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Report to Rep. Elizabeth Holtzman; by Monte Canfield, Jr., Director, Energy and Minerals Div.

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Authority: Outer Continental Shelf Lands Act (43 U.S.C. 1331). Energy Policy and Conservation Act (42 U.S.C. 6383).

Oil and natural gas Outer Continental Shelf leases are awarded through sealed bids on the basis of the highest cash bonus with a fixed royalty or on a percentage royalty bid with a fixed cash bonus. The royalty rate has customarily been over 16%; some experimenting is now being done with a fixed sliding scale royalty or with a higher royalty rate with no fixed cash bonus. While the lease production information needed to determine the royalties owed the Government is routinely collected, the information necessary to make a rate of return evaluation is not. The Securities and Exchange Commission is in the process of developing accounting procedures which will enable the compilation of reliable petroleum exploration and production data. (SC)

(Author/SC)

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

ENERGY AND MINERALS DIVISION

B-118678

April 25, 1978

The Honorable Elizabeth Holtzman
House of Representatives

Dear Congresswoman Holtzman:

This letter provides information on royalty rates applied to Outer Continental Shelf (OCS) leases and financial data the Department of the Interior has available to assess the rate of return industry receives from OCS operations. The information was compiled based on your request and subsequent discussion with your office. Our work was limited to reviewing previous OCS work and discussing these matters with representatives from the Departments of the Interior and Commerce, an industry trade association, and university professors who have researched similar questions.

ROYALTY RATES FOR OCS LEASES

The Outer Continental Shelf Lands Act (43 U.S.C. 1331-1343) provides for U.S. jurisdiction over OCS submerged lands--all submerged lands seaward outside State waters. The Act requires that oil and gas leases be issued only on a competitive bidding basis. Leases are awarded through sealed bids on the basis of the highest (1) cash bonus bid with a fixed royalty or (2) percentage royalty bid with a fixed cash bonus.

Since Federal OCS leasing began in 1954, the Government has leased over 3,100 tracts--almost 15 million acres--of OCS lands. These lease sales have provided almost $20 billion in cash bonuses to the Government. The Department of the Interior has estimated that at least an equivalent amount of receipts eventually will be generated through production royalties and income tax payments from these leases.

Historically, the conventional OCS bidding procedures involved a fixed royalty rate of 16 2/3 percent of production with variable cash bonus payments. Interior officials stated that they did not know how the 16 2/3 percent royalty rate was first determined. They believed that it was probably adopted about 24 years ago because the State of Louisiana's offshore leasing program used this rate; the officials were unaware of how Louisiana decided on a 16 2/3 percent rate.

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Over the past few years, Interior has experimented with three royalty bidding systems. On two sales, the Government leased tracts on the basis of variable royalty rate bids with fixed cash bonus payments (see the table below).

OCS Lease Sales With Tracts Offered On The Basis Of Royalty Rate Bids

Date of sale	Total tracts offered	Tracts offered based on royalty bids	Tracts leased based on royalty bids	Percentage range of winning royalty rate bids
Oct. 16, 1974	297	10	8	52 - 82
Oct. 27, 1977	135	46	30	20 - 63

Of the eight tracts leased based on royalty bids in October, 1974, only one had an initial gas discovery. A platform is installed but production has not started.

The Government has twice leased tracts without a fixed cash bonus, but at a 33 1/3 percent royalty rate instead of the customary 16 2/3 percent rate. In a December 11, 1975, sale of 231 tracts off southern California, 3 tracts were offered at this higher rate and all were leased. In an August 27, 1976, sale, 15 of the 154 mid-Atlantic tracts offered were at the 33 1/3 percent rate. Thirteen of these tracts were leased.

In a March 28, 1978, sale, the Government offered 80 of 224 tracts for sale off the coasts of Florida, Georgia, and North and South Carolina on a cash bonus bid basis with a fixed sliding scale royalty. Under the fixed sliding scale formula, the royalty will be no less than 16 2/3 percent and no more than 50 percent of the adjusted quarterly value of production.

This sale resulted in 99 bids with 77 bids on 40 of the 80 tracts offered under the fixed sliding scale royalty. These 77 bids had cash bonus bids ranging from the minimum amount (about $143,000) to over $9 million. As of April 11, 1978, no leases had been awarded.

A planned April 25, 1978, sale of 146 tracts off the coasts of Texas and Louisiana will offer 16 tracts on a cash bonus bid basis with a fixed sliding scale royalty.

This trend in the Administration's implementation of alternative bidding systems in the OCS leasing program is consistent with proposed

OCS legislation. During the first session of the 95th Congress, the Senate passed S. 9 and the House recently passed H.R. 1614. Both bills contain mandates authorizing the Government to test several alternative bidding systems in addition to the presently mandated royalty and cash bonus method. The Administration has announced its support for these bills.

AVAILABILITY OF INDUSTRY INFORMATION FOR USE IN DETERMINING RATE OF RETURN FROM OCS OPERATIONS

Interior does not collect the information necessary to establish the rate of return that energy-producing companies have experienced from their offshore energy development operations. While the lease production information needed to determine the royalties owed the Government is routinely collected, the information necessary to make a rate of return evaluation, including operating costs, lease investments, and allocated overhead and joint costs, is not routinely provided. We were told, however, that company financial data can be obtained to examine the reasons for certain actions on a Federal lease (such as shutting in a lease).

The Energy Policy and Conservation Act (42 U.S.C. 6383) was enacted in December 1975 to develop a reliable energy data base for the production of crude oil and natural gas. Section 503 of that Act requires the Securities and Exchange Commission to develop accounting practices that will enable the compilation of reliable petroleum exploration and production data. Under Section 505 the Department of Energy must collect information kept in accordance with the accounting practices and submit quarterly reports to the President and the Congress.

Both the accounting practices and the data system are in the development stage. However, the Department of Energy has indicated that it hopes to collect certain data that would be useful in computing some rate of return information.

It will not be clear for some months, however, just what information will be provided through this data system and how complete that information will be for determining rate of return computations. This is important because measures of profitability (such as rate of return on a company-wide basis) may bear little relationship to profit margins realized on individual prospects or groups of prospects such as those on the Outer Continental Shelf.

Various studies have attempted to establish the rate of return that developers have experienced from their OCS operations. The studies generally concluded that the rate of return from OCS operations has been between 6 and 10 percent. These studies, however, were based on many assumptions, and some apparently did not have access to detailed cost data.

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We share your interest in OCS development and will continue to examine energy resource development on the Outer Continental Shelf.

Sincerely yours,

Monte Canfield, Jr.
Director