Minutes from Federal Oil Rule Workshop
Houston, Texas
Wednesday, March 5, 2003

As announced in the Federal Register on February 12, MMS held a public workshop on valuing crude oil from federal leases in Houston, Texas, on Wednesday, March 5, 2003. In the same Federal Register Notice, we reopened the public comment period on the proposed Indian rule, establishing a deadline date of April 14, 2003.

We had 45 industry and 2 State representatives at the Houston workshop. The industry attendees were a cross-section of the corporate landscape, ranging from relatively small companies (like Walter Oil or Newfield Exploration) to major, integrated concerns (like ExxonMobil and Marathon). 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 steps will be for the Department to evaluate 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.

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

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:

- Similar to the beginning of the Denver workshop, some companies said that the federal oil rule was not as bad as they had originally feared. However, they felt it needed some fine-tuning and more certainty/clarity.
- They support reviewing whether additional indices could be identified to better reflect the market, with support for a NYMEX calendar month average approach. MMS uses published indices (like Platt's) but values next month using current month (trade month approach). This creates uncertainty that suggests a closer look at adopting the same timing that industry uses for the specific market where prices come from.
- Try to use indices established during the month of production applying differentials that pertain to that month—e.g., use of a calendar month (WTI basis) coupled with differentials for various types of oil (sweet, sour, etc.).
- Regarding the propriety of NYMEX versus Koch's P-Plus (posted plus premium):
    - NYMEX is widely referenced by traders, industry. As long as the market is open, traders key off what NYMEX says.
    - Koch's P-Plus is viewed as the prevalent index in the field (primarily in the Gulf region). In the Rockies and California, some NYMEX is applied, but posted prices still predominate.
    - Try to use an index that correlates with market conditions—whether it's NYMEX price basis or Koch's P-Plus, two dominant indices that correlate closely with the production region.
- Concerning the preferability of NYMEX to ANS in California, ANS is a thinly traded market requiring adjustments from a light sour in San Francisco to the localized market and then back to the lease. In California, limiting to ANS is not appropriate because this index doesn't really correlate with the market in California. It's better to use Line 63 or Kern River spot prices to bridge the gap to the local market center. Using Line 63 or Kern River is how you get the P-Plus for the California market.
- For the Rockies, Wyoming sweet at Guernsey should be viewed as an acceptable index. In other words, start with NYMEX or Koch's P-Plus, but for Wyoming take the difference between NYMEX and Guernsey to establish a value at the lease for sweet crude.
- For Wyoming sour, some companies (like Marathon) have used Canadian prices to value production. The biggest problem has been "normalizing" the transactions from the Canadian market back to the production location (i.e., the lease). Guernsey could be used for sweet, while Bow River is representative of asphaltic sour.

- Some companies who sell their production at arm's-length (like ChevronTexaco) have problems with weight averaging and adjusting back to the lease—with special problems presented by commingled production. There are also various disposition scenarios causing the rule to be non-useful requiring a future valuation agreement or valuation determination. These companies would like to be able to have the option of using index prices for valuing oil that is sold arm's-length downstream of the lease.

States:

- New Mexico suggested getting away from using spot markets, which are easily manipulated. NYMEX is more reflective of the market and less susceptible to manipulation. If MMS goes with flexibility based on how a company markets its production, it would be at the risk of simplicity; however, greater specificity adds simplicity for auditing.
- Wyoming opts to keep things simple—keep it in the arena of Koch's P-Plus or NYMEX. Going with a calendar month makes sense.

Further industry comments:

- If index is market responsive, MMS should be indifferent as to whether a company chooses to value using an index. This would help compliance establish a minimum expected value. RIK benefits, too, by knowing whether bids are close to RIV. RIK and RIV should be on a level playing field.
- In response to the issue of what to use when market centers are way downstream of the lease, some (like ChevronTexaco) suggested using a recognized terminal where someone takes ownership. You could also apply known differentials; otherwise, they would contact MMS to get the appropriate differential. Another option would be to simply use the index that's applied as part of an affiliate sale.
- When faced with the regulatory option of using an index or affiliate proceeds, several companies responded that they have elected to use index when their production is not being taken in kind by MMS.

<u>Allowable Transportation Costs</u>

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?

As with the Denver workshop, attendees recommended tweaking the rule to achieve greater clarity and simplicity. Additionally, the goal should be to increase certainty for paying royalties.

Industry:

- MMS should make modest changes to the rule, providing 2 lists: one showing allowable transportation deductions; another showing those that are not allowable. Marathon reiterated its 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

States:

- State of NM said that going with the above laundry list of allowable deductions would result in litigation forcing the courts to better define these various costs; no changes to the existing rule would leave things "vague." Wants auditors to know with certainty what's allowable or not, so the State favors more clearly identifying costs that are allowable even at the risk of litigation.
- State of WY favors identifying what's deductible with the caveat that authorized deductions should be limited and certain costs like credit and storage disallowed. Do not put the risk on States and MMS—"carefully" select authorized deductions.

Industry:

- "Costs of credit" can be considered transportation costs because going through a proprietary pipeline may require a Letter of Credit or sufficient guarantees to sell the production to the pipeline. Similarly, "storage fees" are sometimes defined in tariffs and, therefore, comprise an indirect cost of product shipment. (Storage, when defined as the cost of holding product awaiting a better market, applies to long-term market discussions and, in that context, could be viewed as a marketing expense. As advocated by industry, storage would be more of a short-term concept and could be very intrinsic to the scheduling and other indirect aspects of product movement.)
- MMS should learn more about the pipeline aspects of selling oil downstream of the lease—much like what has occurred with RIK.
- MMS has poor guidance on 3rd party transportation costs (items less incidental to transportation, but causing considerable confusion in the area of royalty calculation).
- To mitigate audit cost and administrative burden of tracking costs downstream of the lease, it may be worthwhile for MMS to authorize a standard deduction (e.g., 5 cents per bbl) for indirect costs of transportation. Costs like "line fill" (see above) are indirect costs of using a particular pipeline.
- There are winners or losers when you go with a standard deduction. For example, some companies have staffs dedicated to tracing production and balances every month. On the 25th of every month, these planners and logisticians make nominations to every pipeline involved. If everything were sold and valued at the lease, these folks would be unemployed.
- However this turns out, don't dismiss small company concerns about the administrative burden of tracking downstream costs for valuation purposes.
- When updating the rule, perhaps the starting point (or 1st principle) should involve dealing with downstream costs.

MMS: MMS panel members urged attendees to send an email or correspondence to the address provided in the Federal Register Notice regarding the list of indirect costs described earlier.

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? For geothermal projects, the rule provides for 2x BBB because these projects are riskier in an economic sense.

Comments (unless otherwise indicated, feedback below was from industry):

- The current 1x BBB factor is inadequate. The proper ROR is probably much higher to reflect current market conditions. The Standard Industrial Classification (SIC) Codes, upon which the BBB is based, are an imperfect collection of companies that build oil pipelines—so this area is ripe for changes.
- State of Wyoming offered that the pertinent question is whether the rate reflects the cost of capital to industry. In other words, what's BBB versus current cost of capital? It could be that the cost to industry is less than the BBB, in which case we should go with actual figures. If we allow different factors here (multiples of one-tenth, for example), we need to exercise extreme control.
- MMS stated that the S&P BBB bond rate is a known, published amount, helping us avoid the administrative burden of having to calculate this on a company-by-company basis. It is meant to be a "proxy" of a company's average cost of capital.
- An index is preferred over data from FERC, but the index needs to be revisited under the "rule of reason." MMS chose a factor of 1.0, but we should look at some other multiplier.
- There are lots of financial/technical risks. One issue is long lead-time for project start to completion. *Interest costs associated with construction of a pipeline should be included as part of the depreciable base. (MMS explained that interest during construction is an allowable cost, covered in the allowance guidelines, but we may need to make this clear in a rule amendment.)
- Consistent with the Denver workshop, MMS advised that per 2001 royalty collection data, each one-tenth change in the BBB multiplier affects royalties by about $750,000 annually (only for oil and mostly offshore).
- State of NM suggested that we may want to project the royalty impact of multiplier changes on gas, Indians, and solid minerals as well. Also, we shouldn't forget facility or gas processing plants as part of this review.

Joint Operating Agreements (JOA)

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 (as made by industry, unless otherwise indicated):

- In response to State of New Mexico's question about how MMS values under these scenarios, an industry representative responded by saying that each party takes and separately disposes of production. Otherwise, the operator has the right to take and market his/others' shares; alternatively, they can buy the production under a separate agreement (which then qualifies the transaction as arm's-length). MMS probably views these as situations where some party comes in and takes another interest's production and markets with theirs. (MMS panel agreed with this assessment.)

- Industry commented that some company's interests are so small, it's better to let someone else with pipeline clout or connections handle the marketing and movement. MMS should just give these small guys a break, and assume the transaction is a sale. MMS responded that we would still evaluate the transaction to determine if it's really an arm's-length sale.
- Since this is a ma-'n'-pa issue, where there's little market power or leverage, small companies will take whatever they can get. Volumes are *de minimus* and smaller companies should not be burdened with tracking ultimate disposition; similarly, MMS should not spend time auditing this stuff.
- An independent producer (Apache) said they have lots of these sales; as a result, they started requiring non-operators to enter into purchase/sale agreements. When these transactions were audited and it was determined that more royalty was owed, the company passed the burden (presumably on a pro rata basis) to its business partners as represented under the sales agreements.
- According to the Apache representative, for independents, it's definitely worthwhile to amend the preamble.
- Typically, companies involved in these transactions are smaller, nonoperating companies—those with little to no marketing or E&P experience. They look to the operator for help in accounting for these transactions. This requires external audit to assess the revenue stream. It could lead to settlement or litigation. When operator sells for other parties or owners, he generally makes the report and payment to MMS.
- Regarding how companies who don't know how to value at the lease do a netback, one respondent said there has to be a transfer price to use as the valuation basis.

<u>Other Comments</u>

MMS: MMS panel reminded everyone that comments for the Indian oil rule had been extended until April 14.

Industry: What about Form MMS-4416? Industry commented that they believe the earlier estimates regarding industry's admin burden are understated. MMS should do a more current evaluation of industry's burden in this regard. MMS' 30-minute estimate for providing supplemental cost data is way out of line. It takes a lot longer, plus the nature of contract changes more frequently than twice annually. MMS encouraged the commenter to submit this feedback to us in writing.

MMS: In response to questions about an updated Payor Handbook, MMS said that resource issues have precluded this, but we're working on it, as staff becomes available.