

OCS WORKSHOP
Offshore Federal Royalty Issues

Jonathan A. Hunter
Liskow & Lewis

REASON TO STAY NO. 1

You can't actually die from boredom. Really, it's going to be OK.

REASON TO STAY NO. 2

Royalties are cool. Way cool.



The Daily Show

May 7, 2009

"I'm under the impression that the oil companies have not been paying the American taxpayer to lease these lands over these last 8 years – to the tune of about fifty million dollars, is that correct? ... What recourse do we have? ... Can you kick them off? Can you say, 'if you don't give us our royalties, that's my derrick now, brother' – can you do that?"

Jon Stewart



Rolling Stone
April 16, 2004 \$5.99
rollingstone.com

Rolling Stone

**THE BUSH
CRIMES**
INSIDE THE
INTERIOR DEPT.

Lil Wayne Goes Rock

Rap's
Genius
Changes
His Game

The Last Outlaw

Kris Kristofferson's
American Journey
BY ETHAN HAWKE

PRINCE

**ALLMAN
BROTHERS**



Rolling Stone
April 16, 2004 \$5.99
rollingstone.com

Rolling Stone

**THE BUSH
CRIMES**
INSIDE THE
INTERIOR DEPT.

Lil Wayne Goes Rock

Rap's
Genius
Changes
His Game

The Last Outlaw

Kris Kristofferson's
American Journey
BY ETHAN HAWKE

PRINCE

**ALLMAN
BROTHERS**



"The Bush Crimes/Inside The Interior Department"

"In what would become the costliest scandal, [MMS] also looked the other way when it learned that, because of a massive bureaucratic [foul]-up, it had failed to collect billions in royalties for deep-water drilling in the Gulf of Mexico. Instead, the Bush administration fought to let oil companies keep the money, and a judge appointed by Bush recently overturned royalty collections on 75 percent of all oil produced in the Gulf. Should the ruling stand, taxpayers will forfeit as much as \$53 billion owed by Big Oil."

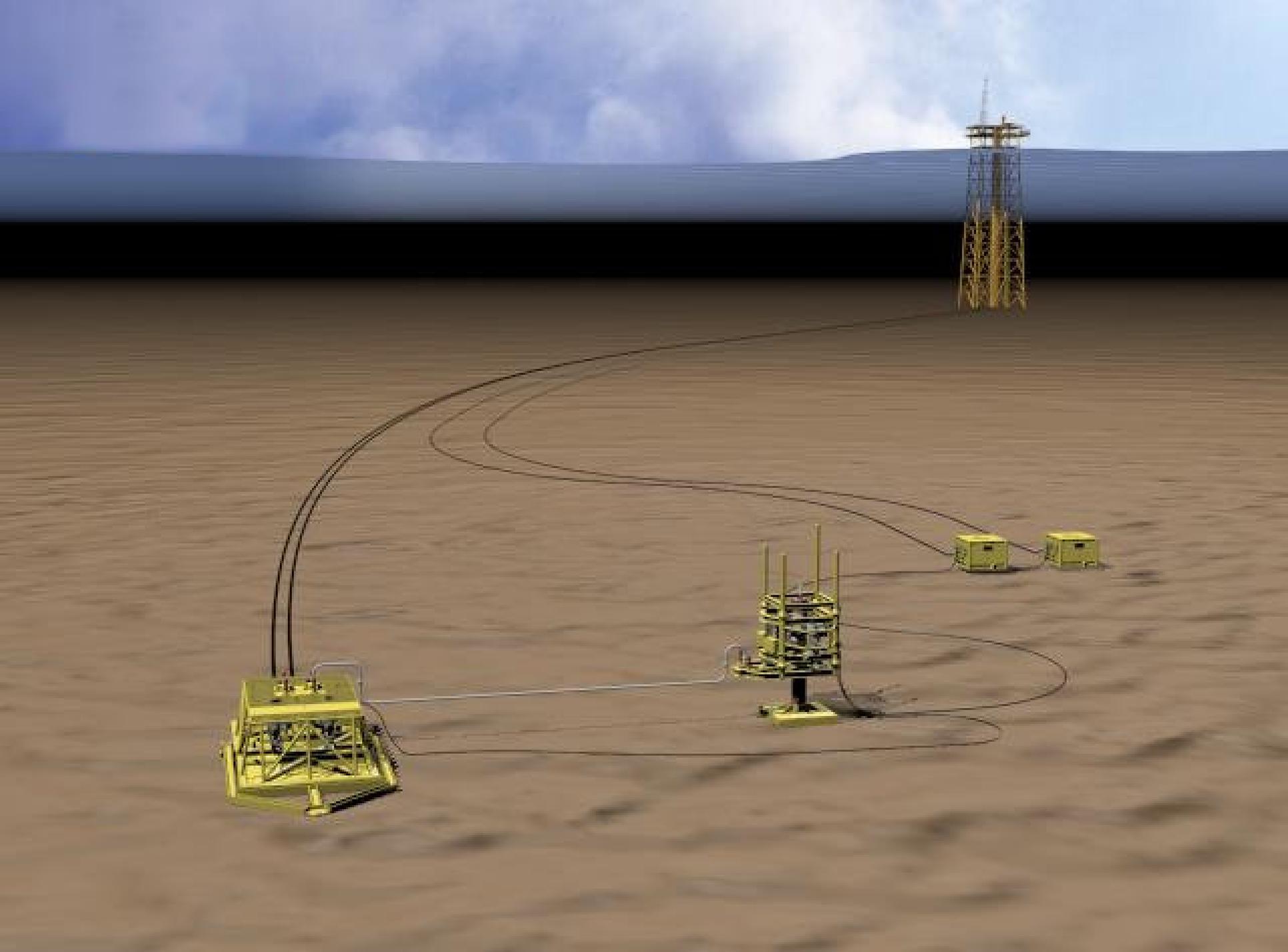
Rolling Stone (April 16, 2009)

REASONS TO STAY

1. You will probably survive.
2. Royalties are cool.

Royalty Valuation 101

- You can deduct the cost of transporting production from the lease to the location (usually the point of sale) at which the production is valued for royalty purposes.
- *But, you can't deduct* the cost of "gathering" and you *can't deduct* the cost of putting the production into "marketable condition."
- What qualifies as a "transportation cost"?



Subsea Production

May 20, 1999 Memorandum from the
Associate Director for Royalty Management

“Guidance For Determining Transportation
Allowances For Production From Leases In
Water Depths Greater Than 200 Meters”

1999 MMS Guidance Subsea Transportation Allowances

- “Movement prior to a central accumulation point is considered gathering. A central accumulation point may be a single well, a subsea manifold, the last well in a group of wells connected in a series, or a platform extending above the surface of the water. Movement beyond this point is considered transportation.”

1999 MMS Guidance

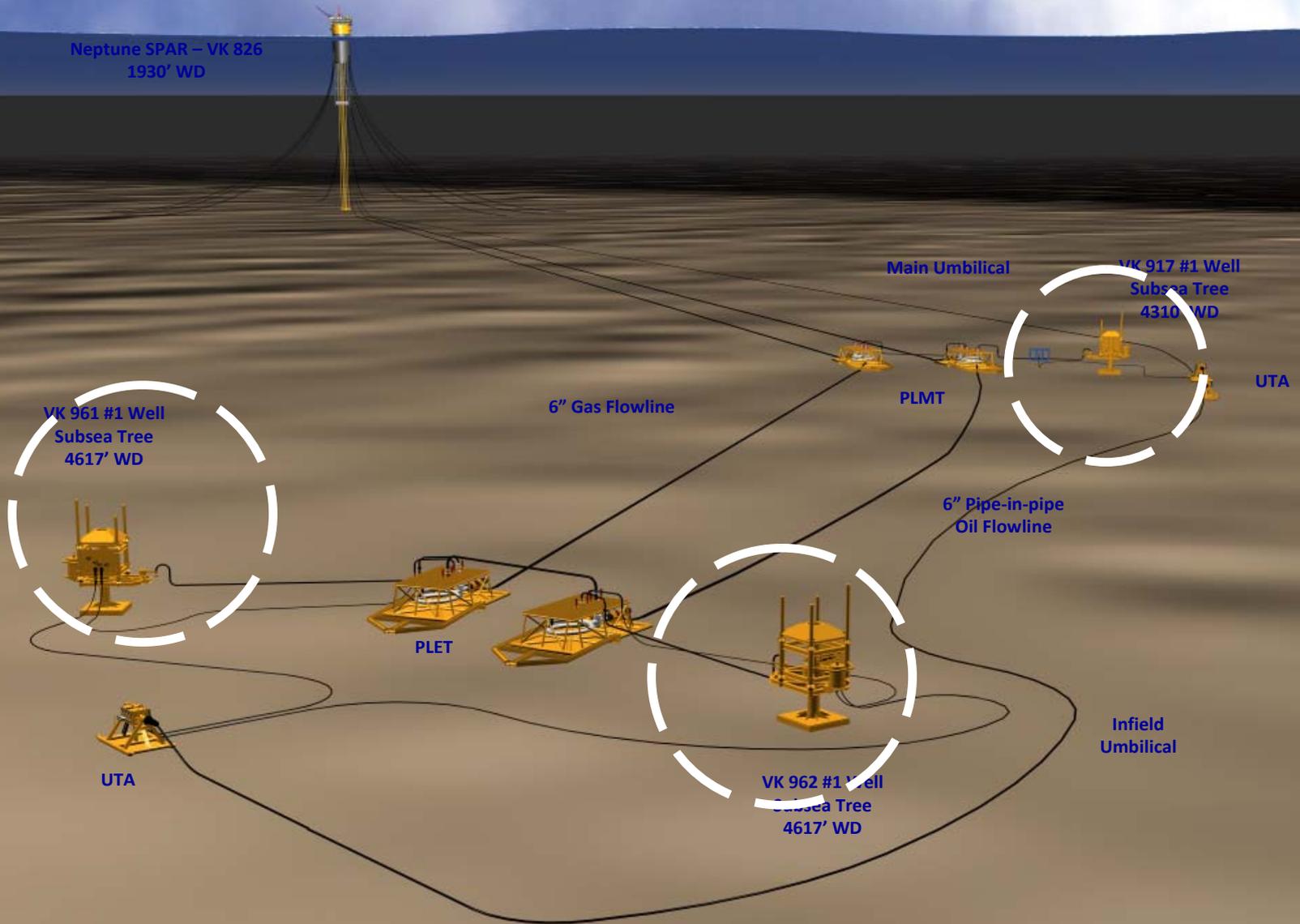
Subsea Transportation Allowances

- "...the movement must be to a facility that is not located on a lease adjacent to the lease on which the production originates. An adjacent lease is defined as any lease with at least one point of contact with the producing lease/unit. Typically, for a single lease, there would be eight leases adjacent to the qualifying deep-water lease."

Swordfish Project Development

3 Well - Oil & Gas

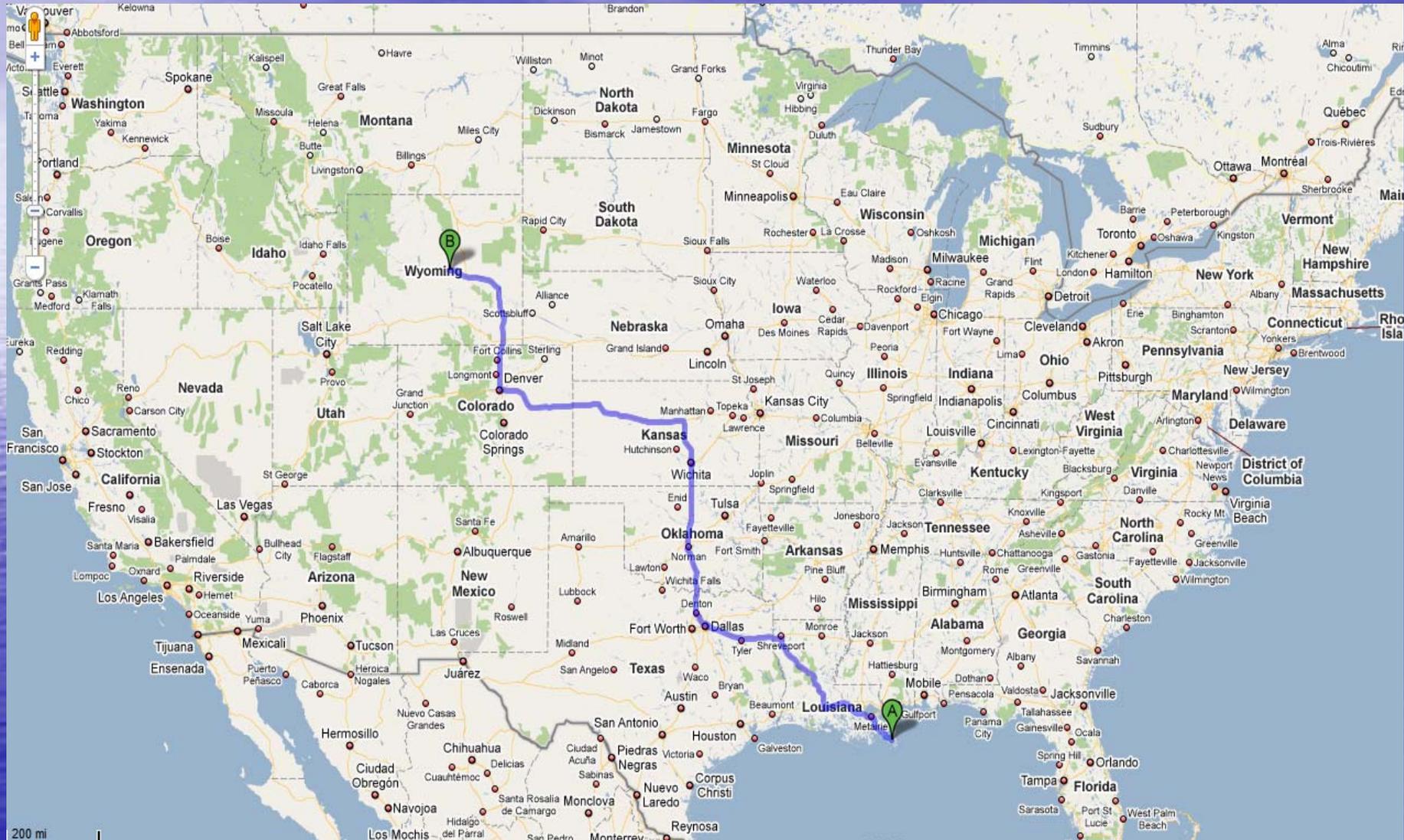
13.5-Mile Subsea Tieback to Spar



1999 MMS Guidance Subsea Transportation Allowances

- Guidance memo primarily addresses “gathering vs. transportation”
- Does not address many important questions arising from the use of subsea technology
 - Umbilical costs deductible?
 - Methanol costs deductible?
 - Chemical costs deductible?
 - Compression costs deductible?

Devon Energy v. Kempthorne



Marketable Condition Rule

"The lessee must place gas in marketable condition and market the gas for the mutual benefit of the lessee and the lessor at no cost to the Federal Government. Where the value established under this section is determined by a lessee's gross proceeds, that value will be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing services the cost of which ordinarily is the responsibility of the lessee to place the gas in marketable condition or to market the gas."

30 CFR 206.152(i)

Marketable Condition Rule

- *Mesa Operating Ltd. P'ship v. U.S. Dep't of the Interior*, 931 F.2d 318 (5th Cir. 1991); *Amerada Hess Corp. v. Dep't of Interior*, 170 F.3d 1032 (10th Cir. 1999).
- *IPAA v. DeWitt*, 279 F.3d 1036 (D.C. Cir. 2002).
- *Amoco Prod. Co. v. Watson*, 410 F.3d 722 (D.C. Cir. 2005), *aff'd on other grounds sub. nom BP America Prod. Co. v. Burton*, 549 U.S. 84 (2006)

Devon Energy v. Kempthorne

- Coalbed methane development (Wyoming)
- Dispute over whether compression and dehydration costs could be included in transportation allowance.
- Costs incurred after the approved royalty measurement points (CDPs) to move production to the sales point more than 100 miles from the lease.
- Deductions were supported by a series of Guidance Documents – two internal MMS memoranda (December 1995) and a 1996 Dear Operator letter

Dear Operator Letter (April 1996)

"If you sell your coalbed methane at the tailgate of a carbon dioxide removal or other treating facility . . . [y]ou can include costs of dehydration occurring after metering at the royalty measurement point in your transportation allowance but you cannot deduct costs of dehydration occurring at the wellhead. You can include costs for compression occurring downstream of the royalty measurement point, to the extent the compression is necessary for transportation. This includes compression at the CDP and in the transportation system to the [carbon dioxide] removal facility."

Devon Energy v. Kempthorne

- Assistant Secretary rejected Devon's request for confirmation that costs were deductible.
- Assistant Secretary found the Guidance Documents to be ambiguous, incorrect, or inconsistent with the marketable condition rule.
- District court and D.C. Circuit both ruled in favor of Interior

Devon Energy v. Kempthorne

"It is true that the DOI marketable condition rule is ambiguous, and Devon's preferred interpretation of the rule is not unreasonable. In other words, we assume that the costs of dehydration and compression can reasonably be interpreted to fall within the compass of "transportation costs." However, we are obliged to afford "substantial deference to an agency's interpretation of its own regulations." *Thomas Jefferson Univ.*, 512 U.S. at 512 (citations omitted). On this record, we find that DOI's contested construction of the marketable condition rule is reasonable." 551 F.3d at 1037

Devon Energy v. Kempthorne

- Combination of (i) MMS authority to establish the value of production, (ii) judicial finding that the marketable condition rule is ambiguous, and (iii) judicial deference to agency interpretation of ambiguous regulations ... too much authority?
- Serious questions about relying on MMS guidance documents
- 1999 MMS Guidance re subsea transportation?

Deep Water Royalty Relief

“Lost Language Drains Billions/Mysterious Error To Cost Government Energy”

(Houston Chronicle 3/3/06)

“Vague Law and Hard Lobbying Add Up To Billions for Big Oil” (NYT 3/27/06)

“Flub Could Cost U.S. \$10 Billion” (Bucks County Courier Times 6/21/06)

“Some Firms Would Yield On Oil Windfall” (Pittsburgh Post-Gazette 6/22/06)

Deep Water Royalty Relief

- “US Official Told To Alter Oil Lease Royalty Clause” (Dow Jones Newswires 9/13/06)
- “Inspector General Levels Broadside At Interior Department At Hearing On Missing Price Thresholds In Leases; Another Royalty Controversy Emerges” (Foster Natural Gas Report 9/22/06)
- “MMS Royalty Plan Slammed” (Oil Daily 9/27/06)

"Royalty Rip-Off" (New York Times Ed. 12/12/06)

"The American treasury is already short more than a billion dollars because of the Interior Department's failure over the last decade to collect all the royalties owed from oil and gas producers in the Gulf of Mexico. The new Congress needs to fix the problem, or persuade a sluggish Bush administration to do so...."

"Royalty Rip-Off"

(New York Times Ed. 12/12/06)

" ... [A] loophole in leases signed by the Clinton administration in 1998 and 1999 to encourage deep-water exploration at a time when oil and gas prices were relatively low ... did not include a standard escape clause that would have restored full royalties when prices went up. The loophole has already cost the taxpayers \$1.5 billion and, if not corrected, could cost \$10 billion over the course of the leases."

OUTER CONTINENTAL SHELF DEEP WATER ROYALTY RELIEF ACT OF 1995

- **Section 302**
 - General authority for royalty relief in Central and Western Planning Areas. Detailed program for deep water relief for Pre-Act Leases.
- **Section 303**
 - Permanent change to OCSLA. Adopted new bidding system for awarding new leases (43 USC 1337(a)(1)(H)) and authorized royalty relief to be determined by Secretary for any lease, in any location and any water depth.
- **Section 304**
 - Mandated that the new bidding system of Section 303 be used for deep water leases in Central & Western Areas granted at 1996-2000 lease sales ("New Leases"), with set volume of royalty relief depending on water depth. Removes the discretion otherwise granted in Section 303.

Section 302 – Pre-Existing Leases

- General authority for royalty relief in Central and Western Planning Areas. Detailed program for deep water relief for Pre-Act Leases.
- Requires lessee to demonstrate that royalty relief is necessary to make “new production economic.”
- Imposes “new production” and “price threshold” conditions.
- Minimum royalty suspensions increase with water depth: 17.5 MMBOE, 52.5 MMBOE, 87.5 MMBOE.

DWRRA SECTION 303

- Permanent change to OCSLA. Adopted new bidding system for awarding new leases and authorized royalty relief to be determined by Secretary for any lease, in *any location* and *any water depth*:
 - “(H) cash bonus bid with royalty at no less than 12 and 1/2 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.***”

DWRRA SECTION 304

For all tracts located in water depths of 200 meters or greater in the Western and Central Planning Area of the Gulf of Mexico... any lease sale within five years of the date of enactment of this title [November 28, 1995], shall use the bidding system authorized in [Section 303], *except that the suspension of royalties shall be set at a volume of not less than the following:*

- (1) 17.5 million barrels of oil equivalent for leases in water depths of 200 to 400 meters;
- (2) 52.5 million barrels of oil equivalent for leases in 400 to 800 meters of water; and
- (3) 87.5 million barrels of oil equivalent for leases in water depths greater than 800 meters.

PRE-DWRRRA LEASE SALES

<u>Date</u>	<u>Tracts Offered</u>	<u>Tracts Bid On</u>	<u>Acres Bid On</u>	<u>Total Bonus High Bids</u>
3/94	5759	375	1,784,480	\$277,016,796
5/95	5810	588	2,965,968	\$307,328,550

POST-DWRRRA LEASE SALES

<u>Date</u>	<u>Tracts Offered</u>	<u>Tracts Bid On</u>	<u>Acres Bid On</u>	<u>Total Bonus High Bids</u>
4/96	5649	924	4,761,167	\$520,924,644
3/97	5059	1,032	5,405,298	\$824,578,599

MMS Implementation Of Section 304

- MMS lifted the “new production requirement” and “price threshold requirement” that Congress had included in Section 302 and applied it to Section 304 Leases
- MMS also imposed a “field”-based method of allocating royalty suspension volumes.
- All three conditions have now been declared unlawful.

Santa Fe Snyder v. Norton (5th Cir. 2004)

- Held MMS violated the RRA by imposing “new production requirement” and field-based method of allocating royalty suspension volumes.
- Section 304 “unambiguously provides that the royalty suspensions apply in full to each [Section 304] Lease.”
- Section 303 did not give MMS discretion to reduce royalty suspension volumes below statutory minimums
- August 2005 ITL – MMS acquiesces in *Santa Fe Snyder* for all Section 304 Leases
- December 2008 – MMS promulgates new regs (30 CFR 260.112-117) – estimates impact at \$3B-\$10B

Kerr-McGee v. DOI (5th Cir. 2009), cert denied (!), (U.S. Oct. 5, 2009)

- “Price threshold” provisions inserted into Section 304 Lease Addendum held to be unenforceable, because they operate to reduce royalty suspension volumes below statutory minimums
- Identical to the statutory price thresholds enacted by Congress in Section 302
- Price threshold provisions contained *only* in Lease Addendum – not in regulations
- Price thresholds inserted *only* into Section 304 Leases granted per lease sales held in 1996, 1997 and 2000

Kerr-McGee v. DOI (5th Cir. 2009)

- Price thresholds for gas were exceeded in 2000, 2001, 2003, and 2004. The price threshold for oil was exceeded in 2004. Since 2004, the price thresholds for oil and gas have been exceeded in every calendar year (except for gas in 2009?).
- KMG sought judicial review of January 2006 royalty payment order (eight Section 304 leases; 2003-2004 production).

Kerr-McGee v. DOI (5th Cir. 2009)

- Undisputed that the price thresholds *reduced* the royalty suspension volume below the statutory minimum – dispute was *whether* this reduction was lawful
- District court and Fifth Circuit both ruled in favor of Kerr-McGee, holding that the price threshold provisions violated Section 304's guarantee of minimum royalty suspension volumes.
- "The current case is the logical and inevitable extension of *Santa Fe Snyder*, as the district court correctly reasoned."

Kerr-McGee v. DOI (5th Cir. 2009)

“Interior’s reading would render Sec. 304’s mandatory language meaningless: if price thresholds trigger royalty payments before Sec. 304’s production volumes are exceeded, then the royalty suspension *is* being set at a volume less than Sec. 304’s specified production levels....Had Congress intended to impose price thresholds on the royalty relief for these new leases, it certainly knew how to do so. However, Congress refrained from specifically establishing such price thresholds, and we refuse Interior’s invitation to read this royalty-relief limitation into the statute.”

Kerr-McGee v. DOI (5th Cir. 2009)

- Supreme Court *denied* the Solicitor General's Petition for a writ of certiorari (October 5, 2009)
- November 6, 2009 Dear Reporter Letter:
 - "As a result [of the *Kerr-McGee* decision], companies who have paid royalties ... are entitled to recoup those royalties.
- Numerous pending administrative appeals of orders to pay awaiting a decision
- Omission of price threshold provisions from 1998 & 1999 leases is meaningless

Price Threshold Dispute: How much is it worth?

\$80 billion ... GAO 2007 Estimate

\$60 billion ... GAO 2007 Estimate

\$53 billion ... GAO 2008 Estimate

\$38 billion ... GAO 2008 Estimate (cited in
DOI Reh'g App)

\$21 billion ... GAO 2008 Estimate

\$19 billion ... MMS letter to Sen. Feinstein
(March 2009) (cited in DOI Cert Petition)

\$ Less than \$10 billion? ...

Price Threshold Dispute

- Extraordinary case? >Nah ... application of basic legal principles
- “But we signed the lease...” >But it wasn't negotiated, and there was no realistic opportunity to challenge until numerous variables (production, prices, etc.) came together
- The offshore leasing program is a creature of statute, and MMS's authority is ***both created and limited*** by statute
- Lease terms deemed to conform to the minimum statutory requirements by operation of law
- *E.g., Chevron v. Watt* (E.D. La. 1983) (MMS civil penalty regulations held unlawful because they contradicted OCSLA)

RIK RIP

- OIG's September 2008 Report identified a series of improprieties and led to widespread press coverage
- Legal issues have been few
- September 2009: DOI Secretary Salazar announced the termination of the RIK program
- Program will be phased out over two-year period
- Unresolved balancing and transportation cost issues
- Likelihood of increased disputes over royalty valuation