United States Senate

COMMITTEE ON
ENERGY AND NATURAL RESOURCES
WASHINGTON, DC 20510–6150

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April 27, 1999

Minerals Management Service
Royalty Management Program
Rules and Publications Staff
P.O. Box 25165, MS 3021
Denver, Colorado 80225-0165

Dear Sir or Madam:

I am submitting the following comments in response to the proposed rulemaking of the Minerals Management Service amending the royalty valuation regulations for crude oil produced from Federal leases.

I would first like to take the opportunity to commend the Department for its efforts in this matter. Because I believe that most of the issues involved in this rulemaking are capable of reasonable resolution, I asked you to reopen the comment period on this rule. I appreciate your agreeing to that request, and believe that the recent public hearings you have held have proven beneficial. From all accounts, these meetings allowed some very constructive dialogue to occur among all affected parties, and resulted in important progress on some key issues.

Attempting to finalize the rule in its present form would not, I believe, move this process forward. In light of the progress that has been made, I urge you to re-propose this rulemaking, and request that you incorporate the following changes.

One issue of great importance to New Mexico's independent oil and gas producers is that, as MMS considers switching to some sort of index pricing system, the agency not "second guess" the arms-length transactions of independents and expect them to pay higher royalties simply because the actual fair market price they received may not equal the index price, or some other price not reasonably related to their transactions. I therefore ask that you add the following language to section 206.102 of your proposed rulemaking of February 6, 1998, 63 Fed. Reg. 6113, 6127. This would involve adding a new section 206.102(c)(3), changing the existing 206.102(c)(3) to (c)(4), and renumbering the remainder of the section accordingly:

"(3) An arms-length price will not be considered a breach of the duty to market solely because it is less than spot prices, NYMEX prices, or other index prices, or prices received in other arms-length transactions."

The allowed deduction under the proposed rule for transportation by an affiliated pipeline, section 206.111, remains one of the most controversial provisions in the rule. Clearly, the Department is attempting to find a relatively simple cost-of-service mechanism to value non-arms-length transportation for royalty purposes. Given the continued controversy, I asked Dr. Ken Nowotny, Head of the Department of Economics at New Mexico State University, to review this provision and provide his analysis of the particular assumptions and methodology. He raises a significant issue on capital structure that needs to be addressed. I am attaching a copy of his letter for the record. I urge you to confer with the Federal Energy Regulatory Commission, the agency charged with establishing rates for interstate utility services, including most pipelines, and develop a proposal that is more consistent with accepted public rate setting practices.

Other issues remain of concern to wellhead producers and others in the industry, including how marketing costs are treated, how lessees can receive binding determinations on valuation issues after disclosure of all material facts, and whether some sort of appropriate comparable sales methodology is possible in regions such as New Mexico and the Gulf of Mexico. I urge you to continue to work toward addressing possible alternatives to your present proposal, alternatives that would replace posted prices with a system that more accurately represents a fair return to the American taxpayer, and that also provides a fair and reliable system of payment for the lessees who produce this important Federal resource.

Ultimately, some issues, such as duty to market, may be incapable of resolution outside of litigation. To the extent possible, it may prove beneficial to segregate these issues from the main rule, and propose them separately so as not to delay the other important elements of this rulemaking.

It is in everyone's interests to move this rule forward as quickly as possible, but I believe no real progress will be possible without a reasonable resolution of these issues.

Again, I appreciate your efforts in this complex matter.

Sincerely,

Jeff Bingaman
Ranking Member

attachment

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March 1, 1999

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

Dear Senator Bingaman:

Thank you for the opportunity to review the proposed Department of Interior rule, particularly, section 206.111. I have been a student of utility regulation for over 23 years, all of my professional career. I have been engaged in training utility professionals since 1978. The Center for Public Utilities at New Mexico State University that I cofounded is one of two training centers sanctioned by the National Association of Regulatory and Utility Commissioners to train regulatory personnel. I have testified before the New Mexico Public Utility Commission and my testimony has been presented before the FERC. On the basis of my experience and my understanding of utility matters, section 206.111, subsections (b) 1, 3, and 4 are fatally flawed on the basis of the logic of capital recovery.

To be consistent with the logic of Supreme Court rulings in ***Bluefield Water Works and Improvement Co. v. West Virginia Public Service Commission***, 262 U.S. 679 (1923) and ***FPC v. Hope Natural Gas***, 320 U.S. 591 (1944), it is understood by regulatory professionals that a privately owned utility must be allowed the opportunity to recover both the invested capital, through depreciation, **and** a return **on** the capital invested. The proposed rule will not provide the DoI with the information necessary to determine whether the pipeline companies are **under** or **over** collecting their invested capital and return.

As I read the proposed rule, the companies are to be allowed to expense **either** depreciation **or** collect what the rule suggests is a return on undepreciated capital. Clearly, if the company were to elect the former option (which they would never do) they would only be collecting the return **of** capital and no return **on** capital. Therefore, given no other choice, they will elect the latter option.

Under section 206.111, subsection (b) 1, the company should be allowed to expense annual depreciation, and thus be allowed a return **of** its capital. Under subsection (b) 4, the company should be allowed to earn a return **on** its **depreciated** original cost investment, that, the original cost of the investment **minus** accumulated depreciation. In this way, the company recovers, through the depreciation, its original investment. Also, the company annually earns a return on the **remaining** capital. After it has recovered all of the investment through annual depreciation, the computation "investment minus accumulated depreciation" leaves a zero balance, and thus no return can be earned further.

Two other items must be addressed.. First, subsection (b) 3 says "State and Federal Income taxes and severance taxes and other fees, including royalties, are not allowable expenses." To the extent that any of the above are legitimate expenses in the operation of the pipeline, this part of the rule seems arbitrary and capricious.

Second, there is the matter of the selection of the rate of return. The proposed rule states that it will be the rate for Standard and Poor's BBB rating. Likewise, this is arbitrary and capricious. Regulated utilities are allowed the opportunity of earning their **own** cost of capital, not some arbitrarily chosen bond rate. Privately owned companies must pay out a return to equity holders as well as bondholders to the extent that equity capital exists in its capital stucture.

There are 3 basic kinds of capital sources, Debt Long-term and Short-term,Equity.....Preferred and Common Stock, Customer Provided Deposits and Payments in Advance of Expense Accrual.

Capital Structure is

The Proportion of each of the aboveIn the Company's portfolio, e.g.,

CAPITAL STRUCTURE

	1989	**1990**	**1991**
Long Term Debt	49.5%	49.8%	49.4%
Preferred Stock	7.6%	7.4%	7.6%
Common Stock	42.9%	42.8%	43.0%

(Source: "Industry Surveys", Standard and Poors)

Average Capital Structure for Electric Utilities

Other than Customer supplied capital, which is treated as a zero cost source, Sources of Capital involve a COST to the firm. Each source of capital has a particular cost, expressed as a petUtility firms are no different. When a utility borrows money for 30 years, with which to build new piece of plant, the utility must pay interest, say, 8.5%.

When a person acquires stock in a utility, they expect a return on the investment, which may be expressed as a percent. The return may be derived in two ways:(1) dividends, and (2)growth in value. But the stockholder must compare the return from buying stock with all of the other places into which a person may put their money The Cost of Capital is the weighted average of all of these component costs.

The weights are determined from the capital structure. For example:

Component	Amount	% of Capital		Cost		Wtd Cost
Debt	$600,000	40%	x	10.0%	=	4.0%
Equity	$400,000	60%	x	13.0%	=	7.8%
Total	$1,000,000	100%				11.8%

Determining precisely what number should be used for the equity cost rate can be a contentious and tedious undertaking, but utility commissions do it every day. There are experts who will provide testimony in a friendly or adversarial setting. In any event, it must be done if the company is to be allowed the opportunity to earn a **reasonable** return on its investment, to be able to attract capital in the future. If this is not done, the company's right to procedural due process has been violated

This has been a rather extended comment. I hope that you have found it useful.

Sincerely,

Kenneth Nowotny
Professor of Economics
Department Head
Director, University Statistics Center