

**Federal Oil Valuation Rulemaking Workshop
Houston, Texas
January 19, 2000**

MINUTES OF PROCEEDINGS

Opening statements

MMS--Lucy Querques Denett

Introduced the panel members and welcomed the participants.

Introduced the purpose of the workshop:

- Focus workshop on changes to the rule
- Intent to publish final rule on March 15, 2000
- Encouraged constructive dialogue
- Encouraged comments from States, industry, and public interest groups
- Any opening statements?

State of Wyoming:

“Thank you for providing the State of Wyoming an opportunity to comment on this extremely important change in valuation methodology for federal royalty purposes.

If the valuation methodology proposed in the new rule is a valid, defensible method, it might be difficult for the State to justify adopting a different valuation method for royalties in state leases, and maybe even for taxation purposes. This is why it is not lightly that we comment on the proposed rule.

The calculations required to arrive at a netback value from Cushing, Oklahoma may have two opposite effects, neither one yielding a fair value. An independent’s gross proceeds at the lease may actually be higher, based on the local supply and demand forces for his quality of crude, than the Rocky Mountain Region value adjusted for transportation. Both State treasuries and US treasuries would lose royalty revenue. On the opposite side, and for the same reasons, adjusted Rocky Mountain Region value may be higher than gross proceeds. In this case the lessee would pay royalties on phantom income. Neither situation is fair. This is a serious concern.

We applaud the efforts to simplify the administration of the valuation function. However, we must take great care not to paint with too broad a brush for fear of creating another set of complexities that might be tainted with unfair results, or

result in unintended administrative burden for industry, as well as, State and federal auditors. For example, there are still questions regarding the Rocky Mountain Region value in terms of having to make adjustments for applicable location and quality differentials, and for transportation costs. These concerns are particularly well-founded given the fact that it is rare for Wyoming oil to ever actually be physically transported to Cushing, Oklahoma. This begs the question, what will transportation be based on? These uncertainties cannot help but increase the administrative burden and costs for industry, as well as, State and federal auditors.

Wyoming encourages MMS to continue to dialogue with the states, Congress, and industry in order [to] resolve these valuation issues. And finally, Wyoming reiterates its position that States should be allowed to take their production in kind, thus resolving all valuation issues.”

(No other opening statements provided)

MMS overview of current proposal--Debbie Gibbs Tschudy

Summarized changes and general provisions in the proposal:

- (1) Affiliate definition: where ownership is between 10 and 50 percent, the rule would eliminate the presumption of control and gives factors for determining control.
- (2) Same two arm's-length exceptions as in 1988 rule - total consideration and breach of duty to market.
 - Proposed preamble and rule contain specific language saying MMS won't "second guess" lessee decisions.
- (3) Lessee has two options after arm's-length exchanges or non-arm's length transfers followed by arm's length sales: (1) gross proceeds or (2) index/benchmarks.
- (4) For oil not sold at arm's-length, use index (spot) prices, or in the Rocky Mountain Region, use benchmarks.
- (5) Form MMS-4415 has been eliminated.
- (6) Quality adjustments are permissible where quality banks exist and do not duplicate other deductions.
- (7) A new depreciation schedule would be permitted for new owners based on the amount paid when a pipeline is sold at arm's-length.
- (8) Return on investment - even after a pipeline is fully depreciated, the owner can claim a rate of return against 10 percent of the original capital investment.

- (9) Did not propose changes to rate of return, but MMS asks for comments on multiples of BBB bond rate, weighted average cost of capital, or other methods.
- (10) Actual costs for transportation continue to be required, but there is no option to use FERC tariffs in lieu of computing actual costs in situations involving non-arm's-length transportation agreements.
- (11) Change in guidelines for issuing valuation determinations:
- Signed by AS/LM (binding on lessee and MMS until AS/LM modifies or rescinds; final DOI action).
 - Or, signed by MMS staff (binding on MMS & States with delegated audit agreements but not on lessee; valid until AS/LM modifies or rescinds; not appealable unless an order is issued based on the determination).
 - Or, MMS would not issue a valuation determination if the request is hypothetical, inherently factual, or currently in litigation.

“Second-guessing language

- Industry: Non-working-interest owner whose royalty paid by designee/operator: may cause problems where values received by two parties are different.
- MMS: MMS may clarify rules intent
- Industry: Look at term “unreasonable.”
- MMS: MMS will clarify in final rule/preamble
- Industry: “Designee” remains in rule, but clarify intent?
- MMS: Yes, if a working interest owner sells at arm’s length, it would use its arm’s-length gross proceeds as royalty value.
- MMS: May use examples to illustrate in preamble.
- MMS: MMS elaborated on “unreasonable” in preamble - - very rare occurrence.
- Industry: “Commercial” concept re. “unreasonable”?
- MMS: Would be rare occurrence; Department hasn’t second-guessed.
- Industry: Disagreed re. MMS never having second-guessed industry (examples: NTL-5 & major portion values).
- MMS: Disagreed that examples given are on point.

Industry: Lessee (A) selling arm's length at lease to lessee (B's) market affiliate, who can get higher price downstream. Any chance MMS would increase (A's) royalty value if (A) got lower price at lease?

MMS: No.

Industry: Will that require changes in 206.106: must increase value to extent someone else performs services on lessee's behalf?

MMS: No, we wouldn't second-guess. Suggest commenting on possible changes.

Industry: Where are major portion lease provisions treated in regulations? Many leases, especially onshore, have these provisions. Would be helpful if reg's. themselves would cover this circumstance since lease terms override regulations.

MMS: We will abide by regulations. MMS will look at comments on this issue and consider clarification.

Industry: Problem with getting determination retroactively by regulation (see p. 73833, middle column, last paragraph). Should clarify that determinations are applied prospectively (... would apply to all periods to which change in statute/regulation applies.)

MMS: Will look at clarifying.

Binding Determinations

MMS: (1) time limits on determination and (2) matters inherently factual came up in Denver workshop.

Industry: Also question whether RMP staff decision not followed by industry would result in penalty

MMS: No, because decision not binding on Company. Only when an audit order is issued based on that determination would Company be bound.

Industry: Won't be knowing and willful if don't follow MMS staff decision?

MMS: Right.

Industry: In making valuation determinations, why did MMS remove language from existing rule saying MMS could use other parts of reg's. as value basis? (For example, "other relevant matters.") Example: use tendering in Gulf if spot price not deemed appropriate?

MMS: Started from scratch; no intent to specifically exclude in proposal; can consider adding.

Industry: Noted that MMS has option of not responding, or providing different alternative than lessee proposed. Concerned that MMS may interpret regulations differently, even though may not be binding.

MMS: Will consider clarifications

Industry: Is there difference in meaning of words between rule and preamble?

MMS: Preamble meant to provide narrative explanation. Preamble interprets rule.

Industry: “Matters inherently factual” is a basis for MMS not giving determination; explain?

MMS: Generally refers to additional factual inquiry. MMS will look at possible clarifications.

Industry: Can MMS define meaning of “expeditious” determinations and clarify “settlement”?

MMS: None of other agencies MMS looked at provided specific time frames for determinations
 Language concerning. settlement resulting from administrative appeal or judicial litigation (206.100): will consider clarifying that a settlement would prevail.

Industry: If someone, e.g. AS/LM, decides staff was incorrect, can change retroactively?

MMS: No, unless it’s shown that facts industry presented were wrong.

Industry: Tendering considered non arm’s length per se?

MMS: No. Volumes sold at arm’s length under a tendering program would be valued based on price received. Tendering only available as benchmark in RMR.

Industry: What does “lease plant” mean?

MMS: Whether lessee is operator of plant may be a criterion for establishing control.

Industry: Should distinguish between physical and business operations; there’s a difference between who’s physically running plant and who’s running business side. Could affect royalty value.

- Industry: If affiliate partially owned (say, 50%) by a lessee, and affiliate owns some (say, 20%) of a plant, do we look at “% of %”?
- MMS: Look at entire situation under consideration – generally looking at first sale to affiliate. Must do case-by-case.
- Industry: Can have non-arm’s-length sale to nonaffiliate. Confusing as to how criteria applied re. control. 206.102(d)(2)(i) vs. 102(a)(2) seem to be at odds with one another.
- Industry: If Company ignores RMP staff decision, penalties applied?
- MMS: No. MMS will clarify 206.102(d)(2)(i) and 102(a)(2).
- Industry: Where can we deduct transportation costs under exchange?
- MMS: Under 206.110 or .111 - - also referenced at 206.102 - - 206.102 could better say “under 206.110 or 111,” rather than “under this subpart.”
- Industry: What’s process for industry getting differential/allowance approved?
- MMS: Request approval of differential under 206.112 (f).
- Industry: How define “opposing economic interest”? Criteria?
- MMS: Each case different. Joint operating agreements - - participants not necessarily affiliated.
- Industry: In sale from one party to another, who participate in joint operating agreement, how does the rule consider affiliation? Can also apply to transportation allowances.
- MMS: Will try to clarify in preamble.
- Industry: Re. binding determinations: clarification whether MMS will publish determinations on-line?
- MMS: We must protect proprietary information; would only do if company for whom decision issued agreed.
- Industry: 206.102(a)(2) and (d)(2) - - difficult to see differences; also hard to trace through third parties if there is no opposing economic interest. Consider writing in form of fact patterns. More easily understood then.

Transportation

- Industry: Happy for any simplification. It may have to provide information to affiliate that never had to before.
- Thinks government permits too little in transportation deductions.
 - May result in more audit.
 - Changing rules after pipeline built doesn't seem fair.
 - Changing to 10% of original capital investment as ROR base is good, but ROR probably should be multiple of BBB bond rate.
 - Appreciates starting over with depreciation schedule if pipeline sold at arm's length
 - Probably won't suggest ROR on case-by-case basis – will try to suggest standard procedure. BBB bond rate is borrowing rate, so will look at equity considerations, tax effects, risks, admin costs. Perhaps suggest some multiple of BBB rate.
 - Behind each tariff rate there may be 2 to 3 quality banks.
 - Transportation as service supports buying at lease.
 - Would like to find ways to consider affiliates as arm's-length.
 - How will MMS make quality adjustments in reengineering?
- MMS: Looking at quality banks and determining index-prices at individual points; then look at what appropriate matching quality adjustments are made to indexes.
- Industry: Other detail questions:
- Timing of adjustments complicated because, for example, qual. adjustments can spill over into subsequent month(s).
- Industry: Commenter new to rulemaking effort, concerned because they are the ones who will have to provide cost data and rule unclear in some areas.
- Disallowing tariff as deduction will cause more involvement in audit process.
 - Cost of dealing with MMS - - who bears that cost? Ratepayers?
 - Understand, develop, and design reporting system - - very difficult by time rule effective.
 - Recordkeeping burden may be problem.
 - How transition from tariff-based allowance to actual cost under regulatory standard, where pipeline has been operating for some time and actual costs not retained?
 - Concerned about overall burden.
- Industry: Requests for approval for location/quality differentials - - same as for value determinations?
- MMS: No, requests for location/quality similar to current exception requests contained in current rule for allowances greater than 50% of the value. Will outline in preamble/rule that value and differential determinations different.

Industry: Exception to all-encompassing election nationwide considered by MMS? (For example, different election allowed for different regions or pipeline systems?) If exchanges essentially arm's-length transportation, treat them individually outside the otherwise-mandated all-encompassing option? Should be able to opt out for transportation situations.

MMS: Principle is continuity, prevention of abuse. Also ease of administration.

Industry: Why does MMS consider it "gaming," if choice is between 2 valid options? Will MMS set different expected values by method?

MMS: Will establish by property to extent MMS knows method used. Expected values are targets, not billing base. Helps MMS target its resources.

Industry: May be many specific cases, especially for offshore pipeline system, where it would be appropriate to have different methods/options apply. Appropriateness not linked to "gaming."

Industry: Noted that in preamble to 1988 regulations, MMS said they would revisit ROR.

Industry: Differentials/adjustments very inadequate in rule. "Dis-link" - - crude oil valued at a certain index often not delivered at the index pricing point. How deal with this?

MMS: 206.112(f) permits lessee to request MMS for location/quality adjustment.

Industry: CA production - - Kern River at 18 degrees API gravity, ANS at 28 degrees- - should lessee come to MMS for differentials?

MMS: Exchange agreements or quality banks should provide answers, but lessee can also come to MMS for differentials.

Industry: What if no exchanges and oil transported directly to refinery?

MMS: Use index price less transportation costs, and, where appropriate, quality adjustments.

Industry: Use differential in tendering arrangements as differential from index? And why not just accept tendering? Why accept comparability on transportation but not price?

MMS: Would accept tendered price for arm's-length sales, but not non-arm's-length

Industry: Regulatory analysis used tariffs and gravity and sulfur adj.'s in CA. In Gulf, used tariffs and more limited quality adjustments (no sulfur adjustment.). Location differentials not treated same in regulatory analysis as in rules wording.

MMS: Didn't have exchange agreement data available for regulatory analysis.

Industry: When ask for differential, suggests MMS should give criteria for request - - i.e., provide wording in preamble to show applicants a framework.

MMS: Will consider.

Industry: Determining quality/location differentials a value determination?

MMS: No; same as a transportation exception in current rules (re. 50% limit exception.)

Industry: Pipelines have books that capture their costs; some of these not allowed within MMS regulations. - - example: allowance for funds used during construction.

MMS: We do have policy (in Payor Handbook) for allowance for funds used during construction. May be included in initial capitalized cost to be depreciated.

Industry: If a pipeline already fully depreciated, regulations. should clarify that minimum of 10% of capital investment would be allowed. Also, if books already destroyed re. old pipelines, how do we come up with costs?

No transition provision for tracing production either; can industry systems comply with and report based on new regulations?

MMS: Good comments; please provide more details in writing. Changes in regulation not same as reengineering changes.

Industry: Re. BBB bond rating - - before or after tax?
Also, did MMS look at royalty relief procedures, which involve 10-15% ROR?

MMS: Income taxes not allowable in transportation calculations. Only taxes directly related to transportation allowed. Asking for comments now on ROR.

Industry: Detailed comments may address entire cost of capital - - more than just debt. (To include equity.)

Industry: 206.109 - - RIK - - circular reference to 206.108, which refers back to 206 value regulations - - suggest keeping RIK references out.

(End of a.m. session)

Industry: Clarification needed: Index vs. gross proceeds--arm's-length exchange occurs, with majority of barrels ultimately sold (say, 80%) at arm's length and rest (20%) sold to affiliate. How to handle?

- MMS: Can elect to use index for all of property. So all other production exchanged also would be at index. MMS might look at possibility of applying to systems rather than nationwide.
- Industry: What if, on adjacent lease, company has non-arm's-length buy/sell agreement and then 80% sold at arm's length?
- MMS: The portion sold at arm's length would be valued based on gross proceeds. The portion transferred under a non-arm's-length exchange agreement must be valued based on index.
- Industry: Suggests the option be less than all or nothing
- MMS: Option as proposed is all or nothing.
- Industry: 206.100(b) re. settlement agreements - - clarify whether regulation or settlement agreement would prevail?
- MMS: Will go back and look at this provision.
- Industry: Timing for index methodology - - use trade month vs. calendar month?
- MMS: Example: For December 26 – January 25 spot prices, would apply to February production with royalties due in March.
- Industry: Understand opposing economic interests determined case-by-case by auditors. Provides element of uncertainty - - would like additional guidelines in rule, preamble, or handbook to better identify opposing economic interests.
- MMS: Will review.
- Industry: Chevron has transfers downstream to marketing division, but not considered non-arm's-length because not a transfer between affiliates - - thus disposition by marketing affiliate at arm's length would use gross proceeds for value; if not at arm's length, would go to index. But large producer has all kinds of dispositions - - to refinery using index; sales at arm's-length and hence use gross proceeds; exchanges. Would have to allocate all transactions at market center back to leases - - major administrative difficulties in such allocations. Wants option to use index across the board. Doesn't think MMS has adequately addressed the tracing issue. Requests reconsideration.
- Alternatively, consider “affiliate” to include transfers between Divisions, or
 - Have rule state that MMS has authority to apply any approved method.
 - Regulatory analysis - - takes issue with manpower estimates - - says would be much more manpower-intensive to apply rule using different procedures (index vs. arm's-length tracing).

- Industry: ERA Energy (CA) –Exxon/Mobil/Shell: do this entity’s elections bind all three companies?
- MMS: Each Company can make their own election. Having a common affiliate (e.g., Texaco and Shell w/Equilon) doesn’t make Texaco and Shell affiliated, so can make separate option selection.
- Industry: Not sure rule says this (above). Affiliate definition may confuse issue. Can clarify in regulations? Perhaps example in preamble, 206.102 concerning election to use proceeds or index - - maybe clarify here that election is for leases you’re making payments for.
- Industry: Demonstrating differentials - - go to refinery sales to determine - - suggesting Company comes to MMS?
- MMS: No. Company may come to MMS if they think differential doesn’t apply; case-by-case. Value of oil at refinery could depend on acquisition cost.
- Industry: Would like this to be more explicit. Also:
- Transportation exchanges should be treated as separate exchanges.
 - For RMR benchmarks, rule says additional criteria regarding tendering would be in Payor Handbook. Clarify?
 - What does second benchmark say?
 - Benchmarks ordered?
 - Would like option to go directly to benchmark three.
- MMS:
- New Payor Handbook wording along lines of extraordinary allowances.
 - Described second benchmark.
 - Yes, benchmarks ordered.
 - Lessee can have option to pay on affiliate resale.
- Industry: For RMR, would have to spend lots of money tracing under benchmark 2 to verify applicability before could even go to benchmark 3. Also would have to do month-to-month.
- Industry: “Area” definition hasn’t changed from 1988. But gives no guidance, purely subjective. Wants MMS to better define, or summarize fields included, or remove “Area” definition from rule.
- Industry: Not supportive of eliminating “Area” definition, but wants more specific definition. Possible approach might be a grid or matrix.
- Industry: Tendering under benchmark 1, RMR: what if high bid comes from purchaser with tendering program; use that bid?

MMS: Yes.

Industry: Question re. index prices/production month.

MMS: Will give example in preamble.

Industry: RMR, benchmark 2 - - could be on volume-weighted average price of different-quality crudes. Should this be normalized to a specific quality, or some other method?

MMS: Under 206.119, royalty quality has to equal quality at royalty meter - - MMS may add clarifying language.

Industry: Concern over ANS prices used for AK oil. Whatever oil produced probably sold at arm's length, but what if not so in future--use ANS price in CA and make adjustments? Perhaps a comparable would be better solution. Merits further consideration.

Industry: Where did MMS get definition of characteristics of competitive markets?

MMS: From various economic textbooks.

Industry: Incredulous that statement on p. 73820 (none of the comments submitted throughout this nearly four-year rulemaking effort demonstrated that as a general rule a competitive market exists at the lease) (middle column, last paragraph) - - MMS seems to be confusing with lack of price transparency.

Industry: Other spot prices in CA (rather than ANS) more appropriate so can better reflect lease market.

Industry: With comment period closing 1/31, how to get final rule published by 3/15/00, especially given OMB review time?

MMS: Will work around the clock; Department has coordinated with OMB.

MMS: Will try to get meeting minutes from Tuesday (1/18/00) on Internet by Friday (1/21/00); today's minutes by Monday (1/24/00).

Industry: Exchanges for physicals (EFP's) - - why include in exchange agreement definition? Would apply provisions of "paper" deal to actual, physical movement/sale.

MMS: Did so in response to comments; EFP's would be used only to derive differentials, not value from paper sales.

Industry: Would MMS make statement in preamble that its intent is to value production at lease?

MMS: Will consider.

MMS: Noted that because of impending snowstorm, Washington, D.C. meeting scheduled for Jan. 20 could be affected. Call (202) 208-3512 for details.

-adjournment-

ATTENDEES:

Deniese Palmer-Huggins	NYMEX
Karen Westall	B P Amoco
Rick McGovern	Exxon Mobil
Charles E. Taylor	Coastal States Trading
Pat Kent	Exxon Mobil
Malcolm Taylor	Texaco
Suzanne Hight	Amerada Hess
Robert Teeter	Coastal Oil & Gas
Tyler Langenkamp	Arthur Anderson
Tim New	Murphy Oil Corp.
Eddie Halforce	Murphy Oil Corp.
Mike Smith	Marathon
Ken Leonard	A P I
Alpheus Moss	Coastal
Jim Maury	Oxy USA Inc.
Jerry Moynier	Equilon Pipeline
Joan Weessies	Equilon Pipeline Co Inc.
Sensimone Williams	Exxon Mobil
Steve Dilsaver	State of Wyoming
George Butler	Chevron
Rayanne Tosey	Gardere & Wynne
Carol Westmoreland	Unocal
M. Wallace	Equilon Pipeline
David Castro	Amerada Hess Corp.
Robert Green	Chevron P/L Co.
Sandra Bartz	Apache
April Andres	Arthur Andersen
Brian Barry	Apache
Jana Laird Phillips	NYMEX
Jim Drexler	Unocal
M. Coney	Shell Oil
Fred Watson	Exxon Mobil
Sara Tays	Exxon Mobil
Debbie Haglund	Exxon Mobil
Fred Hagemeyer	Marathon Oil
Timothy J. Jacquet	CNE Producing Company
Don Lynch	Texaco
Ronnie Martin	Texaco
Brent Moore	OXY USA Inc.
Jerry Harrison	Citco Petroleum
Jeff Kralowetz	Petroleum Argus
Anita Gonzales Evans	MMS
Norma Rosner	Vastar
Tom White	Walter

John Clark
Terry Kyle
Tammy Naron
John S. Haley
Bruce Carroll
Randy Spaulding
Kris Knobles
Dan Reemer
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