

Roswell Workshop

Meeting held at BLM office, Roswell, NM, October 21, 1997.

Attendees:

Jennifer Hurst - Yates Petroleum
Neale Hickerson - Navajo Refining
Rhonda Nelson - Marbob Company
Dave Hubbard - MMS Royalty Valuation Division
Peter Christnacht - MMS Royalty Valuation Division
Todd McCutcheon - MMS Policy and Management Improvement
Dave Domagala - MMS Royalty Valuation Division
Johnny Knorr - Navajo Refining
Margie Oleson - Hayco
Kay Huffmon - Hayco
Will Waggoner - Independent Petroleum Association of New Mexico
Dan Girand - Mack Energy
Mark Murphy - Strata Producing Company

Meeting begins at 1:30 p.m. Dave Hubbard begins with an explanation of rule and goes through the handout.

Johnny Knorr - The terminology in using the trade month with NYMEX is different than what we use. October quits trading in September.

Dave Hubbard - The first of the production month is how you tie to the production month.

Peter Christnacht - We have had comments to revise the timing of using NYMEX.

Johnny Knorr - You might want to change that to the calendar month.

Dave Hubbard - As of the first of any month, we would look at the near term trading month.

Johnny Knorr - What price will you use?

Dave Hubbard - The average of the daily close prices in the trading month.

Todd McCutcheon - How about using a calendar to describe what we propose to do?

Johnny Knorr - No one does it the way you are describing it.

Dave Hubbard - (draws diagram of October trade month.)

Johnny Knorr - What would you use for October?

Dave Hubbard - We move the value up one month.

Peter Christnacht - We wanted to value production with the NYMEX values that match the production month.

Johnny Knorr - You should use the trading month value for value or the October calendar month average. It ought to be one or the other.

Dave Hubbard - For the production month we are talking about, I'm a bit confused.

Johnny Knorr - Use the November trade month, use either the trading month or the calendar month. P-Plus uses the calendar month. Prices change every day in the NYMEX that affect today's price even if it is delivered in the future.

Peter Christnacht - You want to use what is in effect at the time of production?

Johnny Knorr - Yes, the near month price, what is in effect at the time the production occurs.

Dave Hubbard - (Begins going through handout again.)

Johnny Knorr - There is a difference in the values of Spot and NYMEX. The difference between Platt's, Cushing and NYMEX was about 30 cents for the last few months.

Dave Hubbard - Is that common?

Neale Hickerson - There are alternative crudes there, that affected the price. Traders were able to buy Brent at that price and deliver it. This created arbitrage that lasted for about three months.

Johnny Knorr - I'd recommend the Platt's Cushing price.

Neale Hickerson - Eliminate the NYMEX-- that eliminates the arbitrage games. You will eliminate some problems.

Johnny Knorr - Will the information we report on the proposed form MMS-4415 be public information? I don't want to send that out.

Dave Hubbard - MMS will collect it and calculate representative

rates -- the MMS-calculated numbers will be the only information published. We would come up with a representative number for an area.

Johnny Knorr - For us, it is not too hard to figure our situation out, it won't be hard to isolate us. That is, there are only a few other traders in the area.

Todd McCutcheon - Is there or will there be a time when that concern goes away?

Johnny Knorr - All crude is sourced locally over the years, we deal in 30 day evergreen contracts.

Todd McCutcheon - Time is not a factor then.

Dave Hubbard - You can give us the same comment in writing, it would be worthwhile to do that.

Dave Hubbard - (finished going through the handout at 2:12) any questions? (None were asked.)

Dave Hubbard - I want to assure you that arm's-length gross proceeds will remain. The tighter restrictions in the original proposed rule have been relaxed. True arm's-length transactions will be royalty value. But are there alternative ways to value non-arm's-length transactions? I'm looking for suggestions in this area. Is NYMEX even a workable option?

Johnny Knorr - Platt's is better, but trying to get to the lease is tough because of actual transportation costs, we move by truck to 5 different locations. We are successful because we are in a niche, why should MMS benefit from that? Why should MMS get a higher price because it is closer to Midland? My comment is to pick a number for this area, like 1 dollar from the NYMEX or Platt's, that is a price that would be fair.

Dave Hubbard - How do we get that number?

Johnny Knorr - Look at trading at that level to buy oil, it varies by each lease.

Dave Hubbard - Are you suggesting a market survey to get an idea of what goes on there?

Johnny Knorr - Transportation really will vary in every area. You can simplify a great deal and still get a fair price or take it RIK and sell it back to us.

Dave Hubbard - You recommend using the Midland Spot for the area?

Johnny Knorr - Cushing for intermediate oil, for sour oil use Midland.

Johnny Knorr - Most oil is equivalent to Midland however there is a lower grade up north, 24 degrees API gravity and its worth less.

Dave Hubbard - Are there any suggestions on other alternative ways to value non-arm's-length situations? If not, we can move to the 5 alternatives in the notes. First, the Conoco tendering program?

Johnny Knorr - Not everyone here knows about Conoco's program.

Dave Hubbard - They bid an amount (10%) in the area where the production is, the price that is paid for that oil is used for royalty volumes. One of the concerns is that the 10% is not as large as the royalty share, this may lead to gaming.

Johnny Knorr - They treat us as a competitive call type situation, when we bid on it, if we were high, they sold it to us. It is a competitive call situation.

Will Waggoner - Can you describe the Conoco program again for Dan? I've got some problems with it.

Dave Hubbard - (explains the Conoco program again.)

Dan Girand - We're more inclined to like the IPAA proposals, the tendering program is more complicated, keep it simple or it's a mess.

Dave Hubbard - IPAA, as I understand it, would use tendering as one of their benchmarks.

Margie Oleson - How far in advance is the oil tendered?

Johnny Knorr - Conoco uses a 6 month period, 45 days ahead, they are not the only ones tendering oil.

Dave Hubbard - There is at least another company using tendering. The IPAA benchmarks, the first benchmark is tendering and the second is a combination of purchases and sales as long as there are significant quantities. If those fail, then a netback methodology is used.

Dan Girand - Keep in mind Johnny's comments.

Will Waggoner - We are in favor of IPAA comments, we feel that their comments are a good solution to the problem.

Johnny Knorr - Can the outright sales be not necessarily by the lessee but just from others? How about an outright sale by somebody else to us?

Dave Hubbard - IPAA's proposed second benchmark includes sales or purchases, does that help? (General consensus that second alternative -- IPAA benchmarks -- were good.)

Johnny Knorr - Is there a circumstance where our posted price will be used as a benchmark?

Dave Hubbard - If there is an arm's-length sale at that price, then that will be the royalty value.

Dave Hubbard - The third item is the MMS calculated benchmark. It is an area-by-area approach, and MMS would publish that as royalty value. A problem with that is timing and that the current form MMS-2014 does not collect that information. What do you think?

Will Waggoner - Industry and the government can come together on that-- no-one likes that idea very well. (There was general concurrence.)

Dave Hubbard - The fourth item is fixed differentials, these would be from NYMEX or spot. We trade simplicity for accuracy in the numbers. You would start with NYMEX and use a fixed differential to get to the lease. You probably will have zones, on a cents-per-mile or per-barrel basis.

Johnny Knorr - Cents per mile you can't audit, if anything, use a per-barrel amount.

Peter Christnacht - We've found that others believe the same thing.

Johnny Knorr - Use Platt's Midland price less a particular amount.

Dave Hubbard - What about collecting information?

Johnny Knorr - The information you get will be bad, and it will be too hard to get.

Dave Hubbard - We are talking about differentials that are in an exchange agreement.

Johnny Knorr - We have oil going to many areas, other places, based on volumes....it can't be done.

Dave Hubbard - Transportation is tough to determine, especially divorcing transportation from quality and other market adjustments.

Johnny Knorr - For a zone or a specific number, you should not get involved in anyone's exchanges.

Will Waggoner - We are not real supportive of that idea.

Dave Hubbard - Spot versus NYMEX? We've heard already this afternoon that the spot is better, right?

Johnny Knorr - I would not use Bloomberg's publication only Platt's numbers.

Dave Hubbard - Some have said we should use an average of several publications for the area, that way no one influences the market.

Johnny Knorr - I'd stick with one, keep it simple.

Dave Hubbard - Spot over NYMEX though?

Dan Girand - The more you complicate this the harder it is for you. It is not worth it for you, you are inviting all kinds of problems. (Thus implying that spot is preferable to NYMEX.)

Will Waggoner - We are here because MMS feels that they are getting less than they deserve, less than what you would receive in true arm's-length transactions. That is the greatest motivator here, right?

Dave Hubbard - That's fair.

Will Waggoner - We want to make sure that everyone is paid right, however, we don't want to get into a situation we have not caused. We may have sinned in the past but we are on the road to redemption.

Johnny Knorr - Your Federal oil is not worth that much, because of the administrative burden, you should not be entitled to the same amount as the oil is worth from non-federal leases.

Will Waggoner - The question I have is how is this proceeding in the eyes of MMS?

Dave Hubbard - I can't be definitive on this, we must review and address all the comments we get. The biggest issue is non-arm's-length pricing. Arm's-length gross proceeds is still going to be valid. Beyond that, nothing is definitive.

Peter Christnacht - What he said is correct, we need to summarize the comments, then it is up to management. There will likely be a further notice of proposed rulemaking in the spring.

Dave Hubbard - There are different perspectives from all areas.

Dan Girand - Have you checked to see if this will get you any more money?

Dave Hubbard - MMS is required to do such an analysis when they put a rule together, we have some estimates of about 50 million dollars a year gain nationwide.

Johnny Knorr - That figure is with a differential?

Peter Christnacht - Yes.

Johnny Knorr - The State of New Mexico said value in this area should be NYMEX less 30 cents, I don't know how they got that.

Dan Girand - With all the costs considered? Lawsuits? You have to be close to breaking even on this new rule.

Will Waggoner - It has to be simple and straightforward, otherwise, you are not going to get anything additional here.

Dave Hubbard - That's part of the balancing act here.

Dan Girand - No one wants to pay royalty on something they did not get.

Will Waggoner - That would be a killer for us, transfers that are arm's-length are most of our transfers. It is just the few on the outside that will hurt.

Peter Christnacht - What about these few on the outside?

Will Waggoner - I don't have the other situations at hand, I don't have the details here. I don't know if there is that much out there. We are worried about getting into a system that is administratively tough and forced to pay royalty on phantom value, we are in a problem that does not apply to us.

Johnny Knorr - We don't want to handle all the forms that go with the rule just to get oil to a refinery, in some cases, it does not have anything to do with you.

Neale Hickerson - This moves value away from the lease, it is the first step in the chain and then someday the value required to be reported will be just the Platt's Cushing price.

Johnny Knorr - That was the way it was when this rule was first considered.

Will Waggoner - We appreciate you taking the time to talk to us.

Dave Hubbard - We appreciate that and we've got a lot a good comments so far. We are trying to make it simple.

Johnny Knorr - Do you have percentage of the oil companies that are integrated?

Peter Christnacht - Depends on region, OCS is all majors, I don't know state by state, California offshore is almost all Majors, onshore it is even.

Todd McCutcheon - Integrated refiners, 60% of the revenue comes from them, but they are just 5% of the lessees. 100 to 200 of the lessees are mid-level marketers, there are 2500 total lessees and up to 200 of them are affiliated, there are 10 or less integrated refiners, the rest are small independents. 70-80% of the revenues come from the top 200 lessees but all the business is from all of you.

Will Waggoner - Ben Dillon of IPAA would know, but your numbers seem a bit high.

Johnny Knorr - Are the terms changing when a new lease is issued?

Todd McCutcheon - Not that I know of, that is up to BLM, it's a good idea though.

Dave Hubbard - I don't understand some of the provisions in calls as well as I'd like to. How active is this aspect?

Margie Oleson - We only have two groups where calls were ever exercised, the only leases that we have now with call provisions Amoco has.

Todd McCutcheon - Were these old agreements?

Margie Oleson - Late 80's.

Margie Oleson - They contained no pricing provisions, they just took the oil. They were their Federal leases, so they take their share in kind.

Johnny Knorr - Most of the ones that we have are competitive calls, the oil company agrees to make them competitive.

Peter Christnacht - They are like overriding royalties then, they

can take a percentage of the oil in kind.

Margie Oleson - Yes, they were once their leases, we acquired them.

Dave Domagala - I would like to go back to why you prefer Platt's versus NYMEX?

Johnny Knorr - Platt's is not subject to arbitrage opportunities like we have seen with using NYMEX.

Neale Hickerson - Platt's is used as a trading tool in the area, it's well recognized.

Peter Christnacht - The thought was to give the lessee the option to select a publication. We didn't want to choose one and give an unfair advantage to that publication. You could use a publication for a two year period and then change.

Dave Hubbard - We are not locked into any specific one of them. However we originally picked NYMEX because we believed it was subject to less influence by individuals than spot prices.

Peter Christnacht - In terms of using a differential, the proposed rule requires MMS to publish various differentials for trading around the country. However, you could use actual costs in lieu of the MMS prices.

Mark Murphy - Is there a sense of the feedback on the proposed rule that you have got so far?

Dave Hubbard - I don't get a sense of any uniform response for any of the areas.

Peter Christnacht - In California WSPA had some ideas, but as for the independents, as long as the gross proceeds aspect is maintained, they were satisfied.

Dave Hubbard - In Casper, preservation of arm's-length gross proceeds was important, non-arm's-length transfers with affiliates was also important.

Will Waggoner - We support the IPAA.

Dave Hubbard - What about a word from the state auditors?

State Auditors - We are here to learn that's all.

Dan Girand - The costs of this rule will filter down to us, we must absorb them, if we were connected to the majors in some way, it

will flow back to us, we need to emphasize that, we absorb it, we don't pass them on.

Will Waggoner - We don't pass them on, we are takers, the sponge is the independents without the marketing position, we eat any additional costs that may occur with the rule.

Will Waggoner - We support IPAA and the "keep it simple stupid" principle. Is the comment period to be extended?

Dave Hubbard - Yes -- until November 5th.

Jennifer Hurst - Will the comments given today be on the Internet?

Peter Christnacht - Yes.

Dave Hubbard - Check with Dave Guzy to get the exact location on the MMS home page.

Jennifer Hurst - All of our exchanges are mainly arm's-length. As far as paying the royalty, it is all computerized, whatever you do, keep it simple, I'm the labor force in our company.

Meeting adjourned at 3:11 p.m.