COMMITTEE ON GOVERNMENT REFORM

Subcommittee on Energy and Resources

DARRELL ISSA, CHAIRMAN

Oversight Hearing:

Natural Gas Royalties: The Facts, The Remedies

March 1, 2006, 2:00pm
Rayburn House Office Building
Room 2154

BRIEFING MEMORANDUM

SUMMARY

Serious concerns have arisen regarding the implementation of the federal government's natural gas royalty payment program. Recent news reports suggest that the government may be unable to collect anywhere from $7 billion to $28 billion in natural gas royalties from leases of federal land and waters. This is particularly troublesome at a time when natural gas companies are continuing to post record earnings. There are several areas of concern.

The first is whether some gas companies have failed to fulfill their contractual obligations to make royalty payments to the Department of the Interior. There is confusion surrounding figures the industry has supplied to the Interior Department, the accounting methods of the Interior Department, and the degree of oversight provided by the Minerals Management Service. There is a question whether the US government may have been underpaid in excess of $700 million worth of royalties in 2005 on this basis alone.

Second, there is concern that the US could be excluded from billions of royalties resulting from the Deep Water Royalty Relief Act (the "Act"). The Act was enacted to provide an incentive to gas companies to explore and extract oil and natural gas from US waters. This would be accomplished by allowing the Secretary of the Interior and oil and gas companies, between 1996 and 2000, to enter into leases with a defined volume suspension and price threshold so that companies would be able to recover their capital investment before having to pay royalties on their gross revenues. This came at a time when oil and gas prices were low and the interest in deep water drilling was lacking. However, during 1998 and 1999, price thresholds were not included as terms of the leases, thereby allowing companies to recoup their capital investment long before the

expiration of volume suspensions. As these wells are now beginning to reap billions in gross revenues because of record gas prices, the effects of the price threshold-free language are coming to fruition. As a result, the US may be unable to claim part of the billions in gross revenues for the years 1998 and 1999.

This is exacerbated by threatened litigation from Kerr-McGee Exploration and Development, a major industry player. Kerr-McGee maintains that the language of the Act does not grant the Secretary of the Interior the authority to impose price thresholds and that it is not required to pay any royalties based on price thresholds for leases entered into between the years 1996 and 2000. If Kerr-McGee is handed a favorable ruling, it could ultimately force the US government to refund approximately $525 million in royalties to the industry, and preclude it from collecting between $18 and $28 billion over the next five years on leases entered into between 1996 and 2000.[1]

This oversight hearing will attempt to ascertain the facts and explore remedies to assure that the US government receives royalties to which it is entitled.

BACKGROUND

There is considerable confusion surrounding whether, and in what amount, the United States is owed royalties by natural gas companies. Of particular concern are the gross revenues from federal lands and waters leased by the federal government during 1996-2000. Some of this uncertainty is derived from the Department of the Interior's accounting and collection practices, as well as the Department's interpretation and implementation of the Deep Water Royalty Relief Act of 2005. But perhaps the most important issues with respect to royalties are centered around leases entered into in 1998 and 1999. Leases during these two years did not contain the critical price threshold provisions that were present in 1996, 1997, and 2000.

There is also a question as to whether the Secretary of the Interior had the authority to impose price thresholds in addition to the mandatory volume suspensions during the entire 1996-2000 timeframe. Threatened litigation by Kerr-McGee Exploration and Development, if favorable to the company, could preclude the US government from collecting upwards of $28 billion over the next five years, as well as force it to refund approximately $525 million in royalties paid to date.

Royalty Payment Framework

Oil and gas companies are contractually bound to make royalty payments to the US government based upon the value of the oil and gas produced from federal lands and waters. An oil and gas royalty, generally, is defined as a share of the profit from real property, reserved by the grantor of a mineral lease, in exchange for the lessee's right to mine or drill on the land. Put simply, "I give you the right to drill on my land, but you must share your gross revenues with me." In the case of land leased to oil and gas

[1] It must be noted that Kerr-McGee does not challenge the legality of imposed thresholds contained in leases after 2001.

companies by the federal government, the terms of an oil and gas royalty payment structure are governed by statute, enforced by the Minerals Management Service arm of the Department of the Interior, and are set forth in the lease. The terms, however, vary from lease to lease depending on what year the lease was entered into. For example, during the years of 1996-2000, the royalty payment structure is set forth by the Deep Water Royalty Relief Act, an act designed to relax royalty payments prescribed by the Outer Continental Shelf Lands Act. These royalty payment terms were different in 1998 and 1999 and happened to exclude certain provisions contained in other years. Whatever the arrangement, the payment structures have proven to be complex when put into practice and have yielded many questions as to the manner in which they are interpreted and enforced.

The New York Times' Assertions

The *New York Times* recently questioned the accuracy of MMS' calculations for natural gas royalties, ultimately concluding that the US government is owed an estimated $700 million. To arrive at this conclusion, it first derived an average monthly FY2005 price from information listed on the MMS website. It did this by dividing the total value of gas sold, $38 billion, by the total volume of gas sold, 6.7 billion Mcf (thousand cubic feet), reaching an average monthly price of $5.62/Mcf. It then obtained an average of monthly wellhead US natural gas prices from the Energy Information Administration ("EIA") website, which was $6.45/Mcf. Working the equation in reverse, it reached a value of $43.2 billion in FY2005 profits, which exceeded the MMS calculation by $5.2 billion. It then multiplied by a 13.6% royalty rate to reach a difference of roughly $700 million. The Department disputes the *New York Times* methodology, noting the $700 million shortfall is non-existent.

The Department contends that the $5.62/Mcf figure contains adjustments for prior year transactions and can be misleading when applied strictly to FY2005 sales. Oil and gas royalties are generally due by the end of the month following the month production is removed or sold from a lease. For example, royalties on oil produced and sold in January 2006 must be reported and paid to Minerals Revenue Management by February 28, 2006. It is common practice for the industry to submit subsequent adjustments for past periods. Under the Royalty Simplification and Fairness Act of 1996 (P.L. 104-185), industry is allowed to make past period adjustments for up to 6 years. Adjustments are necessary for a number of reasons, including reporting errors, sales contract amendments, retroactive adjustments to leases and agreements, deep water royalty relief, where the threshold for relief is met at year-end, and MMS-directed adjustments resulting from audits, etc. So strictly speaking, the *New York Times'* arithmetic was accurate. However, its methodology was incorrect because it assumed that the data reflected was only from FY2005.

The Department posits that the true volume of gas sold in FY2005 was 5,865 million Mcf. Using this figure, the average monthly price is actually $6.59/Mcf, fourteen cents higher than the EIA figure. This means that oil and gas companies paid royalties on an amount higher than the *New York Times* reported. Hence, there is no shortfall.

Other concerned individuals have pointed out what they believe to be a discrepancy between the gas royalties generated in FY2005 and those generated in FY2001.

The 2005-2001 Discrepancy

Some have expressed a concern that according to MMS data, there seems to be little difference between the gas royalties generated in FY2005 than in FY2001. This is troublesome, especially in a year that, along with record prices, should have generated record royalty payments. The Department of the Interior maintains, however, that any perceived lack of difference can be attributed to several factors. Moreover, had it not been for these factors, royalty revenue would have been $1.3 billion higher.

First, the Department contends that there was an overall decrease of 1Tcf (trillion cubic feet) in natural gas reported sales volume from federal leases due to the general trend of decline in production and the effects of hurricanes Ivan, Katrina, and Rita, and other storms. Another effect was an MMS rule that allowed for delayed reporting in order to give companies based in New Orleans time to access their data. Some of these companies did not report their figures until FY2006. Though these figures will be attributed to, and calculated with respect to, FY2005 royalty payments, some have yet to be processed by MMS.

The second is that some drilling has shifted to cheaper royalty brackets. MMS reports that some gas companies shifted their resources to include more deep water drilling. Although it was offset by a 17% increase in gas prices, this deep water increase resulted in less royalties than from an equivalent Gulf of Mexico shallow water offshore sales volume since royalty rates are lower (1/8 v. 1/6). This would account for an estimated $57.6m in gas royalties over the 2001-2005 period.

The third and most notable factor is the effects of the Deep Water Royalty Relief Act.

The Deep Water Royalty Relief Act

The Deep Water Royalty Relief Act of 1995 (the "Act") was enacted to provide incentives to oil and gas companies to explore and extract oil and natural gas from US waters. This came at a time when oil and gas prices were low and the interest in deep water drilling was lacking. To spur renewed interest, the Act allowed the Secretary of the Interior and oil and gas companies, between 1996 and 2000, to enter into leases with defined royalty suspensions based upon either a period of time, amount of gas or oil produced, or the value of gas or oil sold, in conjunction with a price variable, also known as a price threshold. [2] Since market prices always fluctuate, the Act presumed that, given

[2] ". . . The bidding [for oil and gas leases] shall be by sealed bid and, at the discretion of the Secretary [of the Interior], on the basis of . . . cash bonus bid with royalty at no less than 12 and ½ per centum fixed by the Secretary in amount or value of production saved, removed, or sold, and with suspension of royalties for a period, volume, or value of production determined by the Secretary, which suspensions may vary based on the price of production from the lease . . ." 43 USC §1337(a)(1)(H) (1995).

average wellhead prices, companies would recover their capital investment after attaining a certain volume of production.[3] Presumably, the Act included the price threshold variable as a precaution so that companies would not profit beyond their capital investment if they had not surpassed the volume suspension threshold. For example, investment recovery by a natural gas company would be based upon volume produced so long as the price of gas did not exceed $4/Mcf. If market prices exceeded the threshold, the company would profit at an accelerated rate and the purpose of the Act would therefore be moot. The Act had the desired effect, spawning thousands of new leases.

A number of these leases have entered into production and are partly responsible for the lack of difference between FY2001 and FY2005 profits. MMS reports that due to the time delay between well construction and profit generation, the industry is now seeing the gross revenues generated by these wells. The royalty payments made to the federal government in FY2005, however, were significantly reduced by the royalty suspensions provided for by the Act. This, in turn, lessened the overall royalty collection for FY2005 by approximately $193 million. But this was likely to happen and comes at no real surprise. The seemingly unintended effect of the Act's implementation, however, comes from leases entered into during 1998 and 1999.

1998 and 1999 Leases

Leases entered into in 1998 and 1999, though they included volume suspension provisions, lacked price thresholds. Again, price thresholds were presumably designed to promote and protect the overall policy of the Act by setting a gross revenue ceiling so that companies would not benefit from both high market prices and volume suspensions. The *New York Times* reports that by 2011, the absence of price thresholds could result in approximately $7 billion in royalty payments that the US government may not be able to collect. There is no explanation as to why price thresholds were included in leases in 1996, 1997, and 2000, but not in 1998 and 1999. Were revenues and drilling interest so low during this time that the previous Administration felt it necessary to offer price threshold-free leases? Was this unintentional? How is this in accordance with the policy set forth by the Act? Was this legal? The latter question has implications in litigation challenging the legality of price thresholds in 1996, 1997, and 2000.

Impending Kerr-McGee Litigation

Kerr-McGee Exploration and Development, a major industry player, reads the Act differently than the Interior Department. The Interior Department maintains that the Act gives the Secretary the authority to set price thresholds for the period between 1996 and 2000. Kerr-McGee, however, believes that the language of the Act does not grant the Secretary of the Interior the authority to impose price thresholds and that it is not required to pay any royalties based on price thresholds for leases entered into between the years of

[3] ". . . [I]n no case will that volume be less than 17.5 million barrels of oil equivalent in water depths of 200 to 400 meters, 52.5 million barrels of oil equivalent in 400-800 meters of water, and 87.5 million barrels of oil equivalent in water depths greater than 800 meters." 43 USC §1337(a)(3)(C)(ii) (1995).

1996 and 2000.[4] As such, it has refused to pay these royalties and is challenging the legality of the imposed royalty thresholds. According to the *New York Times*, a favorable ruling for Kerr-McGee could set into motion a series of lawsuits challenging the Interior Department's interpretation and implementation of the Act, thereby precluding the US government from collecting an estimated $28 billion over the next five years. Moreover, MMS reports that this could also force the US government to refund approximately $525 million in royalties already collected and invoiced.

ISSUES TO BE RESOLVED BY THIS HEARING

This oversight hearing will investigate:

- Whether the Interior Department's accounting and oversight practices are adequate and transparent;
- Whether the Deep Water Royalty Relief Act is being interpreted and implemented according to the policy it sought to promote;
- Whether leases entered into during 1998 and 1999 are in accordance with the policy promoted by the Deep Water Royalty Relief Act; and
- Whether, and in what amount, the US government is owed royalty payments from natural gas companies that drill pursuant to federal land and water leases.

WITNESS

- Walter Cruickshank, Ph.D., Deputy Director, Minerals Management Service, Department of the Interior

[4] Again, Kerr-McGee does not challenge the Secretary's authority to impose price thresholds in leases entered into after 2001.