November 9, 2006

Input Response of the Wyoming Department of Audit Related to Using Index Pricing for Federal Natural Gas Valuation.

Comments provided in addition to comments received by the Chair – Oil and Gas Valuation Subcommittee – from Harold Kemp, State of Wyoming.

Are gas index prices transparent? No not enough to be used without a healthy skepticism. Particularly as to smaller regional areas and indexes. It is absolutely crucial that there be large volumes and large numbers of contract deals incorporated in any index used.

Are gas index prices liquid? Yes in the larger market centers with large volumes and large amounts of trades and contracts. The large market centers are more liquid than the smaller market centers and less heavily traded market centers. This is a case-by-case basis directly dependent on the market center or index used. There are reported indexes out there lacking in liquidity.

Are gas index prices accurate? Gas index prices are an indication of pricing trends, nothing more. By the very fact that there are contracts that include a premium in addition to the index price demonstrates that the contracting parties themselves did not believe the index price was accurate. Companies pick and choose what prices to report and what not to report. Furthermore, all the recent price manipulation litigation demonstrates index prices are subject to manipulation.

Should index methodology be mandatory or optional? Optional.

If optional, should the option apply to arms-length, or just to gas not sold at arms-length by lessee or lessee's marketing affiliate?

Index pricing should only apply to cost of service gas, and then with an add on factor.

Should MMS define index zones and use a basket of indices in zone or require index tied to actual flow? Gas index pricing should use an average of a basket of indices predetermined by the regulations after an opportunity to consider comments.

Should MMS prescribe First of Month or Daily average or combination or something else? First of Month.

Should MMS prescribe midpoint or high end or something else? High end at the very least, to more closely approximate the use of premiums that are added to indices. The index should be high end plus a preset premium as explained below.

How should premiums and discounts be applied? In arms-length transactions actual premiums and discounts should be applied as set out in the arms length contracts, negotiated by parties with opposing economic interest. However, if index pricing is used for non-arms length contracts only, (arms-length contracts we use the arms-length contract price) the use of index pricing will in all practicality be applied by the large integrated producers, who by their very nature out perform the market as a whole. Large integrated companies trade at index plus a premium. Therefore, the index price should be an index plus some preset regional premium. Self-dealing requires a greater amount of scrutiny. Therefore there should be no discounts applied because large integrated companies do not sell at a discount but rather a premium over smaller producers and non-integrated companies the pricing convention adopted should reflect this reality.

How should deductions for transportation and processing be calculated; actual costs based on actual flow or a set formula?

Actual costs. Formulas are cumbersome and much more subject to manipulation and litigation.

Summary

Wyoming should reiterate that what is really needed here is for the MMS to fix the ***Marketing affiliate*** definition in the regulations. Section 206.151 Definitions currently reads:

> "Marketing affiliate means an affiliate of the lessee whose function is to acquire **only** the lessee's production and to market that production." (Emphases added.) C.F.R. §206.151

We would recommend that the word "only" be removed, or changed to "any of" in the definition of *Marketing affiliate* in keeping with the United States Court of Appeals' rational in *Fina Oil and Chemical Company v. Gale Norton* (Decided June 27, 2003) as to what is necessary to require valuations based on down stream resales. The proposed language of §206.157(b)(5) removes "only" without even commenting on its removal, and yet it was the presence of "only" in the definition of *Marketing affiliate* that the court in *Fina* addressed as a regulatory flaw that could be changed in precisely this manner. We continue to press for the regulations to conform to the United States Court of Appeals' *Fina* decision.

By removing the word **only** from the definition of marketing affiliate companies would be required to report and pay on the arms-length down stream resale price, this is by far the preferred price to use.

Index pricing should only be considered in the case of cost of service gas, and if the definition of marketing affiliate is corrected by removing the word **only,** would most likely only be needed by cost of service gas payors.

In short we would only support the use of gas index pricing for cost of service gas only and then it should be index plus some premium.