CRUDE OIL WORKSHOP--
Washington DC
October 27, 1997

Attendees

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Washington Work Shop
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Deborah Gibbs Tschudy

-- Goal is to get input on 5 alternatives and to hear any new proposals. We=re not trying to get consensus. RIK not part of proposal. There is a separate initiative on RIK. Alternative is bid out or tendering program.
-- Company would put out procedure for bidding.
-- Set up by company
-- needs MMS approval to be used to value for royalties

Daniel Brian

-- Fail to see why this would be better than postings

Lin Smith

-- Captures market values--competitive players bid on production. This is a real market.

Daniel Brian

-- Postings are not working because lack of price liquidity. Will you have more purchasers than before.

Tom White

-- We purchase from 3rd party. Prices are higher than postings. I think these postings plus price area dynamic representation of the whole market

Donald Sant

-- Is the minimum of 3 bids ok?

Tom White

-- 12-20 prospective purchasers compete against me for gulf purchases. I don=t think this will be a problem to get 3 bidders in GOM - onshore. I=m not sure about Rocky Mountain or other onshore areas.

Fred Hagemeyer

-- Postings not the issue--posting could be basis for bids. Range of postings are wide. You might not always get 3 bids. I=m not sure if this restriction is necessary.

Jim McCabe
-- Tendering won't work in California. Our experience with the Long Beach sell offs showed us that. Posting are not competitive. As fare as the rest of country goes, I'm not sure. But, does MMS really want to get into the business of verifying if tendering prices are competitive?

Deborah Gibbs Tschudy
-- Does it make a difference if independent producers are the bidders

Daniel Brian
-- Why would this give us higher values?

Ben Dillon
-- We are trying to get to lease value. We don't see why you wouldn't have a competitive market at the lease.

Daniel Brian
-- Why wasn't this the case 10 years ago? I don't see why tendering will get you to a true value to correct the problems of the past.

Becky McGee
-- These mechanisms have been there in the past but this is an attempt to demonstrate that fair value is achieved. MMS wants a comfort level with the pricing basis for royalties.

Ben Dillon
-- We don't think NYMEX is the right value-- theoretical adjustments have to get us to true value. We think the true market is at the lease.

Donald Sant
-- I agree with Becky. We want lessees regulations to give them guidance. We don't want to change their behavior.

Fred Hagemeyer
-- The problem is trying to give MMS comfort that sales are truly arm's length.

Donald Sant
-- The intent of 88 regulations was to have companies comply. But we see that postings were reported as the royalty price even where they received premiums.

Becky McGee
-- Do you want to stick with modified 88 rules?

Donald Sant

-- Repeat of 88 rules philosophy. There was no validation of 88 rules in practice. Oil has value only at a refinery we can't verify the benchmarks.

Lin Smith

-- Why does oil only have value when you get it to refinery?

Donald Sant

-- Integrated companies did not give assurances of price discovery. Market value was not achieved at the lease so we believe we need to start at NYMEX

Bob Speir

-- Tendering would be subject to Audit?

Fred Hagemeyer

-- Yes

Deborah Gibbs Tschudy

-- To Fred: Clarify how audit would work

Bob Spier

-- How companies verify tendering program? You need a record or all bidders to verify that bids are real!

Fred Hagemeyer

-- You need how to verify outright sales are arm's-length. This would simplify the process. The bid process is arm's length.

Bob Spier

-- Currently there is a real audit burden to get to affiliate sales. I am not convinced this will be any easier.

Tom White

-- Our offer is the best price we can offer. Sometimes we win; sometimes someone else beats our price. From a buyers point of view we see MMS oil under tendering as an opportunity.

Jim McCabe

-- Oil is tendered now but task force has found that posted prices don't represent the market. Most of the tendering is at or very near postings.

Tom White

-- We don=t agree the tendering in Gulf of Mexico is not market value. I think that Gulf of Mexico tendering is at market value. California may be unique?

-- For a company who sells production at the lease, my offer is based on same fundamentals as an offer to Exxon. We don=t low ball the bid.

Deborah Gibbs Tschudy

-- This would be first in series of benchmarks.

Ben Dillon

-- We will work with MMS to set parameters for a tendering program. Don talks about not wanting to force businesses to change their business practices because of regulations.

-- NYMEX will force a business practice change.

Donald Sant

-- Regulations are meant to change business practice but the underlying approach to business is not meant to change.

Lee Helfrich

-- Intent is only for tendering--not for comparable sales. This would be for the majors. Why independents pushing for this?

Ben Dillon

-- Let=s put it in context--this is better than what has been proposed by MMS. We have spent 3 weeks laying out costs. But we don=t get marketing costs. We were told by MMS its not open for discussion, but States, except California, would consider this.

Lee Helfrich

-- We agree that costs would not be deducted. We don=t see a legal basis or economic basis for deducting these.

Ben Dillon

-- If industry forms a business affiliate to market oil down stream, this is an added cost.

Lee Helfrich

-- We don=t see this as added value. You didn=t do anything to add value over postings.

Ben Dillon

-- moving oil requires taking risks. This costs money.

Tom White

-- You are looking at situation in California and imposing your solution on all of the U.S. This is unfair. I have staff of 5 people who do nothing but move oil away from leases and market away from lease. We would lay off 4 people if we sold at lease and bought at market centers.

-- We have to go through buy/sells and put up $ for transportation risk. These are business changes. We think there is value added.

Lee Helfrich

-- I think transportation deductions will give you your cost

Tom White

-- I will lay off 5 employees

Lee Helfrich

-- You didn't do this in 88 or in 1980

Ben Dillon

-- We will sell at the lease under tendering

John Munch

-- Costs represent value added other than transportation

Daniel Brian

-- Is this all new?

John Munsch

-- We have always wanted to maximize company net worth

Daniel Brian

-- Is something different now than from the 1980's? Why now when MMS says the gig is up do you now want to deduct these costs?

Becky McGee

-- Under the new rules value is determined away from the lease. Now we need to consider these added costs.

Alby Modiano

-- Snapshots in time don't give a real picture--changes are dynamic. It's responsive to market forces. The fundamentals have changed. At its basis, you need to treat MMS value of its oil with the same philosophy. Government has adapted to changes. If we have an approach to value over time it is reasonable to adapt to changes in industry. Government is in a contractual relationship with industry.

Deborah Gibbs Tschudy

-- Have we exhausted Tendering? Are there anymore comments on No. 1, otherwise, lets move on to No. 2.

Hank Banta

-- I agree with Alby but I come to a different conclusion. Arbitrage is created by monopsony power. Does the government get a fair shake? I don=t think that your costs have changed?

Deborah Gibbs Tschudy

-- Anymore comments on Alternative 1?

-- OK lets move to alternative 2.

-- These are the IPAA Benchmarks

1. Outright sales
2. Outright purchases
3. MMS comparables
4. Netback

-- Criteria for evaluation:

Benchmarks should be simple with certain and real time determinations.

- You need to define field or area
- You need to set minimum volumes
- The contract must be verifiable
- Netback must be tied to proper index value

Ben Dillon

-- We have had a long debate about the benchmarks. There is concern about 3rd party contracts. We withdraw that idea. We gave looked at benchmark order. Our four benchmarks are:

1. tendering
2. buy or sell in field (look at these values)
3. RIK
4. Netback with actual costs to market center or closer.

-- We have looked at the order. Under number 2, if you buy as much as your equity production, IPAA asks, why can=t you use this?

-- Membership is interested in actual costs. The independents have concerns of how you get from NYMEX to lease value.

--- Comparison made by field or area for like quality (this must be worked out up front).

-- We disagree about 50% number for minimum tendering volume.

-- Comparability--like quality to like quality recognize that MMS has concerns about comparable contracts.

-- Certification of no overall balancing agreements have utility.

-- Time frames are a constricting factor

-- W want to tighten up benchmark to get to certainty.

-- We say get rid of posted prices. That means gross proceeds is it. All companies won't meet lease activity prices. Some independents will be forced to netback. In certain circumstances this will be appropriate. We will try to address these in the next set of comments.

Deborah Gibbs Tschudy

-- Any Comments on alternative 2. The states have not been warm to this idea. The Rocky mountains present a unique set of problems.

Lin Smith

-- The IRS has to grapple with oil valuation too. It's worth looking at their approach To make adjustments to prices between affiliate they use a negotiated process. It is subject to audit. It works. IRS standards are available to company. Net back is lease preferable method. Not all companies choose this route. Alternatively, companies maintain contemporaneous records subject to audit. If they don't follow standards there are penalties.

-- If company doesn't fit this Mold, it comes to IRS and asks for negotiated solution. MMS could fashion a similar approach.

Deborah Gibbs Tschudy

-- Where is the continuity? Lease based benchmarks don't have certainty. We would have to negotiate with many non-arm's-length payors.

Lin Smith

-- Most companies have contemporaneous record keeping.

Deborah Gibbs Tschudy

-- You don't have certainty until audit.

Ben Dillon

-- We don't want to be to narrow with benchmarks. We will consider IRS approach.

Daniel Brian

-- This is cumbersome to MMS. This doesn't seem to simplify things.

Jim McCabe

-- An ad hock approach would be a mess

Ben Dillon

-- NYMEX wouldn't simplify things either.

Fred Hagemeyer

-- It's not ad hoc at all. It will satisfy MMS concerns. IT will move toward certainty. We think this will reduce audit.

Deborah Gibbs Tschudy

-- Do I hear agreement that we will value based on a benchmark for 2 years. Is this what the proposal is?

Lin Smith

-- This is not a real proposal, but more of an approach or philosophy

Ben Dillon

-- We would have certainty in advance

Deborah Gibbs Tschudy

-- But you still need audit, same as today.

Fred Hagemeyer

-- Yes but I see a move toward a level of understanding

Ben Dillon

-- You would have a check list with certainty of how to proceed.

Lin Smith

-- Most IRS payors don't choose to negotiate with the IRS. They follow the guidelines and pay accordingly.

Jim McCabe

-- It seems like variation on lease based benchmarks.

Deborah Gibbs Tschudy

-- Benchmark number 3 is netback

Lee Helfrich

-- It doesn't seem that Netback will be the primary value

-- Lease base equals postings. MMS might want to look at this. To California RIK is not feasible. It seems like we have the new method of the month here. None of these address how to get away from undervaluing California crude.

Bob Speir

-- Do the Companies get to choose which benchmark they pay on?

Lin Smith
-- Burden is on companies to prove method is the best one available.

Bob Speir
-- If MMS audit disagrees what recourse do they have?

Lin Smith
-- The same procedures they have now.

Bob Spier
-- It seems that order doesn't matter if companies come in. If order doesn't matter why not go to NYMEX first?
-- Your proposal suggests that benchmarks are equally relevant in reverse order.

Lin Smith
-- IRS lays out the methods payors are to follow. It's a well structured framework.

Deborah Gibbs Tschudy
-- I'm not sure this is a good time to model our regulations after the IRS

(LAUGHTER)

Lin Smith
-- I would suggest that there is some support now because another Federal agency is using this method.

Ben Dillon
-- This is not a flavor of the month. It's a refinement of an earlier proposal.

Break (11:00AM)

Deborah Gibbs Tschudy
-- Let's continue with the discussion of the 2nd alternative. (No further response from the audience). OK, then let's move to Alternative 3
-- MMS would establish value based on reported royalties for arm's-length transactions and would use these for non-arm's-length payors. Making correct royalty payments 30 days after the production month is a problem with this method.

Lee Helfrich
-- There is no support from California on this idea.

Deborah Gibbs Tschudy

-- What if we collected prices from purchases in Rocky Mountain region--could we develop system that uses purchaser data?

Lin Smith

-- How would you do this and make quality adjustments? You would have a similar undertaking with 4415. This would be burdensome for purchasers.

Jim McCabe

-- The prices would be low.

Tom White

-- Why wouldn=t price be okay? I don=t think people are crooks. I think people are basically honest.

Jim McCabe

-- postings are not market value.

Fred Hagemeyer

-- I disagree

Jim McCabe

-- If you are saying posted price is a transaction, yes it is, but it is not the same as an active market at the lease.

Tom White

-- California is not representative of the rest of the country.

-- If you have willing buyer and seller at the lease it=s a sale.

Daniel Brian

-- East of the Rockies between 3-10 percent of royalties are market value. This is based on DOI report. Why did Phillips break rank and raise its posting in the eighties if postings are market value.

Tom White

-- This was a change in the market. Postings are really a range of prices. There is not one price that represents Athe@ posted price. It=s a range of value.

John Munch

-- Phillips was just recognizing a change in the market. Posted price is a starting point for a negotiated price.

Tom White
-- I bid off of a posted price bases. My offer is posted price in some cases. In other cases I pay a premium.

Deborah Gibbs Tschudy
-- We want help with alternative 3 or some other way to value crude oil in remote markets.

Lee Helfrich
-- State that proposed alternative 3 excluded contracts at posted prices.

Lin Smith
-- This strikes me as a reason to use RIK

Deborah Gibbs Tschudy
-- We do have refiner program in Rockies

Fred Hagemeyer
-- Statistical analysis would take months

Deborah Gibbs Tschudy
-- What would net back look like in Rockies? What do you do in Rangely and other captive markets?

Fred Hagemeyer
-- It's not our experience that prices in the Rockies don't reflect market value.

Donald Sant
-- It depends upon what you set up as comparable contracts. Volume/quality at small volume sales may not be significant.

Becky McGee
-- DPC has asked members. Will have comments back by end of comment period.

Ben Dillon
-- Was there any thing said in Casper that would help us here?

Deborah Gibbs Tschudy
-- I haven't reviewed Dave Hubbard's comments from 88 oil.

Ben Dillon
-- Wyoming or Colorado submitted comments yet?

Deborah Gibbs Tschudy

-- States have said that 4415 is too burdensome. Fixed differentials are an option.

John Munsch

-- there will be winners or losers--the Mobil and Cheveron settlements capture 1-2 companies.

Deborah Gibbs Tschudy

-- will small enough areas fix this?

Tom White

-- It still assumes you can get NYMEX prices.

Donald Sant

-- You are measuring against what?

Tom White

-- I don=t want to win or loose with MMS oil.

Daniel Brian

-- NYMEX is a market determined price

Ben Dillon

-- We have not heard back from our members on this issue

Donald Sant

-- Certainty is attractive.

Deborah Gibbs Tschudy

-- What if you retain an option for affiliate resale or NYMEX? Burden would be reduced for all.

Lin Smith

-- There is variation between value Midland and Cushing value overtime. Fixed differentials don=t capture these differences.

Deborah Gibbs Tschudy

-- You could use Platt=s for market center to market center comparisons.

Lin Smith

-- The dynamics are the same between market center and aggregation point

Deborah Gibbs Tschudy

-- You would have to be willing to give up accuracy for simplicity and certainty

Lin Smith

-- You can agree to some level of this if everyone gets something in return we need more detail.

Lee Helfrich

-- Formula is a good idea. Currently administrative burden is tremendous? You will have winners and losers in any regulatory change. Identify these up-front.

Becky McGee

-- What if Calif comes up loser?

Lee Helfrich

-- California has been a loser for 20 years

Jim McCabe

-- It's not possible to have perfect accuracy.

Becky McGee

-- It's possible its just not likely

-- some other State might come up looser under this proposal

Deborah Gibbs Tschudy

-- In the interest of time, I think we should move on. What about the proposal from Louisiana? It has been given the name 4415 light. It would significantly reduce aggregation points.

-- Another idea came out of the Houston workshop.

-- Don't all companies with non-arm's-length transactions move oil or exchange this oil to aggregation points? If so, we would not need to collect those forms. The companies would already have the differentials they need to report an adjusted index price

Ben Dillon

-- We are surveying members to see if this will work. Actual costs are preferable. Outer Continental Shelf will be more likely to work than onshore.

Deborah Gibbs Tschudy

-- The concept of not having this form at all was attractive to workshop participants.

Lin Smith

-- How do you get quality adjustments?

-- Start with NYMEX will have blend of crude after the aggregation point is reached. Ho do you get to the lease value and make quality adjustments?

Deborah Gibbs Tschudy

-- You might have bands of quality. MMS would come up with these if we did it. If you do it in your differentials.

John Munsch

-- How do you show that? What would it take to justify these adjustments to MMS auditors.

Fred Hagemeyer

-- Gravity banks would be useful.

Tom White

-- Agrees with this

Deborah Gibbs Tschudy

-- Assuming we were to use NYMEX, is there general support to go to a 4415 lite or to company differentials?

Tom White

-- Yes

Deborah Gibbs Tschudy

-- What about the idea of using spot prices instead of NYMEX?

John Munsch

-- Since there is a suggestion to use spot prices vs the NYMEX price, why not Kern River in California?

Peter Christnacht

-- Spot services have told us they it may drop this report because Kern River is too thinly traded.

Deborah Gibbs Tschudy

-- What is the alternative to ANS?

Bob Spier

-- Other crudes are now coming into California. At the Bakersfield workshop industry had a consultant that suggested a Governing Board

Deborah Gibbs Tschudy
- -- The governing Board would be comprised of diverse interests. It would announce prices that everyone would use for non-arm's-length transactions.

John Munsch
- -- This seems to be a lot of work.

Peter Christnacht
- -- After the initial setup, the board would be little work to maintain. It would provide price transparency. Industry participates so it would have buy in.

Jim McCabe
- -- You would have two sets of points: Captive sellers and spot sales.

Kyle Harris
- -- There will always be some problems with data reporting. NYMEX is comprised of actual prices transacted.

Becky McGee
- -- What about in California?

Kyle Harris
- -- Rocky mountains and California is different than the Gulf and mid continent. You would get back to assessments in these markets.
- -- If you stick with spot prices you now have assessment for all markets

Lin Smith
- -- RIK would give you market value

Lee Helfrich
- -- Arm's-length transactions in the field in California is not market value.

Lin Smith
- -- I don't know about California, but auction price is a true value.

Jim McCabe
- -- In California the market value is not postings.

Lin Smith
- -- Should MMS be driven to impose the solution for California problems for the whole country?

Jim McCabe

-- Duty to market is part of their responsibility

Lin Smith

-- I agree with the gentlemen from NYMEX. There is no way to verify this price. You have a problem in getting value back to lease

Daniel Brian

-- If industry doesn't like NYMEX, then spot would seem to be an improvement.

John Munsch

-- If spot is a real price anyway, it would leave one less step, then let's do it.

Tom White

-- Use spot price employed during trading session (month). This would reduce burden to industry. Use the spot price for month of production.

Ben Dillon

-- For the record NYMEX is the last resort. Benchmark when other conditions are not met. This is not an endorsement of this method.

Deborah Gibbs Tschudy

-- Other alternatives at October workshops. We received general agreement that when crude oil calls are non competitive, allow the producer to demonstrate that price is competitive.

Ben Dillon

-- We are surveying our members on this idea.

Bill Whitsitt

-- I think you will find these have been negotiated away with larger producers. Small producers are the only ones affected by this.

Deborah Gibbs Tschudy

-- In cases where you have multiple exchanges in the Gulf of Mexico, will you need this flexibility to market oil?

John Munsch

-- We need this flexibility to market oil.

Jim McCabe

-- In California, multiple exchanges provide tax and royalty avoidance opportunities.

John Munsch
-- Multiple exchanges are needed to get oil out of ground and make a profit

Jim McCabe
-- They are done to avoid paying full royalties.

Tom White
-- California is a different animal. In the Gulf you need the flexibility of arm's-length exchanges to transport oil along pipeline legs to get oil to shore.

Jim McCabe
-- How will MMS determine on case by case basis which are arm's-length and which are non-arm's-length?

Tom White
-- You have our contracts in audit

Jim McCabe
-- Those are common carriers?

Tom White
-- Most of these are proprietary pipelines. You must move the oil. Companies must own the oil in their pipelines.

John Munsch
-- These are arm's-length transactions. The oil s sold back at end of pipeline.

Lin Smith
-- I have a procedural question. Congresswoman Maloney claims that 133 million dollars has been lost due to this issue. This means that MMS must do a 12866 analysis for OMB. It's required because its over $100,000. The MMS would be required to do this. This is a good basis for performing the analysis.

Deborah Gibbs Tschudy
-- We did this analysis. The impact was less than 100 million.

Donald Sant
-- OMB will determine if we need to do this.

Lin Smith
-- Due to the Maloney letter and RIK statement a more thorough analysis is needed.

Jim McCabe

-- California would like the 2 year purchase provision back in the rule. We also have problems with the exchange of crude for products. This should be the same as crude for crude. Still good Idea.

Ben Dillon

-- We might as well start over. The problem is with oil use for lease purposes. We are strongly opposed to this. This may throw a small producer to NYMEX.

Daniel Brian

-- At Pogo we are overwhelmed with e-mail from independents that support refiners paying at NYMEX.

Ben Dillon

-- I don=t know who is telling you that. None of my members are saying that. Producers don=t feel arm=s-length transactions should be disallowed.

Donald Sant

-- That is not on the table

Daniel Brian

-- Only responding to the issue that is on the table.

Ben Dillon

-- California=s proposal is a step back words

Bill Whitsitt

-- I agree with Ben.

-- We will have survey results soon

-- Independent with affiliates are disappointed that there is a lack of appreciation for downstream costs. They want to sit down with MMS and solve this.

Daniel Brian

-- NYMEX web page says oil companies are using this service. All of these companies are using it.

Bill Whitsitt

-- NYMEX is not a surrogate for prices it is a hedging tool

Kyle Harris

-- It is a measure of value at wellhead

Bill Whitsitt

-- We will be forced to pay on a price we can't get. It's appropriate with proper differentials, but only half of issue is addressed. What if you don't get this price and the differential doesn't cover the difference?

Lin Smith

-- Can you really come up with a set of differentials that accommodates a gas station range of prices?

Deborah Gibbs Tschudy

-- We can't get to lease base benchmarks for comparison

Bill Whitsitt

-- Affiliates are in bind they will be forced to pay on the wrong value.

-- We have not seen the next proposals, but this is a huge issue for our members.

Ben Dillon

-- IPAA has acknowledged that the system is broken. We have worked hard and there is a continued willingness to work for a fair system

Bob Speir

-- Large producers trade using NYMEX because they are confident their production moves along with NYMEX

-- I have been involved in this process going on 4 years. Would MMS consider that whatever the final rule says that it would apply retroactively. It would seem that logically it would protect the lessor.

Deborah Gibbs Tschudy

-- Our attorneys say without statutory authority, we can't do this. We don't have the authority.

Bob Speir

-- Could you lock in with a rule while details are ironed out.

Lee Helfrich

-- An interim rule was part of the initial proposal

Deborah Gibbs Tschudy

-- It was met with firm resistance

Donald Sant

-- We couldn't get buy in for this on the Federal gas rule either.

Bob Speir
-- To close this you would have to publish interim final rule?

Jim McCabe
-- Is there any interest in publishing an interim final rule?

Donald Sant
-- Our goal is to have a final rule by the middle of next year.

END OF SESSION