in the preamble that "[o]nly a minimal recordkeeping burden would be imposed annually by this collection of information". Compliance with the safety net requirement, as well as the requirement for separate major portion and dual accounting calculations for natural gas liquids, and the tracing of gross proceeds will impose an enormous administrative burden on industry. Moreover, these requirements will necessitate the development of entirely new accounting procedures and systems modifications, resulting in significant implementation and maintenance costs.

Clearly, the proposed rule fails to meet the Committee's objectives of fairness, simplicity, predictability, adaptability, certainty and closure, and ease of administration. MMS's estimate of only $935,000 per year in increased costs to the industry is a paltry sum compared to the compliance costs estimated by industry.

MMS requested comments on the development of two new forms. Form MMS-4410, "Certification For Not Performing Accounting for Comparison (Dual Accounting)", which would be required to be submitted by the lessee to certify that gas was never processed prior to entering the pipeline with an index located in an index zone, in order to avoid performing actual dual accounting. It is RMOGA's opinion that Form MMS-4410 is unnecessary because this information could more

efficiently and effectively be reported by means of a specific transaction code on the MMS Form-2014. Moreover, it should be noted, as discussed above, the Committee agreement was that dual accounting would not be required for gas entering a *main line* prior to processing.

With respect to the Form MMS-4411, "Safety Net Report", which would be used to establish the minimum value for royalty purposes, as discussed above, RMOGA is completely and unabashedly opposed to the concept of a safety net. Because we recommend the safety net be omitted in the final rule, this form would not be needed either.

Comments on the Preamble

RMOGA supports MMS's objective to write the rule in plain English with the caution that, where unamended portions of the regulations require revising, care must be taken to avoid making any substantive changes to the regulations. The use of "you" and "your" in the plain English dialect is particularly perilous because of its potential to inadvertently influence interpretation of the regulations with respect to payor/lessee/operator liability issues and with respect to the affiliate proceeds issue.

RMOGA recommends the preamble include a disclaimer expressing that plain English revisions are made with no intent to substantively alter the meaning of the existing regulations. In addition, the preamble should state that incorporating the Committee concensus into the existing regulations should not be interpreted or infer that any concensus was reached on longstanding differences of opinion on the meaning and interpretation of existing regulations, or that these differences of opinion were waived or withdrawn.

The preamble, at page 49898, in the fifth paragraph under Section 206.173, states, "[t]he [formula dual accounting] increments represent the average uplifts in the value of gas prior to processing". RMOGA believes this statement is misleading in that the Committee's study was very restricted, examining only a single producer and a limited geographic area. Thus, the increments cannot be fairly characterized as representing any kind of "average".

In the fourth full paragraph on page 49899 of the preamble, MMS states in the last sentence, "[t]he Committee agreed that the price at which 25 percent or more of the gas is sold is a reasonable compromise" of the term "major portion". In fact, the industry representatives never agreed that the 25 percent figure was reasonable, only that it was an acceptable trade in return for audit closure. Moreover, the language in the proposed rule in Section 206.174(l) limiting the closure provision to Montana and North Dakota runs directly afoul of that compromise. As discussed above, the Committee agreed to two year closure *anywhere* the 25 percent major portion rule would apply.

Also on page 49899 of the preamble, in the second paragraph, middle column, MMS states the Committee "voted to include in the proposed rule a minimum value based on some concepts MMS used previously in a procedure paper on natural gas liquid products valuation". The Committee did agree to request comment on the issue, but did not agree that any specific proposal should be included in the regulation. (Also see RMOGA's comments on Section 206.174(g) above.)

Conclusion

RMOGA cannot support the rule as currently proposed. The "safety net" requirement for non-dedicated sales; the requirement for separate major portion and dual accounting calculations for natural gas liquids; and the requirement to trace gross proceeds were last minute additions to the proposed rule, made to accommodate a single Committee member's and MMS's objectives.

These provisions were railroaded through the Committee in such a manner as to circumvent any reasonable opportunity to thoroughly analyze and/or discuss them, or they were unilaterally introduced to the proposed rule by MMS, preventing any analysis or discussion of them. Industry's request for a vote on the modified index-based formula was summarily denied.

These provisions represent a critical breach of the Committee's agreement on the original index-based formula. Moreover, MMS's unilateral and arbitrary "tweaking" of the rule has made a bad regulation worse.

Industry has lost all certainty and relief from the administrative burden of major portion calculation and dual accounting which it had sought through participation on the negotiated rulemaking committee, and which it believed it had gained through the agreement on the original index-based formula. Under the proposed rule, industry's accounting and compliance costs will vastly exceed current costs, *over and above* paying higher royalties based on higher values.

We disagree with MMS's assertions the rule will not have a significant economic effect on a substantial number of small entities and that only a minimal recordkeeping burden would be imposed. In fact, RMOGA believes the impact to industry will be enormous.

Finally, RMOGA simply does not believe the rule as proposed meets either the industry's objectives in participating on the Committee or the Committee's objectives as professed in the September 1996 Committee Report.

The measure of successful negotiation is where all parties achieve at least some benefit from the resulting agreement, based on arbitration and the premise that each party will gain something and lose something in the bargain. With respect to this proposed rule, it has certainly not been the case from RMOGA's perspective. While RMOGA desires to continue to work with MMS and its other constituents in developing regulations and policies, it is difficult to request our members to commit the considerable time and expense involved in participating in such efforts as negotiated rulemaking when the results are so devastatingly disadvantageous to them.

It is RMOGA's sincere hope that MMS will thoughtfully and carefully consider deleting from the final rule those modifications to the concensus agreement which were added during the final meetings of the Committee. We also hope MMS will remove those objectionable provisions which were unilaterally added to the proposal after the Committee had concluded its work. Absent these onerous provisions, RMOGA could support the regulations.

November 22, 1996

Mr. David S. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program

Thank you for the opportunity to provide you with our comments. Please do not hesitate to contact me if you would like to discuss our comments in greater detail.

Very truly yours,

Carla J. Wilson
Director
Tax, Finance & Accounting