Minutes from Federal Oil Valuation Workshop
Denver, Colorado
March 4, 2003

As announced in the Federal Register on February 12, MMS held a public workshop on valuing crude oil from federal leases in Denver, Colorado, on Tuesday, March 4, 2003. In the same Federal Register Notice, we reopened the public comment period on the proposed Indian oil valuation rule, establishing a deadline date of April 14, 2003.

We had 7 industry, 12 State, and 2 Indian Tribal representatives at the Denver workshop. A synopsis of the feedback received, keyed to the agenda items, is below.

Note: Because MMS was delayed in getting the minutes from each of the workshops onto the MMS website due to the snow storm in Denver, MMS will accept written comments on the proposals discussed at the workshops until April 4, 2003.

Opening Statements

MMS

Debbie Gibbs Tschudy

Introduced the panel members and welcomed the participants.

Introduced the purpose of the workshop:

- Purpose of the Federal Oil Rule is to ensure that the public receives a fair return on federal resources.

- The oil rule is working well and accomplishing its objective. Because we have gained experience over the last several years with the rule, with taking royalties in kind and with information learned during litigation of valuation rules, MMS staff has identified specific technical areas where we would like additional clarification.

- We think the changes to the oil rule will have some potential benefits such as simplifying and clarifying aspects of the rule, streamlining audits and reducing litigation.

- MMS has also reopened the comment period on the proposed rule for valuing crude oil produced from Indian leases so that we don't find ourselves in an *ex parte* situation during the workshop discussions.

- The next step will be the Department's evaluation of the comments received from the workshops. If a decision is made to modify the oil valuation regulations, the agency will move quickly to issue a proposed rule.

MMS: We will begin by going through the agenda items.

Timing/Use of Published Indices and Calculating Location-Quality Differentials

MMS: Should we amend the rule and move toward using calendar month NYMEX pricing for the Gulf of Mexico, Rocky Mountain and Mid-Continent Regions? Should we use NYMEX with a roll? Should we use ANS spot price for California?

Industry:

Some industry representatives (including the American Petroleum Institute's Royalty Strategy Task Force and Marathon, a large independent) stated their belief that the workshop was worthwhile, especially in terms of reviewing various pricing indices with the goal of valuing crude in concert with how the market behaves.

More specifically, industry representatives said:

- They favored use of NYMEX calendar month average (over Platt's trade month data) because it allows the shipper/producer to price using actual production month values;
- NYMEX could be a viable starting point for all 3 regions—Gulf Coast, Rockies, and California—with Line 63 and Kern River spot prices potentially more appropriate for onshore production than Alaska North Slope spot prices;
- MMS should consider valuing as close to the lease as possible using market price and appropriate differentials (when moving product from a large market center like Cushing to someplace like Guernsey, can bridge the value gap by using differentials and other adjustments; for the Rockies, could use a published index—perhaps Guernsey—on a daily basis for sweet crude; on the sour side, Platt's has a Bow River index that could be normalized for Casper, Wyoming);
- There are 3 prime West Texas Intermediate (WTI) indices: Koch's posted price plus the P+ premium; Platt's assessment for WTI; and NYMEX. NYMEX is the dominant of the 3 indices, being widely referenced for crude transactions.
- Use of a "roll" (increase or discount to a market index) is already built into certain indices (like Koch's WTI index.) The roll concept is specific to Gulf Coast production, and is not used in the Rockies or California. The purpose of the roll concept is that it allows for a "floating" monthly price that adds a premium to what the market would have provided. The floating price approach helps avoid being locked into a "fixed differential."
- In some areas, like the Gulf and parts of California, companies don't have to worry about valuation because it's handled through the RIK process. (Greg Smith shared that the RIK program was seeing some ANS for pricing, with a "basket" of local postings—these scenarios predominate in California. Dave Domagala further explained that small refiners are comfortable using postings rather than NYMEX.)
- Most pipelines are common carrier and have published rates, making it do-able to adjust for transportation differences and quality adjustments if you can't go from ANS or NYMEX to the lease.
- A NYMEX adjustment can be used nationwide when used in conjunction with going to the nearest market center. This formula could apply to the Gulf, Rockies, and California. The need to move to NYMEX in the Gulf (instead of using Platt's trade month) would be to replicate market conditions.

The general feeling was that the Platt's assessment doesn't work as well as NYMEX calendar month with adjustments.
- Line 63 and Kern River spot prices are more appropriate as grade differentials for some crude in California.

States: State representatives generally supported use of NYMEX as the third benchmark for valuing non-arm's-length sales in the Rockies. They expressed some concern about the location/quality adjustments as they stated that contracts could sometimes be NYMEX plus. They stated that if a company or its affiliate resells the oil somewhere then they should pay royalty on their gross proceeds.

Allowable Transportation Costs

MMS: Should we publish a proposed rule clarifying what costs are allowable and what costs are not – similar to the February 1998 gas transportation rule? If so, what specific costs should be deemed allowable and what costs should be deemed non-allowable?

Industry:

- Import language from the gas rule, which does contain some specificity regarding transportation.
- The "indirect" transportation or pipeline costs are the items causing confusion, making it worthwhile to develop a list of authorized deductions and include in the rule. An example of an indirect cost is "line fill," or a company's pro rata share of inventory throughput on a given pipeline. Some companies, like Marathon, carry this item as a capital cost of inventory on their accounting records and believe it should be allowed as a transportation deduction. Marathon provided a list of costs that they believe should be allowed under an amended rule:
    - 3rd party transportation costs including pipeline tariffs and contract rates
    - Line losses
    - Line fill carrying costs (explained above)
    - Pump-over fees
    - Transfer fees
    - Gauging fees
    - Short-term storage fees
    - Terminal for loading and unloading fees
    - Quality bank administrative fees
    - Scheduling fees
    - Indirect product charges (e.g., high-gravity deductions)
    - Credit costs to secure transportation services
- Dealing with the above costs has become an issue under the new rule because companies must use the netback-based-tracing-with-adjustments method under the new rule. This has forced industry to carefully examine all these costs, contacting MMS to adjudicate their allowability given the lack of clarity in the rule.
- Items that shouldn't be deductible as transportation include brokerage or commission fees.
- One approach suggested by industry was to authorize a "standard deduction" for costs incurred as you move product downstream from the lease. Certain companies advocated including a standard deduction in the rule for indirect costs that are difficult to calculate, trace, and audit. Another

possibility suggested by an industry representative is to allow the company to choose between a standard deduction or they can calculate their actual costs, subject to audit at a later date.

States: State representatives were opposed to the notion of a standard deduction, reiterating that costs should not be allowed unless actually incurred. Tribal representatives echoed this sentiment. State representatives further cautioned that MMS should carefully consider the "propriety" of even allowing a deduction for indirect costs.

Regarding transferring the concept of a standard deduction to Indian leases, MMS pointed out that we use a standard deduction (10%) for index zones. So, the notion is not new to the Indian side of the equation.

The panel urged attendees to submit for the record a list of costs incurred in moving oil production downstream including a definition of each of those costs to the address cited in the Federal Register Notice.

Rate of Return

MMS: Is the Standard & Poor's 1x BBB bond rate still appropriate when calculating transportation allowances for crude oil under non-arm's length situations?

Comments:

- Industry stated that the 1x factor is an "inadequate" rate of return because it understates the actual cost of capital. There's no problem with the BBB rate being used as a surrogate or convenient tool, but market conditions would probably argue for a much higher rate like 1.8 or 2.0x BBB.
- Several commenters warned that opening this discussion would force re-examination of the geothermal rate as well.
- MMS did a study where every 1/10 change in the multiplier (e.g., going from a multiplier of 1.0 to 1.1) resulted in a change to the royalty stream of about $750,000 – most of which is OCS revenues.
- From many companies' perspective, a return on investment lower than the weighted cost of capital becomes a fairness issue.
- The difficulty comes in the area of commingled production (Federal and Indian). Do we use one rate for Federal and another for Indian? Geothermal may require ratcheting up or down, too.
- If you go with actual costs, it should work across the board for all products—oil and gas.
- Regarding whether a change in rate of return would encourage any infrastructure changes by region, some agreed that this may create an incentive for capital development. (It was noted that BLM resource plans and environmental concerns may not allow an operator to start drilling, develop a pipeline, or make infrastructure changes as a result of increasing or changing the rate of return.)
- One of the State representatives questioned why we allow any rate of return in the allowance calculation.

Joint Operating Agreements (Federal oil issue only)

MMS: Should MMS view Joint Operating Agreements like all other transactions—i.e., remove any presumption of arm's-length versus non-arm's-length in the preamble?

Comments:

- Companies want the certainty that these are arm's-length transactions for royalty valuation purposes.
- If MMS allows companies to view these as arm's-length, they would still be scrutinized to determine the exact nature of the marketing arrangement.

<u>Other Comments</u>

- One industry representative asked a question about the Information Collection Request for the Form MMS-4416 related to the Indian oil valuation rule. The question was whether the intent of the Indian rule's Form MMS-4416 is to report major portion calculations? We responded that the form would be used primarily to provide lessees with location/quality differentials when they are required to use index prices. OMB approved the Form MMS-4416 3 years ago even though the rule was not finalized. The form is now up for renewal.
- On behalf of attendees, one company expressed appreciation for the chance to comment on the rule. In the event of a proposed amendment, attendees would also welcome the opportunity to comment in writing.