Minutes

Indian Oil Valuation Rule - Public Workshop
Billings, Montana
March 16, 2005

As announced in the Federal Register on February 22, 2005, the Minerals Management Service (MMS) held a public workshop in Billings, Montana, on March 16, 2005, concerning the valuation of crude oil from Indian oil and gas leases.

One industry, one Bureau of Indian Affairs, and seven Indian tribal representatives attended the Billings workshop. A summary of the comments received at the Billings workshop is outlined below.

In the introductory remarks at the workshop, MMS reiterated that the February 1998 proposed Indian oil valuation rule and the January 2000 supplementary proposal have been withdrawn because of the passage of time and market changes that have occurred since their publication.

The MMS also reiterated that MMS has begun a new rulemaking process regarding the royalty valuation of crude oil produced from Indian oil and gas leases. Comments from the Oklahoma City, Oklahoma, Albuquerque, New Mexico, and Billings, Montana, workshops will be considered in the new rulemaking process.

Should MMS adopt certain Amendments to the Federal Oil Valuation Rule in the New Indian Oil Valuation Rule?

As stated in the Federal Register notice announcing the public workshops, one of the workshop goals was to obtain public comment on whether certain amendments to the Federal oil valuation rule promulgated in May 2004 should be adopted in the new Indian oil valuation rule—for example, using New York Mercantile Exchange (NYMEX) prices adjusted for location/quality and transportation costs for oil that is not sold at arm's-length, and using 1.3 times the Standard & Poor's (S&P) BBB bond rate as the rate of return when calculating non-arm's-length transportation costs.

Indian comments:

- In general, an Indian representative recommended not segregating oil produced from the reservations from oil produced from other types of land categories for purposes of the "major portion" calculation. An Indian representative indicated that she would like to remove the borderline of the reservation for purposes of royalties so that Indian lessors obtain prices comparable to those paid for production from non-Indian lands. In addition, an Indian representative stated that part of the issue has to do with ownership on the "other side of the river" from the reservation where most often the land is privately owned. The Indian representative didn't want to see a border between the reservation and other land types for valuation purposes because the production produced from the Indian's leases comes from the same formation and, as a result, the royalties should be based on similar market values.

- Some Indian representatives expressed concerns regarding being able to find certain "premiums" they often hear about in the industry while performing audits. An Indian representative also stated that lessees often use the posted price to value oil production, however, they have been unable to always verify whether these premiums are part of the gross proceeds or not.

- Some Indian representatives stated that they simply want the best price for the oil and whatever that takes is what they want. An Indian representative stated that they are a long way from determining how this process should all work. For example, some Indian representatives were uncertain how the S&P BBB bond rates are used and indicated that the Indians need more training regarding the oil industry.

- An Indian representative questioned whether the new Indian oil valuation rule will parallel the current Indian gas valuation rule and if MMS will adjust the new Indian oil rule to avoid the Fina decision issue, which addressed valuing production based on an affiliate's arm's-length resale of the production.

- An Indian representative questioned why MMS was changing the current regulatory system and if the system has been working thus far.

- An Indian representative asked if MMS believes NYMEX pricing is a fair value of what is being produced on Indian lands.

- The Indian representatives stated their concerns about the lack of Indian representation at these public meetings. An Indian representative asked, if the government is here to represent Indian interests and to talk about Indian trust for the beneficiaries, then why isn't this public meeting more accessible to Montana Indians?

Industry comments:

- Industry generally agreed that NYMEX may be a viable indicator of value because it's fluid and represents a fair price. An industry representative indicated that volume information upon which that indicator is based is very large, making it difficult for anyone to manipulate the index. NYMEX's usefulness and viability are further evidenced by the fact that spot prices are generally influenced by NYMEX prices, and that certain traders wait until NYMEX closes before posting their prices for crude oil. An industry representative also stated that as the dominant index, using NYMEX could be a good starting point when adopting a new Indian oil valuation rule.

- An industry representative suggested using Guernsey Sweet as a viable indicator and, more specifically, using NYMEX with an adjustment to Guernsey for oil produced from some Indian leases in Wyoming. The industry representative also indicated that for oil produced in southwest Wyoming and the Four Corners area, there is no index and that oil from these areas generally does not flow through Guernsey. However, the industry representative further suggested that MMS could look back at history to get an absolute value for San Juan crude (as an example) and compare that value with the values reported on the Form MMS-2014 and then with NYMEX to determine if there's a reliable correlation.

- An industry representative stated that under the Federal oil valuation rule, use of the BBB bond rate was handled very well when determining the actual cost of capital for the pipeline transportation segment of the royalty transaction. The industry representative indicated that he believes this is a fair method for meeting the intent of the actual cost objective, and the 1.3 multiplier is a fair multiplier. Generally, the industry representative agreed with using another rate or index provided it yields essentially the same rate of return when calculating transportation allowances. The industry representative indicated that since most pipelines are fully depreciated anyway, this rate has a small impact.

The MMS comments:

- The MMS had hoped for more Indian participation in the public meetings. In addition to notice in the Federal Register, MMS also sent letters notifying tribal representatives, recognizing that there would be a tradeoff going to each of the tribal areas. While MMS understands this concern, nevertheless we have to develop a new proposed rule that is useful in a very technical area. One purpose for the workshops is to determine if the Federal experience with valuing crude oil has application with similar Indian transactions. MMS also committed to come back to Indian country for more consultation once the proposed rule is published in the Federal Register.

- The MMS discussed how in 1998, the proposed Indian oil valuation rule based the value of oil not sold at arm's-length on the average of the five highest NYMEX prices. In terms of whether NYMEX pricing is a reasonable value, the record for the Federal rule shows that it depends on the region of the country and how much oil different basins were trading into the area into which West Texas Intermediate (WTI) oil was traded into. NYMEX is generally representative of mid-continent production where the majority of onshore production occurs. However, the majority of Indian production is in the Rocky Mountains. It is considerably more difficult to determine differentials for NYMEX to the Rocky Mountain Region. MMS also discussed the small degree of exchanges between the Northern Rockies and Cushing, Oklahoma.

- The MMS is most mindful of the government's trust responsibility when determining a fair value of oil produced from Indian lands while working to make Indian lands attractive for development.

- Regarding using 1.3 times the S&P BBB bond rate as the rate of return:

  - We have traditionally allowed investment times some rate of return, or some depreciation factor. The BBB bond rate is the lowest grade rate available and is the rate we currently use. We studied rates of return for pipeline companies when we did the Federal oil valuation rule, and they generally ranged from the single BBB rate to 1.5 times that rate.

  - The question becomes, does it really matter whether we use that S&P BBB bond rate or if we use other information (like Treasury bonds, for example) when establishing rate of return for computing non-arm's-length transportation deductions.

Should MMS use Arm's-Length Reported Values for Production from a Reservation or Other Designated Area when calculating "Major Portion" Prices?

Indian comments:

- An Indian representative believes that major portion is not an issue within her reservation borders; but it could be outside those borders, and she reiterated that MMS should erase the reservation borders for valuation purposes because the oil from Indian leases is being produced from the same formations as production from outside the reservation.

- An Indian representative indicated that the oil production from his reservation includes black wax and yellow wax crude. The Indian representative further indicated that yellow wax crude is $2.00 to $3.00 higher in value, and questioned how MMS would determine the type of oil for major portion calculations. The Indian representative stated that when they perform audits and industry pays on a yellow or black wax crude price, they generally accept the reported price for that type of crude.

Industry comments:

- An industry representative generally agreed with the concept of crude oil from a particular reservoir or of similar quality that flows to a similar market center being subject to the same ultimate market price. The difficulty is working back and making adjustments for quality and location.

The industry representative generally agreed with expanding the definition of field to include more data. He indicated that industry is willing to work out a mutually acceptable way to do a good, adequate major portion calculation (especially as it relates to making quality/location adjustments).

- The industry representative indicated that in terms of West Texas Intermediate, there may be some marginally sour oil (.5 percent or more sulfur) for which a purchaser or aggregator may pay a sweet price because it will blend the sour crude with sweet crude. The industry representative further indicated that the contract will identify the crude type, define it, and then set a price basis allowing for certain adjustments (such as quality banks and adjustments allowing for commingling). The industry representative believes that in the end, value needs to be governed by "proceeds" under opposing economic interests. The question becomes how to factor this into a major portion array.

The MMS comments:

- The MMS panel clarified that in the proposed Indian oil valuation rule, we need to determine if there's a dataset that will better help define the major portion value. MMS specifically requested feedback regarding how to determine the field or area in the major portion calculations.

- The MMS also requested feedback regarding using arm's-length reported values on the Form MMS-2014 to calculate the major portion prices and how MMS should identify different crude types in a given area (e.g., sweet crude, sour crude).

<u>Should MMS Collect Information to Use in the Major Portion Calculations to Distinguish the Quality of the Oil (i.e., sweet crude, sour crude, yellow wax, black wax)?</u>

Indian comments:

- Several Indian representatives questioned if MMS will determine quality of the crude oil for major portion calculations or if industry will.

- An Indian representative questioned how MMS will know for certain that the type of crude oil reported is accurate without looking at purchaser/seller records.

- An Indian representative indicated that yellow wax and black wax crude can be produced from the same well and questioned how MMS would deal with that situation.

Industry comments:

- An industry representative indicated that he is opposed to having to provide more information regarding types of crude or other data not already being reported or provided. Additional information up front on the Form MMS-2014 won't necessarily eliminate the need for an audit.

- An industry representative questioned how a new process would work if crude type would become a new line on the Form MMS-2014. The industry representative also indicated that he is willing to look at some way of providing extra crude type information on the Form MMS-2014, but MMS needs to determine a non-burdensome way of doing that.

The MMS comments:

- The MMS discussed the necessity of obtaining the crude type to normalize data for major portion and to capture all of this information properly. One purpose of the workshops is to determine what MMS needs, and how best to use that information.

- The MMS panel discussed the royalty report (Form MMS-2014) that contains a sales type code (STC) indicator for arm's-length or non-arm's-length transactions.

- The MMS panel discussed the need for definitions of yellow wax versus black wax crude and asked for feedback regarding collecting this information on the Form MMS-2014.

Additional Comments

At the Billings workshop, additional discussions occurred regarding the Royalty Policy Committee's Indian Oil Valuation Rule Subcommittee; the Indian Mineral Development Act (IMDA); and taking Indian oil royalty-in-kind.