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October 6, 1999

OCT 1999
RECEIVED

David S. Guzy, Chief,
Rules and Publications Staff
MMS Royalty Management Program
P.O. Box 25165, MS 3021
Denver, Colorado 80225

Re: ***Proposed Rulemaking for the Valuation of Federal Geothermal Resources***

Dear Mr. Guzy:

Enclosed are the comments of the staff of the California State Lands Commission concerning the proposed rulemaking by the Minerals Management Service. Should you have questions regarding our comments, you may contact me at 562-590-5205 or mountp@slc.ca.gov.

Sincerely,

Paul B. Mount

Paul B. Mount, II, P.E.
Chief, Mineral Resources Management Division

Enclosure

CALIFORNIA STATE LANDS COMMISSION STAFF COMMENTS ON THE FEDERAL NETBACK VALUATION METHOD FOR GEOTHERMAL

The staff of the California State Lands Commission ("CSLC") is pleased to submit the following comments in response to the August 19, 1999 notice of proposed rulemaking by the Minerals Management Service ("MMS") for the valuation of Federal geothermal resources used to generate electricity.

INTRODUCTION

The CSLC is the governmental agency responsible for issuing leases for the development of geothermal resources owned by the State of California. Its leases prohibit the sale or use of the geothermal resources by the lessee except in accordance with arm's-length sales contracts or *other* methods, which have first been approved of in writing by the CSLC. One such *other* method proposed by a State lessee earlier this year was the Federal netback procedure.

In addition to royalty revenue from State-owned geothermal resources, California is entitled to fifty percent of the royalty revenue associated with Federal geothermal leases within the State, pursuant to the Mineral Leasing Act of 1920, as subsequently modified to include geothermal. The magnitude of this latter revenue is directly affected by the valuation method required by the MMS. Therefore, the CSLC has a genuine interest in the regulations governing the valuation of Federal geothermal resources, and shares with the MMS the common goal of ensuring a fair return for the geothermal resources produced from public lands.

PROBLEMS WITH NETBACK

The recent proposal to utilize the netback method to value the geothermal resources produced from certain State geothermal leases at The Geysers, prompted CSLC staff to analyze the Federal procedure in detail. The analysis disclosed certain problems which ultimately resulted in the CSLC deciding upon an alternative method for its leases. The problems are:

1. The figures that go into the cost rate calculations for the generation and transmission deductions would require extensive auditing on the part of the lessor in order to verify their accuracy and appropriateness. The calculations create a similar problem for the lessee in terms of the time and effort involved in compiling them. This can be eliminated by employing a simpler, more direct valuation method.

2. The netback regulations allow total deductions of up to ninety-nine percent of the gross proceeds. This could result in the geothermal resource value being only one percent of the gross proceeds from the electricity. Such a minimum value seems unjustifiably low. CSLC staff did consider, during discussions with its lessee, modifying this minimum to a more reasonable level, such as thirty percent, but instead chose to eliminate the problem altogether by pursuing another method.

3. The regulations allow a one-time repayment of the royalty share of the costs, less salvage value, to dismantle the power plant and transmission system. CSLC staff believes all costs for dismantling the facilities associated with developing and utilizing the geothermal resources should be borne entirely by the lessee, and not shared by the lessor.

For these reasons, the CSLC decided that a superior method was simply to establish the value of the geothermal resource as a certain percentage of the gross proceeds realized from the electrical power generated from the resource. It is believed this method achieves the two goals identified by the MMS: (1) to reflect market value, and (2) to be easy to apply and verify. A fixed percentage method still requires the verification of gross proceeds, but it greatly reduces the scope of the auditing effort required under the netback method. Therefore, CSLC staff recommends the MMS consider abandoning the current netback procedure in favor of a more concise valuation method.

FIXED PERCENTAGE ALTERNATIVE

A "fixed percentage" method, identified in the MMS's notice as one possible alternative to netback, is precisely the alternative the CSLC agreed to with its lessee at The Geysers a few months ago. The percentage agreed to was established through arm's length negotiations between the CSLC and its lessee, and thus can be considered to represent the fair market value. The actual percentage starts out at thirty-six percent, increasing to thirty-eight percent after one year, then increasing by one-percent annually to a maximum of forty-two percent. The CSLC believes that whether the percentage is fixed, varies with time, or slides with the electrical price, are all issues that could be part of the negotiation process, rather than specified in the Federal regulations.

Prior to negotiating the aforementioned percentages for the State leases at The Geysers, the CSLC determined that a reasonable percentage would be one in the range of thirty-five to forty-five percent. A percentage in this range should yield a level of royalty revenue in excess of that which would have been realized under either the netback procedure or the previous valuation method of a contract sales price, but would not be so high as to make the project uneconomic for the lessee. This conclusion was based on projections made by CSLC staff using its best assumptions of the cost figures applicable to netback, and its best assumptions of future electrical prices in California.

RATE-OF-RETURN ALTERNATIVE

CSLC staff believes the "rate-of-return" method, identified in the MMS's notice as one possible alternative to netback, is an interesting concept. However, it could present an even greater auditing burden than the existing netback method, particularly if the calculations are to be redone on a periodic basis. In order to prepare realistic discounted cash flow projections for both the resource recovery and power plant portions of a geothermal project, a tremendous amount of detailed cost information will required. Besides the workload such an undertaking would present, it raises the issue of the appropriateness and accuracy of the various cost items that might proposed for inclusion in the cash flow analysis. The CSLC has had some experience with this issue in connection with one of its Geysers leases which has a net profit provision. That provision sets up an accounting system to calculate the net profit for the steamfield development, independent of the power plant portion. The lessee pays the State a portion of this profit, on top of the regular royalty. A substantial effort was required in the initial years of the net profit account in order to agree on the actual costs that go into the formula and how they were to be allocated; for example, the portion of road construction and maintenance costs attributable to the steamfield versus the power plant. In addition, the month to month accounting requires a significant effort by the lessee, and reviewing and auditing the figures requires a significant effort by CSLC staff. In retrospect, a simpler method may have provided the State with the same revenue but with less administrative effort.

CSLC staff believes the rate-of-return alternative would be worth considering only if a simpler, more straightforward method were not available. The fixed percentage method appears to be a better choice. However, a rate-of-return analysis may be an appropriate "tool", though not necessarily a requirement, should the establishment of a fixed percentage be achieved through a process of negotiation between lessor and lessee.