Indian Oil Valuation Negotiated Rulemaking Committee

Meeting 7, June 4-5, 2013
Building 85 Auditorium, Denver Federal Center, Lakewood Colorado

Final Meeting Summary (As of 6/20/13)

Attendees

Committee Members and Alternates
John Barder, Office of Natural Resources Revenue (ONRR)
Theresa Walsh Bayani, ONRR
Deborah Gibbs Tschudy, ONRR (Designated Federal Officer)
Paul Tyler, ONRR
Daniel Riemer, American Petroleum Institute
Morris Miller, American Petroleum Institute (Alternate)
Dee Ross, Chesapeake Energy
Kevin Barnes, Council of Petroleum Accountants Societies
Kathleen Sgamma, Western Energy Alliance (Alternate)
Robert Thompson, Western Energy Alliance (Day 1)
Roger Birdbear, Land Owners Association (Day 1)
Darrel Paiz, Jicarilla Apache Nation (Alternate) (Day 1)
Claire Ware, Joint Business Council of Shoshone and Arapaho Tribes
Perry Shirley, The Navajo Nation
Marcella Giles, Oklahoma Indian Land/Mineral Owners of Associated Nations (OILMAN)
Eddie Lagrone, OILMAN (Alternate)
Akhtar Zaman, The Navajo Nation (Alternate)
Manuel Myore, Ute Indian Tribe

Facilitators
Chris Moore, CDR Associates
Laura Sneeringer, CDR Associates

Observers
Janet Price, ONRR
Karl Wunderlich, ONRR
John Kunz, DOI Office of the Solicitor, Denver
Stephen Simpson, DOI Office of the Solicitor, Washington, DC
Harvey Lucero, Jicarilla Apache Tribe
Sharon Paiz, Jicarilla Apache Tribe
Tim McLaughlin, Nordhaus Law Firm, LLP
Emily Kennedy, American Petroleum Institute
Jonathan Broward, Caerus Oil and Gas (Day 2)
Layne Bell, Petroglyph Energy
Jeremy Norton, Samson Resources
Trey Thee, Samson Resources
Dennis Cameron, WPX Energy

Agenda Topics

Tuesday, June 4, 2013 9:00 AM – 5:00 PM

- Welcome, Recap of Previous Discussions and Agenda Review
- Review of the "Straw Man" Rule Developed at the April Meeting
- Overview of Ad Hoc Subcommittees' Initial Recommendations on Designated Areas
- Overview of the Crude Type and API Gravity Reporting Ad Hoc Subcommittee's Recommendation
- Federal Government/Tribes/Allottees and Industry Caucuses to Deliberate on Morning Discussions
- Report Out from Federal Government/Tribes/Allottees' and Industry's Caucuses and Discussion on the Overall Straw Man Package

Wednesday, June 5, 2013 8:30 AM – 3:00 PM

- Federal Government/Tribes/Allottees and Industry Caucuses to Consider an Index Price Methodology
- Report Out from Federal Government/Tribes/Allottees' and Industry's Caucuses and Discussion on the Overall Straw Man Package
- Discussion of Next Steps, Including Tribal Consultations

Action Items

- John Barder, ONRR, will provide Reservation-level data on the 75% major portion values, NYMEX calendar month average (CMA), the difference between the two for 2010-2012, and an average transportation factor/location differential (as a number and percentage). This data will not be normalized for API gravity, but will be netted for transportation. The report will include a summary sheet with basic information for all Reservations.
- ONRR will develop a brochure for Committee Members to use in their consultations with their constituents. It will include descriptions of the current method and rule for calculating major portion, the new Index Price Methodology and an opt-out option.
- All Committee Members should obtain input from their constituents on the Index Price Methodology and opt-out option (described in the summary below). They should consider what an appropriate premium should be. Tribes/Allottees/Federal Government should consider what is necessary to enable them to no longer have gross proceeds reported. Industry members should consider what they would be willing to contribute for the simplicity and administrative ease of not having to report gross proceeds. Any quantitative/qualitative rationale will be useful for further discussions.
- All Committee Members should consider what the Index Price Methodology should be. It was suggested that the following areas could serve as models for determining how to develop an appropriate formula: Oklahoma, Ft. Berthold, Uintah and Ouray, Wind River and The Navajo Nation.
- CDR Associates (facilitators) will check-in with Committee Members in early July to obtain an update on their deliberations concerning the Index Price Methodology and opt-out option. If there are significant differences among Committee Members, an Ad Hoc Subcommittee may be scheduled before the August meeting to explore how the differences could be reconciled and to develop recommendations for the full Committee to consider. If needed, this meeting will likely be scheduled the last week of July or on the afternoon of August 5.
- ONRR will schedule and conduct Tribal Consultations. It will include other Committee Members where appropriate.
- The remaining scheduled meetings are: August 6-7, 2013 and September 16-17, 2013.

Summary of Meeting Discussions

The meeting began with a review of the Tribes/Allottees/Federal Government proposed straw proposal from the April meeting, including areas of general agreement and topics identified for further discussion. The group then reviewed recommendations from the Ad Hoc Subcommittees, which met after the April meeting. After a series of Tribes/Allottees/Federal Government and industry caucuses, the Committee developed an updated straw proposal that they will share with their constituents for input before the August meeting. It involves using an Index Price Methodology for all Reservations, with an opt-out option for each Reservation that involves calculating a traditional major portion by ONRR designated areas.

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

Proposed Rule Straw Man – As of June 5, 2013

Index Price Formula

An index price formula would be developed for each Reservation, using the principles listed below. The approach is simple as oil companies would no longer be required to report gross proceeds, and there would be no prior-period adjustments or audits on price. Tribes and Allottees will be certain of the royalty they will be receiving.

The Committee tentatively agreed to the following principles.

Principles:

- A transportation factor/location differential to consider location would be included in most cases, but it would have to be simple. If the transportation factor/location differential becomes too complicated, this Index Price Formula methodology would no longer be feasible. The group initially suggested that the differential could be zero, a fixed amount, or a percentage with side boards, as is done in the Indian Gas Rule. They suggested that a percentage would smooth out any changes, such as costs of transportation due to changes in oil prices.

- Tribes/Allottees will have an opportunity to opt-out of the Index Price Methodology, and use a traditional major portion analysis. The opt-out option is described below.

- There would be a premium included to the formula over and above the transportation factor/location differential, to ensure that the amount of royalties Tribes/Allottees receive meets the 75% major portion over time. The premium paid by oil companies would be in exchange for administrative ease and certainty and for the loss of gross proceeds valuation and reporting for the Tribes/Allottees.

Initial Formula

The Committee discussed the following potential formula:

- **NYMEX CMA**: The reason NYMEX CMA is recommended is that this is how most Indian Oil is sold. In the future, if another benchmark (e.g., Brent) is used more frequently, the Index Price for the formula could be changed. If an area uses multiple prices, they potentially could be averaged.
- **Plus/minus the roll (if contracts in the area typically include the roll)**: The roll could be included if they are typically in contract/lease agreements. For example, Oklahoma contracts generally include the roll and contracts in Ft. Berthold, Wind River and The Navajo Nation do not.
- **Minus a Reservation-specific percentage for the transportation factor/location differential**, based on the average difference between the NYMEX CMA and 75% major portion from 2010-2012.
    - It was suggested that a closer market center price could be used (e.g., WTI Midland, Guernsey) as these index prices would add more accuracy than other market center prices do, and would more appropriately consider location. Others noted that these prices, established by surveys conducted by publications, correlate closely with NYMEX and using them would be more complicated.
    - There are some reservations with significant differences between a NYMEX CMA and a 75% major portion. For example, on the Crow Reservation, the differences range from $12 to $25. This is likely due to a small number of payors, which can lead to more variance in the major portion calculation. The Committee will need to determine what to do in these instances.

- **Plus a percentage, representing a premium**: It has not yet been determined what the premium should be, whether it should be the same for all Reservations or if there could or should be different premiums for different areas. It was noted that the premium could be different, based on the perceived administrative cost savings of an Index Price Methodology versus Gross Proceeds with a traditional Major Portion calculation.

<u>Comments/ Questions for Further Discussion</u>

Impacts on Small Producers
The majority of Indian oil production is from small, independent companies. It is important to ensure that an Index Price Methodology is supported by small producers. Any additional royalty costs are challenging for them to incur, and administrative cost savings are often not as much of an incentive for them as it may be for large producers. One idea on how to address this impact is for small producers to pay a reduced premium percentage. There are government precedents and specific regulations that address the needs of small businesses. If this approach is adopted, it will require more discussion on how to define small producers and procedures to be used if a small producer grows and no longer qualifies as a small producer.

Review of Formula in the Future
If necessary, there may be sources of data that could be used for a future review, such as state tax average oil prices or gross proceeds reporting for similar production on nearby Federal lands. ONRR is not comfortable using data for a review unless the basis for the data and the components of the data are clear and verifiable. If a review of the formula is necessary, ONRR would convene a Technical Conference. This process is included in the Indian Gas Rule. The Rule should be written in a way that will not require changes to the regulation if future revisions to the formula are necessary.

Significance of Not Reporting Gross Proceeds
In the past, reporting gross proceeds has served as a valuation criteria. It has functioned as a safety net to judge other values. Dropping reporting of gross proceeds and no longer having this information would be a significant shift. Therefore, having an accurate premium is very important to help minimize risks.

Formula for Oklahoma
The Committee needs to further discuss the formula for Oklahoma. The current proposals are: 1) NYMEX CMA plus/minus the roll and 2) NYMEX CMA plus/minus the roll, minus a transportation factor/location differential based on 2010-2012 major portion calculations.

Tribe/Allottee Opt Out Option: Traditional Major Portion
Tribes/Allottees would have an opportunity to determine whether they would like to opt out of using the Index Price Methodology and use the ONRR calculated major portion value. This option would periodically be made available to them after a certain period of time (e.g., every two years). Specifics need to be determined on how ONRR will consult with Tribes (e.g., whether a Tribal Council resolution is required for a change). The decision for Allottees would require BIA concurrence.

ONRR would notify companies about the change and effective date, as companies will need to report crude type for Reservations that opt out. The opt out option includes the following:

75% Traditional Major Portion as proposed by Tribes/Allottees/Federal Government
- Crude oil values would be based on the higher of the following:
    - The lessee’s or its affiliate’s arm’s-length gross proceeds, OR
    - An ONRR-calculated major portion value
- By December 31 following the end of the prior calendar year, ONRR would publish on the ONRR website monthly major portion values for each ONRR-designated area for that prior year using values

reported on Form ONRR-2014 for oil produced from an ONRR-designated area. ONRR would also publish stand-alone leases/agreements in each designated area.
- ONRR would array all reported prices, net of transportation, for a designated area from highest to lowest.
- The major portion value would be the price at which 25% by volume of oil starting from the top is sold.
- If the monthly major portion value is higher than the value initially reported by the lessee for that month, the lessee must submit amended Form MMS-2014's by the due date set by ONRR.
- Interest would not accrue until 60 days after ONRR publishes the major portion values – consistent with Indian Gas Rule.

Crude Type and API Gravity

- Crude oil type would be reported using new product codes (e.g. sweet, sour, asphaltic, black wax, yellow wax) on the Form MMS-2014.
- ONRR would use separate arrays and calculate separate monthly major portion values for different crude oil types (e.g. sweet, sour, asphaltic, black wax, yellow wax).
- For purposes of the major portion calculation only, ONRR would "deem" all API gravity the same within a designated area/crude type and would not normalize for API gravity within an array. (This is subject to impact analysis.)

Designated Areas

- The Rule would specify the ONRR-designated areas in a manner similar to the current Indian Gas Rule. Designated areas would be added to the ONRR website after the Rule is promulgated.

- ONRR would be able to change designated areas as necessary in consultation with the affected Tribe or BIA for allottees and consistent with applicable law. ONRR would publish changes to designated areas on the ONRR website. Changes to designated areas would be based on the following criteria and other relevant data.

  Criteria
  - Reasonable sample size (>2 unique payors)
  - Same crude type (e.g., sweet, sour, asphaltic, black wax, yellow wax)
  - Same geographic area
  - Same market served
    - access to similar infrastructure (e.g., refineries, pipelines, rail lines, major roads)
    - similar geography (e.g., no challenging geographical divides such as large rivers)
    - similar geology
  - New development

  Recommended Designated Areas (as Proposed by the Tribes/Allottees/Federal Government on 6/4/13)
  - Reservation-Level: Michigan, Crow, Ute Mountain Ute, Blackfeet, Turtle Mountain, Fort Peck, Jicarilla Apache, The Navajo Nation, Wind River
  - Ft. Berthold: 11 field/combined fields areas
  - Uintah and Ouray: 5 field/combined fields areas
  - Oklahoma: Index Price Methodology

<u>Comments/ Questions for Further Discussion</u>

Crude Type/API Gravity

If API gravity is not reported, more detailed information on crude types will likely be needed. If new crude types emerge (e.g., tar sands and shale oil) they will be added to the ONRR-2014 as a new crude oil type.

Recommended Designated Areas
There is a concern from industry about the recommendation to have the area designation for Wind River be at the Reservation level rather than two areas as originally proposed. This Reservation level designation was recommended by the Tribe and ONNR because there are only two unique payors in the second area. Industry believes that designation at the Reservation level does not adequately consider economic factors for different areas. More discussion may need to occur regarding the area designation for this reservation. An option to address the issue of the need for three unique payors for a designated area is to put in place procedures that would require consideration of creation of new areas if additional unique payors locate and begin production on the reservation.

<u>Tribal Consultations</u>

Paul Tyler, of ONRR, provided an overview of a draft consultation plan. It recommended three regional meetings in Billings, Montana, Albuquerque, New Mexico and Oklahoma City or Tulsa, Oklahoma, in which Committee Members would attend. It also suggested developing a brochure that ONRR's outreach team could share as part of its efforts; they could provide contact information for Committee Members who could address specific questions. Feedback on the consultation plan included:

Regional Meetings
- An additional regional meeting should be scheduled in North Dakota – either in New Town or Bismarck.
- Some Committee Members highlighted that they would be willing to attend Regional Meetings. A Chesapeake Energy facility could be used in Oklahoma City, Oklahoma.
- Cultural aspects should be considered. For example, meetings could begin with an opening in the Tribal language(s) of those in attendance.

Brochures
- A general brochure on the options for addressing major portion issues as described above would be helpful. It should describe the current situation and the straw proposal, including the Index Price Methodology and the opt-out option. ONRR will develop this brochure and share it with all Committee Members for their use in consultations with their constituencies.
- Additional, more detailed brochures could be developed with Reservation-specific major portion information. The formula is not yet determined so only background information should be provided. It would be appropriate to ask for input on what the premium should be.

Tribal Consultation Meetings
- The Federal Government will need to convene and participate in consultation meetings with Tribal Governments on the proposed Indian Oil Rule. A Tribal member suggested that Webinars could be used and that several tribes could be included on each Webinar. Several Webinar time options should be offered. This will help minimize challenges related to the limited time for consultations and government and Tribal travel constraints.