



August 7, 2006

To: Members of the Board
From: Rick Wascak, Staff
Through: Wendy M. Comes, Executive Director
Subj: Oil and Gas Resources Project ¹ (Tab G)

Enclosed are an issue paper on royalty free production of oil and gas and a revised draft of an Exposure Draft (ED) entitled *Accounting for Federal Oil and Gas Resources*. The objectives for the May 2006 Board meeting are to:

1. Review the issue paper on royalty free production of oil and gas.
2. Review the revised draft ED and obtain comments from Board members.
3. Gain Board approval for circulating a pre-ballot ED.
4. Gain Board approval to study coal in the next phase of the natural resources project.

Royalty Free Production of Oil and Gas

At the March 2006 Board meeting, one objective was to obtain Board members' thoughts on royalty free production of oil and gas in the Gulf of Mexico based on some condensed information about royalty free production of oil and gas. After a brief discussion, the Board members agreed that more factual information on the royalty relief program was needed for discussion and asked staff to research the issue. The Board asked staff to research what needs to be done to get an effective valuation of royalty revenue collections foregone on a yearly basis as a result of royalty relief. The issue paper on royalty free production of oil and gas begins on page 3 of this memo and provides background information on royalty relief, currently available information for valuing foregone royalty revenue collections, the major issue relating to the valuation of foregone royalty revenue, and options for addressing the royalty relief program.

Revised ED

The Board also discussed a revised draft exposure draft (ED) entitled *Accounting for Federal Oil and Gas Resources* at the March 2006 meeting. Based on discussions about the revised draft ED and comments from the Board members, staff made various changes to it. Additions to this document are highlighted with an underscore (underscore) and deletions are highlighted with a strikethrough (~~strikethrough~~). Major changes made to the document include the following:

- a. Based on a review of definitions presented in the text of the March 2006 version of proposed standards, various definitions were moved to the Glossary. However, the specification of regions is proposed to be the responsibility of the entities involved in accounting and reporting for Federal oil and gas resources. (See paragraph 15)

¹ The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

b. Questions for respondents were developed and incorporated into the ED. The questions for respondents address:

1. the level of information requested to be disclosed in the footnotes or displayed as RSI;
2. the challenges posed by the use of the present (or discounted cash) value measurement attribute for measuring the value of the Federal government's estimated petroleum royalties; and,
3. the use of reserves classified as proved, probable, and possible to estimate the value of the Federal government's estimated petroleum royalties for capitalization on the balance sheet, instead of using only the proved reserves as proposed in the ED.

c. The paragraphs in the ED that address the "Rights to Future Royalty Stream Identified for Sale" were revised to clarify how they should be accounted for and reported. (See paragraphs 20 and 21).

d. An issue has been raised and explained on one of the proposed required supplementary information (RSI) requirements. (See paragraph 27. a.)

It should be noted that not all suggested revisions based on reviews by representatives from the Department of the Interior have been made to all individual accounting entries in the draft ED.

Approval to Study Coal

In 2002, the Board resumed active consideration of the issues raised by a natural resources task force in a discussion paper. The Board was interested in determining whether values for Federal natural resources, or some surrogate, should be capitalized and reported on the balance sheet. The Board members believed that capitalizing Federal natural resources could increase accountability for their management and improve the comprehensiveness, relevance, and consistency of Federal financial statements. The Board members suggested that Staff address each type of natural resource (e.g., fluid leasable minerals such as oil and gas, solid leasable minerals such as coal, timber, etc.) in separate phases, and to begin with Federal oil and gas resources.

Since the Board is nearing the issuance of an exposure draft (ED) for Federal oil and gas resources, staff is proposing and requesting approval from the Board to study coal resources in the next phase of the natural resources project. Staff is proposing to proceed with developing standards for Federal coal resources next, due to: the extensive historical information on Federal lease programs and royalty collections; the large amount of monies collected in exchange for coal resources, second only to oil and gas resources for all natural resources; and, the same entities that were involved with the oil and gas resources (the Energy Information Administration, the Department of the Interior, the Minerals Management, and the Bureau of Land Management) would be involved in coal resources activities, which staff believes would contribute to a reduction in the timeframe for developing the coal standards .

If you have questions or comments before the meeting, please contact me at 202 512-7363 or wascakr@fasab.gov

RELIEF OR REDUCTION IN ROYALTIES

Board Request:

At the March 2006 Board meeting, Board members indicated that more factual information on the royalty relief or reduction in royalties program, resulting in a decreased amount of royalty revenue collections, was needed. As a result, Board members requested that staff research what needs to be done to get an effective valuation of royalty revenue collections foregone on a yearly basis as a result of royalty relief or reduction in royalties program.

BACKGROUND

What is the Minerals Management Service's (MMS) authority to grant royalty relief?

The Outer Continental Shelf (OCS) Lands Act, 43 U.S.C. 1337, as amended by the OCS Deep Water Royalty Relief Act (DWRRA), Public Law 104-58, authorizes the MMS to grant royalty relief in three situations.

(A.) Under 43 U.S.C. 1337(a)(3)(A), it may reduce or eliminate any royalty or a net profit share specified for an OCS lease to promote increased production.

(B.) Under 43 U.S.C. 1337(a)(3)(B), it may reduce, modify, or eliminate any royalty or net profit share to promote development, increase production, or encourage production of marginal resources on certain leases or categories of leases. This authority is restricted to leases in the Gulf of Mexico (GOM) that are west of 87 degrees, 30 minutes West longitude.

(C.) Under 43 U.S.C. 1337(a)(3)(C), it may suspend royalties for designated volumes of new production from any lease if:

- (1) The lease is in deep water (water at least 200 meters deep);
- (2) The lease is in designated areas of the GOM (west of 87 degrees, 30 minutes West longitude);
- (3) The lease was acquired in a lease sale held before the DWRRA (before November 28, 1995);
- (4) That DOI finds that new production would not be economic without royalty relief; and
- (5) The lease is on a field that did not produce before enactment of the DWRRA, or if a project is proposed to significantly expand production under a Development Operations Coordination Document (DOCD) or a supplementary DOCD, that MMS approved after November 28, 1995.

The three situations for which MMS grants royalty relief or reduction are described below.

(A.) OUTER CONTINENTAL SHELF DEEP WATER ROYALTY RELIEF ACT OF 1995

In an effort to promote the exploration and production of natural gas and crude oil in deep water, the Outer Continental Shelf Deep Water Royalty Relief Act of 1995 (DWRRA) implemented a royalty-relief program that relieves eligible leases from paying royalties on defined amounts of deep-water production. After expiration in 2000 of the DWRRA provisions related to new leases, the MMS introduced its own DWRR program for new leases to promote continued interest in deepwater. The MMS's DWRR program defines a "deep-water" lease as having a minimum water depth of 200 meters (656 feet). To be eligible for relief, the lease must be located in the

Gulf of Mexico and west of 87 degrees and 30 minutes West longitude (the Florida-Alabama boundary). For leases issued prior to DWRRA, royalty relief is available through an application process if MMS determines that the field on which the leases reside are not economically viable without relief. The water depth of the lease essentially determines the amount of production that could be exempt from royalty payments. For deep-water leases considered "new" (purchased between November 28, 1995 and November 28, 2000), the volume of production not subject to royalty obligation was classified into three categories of royalty (see table below).

(Note: Royalty suspension volumes for both oil and gas are expressed in barrels of oil equivalent. Gas, normally measured in cubic feet, is converted to barrels of oil equivalent, accordingly.)

Depth	Minimum Relief Volume (barrels of oil)
200-400 m (656-1,312 ft)	17.5 million
400-800 m (1,312-2,625 ft)	52.5 million
>800 m (>2,526 ft)	87.5 million

The same aggregate water depth related suspension volumes of relief are available to pre-Act leases through the MMS application process. However in these cases, the aggregate amount of relief must be shared among all leases on the field. Relief is also conditional based on market prices for oil and gas.

After the DWRRA provisions for new leases expired in November 2000, the MMS has offered a revised incentive plan for royalty relief. For deep-water leases purchased after November 2000, the royalty relief has been specified by MMS prior to each lease sale. Most importantly, the suspension volumes in greater than 800 meters were reduced from 87.5 million barrels of oil equivalent (boe) under the DWRRA to 9 million boe for leases in 800 – 1600 meters and 12 million boe for leases in deeper than 1600 meters.

(B.) ROYALTY RELIEF INFORMATION REGARDING THE GULF OF MEXICO

The four general royalty relief categories in the Gulf of Mexico Region (GOM) are:

1.) Deepwater, 2.) Shallow Water Deep Gas, 3.) End-of-Life, and 4.) Special Case. MMS has a formal program for the Deepwater, Shallow Water Deep Gas, and End-of-Life categories. There is no formal structure for the Special Relief category. MMS encourages operators to contact our staff directly to discuss the details of any potential submittal in order to expedite the process.

1. Deepwater

The deepwater royalty relief category consists of both: 1) discretionary relief and 2) relief that does not require an economic evaluation.

Discretionary relief under the DWRRA requires an application demonstrating economic need. The discretionary relief applies to "fields" with leases issued prior to passage of the Deepwater Royalty Relief Act of 1995 (i.e., November 28, 1995) in water depths 200 meters or deeper that

lie wholly west of 87 degrees, 30 minutes West longitude. These leases are called Pre-Act Leases. Leases sold beginning in 2001 may apply for relief on a project specific basis.

There is no application process for the relief that does not require an economic evaluation. Relief not requiring an economic evaluation applies to leases under the DWRRA from sales held in years 1996 through 2000 in water depths 200 meters or deeper that lie wholly west of 87 degrees, 30 minutes West longitude. These leases are called "eligible" leases. Eligible leases may be able to apply for discretionary relief. By regulation, neither type of relief can be given to "fields" containing a current lease that produced prior to the passage of the Act. These leases are called Post-Act Leases.

In addition, leases resulting from a Sale held after year 2000 have been issued with an automatic royalty suspension volume through 2006. Post-2000 leases issued with an automatic royalty suspension volume are called "Royalty Suspension" leases. All Post-2000 leases in water depths greater than 200 meters are also eligible to apply for discretionary relief.

2. Shallow Water Deep Gas Incentives

As stipulated in the Lease Instrument and Final Notice of Lease Sale, certain leases issued beginning in 2001 may be eligible for a royalty suspension volume for shallow water (< 200 meters) deep gas production. The Lease Instrument and the Final Notice of Lease Sale provide this information. These leases were issued with a royalty suspension volume of 20 billion cubic feet for the first producing well drilled deeper than 15 thousand feet total vertical depth subsea.

In addition to these leases with shallow water deep gas royalty relief provisions in their lease instruments, certain other leases issued prior to 2001 in shallow water may be eligible for shallow water deep gas royalty relief through the Deep Gas in Shallow Water Rule.

3. End-of-Life Royalty Relief

End-of-life relief is applicable to any producing leases regardless of water depth when it can be shown that the economic limit has been reached and relief will result in "increased production." If approved, the royalty rate will be reduced by half subject to certain stipulations.

4. Special Case Relief

Relief can be requested when the MMS formal programs provide inadequate encouragement to increase production or development. Other conditions must also be met in order to submit an application.

(C.) ROYALTY RELIEF IF PRICES RISE ABOVE A THRESHOLD PRICE

If prices rise above a threshold (base price) for light sweet crude oil or natural gas, set by statute for pre-Act leases, indicated in the original lease agreement or Notice of Sale for post-November 2000 deep water leases, full royalties must be paid as prescribed in this section. For post-November 2000 deepwater leases, price thresholds apply on a lease basis, so potentially, leases on the same field, development project, or expansion project may have different price thresholds.

For pre-Act leases, and leases issued under the DWRRA in 1996, 1997 and 2000, these prices change during each calendar year after 1994 by the percentage that the implicit price deflator

for the gross domestic product changed during the preceding calendar year. For post-November 2000 deepwater leases, different prices may apply for certain leases depending upon year of sale.

AVAILABLE INFORMATION

Royalty relief or reduction has two thresholds, as noted above, quantity and price. Depending on when a lease sale took place determines the effective quantity threshold and price threshold for each lease authorized for royalty relief or reduction. MMS does not track each lease authorized for royalty relief or reduction. Quantity and price thresholds are monitored by operators themselves.

The MMS receives a '2014' royalty report which contains the reported sales value and reported sales volume, but no royalty amount for the government's royalty share not paid because of royalty relief or reduction. In general, the 2014 royalty report is due the last day of the month following the month the product was sold or removed from the lease, in accordance with proscribed legislation. It is not possible to get sales value and sales volume information on royalty free or royalty reduction production of oil and gas more timely because of the proscribed legislation.

At the end of the calendar year, if it is found through an audit that an operator has exceeded either one of the thresholds, the operator must:

- (1) Pay royalties on all oil production for the previous year at the lease stipulated royalty rate plus interest (under 30 U.S.C. 1721 and Sec. 218.54 of this chapter) by March 31 of the current calendar year, and
- (2) Pay royalties on all oil production in the current year.

As a result of exceeding either threshold, all foregone royalty must be paid and would no longer be considered foregone royalty revenue. In addition, in the succeeding year, while the operator must pay all royalties during the year, the operator may be eligible for royalty relief or reduction for the year if the operator complies with all requirements of the lease in accordance with royalty relief or reduction. In this latter case, the appropriate amount of royalties would be refunded to the operator

IDENTIFYING ROYALTY FREE PRODUCTION OF OIL AND GAS ISSUE

There is not a simple way of identifying the royalty free portion of the value of proved reserves at a given time because the quantities of oil and gas subject to royalty relief and the dollar amount of royalties waived during the period are unknown. This is the case because the royalty free portion:

- (a.) depends on future prices,
- (b.) relates to how such proven reserves are distributed among each lease, and
- (c.) is influenced by the royalty relief terms on each individual lease.

One viable option would be to adjust the overall effective royalty rate to reflect the effects to the government's royalty share of royalty revenue (i.e., estimated petroleum royalties). This would be done in the calculation of the effective regional average royalty rate.

The effective regional average royalty rate is calculated by dividing the royalty value (royalties) due on all of the oil and gas reserves that were produced from Federal oil and gas resources in each associated region for the preceding twelve (12) months by the sales value for all oil and gas reserves that were produced from Federal oil and gas resources in each region for the preceding twelve (12) months.

For royalty relief or reduction production, no royalties would be included in the calculation; however, the sales value would be included. For example:

	Royalty revenue	Sales Value
Royalty Relief or Reduction Production	\$0	\$1,000
All Other Production	<u>\$1,000</u>	<u>\$7,000</u>
Total	\$1,000	\$8,000

\$1,000 (royalty revenue) divided by \$8,000 (sales value) equals
12.5% (effective regional average royalty rate)

OPTIONS FOR ADDRESSING THE ROYALTY RELIEF PROGRAM

The following options are presented for addressing royalty relief or royalty reduction:

1. Require disclosures regarding the royalty relief provisions.
2. Permitting or encouraging other accompanying information, and
3. Include a Request for Comments question(s) in the ED relating to the royalty relief or reduction program.
4. No changes to the proposed standard.