

Federal Oil & Gas Royalty Valuation, Royalty in Kind and Royalty Relief 1980- 2008

- 1981-1982** Linowes Commission formed; precipitated by allegations of oil theft on Indian lands but, drawing on 1979 GAO study estimating that royalty underpayments amount to about 10% generally, promptly embraces oil and gas on federal lands. Final report of Linowes Commission, "Fiscal Accountability of the Nation's Energy Resources," published and highly critical of DOI management of royalty program including lack of clear guidance or valuation, especially gas.
- 1983** Federal Oil and Gas Royalty Management Act (FOGRMA), Pub. Law 97-451, enacted. Does not address valuation standards but addresses DOI authority generally, site security, record keeping, civil and criminal penalties, etc.
- 1984** House Committee on Interior and Insular Affairs issues December 1984 report ("Udall Report") highly critical of the Minerals Management Service (MMS) management of the royalty management program. Udall Report does not address valuation standards but restates Linowes Commission call for valuation guidance and urges DOI Secretary to form Federal Advisory Committee.
- 1986** DOI Royalty Management Advisory Committee (RMAC) formed; dissolved after two 2-year terms. Major MMS valuation rulemaking commenced; encompasses oil and gas, offshore and onshore, federal and Indian lands. Key issue is valuation of gas; valuation of oil not very controversial, although California very critical of oil valuation because of posted prices, stemming from several rounds of litigation with major oil companies. RMAC oil valuation and gas valuation recommendations do not muster enough votes to pass but plainly influence 1988 rulemaking that ensues.
- 1987** NTL-5 Gas Royalty Act of 1987, Pub. Law 100-234, enacted; clarifies that actual proceeds, not Natural Gas Policy Act ceiling prices, shall be used for gas valuation.
- 1988** MMS promulgates 1988 Oil Rule, 53 FR 1184 (Jan. 15, 1988) and 1988 Gas Rule, 53 FR 1230 (Jan. 15, 1988) for valuation after short regulatory negotiation-type proceeding; minor challenge to 1988 Gas Rule by handful of companies later settled. Each valuation rule features use of prioritized benchmarks for valuation, notably posted prices for oil and comparable sales for oil and gas.
- 1988** Stemming from a 1987 *Arizona Republic* article, the Senate Select Committee on Indian Affairs commences an investigation of fraud on

Indian lands. The wide-ranging investigation includes allegations of Bureau of Indian Affairs (BIA) mismanagement, corruption in tribal governments and gross underpayment of oil royalties for production on Indian lands. Except for findings of BIA mismanagement and some isolated field mismeasurement of oil production volumes, the committee finds no evidence of any oil company conspiracy to underpay royalties. See “Final Report and Legislative Recommendations,” Report of the Special Committee on Investigations of the Select Committee on Indian Affairs, S. REP. NO. 101-60 (1989).

- 1988** Diamond Shamrock v. Hodel, 853 F.2d 159 (5th Cir. 1988) (gas take-or-pay payments not royalty bearing); leads to several years of take-or-pay related litigation and a buyout-buydown distinction. See, e.g., IPAA v. Babbitt, 92 F.3d 1248 (D.C. Cir.1996)(IPAA I); IPAA v. Babbitt, 971 F.Supp.19 (D.D.C. 1997); In Re Century Offshore Management Corp., 111 F.3d 443 (6th Cir. 1997); Shell Offshore, Inc. v. Dept. of the Interior, 997 F. Supp.23 (D.D.C. 1998); EEX Corp. v. Dept. of the Interior, 111 F.Supp. 2d. 24 (D.D.C. 2000).
- 1988-93** MMS royalty management miscellany: net receipts, single payor, revision of MMS forms, global settlements, royalty refunds, etc.
- 1994-97** MMS conducts protracted gas valuation regulatory negotiation but, after consensus reached and two proposals are published, abandons rulemaking. See 62 FR 19536 (May 21, 1996) for history.
- 1996** California-driven “Final Interagency Report on Valuation of Oil Produced from Federal Leases in California” released; hypercritical of use of posted prices for valuation of crude oil and precipitates MMS publication of oil valuation advance notice of proposed rulemaking. False Claims Act *qui tam* litigation springs up regarding use of posted prices for oil valuation; eventually extends to gas valuation and gas measurement litigation continuing beyond 2004 and resulting in settlements of about \$450 million by 2004. Exposure of private lawyer-government official secret agreement leads to prosecution of one government official but has no impact on validity of later 2000 Oil Rule. See “Report on an Inquiry into Payments Made by the Project on Government Oversight to Two Federal Officials,” report to Senate Committee on Energy and Natural Resources, 106th Congress, 2d Sess., S. Prt. 106-55 (2000).

RIK: MMS conducts first royalty-in-kind (RIK) pilot project for gas in Gulf of Mexico; resulting “MMS Royalty Gas Marketing Pilot Final Report (September 1996)” offers mixed results, but leads to “Royalty In Kind Feasibility Study (August 1997)” with qualified MMS support for a RIK pilot program, especially for Gulf of Mexico gas production and to a lesser degree onshore oil production, notably in Wyoming.

Federal Oil and Gas Royalty Simplification and Fairness Act (RSFA), Pub. Law 104-185; process-oriented statute, not addressing valuation standards, but addressing royalty refunds, statute of limitations, period for agency action appeals, audits, delegation of royalty collection to states, marginal properties.

- 1997** MMS publishes 1997 Oil Proposal to begin protracted and contentious oil valuation rulemaking; industry accedes to abandonment of posted prices, but defends use of comparable sales and promotes RIK. Industry-crafted RIK bill introduced but goes nowhere; Congress enacts appropriations bills which temporarily delay MMS promulgation of final oil valuation rule.
- 1997** MMS promulgates 1997 Gas Rule, 62 FR 65753 (Dec. 16, 1997) which categorically denies deductions for any downstream cost other than narrowly defined transportation costs. Judicial challenge of rule by API and IPAA ensues; core issue (common to oil and gas valuation) is whether lessee has duty to market free of charge irrespective of place of sale.
- 1998** GAO issues report, "Federal Oil Valuation: Efforts to Revise Regulations and an Analysis of Royalties in Kind (August 1998)." Requested by Sen. Barbara Boxer and Rep. Carolyn Maloney, the GAO report voices skepticism about feasibility of RIK.
- 2000** MMS publishes 2000 Oil Rule, 65 FR 14022 (March 15, 2000), whose central feature is abandonment of benchmarks in favor of spot price indexing at nearest market center; with district court rejection of 1997 Gas Rule, judicial challenge of 2000 Oil Rule by API and IPAA ensues with duty to market free of charge issue as its centerpiece on challenging MMS efforts to use indexing to capture post-production value added downstream.
- 2001** MMS continues to energetically explore industry-supported RIK and issues "RIK Roadmap to the Future;" MMS reengineering undertaken to simplify forms, promote better federal-state coordination, industry compliance.
- 2002** Despite 2000 district court victory for Industry in 1997 Gas Rule case, government prevails on appeal in DC Circuit. IPAA v. Armstrong, 91 F. Supp. 2d 117(D.D.C. 2000), IPAA v. DeWitt, 279 F.3d 1036 (D.C. Cir. 2002) (categorical denial of deductibility of marketing costs upheld, except for firm demand charges).
- 2002** Industry-MMS settlement negotiations held on 2000 Oil Rule; framework adopted December 2002 with Industry acceding to NYMEX indexing while getting some concessions on transportation allowances (e.g., higher multiplier for rate of return); no settlement reached but 2003 rulemaking contemplated.
- 2003** Industry victory in Fina Oil and Chemical Company v. Norton, 332 F.3d 672 (D.C.Cir. 2003) (rejecting MMS use of gross proceeds to capture affiliate resale proceeds even though affiliate was not "marketing affiliate").

- 2003** Supreme Court denies certiorari in DeWitt. Oil valuation workshops held and rulemaking commenced June 2003. Gas valuation workshops also held with rulemaking expected later.
- 2003** DOI issues assistant secretary royalty valuation decision in Devon October 9, 2003; addresses deductibility of gas transportation costs for coalbed methane, but underlying 33-page analysis also used as vehicle for MMS to revisit “marketable condition” and deductibility of compression, dehydration, and transportation costs generally. Devon appeal filed; court-directed mediation explored later but fails.
- 2004** MMS issues 2004 Oil Rule, 69 FR 24959 (May 5, 2004) whose central feature is shift from spot price indexing to NYMEX futures price indexing; also increases multiplier for BBB bond rate in calculation of non-arm’s length transportation allowances). Industry elects to abandon 2000 Oil Rule challenge and forego 2004 Oil Rule challenge.
- Santa Fe Snyder v. Norton, 383 F.3d 884 (5th Cir. 2004) holds Secretary without authority to impose two limits on 1996-2000 OCS deepwater leases: “new production” requirement and use of field instead of lease
- 2004** MMS issues “Five Year Royalty in Kind Business Plan (May 2004)” as successor to 2001 “RIK Roadmap to the Future” reflecting agency further shift from RIK pilot projects to RIK program. However, despite increasingly large RIK volumes, much of it oil earmarked for Strategic Petroleum Reserve (SPR) fill, RIK program continues to operate without regulations, relying instead on informal guidance (e.g. “Dear Operator” letters, MMS forms).
- 2004** MMS issues 2004 Gas Proposal, 69 FR 43944 (July 23, 2004); would conform gas regulations with oil regulations and DeWitt decision, but would not abandon benchmarks for indexing or eliminate “marketing affiliate” limitation for affiliate resales.
- 2005** MMS issues 2005 Gas Rule, 70 FR 11869 (March 10, 2005) without many changes from July 2004 Gas Proposal; leaves unaddressed: benchmarks v. indexing; reexamination of the deductibility of compression costs; recapitalization of gas transportation systems; cost of capital for gas processing.
- 2005** Energy Policy Act of 2005 (EPAAct), Pub. Law 109-58, enacted; no oil or gas valuation provisions, but other royalty matters addressed. For RIK, § 342 specifies terms and conditions (e.g., “marketable condition”), administrative provisions (e.g., use of RIK revenues for post-production expenses), program requirements (e.g., RIK revenue benefits equal or greater than royalty in value, business plan), disposition of RIK (e.g., federal agency usage, Low Income Energy Assistance Programs). For royalty relief §§ 343-346 address onshore and deep water offshore applications.
- 2006** Final marketable condition decision in Amoco Production Company v. Rebecca Watson, 410 F.3d 722 (D.C. Cir. 2005), *cert. denied except for statute of limitations issue, sub nom. BP America Production Company v.*

Watson, 126 S. Ct. 1768, 164 L. Ed. 2d 515, 2006 U.S. LEXIS 2851 (U.S., 2006); the D.C. Circuit had affirmed a district court decision upholding the Assistant Secretary's determination that the costs of removing excess carbon dioxide from natural gas produced in the San Juan Basin were not deductible.

Royalty Policy Committee (RPC) receives status report from its Oil and Gas Valuation Subcommittee that no consensus had been reached on whether indexing could be used in lieu for valuation of no-arm's length contracts for gas as had already been done for oil. RPC also establishes in November 2007 a special Royalty Management Subcommittee to undertake an assessment of the federal royalty management program in three areas: production measurement and reporting; audits, compliance and enforcement; and, RIK. In September 2007, a fourth area is added: procedures for review of offshore lease documents to avert a repeat of the Department's omission of royalty relief thresholds for 1998-99 OCS leases.

In December 2006 the DOI Inspector General releases an audit report, "Minerals Management Service's Compliance Review Process" acknowledging the utility of desk audit compliance reviews but with several recommendations for MMS adoption of a strategy that makes cost-effective use of compliance reviews and full audits.

2007

In January 2008 the Secretary of the Interior increased the royalty rate for deepwater OCS leases to 16 2/3%. While both the Mineral Leasing Act and Outer Continental Shelf lands Act prescribe minimum royalty rates of 12½%, royalty rates for onshore had for years been 12½% for offshore and 16 2/3% for offshore; however, as a complement to royalty relief DOI had encouraged deep water exploration and development by reducing the royalty rate for deep water to 12 ½%. With deep water exploration and development well underway and oil and gas prices skyrocketing, however, DOI elected to increase the royalty rate for deepwater.

Decision rendered in Devon Energy Corp. v. Gale Norton, No. 04-CV-0821, 2007 WL 2422005 (D.D.C. Aug. 23, 2007), upholding agency marketable condition decision in all respects; Devon appeals to DC Circuit.

Decision rendered in Kerr-McGee Oil & Gas Corp., (W.D. La. Oct. 10, 2007) holding that the Secretary has no authority to impose price thresholds to limit royalty relief for deep water OCS leases issued in the 1996-2000 period. The Federal Government filed its 5th Circuit appeal and a decision is expected in late 2008 or early 2009.

RPC Subcommittee on Royalty Management in December 2007 completes its 160-page, 110 recommendation report, "Mineral Revenue Collection from Federal and Indian Lands and the Outer Continental Shelf" (RPC SRM Report). The recommendations adopt many of the compliance review recommendations of the December 2006 DOI Inspector General report.

2008

RPC Subcommittee on Royalty Management's December 2007 is accepted by the RPC at its January 2008 meeting and transmitted without

change to the Secretary who directs MMS, BLM and BIA to proceed with implementation. To facilitate MMS consideration of Subcommittee on Royalty Management recommendations RPC directs its existing Oil and Gas Valuation Subcommittee to address gas cost unbundling and revisit gas indexing and establishes a new RIK Subcommittee.

Senate DOI oversight hearing held February 26, 2008, followed by House of Representatives Subcommittee on Energy and Mineral Resources oversight hearing held March 2008; both address RPC SRM Report. House oversight hearing also considers views of DOI Inspector General, Government Accountability Office and others; focal point is not valuation but production verification, MMS compliance review strategy and RIK suggesting a new emphasis for royalty reform.

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