Nacogdoches Oil & Gas, Inc.

August 18, 2014

Submitted Electronically

Armand Southall
Regulatory Specialist, ONRR
Office of Natural Resources Revenue,
Building 85, Room A-614
Denver Federal Center
West 6th Ave. and Kipling St.
Denver, Colorado 80225

Re: Indian Oil Valuation Amendments, 79 Fed. Reg. 35102 (June 19, 2014)

Dear Mr. Southall:

Nacogdoches Oil and Gas, Inc. ("Nacogdoches") appreciates the opportunity to comment on the Office of Natural Resources Revenue's ("ONRR") proposed rulemaking concerning oil valuation on Indian leases. Nacogdoches began in the oil and gas industry twenty-eight years ago and has operated in six states on land owned both privately and by the Navajo Nation Reservation. It currently operates a total of 103 wells—fifty-one of those being within the Navajo Nation Reservation. While these wells only make up fifty percent of its total wells, the Navajo operations account for ninety-one percent of Nacogdoches' total production and revenue. Nacogdoches employs six people in Texas, who perform management and administrative functions, and uses Navajo contractors for the vast majority of its operations on the Navajo leases. By industry standards, Nacogdoches is considered a small oil and gas producer.

The proposed rule significantly changes the major portion pricing provisions relied on by small and medium-sized producers since 1988. Under the proposed rule, lessees are required to value oil produced on Indian tribal or allotted lands based on the higher of (1) the lessee's gross proceeds, or (2) an Index-Based Major Portion ("IMBP") value adjusted by the proposed Location and Crude Type Differential ("LCTD"). As discussed below, the rule in its current form will have a significant economic impact on Nacogdoches' operations. It will likewise impose significant costs on other small oil and gas lessees operating on Indian tribal and allotted leases.

Nacogdoches' leases are located in the Four Corners Region, with many of its wells being located in the Lukachukai Mountains. Nacogdoches must transport its oil in trucks from Red Valley, Arizona to Thoreau, New Mexico—a 310 mile round trip. As such, the options to market, sell, and transport its oil are extremely limited. For example, Nacogdoches takes a significant price deduction of approximately fifteen percent just to sell its oil—even though it should receive a premium price for its forty-three API gravity oil. The proposed rule concerning oil valuation on Indian leases will detrimentally affect

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small producers like Nacogdoches and will ultimately be felt by the royalty owners for which the proposed rule is arguably designed to assist. Below is a brief case study that shows how the proposed changes in royalty calculation regulations will significantly impact Nacogdoches as a company as well as its Navajo contractors:

Nacogdoches produces approximately 300 barrels of forty-three API gravity oil per day on the Navajo Nation. Nacogdoches' oil is of premium quality, yet it receives a significantly discounted price of approximately fifteen percent due to the location of the leases. As such, it is reasonable to conclude that Nacogdoches would see the full 3.93% increase in royalties. Also, under the proposed rule, it is also likely that Nacogdoches will lose the ability to deduct its exorbitant transportation costs—which exacerbates the impact on its bottom line. Furthermore, given the relatively small production when compared to larger producers on the Navajo Nation, it is unlikely that Nacogdoches' production and pricing would have much of an impact on the IBMP calculation.

Based on its current royalty rate Nacogdoches would receive income which equals approximately eighty-three percent of the barrels it produces per month, which with current production numbers would be 7,595 barrels out of 9,150 total barrels produced each month. However, under the proposed rule, Nacogdoches' income per barrels produced would be reduced further from 7,595 to 7,235, a difference of 360 barrels of oil per month. Under current NYMEX pricing this would reduce Nacogdoches' revenue by approximately $31,000.00 per month or $367,200.00 each year, which would also translate into a 3.6% reduction in Nacogdoches' total annual revenue. This would certainly discourage optimizing production on Navajo properties when much better returns on investment can be achieved by developing other leases or investing in other projects. This would not only negatively impact the royalty owners—the Navajo people—but it would detrimentally impact the numerous Navajo vendors that Nacogdoches contracts.

Comments[1]

1. Comments Concerning the Definition of Designated Area Included in Section 1206.51 and the Proposed Designated Areas Listed on 79 Fed. Reg. 35113-04

The major portion provision included in most Indian leases states, in relevant part, that "value for the purposes of the lease may, be calculated on the basis of the highest price paid or offered . . . for the major portion of the oil of the same gravity . . . and sold ***from the field <u>where the lease lands are situated</u>***." (emphasis added). Under Section

[1] As a precursor to these comments, Nacogdoches recognizes that ONRR's predecessor, Minerals Management Service ("MMS") attempted to promulgate a similar purposed rule in 1998 and supplemental proposed rule in 2000. However, in 2006 MMS determined that it was unable to calculate fair localization differentials for the industry, and that using gross proceeds from arm's-length transactions was the best measure of value on Indian tribal and allotted leases. Nacogdoches believes that MMS's 2006 conclusions still hold true today, especially for small and medium-sized companies.

1206.51 of the proposed rule, ONRR proposes a definition for "designated areas." In the proposed definition for the "Major Portion Price," ONRR states that the major portion price will be based on prices "for the major portion of oil produced from the same designated area." 79 Fed. Reg. 35113-04. As a result, ONRR is proposing to use designated areas as the basis for its major portion calculation in lieu of following the actual lease language, which states that the major portion price should be based on the major portion of oil "sold from the field where the lease lands are situated." Section 1206.51 also includes a separate definition for "Field," which is distinct and distinguishable from the proposed definition for designated area. Notably, the definition of the lease term "Field" does not reference or necessarily correlate with the proposed definition for ONRR's designated areas. As a result, the designated areas included in the proposed rule fails to reflect the actual language contained in the lease agreements. *See* 30 C.F.R. § 1206.50(b) (indicating that the express terms of the lease should instead control this analysis).

In many cases, the designated areas consist of entire reservations. Entire reservations, however, oftentimes include vast geographic areas which span state boundaries, and contain multiple oil reservoirs. As a result, some of the designated areas proposed by ONRR fail to accurately capture the transportation costs incurred by many small and medium-sized industry members operating within the more isolated areas of a given reservation. *See* 79 Fed. Reg. 35103-04.

For example, according to the proposed rule the entire Navajo Reservation is a "designated area." That reservation, however, spans across three different states – New Mexico, Arizona, and Utah.[2] It covers approximately 17.2 million acres, and it is reported on the Navajo Nation's website as containing a total geographic area that "is larger than 10 of the 50 states in America." *See* Navajo Nation Government, at http://www.navajo-nsn.gov/history.htm. Access to transportation services throughout the Navajo Reservation varies greatly depending on where in the reservation a lessee is operating. It is accordingly difficult to see how the proposed rule could accurately account for local price differences and transportation costs incurred by lessees who are producing within this area. This concern was recognized by MMS in its proposed rulemaking in 2006. 2006 Proposed Indian Oil Valuation Rule, 71 Fed. Reg. 7454. MMS determined that "it is extremely difficult to obtain reliable location and quality differentials between Cushing and areas where the large majority of oil is produced from Indian leases, including the San Juan Basin, northeastern Utah, Wyoming (for other oil types), and Montana." *Id.*

These considerations are particularly important since, as discussed in greater detail below, the proposed rule eliminates the ability to take transportation allowances when the IMBP price is used. While the language in the proposed rule contemplates that leases

[2] These states will have differing regulations concerning the transportation and taxation of oil once it leaves the reservation. *See, e.g., Ute Mt. Ute Tribe v. Rodriguez*, 660 F.3d 1177 (10th Cir. 2011) (discussing these issues under New Mexico law). Each state's unique regulatory scheme presents local costs that are considered when sellers and buyers negotiate the actual prices used to value oil.

within each designated area will contain similar geography and access to infrastructure (such as pipelines, rail lines and trucking), there is no evidence or information contained in the proposed rule which shows how ONRR took these factors into consideration when it created designated areas by reservation boundaries. As a result, the boundaries for the designated areas do not calculate appropriate location differentials to adjust the New York Mercantile Exchange ("NYMEX") average prices back to a location near or at the lease.

Nacogdoches acknowledges that the language in the proposed rule states that ONRR may modify or add designated areas if necessary. *See* § 1206.51. The rule as proposed, however, fails to specify what criteria ONRR will use to determine when such modification is necessary. Nacogdoches is also concerned that the proposed rule lacks a mechanism for industry members to petition ONRR to modify a designated area in the event that the designated area contains diverse geography and distinguishable access to infrastructure (such as pipelines, rail lines and trucking).

2. The Proposed the Major Portion Price and LCTD Calculations Contained in Section 1206.54

Historically, the "major portion" value for oil produced from Indian tribal and allotted leases has been considered the median value or median price at which oil of like-quality is valued from the field where the lease is located. *See, e.g.*, 30 C.F.R. § 1206.54(b). The current regulations provide that "[t]he major portion is that price at which 50 percent by volume plus one barrel of oil (starting from the bottom) is sold." *Id.* Nacogdoches understands that ONRR and its predecessor MMS have made several previous proposals related to the calculation of the "major portion" of production from Indian leases. In 2006, ONRR's predecessor, MMS, explained that "MMS would not change the percentile at which the major portion value is determined. The MMS historically has used the 50th percentile-plus-one-unit measure for the major portion calculation. Because [it] believe[d] almost all oil produced from Indian leases is sold at arm's length, there appears to be no reason in the oil context to depart from the major portion measure in the current rule." 70 Fed. Reg. 7455-56. The proposed rule fails to state how MMS's conclusions from 2006 have changed. Nacogdoches (along with many other small companies), still sells oil produced from its Indian tribal and allotted leases pursuant to arm's-length agreements.

Nacogdoches would like to express its concern that a standard which uses the value of the 75th percentile of oil as the basis for the major portion price is arbitrary. The plain meaning of the term "major," as defined by Webster's New World College Dictionary (4th ed.), is "constituting a majority." The term "portion" is defined as "a part of limited quantity of anything, esp. that allotted to a person." Thus, the most straightforward meaning on the phrase "major portion" is that which has long been embraced by ONRR and MMS – the value of the 50th percentile of oil, plus one barrel. ONRR's proposed definition for the "Major Portion Price" included in proposed section 1206.51 reflects the straightforward definitions of these terms, which states that "Major Portion Price" would

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mean "the highest price paid or offered at the time of production for the ***major portion of oil*** produced from the same designated area for the same crude oil type." Nonetheless, instead of focusing on the price paid for the major portion of production in its value calculation, ONRR states that it intends to calculate a 75% major portion price, by focusing on the top 25% of prices paid for like-quality oil within the designated area.[3] The top 25% of prices, however, is not the "major portion" of sales. Instead, this figure more accurately describes the minor portion of top sales prices obtained by lessees.

ONRR's use of the LCTD to maintain a major portion price at the 75th percentile also raises concerns. In the proposed rule, ONRR states that it will only use monthly sales volumes which are not reported as STC OINX to monitor the LCTD. When gross-proceeds sales volumes for a specific crude type exceed 28% for the designated area, ONRR will adjust the LCTD downward by 10%. When gross-proceeds sales volumes for a specific type of crude fall below 22%, ONRR will adjust the LCTD upward by 10%. Both of these adjustments focus on a minority of sales from each designated area. In addition, there is no explanation why a 10% adjustment is made under either scenario. For example, what happens if 50% of volume for a designated area is reported via gross proceeds? Under the rule as proposed, this 22% increase in volume reported as non-STC OINX would only mandate a 10% downward adjustment in the LCTD. Similarly, if sales volumes reported as non-STC OINX fall to 5% for a designated area, ONRR will only increase the LCTD by 10%. Thus, the 10% adjustment figure appears to be an arbitrary number.

Finally, in areas where there is insufficient information reported on Form ONRR-2014 to determine a differential, the proposed rule grants ONRR with discretion to determine an IBMP value. *See* § 1206.54(e). Nothing in that provision, however, requires ONRR to consider local values. *Id.* This is important when considering the fact that the major portion provision of the lease states that value should be determined based on a "major portion of the oil of the same gravity . . . and sold from the field where the lease lands are situated." Under the existing regulations, ONRR must "where practicable" calculate the major portion price "using like-quality oil sold under arm's-length contracts from the same field (or, if necessary to obtain a reasonable sample, for the same area)." 30 C.F.R. § 1206.54. Nacogdoches recommends that a similar requirement be included under the proposed Section 1206.54(e) to help ensure that ONRR's discretion to determine an IBMP value is tied to the express terms of the lease. *See* 30 C.F.R. § 1206.50(b) (stating that the express terms of the lease will govern over any inconsistent regulations).

3. Use of the Calendar Month Average of New York Mercantile Exchange Prices as the Basis for Oil Valuation for Indian Tribal and Allotted Leases

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[3] Oil produced from each designated area also may not come from the same reservoir and thus may not come from the same "fields," as defined under the proposed rule. This raises a question of whether or not the value of oil from multiple fields can be used as the basis for a major portion value under the existing language in the lease agreements.

Taking into consideration the above comments regarding ONRR's use of reservations as designated areas, and problems associated with the LCTD, Nacogdoches would like to express further concern with the use of NYMEX prices as the basis for Indian oil valuation. The proposed rule fails to adequately support the reasoning for the use of NYMEX prices as a good indicator of market value at the lease. This is particularly important since ONRR is proposing to use NYMEX prices as the foundation for Indian oil valuation.

NYMEX does not account for many of the local costs and risks associated with each lease, such as transportation, storage costs and abilities, satisfying local customer quality preferences, division order procedures, accounting systems, and local legal review. In addition, there are unique local costs associated with moving production away from the lease such as risk of loss of product, environmental and safety risks associated with spills and releases, price risks, credit worthiness of purchasers, etc. *See, e.g., Ute Mt. Ute Tribe v. Rodriguez*, 660 F.3d 1177 (10th Cir. 2011). These local risks and costs are not adequately factored into NYMEX prices. *See* 2006 Proposed Indian Oil Valuation Rule, 71 Fed. Reg. 7454.

In 2006, MMS stated in the prior proposed rulemaking concerning the valuation of oil on Indian tribal and allotted leases that according to its own analysis and experience, almost all oil sold from Indian leases is sold or exchanged at arm's-length before it is refined. 71 Fed. Reg. 7454. MMS further found that oil sold from Indian leases was not exchanged or sold according to NYMEX published prices. *Id.* Indeed, MMS noted that "it is extremely difficult to obtain reliable location and quality differentials between Cushing and areas where the large majority of oil is produced from Indian leases, including the San Juan Basin, northeastern Utah, Wyoming (for other oil types), and Montana." *Id.* MMS pointed out that valuation for production from Indian lease sharply varies from the marketing and disposition of oil produced from Federal leases, stating that most of the oil produced on Federal leases is exchanged to Cushing or flows to market centers that have "well-established differentials between the market center and Cushing." *Id.* As a result, MMS concluded that the best valuation method for oil produced from Indian tribal and allotted leases was the value of gross proceeds received in arm's-length sales. *Id.*

Nacogdoches' concerns are compounded by its above comments concerning the proposed designated areas, because the arbitrariness associated with utilizing NYMEX pricing cannot be resolved when entire reservations are used as the basis for determining location adjustments. Nacogdoches is currently unaware of any use of reservation-wide pricing mechanisms for the valuation of oil within the industry. Similarly, Nacogdoches is unaware of any existing studies which show that a monthly valuation for the entire Navajo Reservation will adequately adjust NYMEX prices for local costs. Under the proposed rule, ONRR indicates that it will only adjust for local price differences by broadly looking at prices for 22%-28% of production reported in ***each designated area*** (i.e., primarily by reservation). As stated above, applying the same localization differentials for production on an entire reservation will in many cases fail to adequately adjust the royalty values by actual location, and in the case of the Navajo Reservation, it will fail to capture differing local costs presented by the three states where the Navajo Reservation located.

As previously concluded by MMS, the majority of sales occurring on Indian tribal and allotted leases were actually conducted under arm's-length agreements, and those agreements were specific to the areas where the actual leases are located and account for the local costs and risks associated with each lease. As a result, gross proceeds from arm's-length agreements for each lease should be used to determine the value of Indian Oil, in lieu of adjusting NYMEX prices with a reservation-wide differential.

4. Transportation Allowances

Small companies producing Indian leases located in remote areas, in many cases, must sell oil at lower prices to account for their customer's increased transportation costs to obtain oil from the well site. MMS apparently recognized this as a broad reaching problem in 2006 when it found that it was extremely difficult to obtain reliable location differentials to adjust NYMEX-based prices. This problem is, in part, attributable to the wide variety of lease locations in relation to existing transportation infrastructure. As a result, ONRR's proposed rule will unfairly increase costs for operators on many remotely located leases, and ultimately discourage production from those leases. The rule will also have a heavier impact on smaller companies who cannot easily offset these increases with production from leases located in better locations.

Another way to allow small companies operating within the more-isolated areas of Indian country to adjust value for location, would be to allow those companies to take an additional transportation allowance or differential. Under the proposed rule, ONRR will create (in most cases) a reservation-wide monthly value by focusing on the top 22% - 28% of prices (by volume) paid within the reservation. Nothing within this calculation indicates that the actual local costs imposed by the difficulty of transporting oil out of various location will be factored into that analysis. In addition, it is implied in the proposed rule that lessees would not be able to take transportation allowances in the event that they are required to pay royalties based on the IBMP. *See* 79 Fed. Reg. 35107. This is because the LCTD is based on reservation-wide prices which are net of transportation costs. *See* 79 Fed. Reg. 35018. However, as discussed above, a reservation-wide value fails to adequately account for increased local costs—one such cost factored into local pricing is the difficulty to transport oil. As a result, an additional transportation allowance or differential is necessary to provide a value "from the field where the lease lands are situated."

5. Application of the Regulatory Flexibility Act and Small Business Regulatory Enforcement Fairness Act ("SBREFA")

ONRR's analysis for the Regulatory Flexibility Act and the SBREFA is based on its Summary Cost and Royalty Impact Data, included at 79 Fed. Reg. 35108. Under that analysis, ONRR estimates that the industry will experience approximately a $20,000,000 annual increase in royalties. *Id.* It is unclear whether or not ONRR actually used the pricing mechanism of the IBMP in that analysis. ONRR merely states that it "arrayed the monthly reported prices net of transportation from highest to lowest and then calculated the monthly major portion price as that price at which 25 percent plus 1 barrel (by volume) of the oil is sold (starting from the highest price)." This, however, differs from the valuation method proposed under the rule, which is based primarily on a monthly average of NYMEX prices. Accordingly, ONRR should complete an analysis which utilizes the IBMP calculation proposed in the rule.

In addition, the proposed rule will cause major price or cost increases for consumers, the Indian oil and gas industry, and geographic regions under the SBREFA. *See* 5 U.S.C. § 804(2). As further explained in the case study included with these comments, the proposed rule in its current form, will result in significant cost increases for the oil and gas industry, and will unfairly burden industry operating in more remote geographic areas. MMS apparently saw this as a broad enough problem that it declined to implement changes similar to those included within the proposed rule. Small businesses operating in those areas will experience significantly increased royalties. Those increases will either be passed onto customers and consumers, or absorbed by members of the oil and gas industry. ONRR provides no analysis concerning these issues within the proposed rule.

Conclusion

The effect of the proposed rule is to disproportionately raise the royalty rate on lessees operating in the more isolated parts of Indian country. This not only disincentives production on those leases, it also places an unfair impact on small business who have few resources to off-set the increase. In doing so, ONRR is abandoning a long-established practice of valuing production at or near the lease, and instead is embracing the use of a reservation-wide index price. As a result, Nacogdoches respectfully requests that ONRR withdraw the proposed rule, or alternatively make changes which address the above concerns.

Sincerely,

Taylor Mathews
President

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