

OIL AND GAS LEASING ON THE OUTER CONTINENTAL SHELF



Minerals Management Service
www.mms.gov

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BACKGROUND

The Minerals Management Service (MMS) is a bureau in the United States Department of the Interior that manages the Outer Continental Shelf (OCS) and is one of the largest revenue generators for the Federal government. The MMS has a twofold mission of 1) managing all Federal and Indian mineral revenues and 2) managing all Federal offshore renewable and traditional energy and mineral resources. The MMS also manages approximately 1.7 billion acres containing over 8,000 active leases in this federally owned offshore area, while protecting the human, marine, and coastal environments through advanced science and technology research. The approximately 43 million leased OCS acres account for about 15 percent of America's domestic natural gas production and about 27 percent of America's domestic oil production.



The OCS Lands Act authorizes the Secretary of the Interior to grant mineral leases and to prescribe regulations governing oil and natural gas activities on OCS lands. Federal ownership begins three nautical miles off most coastal states. Exceptions are off Texas and the Gulf coast of Florida where the OCS starts at about nine nautical miles. Federal jurisdiction generally ends around 200 nautical miles from the coastline.

Revenues from OCS leases consist of bonuses, royalties, and rentals. These revenues are shared with the coastal states, as directed by statute, and the remaining funds deposited in the U.S. Treasury accounts.

The OCS revenues provide annual deposits of nearly \$900 million to the Land and Water Conservation Fund and \$150 million to the Historic Preservation Fund. By statute, coastal states share a portion of the revenues from OCS leasing and production under three programs: 1) States with offshore federal leases located within the first 3 miles from the state's seaward boundary receive 27 percent of the revenue generated from those leases; 2) Alabama, Louisiana, Mississippi and Texas share 37.5 percent of the revenues from leases in designated areas in the Gulf of Mexico; and 3) for each Fiscal Year 2007-2010, \$250 million is shared with the six coastal states with federal oil and gas leasing off their coasts: Alaska, Alabama, California, Louisiana, Mississippi, and Texas. The remainder is sent to the U.S. Treasury's General Fund.

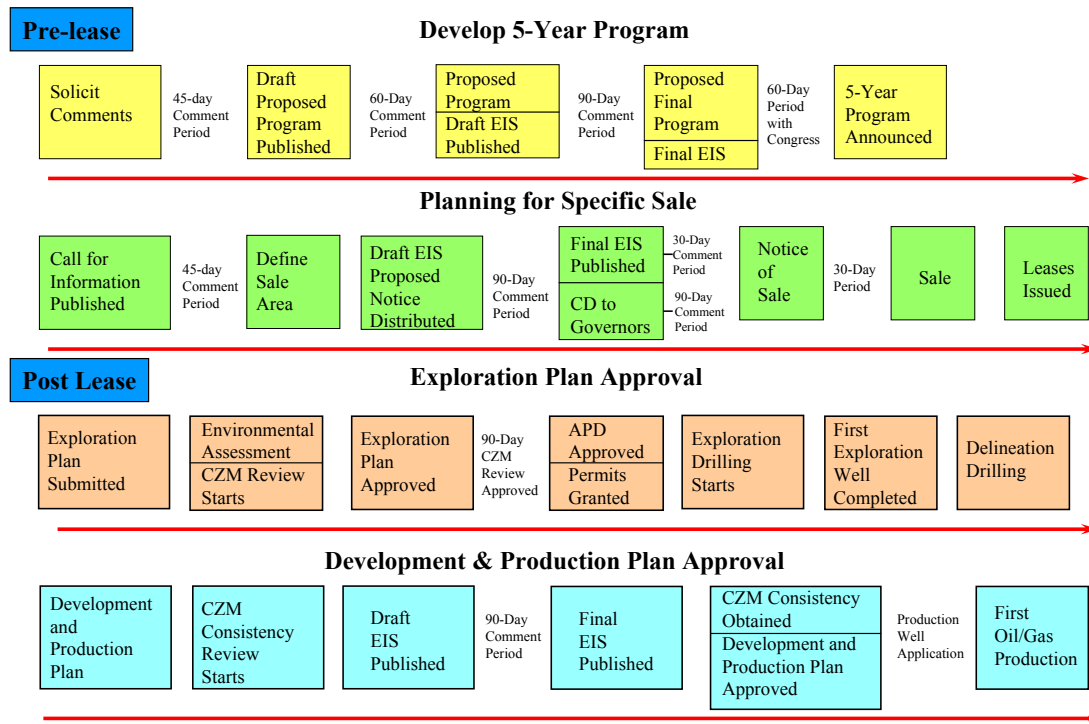
THE OIL AND GAS LEASING PROCESS

The MMS has cradle-to-grave oversight responsibility on oil and gas leasing activities within the OCS. Section 18 of the OCS Lands Act requires the Secretary of the Interior to prepare a 5-year oil and gas leasing program (5-Year Program) that consists of a 5-year schedule of proposed lease sales that shows the size, timing, and location of leasing activity as precisely as possible. The OCS Lands Act mandates that the 5-Year Program must balance the priorities of national energy needs, environmentally sound and safe operations, and fair market return to the taxpayer.

For any specific lease sale to be held, it must be included in an approved 5-Year Program. The Secretary cannot add a lease sale to an existing 5-Year Program. Whether MMS holds a lease sale depends on a sale-specific analysis.

The process to develop a 5-Year Program includes: three separate comment periods, two separate draft proposals, a final proposal, and development of an environmental impact statement (EIS). This statutorily mandated process usually takes about two and a half years. After the Secretary of the Interior approves the Proposed Final Program, the MMS sends it to Congress. If Congress does not pass legislation to modify the proposal within 60 days, the 5-Year Program becomes final.

OCS Oil and Gas Leasing, Exploration, & Development Process



Abbreviations: APD, Application for Permit to Drill; Consistency Determination; CZM, Coastal Zone Management; EIS Environmental Impact Statement

Figure 1. OCS Oil and Gas Leasing Process

THE OIL AND GAS SALE PROCESS

After the adoption of a 5-Year Program, the usual first step in the sale process for an individual area is to publish in the Federal Register a Call for Information and Nominations and a Notice of Intent to Prepare an EIS. The entire process from the Call to the sale may take two or more years (see Figure 1). Some proposed sale areas, such as those in frontier areas, may include an additional first step—a request to industry to indicate their interest in the specific area before MMS proceeds with the sale process. The lease sale process is described below.

- Call for Information/Notice of Intent to Publish an Environmental Impact Statement (EIS) Published – This is the initial request for industry to identify which blocks within an OCS planning area they have interest in potentially leasing. Additionally, the public may comment on areas that should or should not be considered for leasing, as well as issues pertinent to the EIS. The EIS includes: a description of the lease sale proposal, including the oil and natural gas resources estimated to be found and a projection of the exploration and

development activity that might occur; reasonable alternatives to the leasing proposal; a description of the existing environment; a detailed analysis of possible effects on the environment, including socioeconomic and cumulative effects; a description of the assumptions upon which the analysis is based; potential mitigating measures; any unavoidable adverse environmental effects; the relationship between short-term uses and long-term productivity; any irreversible or irretrievable commitment of resources; and the records of consultation and coordination with others in preparation of the document.*

- Scoping Meetings – These are public meetings conducted in the vicinity of the area proposed for leasing consideration in order to receive public comments regarding issues related to developing an EIS.
- Define Proposed Sale Area – After the 45-day comment period, the MMS analyzes comments and considers resource potential and environmental effects and recommends the area to be analyzed in an EIS (called Area Identification).
- Draft EIS Published – The area identified undergoes a full National Environmental Policy Act analysis and a draft EIS is published with a 60-day public comment period.
- Public Hearings – MMS holds public meetings inviting constituents to submit written or oral comments on the draft EIS; these meetings are held in localities near the proposed lease sale area.
- Final EIS Published – After considering comments on the draft EIS, the MMS publishes a Final EIS with a 30-day comment period.
- Proposed Notice of Sale (NOS) Published – This is the first public document stating the proposed time and location of the proposed lease sale with the terms and conditions, as well as any mitigating measures. The MMS sends the Proposed Notice to the Governor of the affected state(s) and the Governor has 60 days to comment on the proposed sale.
- Consistency Determination to Governors – The MMS prepares a consistency determination in accordance with the Coastal Zone Management Act to determine if the proposed lease sale is consistent with the affected state(s)' coastal zone policies. The state has 60 days to agree or disagree with the federal consistency determination.
- Final Notice of Sale (NOS) Published – This Final NOS states the final terms and conditions of the lease sale and must be published in the Federal Register at least 30 days prior to the sale date.
- Sale – No less than 30 days after the Final NOS is published in the Federal Register, sealed bids submitted by qualified bidders are publicly opened and read. Lease sales are open to the public and are conducted by the appropriate Regional Director, usually in the city in which the OCS regional office is located. Qualified bidders may submit bids on each available tract listed in the Final NOS.
- Leases Issued – The high bidder on each block is awarded a lease after MMS determines the bid met fair market value criteria. The Federal government reserves the right to reject any or all bids and the right to withdraw any block from the sale.

ACQUIRING AN OIL AND GAS LEASE

The MMS places some restrictions on who may acquire a lease. In order to become a lease holder, a bidder must be a legal entity under United States law. This includes being an American citizen, national, resident

* The MMS may do a multi-sale EIS covering all sales in a Region for a specific 5-Year program. After the first such sale in each planning area, subsequent sales are covered by an environmental assessment or supplemental EIS.

alien, corporation, or partnership. Prior leaseholders are barred from acquiring new leases if they failed to exercise due diligence or had an unacceptable operating performance. Additionally, a restricted bidder list prohibits major oil companies from jointly bidding on a lease, under certain conditions.

The lease sale is a transparent process. The MMS opens the sealed bids at the place, date, and hour specified in the notice of sale, as published in the Federal Register, for the purpose of publicly announcing and recording the bids. Bids are not accepted or rejected at that time. The MMS accepts or rejects all bids within 90 days, although the time may be extended if necessary. The Department reserves the right to reject any and all bids, regardless of the amount offered, if the bid does not meet MMS's fair market value criteria. If a bid is rejected, any money deposited with the bid will be refunded plus any interest accrued.

A lease conveys the right to explore for, develop, and produce the oil and gas contained within the lease area. Leases are offered as blocks that are generally nine square miles (3 miles on a side). No lease may be sold, exchanged, assigned, or otherwise transferred except with the approval of the MMS. Before MMS issues a lease or approves an assignment of an existing lease, the high bidder must provide either a lease-specific or area-wide general bond.

The MMS may determine that the prospective lessee needs to provide a supplemental bond as security in addition to the requirements for general bonds. The MMS may call for forfeiture of all or part of the bond or pledged security if the high bidder refuses or fails, within the time frame, to comply with any term or condition of the lease.

FAIR MARKET VALUE

In administering the oil and gas leasing program, the MMS is required by law to see that the government receives a fair return for the lease rights granted and the minerals conveyed. To assure that the government receives a fair return for these offshore lease rights, the MMS uses a two-phased system of bid evaluation to assess the adequacy of bids based on multifaceted criteria.

Immediately after the bids are read publicly, the MMS begins the process of determining whether a bid can be accepted and a lease issued. Each high bid is first examined for technical and legal adequacy. Before any bid is accepted, the bidding results of the sale also are reviewed by the Attorney General and the Federal Trade Commission to determine if awarding a lease would create a situation inconsistent with antitrust laws.

Each valid high bid resulting from these determinations is then analyzed from a fair market value perspective. It is important to note that the fair market value at the time of lease award is not based on the value of the oil and gas that may be eventually discovered or produced; instead, it is related to the value of the right to explore and, if there is a discovery, to develop and produce hydrocarbons. This value is therefore based on the expected, not actual, activities and results that are anticipated to occur after the sale. The value is based on MMS's analysis and interpretation of geologic and geophysical information and MMS's estimate of the likelihood of oil and/or natural gas being discovered on the area of the lease.

LEASE TERMS AND CONDITIONS

The oil and gas lease grants the exclusive right to explore, develop, and produce oil and/or natural gas for a specific period (minimum of 5 and maximum of 10 years) and from a specific tract of OCS land. All exploration, development, and production activities are carefully reviewed by MMS to ensure that they are done in an environmentally sound and safe manner. If a discovery is made within the initial term of

the lease, the lease is extended for as long as oil and/or natural gas is produced in paying quantities or approved drilling operations are conducted. The term of the lease may also be extended if a suspension of production or suspension of operations has been granted or directed by MMS. Examples of when a suspension of operations may be granted include weather delays, such as hurricanes, or other circumstances beyond the lessee's control. Examples of a suspension of production may include unforeseen delays in contracting with a drilling rig once a schedule and commitment to production has been demonstrated.

The lease is a contractual agreement and thus further spells out financial requirements for surety bonds, royalty payments, rental payments, and assignment or other transfers of the lease or any partial interest. No lease may be sold, exchanged, assigned, or otherwise transferred except with the approval of MMS.

Special stipulations are often included in OCS oil and natural gas leases in response to concerns raised by coastal States, Federal agencies, and other stakeholders. Examples of stipulations include: required biological surveys of sensitive seafloor habitats, environmental training for operations personnel, special waste-discharge procedures, archaeological resource reports to determine the potential for historic or prehistoric resources, special operating procedures near military bases or their zones of activity, and other restrictions on OCS oil and natural gas operations. Lease stipulations are legally binding, contractual provisions designed as mitigating measures to address specific concerns pertinent to the lease.



In addition, the lease requires that the lessee comply with additional rules and regulations that may be issued after the lease is awarded to provide for the prevention of waste and the conservation of the natural resources of the OCS. The Notice to Lessees and Operators (NTL) is used by MMS to notify operators quickly within a particular OCS region or nationwide concerning changes in administrative practices or procedures for complying with rules, regulations, and lease stipulations and/or to clarify requirements or to convey information. For example, the MMS may require certain safety equipment that previously had not been required, as prescribed in regulation.

When the lease is acquired, the lessee pays a bonus bid. This acquisition cost reflects the opportunity cost of exploring and producing those oil and/or natural gas resources. During the initial term of a lease and before the lease goes into production, the lessee pays annual rentals. Rentals reflect the holding cost of the lease. In recent sales, the MMS has imposed rentals that escalate over time to encourage faster exploration and development.

The Federal government receives a royalty payment when production starts. The royalty rate is a percentage of the value or the amount of production. Under certain conditions, the royalty payment might be temporarily waived. This “royalty relief” occurs as an economic incentive to spur additional production, such as in a frontier area or deeper depth. Price “thresholds” or “triggers” suspend royalty payments if market prices are low but do not suspend royalty payments if market prices are high. Price thresholds provide an incentive when production might not otherwise occur but eliminate royalty relief when oil and natural gas market prices are high and the incentive is no longer needed.

EXPLORATION, DEVELOPMENT, AND PRODUCTION

Leasing and operations activities on the OCS are subject to the requirements of some 30 Federal laws administered by numerous federal departments and agencies. Principal laws that may apply to OCS exploration, development, and production are the:

- Outer Continental Shelf Lands Act (OCSLA);
- National Environmental Policy Act (NEPA);
- Endangered Species Act;
- Coastal Zone Management Act (CZMA);
- Federal Water Pollution Control Act;
- Ports and Water Safety Act;
- Marine Mammal Protection Act;
- Clean Air Act; and
- National Historic Preservation Act.

For oil and gas lease activities, the regulations at 30 CFR Part 250 cover all day-to-day operations. The regulations are a mixture of performance-based and prescriptive requirements to ensure safety, protect the environment, and conserve natural resources. Whenever the owner of a producing or non-producing lease fails to comply with the provisions of the lease or governing laws or regulations, the lease(s) may be forfeited and canceled.

An Exploration Plan (EP) and its supporting information must be submitted for approval to the MMS before an operator (the company assigned by the lessee) may begin exploratory drilling on a lease. The EP sets out how the operator will explore the lease and describes all exploration activities planned by the operator, the timing of these activities, information concerning drilling, the location of each well, and other relevant information.

The MMS has found that the strict enforcement of the lease term is the best means of ensuring expeditious development. To further encourage timely exploration and development, the MMS is employing graduated rental rates that increase with time during the primary term. It is important that actions intended to accelerate production do not increase safety and environmental risks, precipitate the drilling of unnecessary wells, or reduce the ultimate recovery of oil and gas resources.

In accordance with the CZMA, each EP must contain a certification of consistency with approved CZM programs of States that could be affected by the exploration activities. All adjacent coastal States with approved programs are requested to review the EP and may take up to 6 months for consistency reviews but must agree with or request an extension within 3 months after receipt of the EP.

A lessee must file an Application for Permit to Drill (APD) before drilling can begin on a lease. MMS often attaches lease-specific conditions of approval to these permits to address matters such as administrative, technical, and environmental issues. In all cases, these are specific requirements depending on the conditions in the area.

If the operator completes its exploration and discovers oil and/or natural gas, it must come to MMS with a plan on how it is going to develop the prospect. This Development Plan will include how many wells and where these wells will be located, what type of structure will be used, and how it will get the oil and natural gas to shore.

The MMS conducts in-depth reviews along the way, as these plans are approved. The operator cannot conduct any of these operations until it receives its approval. Additionally, because of the many different issues addressed in these Plans, the MMS must communicate with other Federal and state agencies. The MMS reviews and approves pipeline and platform applications consistent with environmental and technical requirements (see Figure 2 for examples of various structures reviewed).

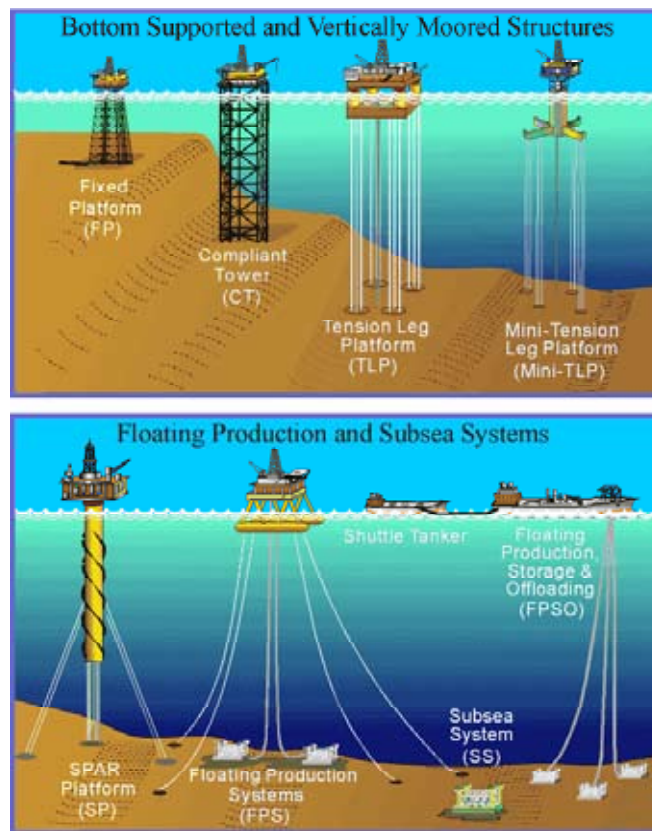


Figure 2. Oil and Gas Platform Structures

ENVIRONMENTAL AND SAFETY ISSUES

The oil and gas lessees are required to submit Oil Spill Response Plans to the MMS for approval by the time they submit Exploration Plans or Development Plans.

The Response Plan outlines the availability of spill containment and cleanup equipment and trained personnel. It must ensure that full response capability can be deployed during an oil-spill emergency. The plan includes specifications for appropriate equipment and materials, their availability, and the time needed for deployment. The plan must also include provisions for varying degrees of response effort, depending on the severity of a spill. The Oil Pollution Act of 1990 requires that spill response plans identify and ensure the availability of private personnel and equipment necessary to respond to a worst case discharge, depending on the severity of the spill.

Throughout the drilling and production phases, the MMS inspects the operations to ensure compliance with regulations, lease terms and statutes. This further ensures operational safety and pollution prevention. It also requires that drilling personnel be trained in well control.

Prevention is the MMS's most important safety strategy. This is accomplished through the regulatory process and the inspection program. The regulatory program includes approval of plans, facilities,

and operations. These approvals include reviews where there is much emphasis on design, operations, and maintenance. Part of MMS's success is MMS presence at offshore facilities. While MMS monitors compliance with the regulations throughout the permitting process and operations, nothing compares to having MMS personnel in the field to ensure operators are complying with the regulations. On average in recent years on the Federal OCS, the MMS has conducted between 20,000 and 25,000 inspections annually.

POST-PRODUCTION REQUIREMENTS

When an oil and gas producing field can no longer be economically produced, the lease is decommissioned. Decommissioning is when the lessee ends oil and natural gas operations and returns the lease to a condition that meets the requirements of regulations of MMS and other federal agencies that have jurisdiction over decommissioning activities.

When the lessee's facilities are no longer useful for operations, the lessee must:

- Get approval from the appropriate MMS District Manager before decommissioning wells and from the MMS Regional Supervisor before decommissioning platforms and pipelines or other facilities;
- Permanently plug all wells;
- Remove all platforms and other facilities;
- Decommission all pipelines;
- Clear the seafloor of all obstructions created by the lease and pipeline right-of-way operations; and
- Conduct all decommissioning activities in a manner that is safe, does not unreasonably interfere with other uses of the OCS, and does not cause undue or serious harm or damage to the human, marine, or coastal environment.

One example of how a structure may be used after the lease has been decommissioned is the Rigs-to-Reef program. Rigs-to-Reefs is a term used for converting nonproductive offshore oil and gas structures to designated artificial reefs. This effort has led to reef construction opportunities presented by the decommissioning process for offshore platforms. In the mid-1980's the National Marine Fisheries Service developed and published a National Artificial Reef Plan. This set the stage for Federal endorsement of offshore artificial reef projects. Petroleum platforms function as entirely new places to live; niches for countless animals. In addition to harboring numerous species of juvenile fish and adult life stages, these platforms serve as hunting grounds for swift open-ocean pelagic fishes.

The MMS takes seriously its responsibilities to develop the nation's OCS oil and natural gas resources in an environmentally sound manner and to obtain fair market value for the American people. The agency is committed to being responsive to the public's concerns and interests by maintaining a dialogue with all affected parties.



The Department of the Interior Mission



As the Nation's principal conservation agency, the Department of the Interior has responsibility for most of our nationally owned public lands and natural resources. This includes fostering sound use of our land and water resources; protecting our fish, wildlife, and biological diversity; preserving the environmental and cultural values of our national parks and historical places; and providing for the enjoyment of life through outdoor recreation. The Department assesses our energy and mineral resources and works to ensure that their development is in the best interests of all our people by encouraging stewardship and citizen participation in their care. The Department also has a major responsibility for American Indian reservation communities and for people who live in island territories under U.S. administration.

The Minerals Management Service Mission



As a bureau of the Department of the Interior, the Minerals Management Service's (MMS) primary responsibilities are to manage the energy and mineral resources located on the Nation's Outer Continental Shelf, collect revenue from the Federal OCS and onshore Federal and Indian lands, and distribute those revenues.

Moreover, in working to meet its responsibilities, the **Offshore Energy and Minerals Management Program** administers the OCS competitive leasing program and oversees the safe and environmentally sound exploration and production of our Nation's offshore natural gas, oil, other mineral resources, and renewable energy. The MMS **Minerals Revenue Management** meets its responsibilities by ensuring the efficient, timely and accurate collection and disbursement of revenue from mineral leasing and production due to Indian tribes and allottees, State and the U.S. Treasury.

The MMS strives to fulfill its responsibilities through the general guiding principles of: (1) being responsive to the public's concerns and interests by maintaining a dialogue with all potentially affected parties and (2) carrying out its programs with an emphasis on working to enhance the quality of life for all Americans by lending MMS assistance and expertise to economic development and environmental protection.

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MMS *Securing Ocean Energy &
Economic Value for America*