Committee on Resources

Witness Testimony

Testimony of
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Before the Subcommittee on Energy and Mineral Resources
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Mr. Chairman and Members of the Committee:

I am Larry Nichols, president of Devon Energy Corporation ("Devon"), an independent producer who has federal production. I am here today on behalf of Devon and the Independent Petroleum Association of America ("IPAA"), a national trade association representing more than 5,500 independent oil and natural gas producers.

Mr. Chairman, members of the Committee, we always appreciate the opportunity to work with you in the pursuit of more efficient and cost-effective ways of managing the payment of federal royalties. In June of last year, I testified before you about the need to reform the federal royalty collection system. I personally want to thank you and the committee for responding by expeditiously moving your Royalty Fairness Bill.

Today, we are discussing another important initiative -- reducing uncertainty associated with the payment of federal royalties in today's natural gas market. We applaud the Minerals Management Service's (MMS) recognition that alternative approaches need to be pursued to develop a more certain and predictable method of determining gas royalty payments. Independents have participated in two of MMS' efforts to change the way they conduct business in the new gas marketplace. Gas production is important to this country and is important to independents, who produce 65% of domestic natural gas. We need to develop a federal royalty system that encourages gas production from federal onshore and offshore leases and, as required by law, always looks to the free and competitive market between a willing buyer and a willing seller as the basis for all royalty payments.

One of the two efforts initiated by MMS, which is not the subject of today's hearing, is the Federal Gas Valuation Negotiated Rulemaking Committee. This Negotiated Rulemaking Committee explored alternative valuation methodologies that would reduce the need to trace federal gas molecules through a myriad of complex marketing transactions in an attempt to

determine market value at or near the lease. The IPAA participated in the last official meeting of the Negotiated Rulemaking Committee in an attempt to find common ground among large and small producers. The IPAA supports an alternative valuation method for gas production and an option to eliminate the burdensome accounting associated with gas processing by allowing payment on a wellhead heating value. This proposal addresses in an equitable manner MMS' concerns about administrative burden, state concerns about revenue neutrality, independent concerns about audit burden and cash flow, and everyone's need for a simplified valuation methodology.

The MMS' second effort, to reengineer and increase certainty of gas royalty payments, is the topic of today's hearing. The effort is called the Gas Royalty-In-Kind Pilot Program (pilot). The MMS asked volunteers with production in the Gulf of Mexico to offer royalty gas for participation in a test in-kind program. Devon participated in the test in-kind program with one federal lease. We appreciated MMS' cooperative spirit of bringing different types of lease forms into the pilot.

For our volunteered lease on the volumes that were attributable to royalty in-kind, Devon replaced the accounting burdens associated with a monthly royalty payment with additional gas control responsibilities. Under the pilot, we were required to notify the government's purchaser of the volume of gas that it was required to take. This additional communication and new relationship with MMS' purchaser appears to replace the administrative costs associated with reporting royalty in value.

<u>Royalty Payments in today's new gas marketplace</u> Between the late 1940s and the 1970s, when a new well was drilled, a producer would negotiate and execute a gas sales agreement with an interstate or intrastate pipeline for the purchase and sale of gas at each new well. The pipeline would then construct a transportation (gathering) line to the new well for receipt of the gas into its pipeline system. Gas was sold and flowed directly into the interstate or intrastate pipeline "at the well." The pipeline moved the gas through its transportation system to its processing plant, if necessary. The pipelines purchased the gas at each well and transported it away from the well to local distribution companies, who sold it to localized industrial, commercial, and residential customers. Because the pipelines bought and resold gas, they functioned as gas merchants and were referred to as "merchant pipelines."

Gas was sold at the well to the pipelines at a price which represented the value of gas in its naturally occurring state at the point of production. For royalty purposes, it has been recognized for over 50 years that the price paid to the producers by the pipelines constituted the "market value at the well" for the royalty gas produced under the lease contracts.

Beginning in the mid-1980s, gas marketing changed dramatically as a result of the Federal Energy Regulatory Commission's ("FERC") initiatives to inject more competition into interstate gas markets. In 1985, FERC issued Order No. 436 which required interstate pipelines to provide "open access transportation" to all producer shippers on a nondiscriminatory basis. Order No. 436 completely restructured the national gas industry and began changing the role of pipelines, from that of gas "merchants" to that of gas transporters. In obtaining "open access" to pipeline

transportation, producers could now transport on pipelines and sell directly to prospective customers throughout the nation.

Subsequently, FERC Order No. 636 mandated the "unbundling" of the pipeline's various sales and transportation functions and other services, and further implemented the open access transportation policies initiated by Order No. 436. As a result of these regulatory changes, interstate pipelines have virtually ceased to be purchasers of gas and instead now function almost solely as transporters of gas owned by others.

As a result of these sweeping changes, potential markets for the sale of gas were greatly expanded. Producers may now sell directly to industrial customers, end-users, local distribution companies, and other former interstate pipeline customers. Rather than sales occurring at the wellhead, as was historically and customarily done during the first 50 years of gas production, producers now must either build transportation lines to transport gas away from their wells or pay third parties to transport gas away from the wellhead for shipment to distant markets. When a producer sells gas away from the well, the producer must incur the cost and expense of getting its gas to that distant point of sale. The "wellhead" price for "any away from the well" sale can be calculated by using a "net back to the well" method, which results in a price that is net of the costs incurred to get gas to the market. A producer taking advantage of today's marketing flexibility by selling downstream of the well, directly incurs charges for such functions as transportation, compression, and processing that were previously reflected in an interstate pipeline wellhead sales price. Prior to this regulatory restructuring of the industry, these functions were generally performed by interstate pipeline purchasers as part of their "bundled" merchant service.

The changing marketing arrangements did not easily conform to the current regulatory structure. As companies sell away from the well, "netting back to the well" to determine value can be administratively complex and increase uncertainty as costs once considered deductible as a cost for "bundled" merchant services are now being tracked and reviewed for royalty purposes. The need for regulatory change for gas production was recognized by MMS in a report it issued in March 1995 entitled "Final Report Federal Gas Valuation Negotiated Rulemaking Committee," which states that "tracing proceeds from sales of gas back to a particular lease is very difficult, and determining the royalty value of gas produced from federal leases has become increasingly complex and burdensome."

Why MMS and producers pursued a gas royalty in-kind project

As stated above, the MMS has acknowledged that the current royalty payment system for gas does not compliment the gas marketplace. When MMS takes its royalty gas in-kind at the wellhead, it relieves the government and lessee of the uncertainties and complexities associated with gas sales occurring at locations remote from the lease. The MMS stated in a press release that the pilot "evolved out of discussions with our customer and typified doing more with less. It is a true example of reinventing government, MMS trying new business practices and procedures to work better and smarter."

A mutual benefit to the government and the producer is the certainty associated with delivering volumes in lieu of royalty payments. Once delivered, the royalty obligation under the lease is satisfied. One question always asked is what is market value? When taken in-kind, market value is the price that the MMS receives from the willing purchasers. In-kind provides flexibility for both the MMS and the natural gas producer in an ever changing and evolving gas market in North America.

While my comments today have been general in nature, we have attached additional background with regard to a royalty in-kind program. The attachment highlights factors that need to be considered that could affect the outcome of an in-kind program. To facilitate continued cooperation between MMS and industry for experiments, such as in-kind, we suggest that MMS allow volunteers and purchasers involved in the pilot to comment on its draft of the report about the in-kind project. Much of the data and information being used by MMS in its report was supplied by participants in the pilot.

For an official analysis of the MMS pilot, we refer you to a paper prepared for the Rocky Mountain Mineral Law Foundation's 41st annual institute. This paper is entitled "Testing the Water: A Cooperative Effort to Design the MMS' Royalty In-kind Pilot Program for Natural Gas."

<u>Conclusion</u> We compliment and encourage MMS to continue to work cooperatively with the industry and states to develop alternatives that restore certainty and create simplicity for paying royalties on natural gas production. In this regard, Devon has volunteered gas for an in-kind onshore pilot. A second pilot will serve as a learning experience as we move forward.

Mr. Chairman, we support the legislative language you submitted to the Chairman of the Subcommittee on Interior Appropriations authorizing MMS to conduct additional in-kind pilots. If these pilots are conducted in a manner similar to your language -- "at or near the lease on a volunteer basis in an onshore area with active gas markets" -- then all concerned parties would be better able to make informed decisions about the future of such a program.

I want to inform the Committee about a separate effort that we have initiated to develop alternatives to the current royalty payment system to better compliment today's gas market. As chair of an advisory subcommittee for the MMS entitled "Nonconventional Alternatives," we will develop payment options to reduce royalty regulatory burdens associated with gas production. Potential alternatives include an extended period for reporting gas transactions to accommodate the thousands of adjustments associated with tracing gas sales back to the well, taking gas in-kind, and buying out royalty streams. This subcommittee is comprised of industry, state, and Native American representatives. When this subcommittee develops recommendations we will submit them to the committee for its review.

As the demand for natural gas increases from domestic sources, we must reverse the trend of independents not increasing their development of gas resources from public lands, an important source of undiscovered gas. Devon and IPAA encourage the Committee to continue with its oversight of activities to improve the state of natural gas production from federal lands. To

encourage additional development, independents cannot be required to pay royalties on values which exceed the proceeds received for the sale of gas at or near the lease.

Thank you for this opportunity to testify. There are a number of options, such as royalty in-kind, that need to be pursued as ways to reduce costs and streamline the royalty payment process for gas production. There is much to be learned about a royalty in-kind program from a federal and state government and industry standpoint. We are available to work with the committee as the process for developing alternatives for paying royalties on gas production moves forward.

Attachment 1

What primary factors affect the outcome of an in-kind program?

The Mineral Leasing Act and the Outer Continental Shelf Lands Act require that the amount of royalties due the government be paid in full the month following the month of production. To ensure proceeds were deposited with the Treasury within the required timeframe, the MMS chose to immediately transfer, or "flip," title of the gas delivered by the producer. The MMS chose not to expend any costs and/or take any risks associated with downstream value-added gas sales activities.

The MMS felt that this payment requirement contained within the law prevented them from entering into any sort of gas balancing or storage situation. These restrictions were passed onto the competitively selected purchaser of the gas which prevented purchasers from entering into traditional balancing arrangements thereby affecting the price received for the gas. The requirement for the purchaser to take all produced volumes may require the purchaser to obtain firm transportation in lieu of interruptible transportation, which could be a more costly proposition.

Other factors affecting the success of an in-kind program:

1. To achieve maximum efficiency, reporting and auditing should be limited to production reports and communication regarding available volumes, including imbalances.
2. Gas balancing should be designed to minimize impacts on the producers and the government. Once production occurs, which is under the sole discretion of the lessee/producer, the lease requires royalties to be paid. The producer cannot segregate the royalty share of production to be left in the ground.
3. An in-kind program cannot interrupt a lessees existing processing and marketing arrangements. When gas is taken in-kind, there should be sufficient notice as not to disrupt existing marketing arrangements.
4. For every federal lease, the MMS or the Bureau of Land Management approves a royalty settlement point as the point of measurement consistent with the terms of the lease. It is imperative that under any in-kind program, production be delivered at this point.

5. States need to be consulted in all future in-kind efforts. If states begin marketing their share of the royalty stream, the entire royalty stream must be taken in-kind to prevent the additional administrative costs of multiple collection systems.
6. Potential purchasers need to have more timely access to information affecting the bids. This includes mapping of actual flow, a longer time before purchasers have to submit bids to understand supply source, cost data regarding non-regulated lateral lines owned by the producer, and the quality of gas being purchased.
7. An in-kind program should not be unnecessarily burdened by an examination of other sales occurring in the area to determine if an in-kind sale received market value. A sale of in-kind volumes by MMS is market value because it is the agreed-to price between a willing buyer and seller at the time of the sale. To clarify this important point, a legislative change may be required.