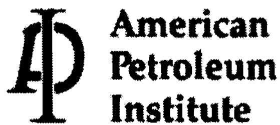

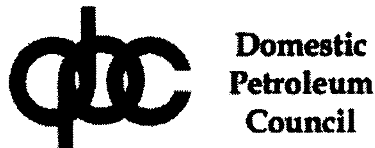

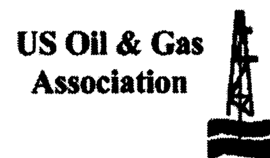

September 21, 2004

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Denver, Colorado 80225

Minerals Management Service Federal Gas Valuation Proposal,
30 CFR Parts 206, 69 FR 43944 (July 23, 2004)

Dear Ms. Gebhardt:

On behalf of a broad spectrum of natural gas , a coalition of diverse producers and their trade associations, the American Petroleum Institute, the Independent Petroleum Association of America, the Domestic Petroleum Council and the U.S. Oil and Gas Association, we welcome the opportunity to file these comments on the Minerals Management Service (MMS) July 23, 2004, federal gas valuation proposal ("Gas Proposal"). Together, our members account for virtually all of the royalties paid for gas production from Federal lands, both onshore and offshore.
Our comments augment the discussions held at the MMS pre-proposal workshops held March 4-6, 2003, and materials submitted by Industry thereafter. Overall, our comments are directed at a revised gas valuation rule that promotes clarity and reasonable certainty, eliminates unnecessary administrative costs for all stakeholders and decreases appeals and litigation with minimal impacts on royalty revenues. We recognize that the 2004 Gas Proposal largely conforms the gas valuation regulations of 30 CFR Part 206, Subpart D, to the oil valuation regulations at 30 CFR Part 206, Subpart C, recently amended at 69 FR 29432 (May 5, 2004) ("2004 Oil Rule). Our comments today address all of these matters, and three other important items not addressed in the Gas Proposal.

Matters Addressed in the Gas Proposal

1. Purpose and Scope

The Gas Proposal would amend § 206.150 to more clearly address situations where the MMS Director and the lessee have reached a written agreement for a production valuation

method. Gas Proposal at 3945, 43954. This change would conform the gas valuation regulations to a portion of the 2000 Oil Rule unchanged by the 2004 Oil Rule. Industry supports this conforming change.

2. Definitions

Under § 206.151 the Gas Proposal would add or amend several definitions. Gas Proposal at 43945-46, 43954.

First, the Gas Proposal would add a definition of "affiliate." While Industry supports the inclusion of this definition, Industry urges the MMS to clarify the meaning of "opposing economic interests as the term is used in another closely-related definition, namely, "arm's length contract." Industry believes that in most cases parties on opposite sides of a transaction have "opposing economic interests," even in many cases where one of the parties has a significant ownership interest in the other. Industry's experience, however, suggests that MMS' view is that "opposing economic interests" are not always present even where a parties' ownership interest in another party on the opposite side of a transaction is small and well short of the 50% control threshold identified in the definition of "affiliate."

In addition, under the current gas valuation rules, affiliate resale proceeds (instead of benchmarks) apply only where an affiliate is a "marketing affiliate," an affiliate wholly owned by the lessee for the exclusive purpose of marketing lessee production. Yet even where an affiliate falls well outside of the definition of "marketing affiliate," the MMS has ignored that definition for the purpose of using affiliate resales as the basis for valuation. *See* discussion of Fina below at 7. Accordingly, to promote reasonable certainty in application of its valuation regulations, Industry urges the MMS to adopt for transportation and processing affiliates a presumption of opposing economic interest where lessee ownership falls short of the 50 percent threshold prescribed by the definition of affiliate.

Second, the Gas Proposal would revise the definition of "transportation allowance" to conform to the 2004 Oil Rule, explaining that the change would correct an "inadvertent clerical mistake" in the 1996 Gas Rule. While Industry concurs that there is no material difference in the 1988 definition of "transportation allowance" and the current definition of "transportation allowance" adopted in 1996, *see* 30 CFR § 206.151, some industry members indicate that they have relied on the regulation as currently written and we recommend that any re-adoption of the former definition be prospective only.

Third, the Gas Proposal would amend the definition of "arm's length contract" to conform to the MMS' revised oil valuation regulations.

Fourth, without any intention to change the meaning of the term "processing allowance," the 2004 Gas Proposal would amend the definition of "processing costs" by adding the term "actual." *See* discussion of processing costs below at 3.

With the two clarifying suggestions noted above, Industry supports the proposed, mostly conforming changes.

3. Determination of Transportation Costs: Rate of Return

The Gas Proposal would amend §206.157(b)(2)(v) to conform the allowable rate of return for calculation of non-arm's length transportation allowance to the 2004 Oil rule, namely, by increasing the BBB bond rate multiplier from 1.0 to 1.3. Gas Proposal at 43946-47. However, the Gas Proposal does not contemplate like changes for non-arm's length processing allowances, but does invite comments on that issue to obtain "sufficient information and data." Gas Proposal at 43947, 43955.

As to *transportation*, Industry supports these conforming changes with the caveat that the 1.3 BBB multiplier adopted in the 2004 Oil Rule is substantially less than the minimum 1.6-1.7 BBB multiplier endorsed by Industry in the rulemaking leading up to the 2004 Oil Rule. As a result, while better than the existing 1.0 BBB multiplier, 1.3 BBB still understates the cost of capital for gas pipelines.

As to *processing*, we are puzzled why the rationale for increasing the multiplier for the transportation-related cost of capital does not apply equally to gas processing. In its Gas Proposal the MMS explains that its prior oil transportation decision and proposed gas transportation decision rest on an MMS study which did not extend to processing plant costs but welcomes such data. Gas Proposal at 43947.

As explained during the rulemaking leading to the 2004 Oil Rule, the cost of capital to an oil and gas company is the same, irrespective of its use. Uncommitted budget dollars are not earmarked for particular projects and have a fungible character because of their competition with other company projects. Accordingly, the absence of specific gas processing plant data from the MMS study (and the API study) should not matter, especially when the 1.3 BBB multiplier for oil transportation pipelines being used as the datum is itself so conservative and understating of capital cost. While Industry does not subscribe to the relative risk rationale employed by the MMS in the recent oil valuation rulemaking[1] or the present gas valuation rulemaking, if Upstream pipeline projects are less risky than other projects, as MMS suggests, it would seem to follow that a Downstream gas processing plant is more risky and deserving of at least the same BBB multiplier as Upstream pipeline projects. The MMS cannot fairly cite a perceived low risk to support a demonstrably low BBB multiplier for pipelines then withhold altogether that multiplier for Downstream facilities that by MMS' own logic are riskier enterprises and should generate a higher cost of capital.

In sum, between its own study and API's study developed during the 2003-204 oil rulemaking, the MMS already has "sufficient information and data" to support application of the 1.3 BBB multiplier to gas processing facilities.

4. Determination of Transportation Costs: FERC or State-Approved Tariffs.

The Gas Proposal would amend § 206.157(b)(5) to simplify how approved tariffs might be employed in special cases in lieu of calculating actual costs for non-arm's length transportation situations, even where there is a short period where no comparable arm's length

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[1] *See* RSTF comments on 2003 Oil Proposal, November 10, 2003, at 6-8, citing several examples of oil pipelines whose commercial success fell far short of the company's expectations for various economic reasons) (Attachment **A**).

transactions exist. Gas Proposal at 43947, 43955. The MMS plainly recognizes that FERC or state-approved gas pipeline tariffs are a sound measure of transportation costs and Industry strongly endorses an improved exception to the actual costs calculation requirement. However, Industry recommends five further changes to the Gas Proposal to make the exception workable.

First, the MMS should clarify – or eliminate altogether – the new § 206.157(b)(5)(i)(A) requirement that the tariff sought to be used has been "either adjudicated or specifically analyzed." However neither term is sufficiently defined to guide Industry in their use. The current regulations provide only that the tariff be "approved" and the MMS offers no evidence that this has generated abuse by lessees. Indeed, under the Natural Gas Act FERC-regulated interstate pipelines rates must be just be "just and reasonable." Similarly, the Natural Gas Policy Act requires state-regulated intrastate pipelines that deliver gas into interstate pipelines can only charge rates that are "fair and equitable." Accordingly, the MMS can streamline the exception process by expressing its confidence in government pipeline regulators without surrendering any audit ability.

Second, the MMS should relax the § 206.157(b)(5)(ii)(A) requirement that the lessee compute monthly the volume-weighted average of third party rates under the tariff paid during the production month. This requirement is very burdensome and all but vitiates the exception option because antitrust concerns, curtail a lessee's ability to obtain third party price information.

Third, the MMS should extend the two-month period prescribed under § 206.157 (b)(5)(iii) to at least three, or preferably six, months to avert the need for too frequent switching back and forth between calculation of actual costs and reliance on third party tariff rates.

Fourth, the § 206.157 (b)(5)(i) requirement, that MMS "grant" an exception sought by a lessee before it can be used, should be eliminated in favor of a rebuttable presumption that the tariff can be used once the lessee has applied for use of the tariff.

Fifth, to avoid windfalls, the MMS should modify § 206.157 (b)(5) to provide that a lessee cannot use a FERC or state-approved tariff if the actual contract rate is less.

Taken together, these revisions would make the MMS-proposed exception process practicable, by recognizing antitrust constraints on acquiring third party pricing information and eliminating unnecessary administrative costs for both Industry and the MMS, while preserving for the MMS undiluted audit ability.

5. Reporting and Accounting Matters

The Gas Proposal would amend § 206.157(c) to eliminate the requirement that the lessee report its transportation allowance using a separate line entry and conform it with the oil regulations at §§ 206.114 and 206.115 Gas Proposal at 43947-48, 43955. Industry supports this simple conforming change.

In addition, our comments support the comments of the Council of Petroleum Accountants Societies (COPAS) on the MMS Gas Proposal submitted September 7, 2004, which include several recommendations directed at a variety of accounting matters.

6. Grandfathering of Pre-1988 Allowances

The Gas Proposal would add new paragraphs § 260.157(c)(1)(iii) and (c)(2)(v) to address certain lingering questions involving the status of pre-1988 allowances, providing that lessees may not use such allowances prospectively. Gas Proposal at 43948, 43955. Industry offers no opinion on the small handful of cases that may present the retrospective grandfathering issue, but supports this change prospectively.

7. Allowable Transportation Costs: General

The Gas Proposal would conform § 206.157(f)(1) to the D.C. Circuit's decision in IPAA v. DeWitt, 279 F. 3d 1036 (D.C. Cir. 2002), by recognizing that unused firm demand charges are deductible transportation costs, subject to reduction if the lessee sells unused firm capacity. Gas Proposal at 43948-49, 43955. The Gas Proposal would also amend § 206.157(f)(7) to allow actual line losses, but still disallow theoretical line losses (unless based on a FERC or State-approved tariff that includes a payment for theoretical line losses). Gas Proposal at 43949, 43955. The Gas Proposal would also amend § 206.157(f)(7) to true up the gas valuation regulations with the 2004 Oil Rule, but expressly requests input on whether other costs should be listed as allowable. Gas Proposal at 43949-50, 43955. Industry supports these conforming changes.

Industry also suggests that two additional cost items be identified as allowable transportation costs:

First, § 206.157(f)(1) should be amended to include "line pack," the gas pipeline equivalent of oil pipeline "line fill," now listed in the oil valuation regulations as an allowable transportation cost item. *See* 30 CFR § 206.110(b)(4); 69 FR 24959, 24977 (May 5, 2004).

Second, § 206.157(f)(1) should be amended to abandon the reduction in transportation costs attributable to excess CO_2; where it is necessary to transport CO_2 entrained in the main gas stream before disposal as a waste product that incremental cost is a transportation cost.

Matters Not Addressed in Gas Proposal

8. Recapitalization

The Gas Proposal does not address another matter deserving of conformity with the current oil valuation regulations, namely, recapitalization and depreciation of gas transportation equipment. As amended in 2000, the oil valuation regulations allow lessees under some circumstances to base the depreciation portion of their "actual costs" of non-arm's-length transportation on the purchase price paid for the transportation system, rather than requiring

them to follow the existing depreciation schedule.[2] The rationale for that amendment to the 2000 Oil Rule applies equally to gas pipelines and Industry urges the MMS to conform the gas valuation regulations to the oil valuation regulations. However, some MMS officials have suggested that this conforming change is not necessary because the gas rule, unlike the oil rule, allows lessees to use FERC and state-approved pipeline tariffs to determine their transportation allowances. Industry disagrees mainly because of the limiting criteria placed on the use of tariffs in the proposed Gas Proposal, addressed above at 3-4, whereby lessees would be required in many situations to determine transportation allowances using their "actual costs" of transportation rather than a tariff. Accordingly, Industry requests that the gas rule be made to conform with the oil rule in respect to the determination of the depreciation cost used in calculating "actual costs" of non-arm's-length transportation.

9. Valuation Standards: Benchmarks or Indexing

Unlike the 2004 Oil Rule, the Gas Proposal does not contemplate shifting from benchmarks to gas spot price indexing for valuation of non-arm's length transactions, at least for now. As the Gas Proposal explains, views on such a shift for gas (as well as treatment of affiliate resales and joint operating agreements) were scattered at the pre-rulemaking workshops that were held in March 2003, and §§206.152 and 206.153 remain unchanged. However, for future consideration the MMS does request comments on two questions:

> a. Whether publicly available spot market prices for natural gas are reliable and representative of market value of natural gas and should be considered by MMS as a means of valuing natural gas production that is not sold at arm's length and, if so,
>
> b. How should these spot market prices be adjusted for location differences between the index pricing point and the lease.

Gas Proposal at 43945.

At the time of the 2003 MMS' pre-rulemaking gas workshops, the flurry of activity over the reporting of gas prices had not yet subsided: FERC and the Commodities Futures Trading Commission (CFTC) still had underway investigations of gas pricing; several individual reporting company civil or criminal investigations or enforcement proceedings were underway; and no clear consensus on gas price reporting had emerged. Now, several months later, and notwithstanding the scatter of views at the March 2003 workshops, Industry believes that the circumstances have changed enough to justify considering the shift from benchmarks to indexing as has already been done for oil.

Reliability of Spot Market Prices. In July 2003, FERC issued its *Policy Statement on Natural Gas and Electric Price Indices*, 104 FERC ¶ 61,121 (2003), which it used to articulate its data reporting expectations and to focus FERC staff monitoring of gas price reporting through technical conferences, surveys and workshops and consideration of myriad submissions by stakeholders. FERC then issued its *Report on Natural Gas and Electricity Indices* (May 5, 2004)(Attachment **B**) to share its findings to date. In addition, FERC and the CFTC have completed their extensive investigations into allegations of gas price manipulation and

[2] *Compare* § 206.111(h) (oil valuation regulations) and § 206.157(b)(2)(iv).

concluded that there is no evidence to substantiate earlier claims. *See Press Release, dated August 30, 2004.* (Attachment **C**)

While the May 2004 FERC Report observes that further improvements in gas price reporting are needed, the Report indicates that the level of reporting has already increased, that the quality of reporting has improved significantly, that index developers have taken significant steps to conform to FERC standards, that the market has been demonstrating a high level of confidence on gas indices, and that confidence in indices continues to grow. FERC Report at 3.

Key natural gas industry commenters agree wholeheartedly. *See, e.g.*, Comments of the Natural Gas Supply Association on the "FERC Staff Report on Natural Gas and Electricity Price Indices (May 5, 2004)," June 14, 2004 (Attachment **D**), which emphasize, among other things, price transparency, high user confidence, and the existence of well-established gas price reporting publications.

While all would agree that further progress can be made in gas price reporting and gas indices, the relevant point here is that significant progress has been made in the last few years with the prospect of even more improvements in the near future. This suggests that now, not years from now, is a good time for MMS to revisit indexing for valuation of natural gas.

Benchmarks v. Indexing. The early promise of the valuation benchmarks has not been realized. While the regulations adopted in 1988 do identify sufficient measures of value, the benchmark regulations' use of judgmental terms like "such other factors as may be appropriate," § 206.152(c)(1), "other information relevant," § 206.152(c)(2), "any other reasonable method," § 206.152(c)(3), has invited MMS second-guessing, thwarted the objective of reasonable certainty and led to more, not less, controversy and litigation. For example, years after the gas valuation benchmarks were adopted, core issues are still being litigated[3] with no prospect of relief especially now that indexing has been adopted for oil valuation but not yet for gas valuation.

As a central part of its rationale in support of indexing, the MMS has continually emphasized that the marketplace had changed appreciably since benchmarks for both oil and gas were adopted in 1988. Indeed, for years the MMS has used changes in the market as the core justification for changes in its 30 CFR Part 260, Subpart D, oil valuation regulations and 30 CFR Part 206, Subpart C, gas valuation regulations.[4] These profound changes justify a reevaluation of gas valuation standards.

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[3] *See, e.g.*, Fina Oil and Chemical Co. v. Norton, 332 F. 3d 672 (D.C. Cir. 2003) (rejecting MMS' use of the gross proceeds rule to avoid its limiting definition of "marketing affiliate" and limit use of benchmarks in order to use affiliate resale prices). *See also, e.g., Tom Brown, Inc.*, 162 IBLA 227 (July 27, 2004) (Interior Board of Land Appeals remands case to MMS for determination of value pursuant to the benchmarks after striking down MMS's initial determination that royalty was owed pursuant to the gross proceeds rule as unlawful).

[4] *See, e.g.*, 2000 Oil Rule, 65 FR 14022 ("significant changes in the domestic market during the 1980's and early 1990's"); 1997 Gas Rule, 62 FR 65753(Dec. 16, 1997)(explaining the myriad changes to gas marketing attendant FERC Orders 436 and 636 as core reason for revising gas transportation rule).

While Industry initially resisted the abandonment of oil valuation benchmarks in favor of the indexing promoted by the MMS and the states, Industry never disputed that changes in the oil and gas markets had occurred. Indeed, for oil valuation, Industry eventually acceded to the shift to indexing in the 2000 Oil Rule and ultimately embraced the adoption of NYMEX future prices in the 2004 Oil Rule. For gas valuation, Industry energetically participated in the negotiated rulemaking the MMS convened in the mid-90's. That protracted process started in 1994 and reached consensus in 1995 on the use of an indexing approach offering great flexibility, fewer disputes, and ample royalty revenue safeguards.[5] The consensus led directly to the commencement of rulemaking in 1995[6] that attracted heavy public commentary and support, only to be abandoned precipitously by the MMS in 1997.[7]

While a few years have passed and elements of the Consensus Report deserve reexamination, Industry urges the MMS to revisit the gas negotiated rulemaking effort and reexamine the consensus report in light of developments since then. The negotiated rulemaking effort represents a huge deposit of intellectual capital, a notable balance of diverse stakeholder interests, and a valuable touchstone for a renewed examination of indexing for gas valuation.

In addition, in its *Five Year Royalty in Kind Business Plan*, the MMS recognizes the efficacy of using a price index for evaluating RIK revenue performance. Similarly, the MMS uses published gas prices to identify an appropriate pipeline index for evaluation of RIK bids.

In sum, based on the profound changes in the gas market, the demonstrable and increasing reliability of gas price reporting, the inadequacy of the present gas valuation benchmarks, and the existence of solid background information, the MMS should take a fresh look at indexing for gas valuation. From the outset it has been apparent that indexing would work well for gas valuation, even better than for oil valuation. With indexing for oil valuation now firmly in place, indexing for gas valuation should be a top priority for MMS rulemaking.

10. Allowable Transportation Costs-Compression

Like indexing for valuation purposes, the deductibility of compression costs issue is an issue where profound changes in the marketplace are relevant. In years past when California v. Udall, 296 F. 2d 384 (D.C. Cir. 1961), was decided it mattered little that compression costs were not regarded as transportation costs. Gas sales, usually arm's length, were at or near the lease, compression served mostly to put the gas into marketable condition for a *wellhead market*, and the use of compression to transport the gas was incidental because of the proximity of the sales point. ("The Secretary is not here claiming that costs incurred in moving gas from the field in

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[5] *See* March 8, 1995, Memorandum of Deborah Gibbs Tschudy, Chair, Federal Gas Valuation Negotiated Rulemaking Committee, and its attachment, Department of the Interior Minerals Management Service, "Final Report Federal Gas Valuation Negotiated Rulemaking Committee," March 1995 ("*Consensus Report*").

[6] *See* MMS proposal at 60 FR 56007(Nov. 6, 1995) and amended proposal at 62 FR 25421(May 21, 1996).

[7] *See* MMS notice terminating rulemaking at 62 FR 19536 (April 22, 1997).

the neighborhood of the wells to a distant selling point are includable in the royalty base.") *Id.* at 387.

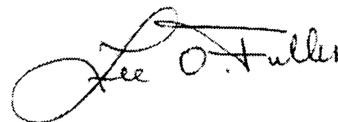
Years later, especially after FERC Order 636, the gas market has changed appreciably with selling points well downstream and compression serving a much more significant true transportation function. Gathering today little resembles gathering at the time of the Udall decision and denying deductions for transportation-related compression unfairly places an extra burden on producers. This is true for existing wells where pressures are dropping and reservoirs are declining and unit production costs are increasing. Moreover, many new gas wells are low pressure (e.g., coal bed methane) or hyperbolic decline wells (e.g., tight sands). Denying appropriate deductions for the portion of compression costs associated with transportation or delivery into a downstream spot market is therefore poor energy policy. Indeed, in Udall, the court noted that "the public does not benefit from resources that remain undeveloped, and the Secretary must administer the Act so as to provide some incentive for development." *Id.* at 388.

In sum, the MMS' handling of compression remains a topic that continues to generate unnecessary confusion and disputes and like indexing deserves reappraisal to make sure MMS regulations fit today's gas marketplace.

# # # # #

We urge the MMS to carefully consider our comments and welcome any further questions you might have to order to reach a satisfactory resolution of this important rulemaking.

Very truly yours,



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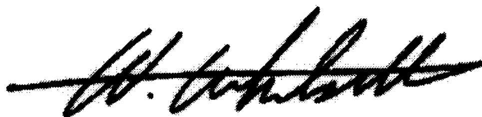

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Attachments