

percent of the oil to its refinery in New Jersey. Under the current regulation, the lessee must come to MMS for advice as to how to value the portion of the oil transported to New Jersey. Under the proposed rule, to determine the value of that 20 percent, the lessee would calculate the volume-weighted average of the other two dispositions. In this example, the volume-weighted average =  $((.35 \times 26.50) + (.45 \times 27.00)) / .8 = \$26.78$ . The value of the 20 percent transported to the lessee's refinery would be \$26.78.

MMS seeks comments on this proposal as well as comments on whether 20 percent is a sufficient volume on which to base the value of oil that the lessee could not otherwise value under the current rule. MMS selected the 20 percent figure for this proposal because it is greater than the royalty percentage under the typical offshore lease (16 $\frac{2}{3}$  percent).

Paragraph (c) of proposed section 206.112 addresses the situation where the lessee does not transport or exchange at least 20 percent of the oil to a market center. The lessee would use paragraph (a) to value the less than 20 percent portion (if any) that the lessee transports or exchanges (or both transports and exchanges) to a market center. For the remainder of its lease production, the lessee must come to MMS with a proposal for a location and quality differential between the lease and the market center. If MMS approves a different differential, the lessee would have to adjust its previously reported and paid royalties, together with an interest payment or credit. The lessee would use the WTI differential to adjust between the market center and Cushing.

Finally, the current rule is not clear about all situations in which a quality differential would be appropriate. For example, a lessee could transport its oil from the lease to its refinery at a market center, but its oil may be of a higher gravity and a lower sulfur content than the crude for which a price is published at the market center. In this situation, the lessee should make an adjustment for quality even though it has no exchange agreement or quality bank to use to make the adjustment. MMS proposes that in such circumstances, a lessee would use appropriate posted price gravity tables to adjust the value of its produced crude for gravity differences from the market center benchmark crude, and use a factor of 2.5 cents per one-tenth percent difference in sulfur content to adjust for quality when it has neither exchange agreements nor quality banks to fully adjust the quality of its oil to that of the crude oil at the market center. MMS has based this

factor on its understanding of common sulfur bank adjustments for California. For instance, MMS understands, from its RIK program, that the All America Pipeline uses a sulfur adjustment of 50 cents per percent, after the first percent difference in sulfur. MMS believes that the typical sulfur content of oil produced from Federal leases is in the one to three percent range. Therefore, MMS' use of 2.5 cents per 0.1 percent sulfur difference would be similar to the factor used by the All America Pipeline. MMS believes that the ability to use a sulfur quality adjustment is a concern in California, but is seeking comments on whether producers in other parts of the country would find it useful as well. MMS also seeks comments on whether these are reasonable differentials, both for California and the rest of the country.

#### *D. Transportation Cost Issues— §§ 206.110 and 206.111*

##### **1. Proposed Change to Rate of Return on Undepreciated Capital Investment — § 206.111(i)(2)**

MMS is proposing to amend the regulations governing calculation of actual transportation costs in non-arm's-length situations by changing the allowed rate of return on undepreciated capital investment. In 1988, MMS determined that the appropriate rate of return was equal to the Standard and Poor's BBB bond rate. MMS explained its choice as follows:

The MMS has examined several options relating to rate of return and decided that a rate of return should be closely associated with the cost of money necessary to construct transportation facilities. The MMS has examined the use of the corporate bond rate very carefully and has concluded that such rates are representative of the loan rates on sums of money comparable to that expected for the construction of transportation facilities.

There is no doubt that there are some very high risks involved with some oil and gas ventures, such as wildcat drilling. However, the risk associated with building and developing a pipeline to move oil that has already been discovered is a much different risk. The risk of default (financial risk) is considered in corporate bond rates. Considering the risks related to transportation systems, a rate of return based on an applicable corporate bond rate would be appropriate for transportation systems.

53 FR 1213 (1988)

In 2000, when MMS revised the oil valuation regulations, MMS explained why it would continue to use the Standard and Poor's BBB bond rate as the rate of return for transportation allowances:

The fact that a lessee's overall operations are funded historically by some proportion of debt and equity does not imply that the resulting aggregate weighted average cost is appropriate for determining a proper transportation allowance for royalty purposes. \* \* \* MMS's research indicates that most recent pipeline investments are financed largely through debt rather than equity. For those pipelines financed entirely by debt, the BBB bond rate is a very favorable rate \* \* \*

The industry proposes using a weighted average cost of capital. \* \* \* [W]e agree with industry's proposal to calculate a before-tax rate of return. Royalties are calculated before tax, so the rate of return used should be before-tax rate as well. \* \* \* Even if, arguendo, we accepted the premise of using a weighted average cost of capital as the rate of return, MMS has found, using more appropriate SIC codes, tax rates, debt rates, and equity rates, that the average cost of capital is much lower than the 2.2 times BBB that industry calculated. MMS therefore concluded that industry's proposal is not well founded. \* \* \* [S]ince the BBB bond rate is adequate as a rate of return used in calculating actual transportation costs for royalty purposes, there is no need for MMS to utilize the expertise of FERC staff to develop costs of debt and equity.

65 FR 14051

MMS believes that a market-based cost of capital is needed to reflect accurately the actual and necessary costs to owners of transportation systems. The capital costs, in addition to operating and maintenance expenses, must be accounted for in calculating costs. Capital costs are normally accounted for by allowing depreciation plus a rate of return on undepreciated capital investment.

Industry has challenged the 2000 rule as allegedly arbitrary and capricious in the lawsuit cited earlier. Among the challenged aspects of that rule is whether the Standard and Poor's BBB corporate bond rate is sufficient as an average rate of return on transportation capital investments. The 2000 rule also eliminated the exception allowing lessees to use tariffs filed with FERC as a transportation allowance in lieu of calculating actual transportation costs. Consequently, after June 1, 2000, calculation of actual costs, and the use of the rate of return as part of the calculation, was required of all lessees who did not have arm's-length transportation arrangements. The judicial challenge to the 2000 rule has led MMS to reconsider whether BBB is a sufficient rate of return.

When MMS promulgated regulations to value geothermal resources in 1992, MMS believed that the return on capital needed to compute properly a deduction for the costs of generating electricity should be the weighted