Stranded Gas Hearings

(0409011545 Minutes)

Sales of State Royalty Gas – The Texas Experience

Richard Bone, Director, State Energy Marketing Program, Texas General Land Office, September 1, 2004.

RICHARD BONE, Director, State Energy Marketing Program, Texas General Land Office (GLO), offered a [PowerPoint] presentation and said that he would speaking about Texas's "take in-kind" program, public customer gas program, and state power program. He went on to say:

> The take in-kind program ... was started in 1983 through state appropriations bills. The program operates by taking royalty payments in [the] form of production instead of receiving monetary payments. The program then sells the mineral interest, oil or gas, to customers, either retail customers or wholesale customers. The program contracts out with mainline transportation and local distribution companies throughout the state of Texas. What I mean by that is, we hold approximately 26 different contracts with either intrastate, interstate, or local distribution companies to get service all the way to the end users.
>
> Natural gas value is established by using ... location differential pricing points around Texas that are then equated back to ... Houston ship channel [prices]. In Texas we have several receipt points for natural gas ... or oil, and ... one of those points is very liquid, which is Houston ship channel. So basically we have production in West Texas, South Texas, some in the Panhandle, and some in East Texas. What we do is, we've [taken] historical differentials off of each one of those locations and did a comparison back to [Houston] ship channel [prices] to try to arrive at a price for the sale of the product. ...
>
> Oftentimes, the product price is actually lower than NYMEX. In 1983, state agencies were directed to reduce their utility cost by buying lower priced gas that was being produced on state lands - that was one of ... the effects of the whole bill. [General Land Office] contracts went into effect in 1985 for state agencies; in 1985 we had contracts with 33 state agencies. That included our largest customers which [were the] Texas Department of Criminal Justice, [the Texas Department of Mental Health and Mental Retardation (TDMHMR), the Texas Department of Public Safety (DPS), and the Texas Department of Transportation (DOT), among others].

MR. BONE, referring to his presentation, said:

> This is a list of some of our producers that we actually have agreements with to take natural gas and oil from; all these producers are either on state lands or in what we call the "8(g)" territory, which is a [common] royalty share territory between Texas and the U.S. government. [With regard to the] type of contracts, we use several different types. One is [an] "interlocal" contract; that's between the General Land Office and other sister agencies or other state agencies such as universities.
>
> The second one is [an] interagency, which is between state agencies. You'll notice there that [it says] "Last Look" ...; what that means is ... [that] the General Land Office has the right to look at the contract prior to it being signed by any state agency to see if we can get a better deal for them. If they go out for an open bid and we believe our gas can be sold cheaper and [transported] ... to them cheaper, then we have the right to come in and actually bump the competitive bid and take the business. We do [North American Energy Standards Board (NAESB) contracts], which is a standard in the gas business these days.
>
> One of the questions that was asked of me was who negotiates contracts for the General Land Office. The staff has traditionally always negotiated all contracts for the General Land Office. We more or less take care of the day-to-day business, we "notice up" the oil producers for natural gas and oil, we work with the agencies, we work with our wholesale customers [and] our buyers of our excess natural gas and oil, and then, when it comes down to it, we send it up for the commissioner for signature. ... Who are our wholesale purchasers? Some of the larger names in

Texas: "Reliant, Houston Pipeline, Energy Transfer, Kinder Morgan, Formosa, CrossTex, Trammo." "Trammo, Plains, [Sunco], and Sempra" are our oil buyers - they're the ones that buy about 750,000 barrels of oil a year from us.

MR. BONE, on the issue of pricing models, said:

> Over the last three years, our pricing model has changed significantly. I was hired three years ago ... and my job at that time was to treat the program and try to make it more like industry. In other words, [mirror] ... the current marketing practices [of] the natural gas business and the oil business. When I came on board, ... the model we had was, basically, we would just sell it for a price equivalent to what we were getting [in] royalty payments. Part of the legislative appropriations bill stated that we were actually supposed to enhance that value - not just take it, but actually enhance it.
>
> The way we did that is through several different methods. One, we streamlined transportation agreements all across the state with a network of pipelines to try to get our gas from one location to another in a cheaper way, maybe by swapping it from one location; [for example], ... if we had gas in far South Texas ... [and] "Kinder Morgan" ... needed that gas to go into Mexico, then we would ... swap that gas ... [to them and they would] give it back to us at Katy, which is a more locational sensitive point for us to get to our customer base.
>
> With that said, we continued to move from there and we went to a market-based pricing. And what I mean by that is, ... we actually looked at the market, we trended what the current marketing companies were doing in Texas ..., and we really went after that same type of market. So what you actually have is ... a state agency more or less competing in a deregulated market .... We also used ... differential base pricing points. ... [And] a lot of our product is competitively priced; in other words, ... we don't have a lot of our gas exposed to high-risk maneuvers in the gas market, we're not in the business to speculate on what it may be ... six months from now.
>
> Our fiduciary duty for the [General] Land Office is directly to the [Texas] Permanent School Fund, so we have to be as risk adverse as possible. And the other ... pricing model ... is "request for proposal" [RFP] pricing: we'll actually go out once a year to sell our oil. We have some very specific things we do with our oil; we sell our oil to the four [entities] that we mentioned earlier, and ... we ... ask them to ... give us the payment in natural gas at a point that we request ....

MR. BONE, on the issue of annual revenue, referred to his presentation and said:

> You can see that we've grown somewhat. In [fiscal year (FY)] 02, there was a drop, more or less, in the market ... for natural gas and oil prices that somewhat ... put a dent in the program ... [though] volumes were still up. The percentage point on the right-hand side of the screen actually represents the percent royalty versus "take in-kind." In other words, ... in FY 01 we took 45 percent of our natural gas in-kind versus [55] percent in royalty. ... Total gross production for the state of Texas is about ... 150 bcf on state lands. Of that, we take approximately 15 percent. That's about [an] average royalty.
>
> [With regard to] annual volumes, you see [that it has] significantly increased from FY 01: 16 bcf; 788,000 barrels of oil. Our oil program, because of the reservoir activity in Texas, has ... been dropping fairly steadily. ... [We're still] doing a lot of exploration; however, the reserves we're finding are a lot smaller and they're ... being depleted a lot quicker. Expected gas for FY 04 is about 36 bcf, so basically what we've done since FY 01 [is] ... more or less doubled the size of the program as far as gas. How do we pay for this program? ... What we do is we ... have an administration fee; we actually charge a fee of [$.03] ... on every mmBtu of gas that goes through our program, whether we buy it in the market or whether we take it in-kind.
>
> In addition to that, we charge a [$.05] per barrel ... administration fee. What that does is it goes to our comptroller and then it's redistributed to the general land office for it's administrative program during the year, specifically for the state energy marketing program. [With regard to] state energy marketing customers, we have a wide spectrum of customers. We supply gas ... and electricity to city and county governments, school districts, and other customers. ... From the gas side, we now

serve about 587 meters at 24 universities, 2 school districts, 1 city, 39 prisons, and 18 state agencies. ... I would say we're the largest supplier of natural gas to public retail customers in Texas. We sell gas or oil to 10 wholesale companies or oil companies and over 26 pipelines and [local distribution companies (LDCs)]. ...

MR. BONE added:

In 1986, we took approximately 2.2 bcf of gas, [and] we saved state agencies over $1.1 million. In 1991, the legislature expanded the program to give us the last look that we talked about earlier. In FY 03, ... the annual volume was 25 bcf, total ... gross revenue was $119 million, and savings to our ... public retail customers ... was $62 million a year.

MR. BONE relayed that the state power program was authorized in 1999 by the 76th legislature via a comprehensive electric restructuring bill. This included authorizing the state power program to sell electricity via exchanging minerals from state-owned lands for electricity. He went on to say:

We started that program a full year and a half before deregulation in Texas; it's been very successful. The state power program ... began in June of 2000, full competition started in January of 2002. The mandate within the [legislation] ... says that we must take in-kind royalties from state mineral production, maybe convert it into other forms of energy, including electricity, for sale to public retail customers. ... Let me define public retail customers: that is a city, county, ... school district, ... university, or other state agency. More or less, any taxing entity in Texas, we have the right to sell electricity to. We don't sell electricity to [restaurants, for example, only to entities] where public tax dollars are used to pay the bills - that's all we do.

MR. BONE relayed:

These royalties are also defined as royalties from [Permanent] University Fund lands - ... in Texas we have a Permanent University Fund administered by the "UT systems," which basically takes control over the oil and gas on lands that have been granted to the universities - and also [from] ... the Outer Continental Shelf known as the "8(g)" and that's the common area I talked about earlier that's shared between the state of Texas and the federal government - it's a three-mile-wide strip on the edge of our territory.

The program objectives [were], one, to increase revenues to the [Texas] Permanent School Fund, which we have done to the tune of about $32 million since 1999 - that has been what we've contributed as far as electricity proceeds - [and] 100 percent of the proceeds go directly back to the [Texas] Permanent School Fund; [two], utility savings to public retail customers combined with natural gas savings ... - that's about $62 million in savings for public retail customers, mainly school districts ...; and [three], to share the experience of competition in the retail marketplace prior to and continuing through deregulation.

What we found ... was that the average retail person ... [doesn't] have the expertise ... to know where the market's going, what it's doing, [and] what different product types [are available], so ... we kind of lead the state agencies and the public retail customers through that process all the way to contract and delivery. ... In the last [legislative] session ..., the commissioner ... was able to have military bases and federal veterans' facilities added [to the program]. ... We've successfully ... contracted with two separate military bases in Texas ... and we're in negotiations for others at this time.

MR. BONE continued:

The state power program originally focused [on] and currently serves many of the independent school districts ... and other public retail customers in the Houston area. ... Today, under deregulation, we serve customers in all areas that are currently deregulated by the public utility commission. We had 93 customers prior to deregulation, we've added [or re-signed] 180 customers ... under the new market value contracts. ... Prior to deregulation, we simply gave the public retail customers a discount off of their tariff rates; after deregulation, we actually started competing ..., through RFP responses, with all the major marketing companies in Texas. ...

We have to take more gas, every day, off of our state lands to provide more power to our customers, so we felt this is a good way to kind of demonstrate the effect of natural gas on the electric market as we see it. ... We now serve 238 school districts in Texas - that's out of 1,040,

> and out of 1,040 school districts, only about 550 of them are able to actually receive deregulated power - 29 cities, 13 universities, 5 state agencies, 40 counties, [and] 30 municipal utility districts.
>
> We're the largest supplier of public retail power in the State of Texas. [The state] power program has increased the value ..., by 50 percent, compared to the monetary royalty payment that we would have received. [What] that means is, we've actually increased our earnings on that same monetary royalty payment by 50 percent over the monetary payment, so we've actually had what we call an enhanced value. If we were to [have] put it in the treasury and earned 5 or 6 percent on it, it wouldn't have done anything like we've done [through the program].
>
> [With regard to electricity, in] FY 01, we had 200 megawatts of power in our program; [in] FY 02, 400 [megawatts]; and [in] FY 03, ... after deregulation started, we have jumped to 1,200 megawatts. ... You can almost see the direct result tied back to the gas page [of the presentation] ..., where we went from about 18 bcf up..., this year, to 36 bcf. So it's quite a significant increase and a way for us to ... market our gas ... to our own customers, be less risk versed for the [Public School Fund], and ... at the same time be able to save money for the public sector. I'd take any questions.

CHAIR SAMUELS surmised that Texas's program does everything in state.

MR. BONE concurred. In response to a comment, he indicated that the Texas program is competitive with regard to both gas and oil, and mentioned that the Texas program has a variety of contract lengths ranging anywhere from two years to four years.

SENATOR LINCOLN asked whether Texas would have lost some of its military bases if it had not been able have them as public retail customers.

MR. BONE said that he couldn't speculate on that point, but noted that having military bases as public retail customers ensured that they got lower utility costs.

SENATOR LINCOLN asked how much of a savings this generated.

MR. BONE indicated that he would research that issue, and mentioned that the Texas program was able to sell military bases "green" sources of power. In response to a question, he said that from a marketing standpoint, there are five different geographical points that traded all the gas in Texas, and by dividing Texas into five geographical areas and taking the historical data regarding price from each of those areas, the take in-kind program has been able to calculate a take in-kind value at each of the five locations. That calculation was then equated, on a monthly basis, to the value at Houston ship channel, which was one of the geographical points. For example, if Houston ship channel gas is valued at $5.00, the value of gas from another geographical point might be $5.00 minus $.50. In other words Houston ship channel provides a single point of reference for the purpose of valuating gas prices. This same type of calculation is also being used to calculate RIK values.

MR. BONE said that this method has allowed the program to provide its consumers with cheaper gas and oil then they would have gotten from competing commercial providers. He mentioned that since the Texas General Land Office has production and transportation capabilities, the Texas program affects pricing from a tariff standpoint.

REPRESENTATIVE HAWKER asked whether, because everything is done in state, the Texas program avoids oversight from the FERC.

MR. BONE said that is correct, and mentioned that some LDCs in Texas do not allow competition, and so the state is the only other entity that can provide gas or oil to such areas. He noted that the state energy program also operates within an existing grid with regard to [electrical] power, and pays the same tariff rates as all other competitors. One advantage the state program has, however, is that it doesn't have to pay state taxes, and so this results in a savings of approximately 2.5 percent on both the commodity and the wire side of the business. Therefore, commercial power providers have to automatically lower their price by 2.5 percent in order to compete with the state program, though, again, the state program only provides to a certain segment of the market: the public retail customers, which are the customers that actually pay their bills with tax dollars.

REPRESENTATIVE CHENAULT asked where the program's funding comes from.

MR. BONE reiterated his comments detailing how the program is self-funded via administrative fees. In response to a comment, he mentioned that in the Texas program, a lot of the oil is converted into natural gas because there is no need for oil. In response to a question, he noted that the aforementioned 50 percent increase in value is strictly a revenue stream, and reiterated that any money the state power program makes goes directly to the Permanent School Fund, which only funds K-12 education.