THE NAVAJO NATION

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Minerals Management Service
Minerals Revenue Management
P.O. Box 25165, MS 302B2
Denver, CO 80225

Re: Navajo Nation Comments on Federal Register Vol. 71, No. 29, Notice of Proposed Rule Regarding Indian Oil Valuation

To Whom It Concerns:

The following comments are submitted by the Navajo Nation (Nation), in response to the notice published at 71 Federal Register 7453 on February 13, 2006.

As a prelude to these comments we want to emphasize that the Nation is the largest oil producing Indian tribe in the United States. The foundation of the relationship between the Nation and the United States is a treaty negotiated in 1849 and ratified by Congress in 1850. In the years following the Treaty's ratification, the United States failed to establish (as it had promised to do in the 1849 Treaty) the territorial boundaries of the Navajo. After subsequent skirmishes with local settlers and military authorities, the United States marched the Navajo people on the Long Walk to a concentration camp in eastern New Mexico. The Government's ignoble experiment culminated in the deaths of one-third of the Navajos. Only then did the United States negotiate a second treaty in 1868, which finally established the Navajo's territorial boundaries.

The Nation uses revenue realized from its natural resources to provide essential and basic governmental services and to improve the standard of living of its citizens. According to the latest U.S. Census Bureau report of 2000, 180,462 people live on the Reservation. The unemployment rate on the Nation is 47 percent and 37 percent of its citizens live below the poverty level. Furthermore, 38 percent of residences lack electrical service and 86 percent are without natural gas service.

For well over a decade, the Nation has urged the Minerals Management Service (MMS) to amend the 1988 crude oil valuation rule ("1988 Rule") and close a loop hole that allows the oil companies to circumvent Congresses' intent and MMS's rules. Under the law, the Nation's royalty is to be a share of the gross proceeds from the sale of oil from Navajo leases. In the 1988 Rule, MMS determined that the value of tribal oil for royalty purposes could reasonably be calculated using a company's actual gross proceeds based on posted prices. However, as the Nation repeatedly and conclusively demonstrated to MMS after the enactment of the 1998 Rule, the oil companies on Navajo were not selling Navajo lease oil at posted prices in arms-length transactions. Instead, the companies entered into elaborate transfer and exchange agreements with affiliates, which allowed the companies to sell oil produced from Navajo leases for prices that were significantly higher than a company's posted price. However, the Nation's royalty share did not reflect the premium prices the companies received for Navajo oil. The Nation was stuck with an MMS valuation policy (actual gross proceeds based on posted pricing) that prevented the Nation from accurately valuing its oil for royalty purposes.

MMS knew in the early 1990s that its exclusive reliance on posted prices for valuing the Nation's oil did not adequately protect the Nation's revenue share. MMS also knew that in order to protect the Nation's revenue share in light of the true market environment on Navajo, it would have to amend its valuation methodology. Specifically, MMS knew that the true market conditions on Navajo required it to amend its policy to include methodologies (such as NYMEX or spot market indexes) that would produce minimally acceptable revenue numbers for royalty calculations. Despite what it knew, the MMS ignored the Nation's request for prompt regulatory relief. It was not until 1997 that MMS finally took steps to fix its value methodology policy (and to make other, long overdue changes to the Indian oil rule) by issuing a draft rule. The draft was followed with proposed rules in 1998 and 2000.

In both the 1998 and 2000 proposed rules, the MMS explicitly recognized that (1) the Navajo market "environment" was unique because of the high percentage of non arms-length sales transactions involving affiliates, which occurred after the lease sale, and (2) MMS's policy of using posted prices in connection with these non arms-length transactions deprived the Nation of the royalty revenue Congress said it should earn. In both the 1998 and 2000 proposed rules, MMS decided that the best way to protect the tribes from undervaluation caused by non arms-length transactions was to establish a spot market pricing benchmark, which would ensure a minimally acceptable value.

In the meantime, the Nation, by August 1995, had determined that it could not rely upon MMS policy-making to protect the Nation's royalty share. The Nation thereupon began to invoke the royalty in kind (RIK) provisions contained in its crude oil leases. In doing so, the Nation was able to obtain immediate relief from MMS's flawed 1988 Rule. As a result of this change, the Nation went from taking 85% of its royalty in value to taking almost none. However, the Nation never viewed RIK as anything other than a stop gap measure, one that would end when MMS fixed its policy. Indeed, even after August 1995, the Nation continued to press MMS to amend its policy so that the Nation could again take its royalty in value. The MMS finally responded to the Nation with its draft rule in 1997.

Then in February 2005, MMS, without explanation, notice or consultation withdrew its 1998 and 2000 proposed rules. It has now replaced the 1998 and 2000 proposed rules with a new proposed rule. MMS's new proposed rule reverses the policy determinations MMS made in the 1998 and 2000 proposed rules, but MMS provides no rationale for its reversal. MMS, by failing to discuss in its February 2006 rulemaking (1) the policy determinations it made in 1998 and 2000, and (2) its reasons for abandoning those decisions now, is creating new policies in a manner that abuses its discretion and is arbitrary and capricious.

<u>Supplementary Information: I. Background, II. General Valuation Approach of the Proposed Rule (Proposed 30 CFR 206.52 and 206.53)</u>.

In its 2006 rulemaking, MMS states that "[e]stablishing proper values, for royalty purposes, of oil produced from Indian leases begins with an understanding of where the oil is produced and how it is marketed." 71 Fed. Reg. 7454 (February 13, 2006). In its 1998 and 2000 rule makings, MMS examined the Indian oil market and concluded that the posted price valuation methodology did not accurately reflect the true gross proceeds of companies that engaged in multiple exchange/transfer agreements with affiliates. In those rule makings, MMS decided that the best way to protect Indian resources was to amend its valuation methodology and require the oil companies to determine gross proceeds in non arms-length transactions by using a spot market pricing benchmark.

In its 2006 rulemaking, MMS conducted another review of Indian oil markets, and contrary to its 1998-2000 determinations, MMS now does not believe that there is any cause or justification to use a spot market pricing benchmark in connection with certain non arms length transactions. MMS simply states that "[b]ecause of the environment in which Indian oil is produced and marketed, MMS proposes to value oil at the gross proceeds the lessee or its affiliates receives in an arm's - length sale." But MMS does not describe the "environment" that it believes justifies continuing its gross proceeds/posted prices methodology. It provides absolutely no findings of how the environment has changed from the year 2000 to the present year, and how this change justifies its policy reversal.

Here is the little MMS does say about the production and marketing environment found on Indian lands in 2006:

- "According to our analysis and experience, almost all oil sold from Indian leases (more than 98 percent in 2003 and more than 97 percent in 2004) is sold or exchanged at arms-length before it is refined. *Included in that percentage are volumes taken by one tribal lessor as royalty in kind* (emphasis supplied);"

- "Consequently, MMS is not proposing to use either NYMEX or spot market index pricing as primary measures of value for oil produced from Indian leases. Because of the environment in which Indian oil is produced and marketed, MMS proposes to value oil at the gross proceeds the lessee or its affiliate receives in an arm's-length transaction." 71 Fed. Reg. 7454 (February 13, 2006).

But these statements raise more questions than they answer:

- Why does MMS cite a high percentage of arms-length transactions as a justification for never using market pricing benchmarks? Based on MMS's 1998-2000 rulemaking, oil companies engage in non arms-length transactions with affiliates to hide their true gross proceeds, and according to MMS, market pricing benchmarks are the best tool to counter this practice. Even if MMS determined that attempts to undervalue Indian oil were rare, why won't MMS allow the tribe's to use appropriate value methodologies to address those transactions?

- Have MMS's findings in connection with the tribal market environment changed since 2000? If so, how? If not, then how does MMS justify its policy reversal?

- By not discussing the findings and determinations of MMS's 1998 and 2000 proposed rules, has MMS concluded that its earlier policy determinations are irrelevant?

- Is MMS stating that the Nation's RIK program has created benign and transparent market conditions on Navajo, and therefore there is now no rationale for imposing market pricing benchmarks on the companies?

The problem with MMS's rationale, is that it is based on a snap shot that ignores the history of this matter. Simply put, MMS has forgotten why it sought to amend its valuation policies beginning with its draft rule in 1997. And those reasons are as valid today as they were in 1997:

to eliminate the practices of the oil and gas industry to undervalue production through artificially posted prices for oil at the wellhead, when oil is actually exchanged/transferred and/or valued at other locations to the benefit of oil companies. MMS has now decided to not address the issues that it sought to address in 1997. What is missing is a rationale.

Section III, Major Portion Analysis.

The MMS makes two assertions for its failure to comply with existing regulation requirements to perform majority portion analysis and further uses these assertions as the basis for this proposed rule. It asserts that: (1) MMS has encountered considerable difficulty in calculating oil major portion value; and (2) that complete sales price data for a producing field that includes particular Indian leases often is not available because the field also includes private or state leases (or both), whose working interest owners do not report to MMS. While we may agree to a certain extent that the calculation involved in determining a major portion value may be difficult, it is by no means an exercise that cannot be performed.

The Nation has been able to complete numerous oil major portion analyses through audits performed under the Cooperative Agreement between the Nation and MMS pursuant to the Federal oil and Gas Royalty Management Act of 1982, and we continue to do so as necessary. Furthermore, the existing March 1988 regulations acknowledge that complete sales data may not be available and in fact, at § 206.12 (a)(2)(I) provide that "For any Indian leases which provide that the Secretary may consider the highest price paid or offered for a major portion of production (major portion) in determining value for royalty purposes, **if data are available to compute a major portion, MMS will, where practicable**, compare the value determined in accordance with this section with the major portion." (Emphasis added.) Also, at § 206.12 (a)(2)(ii), the March 1988 regulations state that "the major portion will be calculated using like-quality oil sold under arm's length contracts from the same field **(or, if necessary to obtain a reasonable sample, from the same area)** for each month. We believe that the existing March 1988 regulation provides language that allows for the calculation of major portion values in instances where certain fields may also include private or state leases and/or wherein certain sales data may not be obtainable. As such, MMS's assertions are without merit and should not be construed as a valid basis to adopt this proposed rule.

Administrative Impact/Royalty Cost.

We disagree with MMS' conclusion that the proposed rule would result in additional royalties of $416,000 to Indian tribes and individual mineral owners. We have reviewed MMS analysis and are not convinced that the Nation will receive any additional royalties upon which it bases their determination. The MMS has indicated that the Nation's royalty oil in kind volumes were not included in the analysis and that they used royalty data as reported to the MMS, in essence, royalty data that has not been verified and certified as being correct. Without the inclusion of the Nation's royalty oil in kind volumes as well as verification of the reported royalty data, the conclusions reached by MMS are meaningless. Furthermore the MMS is inconsistent in stating that they have completed a major portion analysis for 2003, while under the same proposed rule; they state that calculating an accurate major portion analysis is not practicable.

Our comments on this proposed rule are limited because the MMS is proposing a rule that is quite similar to the existing March 1988 oil rule that is still in effect for Indian leases (with the exceptions as noted through our comments), and contrarily, does not contain any of the valuation concepts that were in the previously proposed rule that MMS withdrew on February 22, 2005. While this proposed rule contains a defined "normalization process" within the context of major portion analysis, it has always been acknowledged that for comparability purposes, major portion values would be calculated using "like quality" data for comparison purposes. In short, a "normalization process" is, and has always been a requirement in the performance of major portion analysis and is also provided for in the March 1988 oil valuation regulations.

In Section III, the MMS seeks comments on whether arm's length sales of oil produced from Federal leases within a designated area, as reported to MMS, should be included in the calculation of a major portion analysis. Again, we believe this situation is addressed under the existing March 1988 regulations and the MMS should not deter from what the existing regulation provides. The concern should be that the sales data, as reported to MMS, is validated through system edits and/or audits to ensure that the major portion values calculated are indeed, appropriate. The MMS also seeks comments on whether the boundaries of the designated areas should be expanded beyond the reservation boundaries and should include arm's length sales of oil produced from federal leases in the vicinity of a reservation, as reported to MMS, in the calculation of the major portion value. The definition of field as provided in the existing March 1988 regulation is sufficient for major portion purposes. For purposes of the Nation's oil production, the Greater Aneth oil field is designated as the field for major portion calculation for approximately 85 percent of the Nation's oil production. We believe that there should be no change from the March 1988 regulations in the distinction of what constitutes a field for major portion purposes and that MMS should remove any reference to its authority to redefine a field as designated areas within the context of Indian oil major portion analysis.

Transportation Allowances.

In the past, we provided comments on certain issues regarding transportation allowances on Indian leases, specifically, the transportation allowance form filing requirements and application of a 1.3 times the Standard and Poor's BBB rate as the rate of return on undepreciated capital investment in calculating allowable transportation allowance under non-arm's length situations. During MMS' request for comments at workshops concerning transportation factors on the federal gas rule in April 2003, the Nation expressed concerns that the MMS would ultimately apply transportation allowance criteria established for Federal leases upon Indian leases, without due consideration for certain Indian lease provisions and policies. It appears that the Nation's concerns have now been validated.

The MMS is proposing to extend transportation allowance provisions of the Federal Oil Rule that became effective June 1, 2000 (as amended in 2004) to Indian leases. We wish to restate our opposition to apply the current transportation allowance standards for federal leases to Indian leases. The MMS rationalizes that because very few royalty payors claimed transportation allowances for oil in 2004 on their initial royalty reports (Form MMS-2014), that the March 1988 regulation requiring prior submittal of Form MMS-4110 should be eliminated. Furthermore, MMS states that royalty payors will be required to only submit copies of their transportation contract(s) within a certain time period. The existing requirement for royalty payors to submit Form MMS-4110 should remain unchanged. The MMS worries that this requirement creates an additional burden on industry. We believe that Indian lessors should and must receive prior notification of all allowance deductions from its royalty and if MMS is correct in that transportation allowances are limited for Indian leases, then it should not be burdensome for the few royalty reporters to continue to submit Form MMS-4110. The MMS should be careful in assuming that industry practices with regard to transportation factors under a current market will continue in the status quo.

As aforementioned, the Nation has previously submitted several comments on many of these same issues. Our past comments presented our positions on issues such as the rate of return for transportation capitol costs, transportation allowance form requirements, valuation methodology, and other relevant matters. Unfortunately, through MMS's actions, and as shown in the proposed rule, our comments have been ignored.

Nonetheless, we have enclosed copies of the Nation's previously submitted comments as our positions regarding these issues remain undeterred. All of the previously submitted comments should be inclusive of the comments contained herein.

In conclusion, the Nation has determined that it is in its interest to request that MMS (1) acknowledge that the reasoning behind its proposed policy changes in 1998 and 2000 are still valid and necessary to protect the Nation's royalty valuation, and (2) reinstate the rule withdrawn on February 22, 2005. We believe that the withdrawn rule provides a reasonable and fair return for the Nation's non-renewable oil resources. If MMS does reinstate the withdrawn rule, I commit that the Nation will continue to work with MMS to create a value methodology rule that is beneficial and workable for Indian tribes, allottees, and the industry alike. If MMS chooses not to reinstate the withdrawn rule, then the Nation requests that MMS withdraw the February 2006 proposed rule, and leave the 1988 Rule unchanged. The Nation is not helped by the proposed rule. Indeed, we are hurt by the proposed rule. The Nation would prefer to continue to value its oil pursuant to the existing March 1988 regulations.

If you have any questions concerning these comments, please contact Mr. Akhtar Zaman, Director, Minerals Department, or Mr. Perry Shirley, Assistant Director, Minerals Department at (928) 871-6587.

Sincerely,

THE NAVAJO NATION

APR 13 2006

Mr. Joe Shirley, Jr.
President

Enclosures

xc: Ms. Lucy Querques Denett, Associate Director
Minerals Revenue Management, Minerals Management Service

: George Arthur, Chairperson
Resources Committee, Navajo Nation Council

: John Rutherford, Assistant Attorney General
Natural Resources Unit, Department of Justice, Navajo Nation

: Akhtar Zaman, Director
: Perry Shirley, Assistant Director
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