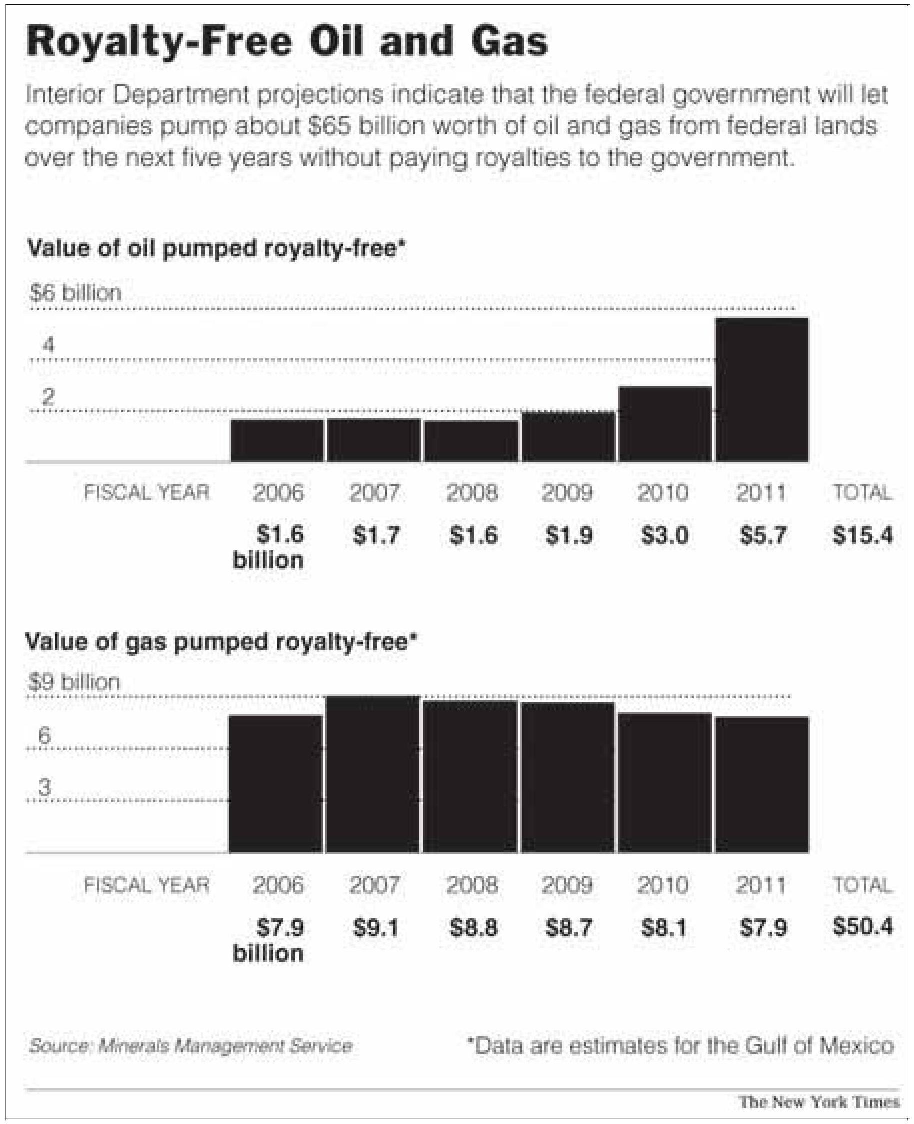
*Published on Tuesday, February 14, 2006 by the New York Times*

# U.S. Royalty Plan to Give Windfall to Oil Companies

**by Edmund L. Andrews**

WASHINGTON - The federal government is on the verge of one of the biggest giveaways of oil and gas in American history, worth an estimated $7 billion over five years.

New projections, buried in the Interior Department's just-published budget plan, anticipate that the government will let companies pump about $65 billion worth of oil and natural gas from federal territory over the next five years without paying any royalties to the government.




Based on the administration figures, the government will give up more than $7 billion in payments between now and 2011. The companies are expected to get the largess, known as royalty relief, even though the administration assumes that oil prices will remain above $50 a barrel throughout that period.

Administration officials say that the benefits are dictated by laws and regulations that date back to 1996, when energy prices were relatively low and Congress wanted to encourage more exploration and drilling in the high-cost, high-risk deep waters of the Gulf of Mexico.

"We need to remember the primary reason that incentives are given," said Johnnie M. Burton, director of the federal Minerals Management Service. "It's not to make more money, necessarily. It's to make more oil, more gas, because production of fuel for our nation is essential to our economy and essential to our people."

But what seemed like modest incentives 10 years ago have ballooned to levels that have alarmed even ardent supporters of the oil and gas industry, partly because of added sweeteners approved during the Clinton administration but also because of ambiguities in the law that energy companies have successfully exploited in court.

Short of imposing new taxes on the industry, there may be little Congress can do to reverse its earlier giveaways. The new projections come at a moment when President Bush and Republican leaders are on the defensive about record-high energy prices, soaring profits at major oil companies and big cuts in domestic spending.

Indeed, Mr. Bush and House Republicans are trying to kill a one-year, $5 billion windfall profits tax for oil companies that the Senate passed last fall.

Moreover, the projected largess could be just the start. Last week, Kerr-McGee Exploration and Development, a major industry player, began a brash but utterly serious court challenge that could, if it succeeds, cost the government another $28 billion in royalties over the next five years.

In what administration officials and industry executives alike view as a major test case, Kerr-McGee told the Interior Department last week that it planned to challenge one of the government's biggest limitations on royalty relief if it could not work out an acceptable deal in its favor. If Kerr-McGee is successful, administration projections indicate that about 80 percent of all oil and gas from federal waters in the Gulf of Mexico would be royalty-free.

"It's one of the greatest train robberies in the history of the world," said Representative George Miller, a California Democrat who has fought royalty concessions on oil and gas for more than a decade. "It's the gift that keeps on giving."

Republican lawmakers are also concerned about how the royalty relief program is working out.

"I don't think there is a single member of Congress who thinks you should get royalty relief at $70 a barrel" for oil, said Representative Richard W. Pombo, Republican of California and chairman of the House Resources Committee.

"It was Congress's intent," Mr. Pombo said in an interview on Friday, "that if oil was at $10 a barrel, there should be royalty relief so companies could have some kind of incentive to invest capital. But at $70 a barrel, don't expect royalty relief."

Tina Kreisher, a spokeswoman for the Interior Department, said Monday that the giveaways might turn out to be less than the basic forecasts indicate because of "certain variables."

The government does not disclose how much individual companies benefit from the incentives, and most companies refuse to disclose either how much they pay in royalties or how much they are allowed to avoid.

But the benefits are almost entirely for gas and oil produced in the Gulf of Mexico.

The biggest producers include Shell, BP, Chevron and Exxon Mobil as well as smaller independent companies like Anadarko and Devon Energy.

Executives at some companies, including Exxon Mobil, said they had already stopped claiming royalty relief because they knew market prices had exceeded the government's price triggers.

About one-quarter of all oil and gas produced in the United States comes from federal lands and federal waters in the Gulf of Mexico.

As it happens, oil and gas royalties to the government have climbed much more slowly than market prices over the last five years.

The New York Times reported last month that one major reason for the lag appeared to be a widening gap between the average sales prices that companies are reporting to the government when paying royalties and average spot market prices on the open market.

Industry executives and administration officials contend that the disparity mainly reflects different rules for defining sales prices. Administration officials also contend that the disparity is illusory, because the government's annual statistics are muddled up with big corrections from previous years.

Both House and Senate lawmakers are now investigating the issue, as is the Government Accountability Office, Congress's watchdog arm.

But the much bigger issue for the years ahead is royalty relief for deepwater drilling.

The original law, known as the Deep Water Royalty Relief Act, had bipartisan support and was intended to promote exploration and production in deep waters of the outer continental shelf.

At the time, oil and gas prices were comparatively low and few companies were interested in the high costs and high risks of drilling in water thousands of feet deep.

The law authorized the Interior Department, which leases out tens of millions of acres in the Gulf of Mexico, to forgo its normal 12 percent royalty for much of the oil and gas produced in very deep waters.

Because it take years to explore and then build the huge offshore platforms, most of the oil and gas from the new leases is just beginning to flow.

The Minerals Management Service of the Interior Department, which oversees the leases and collects the royalties, estimates that the amount of royalty-free oil will quadruple by 2011, to 112 million barrels. The volume of royalty-free natural gas is expected to climb by almost half, to about 1.2 trillion cubic feet.

Based on the government's assumptions about future prices — that oil will hover at about $50 a barrel and natural gas will average about $7 per thousand cubic feet — the total value of the free oil and gas over the next five years would be about $65 billion and the forgone royalties would total more than $7 billion.

Administration officials say the issue is out of their hands, adding that they opposed provisions in last year's energy bill that added new royalty relief for deep drilling in shallow waters.

"We did not think we needed any more legislation, because we already have incentives, but we obviously did not prevail," said Ms. Burton, director of the Minerals Management Service.

But the Bush administration did not put up a big fight. It strongly supported the overall energy bill, and merely noted its opposition to additional royalty relief in its official statement on the bill.

By contrast, the White House bluntly promised to veto the Senate's $60 billion tax cut bill because it contained a one-year tax of $5 billion on profits of major oil companies.

The House and Senate have yet to agree on a final tax bill.

The big issue going forward is whether companies should be exempted from paying royalties even when energy prices are at historic highs.

In general, the Interior Department has always insisted that companies would not be entitled to royalty relief if market prices for oil and gas climbed above certain trigger points.

Those trigger points — currently about $35 a barrel for oil and $4 per thousand cubic feet of natural gas — have been exceeded for the last several years and are likely to stay that way for the rest of the decade.

So why is the amount of royalty-free gas and oil expected to double over the next five years?

The biggest reason is that the Clinton administration, apparently worried about the continued lack of interest in new drilling, waived the price triggers for all leases awarded in 1998 and 1999.

At the same time, many oil and gas companies contend that Congress never authorized the Interior Department to set price thresholds for any deepwater leases awarded between 1996 and 2000.

The dispute has been simmering for months, with some industry executives warning the Bush administration that they would sue the government if it tried to demand royalties.

Last week, the fight broke out into the open. The Interior Department announced that 41 oil companies had improperly claimed more than $500 million in royalty relief for 2004.

Most of the companies agreed to pay up in January, but Kerr-McGee said it would fight the issue in court.

The fight is not simply about one company. Interior officials said last week that Kerr-McGee presented itself in December as a "test case" for the entire industry. It also offered a "compromise," but Interior officials rejected it and issued a formal order in January demanding that Kerr-McGee pay its back royalties.

On Feb. 6, according to administration officials, Kerr-McGee formally notified the Minerals Management Service that it would challenge its order in court.

Industry lawyers contend they have a strong case, because Congress never mentioned price thresholds when it authorized royalty relief for all deepwater leases awarded from 1996 through 2000.

"Congress offered those deepwater leases with royalty relief as an incentive," said Jonathan Hunter, a lawyer in New Orleans who represented oil companies in a similar lawsuit two years ago that knocked out another major federal restriction on royalty relief.

"The M.M.S. only has the authority that Congress gives it," Mr. Hunter said. "The legislation said that royalty relief for these leases is automatic."

If that view prevails, the government said it would lose a total of nearly $35 billion in royalties to taxpayers by 2011 — about the same amount that Mr. Bush is proposing to cut from Medicare, Medicaid and child support enforcement programs over the same period.



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