State of Alaska, Department of Natural Resources, Division of Oil and Gas
Comments Regarding Proposed Rule for Federal Oil Valuation

The State of Alaska/Division of Oil and Gas has several concerns regarding the proposal to change the rate of return on undepreciated capital investment. We take exception to the studies commissioned by MMS and by the American Petroleum Institute (API) that appear to suggest rates of return for oil pipelines would be in the range of 1.1-to-1.5 and 1.6-to-1.8 (respectively) times the Standard and Poor's BBB bond rate.

The relevant question, in determining an appropriate return to capital for royalty purposes, is whether the current capital allowance is inadequate relative to pipeline business risk. Consistent with FERC's stand-alone policy, one needs to evaluate pipeline business risk on its own terms. Economic efficiency requires that the cost of capital assigned to a given category of investment be consistent with its inherent risk. To assign a rate of return that departs from implied risk would result in a misallocation of economic resources. Fortunately, there are plenty of market data that is relevant to this question.

If the current MMS capital allowance is inadequate, relative to pipeline business risk, then affiliated producers that own their own pipelines would have incentive to "spin off" the pipeline investment. Further, one would not see new pipelines being built that were wholly owned by the producer affiliate. This is because, from the standpoint of the cost of capital, it would be less costly for the producer to pay a third party a FERC tariff than it would be for the producer to own the asset itself. However, we are not seeing a trend in a spin-off of pipeline ownership; further, new pipelines continue to be built and owned by producer affiliates. In its proposed rule, MMS itself recognizes that about half of all pipeline transactions subject to its royalty provisions are not "arms-length". The rational conclusion is that the current MMS regime does not "under compensate" affiliated pipeline owners for their costs of capital.

The after-tax weighted average cost of capital for integrated oil companies and independent producers has declined 21 percent over the past six years. The decline is fueled by a combination of lower costs of equity and debt. These declines are in step with the observed pattern of decline in the S&P BBB as well as general rates of interest, as reflected in the 10-Year Treasury bond yields (Figure 1).[1] Raising the rate of return from 1.0 times the S&P BBB to 1.5 times the S&P BBB would result in a windfall to industry at the expense of federal and state royalty owners.[2]

The data In Figure 2 compares the return on total capital for selected major pipeline and oil companies. It shows that for investor owned pipelines, a rate of return that is far lower than what FERC allows is still sufficient to attract capital. To be sure, the business climate in Canada somewhat differs than that in the US, but the differences would seem to not be so great as to render the comparison invalid.

[1] The S&P BBB rate declined by only about 9% during the same period.
[2] Since this rule change is relevant to producer-owned, affiliated pipelines it is important to note that, in addition to lower cost capital, the upstream industry segment has enjoyed an extended period of relatively high crude oil prices, which further boost real industry financial performance.

Figure 1. 10-Year Treasury Bill and
Standard and Poor's BBB Corporate Bond Yield
1971-2003

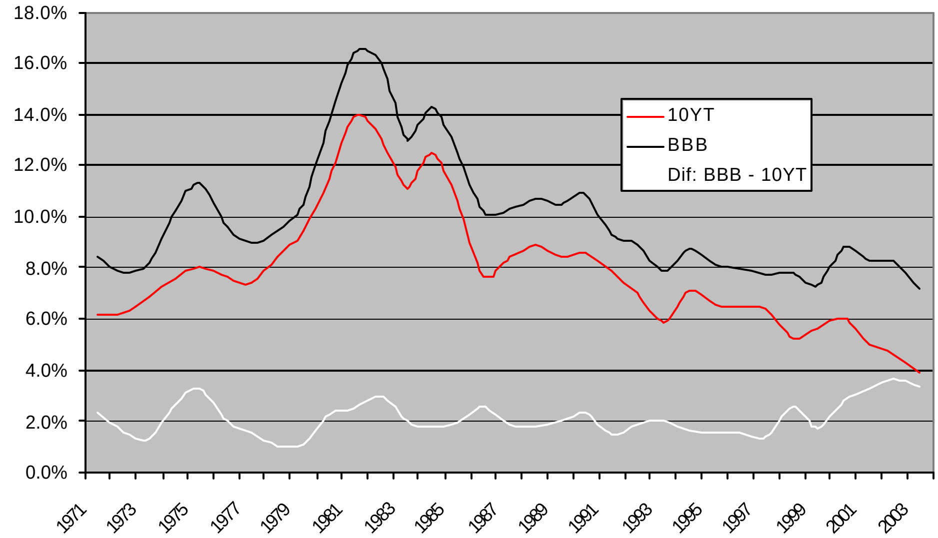
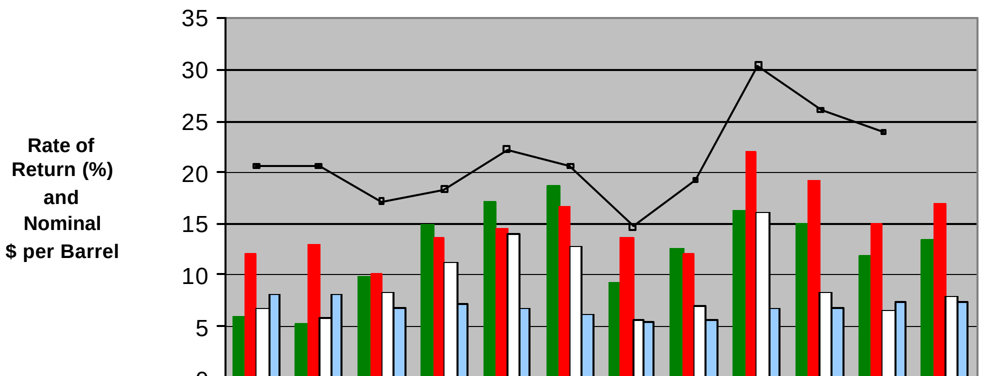


Figure 2. Value Line Return on Total Capital
for Selected Major Pipeline and Oil Companies 1992 - 2003



	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
BP	6.0	5.3	9.8	14.9	17.2	18.7	9.3	12.7	16.3	15.0	12.0	13.5
PHILLIPS	12.2	13.0	10.3	13.7	14.5	16.6	13.7	12.1	22.0	19.2	15.0	17.0
EXXON MOBIL	6.8	5.9	8.3	11.2	14.0	12.8	5.7	7.1	16.2	8.3	6.5	8.0
TRANSCAN PIPE	8.1	8.1	7.0	7.3	6.7	6.3	5.5	5.7	6.7	7.0	7.5	7.5
WTI ($/Bbl)	$20.55	$20.55	$17.13	$18.43	$22.13	$20.60	$14.70	$19.25	$30.30	$26.07	$23.84	

From the standpoint of risk, the S&P BBB is the threshold rate of return that distinguishes investment grade ratings from non-investment grade or high-yield “Junk” bond ratings. Thus, under the current rule, pipeline affiliates of integrated oil and gas companies are assigned rates of return consistent with “medium” investment creditworthiness, one notch above junk status. This medium investment grade category implies medium level of risk that is reasonably consistent with risk associated with pipeline investments because, unlike upstream investments, they are conditional on discovery and reserves development. Pipeline investments have less risk compared with more-speculative, upstream industry segment.

Rating Services and Investment Grades

	Moody's	Standard & Poor's	
Highest Quality	Aaa	AAA	Investment Grade
High Quality	Aa	AA	Investment Grade
Upper Medium	A-1, A	A	Investment Grade
Medium	Baa-1, Baa	BBB	Investment Grade
Speculative	Ba	BB	Not Investment Grade
Highly Speculative	B, Caa	B, CCC, CC	Not Investment Grade
Default	Ca, C	D	Not Investment Grade

Source: Fidelity Investments

We conclude that the 2000 rule regarding undepreciated capital investment for non-arms-length transactions is adequate and should not be changed.