

## Non-Producing Leases in the Federal Offshore

In the last Presidential Election cycle there was considerable discussion about federal offshore energy production. There was the camp of "Drill, Baby, Drill" and the other camp pointing out that most of existing leases had no drilling activity. Since then the current administration has made some changes to encourage quicker exploration of leases. This paper will shed light on the facts of the current situation. This paper used data obtain from Bureau of Offshore Energy Management ([www.boem.gov](http://www.boem.gov)) as of April 2012.

### Background

Offshore leases are issued via a lease sale process ([http://www.boem.gov/uploadedFiles/BOEM/Oil\\_and\\_Gas\\_Energy\\_Program/Leasing/5BOEMRE\\_Leasing101.pdf](http://www.boem.gov/uploadedFiles/BOEM/Oil_and_Gas_Energy_Program/Leasing/5BOEMRE_Leasing101.pdf)). The government has a complicated process to assure the fair market value is obtained ([http://www.boem.gov/uploadedFiles/BOEM/Oil\\_and\\_Gas\\_Energy\\_Program/Energy\\_Economics/Fair\\_Market\\_Value/FMV174-3.pdf](http://www.boem.gov/uploadedFiles/BOEM/Oil_and_Gas_Energy_Program/Energy_Economics/Fair_Market_Value/FMV174-3.pdf)). It is a two phase process. Think of Phase I as a triage. Is there enough information available for a quick decision of acceptance of a bid? Those bids needing additional analysis are sent to Phase II for a detailed review. In both these phases the geologic viability of the lease is assessed. Those leases which are found not to have a economically viable geologic structure are accepted as non-viable. For example in the recent Sale 218. There were 191 tracts bid on, of those only 9 high bids were rejected. Of the remaining 182, 154 (85%) were classified as non-viable. The government has an asymmetrical information advantage in this process. All geologic and geophysical data is available to the government. The government has a competitive advantage because it has access to all the raw data. The oil and gas companies are making decisions based on a smaller information base. When the high bids are accepted, the lease is in a Primary lease status. The owner decides what it will do with the lease for the initial term which runs from 5 to 10 years. The owner can hold, explore, produce or return the property to government.

### Current Status of the Gulf of Mexico

Those leases with limited or no activity are in a Primary lease status. As of April 2012 there are 3,250 leases in the Primary status. That is a very large number of leases available for exploration.

#### Primary Term Lease in Gulf of Mexico

Class	Leases	Pct of Total	Average Bid for the class
Non-Viable	2,571	79.11	\$1,241,883
Others	679	20.89	\$9,420,351

Almost 80% of the Primary status leases in the Gulf of Mexico have been certified at the time of sale as not having economic targets. Further the bids on these leases from the oil and gas companies is less than one seventh of the "Others".

This raises the question, why are oil and gas companies purchasing and paying rent to retain to what is nearly always worthless property? An answer to the question is that they are purchasing an option. The right to drill sometime in the future when the status quo could change. Changes in drilling technology, insights from exploration elsewhere, or increase prices for the commodity are possible.

Now, examine the cash flows for all these non-viable properties that the government has leased:

Case One: Government is wrong about the property being non-viable. The oil and gas company makes a discovery and produces hydrocarbons. The government collects the bonus bid, the rental payment stream, and then the royalty stream. In more recent times the government has scaled back on the royalty relief volumes and increased the royalty rates. This case the government obtains a windfall.

Case Two: Government is correct that the property is non-viable. Government collects the bonus and the rental stream of payments. The property is returned to the government inventory for potential resale. For this case it is effectively a transfer of wealth from the stockholders to the government.

For non-viable leases the government has a heads I win, tails you lose scenario.

#### Current Status of the Alaska Offshore

In the history of this region 2,351 leases have been issued for 9.2 billion dollars in bonus bids. There are only 3 producing leases in the region. About 27 million barrels has been produced in the Alaskan federal offshore history. That works out to \$342 per barrel in bonus bid payments. The rental and royalty payments are in addition to that figure. Another example of the transfer of wealth from the stockholders to the government. To put the 27 million barrel cumulative production into perspective, in the month January 2011, there was 48 million barrels produced in the Gulf of Mexico federal offshore.

Findings:

- A very large share of those non-producing leases in the Gulf of Mexico were certified as non-viable by the government's professional staff.
- For these non-viable leases it represents from the governments perspective as a heads I win, tails you lose financial arrangement.
- In the Alaska Region the government has taken in billions of dollars in revenue for leasing properties. The private sector has paid \$342 in bonus payments for each barrel of oil produced.

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