HPP, What is it?

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Before 1995, the price for Osage royalty oil was determined by using the **"highest price paid or offered"** by any purchaser in the area. The current **Highest Posted Price** (HPP pricing) was a result of the, then newly formed, Osage Producers Association suing the BIA about a perceived problem with the **"highest price paid or offered"** royalty price point that had been used for years. It seems this was prompted by one purchaser who consistently offered a higher price than the others, but could only buy a very limited amount of oil (I think they only bought one or two producers' oil).

The BIA fought the claim and the case wound up in the Interior Board of Indian Appeals' (IBIA) jurisdiction, the same government dispute process where the Jech lawsuit now resides.

This dispute was resolved in 1995, but instead of just fixing the problem where the one company had jacked the price up, they came up with the Highest Posted Price process. The problem was "resolved" by setting a minimum volume of oil that must be purchased before that price could be used in the HPP calculation. Prior to this misguided ruling, the basic concept was----that it is all Osage oil to start with and the producers could sell their share of a 42 gallon barrel for whatever price they wish, but the Osages would be paid a very top of the market price for their 5.25 to 8.4 gallons of that barrel. (that's the modern 1/8th to 1/5th royalty range)

The IBIA's "HPP" ruling changed this whole concept. Instead of us always being paid royalty at the highest price anyone could get, our bottom royalty price became the non-competitive, easy to manipulate Highest Posted Price that the purchasers could set anywhere THEY wished, because it has no real relationship to what they are actually willing to pay for Osage oil. Indeed, this price has proven to be at the bottom of the prices paid for Osage oil rather than at the top. HPP is now derived from the list of the posted prices of purchasers buying at least 95% of the oil in any given week. As we saw in Galen Crum's charts, often the actual purchase price is much higher than the fake "posted price." Sometimes it can be lower, however this doesn't happen often. It all depends on what was negotiated.

Had the IBIA merely added the 95% market share concept to the Highest "**Paid**" Price calculations it would have solved the original problem and we would still be getting paid royalty at a top of the true market price. Instead, the producers convinced the IBIA to adopt the current Highest **"Posted"** Price method and the BIA declined to fight this ruling in an actual court, and so thus came the year 2000 HPP Lawsuit filed against the Government.

This "**posted price**," published each day by each purchaser of the oil, by no means limits a purchaser to paying only that price. In actuality, a purchaser can pay a producer any amount they may negotiate with the producer. But we Osages must still live with the HPP as the basis for our royalty.

Then, there is a very real possibility that a few producers have set up "shell" companies to purchase their own oil at the lower HPP prices, pay the royalty on the lower price, and then resell the oil at much higher prices and pay no further royalty at all. A great temptation to pull this kind of shenanigan is created by the wide difference between the HPP price and what is truly the top of the market price actually paid. If all the royalty our producers are required to pay the Osages is at the HPP price, it is more than a little tempting to do any number of possible manipulations that would allow them to not pay royalty at all on the $4 to $10 difference between HPP and the highest actual market price. If true, this ends up being a ton of money that we Osages never got and **will continue to never get** if this HPP system isn't changed.

This is just one way this rip-off can be accomplished. Another way would be to make a deal with the purchaser whereby the oil is sold for HPP price and a "bonus" payment is made sometime later that is not required to be reported to the BIA because it wasn't called "purchase price." And all of these things and more can be done on paper, with the oil actually going directly from the stock tanks to the final purchaser.

There are no doubt many more ways to do this. When it comes to money, the human mind can get pretty inventive. I don't know for a fact that any of this has ever happened here, and I hope I never do. But, I do know that an effort to correct this "temptation" problem was a very real factor in the decision to use NYMEX for the royalty base in the CFR revisions.

By setting Osage royalty prices somewhat closer to the top of the market, they have removed a good deal of the temptation to pull these kinds of shenanigans. The new proposed CFR requirements for better recordkeeping by the Producers will also make this temptation less attractive. Records can be subpoenaed.

The Federal Office of Natural Resources Revenue's (ONRR) auditing and compliance division actually collects millions of dollars in underpayments on non-Osage Federal and allotted lands right here in Oklahoma by catching producers pulling these kinds of stunts.

But, no matter how high the value of the oil becomes to a purchaser, or how much the producer is paid for his oil, under the current system, the minimum royalty due the Osages will always be based on the Highest Price **POSTED** by the several purchasers for each day. **This must change!** The revised CFR's will change it.

The judge in the HPP Lawsuit settled in 2011 found this HPP to be an improper system because it was not a truly fair and competitive pricing system that would reflect the true market for Osage royalty oil. So you see, this is far more than just a few Indian Shareholders wanting a raise in price for their royalty oil. It could arguably be said that the Federal judge, if not mandated, certainly did suggest that this be fixed ASAP. This was not a "judgment," but a "settlement" between the Osages and the BIA, and the settlement was approved by this same Federal judge. Dudley Whitehorn and Cynthia Boone were on the Trust Team. Surely they know what went on and what they agreed to. It's hard to understand why they suddenly don't agree with something they had already agreed to, brought it to the full Council recommending approval, and then recommended that we all agree to, via the poll.

HPP is calculated each day by determining the highest price posted on the previous day by those purchasers who bought 95% of the oil from the Osage Mineral Estate. For example:

On Friday, 9/6/2013, NYMEX closed at -------------$110.20
The following Monday, 9/9/2013, HPP was --------$107.00

On Wednesday, 10/23/2013, NYMEX was ---------$ 97.16
On Thursday, 10/24/2013, HPP was -----------------$ 93.25
Hopefully, it has bottomed out there, but every day is still a roll of the dice.

The price we receive for our royalty oil in Oct., Nov., and Dec. will be reflected in our March payment, so be advised, it doesn't look too good right now, and I don't see anything in the short term future that will make it much better. Cushing NYMEX prices are established based on the worldwide demand for oil coming from this region. We have very little control over this. However, just one gunshot, in the right place, at the right time, even somewhere in the Middle East, could send these prices back up like a skyrocket. More locally, major disruptions in refining capacity, pipeline transportation problems, and many other things can also affect oil pricing. For instance, Coffeyville Refining buys roughly 75% of the Osage oil. That's about 11,000 barrels per day. Heaven forbid, a long-lasting, disaster based shutdown there would no doubt have a huge detrimental effect on our royalty income. Some of this oil could be shipped to other purchasers, but their prices would go down due to the sudden glut of feedstocks, plus, there is not enough infrastructure available to redirect near all of it to other purchasers. If it's any consolation, we are not the only ones with this problem. North Dakota is shipping a lot of their new-found oil several hundred miles. Some of it even goes by rail to the East coast. We've been selling oil here for over 100 years, and over that time we have seen our infrastructure develop along with the production. We will never have all the infrastructure we could use, but we are in much better shape than many others.

Much of the information in this report flows from the public meetings of the Osage Minerals Council and the BIA's Negotiated Rulemaking Committee. Some came from the internet and some was ascertained through personal conversations with Members of the NRC and the Council. Some of it is just common sense put down on paper. Special thanks go to Councilman Galen Crum for making the charts available to us last week.

Ray McClain, Osage Shareholder