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July17, 2007

U.S. Department of the Interior
Minerals Management Service
381 Elden Street, MS-4024
Herndon, Virginia 20170-4817
Attention: Regulations and Standards Branch (RSB)

Re: "Royalty Relief – Ultra-Deep Gas Wells on OCS Oil and Gas Leases; Extension of Royalty Relief Provisions to OCS Leases Offshore of Alaska; 1010-AD33", *Federal Register* Vol. 72, No. 96, Friday, May 18, 2007.

To Whom It May Concern:

The American Petroleum Institute (API) appreciates the opportunity to comment on the Minerals Management Service (MMS) proposed Royalty Relief for Ultra-Deep Gas Wells on Outer Continental Shelf (OCS) Oil and Gas Leases; Extension of Royalty Relief Provisions to OCS Leases Offshore of Alaska.. API represents more than 400 member companies involved in all aspects of the oil and natural gas industry, including offshore exploration and production and therefore has a strong and direct interest in the development of these regulations.

General Overview

The Energy Policy Act of 2005 ("EPACT") directed the Secretary of the Interior to promulgate regulations for enacting the provisions of the statute. For purposes of this mandate, the proposed rule has been drafted specifically to address Section 344 of EPACT. While it is recognized EPACT leaves to the discretion of the Secretary many aspects of implementing the statute, we believe there are a few areas in the proposed rule where the direction the Secretary has elected to pursue could be contrary to the intent of Congress. In general, since the implementation of the Deepwater Royalty Relief Act in November of 1995 ("DWRRA"), Congress has directed the creation of an incentive program targeted at the offshore oil and gas industry with the objective of stimulating oil and natural gas production in the United States. The MMS has continued to utilize royalty relief in the same manner as Congress originally dictated only in a different form since implementation of the DWRRA in 1995. When the various royalty relief programs are analyzed it is evident two major types of relief become apparent. The first is "need" based relief which has been available through various regulations and the DWRRA for many years and the second is "incentive" based relief which is the underlying bases for both the DWRRA and EPACT.

Under the need based relief program, lessees must prove that their oil and natural gas related projects require some form of royalty reduction or suspension to make their projects economic. Need based relief has been available through existing regulation for many years. In addition, a portion of the DWRRA created another need based format to be used on deepwater leases issued before passage of the Act in November of 1995. The DWRRA format, and implementing regulations, requires lessees prove a project is uneconomic before relief will be considered. Need based relief, even though in existence for many years, is not widely utilized by the offshore oil and gas industry.

Incentive based royalty relief has the purpose of enticing potential lessees to invest in oil and natural gas projects knowing additional financial benefit could be derived should a commercial discovery be made and subsequently oil and/or natural gas produced. Incentive based relief is automatic and not based on whether or not a project requires suspension or reduction of royalty to be economic or profitable. Both the DWRRA and EPACT created incentive based royalty relief programs.

After implementation of the provisions found in the DWRRA, leasing in the deepwater areas of the Gulf of Mexico increased significantly. Bidders most likely paid hundreds of millions of dollars in additional bonus consideration for numerous leases found in deepwater to take advantage of the incentive based royalty relief that automatically applied to these newly issued leases. Considering the fact that most leases issued are not drilled, the federal government collected significant revenue in the form of bonus and rentals from these new leases some of which would probably not have been leased without royalty relief. Since incentive based royalty relief stimulates leasing and ultimate drilling, it would be logical to continue to support incentive based relief to encourage more leasing and drilling through drafting of regulations that reflect the intent of Congress. It appears Congress recognizes the benefits associated with incentive based royalty relief programs by its passage of EPACT.

Section 344 of EPACT states in part that, "the Secretary shall issue regulations granting royalty relief suspension volumes of not less than 35 billion cubic feet with respect to the production of natural gas from ultra deep wells on leases issued in shallow waters less than 400 meters deep located in the Gulf of Mexico wholly west of 87 degrees, 30 minutes west longitude." In addition, "the Secretary shall issue regulations granting royalty relief suspension volumes with respect to production of natural gas from deep wells on leases issued in waters more than 200 meters but less than 400 meters deep located in the Gulf of Mexico wholly west of 87 degrees, 30 minutes west longitude. The suspension volumes for deep wells within 200 to 400 meters of water depth shall be calculated using the same methodology used to calculate the suspension volumes for deep wells in the shallower waters of the Gulf of Mexico, and in no case shall the suspension volumes for deep wells within 200 to 400 meters of water depth be lower than those for deep wells in shallower waters." EPACT also states that "the Secretary ***may*** (emphasis added) place limitations on the royalty relief granted under this section based on market price."

MMS seeks comments not only on the text of the proposed rule but also on a few of the concepts that underpin the basis for the way certain sections of the rule have been drafted. The first concept we would like to comment on deals with MMS' decision "to grant royalty relief for [only] the first ultra-deep well" drilled on a lease. As reflected above in the language from Section 344 of EPACT, Congress did not stipulate that the new royalty relief suspension volumes be limited to only the first ultra-deep well drilled on a lease nor did it limit the relief to only new leases issues in the Gulf of

Mexico wholly west of 87 degrees, 30 minutes west longitude. Congress' intent was that existing leases, as well as leases issued in the future, would enjoy this new form of royalty relief when "a well drilled with a perforated interval, the top of which is at least 20,000' true vertical depth below the datum at mean sea level" discovers natural gas in commercial quantities. The MMS decision to restrict relief to only the first ultra-deep well on a lease is an impermissibly narrow interpretation of Section 344.

Deep wells are expensive and risky. Few lessees are currently willing to assume these risks or incur the expense associated with drilling ultra-deep wells. Considering the fact Congress did not insert the first ultra-deep well limitation in EPACT, we suggest MMS remove the provision limiting royalty relief to only the first ultra-deep well on a lease. Additionally, Congress said that royalty relief "may" be granted for sidetracks and previously produced leases. We believe MMS should include royalty relief for these in the proposed rule. A true incentive is one that entices the lessee to pursue something it otherwise may not do. Since the intent of EPACT is to encourage additional drilling for natural gas in shallow water in the Gulf of Mexico, regulations should be drafted to better support this intent.

MMS has also requested comments on "why a threshold other than $4.47 per MMBTU might be more appropriate ..." than the existing rule's price of $9.88 per MMBTU adjusted for inflation after 2006. Current NYMEX natural gas prices and the NYMEX natural gas forward curve prices exceed the $4.47 threshold currently suggested in the propose regulations. Some projections have natural gas demand in the United States remaining high as supply continues to be restricted. Adopting threshold prices that are lower than current and projected future market prices effectively eliminates royalty relief before it is granted, frustrating Congress' intent. As stated above and in EPACT, the Secretary was given the discretion to limit royalty relief "based on market price." Because this authority was discretionary and not mandatory, the Secretary has the flexibility to offer royalty relief without price limitation or choose to suspend relief when market prices are exceeded. We encourage MMS to reconsider its position on establishing a base threshold price lower than the current market price.

MMS justifies the lower price threshold level based on the lack of a sunset provision. The lack of a sunset provision for ultra-deep drilling is necessary given the immense technical challenges posed by these wells. The need to develop experience and technology will require long lead times making a sunset provision impractical. The lack of a sunset provision is appropriate for ultra-deep wells and is not a sound reason for a lower price threshold.

MMS further justifies the lower price threshold based on the lack of response to deep gas relief to date. The current relief, with a $9.88/mmbtu price threshold, did not result in significant deep drilling because of the high cost and technical risk associated with drilling at these depths. The historical lack of response under the $9.88/mmbtu logically argues that an even higher price threshold than $9.88/mmbtu may be necessary to entice lessees to take on the financial and technical risks of ultra-deep drilling. Lowering the price threshold is illogical and puts up further barriers to any incentives intended by Congress.

If Congress had wanted royalty relief to be limited by a specific market price, they would have stipulated the price threshold. Because they did not do so in EPACT, and only granted the Secretary the option to restrict royalty relief based on market price, our recommendation is that at minimum

the existing rules $9.88 per MMBTU based threshold price (adjusted over time for inflation) be adopted as the applicable price limitation. To truly encourage ultra-deep drilling, a higher price threshold should be considered. Also, in certain situations, the proposed rule provides layering of the price thresholds, which would complicate the administration of it. As an example, the first 25 bcf would be at $9.88/mmbtu and the next 10 bcf would be at $4.47/mmbtu. We recommend that a constant price threshold be applied to the RSV.

The last concept we would like to address deals with MMS' decision stated in the proposed rule to sunset certain provisions of the royalty relief program as the program will now apply to existing and newly issued leases in water depths between 200 and 400 meters. We recognize the fact that EPACT directed the Secretary to draft regulations where "the suspension volumes for deep wells within 200 to 400 meters of water depth shall be calculated using the same methodology used to calculate the suspension volumes for deep wells in the shallower waters of the Gulf of Mexico, and in no case shall the suspension volumes for deep wells within 200 to 400 meters of water depth be lower than those for deep wells in shallower waters." MMS has chosen to adopt the sunset concept in the new implementing proposed royalty relief regulations for 200 to 400 meter water depth to match the current regulations. While adopting the existing regulations is mandated by Congress, a reasonable person could interpret the provisions of EPACT to state that the Secretary should use the current methodology in determining well depth and completion interval restriction along with relief volume factors as complying with the intent of Congress. The time limitation was not stipulated in EPACT. We believe an argument could be made that the time limitation in the current regulations is not a part of the "methodology" the Secretary must use in implementing the application of the existing regulations to leases issued in water depths from 200 to 400 meters. Because we believe the time limitation is not part of the existing relief methodology or mandated in EPACT, we recommend MMS reconsider implementation of the sunset provision by either eliminating it or tying the sunset provision to the commencement of production from a qualifying well. Instead of a specific sunset date (i.e. May 3, 2013) MMS could use "five (5) years from the date operations on a qualifying well are completed."

Finally, one general comment about the rulemaking concerning Alaska leases. API encourages MMS to expand royalty relief beyond the proposed needs-based relief. We encourage the MMS to propose an incentive-based royalty relief proposal for North Slope operations to encourage exploration and development. This relief will need to extend beyond the traditional deep water and deep gas relief to include incentives for the use of innovative technologies such as ultra extended reach drilling and perhaps other higher cost but smaller 'footprint' approaches to encourage exploration and production operations on the North Slope.

Proposed Rule Suggested Modifications

The following suggested modifications are divided into language changes that (1) mirror our conceptual comments stated above and (2) clarify certain changes in the text of the rule for easier reading and comprehension. Our comments begin with the text of the proposed rule as found on page 28412 of the referenced federal register notice.

1. Section 203.0, under the definition of "Certified unsuccessful well," third line, after the word "depth" add the word "length." (This is only for clarification and matches the explanation given in the preamble of the proposed rule.)

2. Section 203.0, under the definition of "Certified unsuccessful well," subsection (1), beginning on the sixth line, delete "before May 3, 2013," and replace with "5 years after the drilling of your qualifying well." (As stated above, the May 3, 2013 date is not mandated in EPACT.)

3. Section 203.0, under the definition of "Phase 1 ultra-deep well," second line, after the word "lease" add " issued in a lease sale held after January 1, 2001 and before January 1, 2007." (This modification brackets the time period that this definition is intended to apply.)

4. Section 203.0, under the definition of "Phase 2 ultra-deep well" subsection (2), second line, delete the phrase "after the lease issuance date" and replace with "from the drilling of a qualified well." (This suggestion reflects our comments regarding the sunset provision in the proposed regulations.)

5. Section 203.0, under the definition of "Phase 2 ultra-deep well." subsection (3), first line, delete "Before May 3, 2013" and replace with "5 years after the drilling of your qualifying well." (This suggestion reflects our comments regarding the sunset provision in the proposed regulations.)

6. Section 203.0, under the definition of "Phase 3 ultra-deep well." subsection (2), second line, delete "after the lease issuance date" and replace with "from the drilling of your qualifying well." (This suggestion reflects our comments regarding the sunset provision in the proposed regulations.)

7. Section 203.0, under the definition of "Qualified deep well," subsection (2), sixth line, delete the word "any" and replace with the word "the." (For clarification only.)

8. Section 203.0, under the definition of "Qualified deep well," subsection (3), eighth line, delete "before May 3, 2013," and replace with "5 years after the drilling of your qualifying well." (This suggestion reflects our comments regarding the sunset provision in the proposed regulations.)

9. Section 203.0, under the definition of "Ultra-deep short sidetrack," third line, after the word "depth" insert the word "length." (For clarification only.)

10. Section 203.2, in the first column of the table under subsection (b) second line after the word "area," add a parenthetical ("200 meters or greater"). (For clarification only.)

11. Section 203.2 - What process is a lessee expected to use to demonstrate a project is uneconomic? If MMS envisions either the DWWRA pre-Act application process, or some variation of this process, will be required, a footnote should be added to the table directing readers to the appropriate regulations or Notice to Lessees for guidance. It is suggested a reference to Section 203.62 be added to the bottom of the table to directing lessees to the application process if this is the one MMS plans to use to show economic need.

12. On page 28414 of the federal register notice in the first column of the page entitled "Royalty Relief for Drilling Ultra-Deep Wells on Leases Not Subject to Deep Water Royalty Relief," under the Sections numbered 203.33, 203.34 and 203.35, replace "RSB" with "RSV." (We believe this is only a typographical error.)

13. Section 203.31, subsection (a), in the first column of the table under number (2), after the word "feet" add the parenthetical ("TVDSS"). (For clarification only.)

14. Section 203.33, subsection (c), line 10, after the word "production" add the phrase "from or allocated to the lease." (For clarification only.)

15. Section 203.34, subsection (d)(2), at the end of the sentence after the word "deep" add the phrase "but less then 400 meters deep." (For clarification only.)

16. Section 203.35, subsection (c), seventh line, after the word "paragraph" delete "(b)(1)" and replace with "(a)(2)(i) and (ii)" (We believe this addition is more appropriate for this subsection reference.)

17. Section 203.35, subsection (d), seventh line, after the word "deep", delete the phrase "or before May 3, 2013" and replace with "5 years after the drilling of your qualifying well." (As stated above, the May 3, 2013 date is not mandated in EPACT.)

18. Section 203.35, subsection (d)(2) , fifth line, after the word "deep", delete the phrase "or before May 3, 2013" and replace with "5 years after the drilling of your qualifying well." (As stated above, the May 3, 2013 date is not mandated in EPACT.)

19. Section 203.35, subsection (d)(3), fourth line, after the word "weather" rewrite the remainder of the sentence to state ", unavoidable accidents and production equipment failure." (In some cases ultra-deep wells may require the installation of serial 1 equipment to be able to effectively and efficiently produce these wells. Occasionally this equipment has been known to fail after installation but before production. Should this happen, clarifying in the regulations an equipment failure event as a reason for delaying production will help to eliminate confusion as to what events qualify for delays.)

20. Section 203.36, page 28417 of the federal register notice, in the price threshold table in the first column, number subsection (2) "$4.47 per MMBtu" should be deleted and the "Applies to…" section in the second column incorporated into the $9.88 per MMbtu category. The other two pricing categories should re-number to reflect the elimination of the $4.47 per MMbtu category. (As stated in the General Overview section above, we believe the establishing a low price threshold under current market conditions and anticipated future market conditions has the same effect as eliminating royalty relief before its every applicable.)

21. Section 203.41, subsection (d)(1) second line, after the word "all" insert the phrase "royalty bearing or royalty free" and in the fourth and fifth lines delete the phrase, "including production that is not subject to royalty." At the end of Subsection (d)(1) add

a new sentence that reads, "Production from the lease not subject to royalty (i.e. fuel gas) will not count towards the RSV." (Only royalty bearing production should count toward reducing the RSV. The modifications we have suggested ensure there is no confusion about what production counts toward the RSV.)

22. Section 203.42, in the second column in the table, first line, delete the word "cannot" and replace with the word "can." In the second line at the end of the sentence, add a new sentence that reads, "If a qualified phase 1 ultra-deep well is drilled after May 18, 2007, RSV can be earned whether or not your lease had previously earned a RSV from a qualified Deep well drilled prior to May 18, 2007." (As stated in our general comments, EPACT did not limit the amount of relief a lessee is entitled to earn. If the intent of Congress was to stimulate drilling and production through the granting of "incentive" base relief, it should not matter whether or not a lease had qualified and earned royalty relief under a previous program.)

23. Section 203.43, subsection (a)(2), third line, after the word "depth" insert the phrase, "or whether or not your lease is included in a unit." (This is for clarity only.)

24. Section 203.43, subsection (d)(4)(ii) on page 28420 of the federal register notice, third line, after the word "deep" insert the phrase, "and less than 400 meters deep." (This is for clarity only.)

25. Section 203.44, subsection (e)(4), third line, after the word "weather" rewrite the remainder of the sentence to state ", unavoidable accidents and production equipment failure." (In some cases ultra-deep wells may require the installation of serial 1 equipment to be able to effectively and efficiently produce these wells. Occasionally this equipment has been known to fail after installation but before production. Should this happen, clarifying in the regulations the equipment failure event as a reason for delaying production will help to eliminate some confusion as to what events qualify for delays.)

26. Section 203.48, subsection (a), in the table delete in it entirety numbered section (2) across the whole table. Re-number section number (3) to section (2) and replace the "$4.47" amount with "$9.88". (As stated in the General Overview section above, we believe the establishing a low price threshold under current market conditions and anticipated future market conditions has the same effect as eliminating royalty relief before its every applicable.)

27. Section 203.69, subsection (e), distinguishes between and provides differing minimum royalty suspension volumes for two categories of leases. They are 1) RS leases in the GOM or leases offshore Alaska and 2) Leases offshore Alaska or other deep water GOM leases issued in sales after November 28, 2000. RS leases are defined on page 28409 as "a lease issued after November 28, 2000 with an RSV". The distinction between these two categories is unclear. First, leases offshore Alaska is referenced in both categories. Second, RS leases include deep water GOM leases issued in sales after November 28, 2000. It appears that the two categories refer to the same collection of leases. Further clarification is necessary to understand the distinctions. (This is for clarity only.)

28. Section 260.122, (b)(1)(ii), sixth line, replace "$4.47" with "$9.88". (As stated in the General Overview section above, we believe the establishing a low price threshold under current market conditions and anticipated future market conditions has the same effect as eliminating royalty relief before its every applicable.)

We appreciate the opportunity to comment on this rulemaking. If you have any questions or need additional information, please contact me or Lisa Flavin of my staff at 202-682-8453.

Sincerely,

Lisa Flavin on behalf of

Doug Morris

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