



Recent Litigation Related to Royalties from Federal Offshore Oil and Gas Production

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Summary

On October 30, 2007, the U.S. District Court for the Western District of Louisiana issued a ruling in *Kerr-McGee Oil & Gas Corp. v. Allred* that rebuffed efforts of the U.S. Department of the Interior (DOI) to collect royalties from offshore oil and gas production leases based on so-called “price thresholds” for previously granted royalty relief.

There has been considerable interest in the impact of this ruling on ongoing congressional efforts related to certain “missing” royalty payment requirements in leases issued by the Minerals Management Service (MMS) of the DOI in 1998 and 1999, including the proposed Royalty Relief for American Consumers Act of 2007, as found at sections 7501-7505 of H.R. 3221. The House of Representatives passed H.R. 3221 on August 4, 2007. This report (1) provides background on the Outer Continental Shelf Deep Water Royalty Relief Act (DWRRA), pursuant to which royalty-free leases, including the controversial 1998 and 1999 leases, were issued; (2) summarizes relevant portions of the proposed Royalty Relief for American Consumers Act, which attempts to encourage the renegotiation of the controversial 1998 and 1999 leases; (3) summarizes the recent ruling in the *Kerr-McGee* matter; and (4) analyzes the potential impact of that recent ruling on the proposed Royalty Relief for American Consumers Act and any similar legislative efforts. This analysis is restricted to a discussion of the potential impact of the recent ruling on section 7504 of H.R. 3221, which would place restrictions on holders of leases that lack price thresholds. It does not address section 7503 of H.R. 3221, which seeks to “clarify the authority” of the Secretary of the Interior to include price thresholds on royalty relief in offshore leases pursuant to section 304 of the DWRRA.

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The Deep Water Royalty Relief Act and the 1998-1999 Leases

Most federal offshore oil and gas production leases contain royalty provisions that require the lessee to pay a certain percentage of revenue on the value of oil and natural gas production to the federal government as the lessor. In 1995, Congress passed the Deep Water Royalty Relief Act (DWRRA),¹ which provides an incentive for exploration of oil and natural gas reserves in “deep water,” which might otherwise be uneconomic, by providing that a certain initial volume of production from deep water wells would be exempt from royalty obligations. Section 302 of the DWRRA provides a mechanism by which holders of existing leases can apply for royalty relief, which is to be granted by the Secretary of the Interior if the lease would otherwise be uneconomic. However, Section 302 also provides that these lessees will not be eligible for royalty relief if the price of oil or natural gas exceeds a certain threshold level.

While Section 302 of the DWRRA addresses royalty relief for holders of leases in existence at the time of the enactment of the act, Sections 303 and 304 address post-enactment lease sales. Section 303 amends the bidding system to allow Interior to offer leases going forward with royalty relief at the discretion of the Department, while Section 304 carves out an exception to that royalty payment requirement for deep water leases that were entered into within five years of the date of enactment of the DWRRA. Pursuant to Section 304, the standard royalty requirement is to be suspended for lessees holding these leases until a certain volume of oil or natural gas is produced by the lessee. The volumetric limitation on royalty relief varies based on the water depth of the leased tract. Once the volumetric threshold is exceeded, a lessee may be required to make royalty payments. Section 304 sets a statutory minimum for the volumetric threshold for royalty relief—the Secretary of the Interior is authorized to grant a higher volumetric threshold at his or her discretion.

In 1998 and 1999, MMS issued deepwater offshore leases that were eligible for royalty suspension but did not include a price-based limitation on that eligibility. As a result, holders of these 1998 and 1999 deepwater leases have no obligations to make royalty payments up to the suspension volumes, regardless of the market price of oil or natural gas; the leases do not contain a price threshold on royalty relief.

The Royalty Relief for American Consumers Act of 2007

On August 4, 2007, the House passed H.R. 3221. Included in this omnibus energy bill is the proposed Royalty Relief for American Consumers Act of 2007.² One section of this proposed act bars the Secretary of the Interior from issuing any new leases to holders of “covered leases” unless said leaseholders either renegotiate their “covered leases” to include price thresholds or pay a “conservation of resources” fee as established in the proposed act.³ The statute defines a

¹ P.L. 104-58, Title III.

² H.R. 3221, Title VII, Subtitle E.

³ *Id.* at section 7504.

“covered lease” as “a lease for oil or gas production in the Gulf of Mexico that is ... issued by the Department of the Interior under Section 304 of the Outer Continental Shelf Deep Water Royalty Relief Act ... and ... not subject to limitations on royalty relief based on market prices that are equal to or less than the price thresholds” described in the DWRRA.⁴ Any holder of a “covered lease” is forced to decide between three options: (1) the lessee can keep the lease under its current terms (i.e., without a price threshold) and lose the right to bid on future offshore lease sales in the Gulf of Mexico; (2) the lessee can pay a newly created “conservation of resources” fee, as established elsewhere in the proposed act; or (3) the lessee can renegotiate the covered lease to include royalty relief price thresholds. Many observers interpret the proposed act as a legislative attempt to correct the perceived oversight in the 1998-1999 leases that lack price thresholds.⁵

Kerr-McGee Oil & Gas Corp. v. Allred

Around the same time that the perceived oversight in the 1998 and 1999 leases described above was brought to the public’s attention, Kerr-McGee Oil & Gas Corp. (Kerr-McGee)⁶ initiated litigation that challenged the authority of the Department of the Interior (DOI) to impose price thresholds on leases sold between 1996 and 2000 (i.e., the effective period of section 304 of the DWRRA). According to Kerr-McGee, section 304 of the DWRRA, which addresses lease sales during the five-year period between 1996 and 2000, barred the inclusion of royalty relief price thresholds to these leases, and therefore the collection of royalties resulting from the imposition of price thresholds contradicted section 304 of the DWRRA.⁷ Kerr-McGee brought its claim in the U.S. District Court for the Western District of Louisiana after the DOI issued an Order directing Kerr-McGee to pay royalties on oil and natural gas produced in 2003 and 2004 under eight leases operated by Kerr-McGee under the DWRRA.⁸

On October 30, 2007, the court issued a ruling that essentially confirmed Kerr-McGee’s position and found that an Order issued by the DOI directing Kerr-McGee to pay royalties based on a price threshold was in error. The court based its ruling on a decision issued by the U.S. Court of Appeals for the Fifth Circuit in 2004 that interpreted the relevant sections of the DWRRA.⁹ According to the court:

The Fifth Circuit interpreted Sections 303 and 304 of the DWRRA as they pertain to new production requirements for Mandatory Royalty Relief leases. Section 303 added a new bidding system that gave the Interior the authority to lease any water depth in any location with royalty relief fashioned according to the Interior’s discretion. The [Fifth Circuit] found that this power, however, was tempered by the next section, where Congress replaced the Interior’s discretion to fashion royalty relief with a fixed royalty suspension scheme based on

⁴ H.R. 3221, section 7504(d)(1).

⁵ For a discussion of some of the potential legal challenges to this legislation, 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 (name redacted) and (name redacted). As explained below at footnote 13, H.R. 6 contained language substantially similar to the provisions of the Royalty Relief for American Consumers Act of 2007.

⁶ Andarko Petroleum Corporation acquired the Kerr-McGee Corporation in June of 2006.

⁷ See Kerr McGee Oil and Gas Corporation’s Memorandum in Support of Motion for Summary Judgment, No. 2:06-CV-0439 (W.D. La., filed May 24, 2007).

⁸ U.S. Department of the Interior, Order to Report and Pay Royalties and Interest Due Under Identified Offshore Federal Oil and Gas Leases (January 6, 2006).

⁹ Santa Fe Snyder Corp. v. Norton, 385 F. 3d 884 (5th Cir. 2004).

volume and water depth. Thus, the royalty relief for Mandatory Royalty Relief leases is automatic and unconditional.¹⁰

Based on the Fifth Circuit's previous ruling, the district court found that Section 304 *mandates* royalty relief up to a certain minimum volume of production, regardless of the market price of oil or natural gas.¹¹ Therefore, the court concluded that the DOI had "exceeded its Congressional authority" when it sought to collect royalties on Kerr-McGee's oil and gas production that did not exceed these volumetric minimums, regardless of whether the oil and gas produced could be sold at prices in excess of the price thresholds for royalty relief that had been included in the lease terms.¹²

The Impact of the *Kerr-McGee* Ruling on the Proposed Royalty Relief for American Consumers Act of 2007

Since the *Kerr-McGee* ruling was issued on October 30, 2007, there has been extensive congressional interest in the impact of the ruling on the proposed Royalty Relief for American Consumers Act of 2007, as described above. Specifically, there is confusion as to how the ruling might affect the restrictions that section 7504 seeks to impose on holders of "covered leases." As discussed above, section 7504 requires that persons who hold "covered leases" either: (1) renegotiate their leases to include price thresholds;¹³ (2) pay a "conservation of resources" fee as set forth in the section; or (3) forfeit eligibility for future oil or gas production leases in the Gulf of Mexico.¹⁴

Section 7504 and the legislative efforts that preceded it¹⁵ have generally been described as efforts to remedy a perceived "error" or "oversight" in the 1998 and 1999 deep water leases by forcing renegotiation of those leases to include royalty relief price thresholds, or by using the "conservation of resources" fee structure to recover from these leaseholders amounts that had previously been calculated to be roughly the same amount as would be owed if price thresholds had been in place.¹⁶ The recent ruling by the U.S. District Court for the Western District of Louisiana, if upheld, would effectively eliminate the distinction between the 1998 and 1999 deep

¹⁰ *Kerr-McGee Oil & Gas Corp. v. Allred*, No. 2:06-CV-0439, slip op. at 7-8 (W.D. La. October 30, 2007) (memorandum ruling).

¹¹ *Id.* at 8-9.

¹² *Id.* at 9.

¹³ One concern that has been raised is whether the court's ruling, if upheld on appeal, would impact the authority of the DOI to renegotiate the "covered leases." Because section 7504, if enacted, would represent a new congressional grant of authority to an administrative agency, this authority would likely supercede any perceived limitations of authority under existing statutes. However, in order to avoid confusion on the matter, Congress might be well served to explicitly state that this new authority supercedes any limitations on the DOI's authority with respect to negotiating the terms of the "covered leases" that were previously in effect.

¹⁴ H.R. 3221 at section 7504.

¹⁵ Section 204 of H.R. 6, as passed by the House on January 18, 2007, contained a substantially similar provision. The Senate-passed version of H.R. 6 does not contain a similar provision.

¹⁶ The conservation of resources fee is set in the bill at \$9 per barrel of oil and \$1.25 per million Btu of natural gas (both in 2005 dollars) for all production years in which the price threshold is exceeded.

water leases, which do not include price thresholds, and the 1996, 1997 and 2000 deep water leases, which contain price thresholds that are not enforceable because they are in violation of congressional intent in enacting section 304 of the DWRRA.

If none of the leases issued pursuant to section 304 of the DWRRA contains royalty relief provisions that are subject to price thresholds, then it appears that all of these leases (*i.e.*, all deep water leases issued between 1996 and 2000) would be “covered leases” as that term is defined in the proposed act. As noted above, section 7504(d)(1) defines a “covered lease” as “a lease for oil or gas production in the Gulf of Mexico that is ... issued by the Department of the Interior under Section 304 of the Outer Continental Shelf Deep Water Royalty Relief Act ... and ... not subject to limitations on royalty relief based on market prices that are equal to or less than the price thresholds” described in the DWRRA.¹⁷

It is important to note that the definition of “covered leases” is not restricted to leases without price thresholds in their terms, or any other definition that would be contingent upon the language in the leases. If this were the case, then only the 1998 and 1999 leases would be “covered leases,” because the 1996, 1997 and 2000 leases contain price threshold language. However, the definition of “covered leases” in section 7504(d)(1) encompasses any lease that is not “subject to limitations on royalty relief” based on oil or natural gas market prices. Thus, if the Western District of Louisiana decision is affirmed on appeal, then it appears that *none* of the leases issued between 1996 and 2000 would be “subject to limitations on royalty relief based on market price,” and thus *all* of these leases may be “covered leases” under the proposed act. As a result, any entity that holds a deep water lease issued between 1996 and 2000 may be ineligible for future oil or natural gas production leases in the Gulf of Mexico pursuant to section 7504(a) of the proposed act until that entity either renegotiates the lease in question or pays a “conservation of resources” fee.

If Congress does wish to encourage recovery of royalties on all leases issued pursuant to section 304 of the DWRRA between 1996 and 2000 that are limited by both price and volumetric thresholds, it could likely do so by passage of the proposed Royalty Relief for American Consumers Act of 2007 as it is currently worded in sections 7501-7505 of H.R. 3221. This option could affect most companies operating in the deep water OCS area. If Congress wishes to restrict the scope of the proposed act to the 1998 and 1999 leases that did not contain price thresholds, it might consider amending the definition of a “covered lease” accordingly.

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¹⁷ H.R. 3221, section 7504(d)(1).

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