Notes--meeting on MMS's proposed oil royalty valuation rule

Meeting held Thursday, July 9, 1998, at Senate Russell Building. Participants at table included:

Diemer True, True Oil Co.
Claire Farley, Texaco North American Production
Thomas P. White, Vision Resources, Inc.
Victor G. Beghini, Marathon Oil Co.
Jack E. Little, Shell Oil Co.
Robert L. Keiser, Oryx Energy Co.
J. Larry Nichols, Devon Energy Co.
Cynthia Quarterman, Director, MMS
Bob Armstrong, Assistant Secretary for Land and Minerals Management
Senator Breaux (Louisiana)
Senator Domenici (New Mexico)
Senator Landrieu (Louisiana)
Senator Bingaman (New Mexico)
Senator Nickles (Oklahoma)

Senator Breaux convened the meeting at 2:05 p.m. He stated that his purpose in holding the meeting was to bring together those concerned by the disputes and controversy over MMS's proposed oil royalty valuation regulations. He and Senator Hutchison as Chair and Co-Chair of the Congressional Oil and Gas Caucus wanted to start a dialogue between industry and the Administration concerning the regulations by bringing the principals together. He noted that Senator Hutchison of Texas wanted to participate also, but was unable to. Senator Breaux noted that he wanted honest, frank talks and that note takers were present to record the proceedings. His goal was to resolve disputes; he believed there is a lot of common ground among the participants.

Senator Breaux then turned to Senator Domenici for additional opening remarks.

Senator Domenici stated that there is at least an inference that Congress should have input into the final rule, given the adversarial positions of industry and the Interior Department. He indicated the disputes must be resolved reasonably, or the current moratorium on the Department publishing a final rule may be extended. He expects Department staff to work in good faith toward a reasonable rule. He wants the process to move along to the point where industry CEO's can say that the Department is not being arbitrary, or that he believes industry itself is being arbitrary. He believed there is a long way to go to achieve this goal.

Senator Domenici emphasized that while some would say he and others are only concerned for the oil companies, that is not so. He is concerned with the needs of the public, including schoolchildren and others, but needs assurance of the rule's reasonableness. He added that Senator Hutchison was pleased he could participate in this meeting.

Senator Breaux then turned to Assistant Secretary Armstrong for a statement.

Mr. Armstrong thanked the senators for the opportunity to explain the oil valuation rule and said it was good to be able to address industry executives directly. He said that the value of Federal oil production needs to reflect fair market value, that the Department has a good proposed rule, and is anxious to finalize it. He stressed that he believed the Department has been responsible and methodical in developing the rule.

Mr. Armstrong summarized the proposed rule as saying that if a lessee sold its production arm's length, its gross proceeds under that sale would represent royalty value. If production were not sold at arm's length, royalty value generally would be an index price adjusted as appropriate by location, quality, and transportation factors. He stressed that the Department got valuable input from industry during the rulemaking effort and that he too wanted frank, open discussions now.

Mr. Armstrong said the Department's goal is to publish a final rule by October 1, 1998. He stressed that this issue is a growing concern for the President and the Secretary and that it is not beneficial to the public to drag it out. He once again thanked Senator Breaux for the meeting and said he didn't believe the interested parties were too far apart.

Senator Breaux then indicated that major industry concerns included unfairly low permissible transportation costs, problems valuing some oil actually sold at arm's length, and problems valuing production sold by affiliates. He also wanted any other concerns brought forward.

Jack Little thanked the senators for the opportunity to share industry's concerns. He indicated that while there is ongoing litigation regarding oil royalty valuation, he suggested the group look only to prospective valuation. As for transportation costs for royalty purposes, he believed they should be market-related. He didn't believe the Department's proposed rule provides for fair deductions based on market rates.

Senator Breaux asked why Mr.Little believed the deductions weren't fair. Mr. Little responded that the rule would start with a spot index price and require adjustments. While he said he was in general agreement with spot prices, taking the price appropriately back to the production source was very difficult. He also believed that existing pipeline tariffs in the Gulf of Mexico should be used for transportation deductions.

Senator Breaux interjected that the Federal Energy Regulatory Commission (FERC) said that they don't have jurisdiction over these tariffs.

Mr. Little responded by summarizing the transportation costs the Department permits now, and would continue to permit under the proposed rule. He said the reasonable actual permitted costs for affiliated pipeline operations include depreciation, operating and maintenance costs, and a return on remaining undepreciated capital based on a Moody's rate. He said that when the

pipeline is fully depreciated, this mechanism ignores the true value of the investment. Further, a partner may use the same pipeline and claim the tariff rate as a deduction, which he said results in different, unfair values for different producers.

Mr. Little said as projects in the Gulf of Mexico move into deeper and deeper waters, structures will become uneconomic. The proposed rule would contribute to this by eliminating gathering deductions from the wellhead to a central accumulation point. He gave an example where, under the proposed rule, a 65-mile pipeline would be termed gathering, and not transportation.

MMS Director Cynthia Quarterman said the existing oil valuation rule would give the same result that Mr. Little described. She said MMS could look at individual situations for possible exceptions where long gathering lines are involved.

Mr. Little disagreed with the existing regulations as well. He said this issue will become a bigger problem over time as more and more projects involving long feeder lines come on line.

Senator Breaux asked if others had transportation comments. Robert Keiser said his company is in the same situation; more subsea completions are being made with long pipelines to a platform that may be considered gathering lines ineligible for a transportation allowance.

Senator Landrieu asked whether it is possible to use arm's-length contract rates whereby the transportation charges for each partner would be the same based on comparable service rates.

Mr. Little suggested a four-step process to lessen the transportation problem. First, allow use of tariffs. If no tariffs exist or apply, permit use of a tendering program--this would establish a fair market price at the lease and eliminate transportation considerations. If tendering doesn't apply, use comparable terms/rates used by everyone locally. If none of these approaches applies, look in the expanded geographical area for rates to apply.

Ms. Quarterman then offered that this meeting provided a good opportunity to discuss such issues and to make progress. She then explained that under the current valuation rules, lessees can deduct their reasonable, actual costs of transportation. She said this wouldn't change under the proposed rule. She said the real issue is that the current rule allows requests for exceptions to use FERC tariffs in lieu of actual costs. But, she said, FERC disclaimed jurisdiction several years ago over offshore oil tariffs. She said such tariffs are on file but that FERC did no review of them. Ms. Quarterman said the Department must revert to exclusive use of actual costs since FERC does not have jurisdiction. She said tariffs do not reflect actual costs.

Senator Breaux asked what the proposed rule would permit for a transportation cost allowance. Mr. Little interjected that internally, his company pays the tariff rate. Ms. Quarterman added that where affiliated pipelines are involved, actual costs are and would be permitted.

Mr. Little then said that his company takes lots of risk in a pipeline venture. He added that other companies are usually involved in moving production over his company's pipeline, yet they can claim the FERC tariff as their royalty deduction. He said that in such situations his company takes all the risk but is penalized by being forced to take a lower deduction.

Mr. Beghini concurred with Mr. Little. He said that offshore, pipelines are being built with large capacities at high risk. Tariffs are set at rates attractive for others' investment profiles. He said it is not fair for one partner then to be eligible only for a lower deduction. Ms. Quarterman added that all parties are treated equally by being permitted to claim their actual costs incurred. Mr. Beghini said he didn't see why other producers should incur different charges from an investment standpoint. At this point Mr. Little reiterated his earlier transportation costs alternative beginning with permission to use tariffs, with tendering programs in the alternative--where the buyer provides transportation.

Ms. Farley then gave a general description of Texaco's tendering program. They take a percentage of production from a field or area and put it up for competitive bid, take the highest bid received, and use that bid to establish a price at the lease to use for reporting royalties on production transferred to affiliates. At least 12 ½ percent of the volume from the field or area is tendered and sold unless Texaco can't get a market price. If Texaco's affiliate offers a higher price for tendered volumes, that price is used for royalty reporting. She stressed there is an active, competitive market for tendered crude.

Ms. Quarterman asked how MMS could be certain that the tendered volumes are sufficient to guarantee that market value is received. Ms. Farley said that volume considerations were really secondary and that Texaco's goal is always to get the highest price it can. The biggest value to the company is in getting the highest price available. Ms. Quarterman then asked whether there were competitive markets in the areas where tendering is taking place, before such programs began. Ms. Farley said yes. She added that Texaco uses letters of credit to assure that those bidding on tendered volumes are creditworthy buyers and that Texaco wants transparency of pricing.

Senator Domenici then asked where tendering would be allowed as a valuation method in MMS's proposed regulations. Ms. Quarterman said it would be used in the Rocky Mountain Region because of the lack of other valid procedures there--there are no reliable spot prices or other acceptable methods. She pointed out that relatively small volumes are involved in the Rocky Mountains. She also stated that MMS's goal is to determine fair value based on markets that exist and not through tendering-created artificial markets because of the regulatory process.

Senator Domenici said it was clear that the benchmarking issue for production not sold at arm's length was key. He suggested the meeting proceed on to other issues. Senator Breaux agreed and added that he thought the dialogue on this and other issues may just be beginning.

Senator Nickles then asked if this was the first meeting the Department had with industry on these issues since the hearing that he held. He said these issues had been around a long time and wondered why more effort had not been expended to resolve them. He was disappointed that more hasn't been done to resolve these conflicts. Mr. Armstrong said that this was the first meeting directly with industry. But he added that the Department had held 14 public workshops including industry participation. He said the rule is in final preparation now and that the Department wants to go forward with it.

Senator Nickles said he wants a rule that gives him confidence and won't be litigated. He said that then maybe Congress would let the rule go forward. Mr. Armstrong said that's what the Department wants also.

The discussion then turned to the fact that MMS would permit lessees to use their gross proceeds to value crude oil sold at arm's length. Mr. Nichols said the rule indeed would allow use of arm's length proceeds, but that a long list of exceptions applied. He cited the duty to market issue as an example. He said that companies may sell oil at the lease and use the arm's-length sale price as royalty value, but MMS could later say the lessee could have marketed the oil differently and gotten a better price. Mr. Nichols said that the proposed rule was neither certain nor fair.

Ms. Quarterman said there would be no change on acceptance of arm's length gross proceeds under the proposed rule and that companies such as Devon Energy should not be impacted. She stressed that the lessee has an obligation to market to the mutual benefit of the lessor at no cost -- that's historical fact and precedent. Various Interior Board of Land Appeals decisions have affirmed this concept. She stressed that this concept hasn't changed from the existing rule.

Mr. Nichols agreed with the basic concept of duty to market, but said the difference now is that the Department would require marketing at some distance from the lease. He said that MMS could use this concept to later say the lessee had not marketed properly. Ms. Quarterman responded that MMS would not second-guess the lessee and will so state in the proposed rule's preamble. Senator Breaux asked how MMS would do this, and Ms. Quarterman responded that MMS could specify conditions where marketing at the lease won't trigger MMS actions. She believed the real question, however, is whether there are marketing costs embedded in what the lessee otherwise would consider transportation.

Senator Landrieu said industry wants assurance MMS won't "second-guess" their marketing actions later. Senator Breaux and Mr. Nichols suggested that MMS put such an assurance directly in the rule as opposed to the preamble. Senator Bingamon asked whether industry was requesting a marketing cost deduction, and Mr. Nichols said they were not.

At this point Mr. White, as a marketer in the Gulf of Mexico with an affiliated producer, laid out his company's goals: (1) to assure that the revenue stream is maximized, and (2) buy oil at arm's length wherever possible at or near the lease. He can continue to sell production at or near the lease, but can also move oil to various different locations and sell it there. He would like to pay

MMS on what is received, but MMS needs to recognize the different types of business and transactions involved when oil is moved distant from the lease. Greater values can be received in such transactions, but at great risk. And he doesn't believe the producer should have to bear this risk alone. He stated that he has participated in several of MMS's workshops, but is frustrated--MMS seems to hear his concerns but doesn't act on them. He said that if the proposed rule is finalized as-is, he will recommend changing his company's business practices.

Senator Breaux asked Mr. White if he believed he has a duty to market. Mr. White replied that he did, but that the associated risks need to be recognized. He said that as the rule is written, MMS gets a "free ride."

Ms. Quarterman said that the "free ride" concept was true to the extent that the Federal share of production gets marketed with the lessee's. She stated that industry also wants an additional deduction for marketing, and she didn't think, given legal precedent, MMS should or could do this.

Mr. Nichols disagreed with MMS's characterization of duty to market. Mr. Beghini added that marketing has changed over time and that duty to market historically was defined as Ms. Quarterman described, but should now be defined differently. He believed this duty should not go beyond the lease boundary. Further, it is different from the merchantable condition concept. He believed the proposed rule doesn't put the lessee and MMS on a level playing field.

Senator Domenici then addressed Mr. Armstrong, referencing the fact that Mr. Armstrong wanted to go forward with the proposed rule by October 1, 1998. Senator Domenici asked how this could occur without an organized process to look at suggested changes and work through them. He believed that MMS should first characterize the issues and possible changes, that industry should submit alternatives in response, that MMS should address the industry proposals, and follow-on meetings should occur. Senator Domenici added that he is prepared, in the alternative, to convince the Department that they are on the wrong track. Mr. Armstrong agreed that the Department would like to proceed in a logical way.

Senator Breaux noted that up to this point only transportation and duty to market had been discussed. He asked what additional concerns there were. At this point Senator Landrieu added that she believed it is in everyone's best interest to reach agreements. She said MMS comes across as not believing industry wants to get the highest price for its product. She said MMS should not distrust this concept.

Mr. Nichols added that there were other issues involving arm's-length contracts and noncompetitive calls. He was concerned that, regarding calls, MMS would substitute its own judgement for that of the lessee. He said the lessee sells for the highest price it can, yet if a call is involved, MMS still would not allow that price as royalty value.

Deborah Gibbs Tschudy of MMS said that company representatives at MMS's hearings said that

noncompetitive call situations were very rare. Mr. Nichols replied that rare doesn't mean fair. Ms. Gibbs Tschudy added that noncompetitive calls are not arm's-length transactions. Mr. Nichols agreed, but noted that if such a transaction is the best deal a lessee can get, and represents small volumes, MMS shouldn't worry. He said that while MMS says it honors arm's- length sales, its actions concerning calls, duty to market, and the affiliate definition don't support that concept. Ms. Quarterman pointed out that MMS intended to change the affiliate definition in the proposed rule to mirror its meaning in the existing rule.

Senator Breaux suggested the participants look at the issues covered during the meeting and meet again to see how they can be addressed. He added that he is tired of hearing how "big oil" is driving the process. He noted that prohibition, vetos, and overrides could continue until/unless some agreements are reached, so it's in everyone's best interests to reach agreements. He thought the Department should prepare a summary of the rule, its status, and related issues. Then more meetings would be in order.

Mr. True then said that the proposed rule doesn't allow benchmarking of non-arm's-length values in the field and that indexing would create a blizzard of paperwork. Ms. Quarterman responded that in Wyoming, where Mr. True operates, the proposed rule would provide benchmarking. Mr. Beghini added that basically, indexing would apply in Wyoming. At this point Ms. Gibbs Tschudy corrected Mr. Beghini, noting that in the Rocky Mountains, if the lessee or an affiliate sells production at arm's length, royalty is the sale price less transportation. If production isn't sold at arm's length, then the first applicable benchmark would apply--first tendering, then a weighted average of sales and purchase prices, then an index value, and finally application to MMS for a different basis.

Mr. True added that by looking to the marketing affiliate's transactions, MMS gets a free ride--industry has inventory costs, additional risks, etc. Ms. Gibbs Tschudy asked whether True Oil is now paying on the price its affiliate pays to True. Mr. True responded affirmatively, but said the new rule would change this. He suggested adding a benchmark for sales affiliates who resell their oil. Ms. Quarterman noted that under both the existing and new rule, True Oil should pay royalties based on its affiliate's arm's-length sale of the oil.

Mr. White noted that, for the Rocky Mountain Region, there is a series of benchmarks for non-arm's-length transactions. He suggested that if MMS is unbending on marketing deductions beyond the lease, lessees outside the Rocky Mountains should have the same opportunities--such as tendering, etc.--as the Rocky Mountain benchmarks provide. Otherwise, he believed MMS is not treating lessees fairly.

Senator Breaux then asked why the Rocky Mountains are treated differently under the proposed rule. Ms. Quarterman responded that there is not a good index price to use there, as there is elsewhere. At this point Mr. White said again that MMS is unwilling to share in additional costs. Ms. Quarterman said that MMS would share in transportation away from the lease, but not marketing costs. She added that there is precedent for this concept in a Marathon case involving

natural gas produced in Alaska and sold in Japan. Mr. Beghini responded that he didn't think a natural gas case was necessarily applicable here. He also asked if MMS charged an administrative fee, representing the costs of marketing, for oil it takes in kind and sells to small refiners. Ms. Quarterman said yes--ten cents per barrel for paperwork.

Senator Breaux noted that the participants wouldn't solve all the problems today, nor was that intended. Rather, he intended a clear, relaxed situation to lay out the issues. After listening to the discussions, he believed the Department already had some changes in its proposed rule. He wanted to know what the timeframe for further Departmental action on the rule would be. Mr. Peter Shaumberg of the Department's Solicitor's Office indicated that there could be Administrative Procedure Act problems if additional meetings went beyond the extended comment period (July 9-24).

At this point another issue in the proposed rule arose--that of non-binding guidance by MMS. Mr. Beghini noted that all involved should remember that the rules will be interpreted by people other than those participating in this meeting. Thus exceptions and uncertainties should be limited. He added that he hoped there are more meetings to come to conclusions on the big issues. Senator Breaux concurred.

As a result of this meeting, Mr. Beghini believed MMS had already made some changes to the proposed rule of which he was unaware. He stated strongly that he believed the lessee's duty to market should die at the lease. He said it would be difficult to move forward if participants can't agree on this concept.

Ms. Quarterman added that she doesn't think industry and the Department will ever agree on some issues, and that duty to market may be an example.

Senator Breaux added that maybe Congress can address some of these issues. He then asked if Mr. Armstrong could provide a summary of the existing proposal and issues as background for further meetings.

Ms. Quarterman noted that MMS has "marching orders" to publish the rule by October 1, 1998, that hold any further actions within the open comment period. Senator Breaux then asked if the Department could get him the requested background materials by early in the week of July 13. Mr. Beghini and others indicated they were willing to return for another meeting that week.

Ms. Quarterman noted that MMS could provide a list of issues and how it intends to address each of them in the rule. Senator Breaux indicated that was acceptable. He noted once again that the rule could become a big negative political issue if the problems aren't resolved now and because of that it is probably not wise to continue to extend the rider.

Mr. Armstrong added that he believes the U.S. oil industry generally operates in a very favorable

climate. The Department is only trying to set proper values, and posted prices weren't accomplishing that. He added that participants may not reach complete consensus, and Congress or the courts may have to settle some issues.

Mr. Beghini acknowledged that nobody uses posted prices and that they are only the starting point for negotiations in today's oil markets. But he reemphasized that anyone who thinks industry doesn't sell production at the highest possible price is wrong.

Senator Breaux set a target to meet again on the morning of Friday, July 17. He expects the Department to provide information on the latest version of the proposed rule before then, to which Ms. Quarterman agreed. During the next meeting he expects that industry and the Department will narrow their differences.

Senator Breaux noted that the meeting was very helpful, but at the same time nothing was yet resolved. The meeting was adjourned at 4:00 p.m.