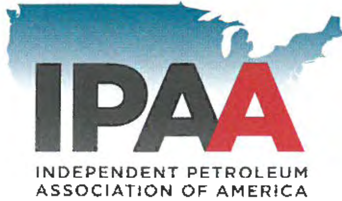

May 4, 2017

Mr. Luis Aguilar
Office of Natural Resources Revenue
Building 53, Entrance E-20
Denver Federal Center
West Sixth Avenue and Kipling Street
Denver, Colorado 80225

Re: RIN 1012-AA21 - Federal Oil and Gas and Federal and Indian Coal Valuation

Dear Mr. Aguilar:

I write on behalf of the membership of the Independent Petroleum Association of America ("IPAA") in response to the Advance Notice of Proposed Rulemaking, published at 82 Federal Register 16,325 (April 4, 2017), concerning royalty valuation for federal oil and gas, as well as federal and Indian coal. We appreciate the willingness of the Office of Natural Resource Revenues ("ONRR") to re-examine royalty valuation.

IPAA is the leading, national upstream trade association representing oil and natural gas producers and service companies. IPAA represents thousands of independent oil and natural gas explorers and producers, as well as the service and supply industries that support their efforts. It is the members of these groups that amendments to regulations on royalty valuation will most significantly affect. Independent producers drill about ninety-five percent of American oil and natural gas wells, produce more than fifty percent of American oil, and more than eighty-five percent of American natural gas.

Nearly two-thirds of America's independent producers are small businesses. Onshore independent producers supported 2.1 million American jobs in 2010 and offshore independents operating in the Gulf of Mexico accounted for more than 200,000 jobs. Since 2014, low commodity prices and misguided policies by the federal government have reduced U.S. employment in the oil and gas sector by more than 94,000 jobs. IPAA member companies actively produce oil and natural gas from leases on federal lands, both onshore and offshore.

Thank you for the opportunity to comment on the Advance Notice of Proposed Rulemaking ("ANPR") on both federal oil and gas royalty valuation and federal and Indian coal royalty valuation. IPAA will limit its comments to oil and gas royalty valuation.

Executive Summary

The current royalty valuation program is a disservice to the American people. From the perspective of the citizenry, the program's vague regulations cause needless delay in collecting money the nation needs. To the oil and gas producers subject to these regulations, the program is unworkable.

The chief problem is that the regulations are both vaguely worded and require a given producer, when paying royalties, to have access to information she is not entitled to have. The most obvious example today is the so-called "marketable condition" rule, a problem on which we will elaborate below. To comply with that rule, as it is now interpreted by ONRR, a producer has to know the internal cost information of counter-parties to its contracts: gathering system operators and owners of natural gas processing plants. But ONRR has known since 1995 that producers typically cannot obtain that data, because the counterparties consider it confidential business information.

When regulations are vague or information is unavailable, many times producers pay more or less than government auditors later believe to be correct. And "later" means years later. Today there are unresolved audits going back to production in 2003. When these discrepancies occur, producers incur unnecessary costs in audit responses and tied up capital unnecessarily in accounting reserve funds.

The program is ready for an overhaul. The overhaul should follow three principles. First, ONRR should continue to follow the longstanding principle that the value of production for royalty purposes is determined at the wellhead. Second, ONRR should continue to follow the longstanding principle that arm's-length contracts are the best indicator of value. Third, to the fullest extent possible consistent with the first two principles, royalty value should be determined using information to which the producer has access.

The Role of Federal Lands and Royalties in Energy Independence

As Secretary Zinke is aware, production of oil and gas from federal leases has traditionally made a substantial contribution to total domestic production. Beginning in 2010, policies discouraging development of federal leases caused production on onshore and offshore federal lands to remain flat or decline. This is especially concerning since total U.S. oil and natural gas production increased substantially due to the growth of production on state and private lands. Federal lands that are currently most attractive for further oil and gas development are in the federal domain, including the Bakken, the Permian, the Piceance, the San Juan, the Denver-Julesberg, and the Gulf of Mexico.

The Department of the Interior can do much to further President Trump's goal of energy independence by ensuring timely leasing, prompt permitting, and workable royalty valuation policies. In a separate notice of proposed rulemaking, the Department has already proposed to rescind the unworkable policies contained in the 2016 royalty valuation rulemaking. And the Department is right to do so. As IPAA will separately discuss in comments on the proposed rescission, that rulemaking went far to undo two Congressional directives to the Department to simplify royalty valuation. But those two directives also apply to any alternatives to the 2016 regulations.

First, Congress enacted the 1996 amendments to FOGRMA because of inequities in the royalty collection process. That amendment was named the Federal Oil and Gas Royalty Simplification and Fairness Act. Congress found:

> The existing mineral leasing laws, regulations, policies and procedures related to obligations arising from leases administered by the Secretary of the Interior are lacking in clarity, consistency, and reciprocity, and contain inequities which impose unnecessary and unreasonable costs and burdens on lessees and the Federal Government alike.

H.R. Rep. No. 104-667, at 13 (1996); *see* S. Rep. No. 104-260, at 13-14 (1996).

Congress believed the federal royalty program was so burdensome that it was driving oil and gas producers off of federal lands.

> Because the Federal royalty program is overly complex, burdensome and unfair for oil and gas exploration and development companies who seek to do business with the Department of the Interior, competition for both onshore and offshore leases is diminished.

H.R. Rep. No. 104-667, at 13.

But the Royalty Simplification and Fairness Act was poorly implemented. By the next decade, Congress tried a different tack. It empowered the Department to take its share of royalty "in kind" instead of "in value" and to sell the production on its own. Although there is much evidence to show that the Royalty-in-Kind program was working and generating greater revenues for the federal government, Secretary Salazar cancelled the program under the Obama Administration.

It is not necessary, however, to return to the Royalty-in-Kind program. Sensible valuation policies will help restore the competitiveness of federal lands in the American energy marketplace. To that end, IPAA is pleased to offer the following recommendations.

Issues Common to Oil and Gas Royalty Valuation

1. ONRR re-valuation of royalties based on a lessee's alleged "misconduct." Royalty value regulations for both oil and gas empower ONRR to reject values received under arm's-length contracts. The regulations identify four kinds of misbehavior that would authorize ONRR to pick something other than the arm's-length value: (1) "misconduct," (2) "breach of your duty to market the oil [or gas] for the mutual benefit of yourself and the lessor," (3) acting "unreasonably," and (4) acting "in bad faith." This approach is nothing but an invitation to mischief. Under it, ONRR could find that a lessee—although acting in good faith without misconduct and in keeping with the duty to act for the mutual benefit of the parties—had still acted "unreasonably." The regulation clarifies that ONRR is not trying to second guess an arm's-length price simply because it seems too low, *see, e.g.,* 30 C.F.R. § 1206.102(c)(1)(ii)(B), but does not clarify what conduct for which ONRR is actually concerned.

2. The definitions of "field" and "area" are unbounded, needing tighter focus and clarification.

Since 1942, the Department has often used prices for sales of oil or gas "in the field or area" to help determine whether sales to affiliated parties were at prices comparable to arm's-length sales. At its origination, the regulation contained a geographical limitation, referring to prices for oil or gas "sold from the field or area *where the leased lands are situated....*" 30 C.F.R. § 221.47, __ Fed. Reg. 4132, 4137 (1942) (emphasis added). The clear purpose of the rule was to capture values at the market near the lease. Today, the Department has gone to the opposite end of the market, rendering irrelevant what producers are getting for sales near the lease under review. "A 'sales contract typical for the field or area' therefore reasonably refers to the contract that are typical in the field or *area into which the gas is actually sold*, which

may or may not be the field or area where the gas is produced." *Encana Oil & Gas (USA), Inc.*, 185 IBLA 133, 142 (2014) (emphasis added). Thus, under the current view, prices of oil and gas produced in the mountains of central Colorado are to be compared with prices of oil or gas sold in San Francisco, California, or Miami, Florida.

3. The "marketable condition" rule is vague and fails to explain the financial measure by which the lessee knows what it owes. The marketable condition rule requires the lessee to pay, without deduction from what it owes the government, for the costs needed to provide oil or gas "sufficient free from impurities and otherwise in a condition a purchaser will accept under a sales contract typical for the field or area." 30 C.F.R. §§ 1206.101 & 1206.151 (2015). Historically, this rule was not difficult to administer because ONRR's predecessors, during audits, looked to see whether the sales contract deducted amounts from the sales price to remove impurities or, in the case of gas, to require the gas to meet a specified pressure.

Now, however, ONRR does not stop with the sales contract. "If you use gross proceeds under an arm's-length contract in determining value, you must increase those gross proceeds to the extent that the purchaser, or any other person, provides services that the seller normally would be responsible to perform to place the oil in marketable condition[.]" 30 C.F.R. § 1206.106. *See also* 30 C.F.R. §§ 1206.152(i) & 1206.153(i) (for gas). But the contract does not place a price on those services. So how is the lessee to value the "increase?" ONRR has tended to say that the lessee should use its counter-party's "reasonable, actual costs." But the lessee does not have access to those costs.

4. ONRR's Failure to Close Audits. One of the major reforms of the Federal Oil and Gas Royalty Simplification and Fairness Act was to bring closure to royalty accounts. ONRR has to serve its "demands" for additional royalty within specified periods of time, and lessees are free to dispose of old documents when the given audit is concluded. But no audit determination is binding on the government "until the audit period is formally closed." 30 C.F.R. §§ 1206.152(k) & 1206.153(k). The problem is that ONRR does not close audits formally or informally.

5. Twenty-One Years After Congress Spelled Out What "Restructured Accounting Orders" Must Contain, They Remain Unstructured. By enactment of FOGRSFA, Congress imposed limitations on the authority of the Department to issue so-called "restructured accounting" orders. 30 U.S.C. § 1724(d)(4). The Secretary is authorized to order a lessee to "perform a restructured accounting . . . when the Secretary . . . determines during an audit of a lessee" that the lessee "has made identified underpayments" which are "demonstrated by the Secretary ... to be based upon repeated, systemic reporting errors...." (*Id.* at § 1724(d)(4)(B)(i)). For the errors to be "repeated" and "systemic," they must be shown to have occurred "for a significant number of reporting months with the same type of error which constitutes a pattern of violations and which are likely to result in . . . significant underpayments...." (*Id.*) Among other things, an "order to perform a restructured accounting shall—(I) be issued within a reasonable period of time from when the audit identifies the systemic, reporting errors; (II) *specify the reasons and factual bases for such order*, [and] (III) be specifically identified as an 'order to perform a restructured accounting'[.]" (*Id.* § 1724(d)(4)(B)(ii)(emphasis added).)

The regrettable truth is that many of ONRR's restructured accounting orders lack the structure the statute imposes: no reasons, no factual bases, no showing of significant underpayments.

6. The definitions of "arm's-length contract" and "affiliate" are unworkable. The Department has not been able to apply its own rule on what "control" means or what constitutes "control." Relying on mere percentages of ownership can lead to arbitrary results, especially in the era of Dodd-Frank, because many companies with at least some public ownership have independent directors who review contracts with related entities to assure a fair deal. Also, the sales and midstream markets are competitive enough that initial sales may follow a bid-out process in which potential buyers or midstream companies, whether affiliated or not, compete on prices and terms. ONRR auditors, however, will just label a transaction "non-arm's-length" without analysis and undo years of reporting and payment.

IPAA believes the Department of the Interior should take this opportunity to fully review the flawed and unworkable ONRR program and overhaul the entire system. We look forward to working with you to develop a royalty program that is fair and provides clarity for America's independent oil and natural gas producers, while at the same time providing the federal government with the royalties on production that are due to the taxpayers.

Sincerely,

Daniel T. Naatz
Senior Vice President, Government Relations
Independent Petroleum Association of America