

**Federal Oil Valuation Rulemaking Workshop
Denver, Colorado
January 18, 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.”

Went on to point out:

- If methods give good results, [Wyoming] could support.
- Calculations: netbacks from Cushing not accurate - Rocky Mountain Region values may be higher than gross proceeds.
- May be an unnecessary administrative burden, especially since Rocky Mountain Region values are difficult to adjust from Cushing, OK.
- Location differentials are hard to come up with; the comparison needs to be “apples to apples.”

(No opening statements from industry or others)

MMS overview of current proposal

Deborah 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 asked 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: In regard to crude oil calls, is it to be presumed that market value has not been obtained?

MMS: No, if sales under crude oil calls are at arm's length, the gross proceeds paid under that contract are acceptable, but auditors will later look to see if total consideration was received. We would follow the same procedure for oil under "call" as for any other oil.

Industry: Procedurally, what does MMS do?

MMS: MMS will make sure that prices received include total consideration.

Industry: What is meant by "unreasonable behavior?"

MMS: It is hard to hypothesize; however, MMS is trying to address companies' concerns with this language. We believe these occurrences would be extremely rare. We are looking at behavior that would not happen in normal business practices.

Industry: Commented that the rule makes great headway on the "second guessing" issue and industry appreciates the removal of call language.

Industry: Suggested that the preamble give more examples, especially regarding what is meant by "unreasonable," such as in the case of a wellhead sale. For example, the producer could sell production at the well at either posting-plus or index-minus. Could MMS later come back and say the other should have been chosen?

MMS: No.

Industry: What about a situation where a working interest owner takes production at the wellhead and sells at a different price than the operator, would that be second guessed?

MMS: No.

Industry: The term "unreasonably" is troublesome. Examples are needed.

Binding Valuation Determinations

Industry: The term "factual" needs to be clarified regarding binding determinations.

Industry: Suggest that 206.107(d)(1) specifically say that this is not binding on a lessee.

MMS: The preamble gives the lessee a choice about whether to follow the determination or not follow it.

Industry: Will the same filing procedures apply to other parts of the rule?

MMS: Yes.

Industry: There is concern that if a non-binding determination is issued by MMS staff and the company does not follow it, the company could later be subject to ‘knowing and willful’ misreporting.

MMS: The preamble gives the lessee a choice about whether to follow the determination or not follow it.

Industry: Is MMS audit staff bound by a staff determination?

MMS: Yes

Industry: Is there any risk of change in RMP staff determinations?

MMS: Determinations would apply only prospectively, so no, there is no such risk.

Industry: Why haven’t these MMS determinations been made appealable?

MMS: The States and the Appeals Subcommittee of the Royalty Policy Subcommittee recommended that MMS determinations should not be appealable so that audit orders are not held up.

Industry: The Royalty Fairness Act regarding \$10,000 limits also generated this RPC recommendation.

Industry: What is the timeframe?

MMS: There is no stated timeframe. It is in MMS’ best interest to move these quickly.

Definition of Affiliate

Industry: The definition refers to “persons,” and also sales or transfers – usually means between entities. Does this include divisions within a corporate entity?

MMS: Moving production within branches of the same entity is not considered an affiliate sale.

Industry: The rule references sales/transfers - is “transfer,” as used here, the same as in the definition?

MMS: Our intent is to include all movement of oil along its path under sale/transfer concept.

Industry: Regarding 206.100, has this changed regarding settlement agreements, administrative or judicial litigation?

MMS: No, simply 1988 regulations in “plain English.”

Industry: When the producing division transfers to marketing division, who then sells at arm’s length? Is a sale by the marketing division a sale by the lessee?

MMS: Yes (e.g., Buick and Pontiac are both parts of General Motors; GM is the entity.)

Industry: Who is the seller (sales to operator, for example)? “You and your” are confusing.

MMS: It could be an arm’s-length sale, but the operator often sells on the working interest owner’s behalf.

Industry: What about joint operating agreement sales?

MMS: We will look to the operator’s sales to determine non-operator’s royalty value, if the operator is selling on their behalf. “You/your” refers to the operator in this situation.

Industry: When a non-operating, working interest owner sells to an operator, is that considered an arm’s-length sale?

MMS: If the operator sells on their behalf, “you/your” refers to the operator’s sales.

Industry: Would a non-operating, working interest owner pay based on the second sale that the affiliate of the operator makes? What if it’s higher than what you received?

MMS: The first sale to the operator establishes value under the arm’s-length provisions of the rule.

Industry: If the operator acts as the designee, would royalty value be the proceeds accruing to operator’s affiliate?

MMS: This is a different situation than the previous example.

Industry: If you pay your own royalty, you do not have to concern yourself with operator’s receipts.

Industry: Small interest owners won’t designate if they have to pay MMS royalty based on what the designee gets. What if a non-operating interest owner gets cash from the operator but has a designee, then what? If you sell to the operator but the operator is the designee, what happens?

Industry: MMS should clarify that a “designee” means the operator pays on behalf of the working interest owner.

Industry: “Sells on behalf of” and “is designee” needs further clarification. Otherwise you may end up with excessive numbers of payors.

Industry: What is important is the ultimate sale by the operator, not the designee concept.

MMS: Please lay out these concerns in your written comments.

Industry: If a designee chooses an option under the two-year election, are others locked in too?

MMS: The term “designee” may add confusion. We agree that MMS needs to clarify this. MMS would not want the working interest owner to pay on a higher value than received under an arm's-length contract.

Industry: How often would operators and working interest owners really have different prices?

MMS: What do we do if/when operator puts working interest owners at a disadvantage?

Industry: What is the intent if a small working interest owner gets \$20, but the operator gets \$22? What is the working interest owner’s royalty obligation?

MMS: \$20

MMS: The point, or intent, is to pay on what you receive.

Industry: In the “affiliate” definition what does the “extent of participation by other owners in the operations and day-to-day management” mean?

MMS: It means how much impact does any one owner have relative to other participants.

Industry: The examples given in the preamble were clear-cut. What if, in reality, things are more “gray?”

MMS: Each situation must be looked at case-by-case. Under 206.107, MMS may make a value determination.

Industry: A lot of details will be considered, but there are no criteria.

MMS: The rule simply tries to lay out types of details to be considered; no two cases are the same.

Industry: What is a wholly-commonly-owned affiliate?

MMS: Two affiliates of one company are wholly-commonly-owned affiliates.

Transportation Allowances

Industry: The Payor Handbook lists allowable costs, including condensate separation, but this is not in the proposal.

MMS: The rule does not go to that level of detail. The Payor Handbook would be addressed later.

Industry: Would be more comfortable with the rule if the condensate language was in the preamble and the regulations themselves, similar to the Payor Handbook language.

MMS: Perhaps this should be put in the preamble.

Industry: The 4415 is eliminated, but there are references to taking appropriate transportation, location, and quality differentials. Are companies to take their own?

MMS: Yes, companies will use their own exchange agreements to determine location/quality differentials.

Industry: What about when a company's Rocky Mountain Region production and others' have a big quality difference but they do not have an exchange agreement, what then?

MMS: The rule provides that when a lessee does not have differential information, they may request a differential from MMS. MMS would consider the companies' proposals.

Industry: Is monthly approval required?

MMS: This is not the intent, MMS will try to give a determination that will apply for a longer specified time period.

Industry: The rule states you must adjust value for quality and location differences; may adjust for transportation – where can the company ask MMS for a determination?

MMS: The 206.112(f) gives the company the right to come to MMS.

Industry: Is one deal enough to determine the differential?

MMS: Yes, but MMS wants the company to account for different qualities involved.

Industry: Is this less than a valuation determination?

MMS: Yes, it would be similar to the 50 percent transportation allowance exception contained in the current rules.

Industry: In the Rockies, a simple gravity adjustment may not result in an appropriate value adjustment. (Relative to Cushing) Why not go to the market center nearest in quality. Asphaltic crude values may not be properly reflected otherwise.

State of Wyoming: Trying to calculate an arbitrary transportation differential is a real problem, especially regarding sweet/sour crudes.

Industry: Does MMS have a problem with industry entering an exchange simply to satisfy the requirement of determining differentials? It would help if we could clarify “opposing economic interests.”

MMS: Our immediate reaction is that we would not want you to do something just to satisfy a royalty requirement. Business should not be done differently from the normal in order to satisfy royalty requirements.

Industry: If oil is taken to a company’s own refinery, taking a Cushing price less actual transportation to the refinery would not arrive at a reasonable value.

MMS: There will probably only be a handful of companies that would get to the third Rocky Mountain Region benchmark. They would not have a tendering program or significant arm’s-length sales.

Industry: For both gross proceeds or index, must the proper differentials be found?

MMS: When using proceeds, the actual transactions should reflect needed adjustments.

Industry: We need guidance on quality adjustments other than gravity, like for sulfur.

Industry: Whatever the region, the nearest market center with similar crude should be used. (Canadian crude; California spot prices such as Line 63, Kern River; other Gulf Coast spot prices.) ANS is not the best starting point to make quality adjustments.

State of Wyoming: The final appropriate differential in arm’s length buy/sells can be found, but not where oil is refined by the lessee.

Industry: If MMS can make a ‘leap-of-faith’ in accepting tendering the Rocky Mountain Region due to lack of spot prices, why not let companies use a single arm’s-length exchange agreement for differentials? MMS should not care about the motivation.

MMS: Motivation does matter. It may be the incentive to do less than the optimum to limit royalties.

MMS: The rule gives a lessee the option to show actual refinery value and deduct actual transportation costs.

Industry: Do the tendering program criteria prohibit those with tendering programs from bidding?

MMS: No, the language does not prohibit “tendering” companies from bidding.

Industry: MMS seems to assume producers with affiliates will also sell some production in addition to that sold by the affiliates. Usually the purchaser will buy all 100 percent of the production. Fifty percent may be high for the second Rocky Mountain Region benchmark.

Change to Rate of Return (ROR) on 10 percent of capital investment

Industry: This is the right direction, but not large enough.

(Industry will provide written comments.)

Industry: We are looking for a change that reflects risk components. Changes may include FERC criteria. (Industry has other, general transportation comments to be made later in writing.) We are concerned that satisfying MMS regulations may put us in violation of the Interstate Commerce Act.

MMS: What about the change allowing the purchaser to start with a new depreciation schedule?

Industry: Generally approved of change.

Industry: They are pleased with MMS’s request for comments on ROR.

Industry: Would MMS accept comments on areas in the rule or preamble benefiting from additional examples/criteria?

MMS: Yes, give us such comments.

Industry: Tendering program definition. What if an arm’s-length sale takes place not under competitive bidding? Is such an arm’s length sale part of tendering?

MMS: No, not if the arm’s length sale is outside tendering program.

Industry: Why take just high tendered bids rather than an average of bids?

MMS: To assure we get market value; concern re: bidders being affected by lessee's affiliates right of first refusal.

MMS: The proposal would just use the highest bid to apply to non-arm's length volumes; barrels sold under tendering at arm's length valued at their sale prices.

Industry: The weighted average of accepted bid prices should be used, rather than highest.

Industry: In the Powder River Basin, there is a competitive market; as in some other areas of Wyoming.

- Posted prices are still key to valuation, especially regarding gravity.
- The second Rocky Mountain Region benchmark does not address any quality differentials; a weighted average could skew value if a big gravity range exists. There should be a gravity adjustment.
- What about the effective date?

MMS: We are looking at 60 days after the final rule is published. If we publish on March 15, then the effective date will be June 1, 2000.

Industry: Can we get expedited MMS reviews for administrative purposes?

MMS: You can pay on estimates and adjust later.

Industry: Will extending the effective date be considered?

Industry: Suggest normalizing all sales to one gravity.

MMS: 206.119 applies here.

Industry: Why not give valuation (index) option for arm's length sales?

MMS: The principal of the regulations is to accept arm's length value as royalty value.

Industry: No adjustment is allowed in the regulations for condensate, whose value is lower than the corresponding crude for which spot price applies; how do you make such adjustment?

MMS: 206.112(f) allows the company to request a location/quality differential from MMS.

Industry: Our concern is about the timing of an index price. What is the trading month? Under the proposed rule, what is the procedure for applying published spot prices in relation

to the production month for which royalties apply? Can you lay out examples in the preamble?

MMS: For example, if the production month is February, the spot prices published from December 26 through January 25 would apply to February production and the associated royalty. We heard from many in the industry throughout the rulemaking process that this is the way they do business—that is, based on the trading cycle outlined in the proposed regulations. Does anyone disagree?

Industry: General agreement.

MMS: We can do examples in the preamble.

Industry: Options to pay on index were provided because of a perception of the problems associated in tracing production downstream. A company may have to value different portions of production at arm's length gross proceeds vs. index or gross proceeds for ultimate arm's length sales vs. index. The option should be offered for all types of dispositions.

Otherwise, this puts majors without affiliates in position of doing multiple calculation types. This also applies to companies who don't transfer all production to affiliate. The impact is greater on the largest royalty payors. Please consider offering option of paying across-the-board on one methodology; i.e., index pricing.

Industry: Will you offer the option of allowing a methodology outside rule's provisions under negotiations with MMS?

SOL: Rules should apply to all; audits should be done under objective criteria.

Other comments

Industry: There is vast improvement, such as with "certainty." Industry should provide comments on joint operating agreements. Independents with the affiliate are not pleased as there is little improvement; i.e., index valuation. There may be further concerns about some areas of New Mexico not being part of Rocky Mountain Region. You can expect joint industry comments. We understand that we may have to agree to disagree regarding the duty to market issue.

-adjournment-

List of Attendees

Name	Organization
Derek Weekly	State of Wyoming
Paul Koehler	State of Wyoming
Keith Bloomster	Chevron
Larry Cobb	MMS
Van Williams	Equilon Pipeline
Dave Domagala	MMS
John Ash	Forrest Oil
Dave Hubbard	MMS
Peter Christnacht	MMS
Kevin Lanham	State of Wyoming
Tina Wertz	State of Wyoming
Rebecca Webb	State of Wyoming
Mary Archer	State of Wyoming
Sally Vigil	State of Wyoming
Jerry Hutchinson	State of Wyoming
Jerry Herz	Eighty Eight Oil
Sara Tyes	Exxon Mobil
John Bloomstrom	Eighty Eight Oil
Carla Wilson	IPAMS
Tim Musil	DOI-OIG
Melanie Sorenson	DOI-OIG
Geoff Heath	Solicitor
Ken Leonard	API
John Kjelmyr	Forrest Oil
Pasty Bragg	Gardner & Wynne
Steve Ward	Gardner & Wynne
George Butler	Chevron
Constance Rogers	Holmes Rogers & Owen
Ben Dillon	IPAA
Amy Oeball	Nance Petroleum
Lucy Querques Denett	MMS
Debbie Gibbs Tschudy	MMS
Gary McGee	Devon Energy