

A TAXPAYER'S GUIDE TO DEEP WATER ROYALTY RELIEF

Royalty relief has made billions for the Treasury. That's no mistake.

The House of Representatives has passed and sent to the Senate H.R. 6, legislation to repeal certain tax and royalty incentives enacted previously to stimulate the development of oil and gas resources. Included in the bill are provisions that have received wide publicity because of the Department of the Interior's efforts between 1995 and 2000 to implement the provisions of the Deep Water Royalty Relief Act of 1995.

The Act was the brainchild of Louisiana's Democratic Senator J. Bennett Johnston. It was embraced by President Clinton and signed into law. This guide gives the basic information needed to understand the controversy.

Basics of OCS Leasing

The Department of the Interior manages oil and gas leasing for the seabed of the outer Continental Shelf (OCS). Within the Department, the Minerals Management Service (MMS) is the responsible agency. Before MMS can award an oil and gas lease, it must first issue a notice of sale announcing that leases will be made available for competitive bidding. Among other matters, the notice identifies

- + what **legal provisions** will be included in the lease,
- + how much **annual rent** the lessee will have to pay (usually stated in dollars per acre leased),
- + how much the government's royalty share will be from the oil or gas the lessee produces (usually stated as a percentage and called the "**royalty rate**"), and
- + what the minimum amount of money the lessee must offer to pay at the time the lease is issued as the "**cash bonus**."

Only MMS writes the lease language. The lessee may not negotiate any of its provisions.

To obtain an OCS oil and gas lease, a would-be lessee competes against other companies. Each submits a sealed bid to MMS. The bid is the cash bonus. The bonus is typically in the millions of dollars.

The lease is usually given to the high bidder. But if MMS doesn't think the high bid reflects the fair value of the lease, it can reject the bid. If it rejects the bid, MMS will offer the lease at the next lease sale the following year.



OVERVIEW

- The Deep Water Royalty Relief Act was a well-considered program to share in industry's investment in high-risk deep water exploration. The Government paid its "share" through royalty relief.
- The Government required higher up-front payments from companies when they bid on leases that would receive royalty relief. The companies, in effect, "bought" the right to royalty relief, even before knowing whether the leases had oil or natural gas.
- Because of the royalty relief program and the new discoveries it encouraged, the public's mineral rights in the Gulf of Mexico are far more valuable than they were in 1995, adding billions in revenue to the U.S. Treasury.
- H.R. 6 compels lessees to give up the rights they bought or be barred from future lease sales.
- The Boston Herald has criticized what H.R. 6 attempts to do. "A government's reputation for honoring its contracts is worth billions in its own right. Goalposts should not be moved in the middle of the game." (Feb. 19, 2006)
- So has the Washington Post. "[H.R. 6's] heavy-handed attack on the stability of contracts would be welcomed in Russia, Bolivia, and other countries that have been criticized for tearing up revenue-sharing agreements with private energy companies." (Jan. 17, 2007)

A successful bidder will often sell its lease, in whole or part, to one or more other companies.

This manner of selling a lease is called an **assignment**. Under the terms of the lease form, a lessee may assign its lease at will, subject to MMS's approval. MMS gives the approval freely, as long as the company buying the interest is in good standing and submits the required performance bonds. Because of assignments, most companies operating in the deep water of the Gulf of Mexico are not the major integrated oil companies.

For leases in waters deeper than 800 meters, MMS grants the lessee an initial term of 10 years to find and begin producing oil or gas. After 10 years, the lessee keeps the lease only as long as it keeps producing.

Who Owns Leases in the Deep Water (partial list)

Amerada Hess, Anadarko, Apache, ATP, BHP Billiton, BP, Chevron, ConocoPhillips, Devon, Dominion, El Paso, Eni, ExxonMobil, Flextrend Development, Forest, Helix, Houston Exploration, LLOG, Marathon, Mariner, Marubeni, Murphy, Newfield, Nexen, Noble, Pioneer, Placid, Pogo Producing, Shell, Spinnaker, Statoil, Total, Unocal, Walter.

The Basics of Oil and Gas Royalties

Whether a lessee receives its lease directly from the MMS or through an assignment, its obligations under the lease are the same. Ordinarily, a deep water lessee (like all lessees) owes royalties on the oil or gas it produces. Although MMS is entitled to take its royalty by taking a share of the oil or gas itself, MMS usually directs the lessee to pay the royalties in money. The dollar amount of the royalty is determined each month. The royalty equals the **volume** of oil or gas produced that month, multiplied by the **value** of the oil or gas, multiplied again by the **royalty rate**.

The **volume** is the amount of oil or gas measured at the production platform before it

leaves the lease. The **value** usually is the sales price of the oil or gas minus allowances, such as the cost of transporting the oil or gas from the platform to the point of sale, often onshore. The **royalty rate** for deep water leases is 12.5%, or 1/8th.

Example: From an offshore platform, a lessee produces 8,000 barrels of oil in May, pays \$1 per barrel to move the oil to shore, and sells it there for \$55 per barrel. The royalty for May is 8,000 barrels times (\$55 per barrel minus \$1 per barrel for transportation) times 12.5%, or \$54,000.

The Basics of Royalty Relief and “Price Thresholds”

The issue now before the Congress concerns “**royalty suspension volumes**” and “**price thresholds**.”

There are many ways that Congress could give a deep water lessee relief from royalty. Congress could provide, for example, that a lessee would not owe royalty until it had produced and sold enough oil to pay for the money it had invested in the lease (an amount typically between \$1 - \$2 billion). Another way of thinking about this method is that the government would be paying for 1/8th (the royalty rate) of the investment before it would begin collecting royalties.

A **royalty suspension volume** is also a form of royalty relief, the form used in the Deep Water Royalty Relief Act of 1995. Instead of trying to account for a company's actual cost of investment, the royalty

suspension volume simplifies matters. It provides that no royalties are owed on an initial volume of oil as it is produced. For example, if the royalty suspension volume were 80 million barrels of oil, no royalty would be owed on the first 80 million barrels. With the first barrel after 80 million, the lessee would begin to owe royalty in full. Another way of thinking about a royalty suspension volume is that the government is contributing 10 million barrels of oil to the project (1/8th of 80 million). But at the time the lease is entered, neither the government nor the lessee knows whether oil will be discovered at all or, if it is, what those 10 million barrels will be worth. Both agree to accept those uncertainties, come what may.

A **price threshold** is a dollar amount for a barrel of oil or for a million Btus of gas. The purpose of a price threshold is to reduce royalty relief. The basic idea is that at some point prices for oil or gas can get so high that lessees would not need royalty relief. As the examples show, a price threshold can work in more than one way.

Example 1: In May 2005, the lessee produces 1,000 barrels of oil from a deep water lease. The value of the oil at the lease is \$41 per barrel. There is a price threshold of \$34 per barrel. Because the value of the oil is higher than the price threshold, the lessee owes royalties on the \$7 per barrel difference. In this example, royalty would be 1,000 barrels times \$7 per barrel times 12.5%, or \$875. The lessee would receive royalty relief equal to 1,000 barrels times \$34 per barrel times 12.5%, or \$4,250.

Example 2: The facts are the same as in Example 1. Here, however, because the value of the oil is higher than the price threshold, the lessee gets no royalty relief at all. This is an “**all-or-nothing**” **threshold**. In other words, in this example with a price threshold of \$34, if the value of the oil had been \$33.99, the lessee would get complete royalty relief; but if the value had been \$34.01, it would get nothing.

Deep Water Royalty Relief Act of 1995

The economics of oil and gas investment in the early 1990s were devastating America's oil and gas industry. Between 1982 and 1995, the industry had lost 450,000 jobs. Domestic production of oil and gas had fallen to its lowest level since 1958. Imports of crude oil were expected to rise to 68% by 2005. 141 Cong. Rec. S17023 (1995) (remarks of Sen. Johnston).

In the 103rd Congress, Senator Bennett Johnston (D-La.) took the lead in crafting legislation to jump start the industry in its effort to explore the highly promising deep water area of the Gulf of Mexico. As reported out of committee in 1994, his bill proposed to allow a lessee to produce without paying royalties until it had recovered its "capital costs directly related to" bringing "new production" on-line. The relief for all new production was subject to price thresholds, determined monthly. If the threshold were exceeded in a given month, the relief would be withdrawn for the month. Under this program, there were no provisions for minimum volumes of royalty relief and no provisions requiring that new leases be offered with mandatory royalty suspension volumes. S. Rep. No. 103-248 (1994).

But after extensive discussions with the Clinton Administration and representatives of the offshore oil and gas industry, Senator Johnston modified his proposal at the start of the 104th Congress. Now the proposal drew a distinction between deep water leases already issued and leases that would be issued after the bill became law. A lessee with an existing lease would have to apply to the Secretary of the Interior to receive royalty relief, and any relief given would be subject to price thresholds.

New leases, however, did not require any application. Section 304 of the Act applied to

all new leases issued in the Gulf of Mexico from 1996 through 2000. It provided –

For all tracts . . . *the suspension of royalties shall be set at a volume of not less than the following:*

- (1) 17.5 million barrels of oil equivalent for leases in water depths of 200 to 400 meters;
- (2) 52.5 million barrels of oil equivalent for leases in 400 to 800 meters of water; and
- (3) 87.5 million barrels of oil equivalent for leases in water depths greater than 800 meters.

Pub. L. No. 104-58, § 304 (emphasis added). Section 304 did not require that price thresholds limit the royalty relief.

How Well Did The Royalty Relief Program Work?

The program has worked brilliantly. The full story is told in MMS's most recent regular report on deep water development, OCS Report MMS 2006-022. Here are some of the highlights. Since 1996, more than 100 new oil or gas fields have been discovered. At the end of 2005, 50 deep water projects with royalty relief leases were already producing. In 2004, deep water leases provided 18% of America's total oil production. As of early 2006, deep water discoveries were estimated to have oil and gas resources with an energy equivalent of more than 18.5 billion barrels of oil. America's balance of trade would be in even greater deficit were it not for deep water production.

Just as important is the deep water's contribution to natural gas supply. High natural gas prices make fertilizer too expensive for farmers, force petrochemical plants to move overseas, and drive up electricity costs. The deep water supplied 7% of America's gas supply in 2004.

The Current Dispute Over Deep Water Royalties

MMS believes that, for deep water leases issued between 1996 and 2000, Congress gave it the discretion to put in price thresholds or not to put them in. Many companies with deep water leases believe that when Congress offered them royalty relief of 87.5 million barrels without limiting the relief with price thresholds, it meant that companies were to get 87.5 million barrels of relief.

Between 1996 and 2000, MMS held 10 lease sales in the Gulf of Mexico, two per year. In practice, MMS put price thresholds in the lease language included in the notice of sale for the two sales in 1996, the two sales in 1997, and the second sale in 2000. MMS did not put price thresholds in leases issued at the four sales in 1998 and 1999. MMS did not put price thresholds in the notice of sale for the first sale in 2000, but it added price thresholds to the leases after the bids were in.

The fact that MMS did not include price threshold clauses in the 1998 and 1999 leases is the “mistake” that has been publicized by the media. It has been the subject of several hearings in the Senate and the House, as well as an investigation by the Inspector General of the Department of the Interior, Earl Devaney.

How MMS's Price Thresholds Work

MMS's price thresholds (included in leases in 1996, 1997, and 2000) started with an initial price that was adjusted each year for inflation. But unlike in the examples above, MMS did not use the lessee's sales price for the oil or gas to determine whether the price threshold had been exceeded. Instead, MMS determined an annual average price for oil and gas for contracts sold on the New York Mercantile Exchange (Nymex). Additionally, MMS used an all-or-nothing threshold. In other words, if a lessee produced 50

million barrels in 2005 and the price threshold were exceeded, the lessee would owe royalty on all 50 million barrels. What is more, those 50 million barrels would be deducted from the 87.5 million barrels promised as royalty relief. So the most relief the lessee could hope to get after 2005 would be 37.5 million barrels, but the lessee could lose that too if the price threshold were exceeded in 2006.



Royalty Relief Illustration (see page 7)

In 1996, a lessee pays \$7 million to obtain a deep water lease in waters 4,000 feet deep.

The royalty suspension volume for that water depth is 87.5 million barrels.

The lessee spends \$156 million to drill 3 exploratory wells. In 1998 the third well discovers a field with 300 million recoverable barrels of oil. The lessee spends an additional \$1.21 billion to build and emplace a floating production platform 4,000 feet above the seabed, and to drill 23 additional production wells.

Beginning in 2000, the field begins production, producing 50 million barrels a year for 6 years. Production ends in December 2005.

This illustration uses the actual MMS price threshold for each year.

Using these assumptions, we will look at how much royalty relief a lessee would receive and how much royalty it would pay in each of these years in two hypothetical cases. In both cases, the lessee's actual price at the lease (which is less than the Nymex price) is the value MMS uses to determine how much money the lessee owes in royalty. MMS uses the Nymex price only to determine whether the lessee receives any royalty relief for that year.

The first case is a "low-price case:" in each year the annual average Nymex oil price is below the MMS threshold price. The low price case assumes that MMS's price thresholds apply.

The second case is a "high-price case:" in each year the annual average Nymex oil price is above the MMS threshold price. The high-price case assumes that price thresholds do not apply, but also shows what the royalty relief would be if they did.

The two illustrations show that, at the policy level, the two sides to the deep water royalty debate are not as far apart as the media may lead one to believe.



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LOW-PRICE CASE (IF THRESHOLDS APPLY)

	2000	2001	2002	2003	2004	2005
Royalty Suspension Volume Available Jan. 1	87.5	37.5	0	0	0	0
Production (Millions of bbls)	50	50	50	50	50	50
MMS Price Threshold (\$)	31.22	31.90	32.27	32.96	33.90	34.92
Nymex Annual Average Price (for illustration only) (\$)	31	31	32	32	33	34
Royalty Value at Lease (\$/barrel)	30	30	31	31	32	33
Value of 1/8 Royalty (million \$)	187.5	187.5	193.8	193.8	200	206.2
Value of Royalty Relief (million \$)	187.5	140.6	0	0	0	0
Royalty Paid to MMS (million \$)	0	46.9	193.8	193.8	200	206.2

Total Royalties Received: \$840.7 million | Total Royalty Relief: \$328.1 million

Even MMS and the New York Times agree that the lessee would be entitled to \$328.1 million in relief.

HIGH-PRICE CASE (IF THRESHOLDS DO NOT APPLY)

	2000	2001	2002	2003	2004	2005
Royalty Suspension Volume Available Jan. 1	87.5	37.5	0	0	0	0
Production (Millions of bbls)	50	50	50	50	50	50
MMS Price Threshold (\$)	31.22	31.90	32.27	32.96	33.90	34.92
Nymex Annual Average Price (for illustration only) (\$)	40	40	40	40	41.38	56.57
Royalty Value at Lease (\$/barrel)	39	39	39	39	40	55
Value of 1/8 Royalty (million \$)	243.8	243.8	243.8	243.8	250	343.8
Value of Royalty Relief (million \$)	243.8	182.8	0	0	0	0
Royalty Paid to MMS (million \$)	0	61	243.8	243.8	250	343.8

Total Royalties Received: \$1,142.4 million | Total Royalty Relief: \$426.6 million

But MMS and the New York Times think that the lessee is entitled to \$0 in relief. **Remember, though, that both agree that if prices had stayed lower, the lessee was entitled to receive \$328 million. In this illustration, higher prices mean that the lessee gets \$98 million more in royalty relief, but the government gets \$302 million more in total royalties. Unfair?**

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