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MINERALS MANAGEMENT SERVICE ROYALTY MANAGEMENT PROGRAM DOCUMENT PROCESSING SEC.
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The State of New Mexico Taxation and Revenue Department appreciates the opportunity to comment on the Minerals Management Service (MMS) proposed Federal Gas Valuation Rule published in the Federal Register on July 23, 2004. The Taxation and Revenue Department participates in a cost reimbursement audit contract with the Department of Interior, Minerals Management Service and has extensive knowledge and understanding of gas valuation as it applies to Federal royalties. We offer the following comments to the proposed amendments to the existing regulations governing the valuation of gas for royalty purposes produced from Federal leases.

Use of Publicly Available Spot Prices and Location Differential

We do not feel that the use of publicly available spot market prices for natural gas are a true representation of arm's-length market value due to the inclusion of non-arm's-length sales within the index. History has shown that these spot market prices can be manipulated and there is no certainty that there are enough controls to support the overall accuracy of the volumes and price derivatives that support the make-up of these prices. Based upon our historic participation in a Federal Royalty Natural Gas Valuation Committee, we found that the location of spot market prices was not consistent from producing area to producing area. Also the location differences between the location pricing point and the lease was complex based upon the availability of transportation opportunities and there was no common agreement between parties involved in the committee because of opposing interests.

The second point related to commenting on the use of spot market indexes is that the MMS has historically argued that the market value associated to the sale of natural gas is represented by the first arm's-length sale from the Federal lessee. We propose that MMS should publish totally new Federal gas rules, which require that the Federal lessee price natural gas and associated products based upon their first arm's-length sale.

It's interesting that the MMS is requesting comments on the use of price indexes when our experience has shown that the majority of major producing lessees are tracing their natural gas sales to the first arm's-length transaction when valuing such products for Federal royalties. We feel that if the lessee can trace their natural gas production to a first arm's-length sale, then all production and sales for all products should be traced to their first arm's-length sale and those sales should be used for valuation.

Written agreement between the lessee and the MMS Director

While we understand and agree with the intent to provide flexibility between both the MMS and the lessee, we have concerns as it relates to the potential of overriding the regulations and the attempt to "at least" approximate the royalty value for the production that would apply under these regulations. If MMS is to move forward on this proposal, we ask that this proposal specify that any written agreements will have the full participation of any State interest and that the written agreement will have a signature representing the State's approval.

Determination of Transportation Allowances

1. Rate of Return Increase on Transportation Systems

   We do not think that a rate of return should be included as a cost factor in a calculation of transportation cost for non-arm's-length transportation arrangements. We feel that this rate of return is a profit element, and the Federal government already recognizes this element, by the lessee's receiving a working interest share (for example 7/8's of the product) and the Federal government retaining a royalty interest (for example 1/8 of the product). We are not aware of any entity that invests in a business operation that is allowed to recognize a separate rate of return on that investment as an expense/deduction/allowance on a financial statement or tax return. However, we feel that they should be allowed their actual cost of debt to finance the operation.

   If the MMS moves forward on this proposal, we propose that MMS only apply the rate of return to non-arm's-length transportation arrangements as it relates to Federal offshore production. If this is moved to onshore, it should apply to new transportation facilities only, and current and existing facilities should have the current regulatory BBB rating. We don't feel that the risk involved in an onshore transportation system is as great as an offshore system and from the statements made within this proposed rule, it appears that all of the studies included in this proposed regulation change apply to offshore transportation only.

2. Rate of Return Increase on Processing Systems

   From our comments above, we do not think that a rate of return should even be recognized. However, if the MMS is not willing to make this change, we do not feel that a rate of return increase should be recognized in the non-arm's-length processing cost calculations. We feel that the investment risk as it relates to onshore processing plants is not as great as a transportation system.

3. Actual Cost exception – FERC / State Agency Oversight

   Anytime the FERC or State agency is reviewing the tariff, they are looking at it from their business perspective. The MMS doesn't have the same business perspective and by moving to the acceptance of these tariffs, it moves away from their long-standing position that non-arm's-length transportation arrangements be based on actual costs. An approved tariff has the potential to include a greater profit margin than is currently allowed in the regulations. Also, FERC could change their requirements as to the information in their approval process in allowance rates and MMS would be held to recognizing this change without any ability of oversight.

4. Cost of Securing a Letter of Credit

   We feel that if you move forward on allowing this as an allowable cost, it further erodes the valuation associated to the Federal government's royalty share and in reality increases the profit margin associated to the working interest (standard 7/8's share) that is provided the producer. As MMS identifies in their proposal, this cost is actually a service fee and it has been MMS's historic position that service type fees are associated to the lessee's responsibility to market the production at no cost to the lessor.

5. Theoretical Line Losses

   MMS should only allow actual direct reasonable transportation costs to be deducted. Not only are line losses indirect costs they are a direct result of metering differences and very inaccurate and as such should not be an allowable deduction carved out of the royalty owner's interest. As MMS identifies, these are theoretical in nature and by allowing a theoretical cost to be an allowable deduction, it removes any oversight or ability to question how these costs are derived.

6. Other Identified Non-Allowable Costs

We support the clarification provided by the MMS in clarifying the specific types of transactional costs that are not allowed.

In conclusion, we appreciate the efforts that the MMS went through in having workshops and providing the opportunity to participate throughout the process and we feel that the MMS is moving in the right direction as it relates to defining what specifically is allowed and not allowed from a cost deduction perspective. However, we feel that the MMS missed in the opportunity to provide regulations in all issues as it relates to the valuation of natural gas. We feel that a concerted effort should have been made in resolving the benchmark process pertaining to valuation of natural gas and related products which are sold in non-arm's-length transactions by proposing regulations that supported the historic federal position and most recent arguments as made in the Fina litigation and costs and allowable deductions as it relates to specific situations (i.e. coal bed methane production, processing of natural under keep whole agreements).

Sincerely,

Jan Goodwin
Secretary