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RE: Indian Crude Oil Valuation Report
As Published in 2/12/98 Federal Register
Volume 63 Number 29

Gentlemen/Ladies:

Per your request for comments regarding the referenced Report, I would like to make the following observations/suggestions:

1. You first state that lease payments will be made after determining whether a lessee's gross proceeds or a NYMEX-based index price would yield a higher value. The lessee would then determine if the major portion value was higher to determine if additional moneys were owed. The assumption here is that everybody can receive the maximum price available for every barrel of crude they sell, regardless of the volume they are able to market and the quality of the crude they have to sell. If they cannot, they will be forced to pay royalty on the highest price possible anyway. Simply a side note, but that seems inherently unfair and a case by the Federal Government of "having its cake and eating it too".

2. Regarding (a)(5), using prompt month futures prices to valuate an asset before its physical production, delivery, and sale is inherently flawed. The actual flow of the physical oil on a certain date could be well below or above what its futures price was before the contract expired. For example, assume February crude on the NYMEX is trading for $20/bbl on January 10. During actual delivery during the month of February current spot crude may have fallen to $13.50, or may gone up to $30. Rarely does a futures price actually reflect the eventual price received during the physical month of production. If one is to start playing with the futures market to place a value on some future month of physical delivery, ask yourself this: what's to stop somebody from crying foul if some month's future delivery price could have been maximized by pulling a trigger off the NYMEX with a crude purchaser at some high level, or through the purchase of a strip for some set period of time? If crude runs up to $40 on the threat of supply shortages or a war, and a lessee could have capitalized by pulling a trigger to lock in said price but either doesn't do so or doesn't have the capability to do so, will the MMS then come back and say "well, you should have, so pay up"? As an alternative, utilize published

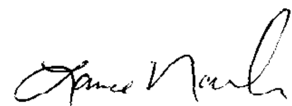
postings of daily spot market trading during the actual physical month of production, not a futures price based upon some financial market's decision to buy or sell large quantities of contracts because they're short some month and need to cover their losses, thereby artificially driving up the "market" price. The same mechanisms occur in the gas market. The futures contract for December 1997 delivery got all the way up to 3.836/MMBtu on October 27, 1997, only to eventually settle at $2.577/MMBtu on November 24, 1997. Does that mean that royalty should be paid at $3.836? Or that that's what gas was actually worth during physical delivery in December? The daily average for the Henry Hub's physical delivery for the month of December per Gas Daily was $2.322/MMBtu. So why force a lessee to pay some range between $2.577 and 3.836 when physical sales averaged $2.322? You stated yourself that the lease must reflect the "highest price paid or offered at the time of production for the major portion of oil production from the same field". The use of the futures market to determine a physical delivery price goes against your own lease language.

3. Gross proceeds is the best method. I agree that strict monitoring of affiliate relationships must occur in this situation. I am aware of cases where a marketing affiliate was paying its producer arm a lower price for its product, and allowing the "profits" from the purchase to be booked to the affiliate, without benefit to the royalty owners. These abuses do occur, but for the most part a producer has no incentive not to attempt to receive the maximum price possible under its circumstances. Remember that not all producers have the same market power. Some producers, due to volume restraints, location relative to market, or other reasons, may not be able to receive the same price for their 100 barrels of oil as their neighbor down the road who's gathering and selling 1,000 barrels of oil.

4. Paragraph (b)(4) states that the lessor wants the highest price lessee can receive through legally enforceable claims under its contract. If the lessee doesn't receive that price, he must pay based on that "obtainable" benefit. Again, no producer can guarantee that he will maximize the value received for every barrel of oil sold. It's called opportunity cost. If a producer fails to do so, he loses an opportunity. If the lessors feels the producer is losing too many opportunities, then he has the right to take in kind and indeed should if in doing so he feels he can capture his the perceived lost opportunity. Let the lessor take the risk, expense, time, and staff necessary to achieve his own "maximum" price. If the lessor isn't willing to do so, and if his lessee is acting in good faith to achieve the best price possible under his circumstances, then the lessor shouldn't complain.

These are my comments relative to your proposed changes in Indian lease crude oil valuation. I'm certainly no expert in crude oil, as my expertise derives primarily from being a former landman and a current natural gas trader, but I do take interest in topics such as this. Thank you for your time.

Sincerely,



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