

Oil Valuation Workshop
Washington, DC, April 6-7, 1999

1. Introductions/Opening Comments

Lucy Querques Denett, MMS

- Welcome and announcements

Larry Wooden, Shell E&P

- representing inter-association industry task force
- thanks for reopening comment period, constructive dialogue at prior workshops
- supports overall goals of rulemaking--fair valuation and simplification
- industry working together, has developed consensus proposals and new approaches
- hopes to come to mutual agreement on outstanding issues
- industry committed to paying full royalty on value at the lease

Valdean Severson, New Mexico

- Represented Taxation and Revenue Department
- rule should not change historical practice on valuation of arm's length sales, but favors index-type valuation for non-arm's length; some differences with MMS on the deductions to be allowed
- consider other alternatives

Lee Helfrich, California State Controllers Office (SCO) (written statement submitted for record)

- disagrees with view that Interior Dept. has not listened to industry
- Interior has already gone on too long with this process and made many changes to the rule to appease industry, e.g.:
 - changed from NYMEX (industry concerns about the use of it despite use of it in reports to shareholders, current rider in appropriations process)
 - balancing arrangements--industry challenged that they even existed but now has disclosed them in a State court--but MMS changed rule to put burden on govt. auditors to prove that each particular sales contract is subject to a balancing arrangement
- so MMS listens to industry too much
- current proposal is overly complex as a result of the changes for industry
- current industry proposals are not new--industry documents submitted to Congress show the same issues--and all the new industry requests (new affiliate definition, new comparable sales approach, new benchmarks, binding valuation determinations, deductions for marketing costs) would be purely to industry's benefit; industry appears to want all or nothing
- SCO opposes both the whole and each part of the industry proposals--changes rule into an

- industry relief package.
- SCO supports special provisions for independents who are victims as is the govt. of the majors in California
- suggests:
 - new benchmarks would enable majors to manipulate field prices to their benefit; most independents sell at arm's length, thus O.K. to pay on gross proceeds
 - deduction of transportation tariff rates would benefit majors because rates inflated--independents should be able to deduct the tariffs paid at arm's length
 - eliminating duty to market (second guessing): incorrect fear that rule could be used to second guess a lessee's arm's-length price because another lessee received a higher price; only second guess would be bad faith or negligent failure to obtain a fair price. Even SCO has not second guessed independent's arm's length prices. Only cases on this involved unlawful deduction of marketing costs and cases involving regulated price categories. Only majors benefit.
 - advance binding determinations: no one benefits. If facts are wrong, MMS will not be bound. Industry would have two levels of appeals--once on the valuation determination and again after audit bill. Would delay audit process.
 - marketing allowances: The few pennies for marketing allowances are not enough to save independents. Only majors will benefit. California opposes.
- California cannot accept deduction in revenue stream--will directly affect school funding.
- Doesn't want independents harmed
- California proposals:
 - reconsider proposal to allow majors to pay on gross proceeds under so-called arm's-length situations--because such transactions, often based on posted prices, are not necessarily at fair market value
 - to extent independents don't recommend changes, just publish rule for the majors
 - go forward with rule on California only taking into account California's prior comments

Jim McCabe

- Concurs with Lee Helfrich's comments
- MMS has gone a long way toward reassuring independents, for example on second guessing
- concerned about MMS allowing multiple exchanges.
- appreciate industry desire to reach consensus, but not optimistic that this is possible

Danielle Brian, POGO

- resented having to attend; meetings only necessary because of industry's power to manipulate process
- industry wants to make money on transporting royalty oil by pipeline (\$6-18 million)
- wants to claim marketing costs (\$17-45 million)
- wants to deduct FERC tariffs (\$12 million)

- wants to avoid true spot market prices and instead to establish artificial prices
- only language that makes sense is to clarify language on second guessing of gross proceeds; but MMS should add caveat about balancing or similar agreements—if not, don't allow industry an arm's-length gross proceeds standard.
- does not have sufficient resources to stay for full workshop

Ralph DeGennaro, Taxpayers for Common Sense

- supports Danielle Bryan's comments; this is "our" (taxpayers') oil—we are negotiating terms under which oil taken by others
- nothing to gain as an organization (no false claims suits)
- no need for two day meetings to deal with old issues
- if Congress wants to override MMS, they should be accountable for it and MMS should stop participating
- industry does not deserve benefit of the doubt given false claims cases
- Energy Dept. is concerned about the small independents, not the majors, yet the people here are majors (some independents identified themselves)
- at some point MMS needs to just publish rule and let Congress do what it will
- doesn't have resources to stay for entire workshop

Debbie Gibbs Tschudy, MMS

- detail and rationale on draft final rule, August 1998 letter from Bob Armstrong (direction the Dept. was heading for final rule)
 - definition of affiliate--similar to definition in current regulations, would issue guidelines on rebuttable presumption of control/define arm's length and affiliate separately
 - definition of gross proceeds: similar to current rule definitions but would specifically include marketing services and buydown payments.
 - two exceptions to arm's-length contracts identical to current rule--did not intend to include any additional language in rule but would say in preamble no intention to second guess arm's length prices. Exceptions: does not reflect either
 - (1) total consideration or
 - (2) unreasonable value due to breach of duty (planned to add language to preamble that it was not MMS intention to second-guess)
 - only new exception would be for oil for non-competitive calls (not based on price that would have been paid in competitive environment)
 - option for exchange agreements and sales to affiliate (lessee's option for 2 yrs)—either trace production to ultimate sale or use index price
 - separate options for exchange agreements and affiliate resales
 - ANS prices for California with location and quality differentials (as for rest of country) for non-arm's length sales
 - benchmarks for Rocky Mt. Region for non-arm's length sales
 - 1. MMS-approved tendering program, at least 30% of sales (Federal royalty percent and state severance tax)—at least 3 bids from lessees w/o tendering

- programs
- 2. volume-weighted average price of at least 50% of lessee's/affiliates' purchases/sales--50% level would make it unnecessary to have comparability criteria
- 3. WTI Cushing spot price
- 4. ask MMS to approve alternative valuation method
- rest of country, non-arm's length sales
 - spot prices
 - differentials from own data or data from MMS based on 4415
 - MMS wanted to eliminate 4415, but found based on comments that some companies would not have sufficient data
- transportation allowances--actual costs:
 - costs under arm's length transportation agreements would be accepted
 - non-arm's-length actual costs based on same method as current rule, but no FERC tariff exceptions (offshore no FERC jurisdiction for movement to first adjacent state, and tariffs exceed actual costs)
- still working on subsea tie-in guidelines--proposal under review
- Assistant Secretary may issue binding valuation determinations

Ralph DeGennaro

- What is the goal of this process? To talk about specifics and come up with a win-win situation that everyone feels good about?

Lucy Querques Denett

- This is not a negotiated rulemaking. Purpose is to listen to alternatives and make sure that we understand them and also that proponents of alternatives understand our concerns.
- after workshops and written comments, MMS will review and make recommendations to policy makers. At this point don't know whether there will be any changes to rule, new proposed rule, final rule, or some other action.
- Understand that not everyone will be happy with whatever we do, but our job is to ensure fair return for the public. We also will consider other factors such as simplicity, certainty and clarity.

Ben Dillon, IPAA

- Represents 5000 independents and remains engaged in the issue.
- Independents are concerned about the rule, has recommendations, and strongly supports the recommendations of the industry coalition.
- Believe that the rule adds additional uncertainty and should reduce royalty burden for independents.
- Wellhead sellers' issues are addressed in the industry proposals, and many independents do engage in downstream activities so that they are affected by many other elements of the rule.
- Thinks there are some things that can be done to find some common ground.

- Industry seeking common ground, not demanding that all industry needs be met.

Tom White, Walter Oil and Gas

- Industry is trying to survive now.
- Concerned about multiple layers of Federal and State regulations.
- He used to work for companies who did business in California, and they left because too burdensome.
- Royalty on zero is zero--if regulatory burdens are too high, companies have duty to shareholders to invest in projects with less burden.

Ralph DeGennaro

- Doesn't think the process can serve the majors, independents, and taxpayers' interests all at the same time. Proposes that independents come forward with their proposals on their own. Do independents disagree with any major proposals? Are there differences in what majors and independents propose?

Ben Dillon

- Independents support all of the ideas proposed by the industry coalition. (No difference between independents and majors.) The industry has moved from the pamphlet Lee showed--that presented criticisms that the independents still have, but now the industry has specific proposals to solve those problems.
- Independents have been engaged in this process from the outside.
- don't create regulatory disincentives for independents to expand their business practices.
- if believe independents haven't spoken on these issues, see notes from previous meetings

Fred Hagemeyer

- don't read too much into who is sitting at the table--space is limited, and industry and MMS wanted informal exchange--people will come to the table to talk about specific issues as needed. Industry task force is broad-based.

Ralph DeGennaro

- Secretary of Energy told him he wants to help small independents--seems to be a distinction without a difference, because if major/independent interests are the same, there's no point in making distinction.

Ben Dillon

- the two issues small independents (wellhead sellers) are supporting are in the industry proposal, therefore independents support the industry proposal.

Danielle Brian/Ralph DeGennaro

- So if your issues are resolved, would you support the rule, even if majors' interests are not resolved?

Ben Dillon

- Yes, but independent's interests are broader than just wellhead producers' interests.

Lucy Querques Denett

- Not trying to reach a consensus, but rather to make sure we understand the various positions.

Ralph DeGennaro

- concludes that there is no difference in position between independents and majors, so concerns are the same. Thus, there is no way to do what some have suggested to protect the independent's interests w/o addressing major's interests.

David Deal

- industry never said goals of majors/independents identical

Ben Dillon

- wellhead sellers support the proposal because it resolves their concerns; and independents engaged in downstream activities also support the proposal because it also resolves their concerns.

Bill Condit

- represents House Resources Committee
- reminder that Congress has Constitutional power under the Property Clause to make the appropriate laws/regulations related to these issues, and some members of Congress believes that Secretary of the Interior is going beyond authority of MLA and OCSLA.
- notes that RIK bill supported by the Committee was not supported by all of industry.

Ralph DeGennaro

- Doesn't disagree that Congress has the right to make these laws, and Congress should be held accountable for the laws it makes.

Danielle Brian

- MMS published list of 40 companies in the Oil Daily that it thought were the only ones affected by the rule and asked if any other companies were affected.

Lucy Querques Denett

- MMS didn't get direct response

Ben Dillon

- about 300-400 companies sent letter to Oil Daily saying they were affected.

Fred Hagemeyer

- Oil Valuation Overview (handout)

- note interconnections between the issues.

2. Binding Determinations

George Butler, Chevron

- 1988 rules allow for lessee to propose a valuation determination to MMS and prompt response by MMS.
- If MMS comes up with different method, company required to go back to date of proposal and adjust.
- industry concerned with proposed rule that would allow for only non-binding determination--didn't provide certainty.
- So industry proposes:
 - lessee propose valuation methodology
 - MMS has 180 days to respond
 - if MMS changes proposed method, then it would be an order to the company to adjust
 - if MMS fails to meet deadline, then the proposal would be accepted from time of submission until MMS might respond with prospective effect.
 - precedential value--Department not bound unless appealed and ruled upon by IBLA.
 - MMS would accept delegating authority for this down to appropriate lower officials.
- Dept. of Treasury regulations and IRS regulations distributed
- proposes that initial determination be non-binding order, but that if lessee relies on it and pays accordingly, then lessee will have satisfied royalty obligation.

Lucy Querques Denett

- we saw in other regulations that there was no requirement that the agency make a ruling.
- also saw no regulations that make the industry proposal effective if agency fails to make timely decision

Mike Coney

- Treasury regulations on customs require the agency to make a determination.
- Party required to give all necessary facts.
- No specific deadline for agency, but has to make "expeditious" response.

Lucy Querques Denett

- Agency can respond that no ruling will be given.
- Our proposal was that we could give binding determinations at our discretion.
- Will need legal review

Mike Coney

- Customs Service section that is referenced refers only to where not all the facts given or if

- it was a hypothetical situation
- shows that there are agencies that are responsive to the practical needs of the regulated industry.
 - keeps the flow of commerce going, because it deals with vessels that are ready to be loaded, etc.

Jim McCabe

- Treasury regs. look like rulings on statutory interpretation, whereas MMS rulings would tend to be very fact-intensive.

George Butler

- industry would be looking at approving specific valuation methodologies based on facts industry provides, that are consistent with applicable statutes and regulations.
- not really looking for a way to have binding alternative methodologies at lower levels of the organization
- Trying to get certainty on how MMS interprets its regulations today--concern for changing interpretations over time that are applied retroactively.

Ben Dillon

- Independents were particularly concerned with proposed rule for non-binding determinations.
- Want to be able to go into MMS and say “this is how I think I need to pay under the rules” and have that be binding.

Lee Helfrich

- Are you looking at proposals that are specific for particular leases?
- Would it create multiple standards for auditors?
- Would lessees hold these up as examples of how MMS has treated others and therefore argue that they need to be treated the same today?
- Isn't it precedential that if MMS fails to decide timely, then it becomes binding?
- Is there a revenue neutrality requirement?

Fred Hagemeyer

- It would be binding until MMS does make a decision. Auditors would have to follow the interpretation during the period for which it was approved or deemed to be approved.
- After an audit, if it comes out that the facts were not properly presented, then it could be changed retroactively.

George Butler

- Is subject to audit, meaning that the auditors would examine whether lessee properly paid according to the interpretation.
- Auditors should not be able to come up with a new interpretation of the regulations.

Lee Helfrich

- Concerned that industry comes in and shows some documents and gets a determination, and then auditors find other documents that show a different pattern.
- Auditors should be able to raise such issues and not be bound by the prior determination.

George Butler

- Concerned that MMS approved use of FERC tariffs for Pt. Arguello, but then auditors came in and said company could not use those approvals.
- Problem because company relied upon it.

Alby Modiano, US Oil and Gas

- If new documents came up during audit, then it's fraud. If there aren't sufficient facts to make a determination, then it shouldn't go forward.

Lee Helfrich

- then it's discretionary?

Jim McCabe

- May have a true representation but other relevant information that is not presented. What would happen in that case?

George Butler

- Proposal is for lessee to be required to provide all relevant information, and if MMS needs more information it can ask for it.

Jim McCabe

- But how does MMS know, prior to audit, to ask for those other documents?

Fred Hagemeyer

- Lessee is being asked to make decisions and pay within 30 days.
- May be easier to look into the issue and make the decision while the issue is fresh rather than wait later for audit.

Jim McCabe

- MMS won't know which documents are relevant and hence which ones to request.

George Butler

- discussion of how current proposed rule deals with transfers to affiliates—if then sold outright, would pay on gross proceeds unless one of the exceptions (noncompetitive calls, etc.) apply.

Debbie Gibbs Tschudy

- description of how current rule would deal with this issue. The first exception to using

gross proceeds would be if there was a related sale with the same party--then the gross proceeds wouldn't reflect total consideration, so the total consideration or the non-arm's-length procedures would apply

- Subject to audit means that auditors will look to see if the facts presented in the request for the valuation determination were correct.
- Notes that in FERC tariff cases, MMS changed course when it realized that there were FERC decisions renouncing jurisdiction over the pipelines.

Ben Dillon

- Looks like room for agreement here--independent's main problem was use of the word non-binding.
- Simply looking for up-front agreement from MMS

Lee Helfrich

- that is just like current process of paying, subject to later audit.

Ben Dillon

- No--want certainty of whether the lessee has interpreted the regulations properly as they apply to the lessee's circumstances. Term "non-binding" is troublesome.

Lucy Querques Denett

- Non binding was meant to make it clear that decisions by Royalty Valuation Division (MMS) are not binding
- We understand the concern for certainty; hope that reengineering will improve timeliness and make this less of a problem.
- Our main concerns are the time limit, with its affect on resources (taking auditors away from other activities) and automatic approval if MMS fails to meet deadline.
- Also concerned about the appeals rule.

Valdean Severson

- RPC Subcommittee discussed this issue.
- Asking that the appeals rule be put out again for public comment or go back to RPC for further consideration. Because many have no dollar amount, do not want the RSFA deadlines to apply.
- Took exception to industry binding determination proposal

George Butler

- Would agree to having these matters appealable through the normal appeals process.

Valdean Severson

- But state cannot appeal those it disagrees with.

George Butler/Wendy Daboval

- Would welcome state participation in the appeals process if that would help to provide certainty.

Valdean Severson

- Facts change. Cannot accept if binding unless only binding to the extent of the facts presented and subject to audit.

Mike Coney

- Thinks that is consistent with the proposal.

Jim Munsch, Santa Fe

- MMS also can change the determination if situations change in the future.

Lee Helfrich

- But that puts burden on MMS to track these and know what changes have occurred and their effects.
- Burden should be on industry to come in and reapply if there is a change in the facts.

Danielle Brian

- Doesn't disagree with determinations as long as it is subject to audit.

George Butler

- thinks can deal with the issue of whether all facts presented and if the facts change.
- Crux of the problem is whether the Department's policy and interpretations change. MMS should not be able to change this retroactively if the lessee has relied upon a determination.

Lee Helfrich

- Concern about putting more demands on already overburdened IBLA.
- Agrees that it is valid to deal with this issue, but because of mixed issues of fact and law, may not be easy to say whether the interpretation of the law changed or whether more complete facts changed the result.
- Use term "advance advisory opinion subject to audit"

Wendy Daboval

- Want to reduce appeals burden by dealing with these issues in advance. Wants to pay timely and right, but based on current experience has no confidence that they're paying right.

Mike Coney

- Ruling of customs represents the views of the Customs Service with respect to the facts presented and to the requesting party. Binding on all Customs personnel. All facts must be presented. Subject to audit on the facts.

Peter Schaumberg

- We don't have the resources to review these sorts of issues and make determinations early on.
- They tend not to be unique, and they tend to involve gray areas.
- We aren't in a position to rule on the first few issues that come in until we see more about the common industry practice.
- To the extent that the issue is clear, we have the option under the proposal to make a binding determination.
- But if it is a new issue with broad effects, we may not be able to rule early on.
- We want to treat everyone consistently--don't want to rule on the first few and then change later.
- Particularly concerned if there is a time constraint and a deemed approval if we meet. We would have to divert resources to deal with this.
- Also concerned with binding nature--Valuation Division will provide best guidance, but would take more resources to be able to commit that we will never change it.

George Butler

- Believes that existing rule requires MMS to issue binding guidance. Is the language in the current rules not mandatory?

Debbie Gibbs Tschudy

- RVD is required to provide such determinations, but the determination from that Division does not bind the Department.

George Butler

- But doesn't current rule require determination if requested?

Lucy Querques Denett

- Yes. But there's a problem with binding and the proposed time period involved
- We only have about 12 actual determinations per year. We are concerned about a great increase in the numbers of these under the industry proposal
- We'll look at what other agencies do, at our resources, etc., and will further consider this issue.
- MMS wants to be responsive but needs to recognize that MMS may not have all the information and full understanding when issues first arise because we have not been privy to all the information that industry has.
- With us moving to faster audits and with payment of interest on overpayments, industry's concern should not be so great.
- Thinks reengineering will help the situation

Peter Schaumberg

- With only 12/year compared to about 200,000 royalty lines/year, how can this be so important?

- So we are concerned that industry plans to submit many more, which would overwhelm our resources.
- The proposed regulation would allow us to make binding determinations, but it is at our discretion. Industry's proposals to limit the time period to 180 days, as well as use of the word binding, are problematic.

George Butler

- But if guidance nonbinding, must wait for an audit order for closure.
- Under existing rules, I can appeal the adverse guidance and get an answer within a reasonable period of the time.
- Willing to stipulate that value greater than \$10,000 to deal with the RSFA appeals default provision.
- For example, why can't MMS give an answer on presumption of control today? Wants to be able to get to judicial review now rather than later.

Lee Helfrich

- Corporate control issues are factual—how can MMS make a final decision when other facts may be unknown to them? What's the difference between now and later?

George Butler

- Can challenge an up-front decision without waiting for order—time and money involved.

Sara Tays

- Did MMS think more about time frames?

Lucy Querques Denett

- Talked to leaders of reengineering model teams—don't think we can commit to time frame now—trying to get to two-year audit cycle, but not there yet
- We don't see other agencies committing to timeframes and having deemed approvals if timeframes not met.

Mike Coney

- Just asking MMS to do what it originally stated in preamble to 1988 regulations--stated that companies could request determinations and that they would be appealable.
- Whatever you wind up doing, must be allowed to use that determination in order not to expose the company to allegations of knowing and willful underpayment.

Tim Jacquet, CNG

- NGPA had a statutory procedure for obtaining binding determinations of what price ceilings applied to the gas.
- Not necessarily proposing that precise approach, but note that it did provide a procedure--thinks there was a timeframe.

Break for Lunch

George Butler

- Question about the proposed rule--if facts are clear and only issue is the interpretation of the regulation, and if MMS (not Asst. Sec.) issues a response on how the rule is to be interpreted, is it correct that there is no avenue to appeal the response?

Debbie Gibbs Tschudy

- Yes, but you can appeal an audit order that may later ensue.

George Butler

- Concerned that may pay in accordance with the decision and may later get an audit order requiring payment in a different manner. If I can't rely on it and can't challenge it, then what good is it?
- Asks that MMS focus on this problem and seek way to provide more certainty.

Lee Helfrich

- Why don't you make it a refund issue during the audit and request an offset?

George Butler

- Lessee must do something proactive at beginning of process. No assurance auditor won't have later reinterpretation of original nonbinding guidance--so what good is latter prior to audit?

Lee Helfrich

- If it is a pure issue of law, MMS should be able to issue binding determination, but should not be able to issue binding determinations for mixed issues of fact and law.

George Butler

- There always will be facts involved. But if the facts don't change, the determination should be upheld.

3. Second Guessing

Sara Tays

- Places in rule where there could be second guessing, no certainty.
- suggested removing preamble example about gross proceeds accruing to lessee
- possibility of rewording 206.102(c)(2)(ii), July 16, 1998 proposal: "MMS will not use this provision to dispute lessees' marketing decisions made reasonably in good faith. It will apply only when a lessee or its affiliate inappropriately sells its oil at a price substantially below market value." Suggests that the last sentence be struck.
- 206.103(d)(3): changed from old rule to new language. Plain English rewrite raised concerns that MMS might add back in something by which the original amount had never

- been reduced. Will submit proposed rewrite for the record.
- For arm's-length sales, concerned about MMS evaluating a breach of duty to market. Industry thought that if there is an index methodology out there, it would be inappropriate to compare that index methodology to true arm's length sales and seek more royalties from someone whose arm's length sale was below index. Wants to constrain breach of duty examination to exclude such assessments. Also unfair to take limited deductions against downstream sales/index prices.

Ben Dillon

- Independents concerned about "government adjustment" in areas where there are no benchmarks.
- If value did not reflect entire consideration, then would like to go to benchmarks rather than spot.
- IPAA believes that Taylor Energy case reflects second guessing. If you have an arm's length sale, then it should be accepted short of some fraudulent conduct.

Debbie Gibbs Tschudy

- Understood Sara Tays to suggest using comparables where breach of duty/total consideration questions arise. Would we satisfy all your concerns if:
 1. we delete third sentence in 206.102(c)(2)(ii)
 2. make the change under 206.103(d)(3)
 3. change 206.106 ("to the extent" language)?

Ben Dillon

- "Good faith" is uncertain. Want express statement that your gross proceeds reflect value.

Sara Tays

- Industry will bring in one page with the proposed language tomorrow.

Debbie Gibbs Tschudy

- Also need to address any changes or examples needed for preamble.

Lee Helfrich

- Look at SCO comments of July 24, 1998
- duty includes prudence, good faith, negligence standards
- If there is a substantial discrepancy, then burden on lessee to show the reason for it.
- As for comparable sales, disagrees with the use of deflated posted prices as a benchmark.

Sara Tays

- Concerned with the current language that it could be a basis for MMS asking why lessee didn't sell in a different manner in order to get a higher price and MMS comparing with other sales that may not be comparable. Don't want to be forced to downstream marketing.

Lee Helfrich/Jim McCabe

- That is what SCO proposed with the no legitimate explanation language—can't merely point to higher price as example of non-good-faith..

Sara Tays

- Doesn't know if that provides enough certainty to the lessee.

Fred Hagemeyer

- Don't want to come in and ask for binding determinations (that we can't get).
- Just work on the language now to make it clearer.

Lee Helfrich

- can't come up with a specific list of what is or is not meeting the duty to market, given all the possible changes in industry practices that can happen in the future.

David Blackmon

- concern that in the future unclear regulations will be interpreted differently.

Ben Dillon

- Current regulations refer to misconduct or fraudulent behavior--don't have a problem with that.
- Also support good faith standard.
- Concerned about the word "reasonable"
- propose language along the lines of: "accept gross proceeds, even though that value may not be the same as the value received by other lessees in the area, absent findings of fraud or misconduct." Would like preamble example of what "good faith" is.

Lee Helfrich

- Fraud is a tougher standard than negligence. Misconduct hasn't been tested.
- But should not be negligence-free. Reasonable person standard applied to negligence law would allow for decisions made with the facts available to them, even if the decision turns out to be wrong.

Keith Kosmin, Equiva Trading Co.

- Industry concerned about second guessing investor decisions that turn out wrong.

George Butler

- Who decides if negligent? What are the standards? Lots of deference paid to agency, so industry concerned.

Lee Helfrich

- MMS has said that arm's length normally is OK. Duty to find the "problem" is with MMS.

Mary Catherine Ishee

- Want to ensure that regulatory language incorporates accepted legal standards.
- But industry is afraid that the language in the rule may expand what MMS may try to do beyond those legal standards. For example, don't turn the index price into a new standard for measuring arm's length transactions.

Ben Dillon

- Initial proposal put everyone on index because they buy oil, so the members are concerned that somehow this method would be used to impose index.

Jim McCabe

- Consider language saying that you won't pass up opportunity to get a higher price.

Sara Tays

- That is covered by "selling for the mutual benefit"--no need for the initial words.

Lee Helfrich

- Concern for cases where someone may sell the oil for a lower price in order to reduce royalty obligations.

Lucy Querques Denett

- We'll review the language proposed by Ben Dillon, Sara Tays, and Lee Helfrich.

Peter Schaumberg

- We are saying we will accept gross proceeds as value, subject to certain exceptions.
- The exceptions are minor and don't swallow the rule. Don't know where we have ever even used the exception.
- The rule provides the certainty the industry is seeking.

Ben Dillon

- Remember where this rule started.
- Then litigation on duty to market started up.
- Then MMS added new language on "inappropriately sell"
- And independents worried about what the result is if their gross proceeds are not accepted.
- That's is why industry is concerned about this provision.

George Butler

- Just don't define the standard such that a good faith, arm's-length sale is not accepted.
- Don't use "substantially below" standard.

Ben Dillon

- Agree that we can't define precisely what "breach" is, but add a statement that arm's-

length contracts will stand.

Lee Helfrich

- Look at “MMS will not substitute its judgment for . . .” language from the SCO comments.

Lucy Querques Denett/Debbie Gibbs Tschudy

- tomorrow we will spend a bit more time on this and in particular look at 206.102(d)(3) and language in July proposal on second guessing.

4. Location/Quality Differentials

see industry handout

Keith Kosmin

- goal is value of production at the lease
- current proposal does not always get to that result
- Form 4415 is burdensome and may not reflect actual conditions of sales and may be out of date
- Where a netback or index methodology is used:
 - use actual location or quality differentials where available (e.g. differentials used in an exchange agreement)
 - Use quality banks where available and where actuals are not available
 - where you don't have any actual data on quality differentials, propose to develop tables by region that reflect current conditions in that market.
 - Use data to adjust quality from the quality at the market center to the quality at the lease.
- Quality banks in Gulf of Mexico
 - start with average quality of all the leases going into the pipeline
 - adjustments to the lease based on tables developed

Fred Hagemeyer

- In some cases, you may not have quality banks that exactly fit the circumstances

Keith Kosmin

- MMS and industry would develop tables for each region for use where no actuals or quality banks available.
- For location, use actuals where available.

Dan Riemer, Marathon

- Industry concerned that adjustment for quality and location may not reflect all of the costs associated with movements from the lease to a final disposition point or index point
- It is not correct that all barrels at the lease actually could have been transferred to the

- index point.
- differences based on liquidity and other factors.
- movement from lease to index point involves costs, risks and value-added not reflected in location and quality differentials.
- Previous handout (7-15 cents/bbl) provides good assessment of types of costs involved

Keith Kosmin

- premise of valuing at the lease
- look at example on flip chart:
 - 30 degree 1% sulphur at lease
 - transported to point A and then to market center
 - assume can also move from A to another market center or refinery, or that you trade at point A
 - there may be a location differential at point A included in the exchange agreement (between lease production at point A and production exchanged for at the point it is received)
 - may not be valid to use transportation cost from A to index point--may not be able to get there.
 - may also have to adjust quality between the lease and point A
 - propose using published information for that purpose

Debbie Gibbs Tschudy

- Agrees that you would start with the price of the exchanged oil at the market center, adjust for location differential in exchange agreement, quality bank between the lease (if there is one), and actual costs to transport from lease to A.
- Industry concern is what happens when there is no quality bank.

Keith Kosmin

- Even if there is no quality bank statement, there are adjustments made within the pipeline.
- Just taking transportation and quality differential is not enough.
- Also incurring price risk because may be getting less oil at market center than giving up at point A, to be made up next month.
- also incurring costs (inventory costs, staff to monitor, etc.)

Dan Riemer

- In addition, there should be an adjustment of the spot market price to reflect difference between spot market price and term market price.
- there are many costs that lessees must incur.

Lee Helfrich

- Exchange agreements do not include such additional adjustments.
- These are marketing costs in which the royalty owner does not share.

Keith Kosmin

- midstream costs are not incurred for free.
- there is a price obtainable at the lease.

Lee Helfrich

- person selling at the lease also incurs costs.
- no one is suggesting that these are deductible.

Fred Hagemeyer

- MMS proposal did not reflect situations that don't quite fit the MMS model (no gravity bank, lessee transported itself, etc.)
 - certain location differentials
 - midstream costs
 - certain quality differences

Keith Kosmin

- Where using proprietary lines, there are adjustments made for quality even though there is no quality bank. There would be no third party document showing the differentials. Need a mechanism to allow for them

Debbie

- see 206.112(e)--that could be part of a formal quality bank or some other mechanism. To the extent that lessee is compensated or penalized for quality, we are in it with the lessee.
- But for marketing costs, we do not share. If it is for transportation, however, then it is deductible.

Valdean Severson

- So if they hire someone to schedule transportation, they can deduct those costs if they can show the costs are related to transportation?

Debbie Gibbs Tschudy

- Yes. As in FERC 636 rule.
- But if the quality is deemed to be a certain quality and there is no compensation or penalty, then we would not allow any adjustment.

Fred Hagemeyer

- What about quality of crude transported to a refinery where there is no deeming of quality and also no actual adjustment made?

Debbie Gibbs Tschudy

- We would allow adjustment.

Keith Kosmin

- Not everyone has access to information on quality of crude at the market centers.
- But that is something that we probably could get reported (pipelines could provide more information to reporting services and they could make it available)

Debbie Gibbs Tschudy

- We would like to do away with 4415 if there is a way to gather the information needed to make these adjustments.

Dan Riemer

- For example, MMS could look to information from adjoining leases.

Valdean Severson

- There may be situations where there are multiple exchanges.
- May not go to market center.

Debbie Gibbs Tschudy

- If you are trading oil, you are likely in most cases to have information on differentials.

Mack Curtis

- Only few market centers have transparent published prices.
- Most of business goes to areas where you do not have such prices.

Dan Riemer

- Would only want to get into adjustments as a third benchmark (a.l. gross proceeds, comparables, then downstream adjusted back).
- But if using netback, the lessee wants to use its own differentials

John Munsch, Santa Fe

- Would prefer to prepare own data, rather than relying on someone else data as presented on 4415.

Fred Hagemeyer

- As alternative to 4415, would rely on other available data.

Sara Tays

- How did MMS come up with differentials it used in the small refiner program?
- How did that meet the statutory standard for market value?

Debbie Gibbs Tschudy

- That was the result of arm's length negotiation between MMS and the small refiners.
- We arrived at a price in a free and open market between us and the refiners.

Wendy Daboval

- Industry is asking for the same type of adjustment as MMS gave to the refiners.

Debbie Gibbs Tschudy

- Those were sales at the market center.
- The further adjustments you are asking for are marketing costs, which we don't allow to be deducted.
- We can talk about certain costs and help categorize between transportation and marketing.

Lucy Querques Denett/Debbie Gibbs Tschudy

- We heard your points on marketing costs and will take it into consideration.
- We would prefer to administer this without the form 4415--we'll have to look at how we could come up with data necessary for everyone to calculate the differentials.
- Industry would just keep the data for checking in audit.

John Munsch, Santa Fe

- Our company has all the information it needs.

Tom White

- Walter has all the data.
- But Walter won't need it--they'll sell everything at the lease arm's length if we go with the rule, and both Walter and MMS will lose.

Sara Tays

- Would MMS be willing to just negotiate the differentials with the lessee like it did for RIK?

Lucy Querques Denett/Debbie Gibbs Tschudy

- We are talking about in value, not in kind.
- In the Rockies, we would under the 4th benchmark work out an arrangement.

Hugh Hilliard

- Do the assurances that 4415 not needed still hold if MMS does not accept the comparable sales model?

[no clear answer]

John Haley

- In the Rockies, industry would have to come in under benchmark 4 because there is not enough data available.

John Munsch, Santa Fe

- Discussion of Midstream Activities on IPAA list

Keith Kosmin

- Note that sales at the lease involve some of these activities, but these costs are much different than what the marketer incurs (more pipelines to deal with, have to deal with the producer)

John Munsch

- Look at operations--everything except credit services and environmental and safety compliance are transportation costs

Fred Hagemeyer

- some are “hard dollars” and some are “soft dollars”--easy to identify as opposed to hard to identify. Maintaining inventory costs money (having idle money sitting in a pipeline, inventory risks if price goes down or up)

Lee Helfrich

- but we should not assume cost of price risk, since we don't share in the value if the price increases.

Debbie Gibbs Tschudy

- agrees.

John Munsch

- But the cost of having 5% of first month production in the pipeline is associated with transportation.

Fred Hagemeyer

- Further comments on this can be a to do list.

Dan Riemer

- Asks for clarification on which index price MMS would use.

Debbie Gibbs Tschudy

- outside California, would be the closest market center that trades a similar grade of oil.

Dave Hubbard

- We would use the spot price for the month of delivery.

resume, 4-7-99

5. Transportation

Mike Coney

- wants to offer a method to determine what is a reasonable transportation allowance but

- avoid the issue of whether FERC has jurisdiction.
- MMS is collecting royalties on the transportation rather than just on the hydrocarbons.
- Proposal:
 - accept arm's length transportation costs
 - For non-arm's length transportation arrangements, dual approach:
 - comparability if 20% or more of shipments are arm's length, use weighted average price paid by third parties
 - if < 20% arm's length, use cost approach, with 2 x BBB bond rate but never less than 10% return on capital, plus O&M.

Lucy Querques Denett

- Subsea tieback issue status: plans to issue guidance in about 2 weeks to auditors and will make it available.

Lee Helfrich

- OCSLA defines production to include transportation to shore in § 1331(m). Offers for record a letter to the editor by Gene Wright, formerly of IPAA, stating that there should be no deduction for transportation to shore.

Ben Dillon

- Does not reflect the IPAA position. Held position formerly with IPAA.

Mike Coney

- Suggests that we have a workshop or symposium on transportation on the OCS.

Jerry Moynier, Equilon Pipeline

- Pipeline companies do take risks. Often build pipelines for more than just one project or even in advance of having any projects signed up. Develop pipelines based on projected production in an area and provide for accepting production from producers in addition to the first one in the area. Avoid building fit-for-purpose pipelines. Economies of scale for industry and good business for pipelines.
- Pipeline companies generally are independent from producers--in one case where producer told them what to do, the pipeline was initially too small.
- Don't have secure take or pay contracts, generally.
- Companies bid competitively for projects. Often joint ventures submit bids.
- Because of competition, often cannot get a rate of return as high as FERC would allow.
- The further offshore you go, the more the pipeline tends to be affiliated to the producer. 85% are non-affiliates in some nearshore areas, but much less in newer deep water areas.
- Competition is beneficial--provides options for producers as to which system to use and where they want to deliver onshore.
- Proactive marketers.

(responses to questions from Debbie Gibbs Tschudy and Peter Schaumberg)

- Formerly worked for Shell.
- Equilon participates in about 20-30 pipelines.
- About 90% would have 20% arm's length throughput. Example is Mars. Pipeline is a partnership. About 90% of the pipelines' throughput is from companies that are not participants in the project. Percentage of pipelines probably doesn't change a lot until you get up to about 40% throughput.
- Many challenges (not formally at FERC) from shippers over various issues--complaints about overproduction by another producer, seeking reductions to avoid shut in with low oil prices. Seek to give them a good netback and adjust to producer's conditions. In last 3 years no formal complaints filed with FERC.
- Main costs going into tariffs: capital recovery, labor, various variable losses (energy, loss/mismeasurement), and overhead. Return on capital for all of Equilon pipeline is about 20%--typically do not calculate the figure for each individual pipeline, but can calculate it for various regions.
- Source of capital: joint venture pipelines often third-party financed, 100% Equilon pipelines generally internally financed.
- Policy is to charge affiliated shippers the same as totally third party shippers:
 - lawyers advise to do so
 - within the company, want to have each business unit not subsidize or be subsidized by other business units.

Mike Coney

- Reasons they advise not to discriminate include antitrust reasons, non-discrimination under OCSLA, FERC regulations; but just one company's view--not definitive that you can't legally discriminate.

Tim Jacquet

- Discrimination tends to create division between working interest owners, run into problems building facilities on their platforms, good business decision.

Jerry Moynier

- Wants good relations with their customers.

Mike Coney

- Need cooperation for crossing rights of ways and for connecting to facilities. Industry regulates the rates charged by others in that if you can't easily gain cooperation if you overcharge.

Sara Tays

- Note that internally financed pipelines still have a capital cost.

Debbie Gibbs Tschudy

- We recognize that, but also know that costs are different for debt and equity.

- How many of the tariffs on the 20-30 pipelines are based on cost of service guidelines?

Jerry Moynier

- For all new pipelines, did file cost of service applications (154(b)). Initially had no third party shippers to protest, but now have third party shippers.

Lee

- Is one of the goals to have all values be the same?

Mike Coney

- Wants MMS to recognize that there is a value to the service other than just the costs and the return on capital.

Tim Jacquet

- For their joint venture pipelines, generally the partners provide the financing--have to look at the owners.

Jerry Moynier

- Equilon participates in some joint venture pipelines that are financed on a pipeline-specific basis.

Hank Banta

- Take or pay tends to be for gas--what do you use for oil?

Jerry Moynier

- Call them throughput efficiency agreements for oil, but similar concept--to reduce pipeline's risk.

Peter Schaumberg

- Switching to gas for a moment, do rates vary between interruptible and non-interruptible service?

Tim Jacquet

- There are differences in rates among different types of service, but generally between one platform and one delivery point, there generally is little difference between the rates.

Mike Coney

- Might be helpful to bring in some experts from FERC, for example, to get into these issues in more detail.

Debbie Gibbs Tschudy

- What is Equilon's cost of debt and equity?

Jerry Moynier

- Usually use hurdle rates, but not appropriate to discuss in presence of competitors.

Valdean Severson

- Do risks and factors differ between onshore and offshore pipelines?

Fred Hagemeyer

- Business risks are similar

Jerry Moynier

- Now, in the shelf area, the risks are probably similar to onshore.
- But the projects were considered risks when they were originally built.

Hank Banta

- Are there new onshore pipelines being constructed?

Jerry Moynier

- Some, but more products than crude oil. Possibility of converting some gas lines to crude service.
- Conversion projects are the focus rather than new crude pipelines.

Lee Helfrich

- Why weren't these issues brought up leading up to 1988 regulations?

Mike Coney

- Shell did not oppose use of cost of service in the 88 regs. API urged use of tariffs. When tariffs were accepted, decided not to make an issue of the low rate of return for non-arm's length pipeline costs.

Debbie Gibbs Tschudy/Dave Hubbard

- MMS has consistently used cost of service, even before 1988 rules.
- Can't find any case where value of service approved.

Tim Jacquet

- Independents probably were not as interested in this issue in 1988.
- But now, increasingly independents are building their own lines, so this issue is increasingly important to them.

Lucy Querques Denett

- Can't tell you what decision we will make on cost vs. value of service. We'll consider all the comments we receive.
- Won't commit at this point whether to hold another workshop--we have held one on gathering vs. transportation.

Sara Tays

- Prior workshop did not really get into the issue of cost of service.
- Understands that for 1988 rules, Interior accepted FERC methodology.
- Would like to have FERC and economists come in and have open dialogue on how rates are reviewed.

Lucy Querques Denett

- Is the request for a workshop on transportation, a request to extend the comment period and delay the rulemaking?

Mike Coney

- Thinks MMS has a misunderstanding of pipeline regulations. Wants to help MMS to understand that there is a profit element that is appropriate.

Lucy Querques Denett

- Thinks we do understand. As of today, we have not agreed with the value of service concept. But that does not mean we don't understand it. But we will consider all proposals that are presented.

Don Norman, API

- Not only FERC looks at weighted average cost of capital--it is a standard regulatory practice. But doesn't take into account the opportunity cost of using capital for other purposes.

Sara Tays

- Would be helpful to have both industry and Interior meet with FERC at the same time, because industry says what they hear from FERC and MMS says what it hears from FERC.

Lucy Querques Denett

- Hesitant to continue delaying the rulemaking for a workshop.
- Understands the issue.
- Will consider all proposals--we have not decided that we won't accept the industry proposal -- again, no decisions have been made.

Valdean Severson

- Where did the 20% come from?

Mike Coney

- Tried to select a number that reflected what the marketplace was willing to pay. Thought that 20% of third party shipments indicated a significant number of shippers accept the rate.

Debbie Gibbs Tschudy

- Before 1988 and under the 1988 regs, we have always shared in actual reasonable costs of transportation to the point of sale.
- Concerned that the proposal to allow comparable rates is really just accepting FERC tariffs, since that is what generally is charged.
- We question whether there really are competitive transportation rates.
- We have heard that there appear to be more 3rd party shippers in the market than we thought in the past.

Mike Coney

- MMS rate of return is an issue--rate of return doesn't allow for profit, particularly after the pipeline is fully depreciated.
- If MMS doesn't allow deduction of the profit, then MMS is trying to assess royalties on the transportation.

Tim Jacquet

- Proposal for 2 time BBB was a way to have an approach similar to MMS'--there may be better approaches.

Debbie Gibbs Tschudy

- We do allow inclusion of overhead in the allowance.
- Also allow inclusion of taxes if specific to the cost of transportation, but don't allow income taxes because not directly associated with transportation.

Dave Hubbard

- discussion of handout on Rationale for S&P BBB Bond Rate in 1988 Rule
- view was that risk for building a pipeline was lower than overall risks for oil and gas ventures, since discovery already made.
- BBB bond rate was a readily available rate and was in the middle of the range of corporate debt ratings--last rating before a junk bond rating.
- Comparison with average corporate cost of capital for specific companies:
 - Shell Transportation and Trading Company--in early '90's similar to BBB bond rate, but higher more recently.

Debbie Gibbs Tschudy

- Hurdle rates are hard for us to use because it is not publicly available information.

Fred Hagemeyer

- Comparing apples to oranges because before tax debt rate different from an after tax return on capital.

Debbie Gibbs Tschudy

- Recognizes that it is not an exact measure of actual cost of capital, but it has the advantage of being readily available.

Dan Norman

- What is relevance of showing return on capital--issue is cost of capital?

Debbie Gibbs Tschudy

- Recognize it is not the same, but it was information available to us.

Tim Jacquet

- For smaller companies, BBB bond rates are pretty low. What was the assumption about the types of companies that would be building pipelines?

Dave Hubbard

- Recognize that there is a range of companies, but we viewed BBB rate as being in the middle of the range.

Tim Jacquet

- Thinks it is tilted in favor of the larger companies--smaller companies would tend to pay higher debt rate.

Dave Hubbard

- Are you proposing that we should vary the rate according to type of company?

Tim

- Not necessarily, just pointing out that it doesn't apply to everyone.

Debbie

- Would you recommend that if we used a weighted average cost of capital, would we look at the parent corporation?

Don Norman

- Not necessarily.
- Return on capital is not the same as the cost of capital. No linkage between the two.

Debbie Gibbs Tschudy

- We would be interested in data on weighted average cost of capital.

Tim Jacquet

- FERC has policies as to when they rely on subsidiary's cost of capital and when they look at parent.
- Industry could provide some figures on weighted average cost of capital.

Mike Coney

- How do you reconcile using an index price for value and deduct just a cost of capital rather than a commercial rate?
- Concerns about whether companies can publicly release their cost of capital.

Debbie Gibbs Tschudy

- That is a valid point.
- But we are focusing here on the rate of return to use when we are not using the commercial transportation rate.

Fred Hagemeyer

- Suggesting that we look at what FERC does to see how they look at weighted average cost of capital.

Sara Tays

- Concerned that MMS would have to audit the corporation to see what the weighted average cost of capital is.

Leon Smith, FERC

- Typically uses hypothetical debt equity structure.
- Doesn't collect secret information--only collects publicly available information.
- Unlikely that MMS will be able to resolve that issue by asking FERC.

Jerry Moynier

- Corporation likes to use hurdle rate rather than weighted average cost of capital.

George Butler

- Are you suggesting a company-specific number or an industry average?

Debbie Gibbs Tschudy

- Proposal is to do a utility-type analysis which would be company specific.

Don Norman

- Not recommending use of cost of capital--just pointing out that it tends to be higher than BBB bond rate.

Mike Coney

- Would you just use the rate in the same manner as you currently use the BBB bond rate (without a floor)?

Debbie Gibbs Tschudy

- Yes. Looking at a way to allow for cost of capital and depreciate the pipeline just once.

Tim Jacquet

- Should address situations that have higher risk--higher return.

Valdean Severson

- If you are going to have an exception for high risk, you also should have an exception for low risk situations.

Sara Tays

- Even after depreciation, there still is a cost of that capital asset.

Tim Jacquet

- Some merit in the point that if you recognize higher risk also should recognize lower rate.

Dave Hubbard

- Rate of return under current system still applies to salvage value.

Tim Jacquet

- Utility commissions are pretty restrictive in what they allow.

Don Norman

- Utility commissions are moving away from strict cost of service model.
- Moving toward performance rate or incentive rate--allows return on residual from becoming more efficient.
- Propose that agency look at opportunity costs and ensure that there is a rate of return that will encourage a sufficient level of investment in the activity.
- BBB rate doesn't capture the full opportunity cost.

Debbie Gibbs Tschudy

- But how does 2 x BBB capture that any more accurately?

Don Norman

- Idea is to come up with an administratively simple approach that approximates opportunity cost.

Debbie Gibbs Tschudy

- We need in the written comments comparison of 2 x BBB rate with weighted average cost of capital.

Fred Hagemeyer

- 2 x BBB rate would approximate the opportunity cost, which is going to be higher than simple cost of debt.

Sara Tays

- Emphasize that there still is a cost of equity after many years--rate of return alone doesn't address this issue. Need to recognize continuing return on that equity.

Mike Coney

- Could MMS consider adjusting the index to account for transportation?

Debbie Gibbs Tschudy

- That would be index less tariff, as Valdean Severson proposed.

Peter Schaumberg

- Would you also adjust for "marketing"?
- You would still have to adjust for quality.

Lee Helfrich

- NYMEX officials testified that the difference is a location differential which may be different from the tariff.

John Munsch

- Some of the costs on the IPAA sheet discussed yesterday are not included in the transportation rate.

Tim Jacquet

- Back to the issue on depreciated assets, inequitable result if you don't allow any return on these.

George Butler

- Would like to know exactly what type of comments MMS is looking for on weighted average cost of capital.

Debbie Gibbs Tschudy

- What is your weighted average cost of capital?
- Should it be done on parent, subsidiary, or project basis? Please address that in your comments and provide before-tax data on each if you can.

Sarah Tays

- Again, workshop would be helpful to work out these issues.

Valdean Severson

- If we have a workshop, bring in state public utilities--not sole focus on offshore.
- Recommend that we do an offshore rule separate from onshore rule.

George Butler

- There's a concern about revealing company proprietary data.

Lucy Querques Denett

- Can API mask the sources? That is, group by company size for example? We will consider a FERC workshop and including the PUC's.

6. Non-Arm's Length Valuation

George Butler

- discussion applies to refined production, transferred to affiliate, or exchanged

Fred Hagemeyer

- Presentation of comparable sales model (see handout)
- base value on comparable sales if 20% of sales from comparable area sold or purchased at arm's length.
- industry would have to have data and contracts to back up their claim of 20% arm's length sales; spreadsheet to be available for MMS review.
- minimum number of 3 bids for bid out programs
- use weighted average prices
- adjustments for quality and transportation as necessary
- annual review--make it very clear what the area is that is being used for calculating the comparable value--but not to preclude audit.
- simplifies audit/focuses on simplified spreadsheets.
- Best indicator of lease value.
- Gets away from some of the complexities of having to adjust from the market center to the lease.
- Some experience from RIK that can be built upon.
- Strict criteria for qualification
- Lessee required to keep records

Lee Helfrich

- How does it address California's concerns that third party contracts are based on posted prices?

Fred Hagemeyer

- Doesn't need to be based on posted--whatever the parties agree to.

Lee Helfrich

- Concern that third party sellers are price takers, not price makers.
- Are you saying that the two-tier system (Texaco/Getty merger report) doesn't exist anymore?

Fred Hagemeyer

- Premise is that arm's length contracts reflect value.

John Munsch

- That is the market. The producer would like to get a higher price, but that is the market.

George Butler

- Doesn't agree that posted prices don't reflect value. But nevertheless, this proposal relies on outright sales.

Lee Helfrich

- California does not believe that outright sales at the lease reflect value.

Mac Curtis, Conoco (submitted documents for the record)

- Remarks on Conoco's program that could be adapted to most any location in U.S.
- Conoco is crude short (purchases 90% of refining needs)
- Encouraged by MMS' willingness to listen to the concerns from a broad range of the industry.
- Thinks that if we understand competitive bidding, we will see how it will work well both for MMS and industry.
- Virtually every issue raised yesterday would be resolved by competitive bidding.
- The business is complex--need follow up meeting with MMS and business professionals.
- Sophisticated and structured process for determining the value of all of Conoco's production. Need not be as complex for smaller producers.
- Could develop a small set of core rules on how the competitive bidding system would work.
- Competitive bidding is alive and well, has existed for years.
- MMS has never entertained the Conoco offer to show us the competitive bidding system in detail. Just set aside a day or two, and Conoco will show us about their program.
- Advantages:
 - Resolves the issues discussed so far.
 - Reduce audit resources--just needs to sit in on the bid openings.
 - reflects market value
 - arm's-length at the wellhead
 - simple, efficient, adaptable, certain, accurately reflects crude oil markets
 - distrust for posted prices--Government actually is receiving
 - at least revenue neutral w/ respect to proposed rule
 - reflects local supply and demand conditions
 - all downstream of the lease issues become moot
 - no issue of large number of requests for valuation determinations.
- Details of Conoco program
 - operating the program as if an independent producer
 - open to all qualified bidders--has never rejected anyone
 - actual volume sold is immaterial to bid value
 - 20-50 % of Conoco's production sold through this program (must sell at least 10% according to management direction)

- Conoco does not have the right to bid on the oil
- Bid prices applied in descending order until all the oil used up
- refining right to match on 90%
- annual reviews to make sure it obtains market value at the wellhead
- He is responsible for both selling oil and for acquiring oil for refineries. Conoco tries to sell all of its crude because it believes that sales get a better price than keeping in-house.

Sara Tays

- Industry proposal is broad enough to incorporate individual arm's length sales and these tendering programs.

Ben Dillon

- Independents may not need to develop tendering programs, but they are actively selling oil at arm's length.

Hank Banta

- Question as to whether Conoco is making more money on this program than in alternative ways to sell oil.

Mac Curtis

- Doesn't know how to compare how they would have done had they sold it a different way
- question needs refinement.

Fred Hagemeyer

- It will vary depending on the circumstances as to whether bid out or individual sales will get the higher price.

John Haley

- Gives a good basis for showing the way the price was achieved, but is largely similar to what was done before--calling around and seeing what buyers would be willing to pay.

Lucy Querques Denett

- Did you think more about the 20% number and what production would be included in the calculation?

Fred Hagemeyer

- Yes.
- No specific proposal on any different percentage except should probably be the same everywhere. Thought 20% was the right number. Did not think you should include sales going too far afield from the lease (not the market center). Virtue of the model was keeping it close to the lease - re: Peter's example.

Ben Dillon

- How did you arrive at the 50% figure for weighted-average sales in the Rockies?

Debbie Gibbs Tschudy

- 30 % factor for tendering based on royalty rate plus severance taxes--passed out list of composite tax rates
- Also concerned about ensuring that the company places oil at risk in the program.
- For weighted-average sales, the basis of the 50% factor was for the combination of sales and purchases
- Two general concerns:
 - After royalty rate and severance tax rates, is the company really putting any oil at risk?
 - Does the value obtained for 20% of the production really reflect the value for all of the oil sold by the company?

Ben Dillon/George Butler

- in latest proposal in the Rockies, if you sold 30% of the oil under the tendering program, then could use that for the rest of your production.
- but if you didn't use tendering program, then had to have 50%. Why is number higher?

Lucy Querques Denett

- We're not trying to create a tendering program.

Debbie Gibbs Tschudy

- second benchmark was sales and purchases
- We said we're not comfortable with 20, and asked if the industry could go higher

Ben Dillon

- should use the same number for purchases and sales

Wendy Daboval

- Believes 20% is a representative volume.
- If you go to higher, you can negatively affect the value at the lease because you may offer more than traders can handle.
- Thinks 20% is about optimum.
- Frequently joint venture cannot match the highest bid, so have to increase the amount sold. Recent sales sold as much as 44% of production from the lease.

John Haley, Conoco

- Conoco faced the same issue--how much should they sell.
- Asked outside economists for an opinion.
- Economists confirmed 10% was enough.
- Conoco found by offering 10%, that prices often were higher than Conoco as refiner was willing to pay.

- So decided to bid out essentially 100%.

Debbie Gibbs Tschudy

- Conoco purchases a lot of crude oil.
- So your value under the industry proposal could be different from your tendering proposal.

John Haley

- Including purchases would lower the value.

Wendy Daboval

- Purchases have to be within the producing area. Not all that the refiner purchases.
- Equiva has active program for purchases, which would help to provide competitive prices for use in valuation.

Hugh Hilliard

- Concern that you could have an incentive to sell a bit more oil outright at the lease in order to save on the royalty side more than you would lose on the sale.

Wendy Daboval/Sara Tays

- They are in arm's length transactions (in many cases by their affiliates who operate independently) and will get the best price they can.

Lee Helfrich

- If you are exchanging, then your actual gross proceeds may be higher? Why should we accept a different price?

Lucy Querques Denett

- Concerned that the answer was that the market center sales would not be included in the pool for tendering.

Wendy Daboval

- Doesn't think many companies sell at both places.
- Complicates the issue by having to adjust back to the lease.

Lee Helfrich

- But the companies are making these adjustments themselves.

Peter Schaumberg

- Concerned that the person who exchanges and sells onshore and doesn't have a tendering program treated differently than the person who does.

Lucy Querques Denett

- Royalty perspective--we look at a system that we think that provides more certainty--spot prices--and the industry doesn't accept it - wants to use actual transactions when advantageous. Concern that the industry system will result in lower collections for the lessor.
- If the 20% proposal is so fair, why isn't the industry throwing everything into that proposal?

David Deal

- If you include the downstream sales, then you have to adjust them.
- Tried to come up with something that balances the concerns for simplicity without sacrificing the right outcome.

Lucy Querques Denett

- Fundamentally, our concern is that we get a fair return for the public and for those who share in the royalties. We need to be confident that the answer guarantees a fair return.
- So we need to evaluate the cost of the simplicity.

Ben Dillon

- It is hard to explain to a producer in New Mexico that has a marketing affiliate that he has to go to a published index rather than the prices the affiliate is buying at; and that he otherwise has to go to his resale price, which may be complicated to trace back.

Keith Kosmin, Equiva

- As a marketer, the lease market is very competitive.
- When independents or majors offer at the lease, plenty of purchasers are eager to bid.
- Not surprising that Conoco and Texaco have large numbers of bidders and large amounts of oil being sold that way.
- Texaco is getting offers that are above what Equiva would pay, so Texaco is better off.
- Going out for bid is an accepted practice for determining the value of something.

Lee Helfrich/Valdean Severson

- Where lessee exchanges the oil for ANS or the lessee uses a marketing affiliate to sell the oil, why should the lessor accept a lower value based on the tendering program?

Ben Dillon

- Problem is that you are not recognizing midstream values.

Valdean Severson

- Why take the value offered for 10% of the oil and use that for the entire 100%?

John Haley

- Conoco takes the highest bid for the oil bid out. If not for the entire volume, then it goes to descending bids, until all the volume used up.

- Then shows to the supply managers to see if they want to match the price.
- If they won't match them, then Conoco sells to the bidders.

Valdean Severson

- But the Conoco bid out program as currently run does not match the industry proposal--it would include Conoco's purchases as well.

Fred Hagemeyer

- Proposal could be flexible.

Valdean Severson

- Makes the definitions of arm's length critical for the auditors.

Sara Tays

- Rockies proposal restricts use of tendering programs for producers who are also purchasing. You should not use that restriction. You want as many bidders as you can get, as shown in Wyoming pilot.

Mac Curtis

- Concerned that we will only consider what we heard today--encourages careful look at the materials distributed, and we'll recognize there is a market at the lease.
- Don't understand why there is a reluctance on the part of the government to understand tendering as it is.
- It will get for you the highest value obtainable at the lease.

Valdean Severson

- Thinks tendering has some benefits.
- If MMS allows the tendering program and each company does it differently, does that really reflect market value? Should regulations mandate the structure of the tendering program?

Mac Curtis

- No matter which way you sell at the lease, there is a market there. Should allow the option of tendering. Could have programs reviewed by the MMS, or could have a rigid conceptual framework with some flexibility.

Valdean Severson

- If you have a tendering program that he would approve, that would be fine.
- Otherwise go to index, but not comparable sales.
- Still have some concerns about the percentage, number of bids.

Mac Curtis

- Index system is very complicated and does not get back to value at the lease.

7. Comment Period

Lucy Querques Denett

- Request from API/DPC for 3 week extension
- We'll put out a notice soon for an extension of about 15 days

8. Definition of Affiliate

George Butler

- need clear criteria for rebutting presumption of control where lessee owns < 50 % and at least 10% of affiliate, because difficult to prove a negative.
- propose following criteria:
 - if entity can take any relevant action (e.g. approval of contract) without the affirmative vote of the lessee

Lucy Querques Denett/Lee Helfrich

- Do you vote before each transaction? If you don't vote, what is relevant about this proposal?

Fred Hagemeyer

- There could be some actions, such as taking on additional debt, that are not related to the business conducted between the lessee and the affiliate. These would not be relevant actions.

George Butler

- May be some actions, such as going private, that require all owners to vote. But there may be no need to vote on the action at issue.
- continuation of criteria:
 - not a general partner of a partnership

Debbie Gibbs Tschudy

- Even though the lessee may not be able to outvote the affiliate, the lessee shares in the success of the affiliate and may be able to exert some influence.

George Butler

- If lessee owns minority interest, it will benefit more from selling to the lessee at a higher price than at a lower price. When dealing with an affiliate under a joint venture, the interests are different.

Hank Banta

- Can't just look at it in isolation, can be a complex of various ventures so that there is a community of interests. Could be some shared interests and agreements as to who will act as the owner of which ventures.

Lee Helfrich

- Problem is that the general partner has a fiduciary duty to protect the interests of its owners, including minority owners.
- Control factors differ among partnerships and corporate forms. Even 10% may be too high, since at even lower percentage may owe fiduciary duty to owners.

George Butler

- May need to adjust factors for any instance where one partner must place the owner's interest above his own.
- Continuation of factors:
 - lessee is a natural person not related to the fourth degree
 - if lessee's directors on board or affiliated company cannot block any relevant action of affiliated company, then no control through interlocking directorates

Debbie Gibbs Tschudy

- Directors still may exert influence even if they can't outvote.

George Butler

- Thinks that rebutting presumption of control is enough to show there is opposing economic interests.

Lee Helfrich

- There are cases, such as buy/sell agreements and balancing agreements, where there is not opposing economic interest even though no control. There are too many fact that bear on control to develop a laundry list.

George Butler

- They may have aligned interests in dealing with third parties, but not when they are dealing with each other.
- Could consider that where the auditors show that the interests are aligned, then it could be shown, but difficult to prove a negative.
- Under current rule, there essentially is no way to rebut the presumption.
- It's not fair to give 100% discretion to the lessor on rebuttal - we need some standards.

Lee Helfrich

- In 1988 there was a rise in affiliates. Now there is a rise in joint ventures.

George Butler

- Affiliates and joint ventures both fall under the umbrella of affiliates. Not trying to come up with a set of arrangements that would not be considered affiliates.

Alby Modiano

- Just want to have a way to come to agency to show that there is no control.

- Willing to consider other criteria.

George Butler

- Objects to a process where the government has no objective standards to apply and has utter discretion to determine whether there is control.

Lucy Querques Denett

- MMS is looking at coming up with guidelines on this, but not regulatory standards.

George Butler

- Not a fair relationship between the Government and its lessees to have a presumption with no standards on how to apply them.

Lee Helfrich

- Even if we were able to come up with a list, would need to have a provision for extraordinary circumstances that do not fit those guidelines. Concerned that they tend to become too hard. May be unclear as to whether one factor is enough or all of them.

8. More on Second Guessing

Ben Dillon

- handout on language to deal with second guessing

Sara Tays

- 206(d)(3) rewritten in plain English.

Lee Helfrich

- Concerned with “fraud, affirmative misconduct or illegality”-- prefers “prudence” and “negligence” standards.
- fraud starts to bring in the Justice Department.

Ben Dillon

- Submitted for the record and for further consideration.

9. Clarifications for the Record by IPAA

Ben Dillon

- Submits March 4, 1999 letter to Director outlining the concerns of independents.
- Clarify Gene Wright was not a VP of IPAA, was on the Natural Gas Committee (not offshore committee) in 1980 and 1981

10. California Proposals

Lee Helfrich

- Majors get gross proceeds as a minimum value
- apply new rule to majors but not to independents
- have a separate rule for California, as modified as proposed by California

David Blackmon

- How do you define majors?

Lee Helfrich

- could consider various definitions (production standard, or depletion allowance standard--no refineries)

George Butler

- troubled with proposal for gross proceeds as a minimum value because of issues about what are gross proceeds, whose gross proceeds.
- What you end up with is two standards, so that when you make a royalty payment, you may think you did it right, but someone may come in with the second standard and create an issue about whether it was right.
- propose that the choice to use index, if there is one, be made available to everyone, regardless of how they sell (whether refined, buy-sell, or arm's length)

Alby Modiano

- Need full airing of proposal on gross proceeds as a minimum value.
- Industry can consider it and include in the industry comments without needing to add more time to the process.

Sara Tays

- Lease value is the same regardless of whether you are a major or an independent. With the bid out program, there is no issue.
- Industry will provide comments on why they think Kern River spot would be a better alternative to ANS.

11. General Comments

Valdean Severson

- Discussion has focused on offshore and has not adequately addressed New Mexico. The revenues for New Mexico are very important to New Mexico.
- Particularly concerned about natural gas--something that may be acceptable for oil would not be acceptable for gas.
- Urges Congressional staff, associations to come out to New Mexico to get the specific concerns out there.

Lee Helfrich

- Similarly for California, most of the revenues are onshore--not that much 8(g).

Valdean Severson

- For some issues, like duty to market, litigation may be the best way to deal with it.

Sara Tays

- Need to figure out how to resolve issues prospectively so that we don't need to wait for audits and then the results of litigation.

Valdean Severson

- Perhaps MMS can publish rule requiring index with no downstream deductions and let the industry litigate it.

David Blackmon

- Would want to know if Burlington would be treated as a major.