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October 15, 1999

Mr. David S. Guzy
Chief, Rules and Publications Staff
Minerals Management Service
Royalty Management Program
P.O. Box 25165, MS 3021
Denver, CO 80225

SUBJECT: Netback Procedure – Geothermal Resources

Dear Mr. Guzy:

The Northern California Power Agency (NCPA) welcomes the opportunity to respond to the request for comments from Minerals Management Service (MMS) regarding the use of the netback procedure to value geothermal resources.

NCPA is a joint powers agency that is owned by a membership of 11 separate cities with publicly owned electric distribution systems, one irrigation district, one public utility district, one port authority and a rural electric cooperative. NCPA distributes the electricity it produces to its owners/member cities at cost, rather than selling it, and consequently NCPA has had no sales revenue from its electrical generation.

For the years 1986 through 1998, NCPA paid approximately \$54,000,000 in royalties to MMS on behalf of all its geothermal facility participant owners. All those royalty payments were based on the steam being valued in accordance with the steam sales contracts signed in 1977 and 1980. This payment method has been in continuous use even though the actual sale of steam ceased in late 1985, when NCPA bought the steam wells that supply its geothermal power plants. During the period of 1985 to 1998, the price paid for electricity generated at The Geysers dropped from a high of nearly \$70 per MWh to as low as \$15 per MWh.

When the netback procedure was introduced by the MMS in 1988, as the preferred method to value geothermal resources not sold under an arms-length contract, we were not able to switch to the new valuation method. NCPA and MMS were unable to clearly establish an appropriate market value of the electricity being produced, as it was being used exclusively by the public agencies for their customers. Consequently, NCPA's royalty payment rate on steam production continued to rise after 1988. Meanwhile, others' royalties fell along with the price of electricity. This resulted in the NCPA project owners collectively paying royalties to the MMS at a rate twice

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as high as private companies that were selling their steam to PG&E. The net result is that NCPA contributed to MMS \$22,700,000 more than it would have if it had paid royalties at the same average rate of the others that were performing identical operations on neighboring BLM lands at The Geysers.

However, with the passage of AB 1890, the deregulation of the California electric market removed the previous pricing problem. Electricity prices are now posted each day by the California Power Exchange. These prices establish the value of electricity within each geographic region. With this change in March 1999, NCPA was able to initiate use of the netback procedure to calculate royalty payments based on electricity value, on behalf of its members. We expect that by the use of the netback procedure our future geothermal royalty payments will be less than previous over the near term. In the long-term, the royalty payments will rise as the price of electric power increases.

We believe the netback procedure is a fair method of valuing geothermal steam production. It reflects the now deregulated electric market. Royalty payments will rise in the long-term as deductions, such as depreciation are exhausted and rise and fall with the electric market prices. In fact, based on the increased NYMEX future price of electricity for CY 2000, it is estimated that NCPA will pay close to \$1,000,000 in geothermal royalty. Furthermore, the netback procedure allows our public utility to compete in the open market and allows for the production of clean geothermal energy. We now know of no reason why the netback procedure of valuing geothermal resources should be significantly changed or entirely eliminated in favor of some alternative method of valuation.

However, we certainly do understand the recent concerns expressed by local government, specifically those voiced by Lake County. Furthermore, we equally understand the statutory requirement for the MMS to receive an equitable return for the use of the geothermal resources obtained on BLM lands, a concern recently expressed by the California Congressional Delegation. Lake County has asked for more stability in the rate that their share of the royalty payments be received, which on a monthly basis can vary from less than \$10,000 to more than \$50,000. Certainly there are ways to better levelize their income, and we are prepared to work with the MMS and others to select a simple methodology to achieve this reasonable goal. We do not believe that to reduce the variability in the monthly royalty payment would require a rule change. The present regulations allow for the implementation of a methodology that will reduce payment variability. This method was described at the Public Workshop held on October 7, 1999. The method is based on annual average NYMEX future electricity prices.

The other issue is whether or not the total amount of royalty payments presently being paid annually to the MMS for the use of the public's geothermal resources is truly fair and equitable. The most analogous operations are those of the oil and gas industry, and the royalties being paid by that industry can be directly compared to those being paid by the geothermal industry. The most recent available data indicates that in 1997, the MMS received an average royalty payment of 5.15% of the value of the onshore oil produced in California, while it received an average royalty payment of 11.77% of the value of the geothermal resources produced in California, more than

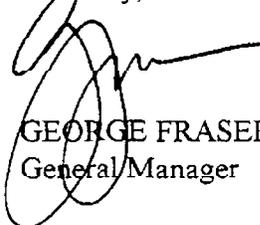
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twice that of the oil and gas industry. This is a startling fact, given the present need to encourage the economic use of the country's renewable resources. This fact also clearly demonstrates that the geothermal industry is already paying more than its fair share of royalties on the public resources that it is using, and that there is no rational argument that it should be forced to pay at higher rates than it already is.

Our final comment relates to the "rate-of-return" method, which is one of the valuation alternatives suggested in the Advance Notice of Proposed Rulemaking published in the August 19, 1999 Federal Register. That method would use discounted cash flow analyses to determine a resource value that yields the same rate of return for both the resource recovery and the power plant portions of the geothermal project. Title 30 of the United States Code states that "geothermal leases shall provide for... a royalty of not less than 10 per centum or more than 15 per centum of the amount or value of steam, or any other form of heat or energy derived from production under the lease and sold or utilized by lessee..." NCPA's leases provide for a royalty based on the value of steam, or any other form of heat or other associated energy produced... by the lessee." The underlined language requires that royalties be based on the value of a lessee's steam alone, not that they be determined in part by the rate of return on its power plant. Expenses associated with the power plant are simply costs that can be measured and must be deducted from the value of electricity to determine the value of the steam field.

As explained above, NCPA is prepared to work with the MMS and others to select to ensure an equitable rate of return on its geothermal resources and to stabilize the monthly payments from those royalties that Lake County receives. But NCPA and its members need to be afforded the use of regulations that conform to the applicable statute and that will enable it keep geothermal electricity competitive in California's rapidly changing electric market.

Sincerely,



GEORGE FRASER
General Manager

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Via Fed Ex