Indian Oil Valuation Negotiated Rulemaking Committee

Meeting 3, August 1-2, 2012

Building 85 Auditorium, Denver Federal Center, Lakewood Colorado

Meeting Summary

Meeting Participants

Committee Members and Alternates

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), Day 1
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, Day 1
Robert Thompson, III, Western Energy Alliance
Jeanne Whiteing, Blackfeet Nation (Alternate)
Thomas Birdbear, Land Owners Association (Alternate)
Alan Taradash, Jicarilla Apache Nation
Darrel Paiz, Jicarilla Apache Nation
Claire Ware, Joint Business Council of Shoshone and Arapaho Tribes
Marcella Giles, Oklahoma Indian Land/Mineral Owners of Associated Nations (OILMAN)
Eddie Lagrone, Oklahoma Indian Land/Mineral Owners of Associated Nations (OILMAN) (Alternate)
Perry Shirley, The Navajo Nation
Akhtar Zaman, The Navajo Nation (Alternate)
Winifred Serawop, Ute Indian Tribe

Facilitators

Chris Moore, CDR Associates
Laura Sneeringer, CDR Associates

Observers

Karl Wunderlich, ONRR
John Price, ONRR
John Kunz, DOI Office of the Solicitor, Denver
Tim McLaughlin, Nordhaus Law Firm, LLP
Dixon Sandoval, Jicarilla Apache Nation

Agenda Topics

Wednesday, August 1st, 2012, 9:00 AM – 5:00 PM

- Welcome, Recap of Previous Discussions and Agenda Review
- Update from Tribal Information Sharing Conference Call
- Sample Normalized, Major Portion Analysis and Correlation to Initial Proposals (Presentation, questions/answers and discussion), *John Barder, ONRR*
- Overview of Previously Proposed Indian Oil Valuation Rules (Presentation, questions/answers and discussion), *Deborah Gibbs Tschudy, ONRR*
- Discussion of Potential Standards and Criteria to Apply When Considering Options and Recommendations for a Future Proposed Rule (Large group discussion)
- Insights and Wrap-up of Day 1

Thursday, August 2nd, 2012, 8:30 AM – 3:00 PM

- Agenda Review for Day 2
- Review and Refine Initial List of Potential Models for Consideration by the Committee *(Discussion)*
- Evaluate Strengths and Weaknesses of Potential Options Using Standards and Criteria as a Reference *(Discussion)*
- Discussion of Next Steps for Exploring Options
- Meeting Wrap-up

Action Items

- Group caucuses will be held to review whether the "Higher of Index-Priced Formula with Differential for Location and Quality or Gross Proceeds" and other options are worth exploring further. They will include conversations: 1) among industry representatives and 2) among federal and tribal representatives.
- Deborah Gibbs Tschudy, Dan Riemer and Perry Shirley and will serve as the Executive Committee for the next meeting, and will work with CDR to develop the agenda. They will use input from the causes to determine what additional information needs to be provided at the meeting.
- 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 (see e-mail sent by Paul on 8/6).
- The next meeting is scheduled for September 5-6, 2012 at the Building 85 Auditorium at the Denver Federal Center, Lakewood Colorado. Future meetings are scheduled for October 24-25, 2012 and December 11-12, 2012.

Potential Topics for Future Meetings

The Executive Committee will determine whether any of the following topics are still relevant and if they should be discussed at the September meeting.

- Concept overview of the "Higher of Index-Priced Formula with Differential for Location and Quality or Gross Proceeds" option and any other options Committee Members would like to share
- Longer-term analysis (e.g., 4 years) to determine correlation between proposed major portion prices and 1) NYMEX and 2) spot prices. This would include:
    - Fixed increment off of NYMEX and spot price
    - Percent off of NYMEX and spot price
    - Overall curve of major portion price compared to NYMEX and spot price
    - High/median/low differential off of NYMEX and spot prices for each year per reservation

- Additional information on what contracts generally contain in order to understand what appropriate formula priced differentials would be.

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/

Sample Normalized, Major Portion Analysis and Correlation to Initial Proposals
At the previous meeting, John Barder, ONRR, shared results of a traditional major portion analysis at 50% and 75% for all Indian oil producing reservations/areas (including allottees' land) over a four-year period. At this meeting, he shared a sample of updated data that was normalized for quality in order to make the prices more consistent and increase the accuracy of the major portion analysis. In order to do this, he used posted prices and added or deducted $0.015 per degree of API to get to a normalized value of 40-45 degrees API. He used the OGOR and 2014 data for this analysis. John was unable to distinguish by oil type as the data available was not distinct enough to see differences (e.g., between black and yellow wax). There were few anomalies. When John found them and could make a strong case that it was a reporting error, he took them out. Otherwise, he left them in. Oklahoma data was not included due to the amount of time required to analyze the volume of data.

John used this information to calculate what a gross proceeds bump for all payers per reservation would be. This is based on the total amount of additional royalties owed to meet the major portion (50% or 75%) divided by the number of payors. He developed a series of graphs that compare the 50% and 75% major portion prices to the highest and lowest prices. He also added the NYMEX calendar month average (CMA) and any relevant local market center prices, in case there are any market-related trends that the Committee may want to consider. For more detailed information, refer to John's presentation, which will be available on the Committee website.

The Committee discussed the following observations, comments and questions:
Oil Price Spread

- ONRR assumed prices from low to high would compress when normalized, but that did not seem to happen.
- Generally speaking, reservations that have a lot of production have a larger spread from low to high prices.
- On quick glance, the additional royalty owed per year for all reservations combined is about $2 million per year at a 50% major portion and $5-6 million per year at a 75% major portion.

Relationship to Market Centers

- In general, there seems to be a consistent differential to NYMEX and local market centers. It was suggested that this correlation is likely because industry is using market prices in its contracts.
- There seems to be a reference to NYMEX in Bakken and the Ute Indian Tribe (Uintah and Ouray (U & O). This is based on audits that include a sample of 5-10% of contracts. They are likely starting with NYMEX, but then adding a differential to a local market center (e.g., Guernsey). They are likely also including a differential for quality and transportation costs.
- WY Sweet Guernsey is still not heavily traded, and therefore may use the same reported price for a week. This is improving with the increase Bakken production.
- WTI Midland seems to be off about a month. This is likely because the Argus trade month average was not correctly applied to the NYMEX calendar month average.
- A formula price seems like it would have merit, whether it is per reservation or region. It would be difficult for Blackfeet since there are not any US local market centers nearby.

Gross Proceeds Plus Bump

- It would not be possible to have one price bump percentage for all reservations due to the range in prices. The bump would have to be based on each individual reservation or region.
- There is likely a wide variance in median prices, for individual months in a calendar year for one reservation. Therefore, in order to determine if a gross plus bump option has merit, a more detailed statistical analysis would be needed. (See potential topics for future meetings above).

Overview of Previously Proposed Indian Oil Valuation Rules

Deborah Gibbs Tschudy, ONRR provided a history of proposed Indian Oil Valuation Rules, including each proposal's recommendations on how to conduct a major portion analysis and comments received. The proposals ranged from using a traditional major portion analysis, to NYMEX prices, to spot prices to a comparison of these values. They also ranged in how they would collect additional required information. For more detailed information, refer to Debbie's presentation, which will be available on the Committee website.

There was some confusion on the difference between posted prices, spot prices and NYMEX prices. The following overview was provided by Don Sant.

- Posted prices: There have been some legal cases associated with posted prices, due to industry reporting the posted price and not including the premium that they added to their contracts. Therefore, they were not paying royalties on the full price received.
- Spot prices: They are developed through analysis of what is actually being sold on the market through actual contracts. Firms like Platts and Argus develop spot prices. Information on their methodologies was provided. Based on information provided at the June meeting, spot prices are based on approximately 5% of transactions.
- NYMEX prices: NYMEX is a futures market. It is a place where people go to buy or sell risk. It enables people to make monthly contracts in advance. Everyone in the market has to prove they have enough money to cover their contracts. It is transparent because it is published every day. There seemed to be general agreement that NYMEX is a better data input source. The reason industry objected to NYMEX in 1998 and 2000 is that it was still fairly new and not evident in actual sales contracts for oil produced from Indian leases.

The Committee discussed the following observations, comments and questions:

Comment: A tribal representative highlighted that the tribes like the 1998 proposal because it used NYMEX, which they feel represents true transactions that are occurring in the market place.
Comment: A traditional major portion option is not accurate if it uses different data sources (e.g., higher of gross proceeds or NYMEX or spot price) to come up with the major portion price. It needs to be based on consistent information type and needs to be the price industry is actually receiving.

Comment: There was a lot of litigation in the past related to non-arm's-length issues. In 2006, ONRR conducted its first analysis of the amount of arm's-length transactions and realized that they cover 97-98% of all transactions. This percentage is assumed to be even higher today. An industry representative highlighted how, based on the previous Committee meetings, reminder information is being shared via industry associations on how to accurately report transactions due to some confusion. For example, one company was reporting a transaction as non-arms-length even though the final prices it reported were after the first arms-length sale.

Discussion of Potential Standards and Criteria to Apply When Considering Options and Recommendations for a Future Proposed Rule

The Committee outlined the following criteria for evaluating options.

Must Have Criteria

- Consistent with DOI's Trust responsibility
- Maximizes revenue
- Meets major portion requirements
- Adheres to statutory rules of interpretation/ canons of construction
- Adheres to/ is congruent with lease terms
- Data availability (i.e., crude type, API gravity at lease level and determination of field where well is located)
- Implementable and enforceable (e.g., ability to validate reported data)

Other Criteria/ Considerations

- Certainty
  - In price determined by ONRR or formula calculation
  - Industry knows that when they pay they are paying the right amount
  - Tribes/allotees know they are getting the right price
  - No need for safety-net or look back
- Simplicity - e.g., fits into electronic reporting; minimization of manual modifications; user-friendly reporting process/ easy to understand reports; no 4416 or the like
- Clarity - e.g., valuation regulations are easy to understand
- Timeliness
- Accuracy and consistency (includes consequence if inaccurate payment)
- Cost
  - Minimize time and personnel costs for federal government and industry
  - Save money on audits, appeals, etc

The Committee had more detailed conversation on the following points.

Adheres to/ is Congruent with Lease Terms
The group described the variation that exists in lease terms' major portion language. Lease terms do not describe specifically how to do major portion. Therefore, ONRR develops regulations to interpret and provide direction on how to implement the major portion lease term requirements. Lease terms supersede the Indian Oil Valuation Rule. If a lease includes major portion language or says that the "Secretary has discretion to apply values" then ONRR will conduct a major portion analysis. If a lease does not include a major portion clause, ONRR's response is to include all leases in a major portion analysis unless the lessee provides evidence that their lease does not include a major portion provision.

Meets Major Portion Requirements
Current regulations include language stating that major portion has to include comparison of other prices. Therefore, unless regulation language is changed (which the Committee can recommend), gross proceeds alone cannot be an option. There were some differing opinions on this issue.

> The standard lease form states that major portion will "be calculated based on the highest price paid or offered at time of production for the major portion of the oil of the same gravity produced and sold from the field where the leased lands are situated" (section 3(c) of a standard Indian lease).

One person's interpretation is that this means the highest price within an individual lessees' leases (as opposed to the highest price among a specific lessee's leases and neighbors' leases), while another said that it would not say “leased lands” if this was the intent. Another person noted that industry cannot conduct its own major portion analysis because it requires seeing competitors’ prices.

The group reviewed the following definitions, which ONRR uses to interpret major portion requirements.

> “Major portion means the highest price paid or offered at the time of production for the major portion of oil production from the same field. The major portion will be calculated using like-quality oil sold under arm’s-length contracts from the same field (or, if necessary to obtain a reasonable sample, from the same area).” (1988 Regulation, Section 206.102 (ii) and 1206.54(b))
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> “Field means a geographic region situated over one or more subsurface oil and gas reservoirs encompassing at least the outermost boundaries of all oil and gas accumulations known to be within those reservoirs vertically projected to the land surface. Onshore fields are usually given names and their official boundaries are often designated by oil and gas regulatory agencies in the respective States in which the fields are located. Outer Continental Shelf (OCS) fields are named and their boundaries are designated by MMS.” (30 CFR 1206.51)
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> “Area means a geographical region at least as large as the defined limits of an oil and/or gas field, in which oil and/or gas lease products have similar quality, economic, and legal characteristics.” (30 CFR 1206.51)

Review and Refine Initial List of Potential Models for Consideration by the Committee and Evaluate Strengths and Weaknesses of Potential Options Using Standards and Criteria as a Reference

The Committee initially decided to evaluate options A, B and D below. They decided that if a formula price is determined merit, they may further evaluate sub-options at a later time (e.g., using NYMEX, another market center or spot prices). Toward the end of the discussion, a forth option was discussed (C).

- A.ONRR Major Portion Calculation (retroactive/ look-back with true-up)
- B. Index-Priced Formula with Differential for Location and Quality
- C. Payment of Higher of Index-Priced Formula with Differential for Location and Quality or Gross Proceeds
- D. Gross proceeds price + % or $/barrel bump

The Committee decided it would be easiest to evaluate based on strengths and weaknesses, as opposed to comparing to the outlined evaluation criteria. However, they did reference the evaluation criteria throughout the discussion.

An overview of the discussion is provided in Table A: Evaluation of Proposed Indian Oil Valuation Concepts (As of 8/2/12).

The meeting ended without a consensus on whether to explore Option C or other options in more detail.
The Committee decided not to pursue further exploration of option D, gross proceeds price + % or $/barrel bump.

The Committee decided to have the Executive Committee use feedback from interim interest-group caucuses to plan the agenda for September 5-6.

Table A: Evaluation of Proposed Indian Oil Valuation Concepts (As of 8/2/12)

	A. ONRR Major Portion Calculation (retroactive/ look-back with true-up)	B. Index-Priced Formula with Differential for Location and Quality	C. Higher of Index-Priced Formula with Differential for Location and Quality <u>OR</u> Gross Proceeds	D. Gross proceeds price + % or $/barrel bump
Strengths	- **Uses readily available price data -** uses actual contracts, sales, adjustments for location and quality - **Limited risk of being challenged** (based on Gas Rule experience - due to proven/ reasonable methodology) - **Strong from a compliance stand point** - **May provide some certainty on price** if set up so ONRR is not having to redo major portion calculations	- **Contemporaneous** - **Timely -** industry pays and fulfills requirements once - **Transparent** - **Reduced risk of being legally challenged** based on Gas Rule experience - **Strong from a compliance stand point -** easy to verify - **Flexibility as customized by area -** each reservation or regional area has different formula. Could include index in some places and traditional major portion in others - **Simpler** than ONRR major portion calculation (A) - **Audits are still done -** considers volumes, not necessary to look at values - **May not require a safety net**	- **No prior period adjustments** - industry pays once on the higher of index price formula or gross proceeds (unless audits determine that the lessee did not correctly report and pay on the higher of gross proceeds or index) - **Comparison of data points keeps a check on the market -** tribes/allotees know that royalty receiving is in the ballpark; industry reported gross proceeds values used in a traditional major portion calculation ensures location differential is appropriate - **May not require a safety net**	- **No prior period adjustments -** Industry pays bump and is done - **Flexibility as customized by area** each reservation or regional area has different % or $/barrel.

	A. ONRR Major Portion Calculation (retroactive/ look-back with true-up)	B. Index-Priced Formula with Differential for Location and Quality	C. Higher of Index-Priced Formula with Differential for Location and Quality OR Gross Proceeds	D. Gross proceeds price + % or $/barrel bump
Challenges	- **Time delay** – gross proceeds values used to calculate major portion price may not be audited for 3 years which affects industry (e.g., waiting for final payment amount), allottees (e.g., could go to new owner) and tribes (e.g., could be depending on cash flows for operations) - **Complex data analysis** – e.g., sold at the lease vs. away from the lease, consideration of volumes of oil sold downstream, transportation issues *(Idea - use prices offered/paid at the lease instead of calculating netback values for transactions away from the lease*– idea could have effect of bringing prices down; may not comply with lease terms, may require collection of more data) - **Increased cost/ admin burden** to collect needed data and conduct calculations, etc. - **Additional data requirements** - API gravity, crude type and field	- **Difficult to determine out location differential** that consistently reflects the value of ONRR major portion calculation (A) - **Challenges with how to evaluate whether location differential continues to be representative of market/sale of oil in area:** *(Ideas: 1) determine if it is still a valid index based on publications* – oil more complicated to analyze liquidity, not as much transparency close to the lease, etc.; *2) compare to ONRR major portion analysis to ensure it still approximates major portion %* (requires reporting of gross proceeds; historical values do not accurately project future values; could be based on un-audited data) - **Not consistent across the US -** each reservation or regional area has different formula - **Formula price alone does not meet current regulation**	- **Requires dual-reporting** - Need to report gross proceeds value and index value minus location/quality differential so there is a comparison to ensure location differential is appropriate. There are data consistency concerns if industry is not reporting same data (i.e., does not work to report only higher of index price or gross proceeds) - **Subject to audit and prior period adjustment** if audit determines that the lessee did not correctly report and pay on the higher of gross proceeds or index - **Challenges with how to evaluate whether location differential continues to be representative of market/sale of oil in area:** (See Option B)	- **May not be as strong from a compliance stand point** - **Some industry members may be paying for other industry members** - **Challenging to determine what the bump % should be**

	A. ONRR Major Portion Calculation (retroactive/ look-back with true-up)	B. Index-Priced Formula with Differential for Location and Quality	C. Higher of Index-Priced Formula with Differential for Location and Quality <u>OR</u> Gross Proceeds	D. Gross proceeds price + % or $/barrel bump
	name - **Lack of transparency on data** industry can't see data behind ONRR calculation and industry sometimes challenges calculation *(Idea - - on case by case - could share data with company approval)* - **Calculations could be inaccurate because of un-audited data** (level of accuracy increases over time) - **May have to redo major portion** if audit requires it or if tribe or allottee brings forth a claim (difficult from certainty perspective) (*Ideas: 1) can decide to make major portion final and use 75% to cover any audit issues like did with Gas Rule* - idea could affect Trust responsibility) - **Side agreements could change major portion price**– prices going into array could be lower and bring down major portion price *(Idea – use audited prices or higher %)*	**requirements to compare and get the higher price** - **Requires lessee to do manual price entry** into their system to override actual price system is calculating on what offered/paid - **Challenge for industry to sell this concept** to constituents b/c it's not how some sell their oil - **Safety net may or may not be required –** concern about how "beyond index zone" comes into play) - **Additional data requirements** - API gravity, crude type and field name	- **Additional data requirements** - API gravity, crude type and field name	