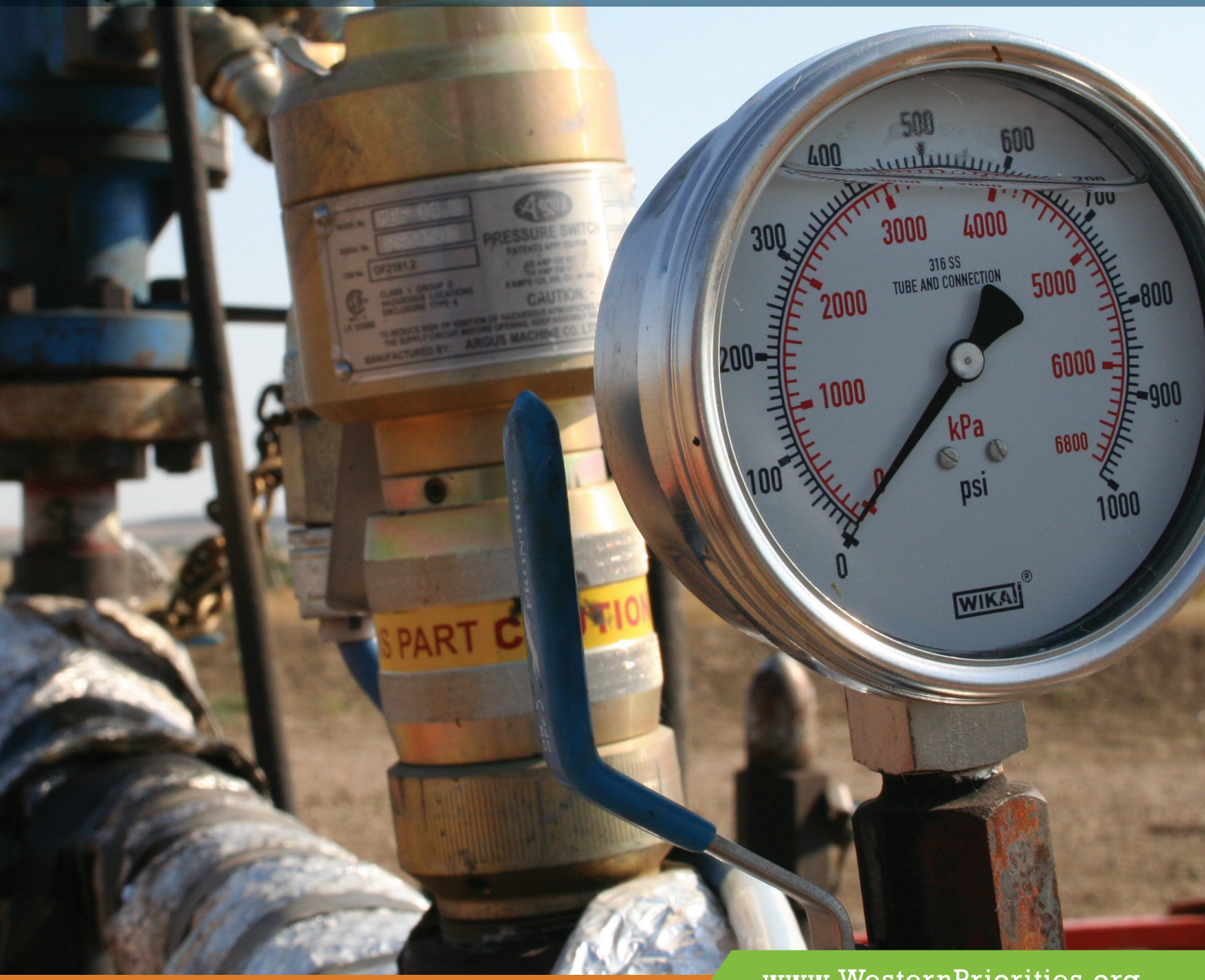
Center for
Western Priorities

A Fair Share:

The Case for Updating Federal Royalties

June 20, 2013



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Summary

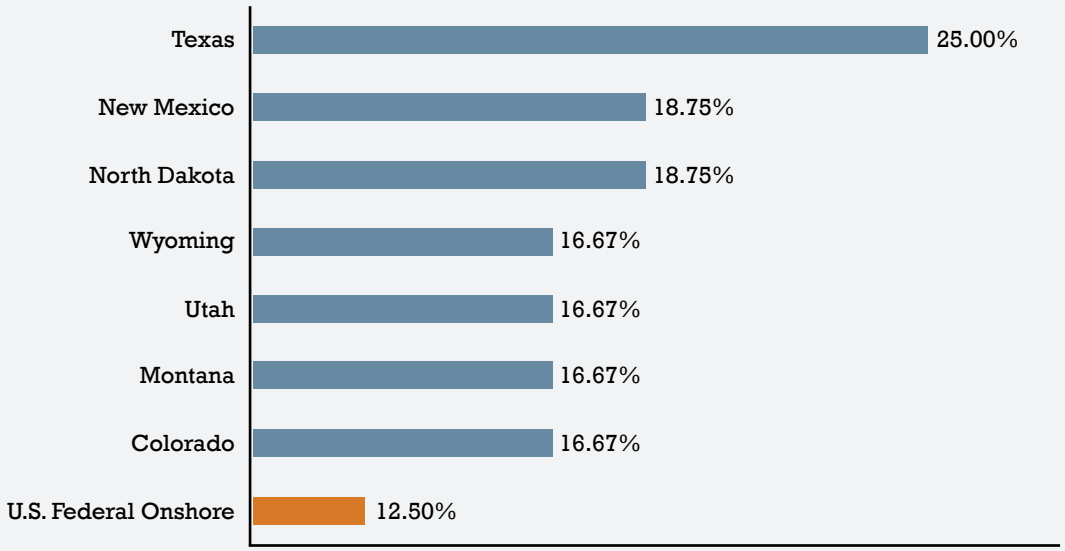
FEDERAL ROYALTY RATES ARE SHORTCHANGING WESTERN STATES & TAXPAYERS

Antiquated federal royalty rates are depriving taxpayers and many Western states of urgently needed revenue that could be used to pay down the national debt, expand access to hunting, fishing, and recreation opportunities, protect public lands, and improve infrastructure strained by oil and gas drilling operations.

The federal onshore royalty rate has not been updated since the 1920s, remaining at 12.5 percent.[1] Most oil and gas producing states in the Western United States charge a significantly higher royalty rate than the federal government—typically a rate of 16.67 percent or 18.75 percent—to produce oil and gas on state-owned lands. Texas collects twice the federal rate in royalties.

By charging royalty rates lower than oil and gas producing Western states, the federal government is leaving revenues on the table and shortchanging taxpayers.

COMPARISON: FEDERAL ONSHORE ROYALTY RATES ARE MUCH LOWER THAN STATE RATES [2]



The royalties that the federal government receives from oil and gas production are split between the U.S. Treasury and the originating states. While oil and gas companies generate billions in profits each quarter,[3] energy rich states in the Rocky Mountain West—Colorado, Montana, New Mexico, Utah, and Wyoming—are being deprived of between $400 million and $600 million in gross revenues annually because of the low federal onshore royalty rate.

The Bureau of Land Management (BLM)—an agency within the Department of the Interior—leases federal lands to oil and gas companies. In return, these companies pay royalties to the agency to compensate taxpayers for the extraction of nonrenewable, publicly owned oil and gas resources.

Under this system, oil and gas companies manage leases to drill on approximately 37.8 million acres of federal public lands.[4] In fiscal year 2012, those leases produced over $2.5 billion in royalty payments.[5] However, failing to update the royalty payment structure costs the states and taxpayers significant revenue each year.

The federal onshore royalty rate should be increased to provide a fair return to states and taxpayers. The law requires the BLM to assess a royalty rate of "not less than" 12.5 percent; the President and the Secretary of the Interior have the executive authority to increase that rate without Congressional action.[6]

Sequester cuts and budgetary restrictions have strained local, state, and federal budgets, creating a significant need to revisit our royalty policies. This paper looks at current federal royalty rates and examines opportunities for taxpayers to receive a fair return on energy resources while encouraging the diligent development of federal oil and gas leases.

PUBLIC LANDS AND THE CURRENT ROYALTY STRUCTURE

Public lands are part of our nation's legacy and are an economic driver in the West. These lands contribute to Westerners' quality of life and are a magnet for businesses that create jobs and grow economies. America's public lands offer millions of people a refuge to hike, camp, hunt and fish. They provide wildlife habitats, sources of drinking water and clean air for towns and cities, and supplies of natural resources including timber, minerals, oil and natural gas.

The BLM, one of the four major federal land management agencies, oversees the 700 million acres of federally owned subsurface mineral resources, in addition to managing 245 million surface acres.[7] The BLM is charged with managing these lands for multiple uses, maximizing their benefits to current and future Americans, and striking a balance between land protection and resource development.[8]

When the BLM leases land to private companies, the companies are obligated to repay the public for the use of the lands, as well as the raw materials that are extracted.

The royalties that companies pay to extract oil and gas from federal lands are an important source of federal revenues. According to a 2010 report by the Government Accountability Office (GAO), royalties from oil and gas development "represent one of the federal government's largest nontax sources of revenue."[9]

Along with royalty payments—the largest source of revenues from oil and gas extraction on federal lands—the federal government also generates revenues from oil and gas leasing through bonus bids and rental payments.

Royalties: An energy company pays royalties to a landowner—the federal government, state government, tribal government, or a private landowner—for the right to extract oil and natural gas from their land. Royalties are assessed as a percentage on the value of the oil or natural gas extracted.[10] Royalty payments contributed 89 percent of all federal onshore oil- and natural gas-related revenues in 2012.[11]

Bonus Bids: Federal oil and gas leases are offered through a competitive bidding process. A company must bid at least $2 per acre to lease federal public land, but bids often range much higher.[12] In 2012, bonus bids contributed about 10 percent of all federal onshore oil and natural gas revenues.[13]

Rental Payments: Rentals are paid on leases that are not currently in production and not making royalty payments. A company holding a lease on public lands, but not currently producing on that land, must pay the federal government an annual rental fee of $1.50 per acre in the first 5 years and $2.00 per acre each year thereafter.[14] In 2012, despite nearly 21 million idle acres of leased land, rental payments accounted for less than two percent of federal onshore oil and natural gas revenues.[15/16] Because rental rates are so low, companies are sitting on thousands of leases. Presently, there are nearly 7,000 approved permits, ready for drilling and energy extraction, sitting idle.[17]

FEDERAL AND STATE ROYALTY DISTRIBUTION

Royalties generated on federal lands provide a direct benefit to the states where extraction takes place. The revenues collected are distributed through a formula that returns approximately half of the revenues to the state where drilling occurred—the remainder is deposited into the U.S. Treasury. The one exception is Alaska, where 90 percent of revenues are returned to the state.[18]

Over the last five years, oil and gas production on federal lands has generated almost $14 billion in revenues, a significant portion of which was redistributed to the states where the drilling took place.[19] In FY 2012 alone, the federal government disbursed over $1.3 billion to states where drilling occurs. A significant portion of that amount was distributed to states in the Rocky Mountain West.[20]

Royalty payments distributed from the federal government to the states are an important source of funds to help alleviate the community and economic impacts of oil and gas development by subsidizing the construction and maintenance of public facilities, like schools and roads.

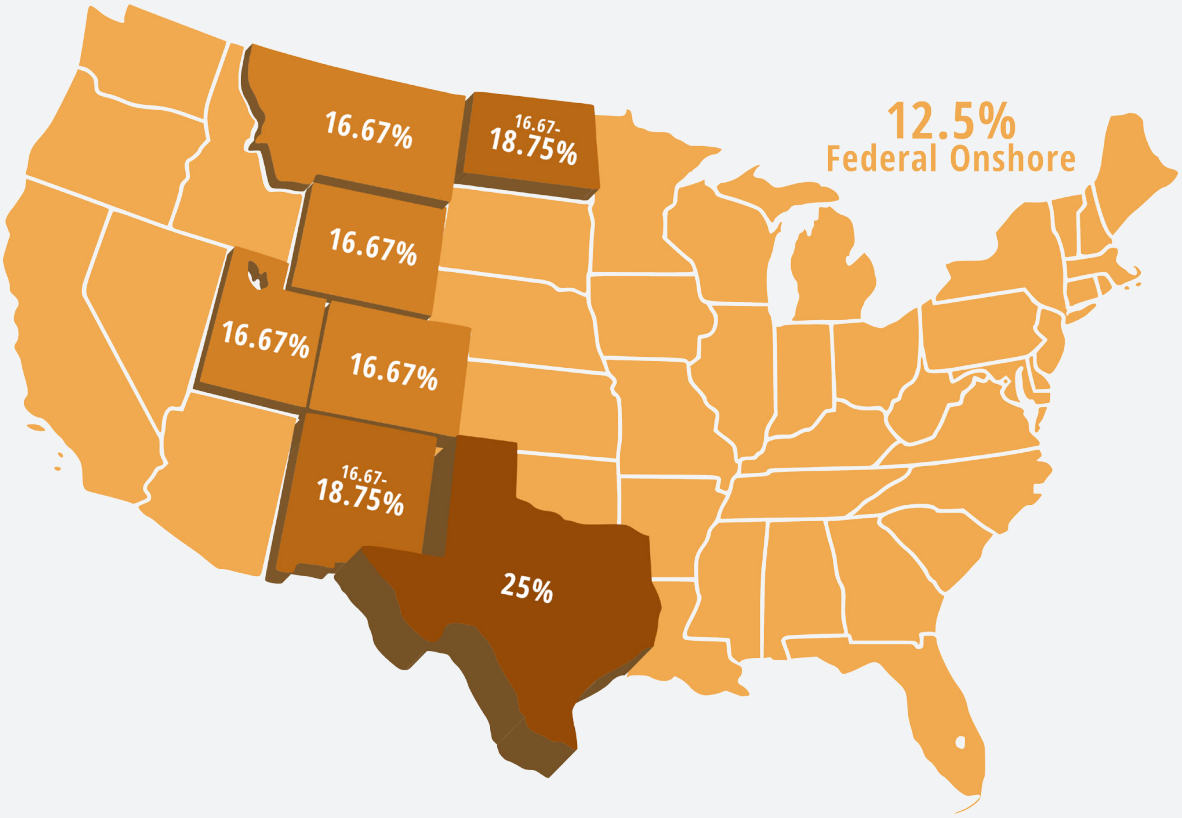
In Colorado, for instance, federal royalties are distributed to counties, municipalities and school districts.[21] In Utah, the large majority of federal royalties are dispersed to maintain local highways in communities impacted by energy development and to the state agencies and towns directly affected by oil and gas development.[22]

FEDERAL OIL AND GAS ROYALTY DISTRIBUTIONS TO WESTERN STATES, FY 2012[23]

FEDERAL ROYALTY RATES BELOW RATES OF MOST WESTERN STATES

States receive a portion of royalty payments from federal lands, and also assess their own royalties on oil and gas extracted from state owned lands. These lands—State Trust Lands—were granted by the federal government to states upon their entering the Union.[24]

Our analysis finds that states in the West—where many federally owned lands are located—charge significantly higher royalty rates to develop oil and gas on state lands. While the federal government charges 12.5 percent on the value of oil and natural gas produced onshore, most Western states charge between 16.67 percent and 18.75 percent. That's anywhere from 33 percent and 50 percent higher than the federal onshore rate. Texas charges a royalty rate of 25 percent, or twice the federal rate.



North Dakota and New Mexico adjust royalty rates on state lands based on the location of known production areas and the likelihood of discovering oil and gas. New Mexico charges 16.67 percent on more speculative lands and 18.75 percent inside known production areas. Similarly, a 16.67 percent royalty is charged in most of North Dakota, but the state levies an 18.75 percent in the counties lying above the Bakken Formation.

In 2007, the federal government recognized that it was not receiving a fair return on federal offshore leases, which, at the time, were 12.5 percent. President George W. Bush's Interior Secretary, Dirk Kempthorne, amended offshore royalty rates to reflect fair market value. Companies drilling for oil and natural gas offshore now pay a royalty of 18.75 percent.[25] More recently, former Secretary of the Interior Ken Salazar championed increasing the federal onshore royalty rate. Each of the previous four Department of the Interior budgets called for increasing the onshore rate, but no action has been taken.[26]

HIGHER RATES DO NOT SIGNIFICANTLY SLOW DRILLING

Resource price, technology and geology largely determine when and where it is profitable for a company to drill for oil and gas. Economic data shows that small, yet fiscally meaningful differences in tax and royalty policy do not significantly affect oil and gas production.[27]

A recent comparative analysis revealed that states with higher oil and gas taxes are not placed at a competitive disadvantage.

Wyoming, for example, has the highest effective tax rate in the West but still remains a national leader in production. At the same time, Montana has among the lowest effective tax rates in an attempt to attract the industry, yet drillers are much more interested in drilling in North Dakota despite the state's relatively higher rates.[28]

Because of Montana's oil and gas tax policy, a new well in Montana will generate $800,000 less for the state than an identical well drilled across the border in North Dakota. Despite this disparity, drilling in North Dakota continues to boom as drilling in Montana lags behind. This suggests that higher rates are not impacting companies' investment decisions.[29]

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POLICY OPTIONS TO ENSURE AMERICANS GET A FAIR SHARE

The Administration has options to encourage the diligent development of federal oil and gas leases, while ensuring American taxpayers are receiving a fair return on publicly owned oil and natural gas resources.

Increase Federal Royalties to Mirror Rates Charged by the States

One option is to create parity between federal and state royalties by increasing the minimum federal rate. While the BLM may consider adopting a 25 percent rate—on par with Texas—a more practical approach is to mirror the federal onshore royalty rate with the rates charged by the majority of states. Raising the base royalty rate to 16.67 percent or 18.75 percent for all federal onshore leases will generate significant new revenues for the U.S. Treasury and for oil and gas producing states.

Sliding Scale Based on Oil and Natural Gas Prices

Rather than charging a flat royalty rate, the BLM may consider adopting a variable rate that adjusts with the market price of oil and natural gas. Under this alternative, the royalty rate would rise incrementally as the price for oil and gas increases. For instance, when oil is selling at $50 per barrel, a royalty rate of 16.67 percent could be assessed. If the price reaches $75 per barrel, then the federal government could charge an 18.75 percent rate. And, if the price rises above $100 per barrel, the royalty rate could be set at 22.5 percent. Precise royalty rates and associated fuel prices would be negotiated to maximize taxpayer returns as oil and gas prices rise and fall.

Sliding Scale Based on the Location of Known Resources

The federal government may also consider adopting two royalty rates: a lower rate in areas that are more speculative and a higher rate in known production areas. This is a common policy at the state level; both New Mexico and North Dakota charge a higher rate on lands where oil and gas companies are having the most success.[30] Similarly, the BLM may consider assessing a 16.67 percent rate on speculative lands, while levying a higher rate in more established production areas. This approach provides an incentive to companies exploring for oil and gas in more speculative areas, while ensuring they pay a fair share on lands with known, high quality resources.

Escalating Royalty Rate to Encourage Diligent Development

To incentivize companies to develop oil and gas leases in a timely manner, the federal government could adopt an escalating royalty rate. A company that chooses to hold onto a lease without taking steps to develop would pay a higher royalty rate after production begins. For example, a company that begins producing energy during the first two years of a lease could pay an 18.75 percent royalty rate, while a company that takes longer than five years to begin extraction could pay 22.5 percent.

Increase Rental Rates to Encourage Diligent Development

Current rental rates are too low to discourage companies from stockpiling and sitting on thousands of acres of public land. The federal government could incentivize diligent development by making it more expensive to leave leased lands idle. Under current rules, sitting on undeveloped leases costs $1.50 per acre during the first five years of a lease and $2.00 per acre during the next five years; a 33 percent increase. The federal government could look towards the states, like Texas, which charges $5 per acre during the first three years of a lease, then $25 per acre for each ensuing year that the lease remains undeveloped; a 500 percent increase.[31]

PROJECTED REVENUE FROM A FAIRER ROYALTY RATE

The Obama Administration's most recent budget calls for advancing royalty reform, including raising the minimum royalty rate, encouraging diligent development, and evaluating other common sense oil and gas management reforms. **The President's budget estimates that reform would generate $2.5 billion in net revenue to the U.S. Treasury over the decade.**[32]

In addition to paying down the debt and offsetting some sequestration cuts, a portion of new revenues could be spent on conserving public lands. This includes restoring lands damaged by oil and gas drilling, purchasing lands from willing sellers to protect water supplies for nearby communities, and protecting more public lands for hunting, fishing, and recreation.

The President's budget does not include the benefits that higher federal revenue sharing payments would bring to states.

An economic analysis by the Center for Western Priorities reveals how continued royalty stagnation impacts the states and projects how states stand to benefit from modernizing the federal onshore royalty rates. [33] The analysis finds that in 2012 alone, **between $400 and $600 million in additional revenue would have been generated and distributed to states in the Rocky Mountain West**, if royalty rates were increased to 16.67 percent or 18.75 percent.

The two states with the most mineral extraction on federal lands, New Mexico and Wyoming, lost over $150 million each in 2012 because of low federal royalty rates.

INCREASE IN GROSS ROYALTY REVENUE TO WESTERN STATES (FY 2012)

State	Royalty Rate: 16.67%	Royalty Rate: 18.75%
Colorado	$36,600,000	$54,856,000
Montana	$5,790,000	$8,678,000
New Mexico	$155,502,000	$233,066,000
Utah	$43,909,000	$65,811,000
Wyoming	$161,219,000	$241,634,000
Five State Total	$403,019,000	$604,045,000

Simplifying Assumptions

- The analysis estimates changes in gross revenue and does not consider changes in net revenue from increasing royalty rates.
- The analysis does not consider the changes of higher royalty rates to other tax interactions, like tax loopholes and federal income tax deductions.
- The analysis does not consider the effect of changes to bonus bids or rental rates.
- The analysis does not consider changes in oil and gas production levels.
- The analysis assumes that 50 percent of the revenues flow to the states and 50 percent of the revenues flow into the U.S. Treasury.

CONCLUSION

Taxpayers are losing out on significant revenue that could be used to reduce our national debt and alleviate the impacts of oil and gas drilling on communities because the federal government charges a decades-old royalty rate on onshore oil and natural gas leases. While little action has been taken to address the imbalance, the issue has not gone wholly unnoticed. The GAO raised concerns in 2008, writing, "the Congress and the public are justifiably concerned about whether the federal government is getting a fair return for its energy resources as oil and gas company profits have reached record levels."[34]

The Department of the Interior has the authority to reform onshore royalty rates.[35] Former Interior Secretary Ken Salazar proposed raising onshore royalty rates to 18.75 percent.[36] The President's fiscal year 2013 budget recommends, "making administrative changes to federal oil and gas royalties, such as adjusting royalty rates."[37] The BLM's fiscal year 2014 budget calls for royalty reforms, including "evaluating minimum royalty rates for oil, gas, and similar products; [along with] adjusting onshore royalty rates."[38]

Given the country's current fiscal situation, it is imperative that the federal government examine all potential sources of revenue. Ensuring that taxpayers are capturing their share of the booming oil and natural gas sector is a reasonable starting point.

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