Order Code RL33493

CRS Report for Congress

Outer Continental Shelf: Debate Over Oil and Gas Leasing and Revenue Sharing

Updated July 15, 2008

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Prepared for Members and Committees of Congress

Outer Continental Shelf: Debate Over Oil and Gas Leasing and Revenue Sharing

Summary

Oil and gas leasing in the Outer Continental Shelf (OCS) has been an important issue in the debate over energy security and domestic energy resources. The Department of the Interior (DOI) released a comprehensive inventory of OCS resources in February 2006 that estimated reserves of 8.5 billion barrels of oil and 29.3 trillion cubic feet (tcf) of natural gas. Another 86 billion barrels of oil and 420 tcf of natural gas are classified as undiscovered resources. Congress has imposed moratoria on much of the OCS since 1982 through the annual Interior appropriation bills. A Presidential Directive issued by President George H.W. Bush in 1990 (and extended by President Clinton until 2012)also banned offshore oil and gas development in much of the OCS. Proponents of the moratoria contend that offshore drilling would pose unacceptable environmental risks and threaten coastal tourism industries. On June 18, 2008, President Bush announced his support for lifting the moratoria on offshore oil and gas development. However, President Bush said that he would not lift the executive ban until Congress acted to lift its ban first. But, on July 14, 2008, President Bush reversed his position and lifted the executive ban on the OCS before Congress acted. A House proposal to increase oil production on current federal leases (H.R. 6251) was defeated under a suspension of the rules vote on June 26, 2008.

Several bills related to oil and gas leasing in the OCS were introduced in the 109th Congress. On June 29, 2006, the House approved H.R. 4761, the Deep Ocean Energy Resources Act of 2006, by a vote of 232-187. The bill would have allowed states, using specified criteria, to petition the Secretary of the Interior to lease the OCS adjacent to state waters. The Senate proposed an offshore leasing bill that was much more narrow in scope (S. 3711). The bill would make available about 8.3 million acres, provide coastal states with a share of the revenues generated from offshore leases (37.5%), extend the buffer zone within which drilling will not be allowed to 125 miles from parts of Florida, and provide a share of the revenues (12.5%) to the Land and Water Conservation Fund state-run programs. On August 1, 2006, the Senate approved S. 3711 by a vote of 71-25. At the end of the 109th Congress (without a conference agreement) the House leadership attached S. 3711 to a broad tax relief measure, H.R. 6111 (P.L. 109-432), that passed the House on December 8, 2006, and the Senate on December 9.

Royalty relief, particularly for deep-water projects, has come under closer scrutiny since it was revealed in a February 2006 *New York Times* article that leases issued during 1998 and 1999 did not contain price thresholds for royalty relief (above which royalties apply) as part of the Deep Water Royalty Relief Act (DWRRA) of 1995 (leases issued between 1996-2000). Language in the FY2009 Interior Appropriations bill as passed by the subcommittee would deny new Gulf of Mexico leases to lessees holding leases without price thresholds. However, Kerr McGee Oil and Gas Corp. (now Anadarko Petroleum Corp.) filed a lawsuit challenging MMS's authority to impose price thresholds in the DWRRA leases. On October 18, 2007, a ruling was issued by the U.S. District Court, Western District of Louisiana, in favor of Kerr McGee.

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Most Recent Developments

President Bush announced on June 18, 2008, that he would like to open areas of the Outer Continental Shelf (OCS) for oil and gas development currently under presidential and congressional moratoria (discussed in more detail below). However, the President stated that he would lift the executive branch moratoria only after Congress did so legislatively. But, on July 14, 2008, President Bush reversed his position and lifted the executive ban on the OCS imposed in 1990 by President George H.W. Bush. Senator John McCain, among others, has called on Congress to lift the offshore drilling moratoria as well. Many in Congress oppose lifting the offshore ban. They argue that there are still several million acres leased onshore and offshore but not yet producing and that production from these lands could increase U.S. oil supply. How much oil could be brought into production in the short-term (from non-producing leased lands or those under the moratoria) and its impact on price is uncertain.

An attempt to lift the offshore moratoria with an amendment to the FY2009 Interior, Environment, and Related Agencies Appropriations bill during the House subcommittee markup was defeated by a vote of 6-9. Meanwhile, on June 26, 2008, under suspension of the rules (which requires a two-thirds majority for passage), the House defeated a measure (H.R. 6251) that would have increased rental fees on non-producing oil and gas leases, shortened initial lease terms from ten to five years, and denied new federal leases to those not diligently developing the leases they have.

Royalty relief, particularly for deep-water projects, has come under closer scrutiny since it was revealed in a February 2006 *New York Times* article that leases issued during 1998 and 1999 did not contain price thresholds for royalty relief (above which royalties apply). As a result, those leaseholders continue to pay no federal royalties on specified suspension volumes, even though oil prices are at an all-time high.

The FY2009 Interior Appropriations bill, as passed by the subcommittee, contains a provision that would deny new Gulf of Mexico leases to lessees holding leases without price thresholds. Details of recent legislative activity related to the price threshold/royalty relief issues are below.

Under the new majority leadership in the 110th Congress, the House passed legislation (H.R. 6) that would offer a remedy for the offshore leases without price thresholds. Under Title II, the bill would, among other things, deny new Gulf of Mexico oil and gas leases to lessees holding leases without price thresholds or

payment or agreement to pay newly established "conservation of resources" fees. The bill would also repeal royalty relief provisions (sections 344 and 345) of the Energy Policy Act of 2005. Opponents of H.R. 6 argue that the companies with valid leases, even though without price thresholds, should not be penalized and that the provision could result in breach-of-contracts lawsuits by the companies. On July 30, 2007, the House introduced H.R. 3221, containing language on offshore royalties (under Title VII) nearly identical to Title II of H.R. 6. The House approved H.R. 3221 on August 4, 2007, by a vote of 241-170. In a recent development, the House amended and passed the Senate-passed version of energy policy legislation (H.R. 6) on December 6, 2007, but without the royalty relief remedy in the earlier House-passed bills. The royalty relief remedy provisions were subsequently not enacted in the final version of energy policy legislation (Energy Independence and Security Act of 2007, P.L. 110-140).

Kerr McGee Oil and Gas Corp. (acquired by Anadarko Petroleum Corp. in August 2006) challenged MMS's assertion in a lawsuit that it had authority to place price thresholds in the DWRRA leases (1996-2000).[1] On October 18, 2007, the U.S. District Court, Western District of Louisiana issued a ruling in favor of Kerr-McGee,[2] meaning that the Secretary of the Interior did not have authority to impose price threshold levels in leases issued under DWRRA. The ruling could apply to potentially $30 billion in future OCS royalties, but may not affect congressional efforts to impose new fees or establish new lease eligibility criteria discussed above.[3]

(For details on Title II of H.R. 6, see CRS Report RS22567, *Royalty Relief for U.S. Deepwater Oil and Gas Leases*, by Marc Humphries.)

Oil and gas leasing in the outer continental shelf (OCS) was a major energy issue in the 109th Congress. On June 29, 2006, the House approved H.R. 4761, the Deep Ocean Energy Resources Act of 2006, by a vote of 232-187. The bill would have allowed states, using specified criteria, to petition the Secretary of the Interior to lease the OCS adjacent to state waters.

The Senate proposed an offshore leasing bill (S. 3711) that was much more narrow in scope. The bill would make available about 8.3 million acres (see **Figure 1**), provide coastal states with a share of the revenues generated from offshore leases (37.5%), extend the buffer zone within which drilling will not be allowed to 125 miles from parts of Florida, and provide a share of the revenues (12.5%) to the Land and Water Conservation Fund state-run programs. On August 1, 2006, the Senate approved S. 3711 by a vote of 71-25. The bill, S. 3711, is described in more detail below. (For further discussion of the bill, see the Senate Committee on Energy and

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[1] For more details on this case, see CRS Report RL33404, *Offshore Oil and Gas Development: Legal Framework*, by Adam Vann.

[2] Kerr-McGee Oil & Gas Corp. v. Allred, No. 2:06-CV-0439 (W.D. La. October 30, 2007).

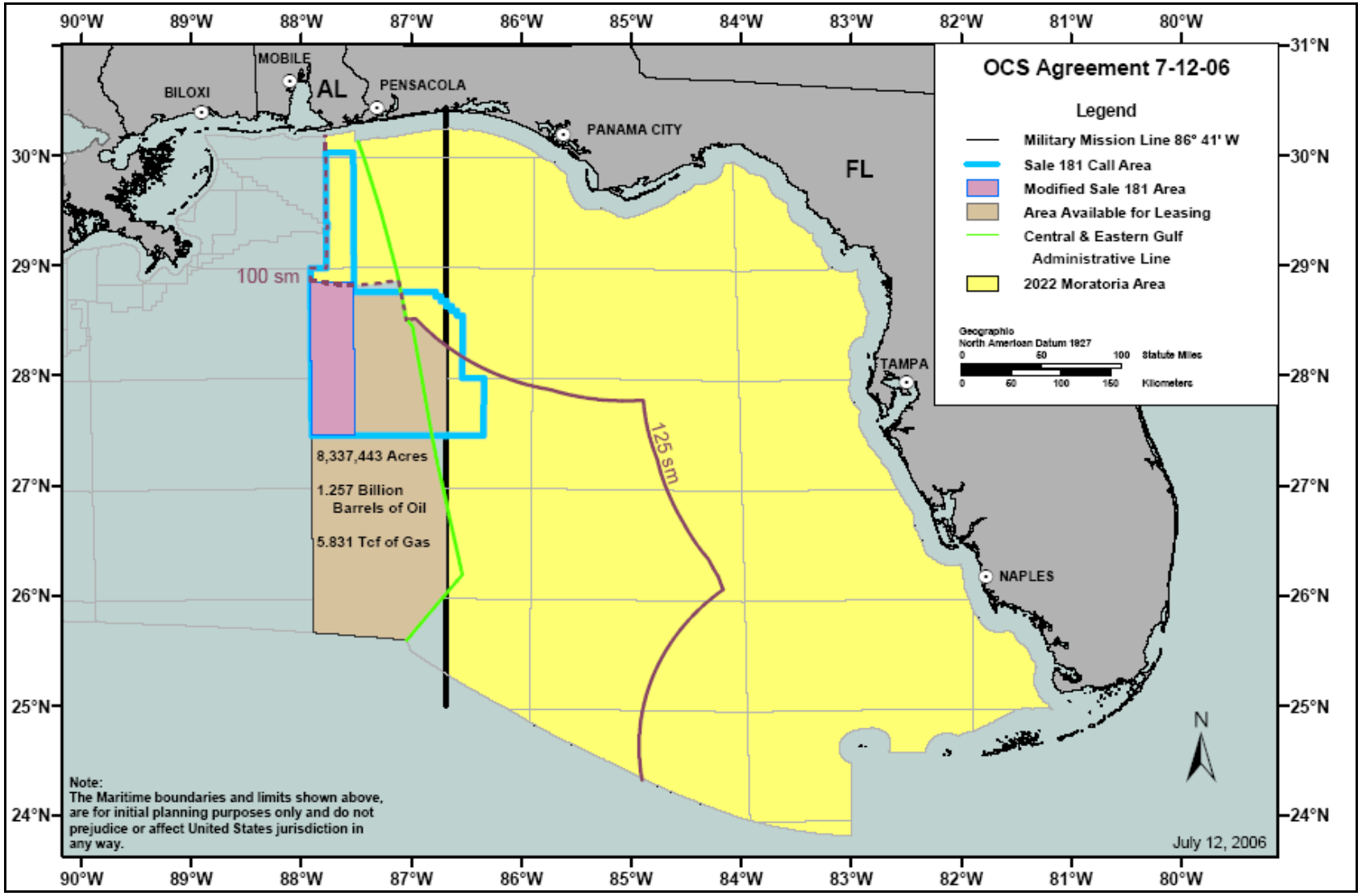
[3] See CRS Report RL33974, *Legal Issues Raised by Provision in House Energy Bill (H.R. 6) Creating Incentives for Certain OCS Leaseholders to Accept Price Thresholds*, by Robert Meltz and Adam Vann and CRS General Distribution Memorandum: *Impact of the Kerr-McGee Oil and Gas Corp. v. Allred Ruling on the Proposed Royalty Relief for America Consumers Act of 2007*, by Adam Vann.

Natural Resources news release July 21, 2006, at [http://energy.senate.gov/public/], and see [http://energy.senate.gov/public/index.cfm?FuseAction=PressReleases.Detail&PressRelease_id=235040&Month=7&Year=2006].

A conference agreement on the two very different OCS bills (H.R. 4761 and S. 3711) did not take place. Instead, at the end of the 109th Congress, the House leadership attached S. 3711 to a broad tax relief measure, H.R. 6111 (P.L. 109-432), that passed the House on December 8, 2006 and the Senate on December 9. Prior to its passage, Representative Ed Markey and others offered an amendment related to royalty relief for deepwater oil and gas lessees that would have, among other things, denied new oil and gas leases on federal lands to lessees that did not have price thresholds in their current oil and gas leases. That amendment was defeated by a vote of 207-205.

On January 9, 2007, the Department of the Interior announced an increase in the deepwater royalty rate, from 12.5% to 16.7%, on most new offshore deepwater oil and gas leases. The Minerals Management Service (MMS) estimates that this increase would raise $4.5 billion additional revenue over 20 years.

Figure 1. Lease Sale Area in S. 3711



Background and Analysis

Oil and gas leasing has been prohibited on most of the outer continental shelf (OCS) since the 1980s. Congress has enacted OCS leasing moratoria for each of fiscal years 1982-2007 in the annual Interior and Related Agencies Appropriations bill (now the Interior and Environment and Related Agencies Appropriations bill), allowing leasing only in the Gulf of Mexico (except near Florida) and parts of Alaska. President George H.W. Bush in 1990 issued a presidential directive ordering the Department of the Interior (DOI) not to conduct offshore leasing or preleasing activity in areas covered by the annual legislative moratoria until 2000. In 1998, President Clinton extended the offshore leasing prohibition until 2012.

Proponents of the moratoria contend that offshore drilling would pose unacceptable environmental risks and threaten coastal tourism industries, whereas supporters of expanded offshore leasing counter that more domestic oil and gas production is vital for the nation's energy security.

The possibility of oil and gas production in offshore areas covered by the moratoria has sparked sharp debate in Congress. A proposal to require the DOI to conduct a comprehensive inventory of OCS oil and natural gas resources drew heated opposition, although it was ultimately included in the Energy Policy Act of 2005 (P.L. 109-58, Section 357). Opponents of the OCS inventory saw it as a first step toward lifting the OCS leasing moratoria.

The Senate-passed bill (S. 3711 contained in P.L. 109-432) required that acreage in part of the original 181 sale area and an area known as South 181(currently under the leasing moratoria) be made available for lease. Industry analysts believe these areas contains significant natural gas deposits. The area of interest (181 sale area), not included in the moratoria, was removed from the original lease sale by the DOI because it was considered too close to Florida's coastline, and was placed off-limits until after the current five-year leasing program (2002-2007). Most of the eastern GOM and the Pacific and Atlantic coasts are included in the OCS moratoria.

Offshore Leasing System

The Outer Continental Shelf Lands Act (OCSLA) of 1953, as amended, provides for the leasing of OCS lands in a manner that protects the environment and returns revenues to the federal government in the form of bonus bids, rents, and royalties.[4] OCSLA requires the Secretary of the Interior to submit five-year leasing programs that specify the time, location, and size of the areas to be offered. Each five-year leasing program entails a lengthy multistep process that includes environmental impact statements. After a public comment period, a final proposed plan is submitted to the President and Congress.

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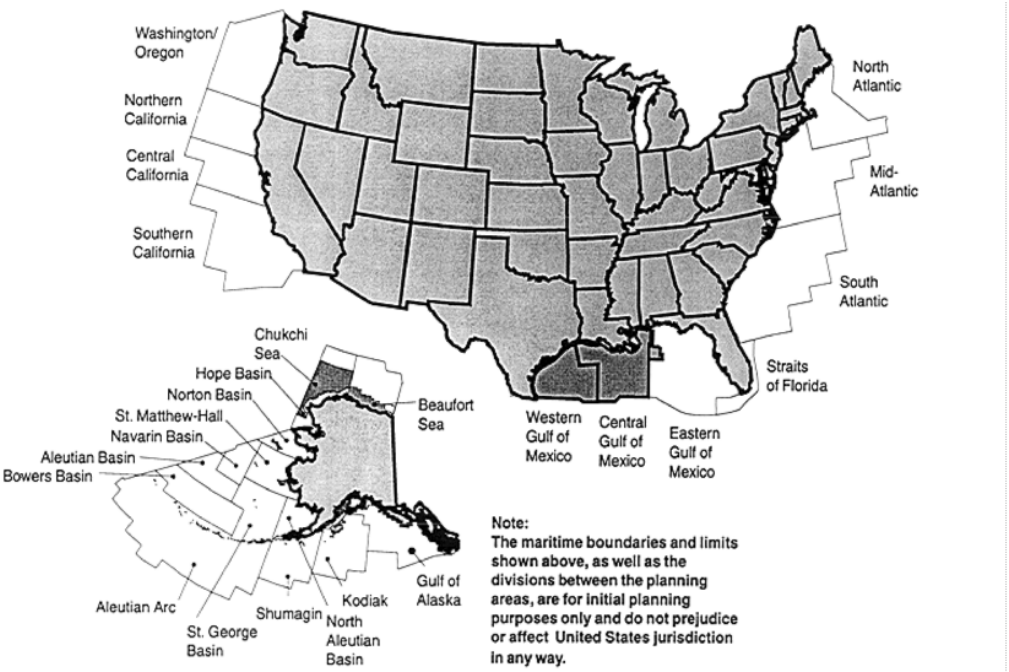
[4] 43 U.S.C. 1331 et seq.

The offshore leasing program is administered by the Minerals Management Service (MMS), an agency within the DOI. The MMS conducted 16 OCS oil and natural gas lease sales during its previous five-year program from 2002-2007. Nine of those sales were in the western or central Gulf of Mexico (GOM), two in the eastern GOM and the remainder were around Alaska. Alaska's lease sales were held in the Beaufort Sea, Norton Basin, Cook Inlet, and the Chukchi Sea/Hope Basin (see **Figure 2**). Two Alaskan lease sales that were not held in the scheduled 2002-2007 leasing program (sales 193 and 203) will be superseded by lease sales in the 2007-2012 leasing program. Sale 193 (Chukchi Sea, Alaska) took place on February 6, 2008.

During the summer of 2005, the MMS introduced its proposed five-year leasing program for 2007-2012. Public hearings on the leasing program have been held, and states and interest groups are filing comments on future lease sale areas for the 2007-2012 leasing program.[5] On April 30, 2007, the Secretary of the Interior announced its Proposed Final Program. Areas along the Atlantic coast (i.e., Virginia, currently covered by OCS moratoria), the North Aleutian Basin (Alaska), and the central GOM are included in the final leasing program. A small area would be offered for lease in the eastern GOM planning area, which has been redrawn to provide for more accuracy in boundaries between states and planning areas.[6] The new five-year leasing program began July 1, 2007.

Figure 2. MMS 5-Year Program Areas



Source: Minerals Management Service, 2002-2007-Year Leasing Program. MMS defines the OCS as submerged lands, subsoil, and seabed between the seaward extent of states' jurisdiction and the seaward extent of federal jurisdiction.

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[5] *Federal Registe*r Notice, 70 FR 49669.

[6] *Federal Register*, vol. 71, no. 1, January 3, 2006, Notices, p. 127.

Nineteen lease sales are scheduled for the 2007-2012 leasing program. Three lease sales have occurred to date. In addition to lease sale 193 in February 2008, lease sales 206 and 224 took place in March 2008. Revenues from lease sale 224 will be shared with coastal states (Mississippi, Alabama, Texas and Louisiana) as required by the Gulf of Mexico Energy Security Act of 2006 (P.L. 109-432).

Lease sales are conducted through a competitive, sealed bonus bidding process, and leases are awarded to the highest bidder. Successful bidders make an up-front cash payment, called a bonus bid, to secure a lease. A minimum acceptable bonus bid is determined for each tract offered. During the past 13 years, annual bonus revenues have ranged from $85 million in 1992 to $1.4 billion in 1997. Bidding on deepwater tracts in the mid-1990s led to a surge in bonus revenue.[7] Offshore bonus bids totaled $374 million in FY2007. In addition to the cash bonus bid, a royalty rate of 12.5% or 16.7% is imposed on the value of production, depending on location factors, or the royalty is received "in-kind."[8] The rate could be higher than 16.7% depending on the lease sale. For instance, lease sale 224 will require a royalty rate of 18.75% in all water depths. Annual rents are $5-$9.50 per acre, with lease sizes generally ranging from 2,500-5,760 acres. Initial lease terms of 5-10 years are standard, and leases continue as long as commercial quantities of hydrocarbons are being produced. Bonding requirements are $50,000 per lease and as much as $3 million for an entire area. The Secretary of the Interior may reduce or eliminate the royalty established by the lease in order to promote increased recovery.

Federal Distribution of OCS Revenues

Federal revenues from offshore leases were estimated at $7.0 billion in FY2007 by the MMS. During the previous 10 years (1997-2006), revenues from federal OCS leases reached as high as $7.6 billion in FY2006. Revenues were as low as $3.2 billion in 1999. Higher prices for oil and gas are the most significant factors in the revenue swings. Of the $7.0 billion offshore revenue in FY2007, $6.4 billion was from royalties.

These revenues are split among various government accounts. Revenues from the offshore leases are statutorily allocated among the coastal states, the Land and Water Conservation Fund, the National Historic Preservation Fund,[9] and the U.S. Treasury. For distribution of all revenue from federal leases, see **Figure 3**. States receive 27% of OCS receipts closest to state offshore lands (drainage tracts) under

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[7] Department of the Interior, FY2002 Budget Justifications, p. 63.

[8] A royalty-in-kind payment would be in the form of barrels of oil or cubic feet of natural gas.

[9] Under the National Historic Preservation Act (16 U.S.C. 470 et.seq.) The National Historic Preservation Fund is authorized to receive $150 million annually from OCS receipts. Authorization for this act expired at the end of FY2005, thus no funds were disbursed from OCS receipts in FY2006. After reauthorization in December 2006, funding from OCS receipts resumed in FY2007.

section 8(g)[10] of the OCSLA amendments of 1985 (P.L. 99-272). In FY2007, this share was $67.6 million out of about $2 million in total state on-shore and offshore receipts. A dispute over what was meant by a "fair and equitable" division of the 8(g) receipts was settled by the 1985 OCSLA amendments.[11] Revenue-sharing provisions in S. 3711 (P.L. 109-432) allow selected Gulf States to receive 37.5% of the revenue generated from specified federal oil and gas leases off their coasts.

For onshore public domain leases, states generally receive 50% of rents, bonuses, and royalties collected. Alaska, however, receives 90% of all revenues collected on public domain leases.[12]

Coastal Impact Assistance

States with energy development off their shores in federal waters[13] have been seeking a larger portion of the federal revenues generated in those areas. They particularly want more assistance for coastal areas that may be most affected by onshore and near-shore activities that support offshore energy development. Proponents of these proposals look to the rates at which funds are given to jurisdictions where onshore energy development occurs within those jurisdictions on federal lands. Coastal destruction has received more attention in Louisiana, where many square miles of wetlands are being lost to the ocean each year. One of the causes of this loss is thought to be widespread energy-related development. Currently, the affected states receive revenue indirectly from offshore oil and gas leases in federal waters. This is in contrast to the direct revenues to states that have

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[10] The 8(g) revenue stream is the result of a 1978 OCSLA amendment that provides for a "fair and equitable" sharing of revenues from section 8(g) common pool lands. These lands are defined in the amendments as submerged acreage lying outside the three-nautical mile state-federal demarcation line, typically extending to a total of six nautical miles offshore but that include a pool of oil common to both federal and state jurisdiction. The states' share of the revenue (27%) was established by the OCSLA amendments of 1985 (P.L. 99-272) and is paid directly to the states. Payments to the states previously had been placed in escrow, which were then paid out between 1986 and 2001.

[11] Department of the Interior, Minerals Management Service, *Mineral Revenues 2000*, p. 95.

[12] However, the manner is which royalties are split between states and the federal government differs. For all states except Alaska, direct royalties under the Mineral Leasing Act (MLA) are divided equally (50-50) between the state in which the deposits are located and the federal government. The MLA also provides that all states except Alaska get back 40% from the Reclamation Fund (established by the Reclamation Act of 1902), in effect giving each state 90% of the royalties and the federal government 10%. Alaska does not receive allocations from the Reclamation Fund, so to equalize royalty treatment among the states, the Alaska Statehood Act and the Federal Land Policy and Management Act provide that Alaska's royalty share is 90% of the direct royalties (rather than 50%).

[13] State jurisdiction is typically limited to three nautical miles seaward of the baseline from which the breadth of the territorial sea is measured. However, the state jurisdiction off the Gulf Coast of Florida and Texas extends nine nautical miles and for Louisiana, three imperial nautical miles. Federal jurisdiction extends, typically, 200 nautical miles seaward of the baseline from which the breadth of the territorial sea is measured.

onshore federal leases within their boundaries, as noted above. On the other hand, opponents point out the budget implications as a result of the loss of federal revenues.

There are two fundamental purposes for revenue sharing programs, according to the Coastal Impact Assistance Working Group (an MMS advisory group): (1) to fund projects that will mitigate the environmental and economic impact of OCS energy development, including the need for infrastructure and public services, and (2) to help sustain development of nonrenewable energy sources.[14]

Two federal revenue sharing programs addressed coastal impacts from OCS energy development: (1) the now-expired Coastal Energy Impact Program (CEIP), established as an amendment to the Coastal Zone Management Act, and (2) the Section "8(g)" zone program, established under OCSLA. A third program, the Land and Water Conservation Fund, has also provided state funding from the OCS revenue stream, but the distribution of those revenues has no connection with OCS activities. Even the CEIP program was not considered a true revenue-sharing program because its funding levels were not based on the amount of leasing activity in the OCS.

A new Coastal Impact Assistance Program (CIAP) is established under section 384 of the Energy Policy Act of 2005 (EPAct '05) (P.L. 109-58) as an amendment to Section 31 of the OCSLA (43 U.S.C. 1356a). Under this program, the Secretary of the Interior is to disburse, without further appropriation, $250 million per year during FY2007-FY2010 to producing states and political subdivisions according to specified allocations. The states must submit plans on how they will spend these funds for approval by the Secretary of the Interior. Among other things, the funds are designated for the restoration of coastal areas, mitigation of damage to natural resources, the implementation of federally approved conservation management plans, and for infrastructure projects. Eligible oil- and gas-producing coastal states include Alabama, Mississippi, Texas, Louisiana, California, and Alaska.

On April 16, 2007, MMS announced allocation amounts available to eligible states for fiscal years 2007 and 2008. Before allocations are disbursed, states are required to submit a plan to MMS for approval not later than July 1, 2008, according to the MMS. Based on the allocation formula, Louisiana would receive 52.6% of the CIAP funds; Texas, 20.04%; Mississippi, 12.76%; Alabama, 10.54%; California, 3.07%; and Alaska, 1%.

Offshore Leasing Moratoria

The offshore leasing moratoria began with the FY1982 Interior Appropriations Act (P.L. 97-100), which prohibited new leases off the shore of California. The imposition of other moratoria came about after many coastal states and environmental groups contended that leasing tracts in environmentally sensitive areas might lead to activities that could cause economic or irreversible environmental

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[14] Coastal Impact Assistance, Report to the OCS Policy Committee from the Coastal Impact Assistance Working Group, October 1997.

damage. Eventually, the moratoria were expanded to include New England, the Georges Bank, the mid-Atlantic, the Pacific Northwest, much of Alaska, and a portion of the eastern Gulf of Mexico. Because of environmental and economic concerns, Congress for the past two decades has supported annual moratoria on leasing and drilling in the OCS. Congress enacted the moratoria for each of fiscal years 1982-2008 through the annual Interior Appropriations bill.

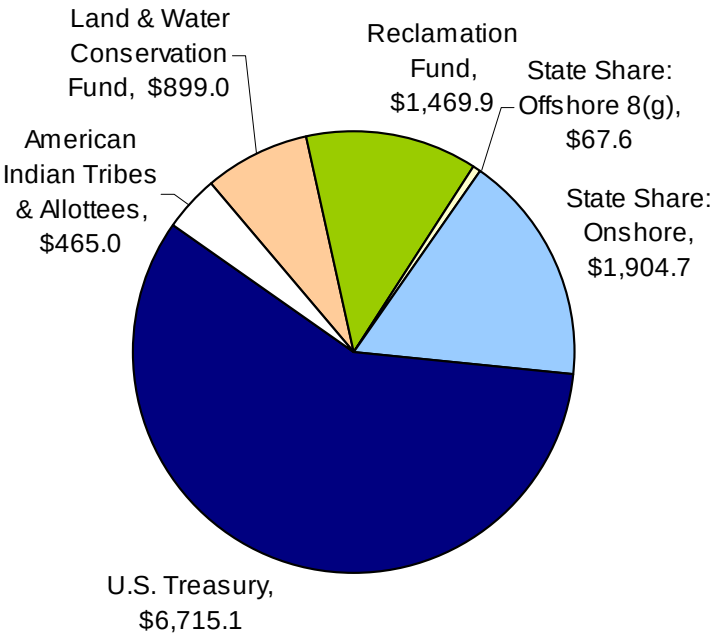
President George H.W. Bush, in 1990, responding to pressure from the states of Florida and California and others concerned about protecting the ocean and coastal environments, issued a presidential directive ordering the Department of the Interior (DOI) not to conduct offshore leasing or preleasing activity in places other than Texas, Louisiana, Alabama, and parts of Alaska until 2000 — prohibiting leasing in the same areas covered by the annual moratoria. In 1998, President Clinton extended the presidential offshore leasing prohibition until 2012.

The FY2006 Interior and Environment Appropriations Act (P.L. 109-54) continued the leasing moratoria in other areas, including the Atlantic and Pacific Coasts. An amendment to lift the moratorium in the eastern Gulf of Mexico was offered (House Amendment 174, Representative Istook) on the House floor during debate but was rejected on a point of order. An amendment (Representative Peterson) that would have lifted the moratoria on offshore natural gas was defeated (see Roll Call vote no. 192, May 19, 2005). Congress extended the offshore leasing moratoria through FY2007 and FY2008.

However, the FY2006 and FY2007 Interior Appropriations Act did not include language to prohibit oil and gas leasing in the North Aleutian Basin Planning Area. The FY2004 law (P.L. 108-108) and FY2005 law (P.L. 108-447) similarly omitted this language. There is reportedly some industry interest in eventually opening the area to oil and gas development as an offset to the depressed fishing industry in the Bristol Bay area. Environmentalists and others oppose this effort. The North Aleutian Basin Planning Area, containing Bristol Bay, is contained in MMS's current leasing program for 2007-2012.

The enactment of H.R. 6111 (P.L. 109-432) containing provisions of S. 3711 (discussed in more detail below) opened 5.8 million acres in the Gulf of Mexico previously under the moratoria.

Figure 3. Distribution of Revenue from Federal and Indian Leases, FY2007 (millions of dollars)



Source: MMS, Minerals Revenues Management, 2008.

Natural Gas-Only Proposals

Under current law, all OCS lease sales include both oil and gas, and a lessee is required to develop the gas or the oil once it is discovered. Natural gas-only leases have been met with much skepticism by many experts in geology, who note that most of these offshore fields are likely to contain both oil and gas. Further, industry might be reluctant to bid on leases that did not transfer ownership of all discovered resources. Proponents argue that production of natural gas only would lessen states' concerns.

H.R. 2784 (the National Environment and Energy Development Act), introduced on June 18, 2007, would revoke all provisions to prohibit preleasing and leasing natural gas in the OCS. The bill would also revoke all withdrawals in the OCS related to natural gas exploration and development. Leasing within 25 miles of a states coastline would still be prohibited but states could approve natural gas leasing between 25 and 50 miles off its coastline. A revenue sharing plan on new natural gas leases would allocate 37.5% of the revenue stream to the producing states, 25% to the general treasury, and 37.5% would be split among various state environmental projects and weatherization assistance. This bill was referred to the House Subcommittee on Energy and Mineral Resources.

Lease Sale 181 — Revisited

Sales in the eastern Gulf of Mexico (GOM) have been especially controversial. A Bush Administration plan (originating in the Clinton Administration) to lease 5.9 million acres in the eastern GOM (Lease Sale 181) sparked considerable debate, although the area was not under a leasing moratorium. No eastern GOM lease sale had taken place since 1988. The Lease Sale 181 area was considered by opponents to be too close to the shore and to environmentally sensitive areas. Some tracts were as close as 17 miles from the Florida and Alabama coastline. The major concern of those in Florida opposing the sale was impairing the value of tourism to the state. If an accident were to occur, causing an oil spill, it could damage the state's beaches and thus the tourist industry. It also could severely affect the marine environment, opponents contended.

The original area of 5.9 million acres, estimated to contain nearly 8 trillion cubic feet (tcf) of natural gas and 396 million barrels of oil, was reduced to 1.47 million acres after intense pressure from environmentalists and state officials. The reduced Lease Sale 181 offered 256 blocks containing an estimated 1.25 tcf of natural gas and 185 million barrels of oil. The sale took place December 5, 2001.

Toward the end of the first session of the 109th Congress, Senator Pete Domenici, Chairman of the Senate Energy and Natural Resources Committee, expressed an interest in opening up offshore areas now under the moratoria in a push to ease the "natural gas crisis."[15] The legislation he introduced (S. 2253) was limited to offering for lease a portion (3.6 million acres) of Lease Sale Area 181 within a year of enactment. Based on revised MMS estimates provided to the committee, there are about 6 tcf of natural gas and 930 million barrels of oil (mbo) in the area that would have been leased under S. 2253. An alternative bill (S. 2239/Martinez) would have extended a buffer zone around Florida's coast out 150 miles and would thus make available a much smaller area for Lease Sale Area 181 — about 740,000 acres. The Senate eventually passed a bill (S. 3711, discussed below) that included 8.3 million acres and revenue sharing provisions for selected Gulf states.

The MMS's five-year leasing program (2007-2012) includes a Lease Sale 181 area that is smaller than the Domenici version but larger than the Martinez proposal. The area recommended by the MMS is 2 million acres and estimated to contain 3.4 tcf of natural gas and 530 mbo. Industry groups contend that eastern GOM sales are too limited, given what they say is an enormous resource potential, whereas environmental groups and some state officials argue that the risks of development to the environment and local economies are too great.

California Leases

Congress has banned additional drilling in the Santa Maria Basin and Santa Barbara Channel areas where there are leased tracts. Companies unable to develop their existing California lease holdings are seeking compensation from the federal government. The companies contend that more than a billion dollars has already

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[15] *Inside Energy Extra*, October 6, 2005.

been spent to obtain the leases.[16] In previous buyback settlements, firms have recouped their bonus bid payments but lost possible future returns that would have been earned if commercial production were achieved.[17] In the case of the offshore California leases, the Clinton Administration continued to extend the leases (through suspensions) that were granted between 17-33 years ago, before the moratoria were imposed.

The last suspension by MMS, in 1999, extended 36 of the 40 existing offshore California leases at issue. This action was taken to give lease holders more time to "prove up" oil reserves and for MMS to show consistency with state coastal zone management plans, as required by 1990 amendments to the Coastal Zone Management Act (P.L. 92-583). A state's objection could prevent development of the oil and gas leases.

On June 20, 2001, the U.S. District Court for the Northern District of California struck down the MMS suspensions, potentially allowing the leases to expire, because it held that MMS failed to show consistency with the state's coastal zone management plan. The Bush Administration appealed this decision to a three-judge panel of the Ninth Circuit of Appeals in San Francisco on January 9, 2002, and has proposed a more limited lease development plan that involves 20 leases, using existing platforms and other necessary infrastructure. However, on December 2, 2002, the Ninth Circuit panel upheld the District Court decision.[18] The Department of the Interior did not appeal this decision and is currently working with lessees to resolve the issue. A breach-of-contract lawsuit was filed in the U.S. Federal Court of Claims against MMS on January 9, 2002, by nine oil companies seeking $1.2 billion in compensation for their undeveloped leases (*Amber Resources et al. v. United States*).

After the lawsuit was filed, several oil and gas lessees involved in the dispute submitted a new round of suspension applications to prevent lease termination and loss of development rights. In response, the MMS prepared six environmental assessments and found no significant impact for processing the applications. However, under the Coastal Zone Management Act, a consistency review by MMS and the state's response to that review must occur before a decision is made to grant or deny the requests. The State Coastal Commission ruled unanimously on August 11, 2005, that the lease suspensions should not be renewed. Following that decision, on August 12, a U.S. District Court ordered the MMS to conduct additional studies under the National Environmental Policy Act (NEPA) of the 36 leases under suspension. MMS argued that it had presented sufficient evidence for the judge to reach a decision on whether to allow MMS to grant further suspensions. Senator

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[16] Inside Energy with Federal Lands, September 3, 2001.

[17] Estimating future revenues with limited drilling is difficult at best because it is not possible to determine the extent (if any) or quality of hydrocarbons. According to the MMS, the leased area contains an estimated 1 billion barrels of oil and 500 billion cubic feet of unproved reserves.

[18] Ninth U.S. Circuit Court of Appeals, *California v. Norton*, 01-16637.

Diane Feinstein of California has urged that the MMS conduct additional studies or, if not, allow the leases to terminate.[19]

In the meantime, on November 17, 2005, the U.S. Federal Court of Claims made a determination in the *Amber Resources* lawsuit that the federal government breached its contract with the lessees regarding the 36 offshore California leases. Although the government was ordered to repay the lessees $1.1 billion, the judge deferred a final judgment until additional claims (such as recovery of sunk costs) are resolved. If a settlement is reached, the MMS would automatically terminate the leases. This action would then negate any further action on the consistency determinations. Thus, no further action will be taken by the Department of the Interior to address the concerns of the California Coastal Commission until a final judgment is reached.

Royalty Relief

Royalty relief is commonly granted to assure full production of offshore oil and gas. OCSLA authorizes the Secretary of the Interior to grant royalty relief in order to promote increased oil and gas production. There are generally four royalty relief categories in the GOM: Deepwater, Shallow Water Deep Gas, End-of-Life, and Special Case. Royalty relief under the End-of-Life and Special Case categories was already in place under OCSLA before the Deep Water Royalty Relief Act of 1995 (DWRRA). The DWRRA expands the Secretary's authority to use royalty relief as an incentive for leasing federal OCS Gulf of Mexico deepwater. Under DWRRA, the Secretary of the Interior may reduce royalties if production would otherwise be uneconomic.[20] Threshold price levels were established in 1995, above which the relief is discontinued. In 2004, the threshold price was $33.55 per barrel for deepwater oil and $4.19 per million BTUs for deepwater natural gas. The threshold price levels are adjusted annually for inflation.[21]

Congressional debate over royalty relief for OCS oil and gas producers has been ongoing. On February 13, 2006, the New York Times reported that the MMS would not collect royalties on leases awarded in 1998 and 1999 because no price threshold was included in the lease agreements during those two years. Without the price thresholds, lease holders may produce oil and gas up to specified volumes without paying royalties no matter what the price. The MMS asserts that placing price thresholds in the lease agreements is at the discretion of the Secretary of the Interior. However, according to the MMS, the price thresholds were omitted by mistake from

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[19] Inside Energy, August 22, 2005

[20] A brief description of royalty relief programs offered by the MMS can be found on its website at [http://www.gomr.mms.gov/homepg/offshore/royrelef.html]. A more detailed analysis of the royalty relief programs is contained in the following report: Department of the Interior, MMS, *Guidelines for the Application, Review, Approval, and Administration of the Deepwater Royalty Relief Program for Pre-Act Leases and Post-2000 Leases*, appendix 1 to NTL no. 2002-No2, February 2002.

[21] Price threshold levels for deepwater oil and gas can be found on the MMS website.

576 offshore leases during 1998 and 1999.[22] An Interior Department Inspector General investigation acknowledged that mistakes were made but were considered to be "blunders" and not intentional omissions.[23] The total value of foregone royalties over the six-year period is estimated by MMS at about $9.5 billion.

The House approved language in the Interior and Environment appropriations bill (H.R. 2643) barring funds in the bill from being used for new leases in the Gulf of Mexico (GOM) for those holding leases under the Deep Water Royalty Relief Act of 1995 without price thresholds. The Senate Appropriations Committee, however, rejected bill language that would have prohibited the government from issuing new offshore leases in the GOM to companies holding deepwater leases issued in 1998 and 1999 without price thresholds.

Lease Development in the Gulf of Mexico

The MMS reports that there is great potential in the central and western Gulf of Mexico (GOM) deepwater regions (> 400 meters).[24] Spurred by the Royalty Relief Act of 1995, significant investment has been made, including bonus bids and annual rents by major and independent oil and gas companies. Overall, since 1995, deepwater production of oil has increased from 16% of total GOM production to nearly 70% in 2005. Deepwater natural gas has risen from 3.8% of total GOM production to 38% during the same period. The deepwater production in the GOM is expected to continue growing over the next 20 years. There are, however, a limited number of rigs available to drill, and there are prospects elsewhere that could make any area available for leasing less likely to get developed in the short-term.[25] Moreover, very little exploration and development have yet to occur within some of the deepwater regions that were leased since 1995.

The amount of development of leases is significantly different in shallow and deep regions. In the West and Central Gulf region, at less than 400 meters deep, about 40% of the leased tracts have been producing since the 1990s, whereas a small and declining fraction of currently leased tracts have been explored but did not produce. About 40% of the active leases at this depth have not been explored.

In the narrow region between 400 and 800 meters, most of the relatively few leases have not been explored, but a small and increasing number have begun production. This pattern is even clearer in the region deeper than 800 meters, where

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[22] This information is from discussions with Walter Cruickshank, Deputy Director of MMS, during April, 2006.

[23] Testimony of the Honorable Earl E. Devaney, Inspector General for the Department of the Interior before the United States Senate Committee on Energy and Natural Resources, January 18, 2007.

[24] Department of the Interior, MMS, *Deepwater Gulf of Mexico 2004: America's Expanding Frontier*, OCS Report, MMS2004-021.

[25] Ibid, p. 107.

a large number of leases have been let, especially since 1995, and only a small fraction of them have been explored.

A major stimulus to exploration and development of a promising lease is the approach of the end of the lease term. MMS officials contend they are allowing leases to expire and putting them up for reletting. MMS officials point out that, with a 10-year lease period, the many deepwater leases let in the mid-1990s will be running out in the next few years, which may stimulate increased activity in that region.

The Department of the Interior (DOI) conducted a comprehensive inventory of OCS oil and natural gas resources, as required by the Energy Policy Act of 2005 (P.L. 109-58, Section 357). In the inventory, the DOI provided mean estimates of 8.5 billion barrels of known oil reserves and 29.3 trillion cubic feet (tcf) of natural gas; 82% of the oil and 95% of the gas is in the Gulf of Mexico (GOM). In the undiscovered resource category, the DOI estimated about 86 billion barrels (51% in the GOM) and 420 tcf of natural gas (55% in the GOM).

Barriers to Development

The high proportion of deepwater leases that have not been explored, in light of the high productivity of those that have been developed, raises questions of barriers that may be impeding full development of the region's potential. Although even developed regions have many leases that are not explored, the fact that more than 90% of deepwater leases have not been explored stands out.

According to MMS officials interviewed by CRS,[26] the major factor in determining exploration is the high cost of activity in the deepwater region, and also the relatively few rigs that are available to operate there. Financing oil exploration and development is an extremely complex process, frequently involving secondary markets for leases and farming out development to obtain financing. According to MMS, no barriers exist to discourage or penalize innovative and flexible financing schemes.

109th Congress Legislation (Enacted)

P.L. 109-432 (S. 3711)

Gulf of Mexico Energy Security Act of 2006. S. 3711 directs the Secretary of the Interior to offer lease sales within the 181 Area, primarily in the Central Gulf of Mexico as defined in the bill, within one year after enactment of this legislation. The 181 Area (defined in the bill) is part of the original Lease Sale 181 contained in the Outer Continental Shelf (OCS) 1996-2001 5-Year Leasing Program before the area was scaled back by the Secretary of the Interior. The 181 Area, as defined in the bill, covers about 2.5 million acres. In addition, the bill directs the Secretary to offer for lease, as soon as practicable, an area south of the 181 Area known as 181 South Area.

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[26] CRS analysts held frequent telephone conversations with MMS official and, on January 18, 2005, met in person for a conference of several hours.

This area covers about 5.8 million acres. 181 South Area is in its 2007-2012 5-Year Leasing Program. The MMS estimates that together, these two areas covered by the bill contain 5.8 trillion cubic feet of natural gas and 1.26 billion barrels of recoverable oil. The Senate passed S. 3711 on August 1, 2006, by a vote of 71-25. At the end of the 109th Congress, provisions contained in S. 3711 were attached to a broad tax relief measure (H.R. 6111), which passed the House and Senate and was signed into law (P.L. 109-432).

Areas where preleasing and leasing activity would be excluded under the bill and placed under moratorium until 2022, would be east of the Military Mission Line (about 230 miles from Florida's west coast), within 125 miles of Florida in the New Eastern Gulf of Mexico Planning Area, and within 100 miles of the State of Florida in the New Central Gulf of Mexico Planning Area. Current lessees within the prohibited areas in the New Eastern and Central Gulf of Mexico Planning Areas could exchange those leases for bonus or royalty credits (valued at the amount paid in bonuses and rents on existing leases) for another lease in the Gulf of Mexico.

Revenue sharing provisions in the bill would allow for Gulf producing states (defined as Alabama, Mississippi, Louisiana, and Texas) to receive 37.5% of revenues generated from leases held in the 181 Area and 181 South Area beginning FY2007. Beginning in FY2017 and thereafter, the Gulf producing states would also receive 37.5% of the revenues generated from leases awarded within the 2002-2007 planning area, including historical leases (described in Sec. 5(b)(2)(C) of the bill). Distribution among the Gulf producing states would be determined by the Secretary of the Interior according to a formula to be developed that would accomplish a distribution inversely proportional to the respective distances from the coastlines to the center of the lease tracts. The minimum amount available to any of the Gulf producing states would be 10% of the qualified revenues. The Secretary would pay 20% of the state's share to its coastal political subdivisions. The Land and Water Conservation Fund (currently funded from OCS revenues) would receive 12.5% of the qualified revenues for state programs and the Federal General Treasury would receive 50% of those revenues. An annual net spending cap of $500 million (on revenues shared with the states) above receipts in the newly opened areas is included in this bill. The MMS estimates that the state's share would total $3.1 billion through 2022 and increase to a total of $59.6 billion through 2067.