Center for Western Priorities

UPDATE

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A Fair Share:

The Case for Updating Oil and Gas Royalties on Our Public Lands

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SUMMARY

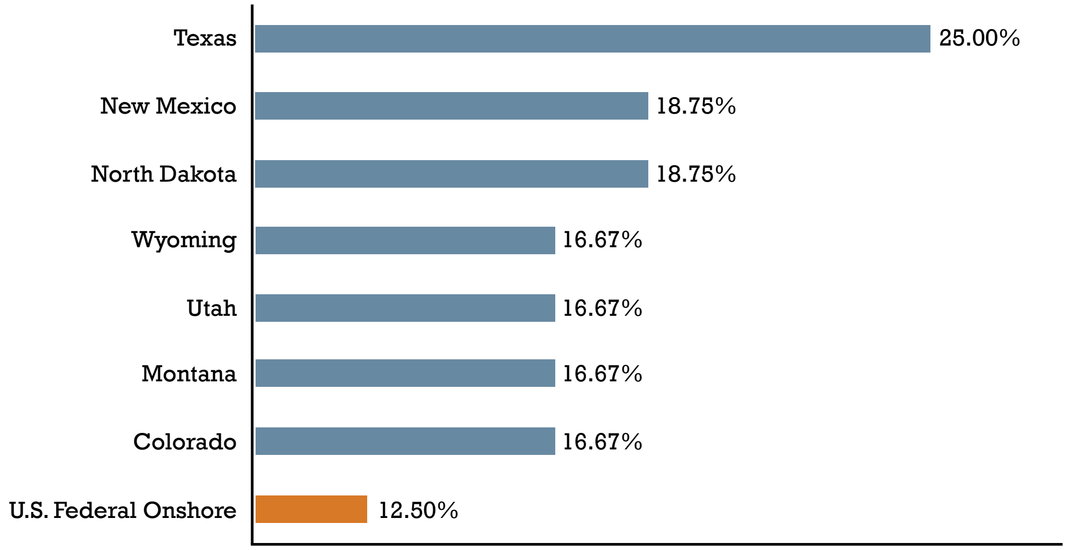
Federal Oil & Gas Royalty Rates are Shortchanging Western States & Taxpayers

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

The onshore oil and gas royalty rate on U.S. public lands 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 U.S. taxpayers receive from oil and gas production are split between the U.S. Treasury and the states. Our new data show that energy-rich states in the Rocky Mountain West—Colorado, Montana, New Mexico, Utah, and Wyoming—are being deprived of between $490 million and $730 million in gross revenues annually because the federal government has failed to modernize royalty rates.

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

Under this system, oil and gas companies have leases on approximately 34.6 million acres of national public lands.[3] In fiscal year 2014, those leases produced over $3.3 billion in royalty payments.[4] However, the government's failure to update the royalty payment structure costs the states and taxpayers significant revenue each year.

The federal onshore royalty rate must 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 and the president and the Secretary of the Interior have the executive authority to increase that rate without Congressional action.[5]

After years of contemplating a policy change, DOI and BLM announced in April of 2015 that the agencies would begin to modernize the outdated royalty rate.[6] In announcing the agency's plans, Interior Secretary Sally Jewell said, "It's time to have a candid conversation about whether the American taxpayer is getting the right return for the development of oil and gas resources on public lands."[7]

The time could not be better. Budget cuts in recent years have strained local, state, and federal budgets, creating a significant need to revisit royalty policies on our public lands. And as oil and gas companies continue developing energy resources on national public lands, low royalty rates are shortchanging American taxpayers.

This paper analyzes deficiencies in the federal onshore oil and gas royalty rate and examines opportunities for taxpayers to receive a fair return on energy resources while encouraging the diligent development of federal oil and gas leases and the need for a balanced energy policy.

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. 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 subsurface mineral resources, in addition to managing 245 million surface acres.[8] 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.[9]

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

The royalties that companies pay to extract oil and gas from national public 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."[10]

Along with royalty payments—which represent the largest source of revenues from oil and gas extraction on national public lands—oil and gas leasing also generates revenues for taxpayers through bonus bids and rental payments.

Royalties: An energy company pays royalties to a landowner—such as 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.[11] Royalty payments contributed 93 percent of all federal onshore oil- and natural gas-related revenues in 2014.[12]

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 national public land, but bids can range much higher.[13] In 2014, bonus bids contributed about 5 percent of all federal onshore oil and natural gas revenues.[14]

Rental Payments: Rentals are paid on oil and gas leases that are not currently in production and therefore the company is not making any royalty payments. Annual rental fees are $1.50 per acre in the first 5 years and $2.00 per acre each year thereafter.[15] In 2014, despite nearly 22 million idle acres of leased land, rental payments accounted for only about one percent of federal onshore oil and natural gas revenues.[16/17] Because rental rates are so low, oil and gas companies are sitting on thousands of leases and millions of acres. Presently, there are nearly 6,000 approved permits, ready for drilling and energy extraction, sitting idle.[18]

FEDERAL AND STATE ROYALTY DISTRIBUTION

Royalties generated on national public 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 for the benefit of all Americans. The one exception is Alaska, where 90 percent of revenues are returned to the state.[19]

Over the last five years, oil and gas production on federal lands has generated over $15 billion in revenues, a significant portion of which was redistributed to the states where the drilling took place.[20] In FY 2014 alone, the federal government disbursed over $1.6 billion to states where drilling occurs. Because they are major oil and gas producers, significant portion of that amount was distributed to states in the Rocky Mountain West.[21]

Royalty payments distributed to the states are an important source of funds that 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.[22] 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.[23]

FEDERAL OIL AND GAS ROYALTY DISTRIBUTIONS TO WESTERN STATES, 2014[24]

Colorado

$112.6 Million

Montana

$16.2 Million

New Mexico

$546.4 Million

Utah

$191.5 Million

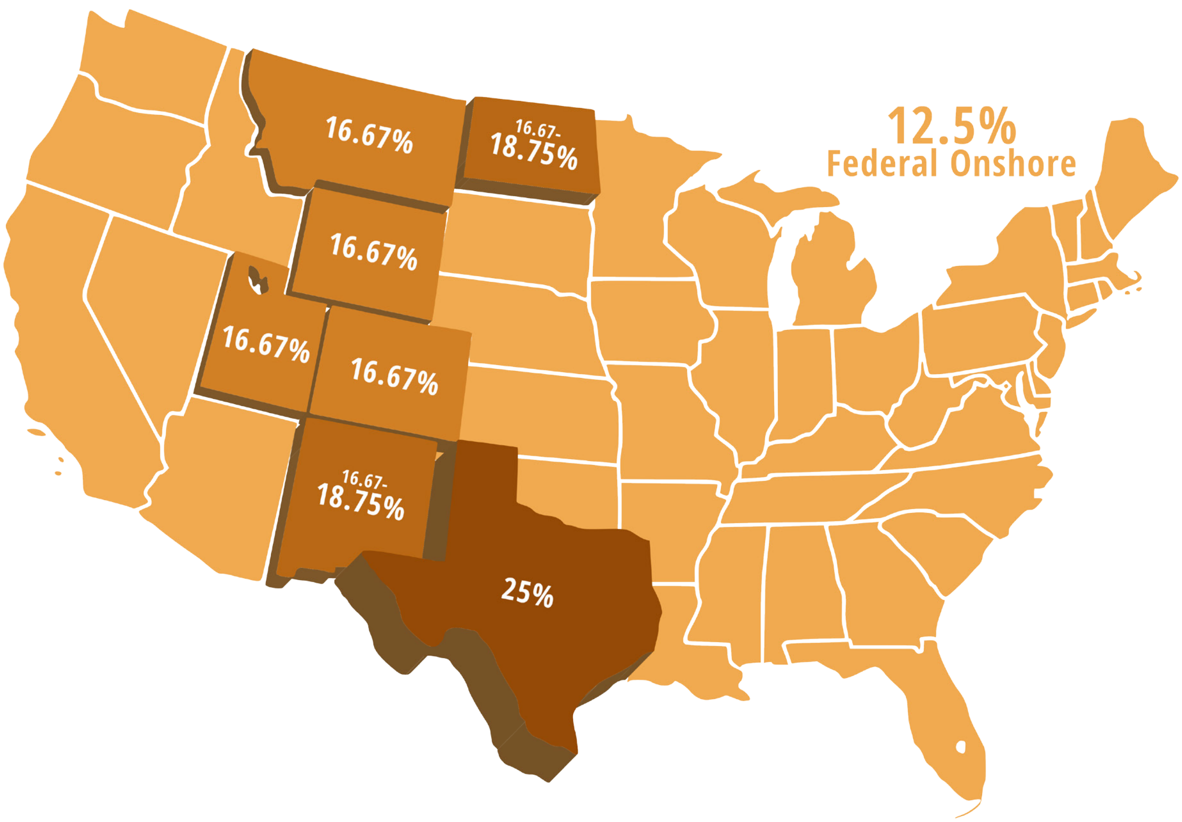
Wyoming

$542.7 Million

FEDERAL ROYALTY RATES ARE BELOW ROYALTY RATES OF MOST WESTERN STATES

States receive a portion of royalty payments from national public lands, and also assess their own royalties on oil and gas extracted from state owned lands. These lands—mostly state trust lands—were granted by the federal government to states upon their entering the Union.[25]

Our analysis finds that states in the West—where many national public 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, which is 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.

Each of the previous six Department of the Interior budgets called for increasing the onshore rate, but no action has been taken.[26] The current effort by President Obama to modernize royalty rates is not unprecedented. In fact, under President George W. Bush, Interior Secretary Dirk Kempthorne twice increased offshore royalty rates to reflect fair market value: first from 12.5 percent to 16.67 percent, then again to 18.75 percent.[27]

LOST REVENUE DUE TO OUTDATED ROYALTY RATES

The Obama administration's most recent calls for advancing royalty reform include raising the minimum royalty rate, encouraging diligent development, and evaluating other common sense oil and gas management reforms. *The president's most recent budget estimates that reforms would generate $2.5 billion in net revenue to the U.S. taxpayers over the decade.*[33] This number does not include the benefits that state taxpayers would receive.

Our economic analysis reveals how continued royalty stagnation impacts the states and projects how states stand to benefit from modernizing the federal onshore royalty rates.[34] The analysis finds that in 2014 alone, *between $490 and $730 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 national public lands, New Mexico and Wyoming, lost over $190 million each in 2014 because of low federal royalty rates.

INCREASE IN GROSS ROYALTY REVENUE TO WESTERN STATES, 2014

State	Royalty Rate: 16.67%	Royalty Rate: 18.75%
Colorado	$46,192,000	$69,233,000
Montana	$5,736,000	$8,597,000
New Mexico	$190,908,000	$286,133,000
Utah	$53,752,000	$80,563,000
Wyoming	$192,122,000	$287,952,000
Five State Total	$488,710,000	$732,479,000

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.
- The study assumes that any royalty rate increase would be applied to current leases.

HIGHER RATES DO NOT SIGNIFICANTLY SLOW DRILLING

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The value of oil and gas resources, technology, and geology largely determine when and where it is profitable for a company to drill for oil and gas. Economic data show that small yet fiscally meaningful differences in tax and royalty policy do not significantly affect oil and gas production.[28]

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.[29]

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 has boomed as drilling in Montana lags behind. This demonstrates that higher returns to taxpayers are not impacting companies' investment decisions.[30]

POLICY OPTIONS TO ENSURE AMERICANS GET A FAIR SHARE

Both Congress and the administration have 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 to ensure taxpayers receive a fair return 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 set 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.[31] 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 Rates 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 also 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.[32]

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 U.S. government charges a decades-old royalty rate on onshore oil and natural gas leases.

After years of inaction, the BLM and DOI are taking steps to ensure Americans receive a fair return from the development of public resources, including adjusting outdated royalty rates, along with considering reforms to low rental rates, minimum bids, and bonding requirements.[35]

While little action has been taken to address the imbalance until now, the issue has not gone wholly unnoticed. The GAO raised concerns in 2008, writing, "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."[36]

Since 2011, each of president Obama's budgets has called for onshore oil and gas royalty reform. 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 2016 budget calls for royalty reforms, including "evaluating minimum royalty rates for oil, gas, and similar products; [along with] adjusting onshore royalty rates."[38]

Former Interior Secretary Ken Salazar proposed raising onshore royalty rates to 18.75 percent.[39] And in a 2015 speech, current Interior Secretary Sally Jewell called on her agency to "[ensure] that the American taxpayer is getting a fair return for the use of natural resources on public lands."[40]

Given the country's fiscal challenges, it is imperative for the federal government to examine all potential sources of revenue. Updating the royalty rate can help to ensure American and Western state taxpayers are finally receiving a fair return from the development of publicly owned oil and gas resources.

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