

Comments Received about the MMS Proposed Federal Crude Oil Valuation Rule  
Bakersfield, California Workshop Oct. 16, 1997

Attendees

Michael Sansing	Independent Oil Producers Agency, Bakersfield
Cathy Reheis	Western States Petroleum Association
Suzanne Noble	Western States Petroleum Association
John Vautrain	Purvin & Gertz
Harold Orndorff	Aera Energy
Greg Meisinger	Aera Energy
Jeff Braun	California State Controllers Office
Jeff Prude	Bureau of Land Management, Bakersfield Office.
Debbie Gibbs Tschudy	MMS
Todd McCutcheon	MMS
Peter Christnacht	MMS

Debbie Gibbs Tschudy opened the meeting by welcoming the participants and explaining that MMS was interested in holding a meeting in Bakersfield to allow producers to comment on the rule without the burden of traveling to Denver or Houston. Next, she gave a brief summary of the proposed rule and supplementary proposed rule. She then gave an overview of the Denver and Houston workshops. She also announced that the comment period would be extended to November 5th, and that an additional workshop would be held October 28th (later changed to Oct. 27th.) in Washington, D.C.

The floor was then opened to comments from the participants.

J. McCabe Let me begin by stating that the State of California has a problem with the modified provision in the July 3 supplementary proposal regarding calls. We will submit written comments asking for the change permitting value based on competitive crude oil calls to be withdrawn. We don't believe that it will be possible for auditors to verify whether lessees are in compliance. We also would like to see the two year purchase provision back in the rule. This would apply to all lessees except for true captive sellers. We don't believe that captive sellers represent a true market price, but we are sensitive to their having to pay royalties on phantom income.

The State also feels that the process is dragging on entirely too long. If MMS wants to tinker with this some more, let's have a separate rule for California. We have been at this issue for over 2 decades, and every day we delay is less money for school funding in our state. Let me also state that we do not hold MMS

responsible for this. It is obvious that the integrated oil companies wish to delay the process as long as possible. It's been almost two years since we began this process and they have brought nothing to the table.

- C. Reheis We don't see where the supplemental rule gives our members any relief. We believe that posted prices are the market value.
- J. McCabe Our experience in the Long Beach litigation is that postings are not the market price. ANS is the swing crude on the West Coast. It has been acknowledged by the majors under testimony. The interagency taskforce documented that the companies compared their purchases of California crude against ANS and considered California postings to undervalue crude oil by \$3-4 per barrel.
- J. Vautrain From an economist's point of view, this is not a real spot market. Only a limited number of tankers during any given month unload ANS. The state sells its production in a bidding process. This would be a better value.
- H. Orndorff B.P. is the only seller of ANS crude. Their price is not a good price indicator.
- P. Christnacht That is somewhat problematic.
- J. McCabe BP is not a take it or leave it price. Other producers sell and exchange ANS. In the contracts we have looked at, we have seen ANS prices track quite nicely with the ANS spot price. There are good incentives for ANS producers to get a competitive price. We don't see the same dynamics with California production.
- J. Vautrain It's difficult to get information on exchanges. There may be a way to get market information. One could correlate gasoline to residual fuel oil.
- C. Reheis It sounds like MMS would like our help in coming up with alternatives for differentials.
- G. Meisinger I am having some trouble grasping the essence of this issue. We have these alternatives but we need to see them fleshed out a bit more.
- J. McCabe We want a rule now. The majors have had nearly two years to get a proposal on the table.
- J. Vautrain Why are you getting less than market value for your State sell-off oil? Why don't we use the State sell offs to set a value for California crude oil?
- J. McCabe The market is not liquid enough to get the adjusted ANS price. The pipelines continue to be a reason for undervaluation of California crude. Access to our oil is

not assured to all parties, and the heated lines in California are still proprietary.

- J. Vautrain     ANS is no longer the swing crude on the west coast. The market for ANS has changed. It's now going to Japan. California is now short on crude supply. If you have access to data on California production it is better to use it than data for crude produced elsewhere.
- C. Reheis        Any proposal is better than ANS. The first and second ones seem reasonable.
- J. Vautrain     MMS will have to be flexible. If the ANS spot price loses its attractiveness as a market indicator, MMS will have to come up with an alternative. What about MMS taking its oil in kind?
- J. McCabe        RIK is not the answer.
- G. Meiniger     Why doesn't MMS just go to an RIK program?
- P. Christnacht  Our lease terms give MMS the option to take our royalty in kind or in value. We are not interested in taking the oil in kind in any area where we might receive less money. MMS has a separate program that is evaluating the viability of taking its oil in kind.
- D. G.T.          That's essentially right. MMS will still need to have a valuation procedure for areas where it elects not to take its oil in kind. Our responsibility to the public is to do what makes more sense. Where we increase value by taking our royalty share in kind, that's what we will do.
- G. Meiniger     The Department of Energy used postings as its base in their Elk Hills sell offs.
- P.Christnacht  Yes, for part of their production. Half of their production is bid on over an average of posted prices in the area. The other half is actually bid on based on the price of the NYMEX at Cushing, OK. NYMEX is set by buyers and sellers in the marketplace. Postings are set by buyers. Purchasers of Elk Hills have no problems making an adjustment to their bids off of NYMEX.
- J. Vautrain     Let's walk through our thoughts on the proposal. Industry doesn't like the black box pricing of the 4415. We would like a limited market area. The entire West Coast is too broad. The screen for quality is very broad. How do you decide if you have comparable crudes? How can industry be sure that MMS's quality adjustments are correct? If oil is sold at the lease, MMS will need to make adjustments. If small volumes are sold, these will not be reflective of the index price.

While I am on the subject of volume, I think that your suggestion to base the minimum volume of a tendering program on the royalty volume is based on specious reasoning. The limited amount of data is of bigger concern to us e.g. where you have small volume of sales that are arm's length. In large fields, smaller percentages may still give you a good statistical sampling.

- D. G. T. IPAA has modified its proposal to include a combination of purchases and sales. Will this help your concerns about significant quantities?
- J. Vautrain If you don't have any confidence that the government can get market value now, why do you think that new benchmarks will get you there?
- D. G. T. Is there enough sales activity in California to use sales and purchases approach?
- J. Vautrain Industry might have to do some shuffling of buying and selling volumes in some areas to make this work.
- D. G. T. How can we be sure that contracts are arm's length -- that no extra consideration is passing from the purchaser to the lessee?
- J. Vautrain Even certification of "no overall balancing" agreement won't be sufficient to satisfy MMS auditors.
- D. G. T. What should we do for refiners who refine their production?
- J. Vautrain I don't think that ANS could work unless you make adjustments monthly.
- D. G. T. How about one method for non-refiners and another for refiners to value non-arm's-length production?
- G. Meininger There is a trend in California to move toward separation between integrated and non integrated companies. Now each entity is a profit center. The whole market place in California is changing rapidly.
- J. Vautrain I am sure if you take a survey of the experts you will get a range of opinions. The truth lies somewhere in between. I have been toying with an idea today I will share with you. In Asia, there is a pricing board. Its purpose is to set prices for crude oils in the area. There are representatives from industry, governments, the academic community, and others who meet periodically to determine the prices. Once this system is in place there is very little effort needed. Lots of data points are put into the system and the computer program spits out a number. There is some small chance that players will try to manipulate the prices but the incentives to do so are outweighed by the consequences. Parties abusing their privilege will

be eliminated from participation. The major selling point to industry is that they will understand the system and will have buy-in to the process. The panelists are objective. Everyone understands the system and its design and implementation.

- J. McCabe All this is predicated by a competitive market that you can determine the market price. You don't have a real market in the San Joaquin Valley.
- J. Vautrain Indonesia is worse than California. The Asian model could be run by MMS. It would be California based.
- J. McCabe My understanding of these models is that the computer program is based on the premise of price liquidity.
- J. Vautrain If you were to find that there was polarity of data points, then I would agree with Jim. But if there are outliers, the board would throw these out.
- D. G. T. We have proposed a similar idea for gas royalties.
- J. Vautrain What we have on the table now, with ANS, is a black box. With a panel including industry representation, you would have buy-in from industry.
- D. G. T. I think the idea deserves further study. We will bring this back to our management. Right now I would like to cover a few other items on our list of questions. How about the proposal to use fixed differentials by zone or area? Here you would sacrifice some accuracy for simplicity and certainty. Any feedback on this or ideas on how to apply this in California? Could it be done statewide? We are looking for ideas.
- J. Vautrain You might need 3 or 4 prices for a state review board. There would be a way to come up with these if you go to a pricing panel.
- D. G. T. If we keep ANS, what about differentials ?
- J. Vautrain The proposal to update yearly will fail to capture the market dynamics present for crude oil transactions.
- C. Reheis Fixed differentials are not attractive to W.S.P.A.
- J. McCabe Companies evaluate differentials on a daily basis.
- J. Vautrain Why would you believe the companies could set differentials (you would like) any better than they set posted prices?

- J. McCabe Differentials are different than absolute prices that companies set. The companies are doing this already. They are in exchange contracts.
- G. Meisinger What would be the burden on a company to do this? These differentials change all the time.
- J. McCabe The differentials in the eighties did not change often.
- D. G. T. Could you give us proof in contracts that differentials change very often?
- J. McCabe What has changed since 1989?
- J. Vautrain You have more companies than in the eighties. There is the All American pipeline to Texas.
- J. McCabe Would quarterly or monthly adjustments help your comfort level?
- J. Vautrain. The gravity spread between ANS and California crudes is problem unique to California.
- D. G. T. Can I get your thoughts on reducing the administrative burden of the 4415 form? Louisiana proposed at the last workshop to reduce the number of aggregation points. The other idea that emerged in the course of this discussion was that the only ones who might pay value on NYMEX minus a differential would be the integrated companies who already have information on these data points so MMS would not need to publish this information.
- G. Meisinger This kind of approach raises the issue of antitrust.
- D. G. T Back to the need for the form --
- C. Reheis WSPA will canvass its members for the need for these data.
- D. G. T. Do I hear any interest from California about marketing costs.
- J. McCabe I'm not sure
- C. Reheis Yes from WSPA. However, WSPA is not yet ready to comment on DPC's list of costs.
- J. Vautrain Quality other than gravity is a real concern in California. The current system has historically had a large administrative burden. MMS has protection against underpricing. Industry has protection by maximum of gross proceeds. But at

lease a symmetry exists now. Under the proposal, protection has shifted toward MMS. There is no way for industry to change the lease terms to give its royalty in kind or for an arbitrator to decide the merits of industry's position.

D. G. T. The court process is all.

J. Vautrain And we would agree that it is too inefficient to solve these problems.

D. G. T. We have agreement on that point. Does anyone else have any additional comments? (none offered) I would like to thank everyone for coming today and sharing their time and insights.