production. Until the late 1980's, these sales were made at the refiner-pipeline owner's posted price. The team believes that if the Department requires oil pipeline owners with Federal right-of-ways to operate their pipelines as common carriers rather than private carriers, posted prices may converge with the real market value of crude oil. This would increase Federal royalties.

- Contracts showed that the cost of California crude oil to smaller independent refiners sometimes included both outright premia over posting and a "hidden" premium in the locational adjustment charged in the contract. One clear example was seen by the team in the contracts reviewed for sales of Midway Sunset crude oil by one integrated pipeline/refining company to two independent refiners in San Francisco. The independent refiners paid $0.20 more as a locational adjustment than was charged to integrated companies that shipped (via exchanges) crude on the pipeline/refining company's pipeline.

- By the late 1980's, premia over postings were so common that they were reported in the trade press and were even paid to some of the larger independent producers. These premia, however, were only a small part of the difference between postings and what the integrated companies' internal documents showed California crude oil was worth compared to the alternative of purchasing

ANS crude oil. Thus, it is likely that the proprietary pipeline systems and trading practices of the major companies sustained a two-tier market wherein prices for San Joaquin Valley and Ventura Basin crude oils never approached the market-clearing levels afforded to ANS crude oil in the refining centers.

- Although the team did not directly review the 1960-70's period of the early Long Beach lawsuits, trading practices were addressed by the Long Beach lawyers in our discussions. In particular, the "three-cut" exchange system is evidence of the extent to which the early California market was not "fair and open." During that period, heavy crude oil (most of the State's production) postings were so far depressed below refining value that the major companies could not use published gravity-based price differentials to adjust value in their extensive exchanges. To compensate, they structured a trading system available only to major companies wherein each type of crude oil was divided for accounting purposes into three fractional barrels: a heavy, residual fuel-type oil; a mid-range oil; and a light, naphtha cut. Rather than account for trading whole barrels, the major companies traded and accounted for the barrels' components--thus the "three-cut" name for the process. The process had phased out by 1980, but its presence earlier indicates that today's restrictive California market practices grew from activity that was much more clearly closed and unfair to a major sector of the State's oil economy.

In conclusion, the Energy and Commerce Department representatives believe that the team's review of refiner/producers' internal valuation procedures, their trading practices, their use and control of proprietary transportation systems, and the history of their market activities provide ample "reasons to the contrary" for looking past the limited arms-length contracts available for review in the pre-1988 period. Further, while it is impossible to prove or disprove[29] the existence of a fair and open market, the evidence reviewed strongly suggests that free and open crude oil trading in the California market is now, and for years has been, prohibited by the restrictive practices of the major integrated companies. In this environment, a two-tier valuation system evolved. Accordingly, the Energy and Commerce Department representatives believe that MMS regulations in effect prior to 1988 permit using the valuation system that is most beneficial to the Federal Government and the public that it represents.

(b) Recommended Valuation Methodology

The team members from the Energy and Commerce Departments recommend that, for royalty payors that are refiners (or were

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[29]There is no standard for "fair and open" specified in the MMS regulations, and no universally accepted methodology available in the literature on the subject of competitiveness measures.

refiners when royalties were due[30]), the pre-1988 value of royalty crude oil should be established based on quality-adjusted prices paid for ANS in the California market. The valuation procedure would be similar to that proposed by Micronomics, Inc., one of the two consultants MMS retained to assist this study group.

Valuation should follow the steps below:

- Begin with the market prices of ANS crude oil in Los Angeles. These may be obtained in one or both of the following ways:

  - After 1984, this is available from data services or the Energy Information Administration on a daily basis. Prior to 1984, Sohio's West Coast ANS prices were available in various industry trade press publications (e.g., Petroleum Intelligence Weekly and other sources).

  - Employ the targeted company's cost (price) of ANS crude oil bought (sold) in the California market. Obtaining these data is discussed under "Procedures" below.

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[30]Regardless of whether their refineries were in California or elsewhere. Refiners with plants out of state could still preserve the value advantage of their California crude oil using exchanges or buy/sell contracts with other large California refiners.

- Adjust the ANS price for the Los Angeles value of the Federal crude by subtracting a cents per API degree figure obtained from posted price schedules--typically this is $0.15 to $0.20 per API degree. Ample data are available to make a monthly calculation if necessary.

- Further subtract appropriate transportation costs to Los Angeles. These are readily available as published Line 63 tariff rates plus nominal local rates ($0.05 to $0.25 per barrel), or derivable from internal tariffs or contracts.[31]

- Subtract from this figure the refiners' posted prices and apply the appropriate royalty percentage to the result. This produces estimates of royalty underpayments, assuming that postings were used to pay royalties initially.

- Add interest.

For non-integrated companies prior to 1988, value should be established based on true (non-exchange) arms-length contracts consistent with the procedure established for the post-1988 period.

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[31]The team reviewed some internal tariffs obtained in the Long Beach lawsuits; it also examined pipeline charges reflected in the Texaco data obtained in the audit phase of this study.

(c) Procedure for Collections

The focus of this collection should be the ten or so[32] largest royalty payors in California. Audit efforts should be minimal and confined to confirming or refuting selected data provided by the companies. To facilitate preparing a bill for each of the companies, a "payor letter" and records review similar in concept to the post-1988 period procedures should be employed. Specifically:

- The "payor letter" should seek records on prices (costs) of ANS crude oil sold (bought) during the target collection period. This should include contract identification (for verification) and other delivery point and transportation cost information. In addition to ANS data, the letter should request:

  - arms-length sales records for clearly identified Federal royalty crude oil;

  - records of payment of Federal royalties for California crude oil including the price basis used to assess value (this assumes that MMS will not be able to provide such data from its records).

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[32]MMS records show that the ten largest Federal crude oil producers paid over 90 percent of California onshore royalties during 1984-93. However, at least one of these was purely a producer.

- Review <u>Long Beach</u> records to locate ANS crude oil purchase and sales records for the targeted companies.

Preparation and submission of a bill for unpaid royalties should immediately follow any limited on-site audit review deemed necessary after these records are obtained. There seems to be no need under this approach to issue an order for restructured accounting, as MMS will have essentially revalued all the companies' California royalty production on the basis of the information obtained above.

Presented with such a bill, it seems likely that the companies will either attempt to settle immediately, or will initiate a long series of appeals. To expedite the appeals process, the Assistant Secretary should initially decide any appeals. This will shorten the standard process wherein the MMS Director initially decides the appeal with further right of appeal to the IBLA. The Assistant Secretary's decision would be the final Departmental decision. The appellant could then take the case to court (the Department of Interior representatives agree with this tactic).

The Energy and Commerce representatives recommend that MMS auditors not approach the companies with a request for an open-ended audit. The Shell and Texaco audits in this study demonstrate that the companies are quite willing and able to delay collection efforts for years if they so desire. If a company does suggest a negotiated solution, then the computed bill will provide the basis for the Interior Department's position in the matter.

3) Recommendation by MMS/Department of Interior Solicitor's Office (SOL) Representatives

These participants believe that the approach recommended for post-3/1/88 periods should also be applied to any periods MMS/Interior may decide to address before that date. That is, they recommend that:

- o Arm's-length sales be valued at gross proceeds accruing to the lessee, and
- o The lessee's volume-weighted contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field or area be used to value oil not sold at arm's-length from that field or area.
- o If the lessee doesn't produce significant quantities in a field or area, look to others' arm's-length sales and purchases of significant quantities of like-quality oil from the same field or area to value the lessee's production.

The MMS/SOL representatives recommend this method because even though the MMS modified its oil valuation rules in 1988, the basic underlying principles did not change. Both the pre- and post-3/1/88 regulations rely on:

- Prices paid or offered in arm's-length transactions for production from the field or area, and

- The overriding principle that royalty is to be based on not less than the gross proceeds accruing to the lessee.

Note that the 1988 regulations effectively continued basic oil royalty valuation policies, guidelines, and procedures. The stated purposes of the new regulations were to:

1) Clarify and reorganize the existing regulations from various parts of 30 and 43 CFR,

2) Create regulations consistent with the then-present DOI organizational structure,

3) Place the oil royalty valuation regulations in a format compatible with the valuation regulations for all leasable minerals,

4) Clarify that royalty is to be paid on all consideration received by lessees, less applicable allowances, for lease production, and

5) Create regulations to guide the lessee in determining

allowable transportation costs for oil to aid in the calculation of proper royalty due the lessor.[33]

The 1988 regulations were the product of a combined effort of the MMS, States, Indian tribes and allottees, industry, and private royalty owner organizations. Their main purposes were to clarify and organize regulations residing in many separate locations, provide valuation criteria that would result in reasonable values, and create an atmosphere of certainty in royalty payments that would correct some of the royalty deficiencies encountered in the past.[34]

Although the MMS/SOL representatives recommend using the weighted-average arm's-length price from the same field or area to value California crude oil not sold at arm's-length, they have questions about the competitiveness of California's oil market. But they are not in a position to simply declare that a fair and open market does not or did not exist there. The Department of Interior is authorized to collect royalties on minerals extracted from Federal lands. Our investigation has centered on determining if royalties have been underpaid in California. Specifically, we have sought to determine whether Federal oil production in California is subject to additional royalty collection. If we were to suspect that unfair market practices exist in the California oil market, we would then refer the

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[33]Notice of Proposed Rulemaking, 52 Fed. Reg. 1858 (Jan. 15, 1987), Final Rule 53 Fed. Reg. 1202 (Jan. 15, 1988).

[34]53 Fed. Reg. 1187 (Jan. 15, 1988).

matter to the Department of Justice.[35]

The MMS/SOL recommended valuation approach complies with the express regulatory provision directing value comparisons to be made in the same field or area. MMS has consistently relied on local crude oil comparisons (field or area) for valuing oil not sold at arm's-length. Reliance on field or area comparisons is integral to the regulations for both the pre- and post-March 1, 1988 periods. The intent of both regulations is to base the valuation process on local arm's-length market activity.

The MMS/SOL representatives believe that their recommended approach is consistent with the Department's long-established practices and interpretation of the valuation regulations. They believe it is important that the Department base its actions on consistent interpretation of the regulations. Higher potential royalty collections alone should not drive the decision. The Department should consider that any approach deemed to depart from past regulatory interpretations may lead to high litigation costs, and, most importantly--potentially lower net collections

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[35] In 1989, the Department of Justice (DOJ) investigated charges that integrated companies operating in California were in violation of anti-trust laws. As part of their review, DOJ examined court sealed documents from the Long Beach II case. A representative from DOJ told team members that DOJ felt that any overt evidence suggesting collusion occurred in the 1960's and this "trail was too cold to pursue." Further, in evaluating which cases to pursue, DOJ must consider the best allocation of its resources. At the time DOJ felt it could better meet this objective by devoting its resources to other cases.

than under other approaches.

Further, an MMS valuation method based on longstanding administrative practice is more likely to be upheld in court than a valuation method that departs from such practice. Great deference is due the Secretary's interpretation of his statutes and regulations. However, when this interpretation departs from longstanding practice, the deference is minimal. Watt v. Alaska, 451 U.S. 259 (1981). Thus, the MMS/SOL team members believe their recommended approach provides the best combination of:

1) Royalty collection procedures conforming with the then-existing valuation rules,

2) Consistency with past MMS practices and procedures,

3) A position likely to be perceived as reasonable and enforceable, and

4) A procedure most likely to result in collections.

D. Recommended Time Periods for Pursuing Royalty Collections

1) Summary

The team deliberated the issue of how far back MMS should attempt to collect additional royalties and interest, but could not reach consensus. The DOE and Commerce representatives recommend initiating collection from 1980 forward, while the MMS/SOL representatives believe the team should not make a specific recommendation on this issue. Their respective rationales follow.

2) Rationale of DOE/Commerce representatives

Crude oil undervaluation in California is a decades-old problem. This study documented a pattern of royalty underpayment occurring over a span of years for the two companies MMS audited, and provided strong evidence that the practice extended to most major oil companies in the State. With the evidence of underpayment so clear, the Federal Government should attempt to collect the majority of the amount it is owed. Consistent with this philosophy, the representatives from the Energy and Commerce Departments recommend pursuing collections of unpaid royalties and interest from 1980 forward.

Beginning with 1980 covers the period when the largest underpayment took place. Analysis supporting the team's December 1995 Option Paper for Interior Department management showed that, of the potentially recoverable royalties and interest attributable to undervaluation during 1978-93, 63 to 74 percent is associated with the 1980-85 period. Restriction of the collection period to the years after 1985 would address only one-sixth to one-third of the unpaid royalty and interest estimate for 1978-93.

During its study, the team received a number of briefings on legal matters pertaining to the effect of the statute of limitations on collecting previously-owed Federal royalties. Due to differing court decisions on the matter, the situation is, at best, unresolved. However, the Department of Interior's position, both in public and in court, is that the statute of limitations does not apply to these matters. Therefore, any policy decision based solely on statute of limitations considerations, thus limiting collections to a small part of what might be recoverable, is not consistent with the Department's position, and may not be required by the courts.

Choice of 1980 as the most distant year of collection is not arbitrary. There are two reasons for this cutoff date:

- First, and most important, crude oil prices were Federally controlled prior to 1980, making the case for collecting royalties based on crude oil undervaluation much more difficult.[36]

- Second, the amount of revenue that might be collected for each year preceding 1980 is relatively small due to low crude oil prices and royalty volumes. Adding 1978 and 1979 to the collection period, for example, would

[36]The State of California in its Long Beach case pursued collections from the companies dating back to 1971 with litigation beginning in 1975. The Department of Interior, in its October 1993 scoping paper, considered potential back royalty payments dating from 1960. Therefore, the choice of 1980 represents a compromise between going back to the late 1960's and limiting the scope of the investigation to post-March 1, 1988.

only raise potential collections by 6 to 10 percent. In addition, as the time period is extended, the likelihood increases that neither MMS nor the companies have records covering Federal royalty production.

The large amount that is potentially recoverable is financially significant to both the Federal Government and, because these funds would be shared, to the State of California. Initiating collections with the year 1980 offers the Federal and California State Governments a reasonable blend of achievable results and relatively high recovery of the amounts owed by the oil industry in California.

3) **Rationale of MMS/SOL representatives**

Selection of the time period for which MMS should attempt to collect underpaid royalties and interest is both a legal and policy issue. There have been different court decisions on statutes of limitations, and MMS's decision on this issue may impact not only its California oil royalty collection efforts, but also other ongoing cases where the statute of limitations is at issue. The MMS/SOL team members believe the Department should carefully consider such impacts; the ultimate course of action should not be determined solely by the level of potential royalty and interest collections. However far back MMS decides to pursue this case, at a minimum, the decision should consider:

1) The chances of collection back to various years, and

2) An overall impact assessment on MMS' programs for pursuing the issue back to various years.

Although the potential collections clearly are higher in the early 1980's compared to later periods, the MMS/SOL representatives believe the team has neither the legal expertise nor the insight into the entire royalty management program to provide a sufficiently-informed recommendation on the time period for which MMS should attempt to collect additional royalties and interest. Before deciding what period should be included in MMS' collection effort, MMS should consult closely with the Departmental Solicitor's Office and the Department of Justice.

F. Revisions to Current MMS Oil Royalty Valuation Regulations

MMS recently received responses to its December 1995 request for public comments on whether and how its oil valuation regulations should be amended.[37] As a result of its California oil valuation review, the team recommends that MMS revise the regulations to address the royalty valuation issues discussed in this report. In addition to its general observation that premia over posted prices occur commonly, the team sees the need to redefine or clarify some key terms in the 1988 valuation regulations. The team specifically recommends the following:

- Consider alternatives to reliance on posted prices.

[37] Advanced Notice of Proposed Rulemaking. 60 Fed Reg. 65610-65611 (Dec, 20, 1995).

This may include the use of one or more index price(s).

- The definition of "marketing affiliate" should be revisited. The regulations currently in effect define this term as "an affiliate of the lessee whose function is to acquire only the lessee's production and to market that production." A revised definition should not be restricted to only acquiring and marketing the lessee's production, but should include entities that also acquire and market others' production.

- The term "significant quantities" can be ambiguous. A more precise definition should be included if this term is retained. One way to accomplish this would be to define a specific percent of a field's production for comparison purposes. Minimally, a set of examples in the preamble to the revised rules outlining how the definition is to be applied would be an improvement.

- The arm's-length/non-arm's-length nature of exchange transactions should be addressed. Examples should be provided in the preamble to demonstrate whether various types of exchanges should be included in establishing royalty value.