

**7TH ANNUAL
NATIONAL OIL AND GAS ROYALTY
CONFERENCE**

Sponsored by

**Professional Development Institute
University of North Texas**



November 3-4, 2003
J.W. Marriott
Houston, TX

The materials in this manual were prepared solely for the purpose of disseminating information, not advice and counsel. They are distributed with the understanding that PDI, its authors, instructors, and conference presenters are not engaged in rendering legal, accounting or other professional services. PDI accepts no liability for verbal remarks or action taken by participants without heeding this hold-harmless clause.

7TH ANNUAL NATIONAL OIL AND GAS ROYALTY CONFERENCE

NOVEMBER 3-4, 2003

TABLE OF CONTENTS

TOPICS/SPEAKERS

TAB

CONFERENCE SCHEDULE

Schedule

NATIONAL ENERGY POLICY – TEN THINGS I HATE ABOUT YOU

General Session I

By: Poe Leggett

EXPLORING THE ORIGINS OF ROYALTY DISPUTES

General Session II

By: David Pierce

MMS OIL AND GAS VALUATION RULES

General Session III

By: Ken Vogel

DRILLING IN THE CITIES AND TOWNS: RIGHTS AND OBLIGATIONS OF LESSEES, ROYALTY OWNERS AND SURFACE OWNERS IN AN URBAN ENVIRONMENT

General Session IV

By: Bruce Kramer

THE FUTURE OF ENERGY – GAS UNCERTAINTIES

Luncheon-Day 1

By: Marshall Adkins

SUBSEA FIELDS MONETARY ADJUSTMENTS AND ASSOCIATED ROYALTY IMPLICATIONS – SOLVING THE PROBLEM OF COMMINGLING OF CRUDE QUALITIES

Concurrent Session A

By: John Russo and David Hernandez

RECENT LEGISLATIVE AND REGULATORY DEVELOPMENTS AFFECTING OIL AND GAS ROYALTIES IN MAJOR PRODUCING STATES

Concurrent Session B

By: Tammy Naron

TWO VIEWS ON USING INDEXED PRICING IN DETERMINING GAS ROYALTIES

Concurrent Session C

By: Obie O'Brien and Ted Gerarden

ASSESSING THE FINANCIAL STRENGTH, OPERATING HISTORY AND BONDING/INSURANCE REQUIREMENTS OF POTENTIAL LESSEES

Concurrent Session D

By: David Mercier

TOPICS/SPEAKERS

TAB

REPORT ON THE MMS' PRODUCTION-IN-KIND PROGRAM

By: Milton Dial

Concurrent Session E

**HOT LEGAL TOPICS INVOLVING MARKETING OBLIGATIONS
AND MARKETING CONTRACTS AFFECTING ROYALTIES**

By: Jeff King

Concurrent Session F

**PROVISIONS IN STATE OIL AND GAS LEASE CONTRACTS
THAT HAVE CREATED DIFFICULTIES – THE EXPERIENCES OF
TWO STATES**

By: Andrew Thomas and Michael Kovich

Concurrent Session G

**IDENTIFYING DEMOGRAPHICS OF ROYALTY AND MINERAL
OWNERS AND ENHANCING THEIR POLITICAL INFLUENCE**

By: David Vinson

Concurrent Session H

**CRITICAL IMPACTS OF THE 2003 ENERGY BILL ON THE
ADMINISTRATION OF ROYALTIES ON INDIAN LANDS**

By: Judith Royster

Concurrent Session I

CONDUCTING THE ROYALTY OWNERS' LEASE AUDIT

By: Joseph Fitzsimons and Rex Howell

Concurrent Session J

**A PROACTIVE INDUSTRY APPROACH TO IMPROVE
COMMUNICATIONS AND RELATIONS WITH ROYALTY OWNERS
AND REGULATORS**

By: Frederick Plaeger II

Luncheon-Day 2

**IMPLICATIONS OF THE SARBANES-OXLEY ACT AND RELATED
REGULATIONS FOR THE OIL AND GAS INDUSTRY-
WITH ROYALTY IMPLICATIONS**

By: Charles Meadows, Jr.

General Session V

**DETERMINING ALLOWABLE POST-PRODUCTION DEDUCTIONS
FROM ROYALTY IN MAJOR PRODUCING STATES**

By: Edward Poitevent II

General Session VI

**IS THE ECONOMIC RECOVERY FOR REAL?
IMPLICATIONS FOR OIL AND GAS**

By: Bernard Weinstein

General Session VII

GENERAL SESSION III

MMS Oil and Gas Valuation Rules

Presented: Monday, November 3, 2003 — 10:35 a.m.

By

Ken Vogel

Dr. Vogel is the chief of the office of enforcement at the Minerals Management Service, a position he has held since the office was founded in 1992. Since coming to MMS in 1989 as chief of the internal review division, he has participated in the drafting of many regulations and policy papers concerning the valuation of oil, gas, geothermal steam and coal. He was the government's expert witness on valuation issues in U.S. *ex rel* Johnson v. Shell Oil Co., which was successfully settled in 2000. Prior to coming to MMS he was Leonard Cohen Chair in Law and Economics and Associate Professor of Law at Loyola Law School in Los Angeles, where he specialized in law and economics, including tax policy and property rights. Prior to that, he was Assistant Professor of Economics and Adjunct Assistant Professor of Law at the State University of New York at Buffalo. He earned his Ph.D. in Public Policy Analysis at the Wharton School of the University of Pennsylvania, his J.D. at the Law School of the University of Pennsylvania and his S.B. at the Massachusetts Institute of Technology.

MMS Oil and Gas Valuation Rules

Professional Development Institute

7th Annual National Oil and Gas Royalty Conference

Kenneth R. Vogel
November 3-4, 2003

- 1) Introduction -- A short history of MMS Valuation
 - a) The Department of the Interior has the power through its lease terms to set value for royalty purposes
 - b) This power has typically been exercised through regulations of general applicability
 - c) The rules have traditionally been consistent with the lease terms
 - d) Until 1988 the regulations were very general, with a lot of discretion in the hands of the administrator.
 - e) Focus on 1988 Federal Gas Rules
 - i) Explain differences and changes
 - ii) Major judicial decisions
- 2) Federal Gas Valuation under the 1988 Rules
 - a) Four way division
 - i) Processed or unprocessed
 - ii) Arm's-Length or not
 - b) Rules based on the general theory that the best measure of value is an arm's-length transaction in or near the field
 - i) Gross Proceeds as minimum value – and presumed value for arm's-length transaction
 - ii) Benchmarks that mimic arm's-length transactions for non-arm's-length contracts (and some arm's-length)
 - c) Duty to Market
 - d) Marketable condition
 - e) Affiliates and Marketing affiliates
 - f) Additions to gross proceeds
 - i) Take-or-pay and contract settlements
 - ii) Breaches of duties
 - g) Allowances
 - i) Transportation
 - (1) Arm's-length
 - (2) Non-arm's-length
 - (a) Actual costs
 - (b) Exception for tariffs
 - ii) Processing
 - (1) Arm's-length

- (2) Non-arm's-length
- 3) Indian Gas Valuation
 - a) 1988 Rules
 - i) Generally parallel to Federal Rules
 - (1) Allowance forms
 - ii) Special factors
 - (1) Major Portion
 - (2) Dual Accounting
 - b) 2000 Rules
 - i) Index zone pricing
 - ii) Changes to major portion
 - iii) Alternative methodology for dual accounting
- 4) Oil Valuation
 - a) 1988 Rules
 - i) Federal
 - (1) Arm's-length
 - (a) Gross proceeds
 - (b) Exceptions
 - (2) Non-arm's-length
 - (a) Benchmarks
 - (b) Gross proceeds
 - (3) Transportation Allowances
 - ii) Indian
 - (1) Generally parallel federal rules, but require major portion
 - b) 1999 Federal Oil Rules
 - i) Arm's-length or affiliate's sales
 - ii) Non-arm's-length
 - (1) Regional
 - (2) Index based
 - (a) Exchange differentials
 - iii) Transportation Allowances
- 5) Possible Proposals for Change
 - a) Federal Oil
 - b) Indian Oil
 - c) Federal Gas
- 6) Conclusions

10TH NATIONAL OIL AND GAS ROYALTY CONFERENCE

Sponsored by

**Professional Development Institute
University of North Texas**



**and the Institute of Petroleum Accounting
University of North Texas**



October 6-7, 2008
Dallas, TX

The materials in this manual were prepared solely for the purpose of disseminating information, not advice and counsel. They are distributed with the understanding that PDI, its authors, instructors, and conference presenters are not engaged in rendering legal, accounting or other professional services. PDI accepts no liability for verbal remarks or action taken by participants without heeding this hold-harmless clause.

CONCURRENT SESSION B

Recurring Royalty Disputes Involving Oil and Gas Gathering, Storage, Location Differentials, and Transportation and Marketing Activities

Presented: Monday, October 6, 2008 — 2:05-3:15 p.m.

By

Ken Vogel

Ken Vogel is a managing director in the Oil and Gas Energy Practice of FTI Consulting, and is based in the Denver office. He brings a wealth of experience as a government manager, a law professor and an economics professor to issues ranging from the relationship between industry and government to the effects of legal systems on effectiveness and efficiency.

Dr. Vogel was a senior official with the United States Department of the Interior's Minerals Management Service (MMS), Dr. Vogel was principal author of most of the valuation and many other regulations concerning minerals royalties paid to the United States on federal and Indian lands. He organized the MMS Office of Enforcement and led it for 15 years. During that time he negotiated settlements of most of the royalty disputes between the federal government and oil, gas, coal, geothermal steam and other mineral lessees. He led settlements that brought in nearly one billion dollars.

He has prepared briefings for senior officials in the Department of the Interior, the Department of Justice and the Federal Energy Regulatory Commission, as well as to Congressional Committees. He developed policy positions for enforcement, litigation and regulation of mineral valuation and exploration and development. He participated in negotiating a boundary dispute between the United States and a state concerning where federal waters ended and state waters began. He has lent his expertise to marketers and traders of minerals and energy commodities in developing marketing strategies and in negotiating financial arrangements. His work has spanned the energy and minerals industries involving production and marketing of energy and non-energy minerals and the marketing of downstream energy products.

During the course of false claims act litigation between the United States and various major oil producers, he was the lead representative of the Department of the Interior. He was the expert

witness on damages and estimated the damages suffered by the United States. As an expert in the legal and regulatory aspects of minerals disputes as well as a professional economist, he was uniquely qualified to be able to represent his client's interests.

He began his professional career as Assistant Professor of Economics and Adjunct Assistant Professor of Law at the State University of New York at Buffalo. Dr. Vogel published research on the effects of legal systems on economic efficiency. He conducted pioneering empirical research on the effect of legal rules on school finance and on how different property rights regimes affect the efficiency of the industries they regulate. As Associate Professor of Law and Leonard Cohen Chair in Law and Economics at Loyola Law School, Los Angeles, he continued this line of inquiry and extended it to social policy. In both positions, Dr. Vogel advised clients concerning the calculation of economic damages suffered through loss.

Dr. Vogel has authored various articles on property rights, both empirical and theoretical. They have ranged in subject matter from animal trespass to discrimination against persons with AIDS. More recently, he has presented papers on emerging topics in federal and Indian royalty law and economics.

National Oil and Gas Royalty Conference

Dallas October, 6-7, 2008

Recurring Royalty Disputes Involving Gas Gathering, Storage, Location Differentials and Transportation and Marketing Activities

Kenneth Vogel, J.D., Ph. D.

I. Introduction

A. Review History of Price Volatility and Market Changes

B. Many lessees have come to believe that they are not sharing in the price increases of commodities and many lessors have not changed their model for how they pay and communicate → Leads to disputes and litigation

- 1. New litigation has lead to new issues and interpretations**
- 2. New litigation has increased uncertainty**

II. Nature of Disputes – Value and Volume

A. Value disputes are the most common

1. The relation is defined by the lease royalty clause, and implied covenants

a) Nature of the relationship between mineral lessor and lessee

b) Leases have a variety of royalty clauses

(1) Proceeds – net or gross

(2) Market Value

(3) “At the lease...” or “At the well...”

(4) Federal leases give power to Secretary to set value

(5) Production

(6) Duty to market and marketable condition

(7) "Free of cost"

c) Different jurisdictions have interpreted the lease language and the implied covenants in a variety of ways

(1) Market Value – Vela (TX) and Tara (OK)

(2) Proceeds Value

(3) Primacy of lease language or implied covenant – Westerman Farms (CO) and Heritage Resources (TX)

B. Volume disputes have dealt with measurement and fuel use

- 1. Mismeasuring oil in tanks and gas in pipelines**
- 2. Gas used off lease for processing and compression has been claimed to be excluded from royalty volume by lessees and included by lessors.**

III. Recently the major disputes have involved deductions from value when gas is sold downstream

A. Transportation and Gathering

B. Compression

C. Processing and Treating

D. Production Taxes

IV. Much of the recent litigation have involved many leases – either through class actions or *qui tam* or other False Claims Act litigation

A. These disputes can become very fact intensive

B. This requires close examination of specific lease terms, marketing arrangements, royalty payments and differences in gas quality for each of the leases subject to the litigation

V. Conclusion – Ways to Avoid Litigation"

A. Lessors should be sure they have a system in place that assures that they are following the lease terms, as modified by implied covenants.

B. Lessors should look for ways to communicate to their lessees how they are marketing the lease production, how they are paying, and why it is proper.

C. If a dispute occurs each side should understand the factual basis as applied to each lease.

1. Courts have not adopted *per se* rules – don't expect a slam dunk in most cases.

2. Courts have typically insisted that they are examining the facts – both surrounding the lease terms and the marketing undertaken by the lessee

3. If you settle, think about agreeing to a future valuation methodology, including possibly amending the lease, so you are not merely setting up the next round of litigation

4. "Never stir up litigation. A worse man can scarcely be found than one who does this." Abraham Lincoln

