

2. Summary Cost and Royalty Impact Data

Summarized below are the estimated costs and royalty impacts of the proposed rule to all potentially affected groups: Industry, the Federal Government, and State and local governments. The costs and the royalty collection impacts, are segregated into two categories—those that would accrue in the first year after the proposed rule becomes effective and those that would accrue on a continuing basis each year thereafter.

A. Industry

(1) Expected Increase in Royalties—NYMEX-Based Valuation Applied to Oil Not Sold at Arm's Length

Under this proposed rule, industry would value oil based on a market price that more closely represents the true value of the oil. We believe this may result in industry paying additional royalties compared to the current regulations. We provide estimates below of any significant increased royalties under the proposed rule.

The proposed rule maintains many of the provisions of the Federal oil valuation rule that became effective June 1, 2000 (the June 2000 Rule), including the concept of three separate valuation methodologies linked to different production locations. This analysis also is divided into the same three areas. They include California/Alaska (onshore and offshore), the Rocky Mountain Region, and the “rest of the country” including the Gulf of Mexico. This analysis highlights the impacts of modifying the pricing provisions and methodologies. The allowed adjustments for transportation and quality as outlined in the June 2000 Rule also would change somewhat, and some additional corresponding analysis is necessary.

“Rest of the Country”

In valuing production not sold under an arm's-length contract, the June 2000 Rule employed the spot price of the oil most closely associated with the production, with appropriate adjustments for location and quality. The timing of the spot month that corresponds with the production month is the quoted average from an MMS-approved publication from the 26th day of the month prior to the current production month to the 25th day of the current production month. For example, December royalty production is valued using the spot quotes for the oil most similar in location and quality from November 26th through December 25th.

The proposed new methodology for the “rest of the country,” as discussed earlier, is the NYMEX Calendar Month Average daily settlement price with the “roll” and a differential. This method uses a trading month differential (found in MMS-approved publications and based on spot price quotes) applied to the average of the daily NYMEX prices, excluding weekends and holidays, during the production month for deliveries during the prompt month as defined in the proposed rule. For example, for the month of December, assume a producer seeks to value production whose characteristics are closely related to Light Louisiana Sweet (LLS) crude oil. The grade differential established over the period October 26 through November 25 would be applied to the average of the daily NYMEX prompt month prices published for each day in the month of December. The grade differential is the WTI spot price for the period October 26–November 25 less the LLS spot price for the same period. Assuming the WTI value is \$29.00 per barrel and the LLS value is \$28.00 per barrel, the differential is \$1.00 per barrel.

The forward “roll” is added to the calendar month average NYMEX value and is determined by taking a ratio of the difference between the current month value, the 2nd month out future value, and the 3rd month out future value as reported on the NYMEX exchange. Assuming the “roll” calculation results in a value of \$0.30 per barrel, the calculated royalty value, assuming the NYMEX calendar month average price is \$29.50 per barrel, is \$28.80 per barrel (including both the roll and the differential). It is calculated as follows for all royalty production not disposed of at arm's length in the month of December:

(NYMEX Calendar Month Average + “roll”) – (Spot average WTI – Spot Average LLS) (\$29.50 + \$.30) – (\$29 – \$28) = \$28.80 per barrel for December royalty production valued as not sold under an arm's-length contract.

We have compared prices under NYMEX adjusted for the roll and the grade differential discussed above with prices calculated under the existing rule based on spot prices at each of the market centers applicable in the “rest of the country”—e.g., Midland, St. James, and Empire. We found that over the period April 2000 through December 2002, or the period from approximately when the current rule became effective through the end of calendar year 2002, the adjusted average monthly NYMEX price exceeded the monthly average

spot prices for these market centers by about \$0.31 per barrel. We also have performed this comparison back to the beginning of 1999 and found that the difference is slightly higher over the entire period January 1999 through December 2002. We chose the \$0.31 per barrel increment as the basis for our royalty impact estimates.

In estimating the impact of a change to NYMEX valuation, we made several assumptions in addition to the \$0.31 per barrel increment. We assumed that 50 percent of all Federal barrels would be valued under the non-arm's-length provisions, that the offshore royalty rate is one-sixth and onshore royalty rate is one-eighth, and that volumes taken in kind would vary from 50,000 barrels per day to 180,000 barrels per day. The former includes only barrels currently taken in the small refiner program, and the latter includes small refiner volumes plus barrels currently going to the Strategic Petroleum Reserve. We then subtracted the volumes taken in kind and applied the \$0.31 per barrel figure to the remaining barrels assumed to be valued under the non-arm's-length provisions. We estimate increased costs to industry in the form of higher royalty payments of \$4,303,913 to \$11,658,663 million per year.

California/Alaska

The current rule specifies Alaska North Slope (ANS) spot prices for oil delivered at Long Beach, California as the valuation basis for all crude produced in California or Alaska and not sold at arm's length. The ANS spot quotes on a monthly average basis (without weekends or holidays) apply directly to the production month. That is, the spot quotes from December 1st through the 31st apply directly to December production. The rule allows for transportation adjustments and quality allowances.

The proposed new methodology is the NYMEX Calendar Month Average daily settlement price with appropriate differentials, but without the “roll” discussed above. This method uses a trade-month differential (found in MMS-approved publications and based on spot price quotes) applied to the average of the daily NYMEX prices, excluding weekends and holidays, published for each day during the production month for deliveries during the prompt month as defined in the proposed rule.

For example, for the month of December, assume a producer seeks to value production whose quality and location are similar to Kern River crude oil (13.4 degree API gravity oil in Kern County). The grade differential