BEFORE THE SUBCOMMITTEE ON
ENERGY AND MINERAL RESOURCES
COMMITTEE ON NATURAL RESOURCES
UNITED STATES HOUSE OF REPRESENTATIVES

Oversight Hearing

"Ensuring Certainty for Royalty Payments on Federal Resource Production"

December 8, 2015

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Chairman Lamborn, Ranking Member Lowenthal, and members of the committee, I am Karin Foster, Executive Director and Attorney for the Independent Petroleum Association of New Mexico. Thank you for the invitation to testify today on the issues of royalty payments on federal resource production.

Currently, the independent Petroleum Association of New Mexico represents about 340 upstream oil and gas producers the majority of whom are independent small family owned companies with on average 25 employees. An independent producer is a generally defined as an exploration and production company that is not integrated and not involved in downstream activities like refining or marketing. In other words, an independent operator does not own midstream assets such as gathering systems, pipelines or processing plants to transport, process or market natural gas.

In New Mexico, nearly 41.8% of the land is federally owned – often in what is commonly known as 'split estate' where the party who owns the surface may be different than the party who has the right to access minerals beneath the surface. The Bureau of Land Management's New Mexico office manages 13.4 million acres of public lands and 26 million subsurface acres of federal oil, natural gas, and minerals. There are currently 30,561 active wells on federal lands ranking New Mexico sixth in crude oil production in the nation in 2013. According to Energy Information Administration statistics, New Mexico's marketed production of natural gas accounted for 4.8% of U.S. marketed natural gas production in 2012, despite a decline in production of 20% between 2007 and 2012. In FY 2015 the Federal Government collected over one billion dollars in royalties from oil and gas production in New Mexico.

The manner in which the Office of Natural Resources Revenue is now 'interpreting' regulations, which create a fictional measuring point or the point at which gas is in 'marketable condition', has resulted in creating a huge regulatory and economic burden for New Mexico's producers. I note

"New Mexico" producers because "unbundling" was hatched and has been applied to New Mexico producers since 2010. In fact, at a workshop IPANM hosted in June 2013, the lead enforcement officer made it clear that this policy was being 'rolled out and tweaked' in New Mexico making our producers the proverbial 'guinea pigs' for 'unbundling'. In addition, she stated, "we could fine you $25,000 per day per violation and if you don't like how we do this, just get out of the business.". However, just this fall, the ONRR published Unbundled Cost Allocation figures for natural gas plants in Louisiana, Wyoming and Mississippi. Several New Mexican oil producers have also told me that they are currently facing ONRR audits with regulators questioning whether the cost of transporting crude oil and processing or refining that oil should be 'unbundled'.

Plants recently placed on the ONRR website as 'unbundled' requiring producers to use the Unbundled Cost Allocations (UCA's), or; engineer defensible unbundled calculations, or; take zero deductions:

North Terrebonne Gas Plant	Plant	Enterprise	LA
Stingray Gas Plant	Plant	Targa	LA
Yscloskey Gas Plant	Plant	Targa	LA
Calumet Gas Plant	Plant	Enterprise	LA
Opal Gas Plant	Plant	Williams	WY
Pascagoula Gas Plant	Plant	BP	MS

Source: http://www.onrr.gov/unbundling/default.htm

I am here today to discuss the 38,000 ft level impacts of the implementation of the royalty valuation and specifically 'unbunding' on the IPANM member companies and New Mexico. First, I would note that IPANM has actively attempted to engage with ONRR on this issue. In 2013 we held a workshop on the unbundling issue; in 2014 and 2015 we filed comments with the agency on proposed regulations – in each instance asking for stakeholder meetings or trainings to clarify this very complex and confusing issue.

In my comments today, I would like to address three points. First, as noted in Ms. Matlock's comments, the concepts of royalty valuation and 'unbundling' are very complex and is based on estimate; Second, the agency's requirements to report and amend several times during the seven year 'lookback' period or face penalties of $25,000 per violation per day is excessive; Finally, I would like to offer solutions and would respectfully request that ONRR work with IPANM to have a training workshop on these issues.

1. **The complexity of applying the 'unbundling' concepts is nearly impossible for the independent operator**

In her testimony Ms. Matlock has outlined the background on how the ONRR believes it may require operators to 'unbundle' the fees they pay for transporting and processing natural gas. But when an operator is required to 'unbundle' the fees charged when gas was sold, he is effectively paying a higher royalty rate than contracted. For example, if an operator is paid $2.25 an mcf less $0.50 for transportation and processing, which includes dehydration and compression. He therefore receives a check for $1.75 per mcf sold. But the ONRR states that the operator must pay royalty based on estimates of a point on the gathering/pipeline or processing path the gas meets mainline quality and pressure requirements which is not at the tailpipe of the plant. Thus, if using

ONRR UCA figures, if only 50% of the processing costs were allowable, then the operator is paying a royalty on $2.00 per mcf – even though he only received $1.75 per mcf. In addition:

a. Independent oil and gas producers do not own gathering systems, pipelines or processing plants- therefore determining where the fictional marketable condition point (as noted by Ms. Matlock, the point where gas meets mainline quality and pressure requirements) is next to impossible.
b. Note that this 'marketable condition' measurement point is different than the royalty measurement point which is an actual meter on lease, or 'at the wellhead'.
c. Attempting to 'engineer' a formula that is defensible is hardly possible for the ONRR with its subpoena powers, or an independent producer – even when employing oil and gas lawyers, accountants, CPA's and pipeline engineers.
d. The ONRR 'annual factors' or 'unbundling cost allocations' figures are based on propriety and confidential business information accessed under the Federal Oil and Gas Royalty Management Act (FOGRMA) but producers may not question or receive information to understand how the agency arrived to their calculations.
e. IPANM does not believe that this agency's insistence on applying the concepts of 'unbundling' is in compliance with the Royalty Simplification and Fairness Act of 1996 (RSFA) or the Accounting Relief for Marginal Properties (RIN 1010-AC30). Further, IPANM members contend that the proposed rule fails to achieve ONRR's stated mission "to provide regulations that (1) offer greater simplicity, certainty, clarity, and consistency in product valuation for mineral lessees and mineral recipients."

2. **The retroactivity provisions of 'unbundling' results in excessive reporting and may violate due process**

As noted above, the 'unbundling' figure is an estimate of where a stream of gas hits an optimal condition on a transportation system that is not owned by the operator. Even if an operator uses the ONRR's Unbundling Cost Allocation numbers, the agency warns operators "*You may use these UCAs* ***as estimates*** *for later time periods until such time as ONRR provides updated information. When ONRR updates or modifies information you may be subject to additional royalty obligations, or a credit, and associated interest under the provisions at 30 CFR §§ 1206.156(d) (for transportation allowances) and 1206.158(e) (for processing allowances).* " Since the ONRR has the authority to audit retroactively for seven years, this places operators in a vicious cycle of reporting and amending several times during that period when the ONRR updates or modifies information.

The ONRR has unbundled several plants in New Mexico and has moved on to unbundle plants in Louisiana, Wyoming and Mississippi. As an example, in September 2015, the ONRR released figures for the Calumet Gas Plant in Louisiana. The figures are for the years 2008 to 2012 – or 60 months of reporting. This means operators must go back and change 60 reports for each well that processed gas thru Calumet. In order to avoid allegations that the operator 'knowingly and willfully' failed to update reports, the reports for 2013, 2014 and 2015 would also need to be changed to more closely reflect the 2012 UCA figures. However, when the ONRR publishes figures for 2013 – 2015, those reports would need to be changed again. As currently implemented by the ONRR, the manner in which an operator must report the royalty calculation becomes a perverse

game of 'cat and mouse' requiring the operator to be watchful that the ONRR may not arbitrarily update a UCA based on 'new information' which would result in amending reports going back seven years. Moreover, the ONRR refers cases it believes constitute "false claims" under the False Claims Act to the Office of Inspector General and Department Of Justice. Any incorrect Form ONRR-2014 that has a royalty consequence may constitute a "false claim" punishable by a fine of $25,000 per violation per day. Therefore, a lessee who makes no attempt to unbundle the fees it is charged for the costs to compress, dehydrate, and treat its gas, and deducts 100 percent of those costs, may be considered to have made a "false claim." As noted by Ms. Matlock, "[t]he goals of rulemaking must be consistent with and required by the due process clause of the United States Constitution in order for a regulation to be constitutional. The United States Supreme Court has held that the void for vagueness doctrine addresses at least two due process concerns: "first, regulated parties should know what is required of them so they may act accordingly; second, precision and guidance are necessary so that those enforcing the law do not act in an arbitrary or discriminatory way." Citing *Grayned v. City of Rockford*, 408 U.S. 104, 108–109 (1972). I would respectfully contend that the lack of guidance or clear formula for the initial calculation of transportation or processing deductions followed by excessive enforcement requirements is clearly violative of due process.

3. **Possible solutions.**

The first solution to the ONRR royalty valuation issue is to have stakeholder meetings with industry to have the agency gain a better understanding of establishing a fair and transparent formula for when 'marketable condition' occurs. Clearly, the royalty measurement point, which is the meter on lease approved by the BLM and the point where the private marketer usually takes transfer of the gas would be the easiest solution.

However, as an alternative, IPANM would support the proscriptive use of a fair index price reporting methodology, for both arm's length and non-arms' length transactions, and for all Federal minerals. IPANM members believe that the prospective use of fair index price reporting will have negligible fiscal impacts and promote production of Federal minerals. In addition, the fair index price reporting figures must be applied to marginal wells as Congress and ONRR have clearly contemplated fair alternative valuation relief methods applicable for marginal properties in the Royalty Simplification and Fairness Act of 1996 (RSFA) or the Accounting Relief for Marginal Properties (RIN 1010-AC30).

IPANM would support use of widely published and readily accessible index hub monthly settlement prices or average of daily settlement prices (i.e. El Paso – San Juan, El Paso Permian – Permian, etc.) as the basis price for an index price reporting and the calculation of royalties. Notably ONRR has proposed using "monthly average prices" for NGLs index pricing, which is a reasonable concept IPANM may support in the context proposed. Using distinct monthly hub average/settlement type index prices, for both NGLs and natural gas, as the basis for royalty payments is a transparent and reasonable point for reporting accountability. IPANM would propose that ONRR post the applicable respective monthly index prices on its website going forward and to avoid confusion. Should ONRR opt to use this methodology, however, as noted above, the numbers, once published cannot change and enforcement cannot be retroactive.

In conclusion, it is the sincere desire of the IPANM members to work with ONRR so that the federal government receives the royalty rate established by Congress for the extraction of federal minerals from public lands. Both producers and the government benefit from decreasing the complexity of royalty calculations – industry appreciates business certainty and ONRR staff would also be relieved of huge workloads of tedious reviews of amended reports. However, the current policies implemented through guidance and two not-final proposed rules are convoluted and complex. The enforcement provisions, requiring retroactive reporting and huge penalties are excessive given the difficulty in calculating consistent valuation figures. While this issue has previously been confined to New Mexico, the ONRR has recently published figures for Louisiana, Wyoming and Mississippi plants and may be expanding the 'unbundling concept' to oil producers.

IPANM would respectfully ask this committee to require the ONRR to go back to the table to rework the 'marketable condition' concept so that all operators can apply an easy-to-understand formula based on a published index price to pay royalties to the federal government. I look forward to working with ONRR to provide a workshop or teaching mechanism to address unbundling and other proposed rules.

On behalf of the member companies of the Independent Petroleum Association of New Mexico, thank you Mr. Chairman and Representative Pearce for allowing me to present to you today. I now stand for questions.