WESTERN ENERGY
ALLIANCE

May 8, 2015

Armand Southall
Regulatory Specialist
Office of Natural Resource Revenue
P.O. Box 25165, MS 61030A
Denver, Colorado 80225

Re: Comments on Proposed Rule on the Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform RIN 1012-AA13

Dear Mr. Southall:

The Office of Natural Resources Revenue's (ONRR) Proposed Rule entitled *Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform* as written does not advance the goal of maximizing royalty revenue from oil and natural gas production on federal lands. By increasing the complexity and imposing burdensome reporting requirements, the rule would divert resources away from productive, revenue generating activities and into complex accounting and legal wrangling, for both the federal government and the industry. Western Energy Alliance believes the rule should be adjusted significantly to increase clarity and reduce the uncertainty caused when too much is left to the discretion of individual auditors. As such, we fully support the changes to the rule suggested in the comments from the Council of Petroleum Accountants Societies (COPAS). We appreciate the opportunity to comment, and respectfully request that our comments be carefully considered.

Western Energy Alliance represents over 450 companies engaged in all aspects of environmentally responsible exploration and production of oil and natural gas in the West. The Alliance represents independent producers, the majority of which are small businesses with an average of fifteen employees. Small producers are especially hard hit by these rules and re-interpretation of reporting procedures years after the fact. Small companies lack the extensive staff and legal resources of larger firms. In fact, we have seen very small companies in New Mexico subject to disproportionately large penalties because of ONRR's reinterpretation of reporting requirements. The proposed rule would exacerbate the situation further.

Calculating royalty payments is a complex undertaking, and our members earnestly attempt to comply with all reporting laws, policies and guidance. However, interpretations can vary between how a company reports and ONRR's assessment. When differences arise, a high proportion of those differences are the result of honest mistakes or differing interpretations of highly complex statutes to the particular situation at hand. The fact that the agency has a 490-page handbook is testimony to the complexity of reporting

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requirements. There are several instances of federal reporting requirements remaining unresolved, leaving companies and auditors no choice but to put their own interpretations on the regulations. Often there is no single "correct" answer to a given situation.

Yet ONRR is now proposing a rule that will increase the complexity and reduce the clarity of royalty valuation. Rather than a collaborative relationship that ensures an open and honest dialogue toward the goal we all share–that of ensuring royalties are fairly paid – this rule will exacerbate needless tension between ONRR and companies. Ultimately, increasing the complexity and cost of complying with uncertain regulations will further discourage oil and natural gas development on federal lands, resulting in less revenue to the federal treasury. Creating rules that result in companies paying more royalty than is owed is not in the best interest of taxpayers or consumers because increasing costs on the producer ultimately decreases supply which eventually drives up prices. By decreasing the value of operating on federal lands to producers, ONRR's rule will drive production off federal lands, resulting in lower returns from leaseholds to the American taxpayer.

This rule as written will create hesitancy on the part of industry to seek ONRR feedback and approval for reporting problems and scenarios that may arise as a result of normal business operations. This will serve to breakdown communication between industry and ONRR and thereby make the ultimate goal of the Federal Oil and Gas Royalty Management Act (FOGRMA) and the stated function of ONRR unattainable. On the other hand, the oil and natural gas industry, primarily through and utilizing the technical expertise of COPAS, is very willing to sit down with ONRR and work out solutions. We encourage ONRR to view industry as a partner in developing solutions that work for the government as well as companies.

Our specific comments on the proposed rule follow.

Economic Analysis

Western Energy Alliance agrees with COPAS that the true cost of the proposed rule likely exceeds $100 million. ONRR has not considered many cost elements that will cause the rule to exceed the threshold that carries the obligation for thorough agency economic analysis. In addition, ONRR has not considered the impact on small businesses. ONRR has the obligation to conduct a thorough analysis of this rule under: i) Executive Order 13563; ii) Executive Order 12866 (Regulatory Planning and Review); iii) the Regulatory Flexibility Act of 1980; iv) the Small Business Regulatory Enforcement Fairness Act; and v) the Unfunded Mandates Reform Act.

Rule Should be Bifurcated

Oil and natural gas production is a completely different industry than coal mining, with different organizational structures, marketing arrangements, and in many cases unrelated end uses. As such, we see no reason for the two separate industries to be treated in one rule, and believe it should be bifurcated.

Index Option

Western Energy Alliance supports the concept of an index option that simplifies the calculation and auditing of royalties. If an index methodology results in less complexity of royalty calculations and reporting procedures and the index prices does not exceed the costs to comply with the traditional gross proceeds reporting methodology, the option could be a benefit to both ONRR and the industry. In such a scenario, ONRR obtains the royalties due with lower overhead costs, and companies benefit from lower costs of compliance. Both the taxpayer and companies benefit.

However, as written, few companies will choose the index option because it would result in costs that significantly exceed any benefit derived from lower complexity reporting. The complexity and additional costs otherwise arising from the proposed rule will not be going to the taxpayer, but will be spent on accounting systems, complex auditing, and lawyers, both on the side of ONRR and industry. As such, the additional costs wrung from producers will not be advantaging the American taxpayer through higher returns on federal energy, but will rather go into further bureaucratic costs and overhead, not to mention providing yet more incentive for producers to abandon federal minerals for greater regulatory certainty elsewhere.

In addition, small producers will be particularly disadvantaged, as many do not choose to market their gas through an affiliate. We suggest that the index methodology be adjusted and that it be available to all companies, whether or not an affiliate is used.

There is considerable desire among the Alliance's membership for a simple, equitable index, which we believe would be used extensively if structured correctly. Several members have been struggling to comply with new interpretations of existing regulations over past years, and incurring considerable costs to retrofit accounting systems and apply the new interpretations to past years. A simple methodology that eliminates the need to retrofit systems while reducing auditing risk is very attractive. However, if it results in paying costs well above the cost of current compliance, it will simply not be used. We request that ONRR adjust the rule as recommended by COPAS.

The index option represents a good opportunity for ONRR and industry to sit down together and work out an acceptable methodology. The recently finalized rule on Indian oil valuation provides an example of ONRR and industry working together to craft an index methodology. While the results are unique to Indian country and not applicable to this rule, the process and collaboration are a model for ONRR to consider. Western Energy Alliance was a key participant in that rule.

Discretion in Royalty Valuation

The proposed rule gives ONRR too much discretion to determine royalty value. The proposed rule allows ONRR to determine the value of oil and natural gas if it determines: 1) the reported value is inconsistent with the requirements of the applicable subpart; 2) a gross proceeds contract does not reflect total consideration that was directly or indirectly transferred; 3) the lessee or its affiliate cannot provide copies of all contracts, which must be signed; 4) the gross proceeds accruing to the lessee do not reflect "reasonable consideration" because of "misconduct" by the lessee or contracting parties, 5) the gross proceeds accruing to the lessee do not reflect "reasonable consideration" when the sale of oil or natural gas is 10% less than the lowest "reasonable measures" of market price including index price; 6) the gross proceeds accruing to the lessee do not reflect "reasonable consideration" because ONRR cannot determine the value of oil or natural gas "for any reason;" or 7) the lessee failed to retain all data relevant to the determination of a royalty value. See proposed sections 1206.104, 1206.106(c), 1206.143, 1206.145(b).

ONRR's ability to determine royalty value in so many circumstances introduces a great deal of uncertainty into a lessee's expected royalty valuation. Further, some circumstances are wholly inappropriate. For example, ONRR's ability to determine royalty value when oil or natural gas is sold for 10% less than the lowest "reasonable measures" of market price ignores that different producers can command different prices depending on their size and bargaining power. Finally, the proposed rule uses ambiguous terminology to define the circumstances in which the ONRR may value royalty. The proposed rule does not attempt to define "total consideration," "reasonable consideration," or "reasonable measures" of market price. These ambiguities yield little guidance to lessees. Given ONRR's unforgiving assertion of authority to determine royalty value, it must provide lessees with clear guidance if the lessees wish to base their royalty value on the value of their actual sales.

ONRR should also incorporate a provision into the final rule that expressly allows a lessee to seek review of an ONRR decision to determine royalty value by the ONRR Director and if necessary, the Interior Board of Land Appeals.

Transportation Allowances

Similarly, proposed sections 1206.110(f) and 1206.152(g) allow ONRR to determine a lessee's transportation allowance if ONRR determines there is "misconduct" between the contracting parties, consideration does not reflect the "reasonable cost" of transportation for a variety of reasons, or an allowance is unreasonably high because it is 10% more than the "highest reasonable measure" of transportation costs. ONRR may also determine a transportation allowance if it cannot determine whether the lessee properly calculated a transportation allowance.

The provisions afford ONRR too much discretion to determine a lessee's transportation allowance. Further, the provision suggesting that a transportation allowance may be unreasonably high if it is 10% higher than the "highest reasonable measure" of transportation costs ignores both that different producers negotiate different prices based on their size and that producers often negotiate long-term transportation agreements reflecting the economic conditions at the time they enter into an agreement.

ONRR should also incorporate a provision into the final rule that expressly allows a lessee to seek review of an ONRR decision to determine a transportation allowance by the ONRR Director and if necessary, the Interior Board of Land Appeals.

Transportation allowances in the federal reporting system have not kept pace with today's industry and innovation. Deductions should be adjusted in line with current practices. In the rule as proposed, the maximum transportation allowance is $.30 per Mcf. The cap on the allowance does not seem justifiable when producers regularly pay more in transportation costs.

In addition, the rule would not allow the deduction of compression costs, even though compression is a major component of transportation. Since compression is a major and necessary cost component of transportation, why is it arbitrarily disallowed? This seems to be incompatible with CFR 30:1206.152 unprocessed gas and 30:1206.153 for processed gas, which requires that producers must get the gas into a marketable condition.

"Misconduct"

The proposed definition of misconduct is too broad. The proposed rule would allow ONRR to determine both royalty value and transportation allowances when it determines that "misconduct" has occurred by or between the contracting parties. See proposed sections 1206.104(c)(1), 1206.110(f)(1), 1206.143(c)(1), 1206.152(g)(1). ONRR proposes to define "misconduct" as "any failure to perform a duty owed to the United States under a statute, regulation, or lease, or unlawful or improper behavior, regardless of the mental state of the lessee or any individual employee by or associated with the lessee."

This definition is problematic for a host of reasons. First, ONRR proposes to define misconduct to mean a failure to perform any duty owed to the United States, regardless of whether it relates to the payment of royalty. Conceivably, a lessee could mistakenly paint a tank the wrong color, in violation of a Bureau of Land Management requirement, and that mistake could result in ONRR determining royalty value and transportation allowances. Such a broad definition is arbitrary, as ONRR has not defined why a failure to perform any duty owed the United States justifies the need for the agency to determine royalty value or transportation allowances. ONRR should narrow the definition of misconduct to relate to royalty payment and reporting issues.

Second, the definition of misconduct does not limit the misconduct to a particular lease. Larger producers may own or operate thousands of federal oil and gas leases. Because of the broad definition of misconduct, the failure to properly paint a tank in New Mexico the correct color would allow ONRR to determine royalty value of oil and natural gas produced from onshore leases across the United States as well as offshore leases. Even if ONRR narrowed the definition of misconduct to relate to royalty payment and reporting issues, it should further narrow the proposed rule to only allow ONRR to determine royalty value or transportation allowances for the federal leases on which the misconduct occurred.

Third, in light of the fact that ONRR has defined misconduct as the failure to perform any duty owed the United States for any reason, its proposal to ignore the mental state of an individual employee has the effect of being punitive. Oil and natural gas producers strive to comply with federal law, yet there are thousands of requirements applied to this very complex industry, and honest mistakes are made that are diligently corrected when brought to light, either by the producer or the regulator. In addition, regulatory complexity means there can be many different interpretations of regulation that lead to different "answers," even from one ONRR auditor to the next. Congress has afforded ONRR the authority to penalize lessees that knowingly and willfully fail to correctly report and pay federal royalties. ONRR should not determine royalty value or transportation allowances because of honest mistakes, particularly when honest mistakes may not relate to duty to report and pay royalty or the lease at issue.

Fourth, the breadth of the definition of "misconduct" is particularly troubling when read with the language of proposed sections 1206.104(c)(1), 1206.110(f)(1), 1206.143(c)(1), and 1206.152(g)(1). These sections allow ONRR to determine royalty value and transportation allowances when misconduct has occurred "by or between" contracting parties. This language, with the definition of misconduct, could allow ONRR to value royalty when the third party with whom a lessee is contracting for sale or transportation of oil or gas has engaged in "misconduct" outside of the transaction. The definition is arbitrary because "misconduct" by a purchaser of transportation that is unrelated to a transaction with a lessee has no bearing on the price or transportation allowance the lessee accepts for its oil or gas. Furthermore, the definition imposes an unreasonable burden on lessees to attempt to discern whether a party with whom they are contracting has failed to perform a duty to the United States that is unrelated to the particular transaction.

Finally, given the extraordinarily and unnecessarily broad definition of misconduct, ONRR must afford lessees an opportunity to seek review of a determination that misconduct has occurred by the ONRR Director and, if necessary, the Interior Board of Land Appeals.

Contracts

The proposed rule contains the requirement that all contracts must be made in writing, otherwise a company carries a large risk of audit. There are several reasons that all contracts cannot be made available without revealing sensitive business information that affects the ability of a company to compete. ONRR should not impose a punitive requirement that could potentially harm the ability of a company to compete in the marketplace successfully.

Western Energy Alliance agrees with COPAS that keepwhole accounting and reporting as processed gas (30 CFR 1206.142) needs to be eliminated because not only is it impossible to accurately report product volumes without complete plant data it requires payment of royalty on a value far greater than the producers owes. Although the proposed rule provides an example of how keepwhole accounting is to be calculated, the plant statement usually does not contain sufficient information on such items as plant efficiencies and NGL values to perform all the calculations. The requirement should be eliminated or simplified, including in the index option.

For keepwhole contracts, plant data to accurately determine the volumes on which royalty is owed is simply not available. ONRR's guidance suggest paying royalty on theoretical volumes with no adjustment for plant efficiency. Creating a situation whereby producers would have to pay royalties on amounts that cannot be attained creates a huge disincentive to maximizing royalties by delivering as much Natural Gas Liquids (NGLs) as possible. The situation will continue to worsen if natural gas prices remain low while NGL prices remain steady or increase, as has been the case for many years.

Unbundling

ONRR's fairly recent re-interpretations of regulations related to unbundling costs have greatly increased the complexity of reporting royalties and audits. Unbundling is resulting in greater overhead costs for ONRR as well as for companies as transactions from years ago are reinterpreted to unbundle costs that were previously considered deductible. Western Energy Alliance members report considerable costs to redesign accounting systems and comply with the new unbundling interpretation. A medium-size company reports spending $2 million on new systems, and even small companies are spending considerable capital, with one six-person company reporting costs of $110,000.

Furthermore, once these companies spend millions on accounting system upgrades, there is nothing to prevent further reinterpretation of the rules a few years from now, once again restarting the expenditure cycle. Finally, ONRR itself has a very difficult time unbundling plants and getting access to the required information for such efforts. These rules should significantly simplify reporting requirements while also providing some assurances that the interpretation will stay grounded in the realities of the oil and natural gas business.

ONRR should not lose sight of the fact that both the federal government and the producer have an incentive to maximize value. Punitive methods for maximizing royalties by arbitrarily requiring royalties be paid in excess of the value a producer can ever achieve are counterproductive, especially over the long term.

For example, both ONRR and producers have an incentive to maximize the delivery of Natural Gas Liquids (NGLs), as their value is much higher than dry gas. The proposed rule contains unnecessary complexity that discourages producers from delivering NGLs, and hence much higher royalties to ONRR and the taxpayer. Because ONRR is pursuing a strategy of unbundling and disallowing processing costs, it is creating a situation of *minimizing* royalties. If producers cannot fairly deduct actual costs of processing, ONRR is being penny wise and pound foolish.

Finally, retroactively applying new interpretations of unbundling has been very counterproductive to the efficient reporting of actual royalties due. If the proposed rule is finalized, it should only be applied prospectively to production months after the effective date of the rule. The ONRR should not revisit royalties paid previously based on the new rule.

Thank you for considering our comments. Western Energy Alliance is available to work collaboratively with ONRR on this rule, as we have done on previous rules, and would welcome the opportunity.

Sincerely,

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