Telecon on Rate of Return (ROR) Issues
For Transportation Allowances with Senate Energy Committee Staff
March 31, 1999

Participants

DOI	Senate Energy Committee
Lucy Querques Denett	Shirley Neff
Dale Fazio	Bob Simon
Geoff Heath	Mary Kathryn Ishee
Debbie Gibbs Tschudy	Sam Fowler
Dave Hubbard	
Jim Morris	
Larry Cobb	

Lucy Querques Denett - Started telecon by explaining that it we modify the rule substantially, we have to repropose. This telecon will be part of the record.

Bob Simon - Referenced the 3/1/99 letter from Professor Nowotny and his analysis of how rates of return are determined in the public utilities business. What is our take on his points?

Lucy Querques Denett - Laid out process for addressing our concerns - What are RVD's (Royalty Valuation Division) points? What did we do for the 1988 regulations? What did we do for the workshops?

Jim Morris - Explained that 3rd paragraph is incorrect; we allow depreciation and a rate of return.
- rest is a difference of opinion
- we don't allow income tax
- severance tax doesn't fit into our transportation or processing allowance determination

Our mission is different than that of the Federal Energy Regulatory Commission (FERC). FERC is trying to establish rates to draw people to build pipelines, recover costs, and make a profit. Our mission is much narrower - providing a well defined cost structure under which the costs of transportation can be deducted from royalty.

Dave Hubbard- Regarding the letter, 1st page, 4th paragraph, the rule <u>does</u> offer an option to select depreciation and a ROR, or a ROR on undepreciated investment. It's difficult to correspond cites in the letter to our rules.

Shirley Neff - Looking at page 6130 of the 2/6/98 proposal- §206.111(b)(4) says "use either depreciation or return on depreciable capital investment." Omits clause about getting a ROR when using the depreciation method. (Note: correct cite is (c)(4).)

Dave Hubbard - The provision for ROR under the depreciation method is under paragraph (b)(1).

Taken together with paragraph (c)(4), it's clear that either option is permitted. Lessees have been applying these provisions to get both depreciation and return on investment since the 1988 rules were implemented.

Shirley Neff - The rule should be clearer on this point. Regardless, the rule should provide enough return to reflect a company's weighted average cost of capital. The Supreme Court has addressed the issue of return based on shareholder's equity.

Debbie Gibbs Tschudy - This is a good time to address the BBB basis in our 88 rules.

Dave Hubbard - The previous method used the prime rate for onshore leases and a flat 6% and, later, 8%, for offshore leases. Based on comments on the 88 proposed rules, we considered increments above the prime, multiples of the prime, the cost of debt and equity financing, and other alternatives.

We have a different purpose than FERC. We are trying to target the cost to a company to build a pipeline. We adopted BBB because it represented a medium grade obligation. It was the middle of the range. Also, it would promote administrative flexibility for everyone.

Shirley Neff - question on cost of debt - mid range of what?

Jim Morris/Dave Hubbard - range of creditworthiness of the companies we dealt with. Oil pipelines are not in the same risk category as geothermal exploration and development.

Shirley Neff- would agree, but issue is companies don't always borrow to finance a pipeline - it's financed on equity too.

Dave Hubbard - The 88 study looked at 10 large payors for 1987 and 1982 and compared their weighted average cost of capital to Standard and Poor's BBB rating. For example, in 87 the BBB was 16.38% and the weighted average cost of capital for the 10 companies was 16.56%. In 82 it was 10.66 and 9.97. The objective was to arrive at a simple rate representing the weighted average cost of debt and equity as derived from <u>Value Line</u>.

Shirley Neff- But oil prices vary and there's risk involved. It's not simply a matter of cost of capital. Companies look at what are the risks -- upstream exploration and development, the price risk -- they set high hurdle rates. Although a pipeline has no price risk, one still has to establish a reasonable rate of return to provide for shareholders.

Jim Morris - The question is what is the desired rate of return on equity?

Shirley Neff- All State public utility commissions use this procedure and still get litigated. The question is what would 1 x BBB represent? The cost should include the cost of equity.

Debbie Gibbs Tschudy/Dave Hubbard/Jim Morris - The fundamental difference is we're trying to represent loan rates for building transportation facilities. We're not trying to develop a cost of equity in our rule. It's solely for royalty purposes.

Shirley Neff - Establishing a separate transportation rate for royalty treats other shippers differently.

Geoff Heath - The term "royalty" is not a royalty share of the production, unless you are talking about royalty in kind. The royalty is 1/8 of all the production, not a segment.

Jim Morris/Geoff Heath - There may be a difference among rates, but we're not establishing a rate for the pipeline, only a deduction for royalty purposes. Again, it's not a rate for a portion of the production stream. It's not a rate for someone to charge a third party.

Bob Simon - Does not see the distinction for all practical purposes.

Debbie Gibbs Tschudy - We're trying to determine their actual costs.

Bob Simon - But methodology does not establish a company's actual costs. Isn't the answer to require FERC to step up and do its job - i.e., reviewing FERC tariffs?

Geoff Heath/Lucy Querques Denett/Debbie Gibbs Tschudy - The problem with that is we don't have the resources; we would have to audit all the filing documents; plus file objections.

Shirley Neff - Aren't we doing that in audit now?

Geoff Heath/Jim Morris - No. We audit systems and controls, not each individual computation of transportation rates.

Jim Morris - If it's arm's-length we allow tariffs - there wouldn't be a lot of auditing there.

Bob Simon - Please clarify your position on FERC jurisdiction.

Lucy Querques Denett - It's not our position; it's just the way FERC operates and conducts its business.

Geoff Heath - The workload would be primarily for non-arm's-length transactions, but we don't know the mix of who is arm's-length or non-arm's-length.

Lucy Querques Denett - It would be inappropriate for MMS to declare what it would support in that regard.

Shirley Neff - The issue is how to determine the cost. The MMS method is arbitrary. The MMS doesn't understand the utility rate concept.

Debbie Gibbs Tschudy - We do, but it would reward those companies with bad debt with a higher allowance and it would be too much burden on resources.

Shirley Neff - Those companies are entitled to recover their cost under the utility business scenario.

Bob Simon - Sounds like we agree to disagree. There are two different concepts here.

Debbie Gibbs Tschudy - At the workshops we asked about the return on weighted average cost of capital, including both debt and equity.

Lucy Querques Denett - We have a fundamental difference on what is believed to be a company's cost of capital.

Debbie Gibbs Tschudy - At the workshops, industry proposed using the value of the service instead of the cost.

Shirley Neff - Industry is getting at the point that the return is too low. When you use a debt-related return, you're not getting at what their costs are. Projects are not financed with debt.

Debbie Gibbs Tschudy - Agree, but in the end we get there.

Lucy Querques Denett - We do understand what you want. On Tuesday we can put the proposal on the table. We will also consider Valdean's (Severson) proposal to subtract a tariff from index. That would be an apples and apples method.

Shirley Neff - We're not trying to mandate, just trying to head off litigation.

Lucy Querques Denett - We need to reserve judgement on this until the workshops. I would point out that the independents had little representation there. We need to and plan to get more feedback from them and other interest groups at the DC workshops.

- meeting adjourned