# **Rocky Mt. Min. L. Inst. 8B-1 2004**

***The Foundation for Natural Resources and Energy Law Annual and Special Institutes (formerly Rocky Mountain Mineral Law Foundation Annual and Special Institutes)*  > *Special Institutes* > *2004 Feb (Federal and Indian Oil and Gas Royalty Valuation and Management Book 1)* > *Chapter 8B (FEDERAL OIL VALUATION: WHERE ARE WE NOW?)***

**FEDERAL *OIL* VALUATION: WHERE ARE WE NOW?**

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**RMMLF *Oil* Valuation Panel: Where Have We Been? Where Are We Now? Where Are We Going?**

**I. Introduction**

The Minerals Management Service (MMS) published the final Federal ***oil*** valuation rulemaking on March 31, 2000, with an effective date of June 1, 2000 - meaning that the rule applies to all crude ***oil*** produced from Federal leases starting on June 1, 2000. In his paper "Where Have We Been?" my co-author, David Deal, summarizes key aspects of the June 2000 rule. Further detail on the operational aspects of the rule can also be found in my paper from the April 2000, Special Institute on Royalty Valuation and Management III, Paper No. 14A.

Section II of this paper will focus first on the MMS's experience in implementing the June 2000 rule including the judicial challenge to the rule, requests for valuation determinations under the rule, future valuation agreements, and what MMS has learned from taking ***oil*** royalties in kind in the Gulf of Mexico and in Wyoming. Following that discussion, Section III will turn to MMS's efforts in 2003 to seek public input as to whether or not we got it right in June 2000 or whether we needed to make refinements to the rule. Section IV summarizes the August 20, 2003, proposed rulemaking including a side-by-side comparison with the June 2000 rule. As of the due date for this paper, MMS had not yet published a final rulemaking. As such, Section V can only provide a summary of the comments received on the August 20, 2003, proposed rulemaking. If MMS publishes the final rule before February 11, 2003, I will provide a summary during my oral presentation at the Special Institute. [[1]](#footnote-2)1

**II. Life After June 2000**

**A. Judicial Challenge**

Immediately following the publication of the June 2000 final rule, the producing industry filed a lawsuit challenging several of the provisions of the rule (Independent Petroleum Association of America v. Baca, Civil No. 00-761 (RCL) (D.D.C.), and American Petroleum Institute v. Baca, Civil No. 00-887 (RCL) (D.D.C.) (consolidated). API and IPAA challenged the following provisions of the rule:

1. Duty to market

2. Downstream indices

a. Rejection of comparable arm's-length prices in favor of indexing

b. Rejection of tendering except in very limited form

c. Failure to adopt adequate quality and location adjustments

d. Application of West Texas Intermediate (WTI) at Cushing for Rocky Mountain Region production

e. Application of Alaska North Slope (ANS) spot prices for California production

f. One-month lag in applying index prices

3. Transportation allowances

a. Rejection of Federal Energy Regulatory Agency (FERC) tariffs

b. Adoption of BBB bond rate

4. Affiliate resales

5. Allegedly tainted rulemaking process

6. Buydown Payments

Plaintiffs advised the Court that the rulemaking, if it goes final, may lead to resolution of many of the issues in the litigation. They asked the Court to hold the case in abeyance until the rule is completed. By Orders dated November 21, 2003, the Court dismissed these cases without prejudice subject to reinstatement and reactivation of the procedural *status quo* upon proper motion. On December 4, 2003, the firm of Lobel, Novins & Lamont, filed a motion on behalf of California State Controller Steve Westly to reinstate the case for the purpose of permitting his intervention under Rule 24 of the Federal Rules of Civil Procedure.

**B. Requests for Value Determinations**

One of the issues of debate during the development of the June 2000 rulemaking was binding value determinations. In its February 1998 supplementary proposed rulemaking, MMS had proposed at 30 CFR 206.107 that lessees may ask MMS for valuation guidance or propose a valuation method to MMS and that MMS will promptly review the proposal and provide the requestor with a nonbinding determination. During the rulemaking process, industry representatives expressed concern that the number of requests for value determinations would increase dramatically because of what they perceived as the complexity of the new rule. Therefore, they argued for binding value determinations that would provide them with certainty as to how to properly value their Federal ***oil*** production.

In the final rule, in response to comments, MMS provided for a procedure for value determinations that is more than simply non-binding guidance. Under § 206.107 of the final rule, lessees may request a value determination from MMS regarding any Federal lease ***oil*** production. In response, MMS may either:

(1) Issue a value determination signed by the Assistant Secretary, Land and Minerals Management; or

(2) Issue a value determination by MMS; or

(3) Decline to provide a value determination.

A value determination signed by the Assistant Secretary, Land and Minerals Management, is binding on both the lessee and MMS until the Assistant Secretary modifies or rescinds it. It is also the final action of the Department and is subject to judicial review under the Administrative Procedure Act, 5 U.S.C. 701-706. In contrast, a value determination issued by MMS is binding on MMS and delegated States with respect to the specific situation addressed in the determination, unless the MMS or the Assistant Secretary modifies or rescinds it.

In actual practice, MMS has not received a large number of requests for value determinations under the June 2000 Federal ***oil*** valuation rule. The requests we have received fall into the following categories:

&bull; tendering program in the Rocky Mountain Region (2)

&bull; approval of valuation method for ***oil*** not sold under tendering in the Rocky Mountain Region

&bull; valuation for ***oil*** placed in inventory and later sold

&bull; use of posted price bulletin schedule to adjust index price for quality differences

&bull; approval of gravity and sulfur adjustments for ***oil*** sold non-arm's length

&bull; use of index price without a location/quality adjustment instead of tracing

&bull; determination of whether the relationship with a pipeline is at arm's length

&bull; clarification of "Four Corners" area

&bull; allowability of stabilizer costs

&bull; use of weighted average of arm's-length sales in lieu of index

&bull; approval to use weighted average costing of transportation allowance

&bull; guidance on non-arm's-length transportation and pipeline depreciation

&bull; use of location differential based on different production areas in North Dakota

&bull; guidance on quality bank adjustments

**C. Future Valuation Agreements**

In the June 2000 final rule, MMS added a separate provision at new § 206.100(d) (3). That provision states that if a written agreement between the lessee and the MMS Director establishes a production valuation method for any lease that MMS expects at least would approximate the value otherwise established under the MMS regulations, the written agreement will govern to the extent of any inconsistency with the regulations. This provision is intended to provide flexibility to both MMS and the lessee in those few unusual circumstances where a separate written agreement is reached, while at the same time maintaining the integrity of the regulations. As noted, any such agreement also must at least approximate the royalty value that would apply under the regulations for the production.

MMS has entered into only a few future valuation agreements under the June 2000 ***oil*** rule. Generally, those agreements have been to accommodate the unique accounting, marketing, or system arrangements of the lessee. In evaluating the requests for future valuation agreements, MMS and the States involved have had an opportunity to better understand the marketing practices of these lessees. Because of the requirement that the value under any such agreement at least approximate the value otherwise established under the rule, the agreements that we do have generally require an annual "true-up" mechanism to compare the value under the agreement with the value that would have been calculated under the rule. In some cases, the agreements contain thresholds within which the lessee and MMS agreed that the lessee would not make prior period payments or adjustments.

**D. What We Learned from Taking our *Oil* in Kind in Wyoming and in the Gulf of Mexico**

The MMS's Royalty-In-Kind (RIK) pilot programs over the past several years have provided valuable commercial insights into crude ***oil*** transportation, marketing, and sales. Some observations with implications for royalty in value regulations include: [[2]](#footnote-3)2

&bull; Pricing Methodologies: The majority of Gulf of Mexico (GOM) crude ***oil*** producers, aggregators, traders, and refiners buy and sell crude ***oil*** based on a Koch Posting basis adjusted for the "P&plusmn;" factor. (Note that the P&plusmn; factor reflects the price of WTI sold into Cushing on the basis of "postings plus." P-plus deals are invoiced at a later date on the basis of a differential to an average of one or more crude ***oil*** postings. For example, a deal done at P-plus 75 cents would be invoiced at 75 sets more than the previously agreed-upon posting basis.) [[3]](#footnote-4)3

An additional prominent methodology, though less widely used, is the "Calendar Month NYMEX" methodology (with and without the "roll" factor). (Note that the "roll" is a commonly used measure of the trend of NYMEX prices for future deliveries in those areas.)

Purchases/sales based on Platts market center assessments are relatively rare in comparison.

Long-term pricing data for GOM crude indicate that both the Koch P&plusmn; and Calendar Month NYMEX methodologies maximize returns relative to other potential pricing methodologies.

&bull; Wyoming Pricing Methodologies: Producers, aggregators, traders, and refiners use a wide variety of pricing mechanisms, focusing on baskets of local postings, Canadian spot prices, and NYMEX-based differentials. Use of the Guernsey, Wyoming spot price is sporadic.

&bull; Commercial Approaches: Fair market value is achieved through adoption of industry-standard, commercial approaches to selling, valuing, or transporting crude ***oil*** production in competitive environments. Use of non-commercial approaches to selling/valuing/moving crude ***oil***, or inflexible adherence to prior approaches in changed market conditions, would distort performance away from fair market value.

&bull; Transportation: The majority of offshore crude ***oil*** properties do not have more than one transportation option. Movement of crude ***oil*** from these properties is typically contracted either directly or indirectly (through exchanges) based on tariff rates. Significant discounts to tariffs occur when producers do have pipeline options either from multiple physical lines or from competition among multiple owners in single lines. A high degree of rate variability also results from individual negotiations for buy/sell exchanges on proprietary (single shipper) lines.

&bull; Other components of transportation: Quality bank administration fees, line fill, and line losses are costs that must be incurred to transport crude ***oil***.

**III. The Year 2003 - Did We Get It Right in 2000?**

**A. Spring 2003 Workshops**

By Federal Register Notice dated February 12, 2003, (68 Fed. Reg. 7086), MMS announced that it would hold four public workshops to discuss specific issues regarding the existing Federal ***oil*** royalty valuation regulations at 30 CFR Part 206 for crude ***oil*** produced from Federal leases. In that Federal Register Notice MMS explained that it believed that the Federal ***oil*** valuation rule was working well and accomplishing its objective of ensuring a fair return on federal resources. However, with our 3 years of experience with the current rule and 5 years of experience with the royalty-in-kind program, MMS identified certain issues needing a more thorough review.

At the same time that MMS announced the public workshops on the Federal ***oil*** valuation rule, it also reopened the public comment period on the proposed rule regarding the valuation for royalty purposes of crude ***oil*** produced from Indian leases (68 Fed. Reg. 7086). In the Federal Register notice, MMS explained that it had published a notice of proposed rulemaking regarding the value for royalty purposes of crude ***oil*** produced from Indian leases on February 12, 1998 (63 FR 7089) and a supplementary proposed rule on January 5, 2000 (65 FR 403). MMS also explained that because of the substantive overlap between the issues being discussed at the workshops on the Federal ***oil*** valuation rule and issues involved in the proposed Indian ***oil*** valuation rule, and to give persons interested in Indian lease issues an opportunity to participate in the workshops, MMS would reopen the comment period on the proposed Indian ***oil*** valuation rule for 60 days so it could include in the record any relevant comments received. The MMS then could consider those comments as it proceeds with the Indian ***oil*** valuation rule. The comment period on the Indian ***oil*** valuation rule ended on April 14, 2003.

**B. Feedback from the Workshops**

The MMS conducted the four public workshops on March 4-6, 2003, in Denver, Colorado; Albuquerque, New Mexico; Houston, Texas; and Washington, D.C. MMS sought public comment and recommendations on the following specific issues:

1) the timing and application of published indices,

2) the calculation of location and quality differentials where lessees do not have that information,

3) allowable transportation costs,

4) the rate of return allowed for calculating actual costs under non-arm's-length transportation agreements, and

5) how lessees value and report crude ***oil*** disposed of under joint operating agreements.

The workshops were widely attended by representatives from industry, States, and Tribes as follows:

Denver (7 industry, 12 State, and 2 Indian Tribal representatives)

Houston (45 industry and 2 State representatives)

Albuquerque (1 industry, 5 State, and 4 Indian Tribal representatives)

Washington, D.C. (6 industry and 2 State representatives)

The minutes from each of the workshops are available on the MMS website at http://www.mrm.mms.gov/OilVal/FCORPubMin.htm.

**IV. August 20, 2003, Proposed Rulemaking**

**A. Proposed Rule**

On August 20, 2003, MMS published a proposed rule for public comment. We explained in the preamble to this proposed rule that we were proposing to amend the existing regulations governing the valuation of crude ***oil*** produced from Federal leases that became effective June 1, 2000. We also explained that the amendments proposed do not alter the basic structure or underlying principles of the June 2000 rule. The August 20, 2003, proposed rulemaking would amend the June 2000 rulemaking primarily in the areas of which published market prices are most appropriate to value crude ***oil*** not sold at arm's length and what transportation deductions should be allowed.

Of particular note is language in the Background Section of the Supplementary Information (68 Fed. Reg. 50087) that states:

In proposing these amendments, the Department of the Interior reaffirms that the value for royalty purposes of crude ***oil*** produced from Federal leases is value at or near the lease. But in determining value at the lease of production not sold under an arm's-length contract at the lease, MMS is not restricted to a comparison to arm's-length sales of other production occurring in the field or area. MMS may begin with a "downstream" price or value, and determine value at the lease by deducting the costs of transporting ***oil*** to downstream sales points or markets, or by making appropriate adjustments for location and quality.

Federal lessees are not obligated to sell crude ***oil*** downstream of the lease. Lessees are at liberty to sell production at or near the lease, even if selling downstream might have resulted in a higher royalty value for the production than selling it at the lease. If lessees do choose to sell downstream, the choice to sell downstream does not make otherwise non-deductible costs deductible (for example, marketing costs). See Independent Petroleum Association of America, et al. v. DeWitt, 279 F.3d 1036 (D.C. Cir. 2002), cert. denied sub nom., Independent Petroleum Association of America, et al. v. Watson, 537 U.S. 1105 (2003).

**B. Comparison of the June 2000 final rule with the August 20, 2003, Proposed Amendments**

|  |  |  |
| --- | --- | --- |
| Regulatory | June 2000 Rule | August 2003 Proposed Rule |
| Section |  |  |
| %w |  |  |
| 206.100 | Purpose of this Subpart | No change |
| 206.101 | Definitions | Proposes changes, additions, and deletions |
| to definitions of terms such as prompt |  |  |
| month, trading month, the roll, etc. related |  |  |
| to change from spot price to NYMEX. |  |  |
| %w |  |  |
| Proposes to modify the definition of |  |  |
| affiliate by removing the words "between |  |  |
| 10 and 50 percent" and adding the words |  |  |
| "10 through 50 percent" in their place. |  |  |
| %w |  |  |
| 206.102 | How do I calculate royalty value for | No change |
| ***oil*** that I or my affiliate sell(s) under |  |  |
| an arm's-length contract? |  |  |
| %w |  |  |
| 206.103 | How do I value ***oil*** that is not sold |  |
| under an arm's-length contract? |  |  |
| %w |  |  |
| Calif./Alaska: Lessee elects for a 2-year | Calif. /Alaska: Same except NYMEX |  |
| period to pay on either its | proposed instead of ANS spot price. |  |
| affiliate's arm's-length resale price or |  |  |
| ANS spot price adjusted for location |  |  |
| and quality |  |  |
| %w |  |  |
| Rocky Mountain Region: Lessee | Rocky Mountain Region: Same except |  |
| elects for a 2-year period to pay on | NYMEX proposed for third benchmark |  |
| either its affiliate's arm's-length | instead of WTI Cushing spot price. |  |
| resale prices or one of four |  |  |
| benchmarks. Third benchmark was |  |  |
| WTI Cushing spot price. |  |  |
| %w |  |  |
| Rest of the Country: Lessee elects for | Rest of the Country: Same except |  |
| a 2-year period to pay on either its | NYMEX plus the "roll" proposed instead |  |
| affiliate's arm's-length resale prices | of spot price. |  |
| or applicable spot price adjusted for |  |  |
| location and quality |  |  |
| %w |  |  |
| 206.104 | What index price publications are | Proposes to eliminate references to ANS, |
| acceptable to MMS? | index prices, and spot market values and |  |
| to add reference to published differentials |  |  |
| 206.105 | What records must I keep to support | No change |
| my calculations of value under this |  |  |
| subpart? |  |  |
| 206.106 | What are my responsibilities to place | No change |
| production in marketable condition |  |  |
| and to market production? |  |  |
| 206.107 | How do I request a value | No change |
| determination? |  |  |
| 206.108 | Does MMS protect information that I | No change |
| provide? |  |  |
| 206.109 | When may I take a transportation | Proposes to change the term "index price" |
| allowance in determining value? | to NYMEX. |  |
| 206.110 | How do I determine a transportation | Proposes to add lists of specific allowable |
| allowance under an arm's-length | and nonallowable costs that lessees may |  |
| contract? | deduct. |  |
| %w |  |  |
| 206.111 | How do I determine a transportation | Proposes to add lists of specific costs that |
| allowance if I do not have an arm's-length | lessees may include and not include in |  |
| transportation contract or | their actual cost calculations. |  |
| arm's-length tariff? |  |  |
| Proposes to remove the words "who |  |  |
| owned the system on June 1, 2000" and |  |  |
| add in their place the words "from whom |  |  |
| you bought the system. Include in the |  |  |
| depreciation schedule any subsequent |  |  |
| reinvestment." |  |  |
| %w |  |  |
| Proposes to change the rate of return to |  |  |
| 1.5 times the Standard & Poor's BBB |  |  |
| bond rate. |  |  |
| %w |  |  |
| § 206.112. | What adjustments and transportation | Proposes to clarify that if royalty value at |
| allowances apply when I value ***oil*** | the lease is calculated by starting with the |  |
| production from my lease using the | NYMEX price, the NYMEX price would |  |
| NYMEX price? | then be adjusted by applicable |  |
| transportation costs or location and quality |  |  |
| differentials between the lease and the |  |  |
| market center, and then between the |  |  |
| market center and Cushing. |  |  |
| %w |  |  |
| Proposes that when some but not all of the |  |  |
| lessee's ***oil*** is exchanged or transported to |  |  |
| a market center, the lessee may value that |  |  |
| portion of the ***oil*** not transported or |  |  |
| exchanged to a market center using the |  |  |
| volume-weighted average of the values of |  |  |
| the ***oil*** that was exchanged or transported. |  |  |
| Lessee must exchange or transport at least |  |  |
| 20% to use the volume-weighted average; |  |  |
| otherwise, lessee must come to MMS for |  |  |
| approval. |  |  |
| 206.113 | How will MMS identify market | No change |
| centers? |  |  |
| 206.114 | What are my reporting requirements | No change |
| under an arm's-length transportation |  |  |
| contract? |  |  |
| 206.115 | What are my reporting requirements | No change |
| under a non-arm's-length |  |  |
| transportation contract? |  |  |
| 206.116 | What interest and assessments apply | No change |
| if I improperly report a transportation |  |  |
| allowance? |  |  |
| 206.117 | What reporting adjustments must I | No change |
| make for transportation allowances? |  |  |
| 206.118 | Are actual or theoretical losses | Deleted |
| permitted as part of a transportation |  |  |
| allowance? |  |  |
| 206.119 | How are royalty quantity and quality | Proposes to remove first paragraph of |
| determined? | paragraph (c) related to actual or |  |
| theoretical losses. |  |  |
| 206.120 | How are operating allowances | No change |
| determined? |  |  |
| 206.121 | Is there any grace period for reporting | Proposes to end-date the grace period for |
| and paying royalties after this subpart | adjustments. |  |
| becomes effective? |  |  |

**V. 2004 Final Rule?**

**A. Public Comment on the August 20, 2003, Proposed Rule**

MMS published the proposed rule on August 20, 2003, with a 30-day comment period. In response to comments received, we reopened the comment period for another 45 days. The final comment period ended on November 10, 2003.

We received a total of 389 pages of comments within 28 separate submissions from 27 commenters. The California State Controller's Office submitted two separate comments. A letter from Wyoming Governor Dave Freudenthal was submitted to MMS by three different commenters, and is summarized as an individual comment in this document. Those submitting comments included:

**States**

&bull; Alaska State Department of Natural Resources

&bull; California State Controller's Office

&bull; Louisiana State Department of Natural Resources

&bull; Texas General Land Office

&bull; Wyoming Governor Dave Freudenthal

**Industry Trade Associations**

&bull; API

&bull; Royalty Strategy Task Force

**Industry Publications**

&bull; Argus Media Inc.

&bull; Platts

**Individuals**

&bull; B. Sachau

**Congressional Submissions**

&bull; Ben Chavet (Chief of Staff for Representative Carolyn Maloney)

&bull; Ben Chavet and Jennifer Keaton (Staff of Representative Maloney), Randolph Harrison (Staff of Representative Capp), Ben Winburn (House Resources Energy and Mineral Resources Subcommittee(Minority Staff)), and the GAO representative on the Proposed ***Oil*** Valuation Rule

&bull; Deborah Lanzone and Ben Winburn (House Resources subcommittee on Energy and Mineral Resources Minority Staff)

&bull; Patty Beneke and Scott Miller (Senate Energy and Natural Resources Committee Minority Staff), Laura Cimo (Senator Boxer), Michael Buchwald (Senator Feinstein), Michael Zeitler (Senator Murkowski), and Kathryn Seddona (Senate Government Affairs Committee Minority Staff)

&bull; Rep. Carolyn Maloney

&bull; Rep. Carolyn Maloney and Rep. Nick Rahall

&bull; Rep. Nick J. Rahall, II

&bull; Senator Barbara Boxer, Rep. Carolyn Maloney, & Rep. Lois Capps

&bull; Senator Barbara Boxer, Senator Diane Feinstein, Representative Lois Capps, & Representative George Miller

&bull; Senator Enzi forwarding a letter from Wyoming Governor Freudenthal

**Producers**

&bull; ChevronTexaco

&bull; ConocoPhillips

&bull; ExxonMobil

&bull; Walter ***Oil*** and Gas Corporation

**Public Interest Groups**

&bull; Project on Government Oversight

**B. Summary of the Comments by Constituent Group**

**1. States**

The State of Wyoming specifically, and States in general, believe that if the 2000 ***oil*** rule must be modified, changes should be limited to the use of NYMEX pricing. States agree that the use of NYMEX as a starting point with the addition of a roll and adjustments for local market centers has merit and is less susceptible to market manipulation than spot prices. States do not believe that NYMEX pricing should be used for production from California and Alaska and suggest that ANS pricing be retained in these regions. Wyoming agrees that NYMEX pricing is less susceptible to manipulation than published spot prices, but asserts that differentials should be allowed only if they are reasonable and actually incurred. The California State Controller's Office suggests that use of WTI differentials fails to account for uplift in value due to location, and therefore gives industry a lower price from which to base royalty payments than actual sales prices support. Wyoming also opposes the suggested use of spot prices from Hardisty, Alberta, Canada. Governor Freudenthal and others believe that spot prices from these locations would be less accurate than using Cushing, Oklahoma, and suggest that using a NYMEX price less a location/quality differential would be more accurate for Wyoming Sour Crude. Wyoming suggests that non-arm's-length royalties be determined by downstream sales price rather than benchmarks.

States were uniformly opposed to modification of the transportation allowances in the 2000 rule and most questioned whether MMS was designating marketing costs as transportation. States were opposed to raising the cost of capital deduction from 1.0 to 1.5 times the BBB Bond rate. Alaska and California believe that 1.5 times the BBB Bond rate is too high and does not reflect actual cost of capital. California was particularly concerned that increasing the rate of return deduction would negatively impact State royalty income, and would conflict with existing regulations concerning redepreciation of assets. The Louisiana Department of Natural Resources suggested applying 1.5 times the BBB Bond rate to pipelines constructed after the passage of the new regulations and applying the lower 1.0 rate to existing infrastructure. States also opposed allowing line fill and line loss to be deducted as transportation allowances.

The California State Controller's Office and the State of Wyoming oppose the treatment of Joint Operating Agreements as arm's-length transactions.

**2. Industry Trade Associations**

The Royalty Strategy Task Force (RSTF), speaking on behalf of industry trade associations, was generally supportive of the Proposed Rule. RSTF is supportive of the move to NYMEX pricing, but is not opposed to retaining use of ANS spot pricing for California and Alaska. RSTF does not believe that the roll should be applied (for NYMEX) to the Western Gulf of Mexico, Alaska, California, the San Juan Basin, or any other area that doesn't have a market center where physical exchanges between that market center and Cushing WTI are prevalent and transparent. RSTF believes that the roll is acceptable, but should not be applied to all circumstances equally, leaving room for modification where it is called for. RSTF states that since Industry has formed no clear consensus on the exclusion of holidays and weekends for calculating production for royalty purposes, a single standard should be adopted.

RSTF supports the renaming of the four benchmarks in the Rocky Mountain Region, and the re-definition of affiliate. RSTF agrees that the grace period for the 2000 rule should be ended, but insists that a new grace period be established after the new ***oil*** rule is passed. RSTF commented that §210.53(1) should be amended to strike the phrase "each working interest owner" and be replaced with "the working interest owners". RSTF endorses the lessee opt-in to index pricing for certain arm's-length transactions, and supports the change from "who owned the system on June 1, 2000" to "from whom you bought the system."

RSTF suggests that lessees be allowed to use WTI differentials in lieu of calculating their own location and quality differentials. RSTF believes that the three benchmarks and the alternative valuation provision currently prescribed for the Rocky Mountain Region are adequate and do not require revision. RSTF further recommends that MMS consider application of market center differentials such as ***Kern*** River and Line 63 to the ANS index to establish location and quality differentials between Long Beach and other market centers should MMS decide to retain ANS pricing for Alaska and California production. RSTF believes that the proposed adjustment for sulfur is inadequate and should be revised to between 50 cents and $1.00 per full percent.

Based on an API study, the RSTF argues that although pipelines are not as risky as drilling wells, some risk is involved, and that the rate of return should be between 1.6 and 1.8 times the BBB bond rate. RSTF notes that the proposed rate of return allowable is also applicable to non-pipeline transportation methods and suggests that non-pipeline based transportation should be dealt with on a case-by-case basis.

RSTF strongly supports the inclusion of specific transportation costs in the proposed rule as a powerful tool for averting disputes arising out of lack of clarification of issues, but suggests that gauging and scheduling fees be included as deductible transportation costs.

**3. Industry Publications**

Industry publications generally support the move to NYMEX pricing. Platts notes that for the three days between the expiration of a particular month's NYMEX contract and the concurrent close of cash WTI trading and pipeline scheduling for that same month, there will be a different basis for the NYMEX value and the differential to the market center. Platts also warns that the NYMEX plus differential proposal may not be universally accurate.

Argus believes that restricting the ability of companies to change from one approved publication to another is fundamentally anticompetitive and suggests that companies be allowed to change publications every ninety days.

Platts and Argus suggest that their publications be considered if MMS decides to utilize prices from Hardisty, Alberta, Canada.

**4. Individuals**

The one individual commenting suggested that additional clarifications be added to the rule to better explain the ways that the new ***oil*** rule will modify existing regulations.

**5. Congressional Submissions**

Congressional submissions were included in the summary of comments by States since all of the Congressional submissions were on behalf of, or in agreement with, comments submitted by the State agencies.

**6. Producers**

Producers uniformly supported the comments submitted on their behalf by the RSTF and provided additional comments regarding the NYMEX "roll", sulfur differentials, and allowable costs. They also suggested that MMS provide an index option for valuing arm's-length sales downstream of the lease and suggested that lessees who sell production away from the lease have the option of valuing production based on gross proceeds or the index methodology.

**7. Public Interest Group**

The one public interest group that commented opposes the proposed changes to the ***oil*** valuation rule and is concerned that the implementation of a new software system within the MMS is affecting the ability of the MMS to gauge the effects of the 2000 ***oil*** rule.

**C. Final Rule**

As of the due date for this paper, MMS had not yet published a final rulemaking. As such, Section IV can only provide a summary of the comments received on the August 20, 2003, proposed rulemaking. If MMS publishes the final rule before February 11, 2003, I will provide a summary during my oral presentation at the Special Institute.

Federal ***Oil*** Valuation: Where Are We Now?

Presented to the Rocky Mountain Mineral Law Foundation

Special Institute

February 11, 2004

Outline of Presentation

&bull; Life After June 2000

- Judicial Challenge

- Requests for Value Determinations

- Future Valuation Agreements

- What We Learned from RIK

&bull; The Year 2003 - Did We Get It Right?

&bull; August 20, 2003 Proposed Rulemaking

&bull; 2004 Final Rule?

Judicial Challenge

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- Downstream indices

- Transportation allowances

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- Plaintiffs asked Court to hold the case in abeyance until the rule is completed.

- November 21, 2003, the Court dismissed these cases w/o prejudice to reinstate and reactivate.

- December 4, 2003, California State Controller filed motion to reinstate the cases for the purpose of permitting his intervention under Rule 24 of the Federal Rules of Civil Procedure.

Value Determinations

- June 2000 final rule provides for a binding value determination.

- A value determination signed by the Assistant Secretary, Land and Minerals Management, is binding on both the lessee and MMS until the Assistant Secretary modifies or rescinds it.

- In contrast, a value determination issued by MMS is binding on MMS and Delegated States unless the MMS or the Assistant Secretary modifies or rescinds it.

&bull; MMS has not received a large number of requests for value determinations under the June 2000 Federal ***oil*** valuation rule. Examples of types of requests include:

- Tendering program in the Rocky Mountain Region (2)

- Approval of gravity and sulfur adjustments for ***oil*** sold non-arm's length

- Determination of whether the relationship with a pipeline is at arm's length

- Guidance on quality bank adjustments

Future Valuation Agreements

&bull; The June 2000 final rule allows for a written agreement between a lessee and the MMS Director to establish a valuation method for any lease.

&bull; The value under the agreement must at least approximate the value otherwise established under the regulations.

&bull; The written agreement will govern to the extent of any inconsistency with the regulations.

&bull; Evaluating future valuation agreement requests provides MMS and the States involved a better understanding of the marketing practices of these lessees.

&bull; Agreements generally require an annual "true-up" mechanism to compare the value under the agreement with the value as calculated under the rule.

What We Learned From Taking ***Oil*** in Kind

&bull; **Pricing Methodologies (Gulf of Mexico):**

- The majority of the Gulf crude ***oil*** bought and sold is based on a Koch Posting basis adjusted for the "P&plusmn;" factor.

- Another methodology, though less widely used, is the "Calendar Month NYMEX" methodology (with and without the "roll" factor).

- Purchases/sales based on Platts market center assessments are relatively rare in comparison.

- Long-term pricing data for Gulf crude indicate that both the Koch P&plusmn; and Calendar Month NYMEX methodologies maximize returns relative to other potential pricing methodologies.

&bull; Pricing Methodologies (Wyoming):

- Wide variety of pricing mechanisms, focusing on baskets of local postings, Canadian spot prices, and NYMEX-based differentials.

- Use of the Guernsey, Wyoming spot price is sporadic.

&bull; **Transportation:**

&bull; Majority of offshore crude ***oil*** properties do not have transportation options.

&bull; Movement of crude ***oil*** is typically contracted either directly or indirectly (through exchanges) based on tariff rates.

&bull; Significant discounts to tariffs occur when producers do have pipeline options either from multiple physical lines or from competition among multiple owners in single lines.

&bull; Rates can vary significantly as a result of individual negotiations for buy/sell exchanges on proprietary lines.

&bull; Other components of transportation:

&bull; Quality bank administration fees, line fill, and line losses are costs that are incurred to transport crude ***oil***.

The Year 2003 - Did We Get It Right?

- In February 2003, MMS announced that it would hold four public workshops to discuss specific issues regarding the existing Federal ***oil*** valuation regulations.

- At the same time, MMS reopened the public comment period on the January 2000 proposed Indian ***oil*** valuation rule for 60 days.

Spring 2003 Workshops

&bull; MMS sought public comment and recommendations on the following specific issues:

- The timing and application of published indices

- The calculation of location and quality differentials where lessees do not have that information

- Allowable and non-allowable transportation costs

- The rate of return allowed for calculating actual costs under non-arm's-length transportation agreements

- How lessees value and report crude ***oil*** disposed of under joint operating agreements

Proposed Rulemaking

&bull; On August 20, 2003, MMS published a proposed rule for public comment

- Would amend the June 2000 rule primarily in the areas of which published prices are most appropriate to value crude ***oil*** not sold at arm's length and what transportation deductions should be allowed.

- Proposed amendments do not alter the basic structure or underlying principles of the June 2000 rule.

- Side-by-side comparison of the June 2000 rule and the August 20, 2003, proposed rule contained in technical paper.

Final Rule in 2004?

&bull; 27 commenters submitted 28 separate submissions for a total of 389 pages of comments. Those submitting comments included:

- 5 States

- 2 industry Trade Associations

- 2 Industry Publications

- 1 Individual

- 10 Congressional Submissions

- 4 Producers

- 1 Public Interest Group

States Comments

- States in general believe that changes should be limited to the use of NYMEX pricing.

- MMS should retain ANS pricing for Alaska and California.

- Differentials should only be allowed if they are reasonable and actually incurred.

- Oppose use of spot prices from Hardisty, Alberta, Canada for Rocky Mountain Region.

- Non-arm's-length royalties should be determined by downstream sales price rather than benchmarks.

- Rate of return should not change.

Industry Trade Association Comments

&bull; Generally supportive of the proposed rule.

&bull; Not opposed to retaining ANS spot pricing in Alaska and California and supports move to NYMEX for other states.

&bull; Suggests that lessees be allowed to use WTI differentials in lieu of calculating their own location and quality differentials.

&bull; Rate of return should be between 1.6 and 1.8 times the BBB bond rate.

Industry Publication Comments

- Generally supportive of a move to NYMEX pricing.

- Platts notes a three day timing issue with NYMEX and that the NYMEX plus differential may not be universally accurate.

- Argus believes restricting companies ability to change from one approved publication to another is fundamentally anticompetitive and suggests companies be allowed to change publications every 90 days.

- Platts and Argus suggest that their publications be considered if MMS decides to utilize prices from Hardisty, Alberta, Canada.

Individual, Congressional, and Producer Comments

- An individual asked for an explanation of how the new rule modifies the existing regulations.

- Congressional comments contained requests for information and submitted comments on behalf of States.

- Producers comments included:

&bull; Supported trade association comments

&bull; Provided comments on the "roll", sulfur differentials and allowable costs.

&bull; Suggested the MMS provide an index option for valuing arm's-length sales downstream of the lease

Final Rule?

&bull; After consideration of all of the comments, MMS has drafted a final rule which is currently in the approval process.

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**End of Document**

1. 1.The views expressed in this paper are my own personal views and not necessarily those of the Minerals Management Service. [↑](#footnote-ref-2)
2. 2.Insights and observations regarding the implications of MMS's Royalty-In-Kind (RIK) pilot programs for royalty in value regulations were provided by Greg Smith, Deputy Program Director, Royalty-In-Kind. [↑](#footnote-ref-3)
3. 3.Platt's 2001 Crude ***Oil*** Specifications Guide - Asia-Pacific, Europe, Africa, Americas [↑](#footnote-ref-4)