Minutes from Federal Gas Rule Workshop
Washington, DC
May 1, 2003

A Federal Register Notice dated Thursday, April 10, 2003, announced that the Minerals Management Service (MMS) would hold four public workshops to discuss specific issues regarding the existing Federal gas royalty valuation regulations at 30 CFR Part 206 for natural gas produced from Federal leases.

Sixteen attendees participated in the Washington, DC workshop representing 5 companies, 2, citizens, 1 State, 2 industry groups, 1 Tribe, and 1 Law Firm.

Opening Statements
Lucy Querques Denett introduced the panel members and welcomed the participants. This is the 4th of 4 workshops to be held around the country. Minutes for the meeting will be placed on MMS's website. You may also send in written comments.

The purpose of the current Federal gas rule is to ensure that the public receives a fair return on Federal resources. MMS believes the rule accomplishes this goal. However, we continually evaluate the effectiveness and efficiency of our rules. The existing rule is now 15 years old. With the changes in the natural gas market, our experience with the 2000 Indian gas rule, and 5 years of taking gas in kind, we are reevaluating the rule and asking for public input from our constituents.

We seek comments on the following issues:

- Should we simplify the current benchmark system for non-arm's-length sales? Should we allow lessees who sell production to an affiliate a 2-year option (similar to the oil rule) to base royalty value on either a published index for natural gas or their affiliate's arm's-length resale?
- Should we consider using NYMEX prices at Henry Hub in place of, or in addition to, published index prices?
- How should we adjust index prices for location differences?
- Are there other pipeline charges since MMS' 1998 amendment to the gas transportation allowance regulations for which we should provide clarification on whether they are allowable?
- Should MMS adjust the allowable rate of return for calculating non-arm's-length transportation allowances?
- Should MMS allow lessees to apply an index price to wellhead volumes to eliminate the requirement of tracing processed gas to remove liquids?
- Should MMS clarify valuation under joint operating agreements (JOA)?

Industry Comment:

- Industry trade associations, such as API, IPAA, and IPAMS are very interested this topic. This workshop is timely. We think form should follow function. Oil and gas have a lot in common, but are also different. Some requirements need changing, such as adding some transportation costs. Industry would like to know upfront what costs are deductible, and are committed to paying every penny owed. We would like to see the rules clarified and want to be involved with this rulemaking.

Affiliate Sales

MMS Comment: From discussions at previous workshops, we learned that the States want to ensure that any changes are revenue neutral. We heard that companies already trace gross proceeds. Industry itself has concerns about the published index, and overall there are strong concerns about the current flux in the market. Many feel that the index can't be trusted.

Industry Comment:
- As a trade association member we have been before FERC and up on the Hill. We urge MMS to solicit other comments, and support a private company solution. Trust has already been regained and the situation is not as bleak as a few months ago. Currently there is enough forward progress, we see no need for FERC or government intervention, and we hope MMS allows the private sector to work on this issue.

Question: At previous workshops we were told that companies are currently paying on arm's-length affiliate resale value and will continue to calculate this for other royalty owners. If so, what is the benefit of going to index?

Industry Comments:
- We don't necessarily have integrated systems between business units. Transfer price is in the production company accounting records and is used to pay royalties. It will take additional work to bring in the arm's-length affiliate resale. It is more work to get this number than to use index. Companies want choices.
- For pipeline affiliates, the issue is transportation. The further away you get from the lease, the more distortion in price. We want the choice.

MMS Comment: Based on a comment from Houston, is it appropriate to allow options on a company-by-company basis? MMS needs to be flexible to allow for individual companies to propose a valuation method. Does it make more sense to clarify the rule, like we did in the oil rule, to give MMS flexibility to accommodate alternative valuation/future valuation agreements as proposed by companies? The few that we have are working well. Value is certain, there are no volume questions. Instead of a complete overhaul, should we clarify the rule to allow for alternative/future valuation agreements? From other workshops, we heard that an index publication had 80 index points, dropped to 8 then dropped to 6, when index became unreliable. Had we done a rule using the index this would have caused problems.

Industry Comments:
- When the issue of a handful of marketers misreporting arose, Platt's withdrew reporting points to make sure its data was reliable. This created a lull, but now they are confident in their data results. They had a 60% increase in reporting and are now back to 93% of their reporting level before the marketer misreporting.
- Companies are reporting, do report, and will report.
- Should MMS reconsider disclosure of RIK transactions? Index is a public disclosure. Disclosure of the RIK transaction would give transparency of pricing. This is a disconnect, if index is available why not RIK?

MMS Comment: It's a little different if an index publisher discloses information to the public, versus MMS releasing company specific, competitive data.

Industry Comment:
- RIK is supposed to represent the market, disclosure would allow market transparency.

MMS Comment: Index is an aggregate price, RIK prices aren't. The bidding company may not wish to reveal its data.

Citizen Comment:
- Companies have a duty on public lands, these are public properties.

MMS Comment: Our RIK prices fluctuate with index. Contracts are plus or minus index. We will continue to evaluate if the RIK program is effective for government. We don't get cash basis bids that are comparable to index, they are 7-12 month contracts. We don't disclose our data because we get the advantage of our competitive position with the large packages of gas we can provide. We don't want other market participants to see our competitive edge. What percentage of production do we bid? About 15% in the Gulf, none onshore, except Wyoming oil. States have not asked us to look at gas. Our policy is that we will not institute RIK in onshore unless the State wants to proceed with RIK.

Question: What do we do in areas that do not have an index, or when gas does not physically flow? If there is a split stream, or the gas flows but the contract is based on an index not on the pipeline where the gas flows, what index do we use and how do we make adjustments?

State Comment:
- The negotiated rulemaking team gas rule never went final because of the revenue neutrality issue. The team tried to simplify, but the proposed rule was complicated.

Citizen Comment:
- If the index is daily, the location adjustment back to the wellhead is a net figure. Private leases tie their royalties to the federal price. If you go to index, determining royalties on a private lease becomes difficult for those individuals. They prefer that MMS doesn't allow companies to net. Some federal leases don't report gross, they report net. We will make comments on that.

<u>Use NYMEX in Addition to, or Instead of, Index Prices</u>

Question: Should MMS consider using NYNEX in addition to, or instead of, index? At other workshops, the general consensus is that this is not a good choice. Spread and price risk must be managed, so a NYMEX price is discounted. Our experience in RIK shows that NYMEX bids are lower. If the rule used NYMEX, adjustments back to lease end up back at an index value. One commenter in Houston liked NYMEX, but had no suggestions for adjustments. What is our alternative to NYMEX? The FERC and Platt's are working on getting reporters back into the market. Two months ago, there was very little reporting and very little trading. Is this an opportune time to propose NYMEX instead of index? Instead, should we wait to see if confidence returns to market index reporting?

Industry Comments
- If we have a final rule in less than 8 months, industry would be surprised. Index may work itself out in that time. We do feel the NYMEX commenter spoke only for himself, much of industry has confidence in index. If MMS is concerned, we suggest that any rule be postponed to see whether confidence is restored.
- From a time standpoint, index needs to be up and running by end of year. Publishers announced internal changes, data providers now have internal audits, over the next few months we should see continued progress.

<u>Adjust Index for Location Differential</u>

Question: How do we adjust the index for location differences? Should we consider the Indian gas concept, where lessees use index and deduct a standard deduction of 10% of the index price for transportation.

Industry Comment:
- We need different deductions for onshore and offshore. Offshore transportation is much more expensive.

MMS Comment: Comments from other workshops suggested that even a standard deduction should be particular to a specific index price. For example, transportation for the San Juan Basin index is very different from transportation for the Powder River Basin. Should MMS have a matrix of standard deductions? Would this work?

Industry Comment:
- Are you assuming gas is not flowing to use the standard deduction? Where gas is sold to an affiliate, we'd like the index where it flows through, why not simply use actual costs when you flow?

MMS Comment: If you use a standard deduction, it is in lieu of actual costs. In previous workshops, comments indicated that calculating actual costs is very costly. Companies wanted to use a standard deduction, even if lower than actual costs, to avoid the expense of tracking costs, making adjustments after actual costs are calculated, etc. This option wouldn't only be in places where no flow occurred, and would be easier than calculating actual costs. It's a way to simplify the transportation deduction. It may not be as accurate, but it is simple.

State Comment:
- The San Juan Basin has many different working interest owners and the operator still must calculate actual costs, even if there was a standard deduction.

MMS Comment: Comments from previous workshops indicate that in the San Juan Basin most operators have accounting systems that allocate back, but that's not necessarily true in other areas.

Industry Comment:
- Would there be standards set for the standard deduction?

MMS Comment: Yes, MMS would set price and explain how it is determined. MMS would probably calculate it on a yearly basis.

Industry Comment:
- Would it be adjusted quarterly?

MMS Comment: No, it would be a yearly calculation.

Industry Comment:
- Would it be different between various seasons, especially during summer when gas is going to storage?

MMS Comment: No.

Question: In Houston we took an informal poll. How many think the rule is still working and MMS should just make some minor changes? (1 hand) Should the rule be changed? (No hands) Aren't sure? (many hands)

Industry Comment:
- Unlike oil, I think it's premature. MMS shouldn't take the tepid response as not caring. The oil rule is a laboratory, don't misread the lack of response. Industry is very interested in exploring this and improving the regulations.

Allowable Transportation Costs

Question: In response to the changes under FERC 636, MMS made some changes to the transportation rules in 1998. Are there additional costs we should consider clarifying as to whether they are deductible or not? At other sessions, COPAS said that they plan to develop a list. They thought the issues are terminology as well as different costs.

Industry Comments:
- It's always good idea to define terms. I can't give specific comments now but have asked our gas marketing department to provide comments.
- Are letter of credit costs allowable? Also, MMS needs to clarify unused demand.
- Industry is sensitive to terminology. Some items sound like marketing, but are transportation. Descriptions will eliminate ambiguity and better explain these costs. Industry will sharpen up definitions and labels to eliminate confusion.

Allowable Rate of Return for Calculating Non-Arm's-Length Transportation Allowances

Question: When a company owns all or part of the transportation system (non-arm's-length) that company must calculate its actual costs. For capital costs/investment costs, the current rule uses the BBB bond rate. Is this appropriate?

Industry Comment:
- No, the BBB rate is not sufficient, it is not rate of return, but is the cost of capital.

MMS Comment: If it is not meant to include profit, why is the BBB bond rate the wrong choice?

Industry Comment:
- It is not the cost of capital investment in the pipeline.

MMS Comment: How do you define cost of capital?

Tribal Comment:
- The cost of capital is profit, cost of investment, and return on investment.

MMS Comment: To recognize the cost of capital and the cost of debt, BBB is easy, simple, and would approximate companies' cost of capital. In a transportation allowance we are trying to determine cost of capital. When the rules were published in 1988, the pipelines we looked at were large, interstate pipelines that owned production. Now, that has changed. The BBB rate was meant to include some risk inherent in costs, we didn't simply look at capitalization of equity. We looked at what industry as a whole paid, with the idea that is was less risky to build a pipeline, than the risk involved in drilling a well. When drilling a well, there is a greater risk of finding production, versus knowing gas exists and needs to be transported. Current business environment is different. Is the BBB bond rate still appropriate? Should MMS do away with FERC tariffs?

Industry Comment:
- We shouldn't pull away from using a simple method, we don't want to turn MMS into FERC. We should not abandon BBB, but perhaps tweak the multiplier. The current rate (1 times the BBB rate) is a disincentive. Maybe look at the oil multiplier (1.5 times the BBB rate).

MMS Comment: Under the current rule a pipeline is depreciated once. Comments at previous workshops felt that it was more important to get a stepped up basis for depreciation rather than a higher rate of return. What method would most reflect the debt of the pipeline owners, and not allow depreciation over and over again? Is rate of return as big an issue? We can still use FERC tariff for gas, is it necessary to change gas rule?

Industry Comment:
- Yes, in the interest of consistency.

MMS Comment: Should we do away with FERC tariffs like we did in the oil rule?

Industry Comment:
- No, bring it back on the oil rule.

<u>**Apply Index to Wellhead Volume**</u>

Question: Should MMS allow companies to apply index to the wellhead volume, adjusted for MMBtu, in lieu of reporting gas as processed gas and liquids?

Industry Comment:
- When you say wellhead volumes, does that take into account the fuel use?

MMS Comment: No, this would not apply to fuel use.

Industry Comment:
- What is appropriate use, gas that is not wasted?

MMS Comment: It depends on what the gas is used for; on or for benefit of lease, or used for processing. If it is used for processing, it is not lease use, but may be included in the processing costs. If you were paying on liquids, you couldn't deduct this gas as lease use. In other workshops, some suggested this would result in huge savings on both sides and industry would avoid a lot of work, but the States were concerned about revenue loss. If we allowed this option, should it be company wide or area by area?

Industry Comment:
- Why only apply this to affiliate sales, why not let the arm's-length payors use this also? It might not be revenue neutral in a particular month, but would even out over several months.

MMS Comment: We can consider that, but we don't want companies to use this to "game" value. There is an issue on the value of liquids and prices, the higher the methane price, the less companies want to process, the lower the methane price, then companies make more money on the liquids. MMS has not studied which direction revenue would go.

Industry Comment:
- Currently it's great for MMS when gas is processed. Under some contracts, it costs companies more to process then they get for liquids, and they can't deduct all the costs. This was mentioned in Houston by several companies.

<u>**Clarify Value under JOA Contracts**</u>

Question: Under a JOA, non-operators can choose to have the operator sell their production. MMS has presumed that this is not a sale, and has gone to the operator's sale to determine how to establish value (was the sale arm's-length or non-arm's-length). Should MMS clarify, or stay silent on how to handle JOA contracts? Many companies commented that it forces them to execute sales agreements with the operator to avoid dispute over value. Is this an issue?

Industry Comment: This is more a small company issue, and there are no small companies here.

MMS Comment: Any other comments? None.

End of workshop.