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The OCS Royalty Rate: Statutory Requirements and General Guidance

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Background

The Outer Continental Shelf Lands Act (OCSLA) (43 U.S.C. 1337; P.L. 83-212) authorizes the Secretary of the Interior to establish a royalty rate as part of the process for leasing acreage for oil and gas developments in federal waters. "The Secretary of the Interior shall establish royalties, fees, rentals, bonuses, and other payments to ensure a fair return to the United States for any lease...." Further, OCSLA requires a cash bonus bid with a royalty set at not less than 12.5% in amount or value of production (43 U.S.C. 1337 (a)(1)(A)) (For details on product valuation, see 30 C.F.R. 1206.100 (federal oil) and 30 C.F.R. 1206.150 (natural gas.)) However, in order to promote increased production on the lease, the Secretary of the Interior may reduce or eliminate any royalty established in the lease. The Bureau of Ocean Energy Management (BOEM)—the Department of the Interior (DOI) agency that administers the offshore leasing program (based on scheduled lease sales in its Five-Year Leasing Program)—sets the minimum bid levels, rental, and royalty rates by individual lease sale based on its analyses of market and resource conditions. The Economics Division at BOEM conducts analyses to ensure that the federal government receives fair market value when issuing rights to develop offshore energy and mineral resources.

In 2007 and 2008 the DOI made major adjustments to OCS royalty rates. At that time, the shallow water (200 meters or less) rate was 16.67% while the deepwater rate was generally 12.5%. Initially, the deepwater rate was raised to 16.67%. Soon after, the rates for new leases in all water depths were raised to 18.75%.

Recent OCS Lease Sale

BOEM reduced the OCS royalty rate from 18.75% to 12.5% for shallow water blocks in the most recent lease sale (lease sale 249) held in the Gulf of Mexico (GOM) on August 16, 2017. This was the first lease sale in the 2017-2022 Five-Year Leasing Program. BOEM's explanation for its decision to drop the royalty rate centered on the declining leasing, drilling, and production in shallow water. BOEM's oil and gas resource estimates in shallow water have declined in recent years. For example, 2016 estimates of oil resources fell by one-third and natural gas resource estimates fell by 40%. BOEM also asserted that low oil and natural gas prices and the marginal nature of the remaining GOM shelf resources supported the need for a lower rate.

In a previous sale, 22 shallow water blocks were leased out of 5,200 blocks offered. In deeper water, there were 165 blocks leased out of 8,300 offered. (Lee Tilton, Chief, Office of Congressional Affairs–BOEM, August 1, 2017.) During the August 16th lease sale, of 14,177 blocks offered 90 blocks received bids, 10 of which were in shallow water. Nearly half (47%) of the blocks receiving bids were in water depths of 1,600 meters or more.

The oil and gas industry remains interested in deepwater exploration and development. Shallow water is considered by BOEM to be a region of the OCS with more gas than oil but increased supply of lower cost onshore gas has made OCS gas less competitive with other U.S. natural gas sources.

In a comparative study of global oil and gas fiscal systems (including an assessment of royalty rates) commissioned by the DOI, the study's author concluded that since the current framework for the royalty rate is not based on net income, and is insensitive to price levels or production levels, the royalty rate can increase the marginal cost and discourage development of marginal fields. Also, reducing the royalty rate is not sufficient in a mature OCS field to incentivize investment.

Royalty Relief Programs

Advances in deepwater drilling technology have been made since the late 1990s and early 2000s stemming from the Deepwater Royalty Relief Act (DWRRA) of 1995 (P.L. 104-58). The DWRRA allowed for specified amounts of royalty free production (suspension volumes—the amount of royalty-free production, some of which are subject to price thresholds, above which royalties are paid) in deepwater regions of the GOM as an incentive to invest in deepwater technology and the abundant deepwater oil and gas resources. Royalty relief for deepwater production was continued under the Energy Policy Act of 2005 (P.L. 109-58).

OCSLA authorizes the Secretary of the Interior to grant royalty relief to promote increased oil and gas production. DOI has established royalty relief programs under two general categories: "automatic" and "discretionary." Under the automatic category, BOEM spells out the royalty relief when they issue the lease. This category includes the GOM suspension volumes for specified deepwater leases, and the Shallow Water Deep Gas (less than 200 meters) program which began in 2004 and was expanded under the Energy Policy Act of 2005.

The discretionary category includes End-of-Life leases and Special Case leases, administered by the Bureau of Safety and Environmental Enforcement (BSEE) and which require an application and economic evaluation. End-of-Life relief applies to producing leases, in any water depths, whose increased production would otherwise likely not occur. Royalty relief under the End-of-Life and Special Case programs existed prior to DWRRA.

Proponents of these royalty relief measures contend that without incentives, little GOM deepwater or shallow water deep gas drilling would have taken place because these areas would not have been competitive on a global level. Further, they argue, GOM drilling enhances national security by reducing dependence on oil imports. Critics charge that the government forfeits millions of dollars through the subsidy and that drilling costs have come down as a result of advances in technology, thus making deepwater tracts in particular more economical. According to the former Minerals Management Service, deepwater drilling in the GOM has benefitted from a combination of improved technology, higher prices, and royalty reductions. (U.S. Department of the Interior, *Deepwater Gulf of Mexico 2006: America's Expanding Frontier*, OCS Report MMS 2006-022, May 2006.)