January 31, 2000

David S. Guzy, Chief
Rules and Publications Staff
Royalty Management Program
Minerals Management Service
P.O. Box 25165, M.S. 3012
Denver, Colorado 80225-0165

Dear Sir or Madam:

Thank you for this opportunity to comment on the proposed oil valuation rulemaking, "Establishing Oil Value for Royalty Due on Federal Leases."

This rulemaking process, as we all know, has been long and contentious. We continue to believe that any rule should provide for a fair return of revenue to the American taxpayer, while also establishing a clear and reliable payment process for those developing the oil resources of our public lands.

We commend the Minerals Management Service (MMS) for the many improvements that have been made in the current proposal. We appreciate the responsiveness shown to suggestions by industry and members of Congress on transportation issues, as well as on concerns relating to second-guessing of prices received under arms-length transactions. We also commend your efforts toward creating a system for binding determinations that goes a long way toward providing greater certainty for Federal oil lessees, while still protecting the public trust.

Obviously, some areas of disagreement remain between your agency and many Federal oil and gas lessees. We believe that several of these may yet be capable of resolution.

Of particular concern is the decision not to allow outside the Rocky Mountain Region the use of comparable sales or tendering programs as an alternative to index pricing in appropriate non-arms length transactions. We realize that MMS has addressed this issue in some depth in the preamble to the proposed rule, but we believe it merits additional consideration.

We believe that it would be in the public interest to allow lessees the option of applying to MMS, on a case by case basis, for a determination of whether comparable sales, or an approved tendering program, would be an acceptable indicator of fair market value in lieu of index pricing in non-arms length transactions. This option would allow lessees to demonstrate to the satisfaction of MMS that they have an active market at the lease such that there are a sufficient number of sales of crude oil of comparable quality and quantity to allow the sales to be used as a reliable indicator of value for the crude oil on which royalty is due. Alternatively, a lessee could show that it has a plan, containing relevant performance indicators, for developing such a market, such as through a tendering program. MMS, as the administering agency, would retain full approval authority over the adequacy of the proposed alternative. Any determination would have to provide for adequate public notice of the process, and would also have to specify the expiration period for the approved alternative methodology, and/or standards for periodic review to ensure that the taxpayers continue to receive fair market value.

Because MMS has addressed the question of comparable sales in the preamble to the proposed rule, we attach below a more detailed explanation of the reasoning behind this recommendation.

MMS has solicited additional comments on alternatives to the rate of return used to develop a transportation allowance. We believe a reasonable compromise would have the professional staff of the Federal Energy Regulatory Commission (FERC) develop a range of equity return percentages appropriate for the industry. This proposal has been vetted with the FERC at the staff level and through correspondence between Senators Murkowski and Bingaman, the Chairman and Ranking Member of the Energy and Natural Resources Committee, and FERC Chairman Hoecker. Copies of the correspondence are attached.

According to the FERC, a range of reasonable returns on equity could be developed based on an analysis of a group of publicly traded companies in similar lines of business. The FERC analysis, unlike the specific rate case example in Chairman Hoecker's letter, would need to reflect a before-tax return consistent with the MMS model. From the established benchmark range, the return MMS applied in a specific case should then be based on the risk profile of the facilities involved, i.e. a pipeline from a deepwater platform versus an onshore line. FERC staff could perform such an analysis on an annual basis so the calculation of an allowance could be set by MMS for a one-year period. An annual adjustment would be reasonably reflective of market conditions while avoiding excessive administrative burden on MMS and the lessees.

The Standard and Poor's Industrial BBB bond rate, as proposed by MMS, could be used as an industry proxy for the cost of debt. An appropriate capital structure, the debt to equity ratio, could be an industry average reflecting the type of business, i.e. offshore versus onshore facilities. FERC has noted that a typical capital structure for onshore common carrier oil pipelines tends toward one- half debt and one-half equity. Offshore facilities directly associated with production systems tend to be financed with internally generated funds and little, if any, debt. Using industry averages for capital structure would reduce administrative burden as long as such significant differences are taken into consideration in establishing the industry proxies.

The FERC has extensive expertise evaluating cost of capital, but would clearly have no role in the valuation process beyond the rate of return advice used in the allowance for non-arm's-length transportation. We believe this approach would meet the MMS goal to "provide certainty and simplicity while assuring that the public receives market value for its royalty interest when Federal lease oil production."

On other issues, it has been suggested that MMS identify more specifically what will constitute "matters that are inherently factual in nature" under the binding determination criteria contained in proposed section 206.107. Producers would also find useful examples of what "unreasonable" means in the context of proposed section 206.102(c)(2)(ii)(B) ("second guessing"). MMS agreed in the most recent round of workshops that it would be able to provide this clarification. Producers also have stressed the need for more specific guidance on calculating location and quality adjustments when index prices are used in non-arms length transactions.

Finally, we urge the agency to consider extending the effective date of the final rule, or making such other changes as would allow industry time to modify its systems to accommodate the new regulatory scheme.

We recognize that in creating this proposal, MMS has had to balance many competing interests. We share the concerns of the agency that a final rule promote the continued efficient and environmentally sound production of Federal oil leases, while safeguarding the interests of the American taxpayers as owners of the resources of our public lands.

We appreciate your consideration of these comments.

Frank H. Murkowski

Frank Murkowski

Jeff Bingaman

John Breaux

Mary L. Landrieu

Three attachments

United States Senate

COMMITTEE ON
ENERGY AND NATURAL RESOURCES

WASHINGTON, DC 20510–6150

WWW.SENATE.GOV/~ENERGY

Attachment #1

January 31, 2000

The Honorable James J. Hoecker
Federal Energy Regulatory Commission
888 First Street, N.E.
Washington, DC 20426

Dear Chairman Hoecker:

The Minerals Management Service (MMS) has pending a proposed rulemaking to establish the valuation of crude oil for federal royalty purposes, "Establishing Oil Value for Royalty Due on Federal Leases." One of the more controversial elements of the rulemaking has been the calculation of a deduction for transportation service provided by a pipeline affiliated with a lessee.

The MMS's proposed cost-of-service type formulation has been criticized by a number of commentators. Dr. Ken Nowotny, Chairman of the Economics Department of New Mexico State University, specifically critiqued the return on capital aspect of MMS's cost of service proposal. In his comments, Dr. Nowotny pointed out the MMS's failure to evaluate and set differentiated rates of return for the distinct components of a company's capital structure, both debt and equity financed. MMS has proposed a return based on the Standard and Poor's Industrial BBB bond rate for the entire undepreciated capital, but has now solicited additional comments on alternatives that would "provide certainty and simplicity while assuring that the public receives market value for its royalty interest in federal lease oil production." 64 FR 73820 (December 30, 1999)

While MMS has acknowledged it does not have the expertise or resources to evaluate companies' cost of capital, we believe the Federal Energy Regulatory Commission has considerable experience and expertise in the area of rate of return regulation. We would appreciate it if you and your staff would evaluate the transportation portion of the proposed rule with respect to how the FERC's expertise might be applied to develop a resolution of this conflict. Specifically, please evaluate and respond to the following questions:

Q1. In its proposed rulemaking for "Establishing Oil Value for Royalty Due on Federal Leases," MMS is seeking comments on how to calculate capital costs for purposes of establishing oil transportation adjustments for the royalty calculation for oil produced from offshore leaseholds. MMS proposes to use the Standard and Poor's BBB bond rate as the rate of return for all capital costs, and seeks comment on other proposals to use a multiple of that figure. What are your comments on this proposal for establishing a rate of return? In your judgment, is it appropriate to use a bond rating as a proxy for the equity component of capital costs?

Q2. MMS has asked for comment on whether use of a multiple of the BBB bond rate (e.g., 1.5 or 2.0) is an appropriate rate of return. What are your views on this proposal? Aren't there other alternatives that the Commission has used in the ratemaking context that might be appropriate?

Q3. Given that the rate of return element of the MMS royalty calculation has been extraordinarily controversial, and given that the Commission is experienced in assessing fair rates of return on energy infrastructure investments, do you believe the Commission staff would be able to provide information to MMS on the establishment of rate of return for purposes of royalty calculation? Would the Commission staff be able to provide a generic rate of return analysis to MMS for the offshore oil pipelines?

We hope the FERC and its staff will be able to help find a solution to this aspect of the oil valuation rule.

Sincerely,

Frank Murkowski
Chairman

Jeff Bingaman
Ranking Member

Attachment #2

FEDERAL ENERGY REGULATORY COMMISSION

WASHINGTON, DC 20426

OFFICE OF THE CHAIRMAN

January 31, 2000

The Honorable Frank H. Murkowski, Chairman
The Honorable Jeff Bingaman, Ranking Member
Committee on Energy and Natural Resources
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman and Senator Bingaman:

Thank you for your letter requesting my views on the most recent version of the Minerals Management Service's (MMS) proposal regarding the valuation, for royalty purposes, of crude oil produced from Federal leases. Your request involves the transportation allowances recognized as proper deductions in determining royalty value, and, in particular, the MMS's proposed methodology for determining the rate of return portion of the cost of transportation of an affiliated oil pipeline. I have asked staff to review the MMS proposal and to prepare the responses to your questions which are attached to this letter.

Let me preface the staff responses to your specific questions with some general observations. Before the Commission determined in 1992 that it lacked Interstate Commerce Act (ICA) jurisdiction over oil pipelines on the OCS [Bonito Pipe Line Company, 61 FERC ¶ 61,050 (1992), aff'd sub. nom. Shell Oil Co. v. FERC, 47 F.3d 1186 (D.C. Cir. 1995); and Oxy Pipeline, Inc., et al., 61 FERC ¶ 61,051 (1992)], offshore oil pipelines filed tariffs with the Commission, and MMS used the rates in those tariffs in calculating the oil pipelines' royalties. MMS thus relied on the Commission's ratemaking expertise for oil pipelines operating on the OCS as well as onshore. Since the Bonito decision, however, oil pipelines have not been required to have tariffs on file with the Commission for the movement of oil entirely on the OCS. As a result, the Commission staff and the MMS staff have met and talked about methods for analyzing oil pipeline costs, particularly on the OCS. MMS is now proposing methodologies for determining pipelines' costs and appropriate allowances for transportation by an affiliated pipeline for the purpose of calculating royalties.

MMS has held numerous workshops to obtain public input on its rulemaking proposal. Members of the Commission's staff have participated in a number of those workshops and further explained the Commission's approach to analyzing oil pipeline costs. To date, MMS has chosen not to employ any of the Commission's methods for its purposes.

As you know, the Energy Policy Act of 1992 required the Commission to issue new regulations to provide a "simplified and generally applicable" ratemaking methodology for oil pipelines. The simplified and generally applicable way that the Commission adopted for pipelines to change their rates was by use of an index that sets a ceiling rate. Oil pipelines, as an alternative to indexing, also may seek to change their rates based on their cost of service and thereby justify rates higher than a ceiling level. If an oil pipeline company chooses to change its rates through this method, it must participate in a "cost of service" proceeding. For purposes of establishing oil pipeline rates on a cost of service basis, the Commission currently uses a method for deriving a return on equity that involves a discounted cash-flow (or DCF) calculation.

Under this DCF approach, as more fully explained in the attached responses to your questions, the oil pipeline company's actual debt is provided a return based on the individual company's average cost of debt used to finance the pipeline. The equity portion of the investment in the pipeline is provided a return reasonably commensurate with the actual cost of equity financing to the company. The equity return allowance is based on figures derived from published information concerning publicly traded pipeline companies and reflects the risk factors of the investment.

As I understand it, MMS has proposed to use the Standard and Poor's Industrial BBB bond rate as an allowable rate of return on all capital investment. The use of an appropriate bond rate would appear to be a reasonable proxy rate for oil pipelines that are financed entirely by debt. However, most oil pipelines with which the Commission has had experience are not financed entirely with debt. Assuming that equity is generally more expensive, the Standard and Poor's BBB bond rate thus would allow an insufficient return to compensate a pipeline for the cost of equity financing. By recognizing the differing costs of debt and equity, the DCF method yields a more accurate return allowance which compensates the pipeline for its investment, than would using the cost of debt alone. This method is explained in more detail in the attached responses.

The calculation of royalties is a task for the Department of the Interior under its appropriate enabling statutes. The Commission has no statutory role in this royalty calculation process. The Commission's staff does have expertise in rate of return calculations for jurisdictional oil pipelines, and I believe the Commission's staff could contribute to the MMS process to the extent MMS would find our participation helpful. To provide any specific rate of return calculations for MMS on an ongoing case-by-case basis, however, could require a commitment of personnel beyond the Commission's current budget.

I hope that this information is helpful to you. If I can be of any further assistance in this or any other Commission matter, please let me know.

Sincerely,

James J. Hoecker
Chairman

Enclosure

Staff Responses to Questions from Chairman Murkowski and Senator Bingaman

Question No. 1: In its Proposed Rulemaking for "Establishing Oil Value for Royalty Due on Federal Leases," MMS is seeking comments on how to calculate capital costs for purposes of establishing oil transportation adjustments for the royalty calculation for oil produced from offshore leaseholds. MMS proposes to use the Standard and Poor's BBB bond rate as the rate of return for all capital costs, and seeks comment on others' proposals to use a multiple of that figure. What are your comments on this proposal for establishing a rate of return? In your judgment, is it appropriate to use a bond rating as a proxy for the equity component of capital costs?

Answer: The use of an appropriate bond rate would appear to be a reasonable proxy rate for oil pipelines that are financed entirely by debt. However, most interstate common carrier oil pipelines with which the Commission has had experience are not financed entirely with debt. Typically, these projects are financed with roughly one-half debt and one-half equity. The Standard and Poor's BBB bond rate would allow an insufficient return to compensate for equity funding.

In the ratemaking context, the Commission has concluded that providing adequate return for capital investment in regulated energy infrastructure is necessary to induce the private sector investment in prudent maintenance and expansion. The Commission's return calculation, as established in Opinion No. 154-B and subsequent issuances [Williams Pipe Line Company, 31 FERC ¶ 61,377 (1985); SFPP, L.P, et al. 86 FERC ¶ 61,022 (1999)], recognizes that different allowances should be provided for the debt- and equity-financed portions of a pipeline to adequately compensate a pipeline for its investment.

In short, the Standard and Poor's BBB bond rate is reasonable to use as a sector-wide proxy for the cost of the debt component of a petroleum pipeline company's capital costs, but it is not an appropriate proxy for the equity component of the capital costs.

Question No. 2: MMS has asked for comment on whether use of a multiple of the BBB bond rate (e.g., 1.5 or 2.0) is an appropriate rate of return. What are your views on this proposal? Aren't there other alternatives that the Commission has used in the ratemaking context that might be appropriate?

Answer: The use of some multiple of the bond rate could be more appropriate than simply using the BBB bond rate for all capital costs because it implicitly acknowledges that equity costs are higher than debt costs. Before selecting a multiplier, one might compare the BBB bond rate to the calculated rate of return for the relevant group of oil pipelines to see what the ratio is and whether it has been reasonably stable over time. The Commission staff has not prepared any such analysis, and thus has no view as to what the most appropriate multiplier might be. The use of an industry-wide rate of return based on a multiplier of the BBB bond rate would necessarily mask some differences between companies, because it would not provide for adjustments based on actual debt costs or the actual shares of debt and equity financing in a pipeline's capital mix.

For purposes of establishing oil pipeline rates in litigated rate cases, the Commission uses a method for deriving a return on equity that involves a discounted cash-flow (or DCF) calculation. Under this approach, an oil pipeline company receives the actual cost of its debt plus an equity return. The equity portion of the investment in the pipeline is provided a return reasonably commensurate with the actual cost of equity financing to the company. The equity return allowance is based on figures derived from published information concerning publicly traded pipeline companies and reflects the risk factors of the investment. This method, by recognizing the differing costs of debt and equity, yields a more accurate return allowance which compensates the pipeline for its investment, than would using the cost of debt alone.

A preliminary step to the DCF calculation is the compilation of a reasonable proxy list of publically traded oil pipeline companies, and possibly companies in a field similar to the oil pipeline sector (such as natural gas pipelines), to derive average growth rates and average dividend yields appropriate for application to the particular company or group of companies (e.g., the offshore oil pipelines) at issue. The return on equity (k) is calculated to be the current dividend(D), divided by the current market price (P), plus the expected growth in dividends (g). Stated mathematically, $k=D/P+g$. In calculating dividend growth rates, the Commission weights the growth rates 2/3 for the short term growth components, and 1/3 for the long term growth components. The short term components are obtained from the Institutional Brokers Estimate Service (IBES), and the long term component is, under current Commission policy, averaged from three sources: Wharton Econometrics, the DOE's Energy Information Agency, and DAI/McGraw Hill.

The sum of the dividend yields and growth rates for each of the proxy companies once determined is used to establish a range of expected returns for those companies. The business and financial risks facing any individual oil pipeline are then assessed as compared to the proxy companies to determine where that individual pipeline's rate of return should be set within the range of returns for the proxy companies.

An example of the Commission's use of the DCF method for calculating the rate of return of an onshore products pipeline company is the SFPP, L.P. case. 86 FERC ¶ 61,022 (1999). In SFPP's case, a starting rate base had to be determined, which reflected the compromise rate base methodology adopted by the Commission on June 29, 1985 when it issued Opinion No. 154-B. Also the capital structure (the debt and equity portions of the Starting Rate Base) had to be determined, as well as the amortization of the Starting Rate Base once it had been created. (See 86 FERC ¶ 61,022 at 61,087-92 (1999) for the details of this process.)

The capital structure found by the Commission for SFPP was roughly 60% debt and 40% equity. To determine the cost of equity, a range of equity costs for six oil limited partnerships and a similar number of gas pipelines was used. The upper end of the range was 14.85 percent and the lower end of the range was 12.74 percent. Then using the discounted cashflow methodology, the Commission adopted a figure for SFPP's equity costs at 14.27%. (See 86 FERC ¶ 61,022 at 61,099-102 (1999)).

MMS could consider as an alternative using a risk premium approach, wherein the return on equity is assumed to be at a particular percentage point premium above the standard debt rate. This methodology has the advantage of being a simple generic return on equity formula that could be applied to the majority of oil pipeline companies. An overall capital cost would be derived based on the capital structure of the particular company. The selection of a generic risk premium for the offshore pipelines could be reasonably based on an analysis of the debt rates and equity returns using a one-time DCF analysis. The risk premium approach is a fairly easily calculated method for providing adequate compensation for the equity portion of financing.

Question No. 3: Given that the rate of return element of the MMS royalty calculation has been extraordinarily controversial, and given that the Commission is experienced in assessing fair rates of return on energy infrastructure investments, do you believe the Commission staff would be able to provide input to MMS on the establishment of rate of return for purposes of royalty calculation? Would the Commission staff be able to provide a generic rate of return analysis to MMS for the offshore oil pipelines?

Answer: The Commission staff has met with MMS staff on a number of occasions over the past several years on issues related to the calculation of transportation adjustments, and staff continues to be available for further such consultations as appropriate. Commission staff input could be provided to MMS process if MMS would find our participation helpful.

The generic rate of return analyses described above are reasonably straightforward. If MMS chooses to adopt the DCF model or a risk premium model for its purposes, Commission staff would be glad to consult with MMS on their application. In establishing a risk premium or setting a ROE based on the DCF model, some judgment would need to be exercised in selecting an appropriate proxy group. Such a computation could provide a range of equity return percentages from which MMS could judge the risk of any individual pipeline company. If helpful, the Commission staff could prepare the analysis using its experience to inform the necessary judgments.

Attachment #3

ADDITIONAL EXPLANATION FOR COMPARABLE SALES/TENDERING ALTERNATIVE METHODOLOGY OPTION

In the proposed rule, MMS allows the use of comparable sales, or tendering programs, as alternative benchmarks in the Rocky Mountain Region. However, the agency has decided that allowing these methods would be problematic outside of the Rocky Mountain Region, and that for all other areas spot markets form the most reliable indicator of fair market value for Federal royalty payments.

We believe that providing the opportunity for lessees to demonstrate the effectiveness of these alternative methodologies on a case by case basis would retain needed flexibility in the rule. This extended rulemaking process has highlighted the difficulty of undertaking a comprehensive revision of oil valuation methodologies. However, as the preamble to the present proposal notes, the oil and gas market continues to change and evolve. In the past decade, the industry has altered dramatically. Mergers, price volatility, and continually changing circumstances in the international market combine to make the oil and gas market largely unpredictable. Even assuming that spot prices are currently the most reliable indicator of fair market value outside the Rocky Mountain Region, rapid or unexpected industry changes could quickly alter that situation. Changes in the crude oil market could mean that spot prices, like posted prices, come to no longer represent an accurate indicator of fair market value in a given area or field.

Many Federal producers assert that there are situations outside of the Rocky Mountain Region where a truly open market exists, or could easily develop. We believe that it would be in the public interest to allow lessees the opportunity to demonstrate to the satisfaction of the MMS, in a manner visible to the public, that comparable sales or tendering would provide a superior indicator of fair market value for Federal royalty valuation than spot or other index prices.

In rejecting the idea of comparable sales or tendering outside of the Rocky Mountain Region, MMS states that there is insufficient evidence of consistently available transactions of the volume and character necessary to demonstrate the existence of an open market at the lease, and that therefore, under present market conditions, spot prices are the best indicator of the value of production.

MMS has clearly articulated in the preamble to the proposed rule the criteria it believes are necessary to establish the existence of an open and competitive market. Applying these criteria, a lessee would need to show that for particular leases or for a field or area, a sufficient number of sellers exist, no one of which commands an excessive share of production, and that relationships between and among buyers and sellers are arms-length. A lessee must also show adequate price transparency, that is, that buyers are adequately informed about the prices of the various sellers. Lessees must be able to demonstrate the reliability of sales and purchase information. Finally, a lessee would show that a sufficient quantity and quality of production is being sold to make the sales truly open.

As stated above, approval of an alternative methodology would necessarily be subject to specified time limits and a process for periodic reevaluation. We believe it should also provide sufficient opportunity for the public to be informed of the existence of an application, and of its (non-proprietary) contents.

Allowing this option would not require a significant revision of the proposed rule. The rule already identifies and thoroughly analyzes the necessary criteria for a competitive market. The rule allows comparable sales and tendering benchmarks in the Rocky Mountain Region, and establishes a process for guarding against manipulation. The rule also already establishes the acceptability of proposing alternative methodologies and valuation proposals in general, and sets out a means for granting binding determinations on such proposals. It would be reasonably consistent with the existing rule to simply specify that lessees may propose comparable sales or tendering as an alternative valuation method. So long as this is conducted in a manner reasonably open to the public, and fully subject to MMS approval, it should not require any significant new analysis or changes to the rule.

Because industry is often in the best position to identify market changes as they occur, allowing lessees an opportunity to quickly bring new circumstances before the agency does no harm, and is likely to result in a truer approximation of fair market value for the American taxpayer in non-arms length situations. We urge your consideration of this beneficial addition to the rule, and recommend as well the possibility of pilot programs, such as MMS is already conducting with royalty in kind, to further evaluate the potential viability of comparable sales or tendering on a large-scale basis.