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RECEIVED

November 14, 1996

Mr. David S. Guzy
Minerals Management Service
Chief, Rules and Procedures Staff
Royalty Management Program
P O Box 25165 MS3101
Denver CO 80225-0165

RE: Comments on Proposed Regulations - Amendments to Regulations Governing Valuation of Natural Gas Produced From Indian Leases

Dear Mr. Guzy:

The Council of Petroleum Accountant's Societies (COPAS) appreciates the opportunity to offer its comments regarding the proposed Amendments to Gas Valuation Regulations for Indian Leases (30 CFR Parts 202 and 206) published in the Federal Register, Monday, September 23, 1996. COPAS offers these comments from the perspective of an association which was represented on the negotiated rulemaking committee.

General Comment

It must be understood from the outset that this rule is the product of a negotiation in which industry was at a decided disadvantage, having been allowed only five seats on a nineteen-member committee. The two-thirds "consensus" rule the Committee operated under, when considered in context of the numerical makeup of the Committee, assured that the industry members could do little to mitigate the most objectionable aspects of the rule.

In spite of the obvious inequities in the process, COPAS is generally supportive of the use of independent published index prices for valuation of natural gas produced from Indian lands. COPAS also supports the concept of allowing the use of the alternative "percentage bump" method of satisfying the dual accounting requirement contained in most Indian leases so long as its use is optional.

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However, COPAS has many concerns about the proposed rule as published, and in fact cannot support the adoption of this rule in its current form. These concerns are detailed in the section that follows.

Specific Comments

Definition of "Marketing Affiliate"

The preamble states that the definition of "Marketing Affiliate" has been removed because it is "no longer relevant to valuation in today's market". This was never discussed by the Committee in any of its deliberations, and COPAS finds this apparent attempt by the government to use this rule to enhance its arguments related to affiliates proceeds issues to be objectionable.

Subsection 206.170(c)

This provision would allow the lessee to calculate royalty values based on methods other than the requirements of the proposed rule, "but only if you, the tribal lessor, and MMS jointly agree to the valuation methodology."

COPAS believes this to be inconsistent with the Committee's discussion, which was that the lessee and tribal lessor could negotiate such alternate methods among themselves. COPAS sees no reason why MMS's approval should be necessary when the lessee and the tribal lessor agree to such alternate valuation methodologies. Most, if not all, of the tribes appear to be fully capable of negotiating such agreements on their own. COPAS does agree that MMS would need to negotiate on behalf of Indian allottees.

Subsection 206.172(b)(iii)(2)(ii)

This paragraph would effectively require a gross proceeds calculation - in addition to the index-based formula calculation agreed to by the Committee - for any gas not sold under a dedicated contract which was subject to a previous contract that was the subject of a contract settlement. The preamble states that this requirement was inserted into the rule by MMS "to continue current policy". In light of several recent court decisions that were adverse to MMS's position on contract settlements, it is difficult to understand the legal basis upon which MMS seeks "to continue current policy".

The arbitrary inclusion of this onerous requirement by MMS is highly objectionable in light of the Committee's lengthy good-faith efforts to devise a rule that would satisfy lease requirements while at the same time avoiding the gross proceeds and contract settlements issues. This was the oft-stated desire not only of industry, but also of the Indian and MMS representatives on the Committee. This sort of after-the-fact disregard for the intentions of the Committee will inevitably lessen industry's enthusiasm for participating in this sort of negotiated rulemaking in the future.

Subsection 206.172(e)

The preamble states that the "safety net" provision contained in this subsection "was a contentious issue with the industry representatives, as they object to tracing gas sales. They also believe that the index-based value is representative of market value." The first is incomplete and the second is inaccurate.

The COPAS representative on the Committee voted in favor of the original index-based formula at the Committee's May, 1995 meeting based on the belief that the use of that formula would satisfy both the gross proceeds and major portion clauses contained in most Indian leases, with the exception of gas sold under certain high-priced dedicated

contracts. The record will show that this was clearly the focus of the Committee's discussions leading up to the vote, and that the prospect of a "safety net" for non-dedicated contracts was not raised until several months later, and came as a surprise to the industry members.

COPAS was willing to support the original Committee consensus in the belief that the certainty and simplicity gained from its use would at least partially offset the higher royalty payments the formula would produce. The addition of this "safety net" provision into the rule over the objections of all but one industry member effectively negates any certainty the rule would otherwise provide. COPAS not only "objects to tracing gas", as the preamble stares, it believes that this provision of the rule will be impossible to satisfy with any certainty, and will inevitably lead to a continuation of the current cycle of endless audit disputes and litigation with regard to gas valuation on Indian leases.

COPAS felt so strongly about this at the time the provision was added to the rule that the COPAS member on the Committee told the Committee that he considered this to be a violation of the Committee's original consensus on gross proceeds and major portion and requested that the Committee be allowed to vote again on the index-based formula in light of the changed circumstances. Although the section of the Committee report dealing with the index-based formula was indeed amended as a result of the addition of this "safety net" provision the request for a re-vote was ignored by non-industry members of the Committee.

The preamble's statement that the industry representatives "believe that the index-based value is representative of market value" is inaccurate. The industry representatives actually believe that the index-based major portion formula will yield a value that is far in excess of actual market value, a value that more than satisfies the gross proceeds and major portion clauses of a typical Indian lease without any need for a "safety net" provision on non-dedicated sales.

The attempt, under the guise of the "safety net", to tie value to markets downstream of the index point strays even further from the field or area and is highly objectionable. In addition, the requirement under this provision that lessees must trace the proceeds of their marketing affiliates is another attempt by the MMS and Indian lessors to win a legal dispute through this rulemaking process, and COPAS finds this objectionable as well.

Subsection 206.174(g)(2)

This subsection deals with the MMS/Indian proposal to require a "minimum value" for gas plant products when a lessee chooses to perform an actual dual accounting calculation. This would effectively establish a dual accounting requirement for liquids values within the dual accounting calculation, and a major portion requirement on liquids within the major portion calculation neither of which is required or even suggested by the lease terms.

COPAS considers this entire concept to be a violation of the Committee's original consensus on the index-based formula which would satisfy the gross proceeds and major portion lease terms. When the vote was taken on that formula at the Committee's May 1995 meeting, there was a clear understanding that this formula

price would satisfy the major portion requirements for the entire gas stream, not just the methane portion thereof. The concept of a separate major portion calculation on liquids was never mentioned until the Committee;s final meeting, in a manner which negated any possibility of conducting a full and informed discussion of the matter.

Aside from the above-stated objections to this portion of the proposed rule, it is objectionable for other reasons as well:

- It ignores the express major portion lease language that refers to the field or area and instead looks to markets downstream of the lease by hundreds, and in many cases, thousands of miles;
- It is based on the erroneous assumption that the lessor is entitled to track its royalty into the downstream markets and that the lessee has a duty to bypass markets in the field or area in favor of those downstream markets;
- It reflects an unprincipled methodology in that the MMS has already characterized netback methodology as the least desirable. Moreover, once value is based on markets beyond those in the field or area, there is no principled basis not to net back from the point of ultimate consumption.

MMS requests comments on several specific questions related to this proposal. COPAS' comments are as follows:

Is a Minimum value needed when a lessee chooses the actual dual accounting methodology?

No. When the committee performed its data analysis in developing its sliding scale of percentage "bumps" for its alternate dual accounting methodology, the value of liquids played a minimal role in determining the amount of increase related to dual accounting. COPAS believes the administrative costs of performing and verifying this minimum value proposal would far exceed any possible benefit derived by the lessor. COPAS also believes that such a provision is neither required by the lease terms nor a desirable part of this rule.

Are there other better methods to use?

No. Since the entire concept is neither desirable nor consistent with the Committee's original consensus on the index-based formula, no method is more preferable than any other.

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

No. The proper location to look for gas plant products values is the point at which the products are sold. This would be consistent with the lease language which refers to the field or area.

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

No. Since the establishment of a major portion calculation for liquids within the actual dual accounting calculation is neither desirable nor necessary, there can be no "right" deduction for transportation and fractionation.

Would a percentage of the price or actual rates paid be a better deduction?
No. Since this entire proposal is neither desirable nor necessary, no one method for determining a deduction is better than any other.

The Paperwork Reduction Act

MMS requests comments on two new forms, MMS-4410 and MMS-4411, as they relate to the Paperwork Reduction Act.

COPAS questions the utility of Form MMS-4410, and believes the same result can be more efficiently accomplished through the use of a specific transaction code on MMS Form-2014. In addition, the language at the bottom of the form certifying that the gas is not processed "before entering a pipeline with an index located in an index zone" is not consistent with the Committee's consensus (this language also appears in the proposed rule at Subsection 206.176(c)). The Committee agreed that the lessee would have to certify that the gas is not processed prior to entering a mainline. Once again, MMS has chosen to modify the consensus of the Committee after the fact.

Since COPAS opposes the entire "safety net" concept on non-dedicated sales, and considers this part of the proposed rule to be a violation of the Committee's original consensus on gross proceeds and major portion, COPAS does not believe that Form MMS-4411 is "necessary for the proper performance of the functions of the agency".

In addition, the statement in Section IV of the preamble to the rule that "Only a minimal recordkeeping burden would be imposed annually by this collection of information" is naive and inaccurate. As the industry members of the Committee repeatedly pointed out during the negotiations, compliance with this "safety net" requirement will force companies to institute entire new accounting procedures and systems, producing large implementation and maintenance costs. In addition, since the tracing required by this part of the regulation cannot be accomplished with any certainty, it will serve as a fertile ground for nit-picking by auditors, leading to high downstream administrative costs. COPAS believes MMS' estimate of additional costs to the entire industry of only $935,000 per year to be absurdly low.

The Regulatory Flexibility Act

Many COPAS members are small entities referred to in this Act. The Department's certification "that this rule will not have a significant economic effect on a substantial number of small entities under the Regulatory Flexibility Act" is not true. There can be no question that this rule will significantly increase the royalty burden on small producers on Indian leases. The unilateral decisions by MMS to include in the rule the "dual" dual accounting and "dual" major portion provisions on liquids at Subsection 206.174(g)(2), as well as the gross proceeds calculation requirements contained at Subsection 206.172(b)(iii)(2)(ii) only serve to magnify the impact on small producers.

Section 202.550

MMS requests specific comments on whether "the department should provide approval for allotted leases: when a lessee who demonstrates economic hardship may request a royalty rate reduction on an allotted lease. COPAS believes that because of the frequent difficulties involved in identifying and locating allottee lessors, MMS should continue to provide the necessary approval when these questions arise.

In addition, COPAS has a concern about the MMS proposal that a "Tribe rather than the MMS would decide when the lessor would take Indian gas royalty-in-kind". COPAS does not object to this proposal so long as the Indian lessor would be subject to the same rules of notification that MMS must comply with.

Conclusion

COPAS cannot support the adoption of the proposed rule as it is currently constituted. At the time of the Committee's original votes on the gross proceeds and major portion index-based formula and on the optional percentage "bump" method of satisfying dual accounting, COPAS believed the simplicity and certainty gained by using the rule justified its support of the new methodology. COPAS supported these concepts at the time, and still supports them on their merits.

Unfortunately, the later addition to the rule of the "safety net" concept on non-dedicated sales, the separate dual accounting and major portion requirements on liquids, and the gross proceeds calculation requirements contained at Subsection 206.172(b)(iii)(2)(ii), have effectively robbed the rule of any administrative benefits to the industry, and could indeed result in an increase in those costs, while in reality providing little if any further monetary benefit to the Indian lessors.

The measure of a successful negotiation requires that all parties involved derive some benefit from the final product. It is unreasonable for the MMS and the Indian lessors to expect COPAS or any other member of the industry to support a rule which would yield substantially higher royalty payments to the lessors while in turn resulting in no positive administrative impact on the lessee.

Finally, the unilateral inclusion of several concepts in this rule by the MMS which were either never discussed or were not agreed to by the Committee is in violation of the agreement to publish a proposed rule based on the Committee recommendations, and may make COPAS and other industry organizations less inclined to dedicate the time and funds required to participate in this sort of negotiated rulemaking in the future.

Once again, COPAS appreciates the opportunity to provide its comments to this proposed rule. If you have any questions regarding our comments, please call me at (405) 767-5044.

Sincerely,

John E. Clark
Chairman, COPAS Federal Affairs Subcommittee

lt
cc:
Darrell Gingerich
Sandy Launchbaugh
Bill Stone
Mary Stonecipher
Salomon Tristan