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DEPARTMENT OF THE INTERIOR

Minerals Management Service

30 CFR Parts 206 and 260

RIN 1010-AB93

Bidding Systems for Leases in the Outer Continental Shelf

AGENCY: **Minerals Management Service**, Interior.

ACTION: Final rule.

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SUMMARY: This rule amends the regulations of the **Minerals Management Service** (MMS) to modify the bidding systems available for use on tracts offered for lease under the Outer Continental Shelf Lands Act (OCSLA). The change gives the Secretary of the Interior more flexibility in setting the terms of a lease sale. This rule provides four methods of modifying the existing alternative bidding systems: (1) setting the minimum prescribed royalty rate charged on Federal offshore leases below 12½ per centum but greater than zero per centum; (2) permitting operating allowances when computing payment obligations under the lease; (3) suspending or deferring royalty for a specific time period, volume, or value of production; and (4) expanding the methods for calculating royalty rates under variable royalty systems to include product prices, as well as value and amount of production, with the ability to use different formulas across time periods. The rule does not affect existing leases.

EFFECTIVE DATE: This rule is effective March 4, 1996.

FOR FURTHER INFORMATION CONTACT:

Dr. Marshall Rose, Chief, Economic Evaluation Branch, telephone (703) 787-1536.

SUPPLEMENTARY INFORMATION: The OCSLA provides authority to modify any

bidding system currently authorized by the Act if the Secretary determines the modification to be useful to accomplish the purposes and policies of the Act (section 8(a)(1)).

This final rule is the result of a review of alternative leasing policies conducted within MMS with input from constituents. The final rule, like the proposed rule, enables MMS to set royalty terms at the time of sale for new offshore leases that will adjust automatically to changing market conditions in the oil and gas industry as lease exploration, development, and production proceed. Implementation is expected to increase competition for new Federal offshore leases, ensure receipt of fair market value, and increase the likelihood that new leases will be explored and developed.

The new royalty terms will be considered for use in the leasing of specific types of tracts, such as tracts that can be identified before a sale containing potential oil and gas resources in reservoirs located below tabular salt formations. Other categories of tracts that we might choose to offer under the new terms include tracts with qualifying wells which have uneconomic reserves or tracts which previously received high bonus bids but were not explored.

When we choose to use the new bidding terms, MMS may set the minimum royalty rate at less than 12½ per centum for all or a part of the lease's productive life as described in the lease terms portion of a final notice of sale. The MMS may designate a royalty rate that is either a fixed constant or varied over the life of the lease or a royalty rate that emerges or fluctuates as specified conditions are met (e.g., royalties would not accrue until a designated time period expires or a specified production level or value is reached, or a predetermined capital cost allowance is recovered, or royalties would be reduced during periods of declining average product prices).

Concurrently, with MMS development of this rule, Congress enacted the Outer Continental Shelf Deep Water Royalty Relief Act (Pub. L. 104-58, November 28, 1995) which amended the OCSLA to add a new section 8(a)(1)(H) which defines a new bidding system. The new bidding system prescribes a cash bonus **bid** with a royalty of no less than 12½ per centum and provides for a suspension of royalties for a period, volume, or value of production determined by the Secretary. Such suspensions may vary based on the price of production from the lease. Any lease

sale held before November 28, 2000, must use the new bidding system for all tracts located in water depths of 200 meters or more in the Western and Central Gulf of Mexico Planning Areas, including that portion of the Eastern Gulf of Mexico Planning Area west of 87 degrees, 30 minutes west longitude.

This rule allows MMS to implement this new bidding system. The proposed rule had included the substance of the required provisions. Thus, MMS is able to include implementing provisions in this final rule. We are preparing another rule to implement further details of the Outer Continental Shelf Deep Water Royalty Relief Act.

Twelve respondents submitted comments during the public comment period and MMS reviewed and analyzed the comments. The following is a discussion of the comments received and our response. Each time MMS announces use of this new bidding rule in a preliminary lease sale notice, interested parties may submit comments.

Narrative Response to Comments

Comment: Several commenters had specific questions regarding uncertainty over aspects or terms used in the proposed rule.

Question 1: What would a "simple price-royalty rate formula" look like?

Response: One example of such a formula is a royalty rate of one-sixth applies if the average oil price is above \$18 (per barrel) and one-eighth if the average price is below \$18. Or, the royalty rate could vary in several discrete increments, or even continuously, as a function of oil (and perhaps gas) prices prevailing during the life of the lease.

Question 2a: What does the MMS mean when it suggests it would be able to "set royalty terms at time of sale for new leases that will adjust dynamically to changing market conditions?"

Response: An example of a royalty term that responds automatically to market conditions would be a royalty rate that depended on gross lease revenues. As prices declined or production from the lease decreased, the royalty rate would decline according to conditions specified in the sale notice, reflecting a lower profit potential on the lease. Such a system could include a predetermined cost allowance that would be deducted from gross revenues for the purpose of computing the net revenue amount, to which the royalty rate would be applied.

Question 2b: How frequently would royalty terms change?

Response: The frequency of change will be specified in the sale notice and lease. It will depend on both the form of the system and the variables defined in the sale notice and lease. For example, if MMS uses an inflation adjustment, the terms could change annually or monthly according to the specified adjustment factor. If MMS uses a fixed volume suspension, the change would occur only at the time the

prescribed production volume is achieved. Once the lease is executed, any change in royalty will be triggered solely by satisfying the objectively determined economic and geologic factors specified in the lease.

Question 2c: Are there limits on the changes?

Response: Yes. The MMS will specify the range of values over which the royalty rate will change in the final notice of sale and the lease.

Question 2d: Is the 12½ per centum royalty the ceiling?

Response: No. When there is a ceiling we will specify it in the notice of sale.

Question 2e: How will MMS and industry administer these leases (e.g., audits)?

Response: We will continue to administer leases in the same manner. However, estimates of future prices could, under some systems, necessitate a recalculation not only in the receipts

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subject to royalty, but also in the size of the royalty rate as well.

Question 2f: How would MMS administer these new leases when unitized with leases with different or fixed royalties?

Response: The MMS will be careful to ensure that lessees properly allocate production to each unitized lease. Normally unitized production from a common reservoir is based on the proportion of recoverable resources present on each lease.

Question 3a: How does the "operating allowances" concept relate to the amendments to the bidding systems regulations?

Response: Under existing royalty regulations, transportation costs and gas processing costs are permissible deductions in computing royalty due. The notion of a predetermined operating allowance is proposed partly to expand the set of tract-specific costs that MMS may consider in calculating payment obligations, without complicating the accounting. Or alternatively, MMS may simply offer some tracts under a bidding system with a specified transportation and processing allowance instead of actual costs incurred.

Question 3b: How do operating allowances relate to existing transportation and processing allowances in terms of substance and reporting requirements?

Response: Because the allowance concept is based on the specified standard, there will be some difference between actual costs incurred and those used to compute payment obligations. However, if set properly, we expect that the allowance will be about right on average. Moreover, this could alleviate some of the administrative and auditing burdens, since actual costs may not affect the amount of payments owed under some of these systems.

Question 3c: What is the effect of the introduction of the new concept of "operating allowances" into the valuation regulations?

Response: Operating allowances could be used in conjunction with valuation regulations in one of two ways. First, predetermined operating allowances, defined at the time of sale, could replace valuation regulations for the purpose of calculating net receipts subject to payment obligations.

Second, a predetermined operating allowance could be subtracted from net receipts after the valuation regulations are applied, to determine the final amount of receipts subject to payment obligations. In either case, the approach used would be designated in the proposed and final sale notices.

Question 4: Can phrases such as "any amounts creditable against future royalties" and "inflation factor" for purposes of determining value "or amount" of production be explained?

Response: Should the governing statutes change, MMS might consider allowing the lessee to credit other payments made to the Government (e.g., rentals) against future payments due the Government (e.g., royalties). Existing statutes do not allow MMS to encourage lessee behavior (e.g., starting exploration or production earlier in the primary term) by reimbursing the lessee in cash. In developing the original sliding-scale bidding system, MMS made the royalty rate dependent upon the gross value of production generated during a period. The MMS used an index or "inflation factor" to make adjustments in production value in future production periods to reflect the prevailing level of aggregate prices in the economy.

For simplicity, MMS will provide the details of any required modifications of this type in the official sale and lease documents, rather than in the regulations.

Question 5: Why would industry have to wait for publication of lease sale packages to examine royalty rate formulas?

Response: In the April 20, 1995, Federal Register Notice asking for comments on the proposal (60 FR 19767), MMS described the general nature of the equations and formulas, along with the applicable variables, and this notice continues the discussion. In many instances, the specific parameters that we will use in specific lease sales may depend on the characteristics of the tracts to which they apply as well as prevailing price and cost conditions at time of sale. The rule itself does not include values for the parameters. Whenever possible we will announce the formulas to be used, along with proposed values for the parameters, in the preliminary notice of sale. This will permit industry to comment on the details of the bidding system before MMS publishes the final notice of sale.

Question 6: What does "suspension or deferral magnitudes or formulas" mean?

Response: During the productive life of a lease, the existing royalty could be suspended (i.e., reduced or eliminated) or deferred (i.e., paid at a later time under some circumstances). Typically, such

provisions will apply at the start of production. We may express the suspension or deferral variable as a specified number of barrels of oil equivalent produced, gross revenues collected from oil and gas sales, or length of time over which royalties would be collected at a reduced rate.

Question 7: What index will MMS use for pricing?

Response: We will specify the index to be used in the final sale notice. We expect that such indices will reflect the rate of inflation in either the energy sector or the economy as a whole. Indices of this nature typically appear in a variety of Federal documents published among others by the Department of Commerce and the Department of Energy.

Question 8: For a particular lease sale, can a bidder choose between a reduced (variable) rate or fixed rate? If so, how would the MMS award competitive bids?

Response: No. The MMS did not envision allowing the bidders to choose between different leasing systems on the same tract. The concept does have some appeal, however, since it would allow bidders with different capacities to bear risk to choose the system that best suits them. With this added flexibility, the ceiling royalty rate associated with the variable royalty rate option will have to be above the fixed rate. Otherwise, bidders presumably would be better off always choosing the reduced (variable) royalty rate. However, unless MMS develops a way to show that the anticipated value of the tract was the same under either system, there will be no simple way to choose among competitive cash bonus bids submitted under each of the systems. Thus, MMS has not chosen to pursue this option.

Question 9: How much lead time can companies expect to have between promulgation of final regulations and the first lease sale where they would apply?

Response: Before using some of the innovative new concepts covered by this rule, MMS will both take time to determine how the new system will be used in the specific lease sale and will solicit industry comments in a preliminary notice of sale. This will provide industry with an opportunity to understand the new system.

Question 10: Would a potential bidder have any flexibility in the bidding process with regard to the royalty rate? For example, could a potential bidder offer a traditional one-eighth royalty?

Response: These changes in bidding systems relate to the manner in which MMS will determine the applicable royalty rate during a give production period. We are not introducing these changes to facilitate various forms of actual bidding on the royalty rate to be paid by the lessee. Thus, we intend to set the form of the royalty rate, and the lessee will **bid** a cash bonus. Under this

format, the lessee cannot affect the royalty rate during the bidding process. Only if the royalty is the **bid** variable, would a potential bidder be free to offer a traditional one-eighth royalty.

Question 11: Would there be any changes to the basis upon which the MMS awards competitive bids?

Response: No. Under the proposed systems, the high cash bonus bidder will be awarded the lease subject to satisfying the MMS **bid adequacy** criteria.

Comment: One commenter mentioned that although the proposed rule does not specifically indicate MMS is contemplating such a system, they are against one which might call for bidding of both a royalty variable and bonus.

Response: The term "variable royalty rate" is meant to convey the notion that the royalty rate, as described in the sale notice, may vary over the life of the lease. This does not mean that MMS is making the royalty rate a bidding variable. This rule does not affect the MMS authority to use the royalty rate as a bidding term, either in place of or in conjunction with a cash bonus. While the OCSLA does not authorize MMS to use more than one bidding variable simultaneously, we may be able to design some systems that operate sequentially.

For example, in the unlikely event that bidding for some tracts involved both the cash bonus and the royalty rate, MMS needs a means to objectively determine the winning bidder. One way to do that would be to require bidding on the two terms in sequence rather than in parallel. Subject to a fixed minimum required cash bonus, bidding could be allowed on the royalty rate up to a predetermined and known maximum. If a bidder chooses to **bid** above the maximum royalty rate, it would do so by offering to add to the minimum required bonus **bid**.

Comment: One commenter stated that it would be unjust for a lessee to relinquish a lease after conducting exploratory drilling, with the possible public release of data, and then for the Government to reoffer the tract under more favorable terms to competitors.

Response: The original lessee purchased the contract for a cash bonus **bid**. If it then voluntarily relinquishes the lease after conducting exploratory drilling, the Government is free to reoffer the tract in the market at any terms it deems appropriate. The original lessee can compete on equal terms with others through the auction process used to reoffer the tract.

Comment: Two commenters suggested that royalty relief and flexible royalty terms would benefit production if MMS applies them to existing OCS leases that are approaching the economic limits of production.

Response: This rule does not affect the authority of MMS, under Sec. 8(a)(3)(A) of OCSLA, to reduce or eliminate any royalty or net profit share on an active tract.

Response: One commenter strongly recommended that MMS consider providing an appropriate allowance for poor quality and/or low gravity

crude in order to foster development of such resources.

Response: Lower quality crude sells for less. Since royalty paid is directly proportional to price, the current fixed royalty arrangement reflects differences in product quality. To the extent that an additional adjustment is needed for low quality crude, to account for higher costs of extraction, then a properly set cost allowance under the new bidding rule would be one way to handle the situation for tracts being offered for lease.

Comment: One commenter stated that it does not believe that royalty relief by itself, in the absence of other financial incentives such as a production tax credit, is sufficient to generate additional substantial deepwater activity.

Response: The MMS does not have taxing authority, so production tax credits are not part of the policies affected by this rule. The final rule differs from the proposed rule in that portions have been reworded for clarity. The final rule also contains a new system, Sec. 260.110(a)(7), designed specifically to address the Outer Continental Shelf Deep Water Royalty Relief Act. This new system includes a cash bonus **bid**, a fixed royalty rate of not less than 12\1/2\ per centum, and an option for MMS to defer or suspend royalties. Although a lease sale of this type would have been possible under paragraph Sec. 260.110(a)(5), MMS added the new paragraph specifically addressing the provisions in the statute. This will clearly indicate when MMS is conducting a lease sale under the provisions of the Outer Continental Shelf Deep Water Royalty Relief Act.

Author

This document was prepared by Marshall Rose, Mary Vavrina, and Keith Meekins, Offshore Resource Evaluation Division, MMS.

Executive Order (E.O.) 12866

MMS reviewed this rule and determined that the rule is not significant.

Regulatory Flexibility Act

The Department of the Interior (DOI) has determined that this rule will not have a significant economic effect on a substantial number of small entities. Any direct effects of this rulemaking will primarily affect lessees and operators-entities that are not, in general, small due to the technical complexities and financial resources necessary to conduct OCS activities. MMS also determined that the indirect effect of this rulemaking on small entities that provide support for offshore activities is small.

Paperwork Reduction Act

The information collection requirements contained in those parts of MMS's regulatory program affected by this rule have been approved by OMB under (44 U.S.C. 3501 et seq.). The forms, filing date, and approved OMB clearance numbers are identified in 30 CFR 210.10 and 30 CFR 216.10.

Takings Implication Assessment

The DOI certifies that this rule does not represent a governmental action capable of interference with constitutionally protected property rights. A Takings Implication Assessment prepared pursuant to E.O. 12630, Government Action and Interference with Constitutionally Protected Property Rights, is not required.

E.O. 12778

The DOI has certified to OMB that this rule meets the applicable civil justice reform standards provided in Sections 2(a) and 2(b)(2) of E.O. 12778.

National Environmental Policy Act

The National Environmental Policy Act (NEPA) compliance for the rule is covered by DOI procedures for implementing NEPA (516 DM2, Appendix 1.10). In accordance with those procedures, MMS will examine the potential environmental effects of the rule during NEPA review for each lease sale. This is appropriate because the potential environmental effects of the rule depend largely on how it is applied, and decisions on application will be made on a sale-by-sale basis.

List of Subjects

30 CFR Part 206

Coal, Continental shelf, Geothermal energy, Government contracts, Indian lands, Mineral royalties, Natural gas, Petroleum, Public lands--mineral resources, Reporting and recordkeeping requirements.

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30 CFR Part 260

Continental shelf, Government contracts, Mineral royalties, Oil and gas exploration, Public lands--mineral resources.

Dated: January 26, 1996.
Bob Armstrong,
Assistant Secretary, Land and **Minerals Management**.

For the reasons set forth in the preamble, the **Minerals Management Service** amends 30 CFR parts 206 and 260 as follows:

PART 206--PRODUCT VALUATION

1. The authority citation for part 206 is revised to read as follows:

Authority: 5 U.S.C. 301 et seq.; 25 U.S.C. 396 et seq., 396a et seq., 2101 et seq.; 30 U.S.C. 181 et seq., 351 et seq., 1001 et seq., 1701 et seq.; 31 U.S.C. 9701; 43 U.S.C. 1301 et seq., 1331 et seq., and 1801 et seq.

2. Section 206.106 of subpart C is added to read as follows:

Sec. 206.106 Operating allowances.

Notwithstanding any other provisions in these regulations, an operating allowance may be used for the purpose of computing payment obligations when specified in the notice of sale and the lease. The allowance amount or formula shall be specified in the notice of sale and in the lease agreement.

3. Section 206.160 of subpart D is added to read as follows:

Sec. 206.160 Operating allowances.

Notwithstanding any other provisions in these regulations, an operating allowance may be used for the purpose of computing payment obligations when specified in the notice of sale and the lease. The allowance amount or formula shall be specified in the notice of sale and in the lease agreement.

PART 260--OUTER CONTINENTAL SHELF OIL AND GAS LEASING

1. The authority citation for part 260 is revised to read as follows:

Authority: 43 U.S.C. 1331 and 1337.

2. Section 260.001 of subpart A is revised to read as follows:

Sec. 260.001 Purpose and scope.

The purpose of this part 260 is to implement OCSLA, 43 U.S.C. 1331 et seq., as amended, by providing regulations to foster competition including, but not limited to, regulations to prohibit joint bidding for development rights by certain types of joint ventures; the implementation of alternative bidding systems (including suspension of royalties for a period, volume, or value of production); and the establishment of diligence requirements for Federal OCS leases issued under the OCSLA.

3. Section 260.002 of subpart A is amended by revising the definition of "OCSLA" to read as follows:

Sec. 260.002 Definitions.

* * * * *

OCSLA means the Outer Continental Shelf Lands Act, (43 U.S.C. 1331 et seq.), as amended.

* * * * *

2. Section 260.110 of subpart B is amended by revising paragraphs (a)(1)(iii), (a)(2)(iii), (a)(3)(i)(C)(4) and (a)(3)(iii) and by adding new paragraphs (a)(5), (a)(6), and (a)(7) to read as follows:

Sec. 260.110 Bidding systems.

(a) * * *

(1) * * *

(iii) The annual rental to be paid by the highest responsible qualified bidder and any amounts creditable against future royalties shall be specified in the notice of sale published in the Federal Register.

* * * * *

(2) * * *

(iii) Rental payment amounts must be as specified in paragraph (a)(1)(iii) of this section.

* * * * *

(3) * * *

(i) * * *

(C) * * *

(4) The production period, inflation factor and procedures for making the inflation adjustment and for determining the value or amount of production shall be stated in the notice of sale published in the Federal Register.

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(iii) Rental payment amounts must be as specified in paragraph (a)(1)(iii) of this section.

* * * * *

(5) Cash bonus **bid** with a variable royalty rate or rates during one or more production periods in amount or value of the production saved, removed or sold, and an annual rental. MMS may suspend or defer the royalty due for a period, volume, or value of production. Such suspensions or deferrals may vary based on changes in the prices of oil and/or gas as specified in the notice of sale published in the Federal Register.

(i) The royalty rate due on production may be less than 12½ per centum, but greater than zero per centum, at any designated time during the lease period based on the amount or value of production saved, removed, or sold. Royalty may be suspended or deferred for a period, volume, or value of production. The applicable royalty rate(s) and suspension or deferral magnitudes or formulas shall be specified in the notice of sale published in the Federal Register.

(ii) The amount and the procedure for payment of a cash bonus must be as specified in paragraph (a)(1)(ii) of this section.

(iii) Rental payment amounts must be as specified in paragraph (a)(1)(iii) of this section.

(6) Cash bonus **bid** with a royalty rate or rates based on formula(s) or schedule(s) during one or more production periods in amount or value of the production saved, removed or sold, and an annual rental. Royalty may be suspended or deferred for a period, volume, or value of production. Such a suspension or deferral may vary based on changes in the prices of oil and/or gas as specified in the notice of sale published in the Federal Register.

(i) The royalty due on production shall be specified as a percentage of the amount or value of the production saved, removed, or sold. When the value of production is used, by unit or in aggregate, the royalty rate will be determined based on prices for oil and/or gas as specified in the notice of sale published in the Federal Register.

(A) The lessee must calculate the royalty due using the formula or schedule specified in the lease based on the adjusted amount or indexed value of the oil and gas produced. The formula or schedule will describe the relationship between the adjusted or actual amount of production, indexed value, or indexed price, and the royalty rate. It will stipulate the lowest and highest royalty rates.

(B) The royalty rate formula or schedule and the suspension or deferral magnitudes or formulas shall be specified in the notice of

sale published in the Federal Register.

(C) Royalty payment calculation.

(1) The royalty rate used to calculate the royalty due on production is based on an adjusted or actual amount of production, indexed value, or indexed price and is set through application of the specified formula or schedule to the designated production period.

(2) The lessee will determine the adjusted amount or indexed value, or indexed price by applying an index or inflation factor specified in the lease to the actual amount or value of production, or to the adjusted price.

(3) The lessee must apply the royalty rate to the actual value of production. The result is the amount in dollars that the lessee must pay to the United States,

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or the amount of royalty oil and/or gas that the United States will take in kind.

(4) The production period, inflation factor and procedures for making the inflation adjustment and for determining the value or amount of production shall be stated in the notice of sale published in the Federal Register.

(ii) The amount and the procedure for payment of a cash bonus must be as specified in paragraph (a)(1)(ii) of this section.

(iii) Rental payment amounts must be as specified in paragraph (a)(1)(iii) of this section.

(7) Cash bonus **bid** with a royalty rate of not less than $12\frac{1}{2}$ per centum fixed in amount or value of the production saved, removed or sold, and with suspension of royalties for a period, volume, or value of production, and an annual rental. Royalty may be suspended for a period, volume, or value of production. Such a suspension may vary based on changes in the prices of oil and/or gas as specified in the notice of sale published in the Federal Register.

(i) Except for a period of suspension, the royalty rate due on production will be specified as a percentage of the amount or value of the production saved, removed, or sold. The applicable royalty rate shall be specified in the notice of the lease sale published in the Federal Register. When the royalty rate is applied to the value of production, by unit or in aggregate, the royalty rate will be determined based on the prices for oil and/or gas as specified in the notice of sale published in the Federal Register.

(A) The lessee must calculate the royalty due using the formula or schedule specified in the lease agreement based on the adjusted amount or indexed value of the oil and gas produced. The formula or schedule will describe the relationship between adjusted or actual amount of production, indexed value, or indexed price, and the royalty rate. It will stipulate the lowest and highest royalty rates that may apply.

(B) The formula or schedule for royalty due on production and the suspension magnitudes or formulas shall be specified in the notice of sale published in the Federal Register.

(ii) The amount and the procedure for payment of a cash bonus must be as specified in paragraph (a)(1)(ii) of this section.

(iii) Rental payment amounts must be as specified in paragraph (a)(1)(iii) of this section.

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