

Section 19

**Minerals Management Services
Denver, Colorado
October 30, 1996**

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Development**

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**New York
Mercantile Exchange**

NYMEX/COMEX. Two divisions, one institution

Issues to be Addressed:

- Introduction to the Exchange
 - » Economic Rationale for Commodity Exchanges
 - » NYMEX Organization
 - » Growth and Market Participation
- Crude Oil Pricing and Methodologies
- Why Agencies Should Hedge Production Risk ?
- Case Study- Texas
- Why Use NYMEX Futures and Options ?

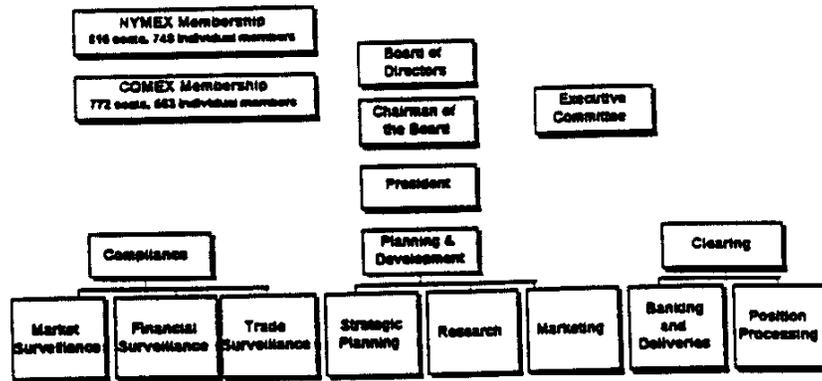
Primary Economic Role of Commodity Exchanges is:

- **Price Discovery**
 - » They record prices made through trades in an open marketplace
 - » Purchase and sale prices are transmitted immediately to be seen (discovered) by all
 - » Commodity exchanges do not determine prices
- **Hedging Function**
 - » Price risk is shifted or (hedged) by using futures and options

NYMEX Organization is Composed of:

- **NYMEX Membership**
 - » 816 seats - 749 individual members
 - » Refiners, Marketers, Brokers, Bankers, Individuals
- **COMEX Membership**
 - » 772 seats - 663 individual members

NYMEX Organizational Structure:



New York Mercantile Exchange Organization - Compliance

- Market Surveillance
 - » Monitors market participants
 - » Analyzes speculative and commercial participation
 - » Analyzes NYMEX trading activity with fundamental factors in the cash market
- Financial Surveillance
 - » Audits contract position of clearing members
 - » Insures that clearing members maintain position limits and margin requirements
 - » Maintains daily communication with clearing members with large positions



New York Mercantile Exchange Organization - Compliance

- **Trade Surveillance**
 - » Enforces a program to prevent market manipulation and anti-competitive activity
 - » Monitors floor activity for proper trading procedures
 - » Uses penalties and tight recording procedures to prevent abuse



New York Mercantile Exchange Organization - Planning & Development

- **Research**
 - » Designs new contracts for submission to CFTC
 - » Monitors current trends in present contracts and initiates any "fine tuning" if necessary
 - » Works closely with advisory committees composed of industry experts



New York Mercantile Exchange Organization - Planning & Development

- **Keys to successful futures contract development**
 - » Long supply chain
 - » Fragmented industry structure
 - » Large numbers of buyers and seller
 - » Well-developed underlying physical market
 - » Pricing largely or completely free of government control
 - » Volatile prices



New York Mercantile Exchange Organization - Planning & Development

- **Strategic Planning**
 - » Investigates new technologies to make trading more efficient
 - » Works with officials of other exchanges to build strength throughout the commodity industry
 - » Works with foreign markets to encourage worldwide trading at NYMEX



New York Mercantile Exchange Organization - Planning & Development

- **Marketing**
 - » Liaison with contract participants
 - » Publishes educational material about NYMEX markets
 - » Holds seminars and lectures about the Exchange domestically and internationally
 - » Provides statistical and industry data
 - » Liaison with the press



New York Mercantile Exchange Organization - Clearing

- **Banking/Deliveries**
 - » Works with clearing members acting as a transfer agent between those traders who generated gains with those that incurred losses
 - » Matches companies choosing to take physical delivery of contracts to companies choosing to receive physical delivery



New York Mercantile Exchange Organization - Clearing

- **Position Processing**
 - » Ensures that all buy trades are properly matched to the correct sell trades
 - » Ensures that all trades are properly assigned to the clearing house
 - » Operates the automated system that makes the clearing of +250,000 trades a day possible



Safeguards for Exchange Participants

- **Financial Integrity**
- **Regulation of Participants**
- **Price Limit Rules**



Safeguards for Exchange Participants - Financial Integrity

- The Exchange is as secure as the collective strength of its Clearing Members
- Requirements to qualify as a clearing member
 - » Must show a minimum working capital of \$2,000,000
 - » Must maintain an account with an approved New York City Bank
 - » Must make a deposit to the NYMEX Guaranty Fund based upon capital
 - Contribution is between \$100,000 and \$2,000,000 (approximate fund assets currently \$75,000,000)



Safeguards for Exchange Participants - Financial Integrity

- Safety Net - in the event of a clearing member's failure to meet its obligations, i.e. maintain margin payments, the loss is restored through the "safety net" system
 - » That clearing member's assets
 - » Exchange surplus as determined by the board of directors
 - » Payments from the NYMEX Guaranty Fund
 - » A pro-rated assessment of other clearing members based on trading participation



Safeguards for Exchange Participants - Regulation of Participants

- Position Limits

- » Hold clearing members and their customers to a value of trade commensurate with their capitalization



Safeguards for Exchange Participants - Regulation of Participants

- Speculative Limits

- » Customers of clearing members can have no more than 1,000 contracts in the first nearby spot month. 10,000 for light, sweet crude, 7,000 for heating oil and unleaded gasoline and 1,500 for propane in all months combined. Limits for Alberta and Permian natural gas and sour crude are 5,000 contracts, Limits for Henry Hub natural gas 7,000 contracts with no more than 350 (A &P) spot natural gas, 750 spot Henry Hub natural gas and 500 spot sour crude oil contracts
- » Hedge exemptions are granted in consideration of customer's financial stability, trading history of the company and the futures and options market liquidity



Safeguards for Exchange Participants - Regulation of Participants

- Reporting Levels
 - » FCMs must report daily positions of customers holding more than 300 crude oil, 150 NY Harbor unleaded gasoline, 250 heating oil, 100 natural gas, and 25 propane contracts
 - » Reporting companies remain anonymous but are qualified by sector for analysis of market participation



Safeguards for Exchange Participants - Regulation of Participants

- Margin Requirements - All Contracts
 - » Good faith deposits which can be used to cover adverse movements in futures prices
 - » Initial margins per contract
 - » Assessments (increases in margin) are required as contract nears delivery
 - » Exchange staff and board of directors closely monitor margin levels, adjusting as necessary

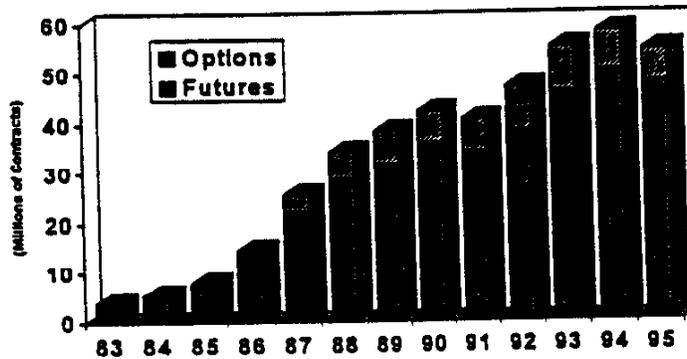


NYMEX Energy Complex

<u>Contracts Traded</u>	<u>Introduced</u>
● Heating oil futures	1978
● Crude oil futures	1983
● Unleaded gasoline futures	1984
● Crude oil options	1986
● Heating oil options	1987
● Propane futures	1987
● Unleaded gasoline options	1989
● Henry Hub Natural gas futures	1990
● Natural gas options	1992
● Crack Spread Options	1994
● Electricity (Palo Verde, CAOB)	1996
● Permian Basin and Alberta Nat. Gas	1996



Growth in NYMEX Trading Volumes



NYMEX Standardized Futures Contract Specifications

	Sweet Crude	Heating Oil	NY Harbor Unleaded Gasoline
Units	1,000 U.S. barrels	42,000 gallons	42,000 gallons
Price Quote	Dollars and cents per barrel	\$ per gallon	\$ per gallon
Delivery	Cushing, OK	NY Harbor	NY Harbor
Contract Months	30 Consecutive months based on a quarterly schedule and rolling 38th and 48th months	18 consecutive months	18 consecutive months



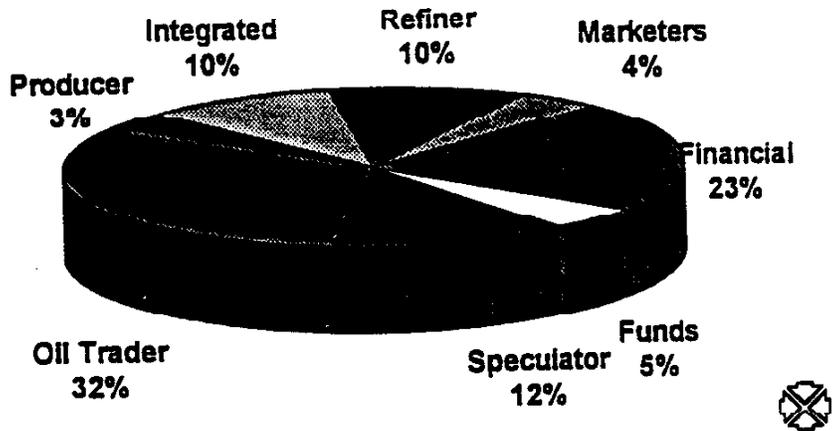
NYMEX Light Sweet Crude Oil Contract (WTI)

- Delivery: F.O.B as any pipeline or storage facility in Cushing, Oklahoma with access to Arco, Cushing storage or Texaco Trading and Transportation, Inc. Cushing Storage
- Domestic Deliveries
 - » West Texas Intermediate
 - » Low Sweet Mix (Scurry Snyder)
 - » New Mexican Sweet
 - » North Texas Sweet
 - » Oklahoma Sweet
 - » South Texas Sweet
- Foreign Crudes
 - » U.K. Brent Blend and Forties Blend
 - » Nigeria: Bonny Light
 - » Norway: Oseberg Blend



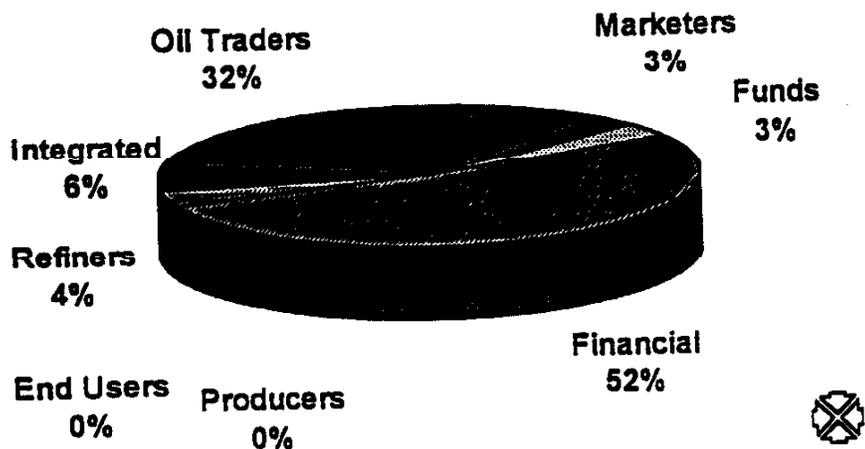
Crude Oil Futures - Open Interest

1996 3rd Quarter market participation by occupation



Crude Oil Options - Open Interest

1996 3rd Quarter market participation by occupation



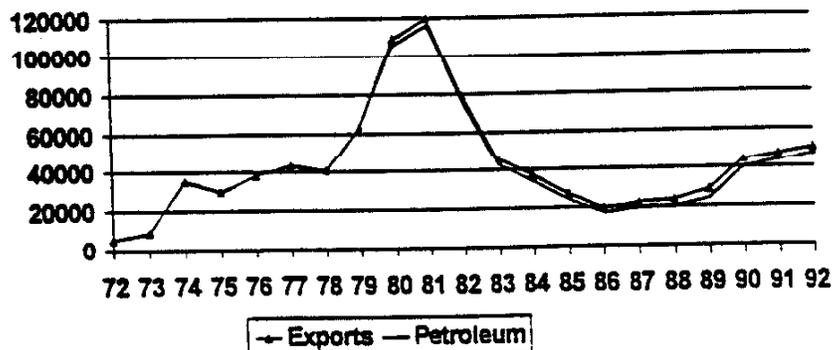
Why Governments Should Hedge Production Risk (continued)

- Oil Price Volatility Makes Budget Forecasting Difficult
 - » Lock-in revenues regardless of market conditions
 - » Hedging allows accurate budgeting
 - » Hedging neutralizes the adverse affect of price volatility

Why Governments Should Hedge Production Risk:

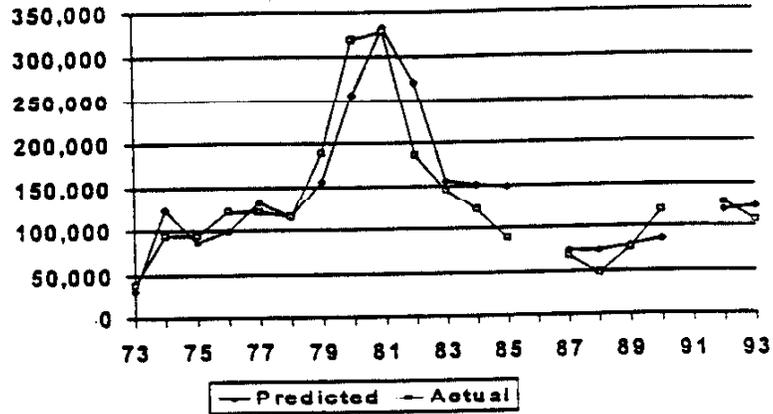
- Oil Exporting Countries Highly Dependent on Oil Revenues
 - » Bulk of National Revenues from Collection of Petroleum Receipts

Exports Revenues vs Petroleum Revenues
Saudi Arabia (Millions of US Dollars)

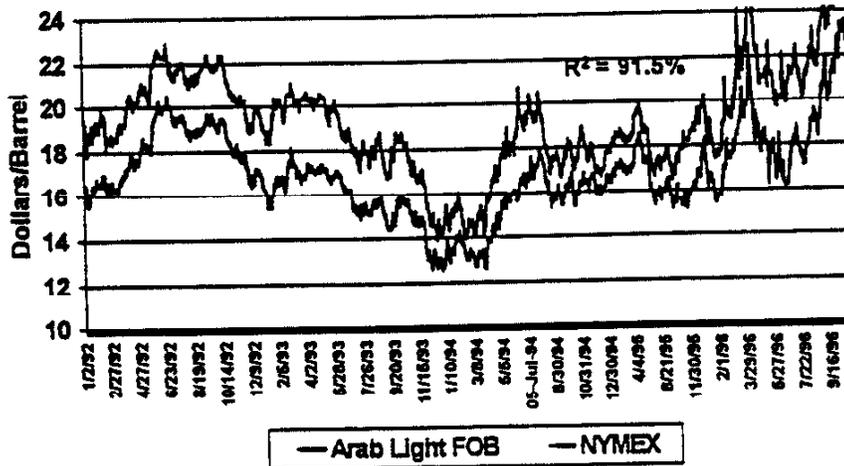


Why Governments Should Hedge Production Risk (continued)

**Predicted Oil Revenues vs Actual Oil Revenues
Saudi Arabia (Millions of Riyals)**

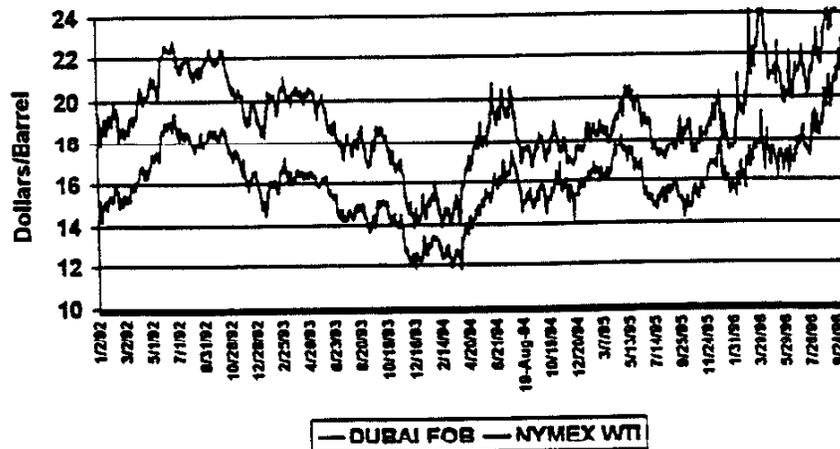


NYMEX Light, Sweet Crude Oil Futures vs. Arab Light- FOB 1992 - 3rd Quarter 1996



NYMEX Light, Sweet Crude Oil Futures vs. Dubai FOB 1992-3rd Quarter 1996

$R^2 = 90.90\%$



Governmental and Government Regulated Entities are Making Increased Use of Energy Futures Markets

- In the United States:
 - » State of Delaware
 - In the Third Year of a successful program to hedge energy product purchases, and has added low income energy assistance to its hedging program.
 - » State of Massachusetts
 - Has developed a program to hedge costs of a state and federal government funded program for fuel assistance to the low income and elderly.
 - » State of California
 - Has approved hedging by public utilities.
 - » State of New York and New Jersey
 - Have developed plans to manage energy price risk.

Governmental and Government Regulated Entities are Making Increased Use of Energy Futures Markets

- In the International Community:
 - » Colombia
 - Recently passed legislation to enable state owned enterprises to hedge financial and commodity price risk.
 - » United Nations Commission on Trade and Development (UNCTAD)
 - Has officially adopted a work plan to encourage the use of Risk Management Instruments
 - » PEMEX
 - Mexican state-owned oil company currently hedges oil price exposure
 - » STATOIL
 - Norwegian state owned oil company currently hedges oil price exposure
 - » Neste
 - Finnish state-owned oil company hedges oil price risk exposure

Case Study- State of Texas Oil and Gas Hedging Program

- Background
 - » 1986
 - Oil prices dropped from \$35 to \$11
 - State of Texas found itself \$3.5 Billion short of expected energy revenues
- Initiation of Hedge Program
 - » 1991
 - State of Texas develops legislation, administration guidelines and procedures to institute a hedge program for energy revenues
 - Legislation insured specific goals and objectives
 - Safety
 - Using commodities for hedging not speculation
 - Implementation of strict controls
 - Oversight to assure objectives and goals would be met.
 - Legislation insured that critical oversight was provided by an existing State Board

Case Study- State of Texas Oil and Gas Hedging Program

- **Initiation of Hedge Program (continued)**
 - » **1991**
 - **Implementation of Program Assigned by the State Depository Board to the Deputy State Treasurer of Texas**
 - **Oil Advisory Committee created by staff to assist in acquiring practical market knowledge**
 - » **1992**
 - **Pilot Program Set in Place by 1992 which had guidelines in place**
 - **Staff authorization total**
 - **Decision making responsibilities**
 - **Hedge position limits**
 - **Daily monetary position**
 - **Segregation of duties**

Why Use NYMEX Futures & Options?

- **The NYMEX light, sweet crude oil contract serves as a world reference price.**
- **Physical delivery ensures convergence between futures and cash**
- **NYMEX crude oil and petroleum product prices closely track key imports and domestic markets**
 - » **WTI Cash**
 - » **LLS**
 - » **Dubai**
 - » **Arab Light (Saudi Arabia)**
 - » **Dated Brent (U.K..)**

Why Use NYMEX Futures & Options?

● Volatility

- » Iran-Iraq War, 1980 - 1988
- » Exxon Valdez, March 1989
- » Winter cold snap, December 1989
- » Invasion of Kuwait, August 1990
- » Soviet Coup, August 1991
- » Nigerian oil "strike"
- » Iraqi "Humanitarian Oil Sales"

Why Use NYMEX Futures & Options?

● Liquidity

- » 80 percent of all exchange-traded energy futures and options trade at NYMEX
- » The NYMEX crude oil contract is the most actively traded physical commodity futures contract in the world
 - Almost 100,000 contracts per day
 - Almost 23,000 crude oil option contracts per day
- » NYMEX offers the world's most liquid petroleum products futures and options contracts
 - Unleaded gasoline
 - Heating oil
- » NYMEX contracts trade out as far as 60 months (crude) - with significant liquidity in the out months out

Why Use NYMEX Futures & Options?

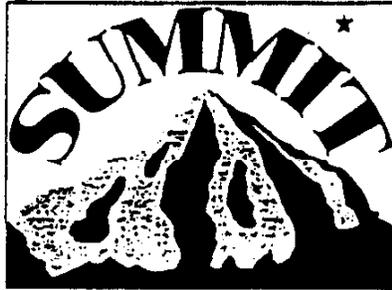
- **Safety**
 - » Strong, well capitalized clearing system
 - » Backed by the financial strength of some of the world's most significant financial institutions
 - » Strict compliance and operational standards ensure fair and orderly markets
 - » Operates under rules and regulations of the Commodity Futures Trading Commission

Why Use NYMEX Futures & Options?

- **NYMEX ACCESSSM**
 - » Round-the-clock price discovery
 - » Round-the-clock order execution

Section 20

CRUDE OIL ROYALTY
PAYMENT ANALYSIS



**Report to the State Lands Offices of
Colorado, New Mexico, and Texas**

February 21, 1995

Summit Resource Management, Inc.

P. O. Box 797467
Dallas, Texas 75379

Methods for Future Enforcement

Improved Payment Regulations:

The first step in achieving better ongoing payment from the oil companies would be clearly defined regulations which let the oil companies know that royalty and tax payments should be based on the true market value, or the *actual net final value received*. If the oil companies know that the state governments are aware of the true market value and expect payment on such a basis, the likelihood of compliance should increase dramatically. Summit suggests that regulations be written to require that the oil companies pay their royalties and taxes based on "*the actual final net value received for sale of crude oil produced from the lease, including all considerations, trades and exchanges, commodity center sales, transportation, and other deductions where appropriate.*" If this is not possible due to an oil company taking the crude oil to its own refinery, or for any other reason, then the tax and royalty price should be "*the fair market value which could be reasonably expected to be received for final sale of like crude oil at the same lease location by a crude oil marketing organization with a level of sophistication similar to that of the responsible party.*" Once new regulations have been implemented, they would, of course, need to be actively enforced to help the oil companies understand what is expected of them. The state agencies responsible for enforcement would need to be educated in crude oil marketing, and the oil company payment personnel would need to be educated in the new regulations.

Audits:

Detailed audits of previous payments by a qualified auditor, skilled in crude oil marketing, would need to be conducted in order to prove tax or royalty underpayments. It would be necessary for the auditor to trace all crude oil trades, exchanges, and final sales. This would therefore require that the auditor have the necessary experience and knowledge to know where to look for documentation of unwritten or un-linked trades which may have been deliberately put in place to evade audits. It is very possible that at least some of the oil companies would cooperate with the state agencies after learning that the states had the auditing expertise to locate the underpayments.

Take-In-Kind Programs:

The only way to be absolutely certain that a fair market value is received for royalty oil is to take the oil in-kind for sale by the state agency. This can be very effective in locations where the volume of royalty oil is large, but it may be impractical where the state's royalty oil is small or where additional physical facilities would have to be built to segregate the state's oil. There would be some overhead costs associated with marketing the oil, however, the cost savings in auditing and compliance, coupled with the higher value, could prove quite advantageous to a state agency. For example, in the Yates Field, the State of Texas has recently received an average of approximately \$2.00 over posted price and significantly in excess of the other reported prices for the same field. On small leases and in tax compliance, however, an in-kind program would not be practical.

Section 21

Written Statement by
Larry Nichols
President and Chief Executive Officer
Devon Energy Corporation
representing
Independent Petroleum Association of America (IPAA)
before the
Committee on Resources
Subcommittee on Energy and Mineral Resources
U.S. House of Representatives
June 27, 1996

Mr. Chairman and Members of the Committee:

I am Larry Nichols, president of Devon Energy Corporation ("Devon"), an independent producer who has federal production. I am here today on behalf of Devon and the Independent Petroleum Association of America ("IPAA"), a national trade association representing more than 5,500 independent oil and natural gas producers.

Mr. Chairman, members of the Committee, we always appreciate the opportunity to work with you in the pursuit of more efficient and cost-effective ways of managing the payment of federal royalties. In June of last year, I testified before you about the need to reform the federal royalty collection system. I personally want to thank you and the committee for responding by expeditiously moving your Royalty Fairness Bill.

Today, we are discussing another important initiative -- reducing uncertainty associated with the payment of federal royalties in today's natural gas market. We applaud the Minerals Management Service's (MMS) recognition that alternative approaches need to be pursued to develop a more certain and predictable method of determining gas royalty payments. Independents have participated in two of MMS' efforts to change the way they conduct business in the new gas marketplace. Gas production is important to this country and is important to independents, who produce 65% of domestic natural gas. We need to develop a federal royalty system that encourages gas production from federal onshore and offshore leases and, as required by law, always looks to the free and competitive market between a willing buyer and a willing seller as the basis for all royalty payments.

One of the two efforts initiated by MMS, which is not the subject of today's hearing, is the Federal Gas Valuation Negotiated Rulemaking Committee. This Negotiated Rulemaking Committee explored alternative valuation methodologies that would reduce the need to trace federal gas molecules through a myriad of complex marketing transactions in an attempt to determine market value at or near the lease. The IPAA participated in the last official meeting of the Negotiated Rulemaking Committee

in an attempt to find common ground among large and small producers. The IPAA supports an alternative valuation method for gas production and an option to eliminate the burdensome accounting associated with gas processing by allowing payment on a wellhead heating value. This proposal addresses in an equitable manner MMS' concerns about administrative burden, state concerns about revenue neutrality, independent concerns about audit burden and cash flow, and everyone's need for a simplified valuation methodology.

The MMS' second effort, to reengineer and increase certainty of gas royalty payments, is the topic of today's hearing. The effort is called the Gas Royalty-In-Kind Pilot Program (pilot). The MMS asked volunteers with production in the Gulf of Mexico to offer royalty gas for participation in a test in-kind program. Devon participated in the test in-kind program with one federal lease. We appreciated MMS' cooperative spirit of bringing different types of lease forms into the pilot.

For our volunteered lease on the volumes that were attributable to royalty in-kind, Devon replaced the accounting burdens associated with a monthly royalty payment with additional gas control responsibilities. Under the pilot, we were required to notify the government's purchaser of the volume of gas that it was required to take. This additional communication and new relationship with MMS' purchaser appears to replace the administrative costs associated with reporting royalty in value.

Royalty Payments in today's new gas marketplace

Between the late 1940s and the 1970s, when a new well was drilled, a producer would negotiate and execute a gas sales agreement with an interstate or intrastate pipeline for the purchase and sale of gas at each new well. The pipeline would then construct a transportation (gathering) line to the new well for receipt of the gas into its pipeline system. Gas was sold and flowed directly into the interstate or intrastate pipeline "at the well." The pipeline moved the gas through its transportation system to its processing plant, if necessary. The pipelines purchased the gas at each well and transported it away from the well to local distribution companies, who sold it to localized industrial, commercial, and residential customers. Because the pipelines bought and resold gas, they functioned as gas merchants and were referred to as "merchant pipelines."

Gas was sold at the well to the pipelines at a price which represented the value of gas in its naturally occurring state at the point of production. For royalty purposes, it has been recognized for over 50 years that the price paid to the producers by the pipelines constituted the "market value at the well" for the royalty gas produced under the lease contracts.

Beginning in the mid-1980s, gas marketing changed dramatically as a result of the Federal Energy Regulatory Commission's ("FERC") initiatives to inject more competition into interstate gas markets. In 1985, FERC issued Order No. 436 which

required interstate pipelines to provide "open access transportation" to all producer shippers on a nondiscriminatory basis. Order No. 436 completely restructured the national gas industry and began changing the role of pipelines, from that of gas "merchants" to that of gas transporters. In obtaining "open access" to pipeline transportation, producers could now transport on pipelines and sell directly to prospective customers throughout the nation.

Subsequently, FERC Order No. 636 mandated the "unbundling" of the pipeline's various sales and transportation functions and other services, and further implemented the open access transportation policies initiated by Order No. 436. As a result of these regulatory changes, interstate pipelines have virtually ceased to be purchasers of gas and instead now function almost solely as transporters of gas owned by others.

As a result of these sweeping changes, potential markets for the sale of gas were greatly expanded. Producers may now sell directly to industrial customers, end-users, local distribution companies, and other former interstate pipeline customers. Rather than sales occurring at the wellhead, as was historically and customarily done during the first 50 years of gas production, producers now must either build transportation lines to transport gas away from their wells or pay third parties to transport gas away from the wellhead for shipment to distant markets. When a producer sells gas away from the well, the producer must incur the cost and expense of getting its gas to that distant point of sale. The "wellhead" price for "any away from the well" sale can be calculated by using a "net back to the well" method, which results in a price that is net of the costs incurred to get gas to the market. A producer taking advantage of today's marketing flexibility by selling downstream of the well, directly incurs charges for such functions as transportation, compression, and processing that were previously reflected in an interstate pipeline wellhead sales price. Prior to this regulatory restructuring of the industry, these functions were generally performed by interstate pipeline purchasers as part of their "bundled" merchant service.

The changing marketing arrangements did not easily conform to the current regulatory structure. As companies sell away from the well, "netting back to the well" to determine value can be administratively complex and increase uncertainty as costs once considered deductible as a cost for "bundled" merchant services are now being tracked and reviewed for royalty purposes. The need for regulatory change for gas production was recognized by MMS in a report it issued in March 1995 entitled "Final Report Federal Gas Valuation Negotiated Rulemaking Committee," which states that "tracing proceeds from sales of gas back to a particular lease is very difficult, and determining the royalty value of gas produced from federal leases has become increasingly complex and burdensome."

Why MMS and producers pursued a gas royalty in-kind project

As stated above, the MMS has acknowledged that the current royalty payment system for gas does not compliment the gas marketplace. When MMS takes its royalty gas in-kind at the wellhead, it relieves the government and lessee of the uncertainties and complexities associated with gas sales occurring at locations remote from the lease. The MMS stated in a press release that the pilot "evolved out of discussions with our customer and typified doing more with less. It is a true example of reinventing government, MMS trying new business practices and procedures to work better and smarter."

A mutual benefit to the government and the producer is the certainty associated with delivering volumes in lieu of royalty payments. Once delivered, the royalty obligation under the lease is satisfied. One question always asked is what is market value? When taken in-kind, market value is the price that the MMS receives from the willing purchasers. In-kind provides flexibility for both the MMS and the natural gas producer in an ever changing and evolving gas market in North America.

While my comments today have been general in nature, we have attached additional background with regard to a royalty in-kind program. The attachment highlights factors that need to be considered that could affect the outcome of an in-kind program. To facilitate continued cooperation between MMS and industry for experiments, such as in-kind, we suggest that MMS allow volunteers and purchasers involved in the pilot to comment on its draft of the report about the in-kind project. Much of the data and information being used by MMS in its report was supplied by participants in the pilot.

For an official analysis of the MMS pilot, we refer you to a paper prepared for the Rocky Mountain Mineral Law Foundation's 41st annual institute. This paper is entitled "Testing the Water: A Cooperative Effort to Design the MMS' Royalty In-kind Pilot Program for Natural Gas."

Conclusion

We compliment and encourage MMS to continue to work cooperatively with the industry and states to develop alternatives that restore certainty and create simplicity for paying royalties on natural gas production. In this regard, Devon has volunteered gas for an in-kind onshore pilot. A second pilot will serve as a learning experience as we move forward.

Mr. Chairman, we support the legislative language you submitted to the Chairman of the Subcommittee on Interior Appropriations authorizing MMS to conduct additional in-kind pilots. If these pilots are conducted in a manner similar to your language -- "at or near the lease on a volunteer basis in an onshore area with active gas

markets" -- then all concerned parties would be better able to make informed decisions about the future of such a program.

I want to inform the Committee about a separate effort that we have initiated to develop alternatives to the current royalty payment system to better compliment today's gas market. As chair of an advisory subcommittee for the MMS entitled "Nonconventional Alternatives," we will develop payment options to reduce royalty regulatory burdens associated with gas production. Potential alternatives include an extended period for reporting gas transactions to accommodate the thousands of adjustments associated with tracing gas sales back to the well, taking gas in-kind, and buying out royalty streams. This subcommittee is comprised of industry, state, and Native American representatives. When this subcommittee develops recommendations we will submit them to the committee for its review.

As the demand for natural gas increases from domestic sources, we must reverse the trend of independents not increasing their development of gas resources from public lands, an important source of undiscovered gas. Devon and IPAA encourage the Committee to continue with its oversight of activities to improve the state of natural gas production from federal lands. To encourage additional development, independents cannot be required to pay royalties on values which exceed the proceeds received for the sale of gas at or near the lease.

Thank you for this opportunity to testify. There are a number of options, such as royalty in-kind, that need to be pursued as ways to reduce costs and streamline the royalty payment process for gas production. There is much to be learned about a royalty in-kind program from a federal and state government and industry standpoint. We are available to work with the committee as the process for developing alternatives for paying royalties on gas production moves forward.

Attachment 1

What primary factors affect the outcome of an in-kind program?

The Mineral Leasing Act and the Outer Continental Shelf Lands Act require that the amount of royalties due the government be paid in full the month following the month of production. To ensure proceeds were deposited with the Treasury within the required timeframe, the MMS chose to immediately transfer, or "flip," title of the gas delivered by the producer. The MMS chose not to expend any costs and/or take any risks associated with downstream value-added gas sales activities.

The MMS felt that this payment requirement contained within the law prevented them from entering into any sort of gas balancing or storage situation. These restrictions were passed onto the competitively selected purchaser of the gas which prevented purchasers from entering into traditional balancing arrangements thereby affecting the price received for the gas. The requirement for the purchaser to take all produced volumes may require the purchaser to obtain firm transportation in lieu of interruptible transportation, which could be a more costly proposition.

Other factors affecting the success of an in-kind program:

1. To achieve maximum efficiency, reporting and auditing should be limited to production reports and communication regarding available volumes, including imbalances.
2. Gas balancing should be designed to minimize impacts on the producers and the government. Once production occurs, which is under the sole discretion of the lessee/producer, the lease requires royalties to be paid. The producer cannot segregate the royalty share of production to be left in the ground.
3. An in-kind program cannot interrupt a lessee's existing processing and marketing arrangements. When gas is taken in-kind, there should be sufficient notice as not to disrupt existing marketing arrangements.
4. For every federal lease, the MMS or the Bureau of Land Management approves a royalty settlement point as the point of measurement consistent with the terms of the lease. It is imperative that under any in-kind program, production be delivered at this point.
5. States need to be consulted in all future in-kind efforts. If states begin marketing their share of the royalty stream, the entire royalty stream must be taken in-kind to prevent the additional administrative costs of multiple collection systems.

6. Potential purchasers need to have more timely access to information affecting the bids. This includes mapping of actual flow, a longer time before purchasers have to submit bids to understand supply source, cost data regarding non-regulated lateral lines owned by the producer, and the quality of gas being purchased.

7. An in-kind program should not be unnecessarily burdened by an examination of other sales occurring in the area to determine if an in-kind sale received market value. A sale of in-kind volumes by MMS is market value because it is the agreed-to price between a willing buyer and seller at the time of the sale. To clarify this important point, a legislative change may be required.

Section 22

OPENING STATEMENT GARY MCGEE, DEVON ENERGY

I am Gary McGee, Treasurer of Devon Energy and today will be making comments on behalf of the Independent Petroleum Association of America (IPAA), a national trade association representing more than 5,500 independent oil and natural gas producers. We always appreciate the opportunity to work with you in the pursuit of more efficient and cost-effective ways of managing the payment of federal royalties. Larry Nichols, President of Devon Energy Corporation and Chairman of the IPAA Land & Royalty Committee, testified in June of 1995 and again in June of 1996 before the U.S. House of Representatives, Committee on Resources, regarding the need to reform the federal royalty collection system, with a focus on RIK. I know last week in Houston, Ben Dillon presented you with a copy of his testimony and correctly stated that Mr. Nichols comments regarding gas in-kind also applied to oil in-kind.

The IPAA continues to support royalty in-kind at or near the lease, especially as MMS proposes royalty schemes to distant financial markets. The IPAA producers agenda for 1997 contains a plank asking IPAA to provide producers an opportunity to deliver royalties in-kind. In support of this agenda, IPAA supported the appropriations language requiring MMS to pursue additional oil and gas pilots for royalty in-kind. Beyond piloting, IPAA supports MMS' pursuit of a more comprehensive, long term commitment to permanently taking oil and/or gas in-kind.

Why royalty in-kind? As more uncertainty and financial burdens are created for producers under proposed royalty schemes, RIK provides a certain and predictable alternative. RIK measures value appropriately by looking to a transaction between a willing buyer and a willing seller at or near the lease. We are always struggling with the question of what is market value? RIK provides a definitive answer to that question -- it is what MMS receives from its willing purchaser for the product delivered at or near the lease.

We understand that in Houston there was some discussion that MMS may want to compare taken volumes and proceeds to what it might

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have received under regulations (such as NYMEX). We strongly object to this comparison and believe that that lease clearly states that the Secretary shall receive royalties in value or in-kind. The IPAA will not accept a royalty in-kind program whereby at some later date MMS will do a look back and hold the lessee liable for additional revenues.

Based on comments Ben Dillon provided to us during your meetings in Houston, we want to provide some additional feedback in the following areas:

1. Production be taken at or near the lease. This position is required by lease term to alleviate complications associated with reimbursements for transportation and balancing. Balancing should be a matter downstream between MMS and its marketer. If MMS takes production away from the BLM approved measurement point, then the producer must reimburse.
2. Once delivered, the lessee has fulfilled all obligations, except obligations directly related to proper delivery.
3. With regard to making an offer, MMS must offer longer lead time (6 months to one-year) and take the product for at least 2 years.
4. To simulate an actual in-kind scenario, MMS should not be selective in its leases. It should agree to a geographic area and take production from all leases within that area. Under all circumstances, the product must be taken in-kind. The MMS should consider differentiating marketing arrangements for different scenarios. For diminimus production, the MMS should consider not taking in-kind and accepting spot value on a less frequent payment basis. Also MMS should consider spot prices for breach situations.
5. We remain concerned about the government performing marketing activities. The IPAA tentatively supports option 1 or option 3. Under both scenarios, we don't expect large government.

We support MMS desire to develop an expertise in the market place. We all have a lot to learn about an ever changing oil market. We need to develop this expertise prior to moving to proposals which

radically change the marketplace and change the business practices of many independents by requiring them to potentially pay higher royalties using values in distant markets.

Today we have been discussing onshore oil royalty in-kind. The IPAA continues to support, as it did in its testimony last year, an onshore gas royalty in-kind program. We believe that all the comments expressed here today also apply to the gas market.

We understand that IPAA asked MMS a number of questions in Houston. We continue to look forward to receiving a response with regard to:

1. Our confusion with the apparent inconsistencies of the MMS. On the one hand, the MMS is proposing new oil and gas royalty schemes that are tracing proceeds to distant financial markets thereby increasing uncertainty and burdens on producers while on the other hand trying to increase certainty and knowledge of the marketplace through their pilot RIK programs; and,
2. MMS desire to move legislation regarding royalty in-kind. As you know IPAA stands ready to move this type of legislation.

Many important "technical" issues have been raised during your conferences. To keep advancing this concept, IPAA suggests that industry outline the mechanics of onshore/offshore royalty in-kind pilots for both oil and gas. Based on counsel from the Canadian, with adjustments for federal lease terms, we believe should be able to produce a proposal by May 31. At this time, we would suggest that we meet with you to discuss the proposal (somewhere in Denver) and then hold some additional public meetings.

Should we make a sequencing comment---take royalty in-kind first, then follow with new rules????????????????????????????????????/

SUMMARY OF WHAT MMS HAS LEARNED TO DATE:

- 1. The program must be cost-effective for both MMS and the industry.**
- 2. The product must be delivered at the lease custody transfer point.**
- 3. Any pilot should be run for a minimum of two years.**
- 4. The government nor the producer should be able to opt out of delivering or taking in-kind during the pilot. All streams within an area should be taken in-kind.**
- 5. The government should assume limited marketing responsibilities.**
- 6. The government should ignore diminimus production volumes.**
- 7. Sufficient lead time must be given before taking in-kind.**