Indian Oil Valuation Negotiated Rulemaking Committee

Meeting 4, September 5-6, 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
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
Kathleen Sgamma, Western Energy Alliance (Alternate)
Jeanne Whiteing, Blackfeet Nation (Alternate) – Day 2
Roger Birdbear, Land Owners Association
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

Facilitators
Chris Moore, CDR Associates
Laura Sneeringer, CDR Associates

Observers
John Price, ONRR
John Kunz, DOI Office of the Solicitor, Denver
Stephen Simpson, DOI Office of the Solicitor, Washington, DC
Tim McLaughlin, Nordhaus Law Firm, LLP
Dennis Cameron, WPX Energy

Agenda Topics

Wednesday, September 5, 2012, 10:00 AM – 5:00 PM

- Pre-Meeting Caucuses: Tribes/Allottees/Government and Industry
- Welcome, Recap of Previous Discussions and Agenda Review
- Overview of Concept A: Traditional ONRR-Calculated Major Portion Methodology (Presentation and questions/answers), *John Barder, ONRR*
- Overview of Concept B: Higher of Gross Proceeds or an Index Price Methodology Based on NYMEX: Higher of Gross Proceeds or Index Price Methodology Based on NYMEX Calendar Month Average

(CMA) Adjusted for a Fixed Location and Quality Differential (Presentation and questions/answers), *John Barder, ONRR*
- Overview of Concept C: Index Priced Methodology Based on NYMEX: Index Price Methodology Based on NYMEX Calendar Month Average (CMA), Adjusted for the Roll (if applicable), Adjusted to the Nearest Market Center with Like-Quality Crude, Less a Fixed Location and Quality Differential (Presentation and questions/answers), *Dan Riemer, American Petroleum Institute*
- Discussion to Compare Concepts (Large group discussion to identify areas where the concepts are similar and different)
- Caucuses: Tribes/Allottees/Government and Industry to discuss initial reactions to the concepts
- Report out from caucuses and discussion

Thursday, September 6, 2012, 10:00 AM – 12:00 PM
- Pre-Meeting Industry Caucus
- Report out from industry caucus, including request for more time
- Discussion on next steps

Committee Conference Call on September 11, 2012
- Report out from extended industry caucus and questions
- Discussion on next steps

Action Items

- ONRR will conduct an example major portion analysis for at least three reservations using: 1) field and 2) reservation as the area. The analysis will use 2011 data and show the difference between a 50% + 1 barrel and 75% major portion analysis.
- Tribal and Federal representatives will hold a conference call caucus to discuss their reaction to industry's proposal presented on the Sept 11th conference call.
- Deborah Gibbs Tschudy, Dan Riemer and Perry Shirley will continue to serve as the Executive Committee for the next meeting, and will work with CDR to develop the agenda. They will use input from the caucuses to determine what additional information will be needed and presented at the meeting.
- The next meeting is scheduled for October 24-25, 2012 at the Building 85 Auditorium at the Denver Federal Center, Lakewood Colorado. A future meeting is scheduled for December 11-12, 2012.

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 Concept A: An ONRR-Calculated Major Portion Methodology
John Barder, of ONRR presented a concept paper to describe to Committee members how an ONRR major portion calculation would work. All prices sold on a reservation over a month-long period, minus transportation deductions, would be lined up in an array. Before ONRR conducts the major portion analysis to determine the price at the agreed upon major portion price (e.g., 75% or 50% + 1 barrel), it would normalize the data to insure that similar oil type and quality are compared. ONRR would then line up all prices in an array and add up volumes from the bottom to determine the major portion price (e.g., at 75% or 50% + barrel). Companies would compare what they initially reported to the published major portion price and pay additional royalties if they were below the major portion price. They would not have to do anything if they paid the major portion price or

more. For Indian Gas, this major portion analysis is conducted once a year for each month in that year. 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:

Q. The only prices that would be excluded are non-arms-length transactions. Is that correct? A. Yes. The regulation says that major portion is based on arms-length sales. There should not be many non-arms-length sales in Indian Oil transactions.

Q. Please describe the difference between price and value. A. Industry receives a price per barrel when it sells the oil (e.g., at St. James). A net back calculation is used to convert this price/barrel to a value and volume that is reported on form 2014. The reason this conversion is necessary is that oil is not always sold at the lease as lessees can often receive a higher price if they transport the oil and sell it elsewhere. The lessee does not have a requirement to market oil away from the lease. However, oil is commonly sold off the lease if it a benefit to the lessee (or they would not do it). A lot of audits are related to the conversion from price to value.

Q. Is the data used for the major portion analysis audited? A. While some data is unaudited, ONRR has check-in mechanisms/edits for all data that it receives.

Comment. It does not seem fair to base the major portion price on the industry that decides to sell off the lease because smaller companies cannot afford to transport oil in the same way larger companies can. For example, not all companies can use rail out of Bakkan. Instead, they may have to sell to Clearbrook at a lower price.

Response: Major portion is described in the lease terms industry signs. The goal is to bring Indian Oil values up to an approximate the value of the market. Industry agrees to sign this lease.

Overview of Concept B: Higher of Gross Proceeds or an Index Price Methodology Based on NYMEX:
Higher of Gross Proceeds or Index Price Methodology Based on NYMEX Calendar Month Average (CMA) Adjusted for a Fixed Location and Quality Differential

John Barder, of ONRR, described Concept B. A monthly price would be published that includes the:

- The NYMEX CMA
- Minus the published differential to the local market center
- Minus a fixed, annual differential that ONRR would calculate from the local market center to the lease.

Past data would be used to determine the differential from the local market center to the reservation, using a 75% major portion. By having companies report gross proceeds, crude type and API gravity, ONRR would be able to recalculate and publish an updated annual differential from the local market center to the lease. 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:

Q. Why does the concept recommend an annual differential from the local market center to the lease instead of a monthly differential? A. An annual differential from the local market center to the lease smooths out any volatility from month-to-month. Also, calculating a fixed differential that is less than a year would be time consuming.

Q. Why does it take a year before ONRR can calculate an updated differential from the local market center to the lease? A. It is important to wait for the data to settle down as industry generally makes adjustments within 6 months due to upfront editing, volume checks, etc.

Overview of Concept C: Index Priced Methodology Based on NYMEX: ***Index Price Methodology Based on NYMEX Calendar Month Average (CMA), Adjusted for the Roll (if applicable), Adjusted to the Nearest Market Center with Like-Quality Crude, Less a Fixed Location and Quality Differential***

Dan Riemer, representative of the American Petroleum Institute, described Concept C. For more detailed information, refer to Dan's presentation, which will be available on the Committee website.

- This concept uses a fixed differential from the local market center to the lease that is based on historical data collected over a 3-4 year period. This method of calculation insures the consistency of the differential over time. The differential would be set and not updated unless ONRR or industry identifies that there is a need to do so.
- The differential is based on a calculated major portion at the lease level because this methodology insures that ONRR is considering similar oil type, quality and market conditions and "field" is consistent with lease terms.
- It defines major portion as 50% + 1 barrel.
- It also includes a provision for a roll, which is used in Federal Oil, but this is only applicable if a contract uses it.

The Committee discussed the following observations, comments and questions:

Q. Why does ONRR need to publish monthly prices if all of the information is publicly available? A. If industry is off by a penny, ONRR will reject it and require an adjusted payment. It is better for ONRR to publish a monthly price so that industry can make the first payment correctly, and not have to make any adjustments later.

Q. Why does ONRR need to publish a field price by the 3rd working day of the month? A. Industry said that there is some flexibility on the timing.

Q. What happens if Platts gives a range for the NYMEX price? A. The high of the daily assessment would be used because it represents the highest price offered. Whatever price gives the highest absolute dollar amount would be the appropriate NYMEX adjusted price to use.

Q. If ONRR does not collect information on gross proceeds, how can it monitor the differential from the local market center to the field to ensure it is appropriate over time? A. It is not clear how monitoring could be done. Perhaps other data (e.g., federal data) could be used to monitor. An Index methodology would not be appropriate unless there is a clear correlation in the differential from the local market center to the field over several years.

Q. Would it be possible to use zones, as a mid-point between the field and reservation? Zones were used in the Indian Gas Rule. A. The reason people were comfortable with zones in the Indian Gas Rule is that all gas went through the same pipeline.

> *Response.* ONRR would be taking transportation into consideration through the major portion calculation to determine the differential from the local market center to the lease. Companies within a reservation generally transport oil to the same refineries. The one exception is the Bakkan area, in which companies may be transporting their oil to different markets.

Comment: ONRR Legal Counsel does not believe ONRR is constrained to the "field" language in the lease. Their interpretation is that it is allowable to expand the area to the reservation. There is precedent for using a larger area in Federal Oil, Federal Gas and Indian Gas Rules. For example, the Indian Gas rule says that it can be all lands within a reservation.

Comment: There can still be differences in oil type and quality within a field. For example, on the Ute Reservation there can be black, yellow and brown wax within the same field.

Discussion on Similarities and Differences between the Index Priced Methodology Concepts

The Committee discussed the similarities and differences between:

- Concept B: Higher of Gross Proceeds or an Index Price Methodology Based on NYMEX and
- Concept C: Index Priced Methodology Based on NYMEX

<u>Similarities</u>

- Same theoretical concept – index and differential to capture major portion
- Based on NYMEX
- Published differential from NYMEX to the nearest market center
- Forward looking – ONRR publishes the index-based price – timing TBD
- Both use historical data to determine differential

<u>Differences</u>

- Different major portion percentages are used to calculate differentials from the local market center to the lease: 75% is use for Concept B and 50% + 1 barrel is used for Concept C
  Interests/Needs
  - C: According to industry, Concept C meets Trust responsibility, follows current regulations (the 1988 interpretation that major portion is 50%+1 barrel) and is consistent with the 2005 Indian Oil Proposed Rule
  - B: According to tribes/allotees/government, concept B meets Trust responsibility, is consistent with the Indian Gas Rule, is consistent with the 2000 Indian Oil Proposed Rule and defines major vs. majority portion.

- What is reported: Concept B includes reporting on gross proceeds, and Concept C does not
- Concept B involves an audit and a potential adjustment if there is a problem with the payment of gross proceeds and the gross proceeds are higher than NYMEX
  Interests/Needs
  - B: Gross proceeds information is required to validate that differential is set appropriately on an ongoing basis
  - B: ONRR will not be able to quickly determine whether the company paid the higher amount if industry does not report on both Index price and gross proceeds
    C: This methodology does not increase reporting requirements and it lowers risks for industry of reporting errors. It also minimizes or eliminates manual entry/system requirements.

- Different amounts of historical data will be required to calculate the differential: Concept B requires 1 year of historical data and Concept C requires 4 years
- Differential updates: Concept B is updated annually and Concept C sets a fixed differential until the Rule is changed
  Interests/Needs
  - B: The tribes/allotees/government' interest is to have the differential be as accurate as possible by looking at a closer time period to set initial differential and review and adjust it each year to insure it is appropriate
  - B: This methodology would require time for the data to settle
  - C: Industry's interest is to see a longer time frame, multiple years, to feel confidence in the calculated differential
  - Other: May need to review the differential more often than once a year to insure its accuracy

- Area: Concept B is reservation based and Concept C is field based
- Normalization: Concept B requires normalization (need crude type/API). Concept C will generally not require normalization, with the exception of some fields where gravity and crude types are different.
  Interests/Needs
  - C: Consistent with the lease terms

- C: Less diversity in price because the same field is generally serving the same market. There is less variance in price, similar transportation costs, etc.
- C: Less variance in crude type/API gravity at the field level
- C: May eliminate need to report crude type/ API gravity
- C: Access to information – it is difficult for ONRR to obtain needed information by field. Not all states make field determinations, and they do it differently. Fields change (expand, get combined), and ONRR has difficulty obtaining data for private parcels of fields (i.e., fields can include tribal/allottee/private and federal in one field)
    - Note: Industry noted that lessees can provide information on fields as a reporting requirement. They can provide field name.
- C: would require ONRR major portion analysis once a month for thousands of fields. Concept B is therefore a reduced administrative burden.

Report out from Caucuses - Tribes/Allottees/Government and Industry

The Committee met in caucuses to discuss their initial reactions to the three concepts. Before they broke into groups, Debbie Gibbs Tshudy, the ONRR Designated Federal Officer, reminded the Committee that the reason for the Negotiated Rulemaking was to develop a methodology that ONRR could use to implement the major portion part of the current Rule. This has been difficult for ONNR to do because it needs API gravity and crude type to be reported to be able to normalize data and conduct a major portion analysis. Additionally, collecting data at the field level has been impossible so far. ONRR needs to determine an appropriate area where accurate data is readily available. As discussed during previous meetings, the goal is for the final Rule to provide certainty, simplicity and to have realistic administrative procedures.

The Tribes/Allottees/Government group provided a proposal for moving forward at the end of the first day and the Industry group, as they requested more time for internal deliberations, provided a proposal via a teleconference on September 11.

<u>Tribes/Allottees/Government Report Out</u>

The group observed that there are many differing perspectives among Committee members on an index priced methodology, and noted that it looked like they would be very challenging to resolve. Therefore, the tribes/allottees/government group proposed that the Committee re-focus on how to implement an efficient and accurate ONRR calculated major portion analysis as preliminarily described in Concept A.

The group noted that ONRR's calculated major portion analysis should include:

- Industry providing ONRR additional information in order to conduct the analysis, including the extension of product code to get at oil type and API gravity.
- Major portion should be defined as the price at 75% of volume.
- There needs to be time for data to settle down before ONRR conducts its major portion analysis (the timeframe needs to be discussed further)
- Interest payments on inaccurate payments should begin from the date of the published due date.

<u>Industry Report Out</u>

Due to the challenges of developing an index-priced methodology, the industry group also recommends that the Committee should focus on refining a recommendation that uses an ONRR calculated major portion that uses gross proceeds. The specifics of the industry proposal include:

- Major portion price should be based on field. If there are multiple API gravities (i.e., a variance of more than 2 degrees), separate major portion analysis should be conducted within the same field.
- Major portion should be defined as 50% + 1 barrel.
- ONRR should publish individual field major portion prices within 12 months. The industry group would prefer to see published prices within 6 months, but they understand that more time may be needed to improve data accuracy by giving data time to settle.
- Industry would provide the following data:

    - The field name as designated by state agencies. More discussion is needed to determine if this can be a one-time setup, or whether it would need to be reported on the 2014.
    - API gravity: This data could potentially be linked through the OGOR report, but more information is needed to determine if this is possible.
- Industry wants more discussion on the following:
    - Why crude type information may be necessary.
    - How condensate would be handled.
- To be consistent with Indian Gas Rule, late interest should not accrue until major portion prices are published.
- ONRR should maintain and publicize a list of all Indian leases that do not contain a major portion provision.

Q. Why do you think normalization is subjective? A. Industry says that it is not possible to consider economic factors adequately. For example, a vast majority of oil in North Dakota is trucked from the production facility to the local market center. Some areas may have load limits during certain times of the year due to flooding or snow. Because of these impacts, the company may only be able to transport one-half as much oil. In this scenario the trucking cost would be a lot more because more vehicle trips will be required, even though the flat rate is the same. Normalization requires ONRR to make subjective decisions on these types of economic factors.

Q. How does ONRR ensure that industry will provide the field name correctly? How does ONRR enforce this requirement? A. Industry is already providing the field name to the state when they initiate wells. Fields are added when there are exploratory wells and they do not change after that point. The state should definitely have field names determined 6-12 months before the major portion calculation is conducted. The regulations already spell out what the appropriate enforcement is.

The Committee outlined next steps/action items as described at the beginning of this meeting summary.