

Royalty Policy Committee "Indian Oil Valuation Rule"

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Background

- In February 2005, MMS withdrew the 1998 and 2000 proposed Indian Oil Valuation Rulemakings.
- MMS held 3 public meetings to obtain information from interested parties:
 - Oklahoma City, OK (March 8, 2005)
 - Albuquerque, NM (March 9, 2005)
 - Billings, MT (March 16, 2005)
- In June 2005, MMS conducted 5 additional consultations with tribes and individual Indian mineral owners regarding the new proposed rulemaking.

Background (*cont.*)

- MMS issued a proposed rulemaking in the Federal Register on February 13, 2006.
 - Tribal and Industry commenters did not agree on most issues regarding oil valuation including the major portion provision.
 - Indian Oil Valuation subcommittee evaluated the 2006 proposed rule and was unable to reach consensus about how the Department should proceed.

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Background (*cont.*)

- MMS decided to make only technical amendments to the existing Indian oil valuation regulations based on the comments received.
- MMS published amendments to the Indian Oil Valuation Rule on December 17, 2007.
- Effective date of the Rule is February 1, 2008.

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Background (cont.)

■ Major differences in marketing of oil produced from Indian leases

- Almost all oil sold from Indian leases (more than 97 percent in 2004) is sold or exchanged at arm's-length (AL) before it is refined.
- Only one payor currently transports oil produced from Indian leases to its own refinery. Oil sold by that payor was approximately 2 percent of oil sold from Indian leases in 2004.
- Only one producing area in which significant volumes (reported by one payor) are initially transferred to an affiliate before being resold at AL.

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Background (cont.)

■ Vast majority of Indian oil sold at AL appears to be sold at the lease.

- Only two payors claimed transportation allowances for oil produced from Indian leases in 2004.
- Except for possibility of some oil sold in OK, oil sold from Indian leases apparently does not flow to (and is not exchanged to) Cushing, Oklahoma, where NYMEX prices are published.
- Thus, extremely difficult to obtain reliable location and quality differentials between Cushing and areas where majority of oil is produced from Indian leases.
- Because the marketing/disposition of Indian oil contrasts sharply with that of Federal oil, The final rule does not use either NYMEX or spot index pricing as primary measures of value for oil produced from Indian lands.

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Product Valuation—Indian Oil Rule

- Applies to oil produced from Indian (tribal and allotted) oil and gas leases (except leases on the Osage Indian Reservation, Osage County, Oklahoma).
 - Explains how lessee must calculate the value of production for royalty purposes consistent with applicable statutes and lease terms.
 - Is intended to ensure that the US discharges its trust responsibilities for administering Indian oil and gas leases under the governing Indian mineral leasing laws, treaties, and lease terms.

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Product Valuation—Indian Oil Rule (*cont.*)

- If regulations are inconsistent with a Federal statute, a settlement agreement, or written agreement, or a lease provision, then the statute, settlement agreement, written agreement, or lease provision will govern to the extent of the inconsistency.

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Product Valuation—Indian Oil Rule (*cont.*)

■ New Definitions

- Affiliate means a person who controls, is controlled by, or is under common control with another person.
 - Ownership or common ownership of more than 50 percent of the voting securities, or instruments of ownership, or other forms of ownership, of another person constitutes control.
 - Ownership of less than 10 percent constitutes a presumption of non-control that MMS may rebut.
 - If there is ownership or common ownership of 10 through 50 percent of the voting securities or instruments of ownership, or other forms of ownership, of another person, MMS will consider numerous factors in determining whether there is control in a particular case.

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Product Valuation—Indian Oil Rule (*cont.*)

- Exchange Agreements means an agreement where one person agrees to deliver oil to another person at a specified location in exchange for oil deliveries at another location and other considerations.
 - May or may not specify prices for the oil involved
 - Frequently specify dollar amounts reflecting location, quality, or other differentials
 - Include buy/sell agreements, which specify prices to be paid at each exchange point and may appear to be two separate sales within the same agreement or in separate agreements.
 - May include, but are not limited to, exchanges of produced oil for specific types of oil (e.g. WTI); exchanges of produced oil for other oil at other locations (location trades); exchanges of produced oil for other grades of oil (grade trades); and multi-party exchanges.

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Product Valuation—Indian Oil Rule (*cont.*)

- Individual Indian Mineral Owner means any Indian for whom minerals or an interest in minerals is held in trust by the United States or who holds title subject to Federal restriction against alienation.
- Lessor means an Indian Tribe or individual Indian mineral owner who has entered into a lease.
- Like-Quality Oil means oil that has similar chemical and physical characteristics.

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Product Valuation—Indian Oil Rule (*cont.*)

- Location Differential means an amount paid or received (whether in money or in barrels of oil) under an exchange agreement that results from differences in location between oil delivered in exchange and oil received in exchange. A location differential may represent all or part of the difference between the price received for oil delivered and the price paid for oil received under a buy/sell exchange agreement.

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Product Valuation—Indian Oil Rule (*cont.*)

- Operating Rights Owner, also known as a working interest owner, means any person who owns operating rights in a lease subject to this subpart. A record title owner is the owner of operating rights under a lease until the operating rights have been transferred from record title (see BLM regulations at 43 CFR 3100.0-5(d))

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Product Valuation—Indian Oil Rule (*cont.*)

- Quality Differential means an amount paid or received under an exchange agreement (whether in money or in barrels of oil) that results from differences in API gravity, sulfur content, viscosity, metals content, and other quality factors between oil delivered and oil received in the exchange. A quality differential may represent all or part of the difference between the price received for oil delivered and the price paid for oil received under a buy/sell agreement.

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Product Valuation—Indian Oil Rule (*cont.*)

- Settlement Agreement means a settlement agreement between the United States and a lessee, or between an individual Indian mineral owner and a lessee and is approved by the United States, resulting from administrative or judicial litigation.

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Product Valuation—Indian Oil Rule (*cont.*)

- Written Agreement means a written agreement between the lessee and the MMS Director (and approved by the Tribal lessor for tribal leases) establishing a method to determine the value of production from any lease that MMS expects at least would approximate the value established under the

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Product Valuation—Indian Oil Rule (*cont.*)

- Revised Definitions
 - Gross Proceeds means the total monies and other consideration accruing for the disposition of oil produced. Gross proceeds also include, but are not limited to, the following examples
 - Payments for services, such as dehydration, marketing, measurement, or gathering that the lessor must perform at no cost to the lessor in order to put the production into marketable condition
 - The value of services to put the production into marketable condition, such as salt water disposal, that the lessee normally performs but that the buyer performs on the lessee's behalf

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Product Valuation—Indian Oil Rule (*cont.*)

- Reimbursements for harboring or terminaling fees
- Tax reimbursements, even though the Indian royalty interest may be exempt from taxation.
- Payments made to reduce or buy down the purchase price of oil to be produced in later periods, by allocating those payments over the production whose price the payment reduces and including the allocated amounts as proceeds for the production as it occurs.
- Monies and all other consideration to which a seller is contractually or legally entitled, but does not seek to collect through reasonable efforts.

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Product Valuation—Indian Oil Rule (*cont.*)

- Indian Tribe means any Indian Tribe, band, nation, pueblo, community, rancheria, colony, or other group of Indians for which any minerals or interest in minerals is held in trust by the United States or that is subject to Federal restriction against alienation.

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Product Valuation—Indian Oil Rule (*cont.*)

- Lessee means any person to whom the United States, a tribe, or individual Indian mineral owner issues a lease, and any person who has been assigned an obligation to make royalty or other payments required by the lease. Lessee includes:
 - Any person who has an interest in a lease (including operating rights owners)
 - An operator, purchaser, or other person with no lease interest who makes royalty payments to MMS or the lessor on the lessee's behalf.

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Product Valuation—Indian Oil Rule (*cont.*)

- Marketable condition means lease products that are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area.

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Product Valuation—Indian Oil Rule (*cont.*)

- Oil means a mixture of hydrocarbons that existed in the liquid phase in natural underground reservoirs and remains liquid at atmospheric pressure after passing through surface separating facilities and is marketed or used as such. Condensate recovered in lease separators or field facilities is considered to be oil.

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Product Valuation—Indian Oil Rule (*cont.*)

- Deleted Definitions
 - Like-quality lease products
 - Load Oil
 - Marketing Affiliate
 - Minimum Royalty
 - Net Profit Share
 - Net-Back Method
 - Oil Shale
 - Posted Price
 - Tar Sands

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How does lessee calculate royalty value for oil that lessee or affiliate sells or exchanges under an AL contract?

- The value of oil is the gross proceeds the lessee or its affiliate receives in an AL sale less transportation allowances. If AL contract does not reflect total consideration transferred from buyer to seller, value is the total consideration accruing to seller.
- If lessee sells oil under multiple AL contracts, value is the volume-weighted average of total consideration for all contracts for the sale of oil produced from the lease.

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How does lessee calculate royalty value for oil that lessee or affiliate sells or exchanges under an AL contract? (cont.)

- For AL exchange agreements, or multiple sequential AL exchange agreements, value oil as follows:
 - If lessee or affiliate exchanges oil at AL for WTI or equivalent at Cushing, value oil using NYMEX price, adjusted for location and quality differentials, and transportation costs.
 - If lessee or affiliate does not exchange oil for WTI or equivalent at Cushing, but exchanges it at AL for oil at another location, and following the AL exchange, the lessee or affiliate sells the oil received in the exchange under an AL contract, use gross proceeds under AL contract after the exchange, adjusted for location and quality differentials, and transportation.

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How does lessee calculate royalty value for oil that lessee or affiliate sells or exchanges under an AL contract? (cont.)

- Lessee must adjust gross proceeds for any location or quality differential, or other adjustments, received or paid under AL exchange agreement(s).
- If MMS determines that any exchange agreement does not reflect reasonable location or quality differentials, MMS may adjust the differentials you used based on relevant information.
- If lessee does not ultimately sell the oil received in exchange, and does not exchange oil to Cushing, the lessee must ask MMS to establish value based on relevant matters.

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How does lessee determine value for oil that lessee or affiliate does not sell under AL contract?

- Unit value of oil not sold at AL is the volume-weighted average of gross proceeds paid or received by lessee or affiliate, including refining affiliate, for purchases and sales under AL contracts.
 - When calculating that unit value, use only sales or purchases of other like-quality oil produced from the field/area during the production month.
 - Lessee may adjust the gross proceeds for transportation costs before including those proceeds in volume-weighted average calculation.

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How does lessee determine value for oil that lessee or affiliate does not sell under AL contract? (cont.)

- Before calculating volume-weighted average, lessee must normalize quality of oil in lessees' or its affiliates' AL purchases or sales to same gravity as that of oil produced from the lease.
 - Use applicable gravity adjustment tables for the field or the same general area for like-quality oil if you do not have gravity adjustment tables for the specific field to normalize for gravity.
- If the lessee purchases oil away from the field and if it cannot calculate a price in the field because it cannot determine seller's cost of transportation, lessee would not include those purchases in the weighted-average price calculation.

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Major Portion Valuation of Indian Oil

- No amendments to the current major portion valuation provision was promulgated. The major portion provision is the same as what was published in the March 1, 1988 rules.
- MMS will convene a negotiated rulemaking committee to consider all aspects of major portion valuation.

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Negotiated Rulemaking Act Determination of Need

- There is a need for the rule.
- Limited # of identifiable interests significantly affected.
- Balanced representation can be reasonable expected.
- Reasonable expectation consensus can be reached within a timeframe.
- Will not unreasonably delay promulgation of a rule.
- The agency has the resources to support the process.
- The agency, within legal obligations will use any consensus "as the basis for the rule".

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Negotiated Rulemaking

- Augments, does not replace, the Agency's rulemaking process.
- Rule must still go through normal Agency and administration review processes.
- Rule must still comply with other applicable statutes and executive orders.
- Draft rule is still subject to appropriate environmental and other reviews (GAS and FACA, OMB, and EIS or EIR requirements).
- Lead agency still required to fulfill consultation obligations with other agencies (i.e., FWS and ESA).
- Rule still is subject to public comment per the APA.
- If agreement is not reached, agency proceeds with its own rule.

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Negotiated Rulemaking General Requirements of FACA

- Obtain a charter.
- Maintain a balanced membership.
- Hold open public meetings.
- Allow the public to speak or file written statements.
- Announce all meetings in the Federal Register.
- Keep minutes or summaries.
- Maintain all committee documents for public inspection.
- Committees may form workgroups, however, workgroups cannot give advice and recommendations directly.

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Transportation Allowances

- No amendments to the current Transportation Allowance provision was promulgated. The Transportation Allowance provision is the same as what was published in the March 1, 1988 rules.
- The Transportation Allowance provisions were redesignated in this rule from Sections 206.54 and 206.55 to Sections 206.56 and 206.57, respectively.
- The MMS believes that further analysis of the transportation provisions is appropriate and is reserving the transportation allowance issue for a possible future supplemental final rulemaking.

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May lessee ask MMS for valuation guidance?

- You may ask for guidance in determining value. Lessee may propose a valuation method to MMS. Submit all available data related to proposal and any additional information MMS deems necessary.
- MMS will review your request and provide a non-binding determination of the guidance requested.

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QUESTIONS?

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