

Minutes from Federal Oil Valuation Workshop
Washington, D.C.
March 6, 2003

As announced in the Federal Register on February 12, MMS held a public workshop on valuing crude oil from federal leases in Washington, D.C. on Thursday, March 6, 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 6 industry and 2 State representatives at the Washington, D.C. 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

Lucy Querques Denett

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.

States: Will the changes go through a public comment period because you mentioned technical changes?

MMS: We will open up the proposed changes for public comment.

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: Representing a coalition of independent producers and a royalty strategy task Force (IPAA, API, Domestic Petroleum Council, etc). After 3 years experience with the oil rule, the rule is working better than they had feared.

Industry was opposed to using NYMEX pricing at the time the rule was written but now holds the unanimous view that NYMEX based pricing with the proper adjustments would better reflect the market. They stated that we should not throw out the choices of indexes that we have now in the regulations but rather, where appropriate, we should add more indexes that reflect value at the nearest market center.

For example, in California, we should keep the ANS benchmark where applicable but also add other index choices such as Kern River and Line 63 to value certain California crude oil.

States: If MMS has experience using NYMEX as a basis for valuation in California, then we are willing to look at the data and come to our own conclusions.

MMS: We heard comments from the other oil workshops that we should establish values with indexes that are generated during the month of production. We asked if we should use NYMEX prices with a “roll.” The roll is a way to capture the second and third trade month futures prices.

Industry: We would support adopting the approach of using prices that are generated using the 30 day monthly calendar basis.

States: What is MMS’s experience and what problems have MMS seen that is driving us to modify the current rules? What analysis has MMS done?

MMS: We have seen the use of NYMEX pricing in our RIK program and in some future valuation agreements. We also did some analyses and saw a higher correlation between NYMEX or P+ prices and arm's-length contact prices. About sixty percent of the time for the last 20 years, the market has been in a backwardation mode and valuation using the calendar month with the roll would have worked well. The scenario would not have been the same if the market was in contango.

States: We do not want to rely on RIK data because MMS does not disclose the pricing information. Can MMS release the pricing data that is now old?

MMS: We will look into the question.

MMS: We heard the concept at the other oil workshops that we should start with WTI or NYMEX and use other indices to get the differentials back to the lease. We've seen in our RIK program bids for sour crude oil using Canadian prices.

States: It is hard to comment on things we are hearing for the first time.

MMS: We heard the comment that we should modify the rule to allow producers with arm's-length contracts to have the option of using index for a 2-year period.

Industry: It may be appropriate not to trace production to the point of sale if it is burdensome to the company. Industry prefers basing value using arm's-length gross proceeds where appropriate but at some point it may become impractical where you have multiple gas streams being commingled. The option to use the benchmarks/indexes would be welcome.

MMS: Our feedback has been that most companies selling to affiliates chose the 2 year election to base value under the benchmarks rather than tracing production to the sale.

We also asked for comments on what we should do when companies move oil directly to the refinery and don't go through the market center.

Industry: The 80/20 rule should be applied here. Have the companies request future valuation determinations under the regulations and do not change the rule for things that don't occur that often.

States: Their comments on the previous oil rulemaking address the issue above.

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: The deductibility of marketing costs looks like a dead item. If we could put a list of exactly what items are transportation costs in the rule, then we would not have to reinvent the wheel all the time. Front load the system to eliminate uncertainty. Because costs have been unbundled under FERC 636 we can more readily identify them.

States: We have an information problem. We do not see the role that all of the costs play for the companies, so it is hard to evaluate them.

MMS: There are several types of costs.

Hard Costs – Amount per barrel to transport production.

Direct Costs – Line fill, carrying costs and costs for letters of credit.

Indirect Costs – A company hires a person to track crude oil from the lease to the point of sale and this is their only job. Maybe his/her salary cost should be deductible.

States: We do not have enough information to properly evaluate the costs. We would have to do an audit to see if the person above spends all of their time just tracking oil. Even through audit it is hard to get independent data to evaluate how things really work. We can make lists of costs but it is still hard to evaluate them in an audit situation.

MMS: The offshore CAM has done some work to identify costs. In another meeting, auditors from New Mexico have supported the idea of identifying specific costs. An idea was floated at the Denver oil workshop about a standard deduction for indirect costs.

Industry: Thought it was a good novel approach to use a standard deduction for generalized costs. Idea is worth exploring at this time.

States: We provided comments in 1997 previous rulemakings, that we use a postage stamp approach that would cover all transportation costs.

MMS: We did not hear a lot of support for a standard deduction from the states at other meetings because the standard deduction might include costs that may not actually have been incurred.

Rate of Return

MMS: Current rules allow 1 times S&P BBB bond rate. Is this the proper rate of return for calculating transportation allowances?

Industry: Standard Industry Codes currently do not accurately reflect industry. Equity to debt ratio assumption used in the past missed the mark. We would support any increase in the ROR because the current rate dramatically understates the actual cost of capital. No matter what basis is used to determine the ROR, the multiplier should be tweaked.

MMS: Each one-tenth increase in the multiplier equates to about a \$750,000 decrease in royalties collected per year. Most of the change would affect offshore revenues.

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?

States: Wanted to know the extent of the problem. Why don't working interest owners address the problem on their own?

MMS: This issue is not as big a problem as when the rule was written. Companies changed the way they entered into agreements with their working interest owners because of the way the rule was written. Currently, many companies pay their working interest owners based on what they get from actual sales rather than at some posted value.

Industry: JOA's are just another type of operating agreement and should be not be singled out under the valuation regulations for special treatment.

Other Comments

The agenda items were finished and we opened up the discussion for any other comments.

There was no response from the audience and the meeting was adjourned.

The audience was asked to submit any other comments that they wished to be added to the record by March 31.

The Project On Government Oversight submitted a 1 page statement.