

Minutes from Federal Oil Valuation Workshop
Albuquerque, New Mexico
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 Albuquerque, New Mexico, 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 1 industry, 5 State, and 4 Indian Tribal representatives at the Albuquerque 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 snowstorm in Denver, MMS will accept written comments on the proposals discussed at the workshops until April 4, 2003.

Opening Statements

MMS

John Russo

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.

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:

- The Royalty Strategy Task Force (IPAA, US O&G Assoc., and others) uses NYMEX pricing. Industry looked at NYMEX earlier and thought it was not the way to go. But, they have rethought that and decided that other indices might be good to use if the price can be brought back to the lease. The Royalty Strategy Task Force considered NYMEX viable, others in certain areas; adjustments are critical. Industry supports using differentials for quality and location. Industry suggested changing the rule to allow companies to choose either index or gross proceeds for arm's-length sales like others can who have affiliates.

States:

- One State representative supported using NYMEX but cautioned that, especially in today's market, MRM must be aware of price manipulation of spot prices. From a monthly perspective, NYMEX is the most simple to use. To estimate the true value of oil, MMS should look to industry to see how they value oil. It is MMS's opportunity to understand how industry is marketing and base what we do on that in that area. MMS will have to recognize locality differential and also has to recognize locality differential manipulation. MMS will have to weigh the options and decide, or could offer a variety of things based on market location.
- MMS should look at companies that move the product past market to refinery who MMS allows to use index rules. Doubted that an index is representative of true value in this circumstance. In New Mexico, the cost of moving product to a refinery at Cushing is lower than moving to a market in the Gulf. MMS should have companies use the nearest market.
- Supported the idea to give the option to all parties to use gross proceeds or index to simplify reporting and compliance.
- New Mexico expressed concern on using published differentials because if you aren't a party to the negotiations of the differential you do not know what other expenses may be contained in them. Therefore, companies could use them inconsistently for their benefit.
- Would like MMS to consider increasing 2-year lock-in period for use of index for arm's-length transactions in exchange for giving additional flexibility of using different index. Suggested we study going to a longer period requiring the option to use index for a 4-year period rather than two.
- There may be a risk using NYMEX or other index for 4 years.
- Support NYMEX, have since 1998. Calendar month is most simple to use – MMS needs to look towards industry how they manage and market their oil, trading or calendar month and consider offering many options.
- In the San Juan Basin companies are getting away from exchanges and differentials.
- There are both location and quality differentials published for Cushing. There are situations where you can trade and bypass the Midland market. Also, there are 1-2 pipelines that move intermediary. There are tariff and buy/sell agreements that support location differentials. From Permian to Midland there are exchanges of sweet to sour, etc. Companies know what the location differentials should be. In the San Juan Basin they are getting away from exchanges and are going to outright

sales to Giant. In the past, there were exchanges at Midland with differentials and also exchanges at Guernsey.

- We received no response on using NYMEX or NYMEX with a roll in the State of California or any California issues. No one representing the State of California attended the meeting.
- Supported allowing companies to opt to use the index for arms length sales that truly don't have an affiliate. So that they are treated like other companies.

Tribes:

- Expressed concern about how much reliance Federal Government is putting on indices, asked about methods used to value RIK. (MMS explained its process and methods). Tribes do not have experience working with NYMEX and do not know what problems are when determining differentials and whether there are other expenses within them.
- Asked how MMS calculated location and quality differentials for Indian rule. (MMS explained its process and methods).
- Expressed concern that differentials contained non-transportation or other non-allowable components.
- Asked MMS to send any studies conducted that analyzed the impact of using the various indexes.

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 rule? If so, what specific costs should be deemed allowable and what costs should be deemed non-allowable?

Industry:

- It would be helpful if the rule listed costs that are allowed and not allowed. They will support this effort. Some of the costs they would like to be allowed are:
 - Line losses
 - Line fill carrying costs
 - 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
 - Others
- 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.
- Stated they would provide a list of proposed deductions in written form.

- There is some possibility that a lump sum (standard deduction) method to capture these costs would work.

States:

- Supported the idea of listing allowable and non-allowable costs because it adds certainty. But did not agree with the industry list. State representatives were opposed to the notion of a lump sum deduction, reiterating that costs should not be allowed unless actually incurred. State representatives further cautioned that MMS should carefully consider the “propriety” of even allowing a deduction for indirect costs.
- MMS is in a catch 22 situation. On the one hand adding certainty to the rule by listing the costs will be of benefit, the arguments over what is in the rule as allowable or not allowable will end up in court. Cautioned MMS to follow historical record on costs that are allowable. By opening up the rule for cost factor could impact gas if defined similarly and New Mexico is concerned that it will impact on natural gas which will have a significant impact on their royalties.

Tribes:

- There are a lot of costs that are questionable on the Industry list- such as line fill.

Rate of Return

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

Industry:

- Did not feel BBB rate is adequate. The Royalty Task Force did work on the earlier rule and research showed that it would be different for each company. It does not represent actual cost and further study needs to be done. 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.)

States:

- Questions why MMS considers this to be an allowable deduction. And expressed concern that industry is double dipping by getting a deduction and charging shippers. Not sure that the cost is actually incurred. Allowing a rate of return conflicts with the State lease terms.
- Do not know what would be appropriate rate if there were a rate. Three B is the lowest rate and MMS has a duty to protect the public interest. As stewards to protect public interest, MMS has obligation not to accept a higher risk than BBB rate. Expressed concern that changing the oil rule could impact on the gas rule.

- MMS should consider making distinction for offshore or onshore. Unless MMS will have different rates for different products, changing will have a big impact in New Mexico as far as revenues received.

General:

There was significant discussion and opinion concerning what is the reason for allowing a rate of return, what truly is the cost of capital and MMS' impact in helping to create infrastructure. The discussion culminated with general agreement that MMS should explain the rationale and purpose of allowing this deduction in the rule.

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 sale versus non-arm's-length sale in the preamble?

Industry:

- Usually JOA's are done by owners with very small interests. Would support removing the language from the rule.

States:

- Do not consider JOA to be a contract. Concerned with how pricing would be determined for joint operating agreement. Speculated that this is a factor in gas more than oil. Suggested that if MMS removes the language it should give specifics on how to value when JOA is in place.

Other Comments

Tribes:

- Tribes expressed concern about delay in issuing the Indian oil rule. Navajo Tribe is very interested in seeing the Indian Oil Rule going forward even though the Tribe is currently taking 83 percent of oil in kind.
- The factors that led the Navajo to RIK are that it has been 5 years since both Federal and Indian oil changes started and almost immediately the Indian valuation regulations were separated from Federal and still have not been finalized.
- Tribes need some other method of comparing what is received for RIK production and the rule needs to go forward.