Indian Oil Valuation Negotiated Rulemaking Committee

Meeting 2, June 18-19, 2012
Building 85 Auditorium, Denver Federal Center, Lakewood Colorado

Meeting Summary

Meeting Participants

Committee Members and Alternates
Bruce, Loudermilk, Bureau of Indian Affairs
Steve Graham, Bureau of Indian Affairs (Alternate)
John Barder, Office of Natural Resources Revenue (ONRR)
Deborah Gibbs Tschudy, ONRR (Designated Federal Officer (DFO))
Donald Sant, ONRR
Paul Tyler, ONRR
Theresa Walsh Bayani, ONRR (Alternate DFO)
Daniel Riemer, American Petroleum Institute
Morris Miller, American Petroleum Institute (Alternate)
Dee Ross, Chesapeake Energy
Kevin Barnes, Council of Petroleum Accountants Societies
Patrick Flynn, Resolute Energy Corporation
Robert Thompson, III, Western Energy Alliance
Kathleen Sgamma, Western Energy Alliance (Alternate)
Grinnell Day Chief, Blackfeet Nation
Jeanne Whiteing, Blackfeet Nation (Alternate)
Alan Taradash, Jicarilla Apache Nation
Claire Ware, Joint Business Council of Shoshone and Arapaho Tribes
Jim Shakespeare, Joint Business Council of Shoshone and Arapaho Tribes (Proposed Alternate)
Marcella Giles, Oklahoma Indian Land/Mineral Owners of Associated Nations (OILMAN)
Perry Shirley, The Navajo Nation
Akhtar Zaman, The Navajo Nation (Alternate)
Manuel Myore, Sr., Ute Indian Tribe

Facilitators
Chris Moore, CDR Associates
Laura Sneeringer, CDR Associates

Observers
Note: Only names of observers who filled in the sign-in sheet are included
Karl Wunderlich, ONRR
Steve Simpson, DOI Office of the Solicitor, Washington, DC
John Kunz, DOI Office of the Solicitor, Denver
Tim McLaughlin, Nordhaus Law Firm, LLP
Grady Ward, WPX Energy
Dennis Cameron, WPX Energy
Dee Graham, OST Field Ops

Additional Presenters
Kurt Barrow, Purvin & Gertz
Gus Vasquez, Argus
Esa Ramasamy, Platts

Agenda Topics

Monday, June 18th 2012, 9:00 AM – 5:00 PM

- Welcome, Recap of Previous Discussions and Agenda Review
- Overview of Federal Government Trust Responsibilities (Presentation, questions/answers and discussion), *Jeanne Whiteing, Blackfeet Nation and Tim McLaughlin, Nordhaus Law Firm, LLP*
- Review of the Updated Committee Operating Protocol (Discussion)
- Overview of Crude Oil Supply and Demand (Presentation and questions/answers), *Kurt Barrow, Purvin & Gertz*
- Overview of Crude Oil Flows, Prices and Market Differentials (Presentation, questions/answers and discussion), *Gus Vasquez, Argus and Esa Ramasamy, Platts*
- Discussion on all Oil Market Topics (Questions/answers and discussion)

Tuesday, June 19th 2012, 8:30 AM – 3:00 PM

- Agenda Review for Day 2
- Committee Member Observations from Industry Presentations and Relevance to Indian Oil Valuation (Discussion)
- Overview of Sample Major Portion Analysis and Correlation to Other Initial Proposals (Presentation, questions/answers and discussion), *John Barder, ONRR*
- Discussion on the Meaning of "Maximize Revenue" (Discussion)
- Review and Approval of the Updated Committee Operating Protocol (Discussion and decision)
- Planning for the Next Meeting (Discussion)
- Meeting Wrap-up

Action Items

- The next meeting is scheduled for August 1-2, 2012 at the Building 85 Auditorium at the Denver Federal Center, Lakewood Colorado.
- Dan Riemer, Perry Shirley and Deborah Gibbs Tschudy will serve as the Executive Committee for the next meeting, and will work with CDR to develop the agenda.
- John Barder will update the traditional major portion gross proceeds bump analysis by normalizing values for API gravity. Where possible, he will divide the analysis by crude oil type.
- Paul Tyler and tribal representatives will meet via conference call to discuss whether and how contract information can be shared with the Committee (e.g., what market centers and indexes contracts generally use for each reservation) and other information sharing issues. This meeting is currently scheduled for Monday, June 25 at 2:00pm MT (see e-mail sent by Paul on 6/21).
- Paul Tyler drafted a letter to all tribes to give them an update on the Indian Oil Valuation Committee. Tribal representatives will review it and provide input by July 9 see e-mail sent by Paul on 6/20).
- Deborah Gibbs Tschudy will develop a presentation on the major portion analysis recommendations in 2000 Proposed Rule for the next meeting.

Topics for Future Meetings

Next Meeting

- Review and discussion of the normalized traditional major portion analysis and gross proceeds bump analysis.
- Review and discussion of the major portion analysis recommendations in the 2000 Proposed Rule.
- Identification of evaluation guidelines.
- Brainstorming of initial major portion analysis options.

- Initial review of major portion analysis options and identification of additional information needs.

Future Meetings
This list includes information shared during interviews and the first meeting.

Oil Market Party Transactions
- What lease contracts generally include
- Overview of typical transaction between operator and purchaser – where purchases are made (e.g., well head or gathering facility)

Regional Specifics
- More detail on different regions– typical transportation costs, where are refineries, types of oil

Data Needs
- More info on non-arms-length transactions – have they increased as described on John Barder's non-arms-length data graph *[John Barder can provide in next few months]*

Overview of Relevant Models (Federal Oil Rule, Indian Gas Rule, Navajo In-Kind etc.)

Summary of the Meeting Discussion

Note that all meeting presentations and handouts will be available on the Committee website at: http://www.onrr.gov/Laws_R_D/IONR/

Overview of Federal Government Trust Responsibilities

Jeanne Whiteing provided a historical overview or the origin of trust responsibilities. Tim McLaughlin then provided an overview of relevant statues and case law related to trust responsibilities related to Indian mineral leasing. He described the requirement to "maximize revenue" and "act in the best interest" of tribes and provided a legal overview on guidance for implementing these requirements. For more detailed information, refer to Jeanne's presentation and Tim's handout, which will be available on the Committee website.

The Committee discussed the following comments and questions:

Comment: Indian Mineral Development Act agreements are determined by tribes and companies, with flexibility by both parties on royalty terms. If a major portion requirement is included, the Indian Oil Valuation Rule would apply. While lease terms may override statutes and regulations, both the Federal government and tribes agree that statutes and regulations provide clear directions on the "playing field".

Q. What is the difference between terms used? A. One person described that "maximum revenue" seems to take into consideration tribal and industry needs, while "maximize" seems like it does not take market value into account and introduces a lot of subjective criteria. Some of the Committee's attorneys described that they have similar meanings and different legal documents use different versions. For example, the Indian Gas Rule uses "maximize revenue"; the Kenai case uses "duty to maximize" and the Indian Gas Rule and Supron cases use "ensure lessors receive maximum revenues." After some discussion, the Committee agreed on language for the Operating Protocol.

Q. Can "maximize revenue" and "act in the best interest" ever be competing? A. The group discussed that in some cases they can be in competing (e.g., if safety concerns outweigh monetary concerns). Another person noted that within the valuation conversation, they are not competing because valuation is focused narrowly on price. For example, it cannot involve waiting until a later date until you can get a better deal. There were some differing opinions on this issue. It was noted that many tribes are in rural areas in which it is challenging to attract companies. In reviewing audits, there are many examples of when leasing land was a great deal at one time period and a terrible deal at another.

It was noted that while the Committee should ensure their intent is clear regarding tribal trust responsibilities of the Secretary of the Interior, both in the protocol and subsequent recommendations to ONRR, its members should not worry too much about specific wording because the regulation review process may include rewrites later in the process. However, ONRR will advocate strongly within the Department of Interior and with other reviewers that the spirit, intent and language of the recommendation by the Committee should be incorporated into the final rule.

Review and Approval of the Updated Committee Operating Protocol

The Committee approved the Operating Protocol with minor changes to the ordering and specific terminology in the overview of trust responsibilities section. Revisions also included a more detailed process for what should occur if one or more Committee members do not support the view of other members, and how this dissent will be publicized in parallel and to the extent of any final recommendation by the Committee. The Committee decided to leave in the supermajority vote section, to be used primarily for less important issues, and noted that if this type of decision making process is ever needed, the Committee will review the process in detail before proceeding. The updated Operating Protocol will be added to the Committee website and sent to Committee members.

Industry Overview on Crude Oil Supply and Demand Flows, Prices and Market Differentials

Kurt Barrow from Purvin & Gertz provided an overview on crude oil supply and demand. He described the refining process and how oil's value and price are determined, including impacts from refinery configuration, transportation infrastructure and demand. Gus Vasquez from Argus and Esa Ramasamy from Platts provided an overview of market dynamics, by describing how spot prices are determined and how they affect the overall market. Argus uses a volume-weighting process while Platts uses a market on close approach. For more detailed information, refer to their presentations, which will be available on the Committee website.

Q. Why aren't we seeing new refineries being developed? A. There are about 150 refineries in the U.S. and they have a capacity of about 20 million barrels. We are in a relatively mature market that does not have a lot of growth potential. It includes sophisticated infrastructure and routes for getting products to where they want to go. In addition, environmental permitting can be challenging.

Q. Are refineries changing based on new types of crude? A. This involves a significant cost. Refineries are not set up for Bakken oil yet, but they will be at some point in the future. The price is not high enough to change. West Texas Intermediate (WTI) is being discounted because it is too difficult to get out with current infrastructure. The production came faster than the pipelines.

Q. What is the cause of a spot price decrease? A. It may be less production, more term contracts, etc. Some of the Bakken deals may not be on the spot market. When production starts in a new field people often do not trade with spot prices because they are just getting to learn what is realistic.

Q. How could we use your assessments to develop a formula for oil sold at the lease in rural places? A. Additional information such as quality is needed. You could take the average of several crudes that are highly active/ traded in an area. The cost of transportation would also need to be part of the formula in order to get a better sense of what the market says at that specific location. Conceptually, you could fix the transportation costs annually. Formulas should never be static because aspects such as flows and quality aspects change.

Q. How can we determine not just a price, but the highest price? A. One idea is to average high prices for a month, which ONRR would have to do. This would only include actual transactions, not offerings.

Q. Is it possible to have a standard WTI differential in the Bakken area? A. You could start with a premium differential for the nearest market center and from there come up with a differential for quality and transportation. There has to be a benchmark so that companies can do risk management. There is a chance that Bakken could eventually become a benchmark. However, there needs to be a standard crude, which is difficult because there are so many producers. It is also very difficult to determine the highest price for Bakken because it is being transported in so many different directions. Once there are new pipelines in the Bakken area, a new standard will likely be developed.

Committee Member Observations from Industry Presentations and Relevance to Indian Oil

In general, the Committee members felt that the industry members' ideas on a formula/index pricing approach seemed consistent (i.e., starting with benchmark and comparing it to the nearest market center and then incorporating a differential for quality and location). However, this process seems difficult for Indian oil, with the exception of Oklahoma and potentially Bakken, because leases are generally located in isolated areas that are far from index points. For other areas, it is difficult to determine a benchmark because there are limited assessments, etc. There was also a concern about being too prescriptive in the regulation with a detailed formula that may require being updated. A better approach is to set out principles for valuation in the regulation and then put details in guidance.

Some initial criteria ideas from this conversation included:

- Consideration of long term affects
- Ability to modify methodology if it is not working
- Include safeguards – e.g., safeguards within ONRR or a safety net policy

Overview of Sample Major Portion Analysis and Correlation to Other Initial Proposals

John Barder conducted a traditional major portion analysis at 50% and 75% for all Indian oil producing reservations/areas (including allottees' land) over a four-year period, though his handout materials included information for a two-year period. He used this information to calculate a gross proceeds bump for all payers based on additional royalty calculated from the traditional major portion analysis. He also developed a series of graphs that compare the 50% and 75% major portion prices to the highest and lowest prices and the relevant market center price, in case there are any market-related trends that the Committee may want to consider. John did not normalize the data for API gravity or oil type, which would likely make the prices more consistent and decrease the amount of additional royalties. He did an initial review to get a sense of the gravity range for some areas and some had large ranges (e.g., 30-70 API). He did not remove anomalies, unless they cancelled themselves out. For more detailed information, refer to John's presentation, which will be available on the Committee website.

Committee member conclusions from this initial data include:

- 50% and 75% major portion prices do not seem to be that different.
- The differential between price paid and the market price is consistent across time for most reservations, though the amount of differential is different for each reservation.
- There is a significant range in the gross proceeds bump amount, going from $0.25 to $5. This range would likely decrease if anomalies were deleted.
- In order to do any kind of major portion, ONRR is going to need API gravity and crude type reported to them on the 2014. Crude type needs to be more than just sulfur content because there are areas that have black and yellow wax differences.

Follow-up Action Items:

- John Barder will conduct a more detailed analysis by combining information from the OGOR and 2014 and normalizing data at the common API gravity. There is no data available on oil type, though in some cases he may be able to segregate the data based on oil type if there are significant differences.
- A discussion will be held with the tribal and allottee representatives to discuss whether and how contract information can be shared with the Committee (e.g., what market centers and indexes contracts generally use for each reservation) and other information sharing issues.
- The Committee will review previous recommendations from the January 5, 2000 Proposed Rule to determine if any are worth reconsidering. ONRR will develop an overview presentation at the next meeting.

The Committee discussed the following comment and questions:

Q. Why does the differential change over time in some cases? A. The differential between WTI and a specific area is a function of location and quality. However, disruptions happen that can cause a shift such as having to sell oil in different areas due to logistical challenges. The volume at Cushing could also affect price; if there is large volume at Cushing other areas will be at a premium.

Q. Can you ask the lessee for a copy of the contract for a given reservation in order to get a better sense of what benchmarks are being used, formulas, etc? A. ONRR has some of this information from audits. However, this data cannot be shared with the Committee without the lessors and lessee's permission, but potentially general findings could be shared. Tribes with audit agreements could also provide this information (i.e., a summary of the price provision paragraph). It was noted that at this point, the main information needed is what market centers are used in contracts. An offline discussion will be held with the tribes to determine if this information should be shared and if so how. Another idea was for industry to poll its members to get a sense of what kind of contracts are being used.

Discussion on the Meaning of "Maximize Revenue"

Some Committee members described that while "maximizing revenue" is the emphasis, there are situations in which other variables need to be considered for the Federal government to be fulfilling its trust responsibility. It's not always a straight forward decision. Similarly, it was noted that while "maximizing revenue" should be foremost in everyone's mind, there are other reasons why the Committee was formed (e.g., clarity and consistency in methodology).

Another perspective is that "maximize revenue" is a very narrow issue in the context of valuation. Other aspects are covered in other parts of the leasing process. For example, if there is a challenge related to Federal leases being priced more competitively (i.e., less expensive) than Indian leases, this is a pre-leasing conversation and not a valuation conversation. There are legal cases (e.g., Supron) to back up this narrow interpretation.

Q. Is ONRR constrained at all by what is in Indian Gas Valuation Rule? Does the Indian Oil Valuation Rule have to follow its precedent for the definition of "major portion"? A. ONRR can be inconsistent but has to have a good reason.

Initial Ideas and Questions on Major Portion Analysis Options

Comment: A reservation-specific formula would be preferred for real time accounting benefits. A formula process may be harder to get than for the Gas Rule because of the variety in oil types and quality.

Q. Would you use a benchmark without any modification? A. The Federal Oil Rule starts with a market center and then adds quality and locational differentials.

Q. Is a safety net needed? A. Part of the reason this was included in the Gas Rule was because at that time some Committee Members were not comfortable enough with index prices. One Committee member noted that he was now comfortable with index prices, based on an understanding of how companies prevent data manipulation.

Comment: Market conditions should be taken into account for whatever method is used to ensure changes flow through contemporaneously. It also allows the best price.

Writing Process and Tribal Consultation Discussion

Q. When the Committee has an agreement on what principles should be included, what is process for turning it into a written document? A. An ad hoc subcommittee or specific person could put draft text together for the Committee to review. After the Committee approves a draft, it can be sent out to members' constituents and to others for input and recommendations for refinement. Finally, an ad hoc subcommittee could hash out legal language and bring it back to the full group for review, modification and approval. This process will ensure that the document continues to meet the desired intent.

Q. What does tribal consultation with other tribes consist of? A. The timing of Tribal consultation with other tribes would be when the Committee has developed a draft text with concepts that it is considering including in the proposed recommendation to ONRR for a future rule. (The language in the draft does not have to be that of a formal rule, merely a document with key concepts.) The draft would be sent to the tribes for their feedback and regional meetings would be scheduled by ONRR for consultations. One idea for attendees in the consultations is for the Committee to send a group of Committee representatives – a tribal or allotee, industry and government agency representative other than ONRR (such as BIA) – to these regional meetings to provide a range of perspectives.

It would also be helpful to do outreach now so that tribes and allottees know that discussions on development of a proposed rule are underway. ONRR will send a letter to tribes and allottees that provides background information on the Committee, who the members are and how they were chosen, the process for future consultation and a link to the Committee website for more information.

Specific opportunities for information dissemination and solicitation of input will also be explored with allottees. Some ideas include sharing information with the Assistant Secretary, which will be funneled to the Regions or adding information within their explanation of benefits.