STATEMENT OF
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UNITED STATES DEPARTMENT OF THE INTERIOR
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COMMITTEE ON GOVERNMENT REFORM
SUBCOMMITTEE ON ENERGY AND RESOURCES
UNITED STATES HOUSE OF REPRESENTATIVES

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Mr. Chairman and Members of the Committee, I appreciate the opportunity to appear here today to discuss oil and gas royalties.

There has been recent media interest concerning natural gas royalty collections from Federal leases and the relationship of royalty incentives for deep water production in the Gulf of Mexico to current high energy prices. My testimony will discuss the development and status of deep water royalty relief and issues surrounding the application of the "price thresholds."

At the outset, I will discuss issues raised by the *New York Times* in its article of January 23, 2006. Attached to my testimony is a PowerPoint presentation on the management of the Nation's natural gas royalty revenues, which addresses these questions. The main conclusions of the presentation are:

- Royalty values paid to the Minerals Management Service are consistent with market prices for natural gas.

- The decline in natural gas royalty revenues is in part the result of changes in the natural gas production profile from federal leases.

- Royalty valuation regulations since 2000 have clarified the rules and increased royalty collections.

- MMS maintains an aggressive and comprehensive audit program.

With respect to deep water royalty relief, it is important to emphasize the following:

- Royalty incentives were established in the Deep Water Royalty Relief Act of 1995 to encourage development of new supplies of energy.

- The purpose of this incentive was to promote investment in a particularly high-cost, high-risk area.

- Since the enactment of the incentive, the deep waters of the Gulf of Mexico have become one of the most important sources of domestic oil and gas production.

- This Administration has taken a conservative approach to implementing the royalty incentives:

    - Once the royalty relief established by the Act became discretionary in 2001, we reduced the amount of royalty relief allowed on new leases.

    - The Administration contested a lawsuit, eventually won by lessees, which increased the magnitude of royalty relief on leases issued between 1996 and 2000.

    - We have ensured that price thresholds limiting royalty relief when oil and gas prices are high have been included in all newly issued deep water leases.

Deep Water Royalty Relief Act and Mandatory Relief for Leases Issued in 1996-2000

The Deep Water Royalty Relief Act of 1995 (Act) (Pub.L. No. 104-58), enacted on November 28, 1995, required the Secretary to grant specified royalty suspension volumes (*i.e.*, specified volumes of royalty-free production), for leases in more than 200 meters of water issued in the central and western Gulf of Mexico in lease sales held within the first 5 years after the statute's enactment. The royalty suspension volumes ranged from 17.5 million to 87.5 million barrels of oil equivalent, depending on water depth. This was not a matter of agency discretion. The Act also granted authority to the Secretary to grant royalty relief to leases in deep water issued after that 5-year period, but did not require the Secretary to do so.

The royalty incentives in the Act were designed to encourage development of new supplies of energy. Specifically, the incentive was intended to promote investment in a particularly high-cost, high-risk area. The deep waters of the Gulf were viewed as having potential for large oil and gas discoveries, but technological advances and multi-billion dollar investments would be needed to realize that potential. The incentive was intended to provide companies that undertook these investments specific volumes of royalty-free production to help recover a portion of their capital costs before starting to pay royalties.

Once the specified volume has been produced, royalties become due on all additional production. There is no royalty relief if there is no commercial production.

The Act also gave the Secretary authority to condition royalty relief on price levels, which I will discuss later in the testimony.

Because the leases were offered with royalty relief, they were more valuable to the lessees than if they had been offered without royalty relief. More leases became worth acquiring and all deep water leases became more valuable. As one would expect, there were overall increases in both the competition for those leases and in the bonuses bid to acquire them. MMS economic experts estimate that the government received approximately $2 billion more in bonus payments in the lease sales held from 1996-2000 than it would have received had the leases been offered without royalty relief.

MMS' regulations implementing the Act's mandatory provisions for leases issued in 1996-2000 took a conservative approach. The MMS rules conditioned royalty relief for a lease issued in that period on the lease being part of a field that was not producing before the Act was enacted. The rules also provided that the royalty suspension volumes prescribed in the Act applied to a field (that may include more than one lease that is eligible for mandatory relief) and not to each individual lease. Lessees disputed the Department's interpretation of the Act. In the case of *Santa Fe Snyder Corp. v. Norton*,[1] a district court in Louisiana in 2003 held that these provisions of the MMS rules were contrary to the Act. The court therefore struck down the MMS rules. The government appealed, but the Court of Appeals for the Fifth Circuit affirmed in 2004. The result of the court decisions was to greatly increase the royalty relief available under the mandatory provisions.

Discretionary Relief for Deep Water Leases Issued Beginning in 2001

The mandatory provisions of the Act expired in 2001. The Department chose to continue deep water royalty relief, with modifications, for Gulf of Mexico lease sales under the Act's discretionary provisions, but has taken a conservative approach. We reduced the amount of royalty relief allowed on new leases. With some revisions in subsequent years, the royalty relief program was changed to eliminate relief in shallower water depths (200-400 meters) and to set suspension volumes of 5 million to 12 million barrels of oil equivalent for each lease, depending on water depth. These relief volumes are substantially less generous than those offered under the mandatory provisions of the Act, even under the Department's interpretation before the decision in *Santa Fe Snyder*. In all newly issued deep water leases, we have included price thresholds that eliminate royalty relief when oil and gas prices are high. At today's prices, royalties would be due on all production from these leases.

Effect on Gulf of Mexico Deep Water Production

Over the last 10 years, since the enactment of the incentive, deep water discoveries have revitalized the Gulf of Mexico as one of the most important sources of domestic oil and gas production. In 1990, deep water production accounted for less than 5 percent of the oil and 1 percent of the natural gas produced in the Gulf of Mexico. In 2004, it accounted for over 67 percent of the oil (362 million barrels) and 37 percent of the natural gas (1.5 trillion cubic feet) from this region. This growth in deep water crude oil production has offset production declines in shallow water, allowing total Gulf oil production to grow from 283 million barrels in 1990 to 540 million barrels in 2004, substituting for a like amount of imported oil. Roughly 20 percent of deep water oil production and 30 percent

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[1] Reported at 385 F.3d 884 (5th Cir. 2004)

of deep water gas production comes from leases with royalty relief, a share that will grow as leases issued over the last several years come into production. It is important to emphasize that once the royalty suspension volume for a lease is exhausted, the lessee must pay full royalties on all subsequent production.

Deep Water Royalty Relief Mandated under the Energy Policy Act of 2005

In 2005, in the Energy Policy Act, Congress extended and expanded the deep water royalty relief program. It affirmed the suspension volumes the Department had set administratively, mandated a greater volume of relief for the deepest waters (16 million barrels of oil equivalent in water depths greater than 2000 meters), and required that MMS use these suspension volumes for leases issued in sales held during the next 5 years. It also continued the policy of limiting royalty relief based on market prices, and expressly reaffirmed the Secretary's authority to do so.

The Administration opposed the mandatory royalty relief provisions. The June 14, 2005 Statement of Administration Policy on the energy bill states, "The President believes that additional taxpayer subsidies for oil-and-gas exploration are unwarranted in today's price environment, and urges the Senate to eliminate the Federal oil-and-gas subsidies and other exploration incentives contained in the bill."

Price Thresholds

As I mentioned earlier, the Act gives the Secretary authority to condition the royalty relief on price thresholds. When the market price exceeds the threshold level for any given calendar year, royalties are due on the production for that year, royalty relief notwithstanding. Because the price thresholds are based on the average NYMEX price for the year, a determination of whether or not a threshold has been exceeded cannot be made until after the end of the year. The production volume on which the lessee owes royalty if the price threshold is exceeded also counts against the royalty suspension volume for the lease.

Consistent with thresholds expressly set in the Act for leases issued prior to enactment, in 1996 the Secretary set the price thresholds at $3.50 per million Btu for natural gas and $28.00 per barrel for oil (in 1994 dollars) for leases with mandatory relief, with the thresholds to increase each year based on the underlying rate of inflation. (With inflation, those thresholds for 2005 are $4.34 and $34.71, respectively.) In 1995, natural gas prices (using the Energy Information Administration's monthly data) varied from $1.43 to $1.84 per thousand cubic feet. Oil prices in 1995 (again, using EIA monthly data) varied from $17.32 to $19.03 per barrel. The price thresholds on these leases were exceeded, however, in the years 2000, 2001 and 2003-2005 for natural gas and in 2004-2005 for oil.

In spite of this authority for price thresholds, there continues to be some deep water production on which royalties have not been paid. In FY 2005, this amounted to an estimated 246.5 billion cubic feet of natural gas (and 16.5 million barrels of oil). There are two reasons for this:

1. Leases issued in 1998 and 1999 were issued without price thresholds. Thus, no royalties are due even though prices are high. This accounts for about 160 billion cubic feet (65 percent) of the royalty-free gas volumes reported in 2005.

2. On some leases with price thresholds, a few producers chose not to pay even though the thresholds have been exceeded. These companies argue that the Department does not have authority to establish price thresholds for any leases issued between 1996 and 2000, based on their interpretation of the *Santa Fe Snyder* decision. The Department does not agree with their argument. The Acting Assistant Secretary has issued a final decision for the Department in the first of these cases that requires the lessee to pay royalty for the years in which the price threshold was exceeded. We have been notified that a challenge to that decision will be filed in court in the very near future. I would emphasize that this dispute applies only to leases issued in 1996-2000. The validity of price thresholds for leases issued beginning in 2001 is not in dispute.

In December 2005, MMS sent letters to all companies that held either a record title or an operating rights interest in a deep water lease, reminding them that royalties were due for all production in years when price thresholds were exceeded. As of the end of January,

- Twenty-eight lessees have paid their obligations in full, or nearly so, and did not dispute their obligation to pay. (Three additional lessees had paid in full already and did not receive a notification letter.) These payments amount to $338 million. An estimated additional $5 million is due from some of these lessees and we are working with them to resolve technical issues about the amounts due.

- Two lessees have paid in full, but filed administrative appeals disputing their obligations to pay. These payments total $24 million.

- Five lessees paid in part, and also filed administrative appeals. These companies have paid $63 million, and an estimated $45 million is still due.

- Three lessees have not made any payments. One of these three has notified us that it intends to file a lawsuit to challenge the legality of the Acting Assistant Secretary’s decision that I mentioned a moment ago that applies the price threshold. Of the other two, one has filed an administrative appeal and one has not. The estimated royalties due from these companies is $59 million.

If, after all administrative appeals and lawsuits have run their course, the price threshold provisions are upheld, the companies will be required to pay these royalties plus interest.

Conclusion

Mr. Chairman, this concludes my statement. It would be my pleasure to answer any questions you or other members of the Committee may have.