Casper Workshop:

Meeting at BLM office 1701 East "E" street, Casper, Wyoming October 16th, 1997.

Meeting begins at 1:02 p.m.

Attendees:
Dave Hubbard - MMS - Royalty Valuation Division
Bob Kronebusch - MMS - Policy and Management Improvement
Dave Domagala - MMS - Royalty Valuation Division
Ron Redding - True Oil Company
Doug Richardson - Goldmark Engineering
Jack Blomstrom - True Oil Company
Bob McDougall - Phoenix Production Co.
Dwain Park - True Oil Company
Rich Huwaldt - Wyo. Dept. of Audit
Francine Schoen - Wyo. Dept. of Audit
Sharon Redding - True Oil Company
Jeff Cook - Mercury Exploration
Jerry Herz - Eighty Eight Oil
Michele McIntyre - Pet. Assoc. of Wyoming
Jack Bradley - Manx Oil

Dave Hubbard begins the meeting at 1:05, begins with going through the handout. Meeting opened for comment including MMS questions, at 1:31.

Jack Blomstrom - MMS is stuck looking at areas and zones. A lot of the things that are of concern in the rule do not fit here.

Bob Kronebusch - We recognize the problem. That's why we are here. Is there a way to value this oil?

Dave Hubbard - The rule probably will have a separate part for Rocky Mountain areas, we need some feedback on non-arm’s-length sales, do you have ideas?

Jack Blomstrom - Gross proceeds will survive? Is there any limit on arm’s-length sales?

Dave Hubbard - The 2-year limitation is gone now; true arm’s-length sales will represent royalty value.

Jack Blomstrom - Lease sales will survive as an arm’s-length Gross proceeds framework?

Dave Hubbard - Yes.

Jack Blomstrom - Calls put to bed if non-arm’s-length is involved?

Dave Hubbard - Do you mean non-competitive calls? Only exercised non-competitive calls would require index pricing.

Jack Blomstrom - We don't have anyone exercising calls, what about duty to market? Is that still alive?

Dave Hubbard - That is contentious, the Dept. will not share in marketing costs, transportation yes, but the official stance is marketing is not a deduction.

Jack Blomstrom - MMS will not use rule to second guess values?

Dave Hubbard - No, that is not our role.

Bob McDougall - If MMS won’t share in the cost of marketing, we are dependent on there being enough marketers in the area to get a true value. What if there is not enough incentive for marketers to be in the area? What determines arm’s-length, how many bids is enough? If we diminish the independent marketer’s role, how do we get the best price? We always try to get a competitive and the best price, if this diminishes competition, we are in trouble.

Bob Kronebusch - You sell at the lease?

Bob McDougall - We always take the highest price from marketers, etc. at the lease, if we diminish the incentive, that is contrary to MMS and the Government's interest. This may leave only the majors.

Dave Hubbard - We are talking about marketing costs off of NYMEX you are talking about sales.

Bob McDougall - We don't market oil, but if there are not marketers in the area, we don't get the highest price.

Dave Hubbard - Will this rule put marketers out of business?

Bob McDougall - Yes, incentives are to leave the market.

Dave Hubbard - Since we are dealing with only 1/8 (the royalty share), will that affect marketing company economics to the point that they would quit?

Bob McDougall - In our area we have a competitive marketer that has raised the bonus value to us and others.

Bob Kronebusch - We could be cutting our own throat?

Jack Blomstrom - You have production and marketing affiliate arms, with NYMEX we could get hit hard because the margins are too slim. We are concerned that postings are being disallowed, here postings are part of the equation. That is the way it is. This is how the area works, something valued out of the midcontinent will hang us. Postings are crucial price. We pay a lot of royalty for others, we pay on the p-plus price.

Dave Hubbard - If you are talking about a non-arm’s-length sales, do you have a suggestion?

Jack Blomstrom - Major integrated companies are treated differently than independents like us, our benchmark is what we are buying oil for in the area. We use the same contracts to purchase other company’s oil. This market is competitive, we pay oil royalties on the highest price. We have comparable contracts that are valid. We are not exchanging oil, its being bought at the lease. If we can use other arm’s-length sales as a benchmark, we can survive. NYMEX split between WY crude is growing bigger. WY is its own market, it responds to its own factors, there are a whole lot of other factors here than at NYMEX.

Bob Kronebusch - Sometimes are there parallels?

Jack Blomstrom - Postings move in the same direction as NYMEX--that’s all, its not a correlation, refiners set the price in this area. If more Canadian oil moves in, it will affect us, Cushing won't know what happened.

Doug Richardson - We sell by truck, this is one more layer that we have to deal with, we're going to have to go to who's buying and ask for trucking reimbursements, etc.. otherwise we are not whole. The small producer gets hit because they don’t have the barrels.

Dave Hubbard - If the transaction is arm’s-length, we'll take gross proceeds.

Doug Richardson - What about trucking allowances?

Bob Kronebusch - Status quo.

Doug Richardson - Truck barrels are worth less than pipe barrels. Transportation is a factor.

Dave Hubbard - Nothing changes the transportation allowance as it is now.

Doug Richardson - As long as arm’s-length remains.

Bob Kronebusch - We won’t make you break it out, just net it at the lease.

Jack Blomstrom - Status quo maintained?

Dave Hubbard - For arm’s-length only; the changes are in non-arm’s-length transactions.

Jeff Cook - Can you define arm’s-length?

Dave Hubbard - The definition is in the Regulations.....no affiliation, opposing economic interest in contract. That’s almost a work of art...there are levels of affiliation, etc.

Bob Kronebusch - In the original rule the definition was too restricted. We backed off with the supplemental rule to the way it was for many years.

Jeff Cook - Example, I have a marketing company, I own the marketing pipeline and the production. X produces and Y buys it and I'm both of them, but charge 25 cents for transaction.

Dave Hubbard -Resale price by the affiliate to a third party is acceptable.

Jeff Cook - Not a benchmark? Royalty on 20.25 with transportation bonus..just no marketing costs.. right?

Dwain Park - Actual transportation costs? Right?

Jerry Herz - How do you define transportation?

Dave Hubbard - Per-barrel amount.

Jack Blomstrom - This creates problems to think that you can take advantage of downstream gains without the losses we had in the beginning of the year, that is not fair. We ought to be able to value on the sales in the area. This is available here. Fields are concentrated in the area, majors are moving out, independents are in the area now. WY majors = 44.9% in 1994, 43% in 1995 Montana: 45% in 1994 to 40% now. Business is keeping the refineries but not producing, they are buying from the marketers, not at the lease. Aggregation is key and this is done by the marketers.

Bob Kronebusch - Is Canadian oil your direct competition?

Jeff Cook - Yes, our bonus is falling because of it.

Bob McDougall - This drives NYMEX spread up. We are really getting hit. The bonus is down $2 a barrel. The basis is the difference of NYMEX/WY Asphaltic major postings has increased from $3 to $4.25 on avg since December 1996. This loss plus decreased bonuses. Our distributions will be $3 less a barrel than they were in September. Most WY oil is sour and gets a $2 deduction for gravity from the world market, currently priced at $13-$14 per barrel. We've already sunk the cost so we have to go at that price. That's why were here to talk.

Jack Blomstrom - (Posts a MAP) - This is a picture of refineries in the area, its a very limited market. Platte pipeline is the only way out, its full of Canadian crude. 75% of input in Montana refineries is Canadian. You can't get to Cushing from here. The market uses the postings, refineries set the parameters.

Bob Kronebusch - Is Guernsey ever a factor?

Dave Hubbard - It is in the rule as a spot price. We hear that it’s a thin market.

Jerry Herz - It’s an exchange point, where its coming from, you can bring crude to Guernsey from anywhere.

Bob Kronebusch - How is it valued?

Jerry Herz - That's the problem, how is the value set?

Jack Blomstrom - We'll sell to some at Guernsey.

Jerry Herz - Its a hub just like Baker, its also a terminal.

Jack Blomstrom - Casper is a good terminal really, we don’t have the volume here though.

Bob Kronebusch - In my audit days posted prices was way to go.

Jack Blomstrom - Postings are the basis here still, refiners buy oil on them, we all use them, otherwise you lose. The split is too large.

Bob Kronebusch - Premiums that began in 1986 threw it all off.

Jack Bradley - How does that throw it off?

Bob Kronebusch - Now you have to go after the premium.

Dave Hubbard - Benchmarks in the current regulations rely on posted prices without mention of bonus.

Jeff Cook - Some still get less than posting, it goes both ways.

Dave Hubbard - Gross proceeds solves that problem.

Jack Bradley - There is a field with a negative bonus, we can't explain it.

Doug Richardson - Lets go to my marginal oil situation. True Oil Company transfers to 88 Oil who is a non-arm’s-length affiliate and takes all its oil and markets it because of volume. Why are we penalized by using what the affiliate gets? Its more than True Oil actually gets. In your case, the Independents will then sell it themselves without the marketing company and you’ll get no bonus anyway.

Jerry Herz - We are penalized because we have our own production, because if affiliates take it, then we’re penalized for those who don't.

Dave Hubbard - That’s beyond our scope here.

Doug Richardson - The current marketing system should be maintained.

Dave Hubbard - The Department’s legal position is that marketing costs/costs to put oil into marketable condition are not allowable.

Jack Bradley - What logic? Can’t we use marketing costs as a deduction? It is totally illogical as to why this exists.

Bob McDougall - We need these independent marketers.

Jack Bradley - Marketer is penalized because it’s their own oil, then they quit buying oil and leave it to arm’s-length transfers at lease, where’s the logic in this?

Dave Hubbard - Court cases set the precedent. Costs are not to be deducted for marketing.

Jack Bradley - Set by Bureaucrats in DC. no logic to it, we're stuck with it right?

Doug Richardson - How much pressure is there on this issue from others in the industry?

Dave Hubbard - A lot.

Doug Richardson - What does the grass-roots level say?

Bob McDougall - Let us value at the lease for what we pay others for it. Let us have the lease value. Marketing affiliates w/o refineries are doing the best they can.

Jack Bradley - Anything over a nickel, I'll change who I'll sell to, it is arm's-length competitive pricing.

Bob McDougall - We go for a few cents even.

Bob Kronebusch - The proposed benchmarks were generally supported by the states, but the Devil's in the details, we need agreement on the comparability criteria. If the benchmarks are enacted, it should handle most of the problems.

Jack Blomstrom - It would, but as purchasers we care about the other 85%, we can show transactions in the area that are comparable, at the lease.

Dave Hubbard - Are the sales transparent and reasonable volumes involved?

Jack Blomstrom - Yes in the area, not a problem.

Bob Kronebusch - Quality?

Jerry Herz - Quality spreads 38 to 22 degrees API for sour.

Jack Bradley - Variance in the sweet?

Jerry Herz - 42-44 degrees.

Bob Kronebusch - Can we do it so it won't be questioned?

Jack Blomstrom - They are transparent so we can do it.

Jack Bradley - Yes, there is never a nickel difference, differences in bonus negotiations, transportations, etc.. all very transparent and readily available.

Jerry Herz - 88 Oil has oil from interest owners, they will cry if the price is too low, it's very competitive.

Jack Bradley - There are very few 100% working interest shares, we fight for all the money for all the interests in the lease, this forces competition. If there is not a competitive arrangement, others will go elsewhere, it’s very competitive.

Doug Richardson - Bighorn basin, 14 gravity crude, it must be blended. If you don’t have the blend, then you are out of service. The smalls producers still can pay posted prices, but majors may not supply feed blend, they should not be penalized.

Bob McDougall - Competition with the independents and incentives to streamline are reduced, any gains that we negotiate we pass to the Government, then the Government wins. Using NYMEX evens this and we all lose.

Dave Hubbard - Efficiencies were won or lost in the past.

Bob McDougall - Arm’s-length gross proceeds is good news to hear, but if we were all equal with NYMEX, we lose the incentive to be efficient.

Jack Blomstrom - We’re not unsympathetic to offshore problems. California has tough situations out there, we’re different than those players, this is different in here. We want you to know it is different here. Leave arm’s-length gross proceeds alone. What do you plan to do with those that have refineries? Our idea is to use a stream of oil to see if it is delivered to the refinery, or if the refinery uses all other’s oil? You can value refinery delivered oil at tender program at some percentage you are comfortable with, and second, you netback with an index.

Dave Hubbard - We feel that the 10% tendering volume proposed by Conoco may not be enough.

Jack Blomstrom - Tendering is tough with trucking, or pipeline, this is something that needs discussion, something less than 50%. The difference may be in the volumes.

Dave Hubbard - That ties into significant quantities. Definition is tough here. It may have to be decided case by case.

Jack Blomstrom - The business side is that circumstances do matter, like if you have isolated fields, but not really in this state, we don’t have that kind of isolation, oil is in quantities in this area. The majors are selling off interests in this area, AMOCO wants totally out of the area. This market is changing as we speak, a year from now it will be different. NYMEX could care less what happens in this market. It’s a big deal here though. It’s really remote.

Doug Richardson - Is there any reason you can't look lease by lease and set a gross production level, not to worry about affiliation under that? Allow gathering with no penalty? Only take the lease price? This means less paperwork for all. Only if you have significant production then do you apply the rule.

Dave Hubbard - What is the price?

Doug Richardson - If I have under 100 barrels we just take price from purchaser regardless if it’s affiliated or not.

Jack Blomstrom - Audit is not worth spending any time there either.

Dave Domagala - 100 barrels or less as a threshold?

Doug Richardson - I’m not saying any number, just an idea.

Bob Kronebusch - In the state of WY 70% of the wells could be classified as stripper.

Jack Blomstrom - The oil here is at its zenith, gas is really moving here. Secondary oil recovery is the best production in the area.

Jerry Herz - There is not that many new wells going in.

Bob Kronebusch - How does that maintain the income?

Jerry Herz - We’re not going to make it.

Jack Blomstrom - Production is falling in Wyoming and Montana. Independents are efficient enough to still make money in the area, but our game is different here.

Bob McDougall - Oil has been as low as $9 in 1994, because of the effect of the world price.

Dave Hubbard - 10 minute break 2:50 p.m.

(After multiple informal discussions with participants)

Dave Hubbard - 3:18 (meeting resumes) the list of the questions that I have are mostly answered, but let’s go through them. What about comments on alternative benchmarks, tendering? In a non-arm’s-length situation. For example, the 10% or as high as 50%?

Jack Bradley - As long as 10% is a representative spread, it seems workable. I don't think you need a large percentage of it, just so long as its competitive.

Jack Blomstrom - The concept is a good one. The percentage is not important.

Dave Hubbard - There is a gaming incentive at less than 10%.

Jack Blomstrom - The concept is good, but we are not into gaming here, it does not go on here.

Jack Bradley - In offshore you may have greater incentive, still a valid price will result even from a game.

Jack Blomstrom - Does a percentage have to work everywhere?

Jack Bradley - 50% might leave you without sufficient feeds, this will affect price with many that have to keep it for their own refinery.

Bob Kronebusch - With Conoco 100% or 10% issue came up. Is it competitive?

Jack Blomstrom - Situations will dictate problems. Other factors will drive equations in different ways. The economics are different everywhere.

Bob Kronebusch - Would 10% change the price anyway, with Canadian crude affecting the price, maybe it does not matter.

Jack Blomstrom - Many producers that have refineries are not producing anymore anyway. Exxon, etc.. Majors are only drilling for gas in the area here. Marathon is the exception though. This situation will probably continue.

Bob McDougall - We've bought many of the major's oil properties, we had several with calls.

Bob Kronebusch - Calls for infinity?

Bob McDougall - Some are, but that is going away.

Jack Blomstrom - Throughput is the reason, they need the feedstock.

Bob Kronebusch - I don’t understand all of the provisions of crude oil calls.

Doug Richardson - You buy the contracts that are in effect at the time of the purchase.

Jack Bradley - They need stable throughput, more than selling of the oil.

Doug Richardson - If the price is right, they'll be back.

Jack Bradley - Price is not the issue, its the supply.

Bob McDougall - They have to be competitive.

Jack Blomstrom - Some of these companies no longer exist. Pricing of it is not a problem.

Dave Hubbard - Other reactions on the other alternatives? Such as IPAA benchmarks: tendering, combination of purchases and sales, netback?

Jack Blomstrom - We support IPAA benchmarks, they get to the heart of the matter. As long as arm’s-length provisions remain.

Doug Richardson - All these things are more costs, this means more people and costs for all.

Bob Kronebusch - They are producer-driven benchmarks.

Doug Richardson - They will have to come up with them, its one more layer we have to do.

Dave Hubbard - The existing regs still ask for the same information, it is not that much different.

Jack Blomstrom - As long as it’s value at the lease or area, we can survive.

Bob Kronebusch - We’re trying to keep administrative costs down.

Doug Richardson - I guarantee it means more costs.

Jack Bradley - I'd have one staff member instead of three if we had zero federal leases, it’s just more work, we want to make sure we have fewer regulations to comply with, regulations trickle down to us.

Bob McDougall - The MMS Form 4295 is the most complex form and the most paperwork that we do in our company.

Dave Hubbard - That form is only required on Indian leases.

Bob McDougall - It is Indian, but without it, my wife could stay at home more, it’s a very difficult form.

Dave Hubbard - How about comments on the MMS calculated benchmark: there are a lot of problems with it such as timing and area definition. Now that we pointed out negatives...

Jack Bradley - We agree.

Bob McDougall - That's a moving target, that changes all the time, how do you stay current?

Jeff Cook - You can’t do it.

Bob Kronebusch - That what we've heard, but it is simple.

Jack Bradley - That number is a disincentive to negotiate a better price.

Jack Blomstrom - If audit functions drive regulations, you can create a monster. We need to understand the market, this will be easier for the auditors.

Dave Hubbard - How about fixed differentials by zone or area?

Jack Blomstrom - Is there much oil in Texas?

Bob Kronebusch - 48 leases.

All - Very impressive, Bob.

Jack Blomstrom - There is not a lot of Federal oil at Cushing, if that is your focal point, it might be a problem.

Doug Richardson - How big are the zones? It won’t work for outliers.

Bob McDougall - The larger they are, the more problem with transportation. How often would you collect the needed information?

Dave Hubbard - The 4415 was to be collected on annual basis, so it will change annually. We could collect it more often, though.

Bob McDougall - It depends on the situation.

Doug Richardson - It always changes.

Jeff Cook - Small independents are paid on supply and demand, we can’t do anything else. With a benchmark, we might win or lose.

Dave Hubbard - That reflects the comments that we've received; the fixed rate idea is full of problems.

Jeff Cook - Its like gambling.

Dave Hubbard - That’s consistent with what we've heard.

Dave Hubbard - Spot versus NYMEX alternative? We’ve seen that generally, once location and quality are accounted for, these two are essentially the same.

Bob Kronebusch - Month to month variance has to be equal or else there is opportunity for arbitrage.

Jack Blomstrom - The spot needs to be deep enough to reflect market. Guernsey is just to thin to use, depth of transactions is important. Otherwise you have not done yourself any good, you are back to winners and losers. There are spot sales in Guernsey but it really is just a transaction place, it really is just a hub.

Bob Kronebusch - With the Express pipeline affecting economics, the transactions there, it might be declining.

Bob McDougall - We don't know about effects of Express.

Jack Bradley - Games may be used to make a fake spot price, it may give you less Federal royalty.

Bob Kronebusch - We feel that NYMEX is uninfluenceable.

Dave Hubbard - Agreed, too many players. Spot prices however, are based on more limited market surveys.

Bob McDougall - My understanding is that the energy markets have more transactions daily than any other field.

Doug Richardson - Storms affect prices on NYMEX, its not clear what influences value there.

Jack Bradley - No validity to it really, just a speculative market.

Bob McDougall - Just a speculative market.

Doug Richardson - You should take it in kind to be in the same ship as us, then you will learn.

Dave Hubbard - We have no plans to take ALL of our oil in kind. We still would need valuation regulations.

Bob Kronebusch - Cynthia Quarterman sent the Governor of Wyoming a letter inquiring about a joint RIK program.

Doug Richardson - If you bundle all Wyoming royalty crude you could do well.

Jack Bradley - It’s too much of a morass, the state will probably abandon their interest in doing it.

Jack Blomstrom - It’s too hard to do with the marketing arms. To combine the State and Federal oil can work. We'd be interested in that.

Bob McDougall - In the entitlement RIK program they could get Canadian oil cheaper than RIK oil.

Doug Richardson - You don’t understand, you will by going RIK, you might understand us better.

Bob Kronebusch - Would others join in such a program?

Doug Richardson - Then you would understand marketing costs.

Dave Hubbard - What about WY auditors? We have not heard from you today. Any comments on what we’ve discussed?

WY Auditors - We just came to listen, really.

Jack Blomstrom - Is there a two-week extension on comments for the notice in the Federal Register? Can you confirm this?

Dave Hubbard - I’m fairly confident. I will clarify that for you.

Jack Blomstrom - There really is more interest in this than the number of people that actually turned out. There is this case in Cheyenne regarding Express Pipeline today, we really are interested in this.

Dave Hubbard - Really this is a good turn out.

Bob McDougall - There are not a lot of independents that live here.

Jack Blomstrom - The people that would have been here would have been represented.

Dave Hubbard - I want to reemphasize that arm’s-length sales will stay the same. That is, true arm’s-length sales would continue to represent royalty value.

Jack Blomstrom - That's very important.

Jack Bradley - Why an artificial price? Why does the Government want to go to that route if there is a well established open market system in place?

Jack Blomstrom - It really is just a different market.

Doug Richardson - If Canada changes prices or tax rates of their crude, then the economics in the area change.

Bob McDougall - Things can change here in a hurry. But we still need a strong domestic industry.

Dave Hubbard - Thank you for your comments. The transcript of the meeting will be on the MMS/RMP home-page.

Meeting adjourned at 4:09 p.m.