TAXPAYERS for COMMON SENSE

O & G REPORT

February 2020

Mounting Losses: Oil & Gas Leasing Mismanagement Costs Montana Millions

17 billion cubic feet of federal gas waste, FY2009-2018 – sixth in the country

$56 million est. revenue losses from outdated rental rates FY2009-2018

36% Over one third of all acres leased at auction 2014 - 2018 sold for $2, the legal minimum

12.5% The federal onshore royalty rate; 1/3 lower than state rate for oil and gas

261,000 acres leased noncompetitively, 2009-2018

$168 **million** in est. revenue loss under the federal 12.5% royalty, 2009-2018

Federal lands in Montana and other Western states contain significant reserves of oil and natural gas. The Bureau of Land Management (BLM), a federal agency within the Department of the Interior (DOI), manages these reserves and is charged with collecting fair market value from their development and sale. The BLM has failed in its mandate to ensure taxpayers receive a fair return from federal resources due to weak, decades-old management policies.

Pervasive problems within the federal oil and gas leasing system have led to billions of dollars in losses for the US treasury. This report will focus on the BLM's policy failures, many of which have remained unchanged for decades, and have resulted in lost revenues and egregious giveaways for both the federal treasury and the state of Montana.

Under current law, income from federal oil and gas development is shared with the states in which the development takes place. For every dollar of revenue the federal government brings in from oil and gas production within the state of Montana, the state receives about half. These funds are an important source of revenue for the U.S. treasury and the western states where the majority of federal oil and gas is produced. When the federal government fails to secure a fair return, the money left on the table deprives both federal taxpayers and the state in which development occurs.

Problems within the federal oil and gas leasing and development system have led to billions of dollars in lost revenue and simultaneously saddled taxpayers with associated pollution costs and long-term liabilities. This report will focus on the costs imposed by the following BLM policies:

- Antiquated procedures that allow companies to lease federal lands noncompetitively without paying any bid;
- Royalty rates on the sales value of oil and gas extracted from federal lands that lag the rates imposed on production from federal waters and Montana state lands;
- Annual rental rates and the minimum bid price for oil and gas leases that have not changed in more than 30 years, and

- Natural gas waste that's ignored on federal lands while BLM refuses to charge producers for it.

Federal oil and gas leasing and development in Montana illustrates how BLM's bad policies can lead to lost taxpayer revenues. An outdated leasing system has allowed oil and gas companies to secure drilling rights on more than 260,000 acres of federal land in Montana over the last decade without any competition for these leases. Because of BLM's low onshore royalty rate and permissive approach to natural gas waste, taxpayers have lost more than $226 million over the last decade. And since states receive roughly half of federal receipts from resource development within their borders, Montana taxpayers lost out on more than $110 million in revenue.

Lease Sales

The BLM's federal oil and gas leasing program generates the vast majority of receipts at two stages. First by conducting a "competitive" lease sale, and second by charging and collecting royalties on production. But leasing loopholes, and decades-old collections policies mean BLM falls short in providing taxpayers with an adequate return from both revenue streams.

When deciding what parcels of land will be offered in a competitive lease sale, the BLM Montana-Dakotas state office takes into account suggestions from private companies regarding what tracts of land (called parcels) should be offered for lease. The office will then conduct environmental assessments, and finally post the parcels it will be offering for lease sale.

During the lease sale, private companies bid against one another for the right to lease each parcel. The company with the highest bid wins the lease. This is a one-time payment and provides the private company with the exclusive rights to develop oil and gas on the parcel of federal land for an initial period of ten years.

Bids on federal land in the state of Montana significantly lag amounts collected by other oil and gas producing states. In the five-year period 2014-2018, over one third of the 89,000 acres leased at auction in the state of Montana sold for

Western Montana District Dillon Field Office. Source: BLM

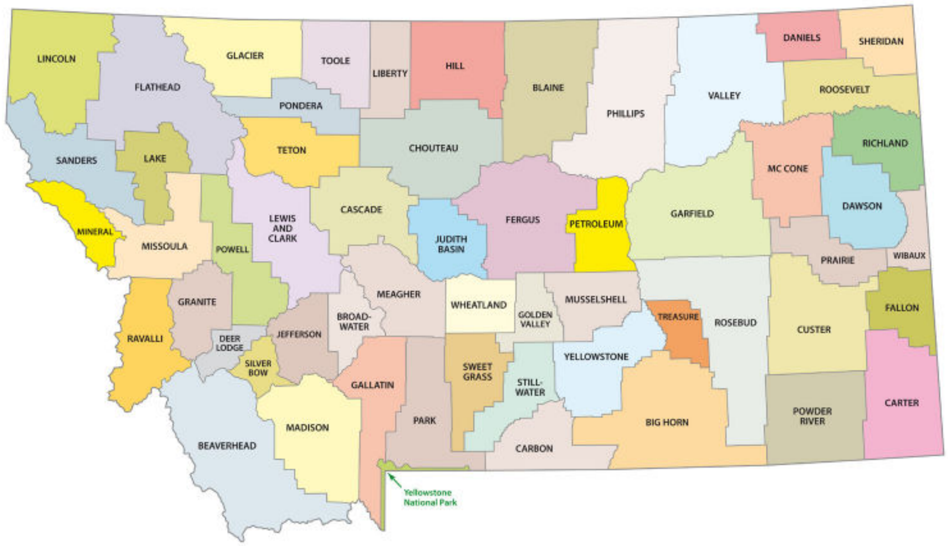
just $2 per acre, the minimum amount BLM can accept for a parcel of land. In 2019, 26 percent or nearly 9,000 acres of the federal lands sold in Montana were leased for $2 per acre.

For parcels that don't receive bids and go unsold at auction, companies can submit offers — the very next day — to acquire drilling rights through a noncompetitive process. The procedural oddity is a vestige of the system in place before federal oil and gas leasing was overhauled in 1987. It allows oil and gas companies, or speculators, to gain title to a federal oil and gas lease without paying the minimum bid of $2 per acre required to win a lease at auction.

Our 2018 analysis of BLM data shows that in recent years, one company has taken advantage of the noncompetitive system more than others and acquired the vast majority of all noncompetitive leases in Montana. In 2017 and 2018, the BLM issued 228 leases to Highlands Montana Corporation through the noncompetitive process, granting the company rights to develop oil and gas on more than 113,000 acres of federal land in the state.

Parcels in Montana are being leased noncompetitively at rates well above the national average. For instance, in 2018, 18 percent of leases issued nationally were acquired noncompetitively. But in Montana, 72 percent of leases issued made up of nearly 96,000 acres were acquired noncompetitively in the state.

From 2014 to 2018, the BLM held nine oil and gas lease sales for parcels in Montana, offering 595 parcels comprising over 250,000 acres. In that period, 252 of the parcels on offer, accounting for 50 percent of offered acreage, were leased noncompetitively. In fact, Montana hosted 38 percent of all BLM parcels leased noncompetitively



Montana County Map. © Getty Images.

in the five-year period 2014-2018, despite offering only eight percent of all parcels available for lease at auction nationally in that period.

Production & Royalties

The BLM manages nearly 8 million acres of federally owned land within the state of Montana.[1] The state produced 3.1 million barrels of oil and 10.7 billion cubic feet of gas in 2018, making the state the 7th largest producer of federal oil and 11th largest producer of federal gas in that year.

The majority of federal oil and gas production in Montana occurs in the eastern half of the state. Nearly 40 percent of all oil and gas royalties collected from 2009 to 2018 came from Fallon county alone. Altogether, a full two thirds of royalty revenues were collected from counties on or near Montana's eastern border, including Fallon county, over the last decade.

From the sale of oil, gas, and natural gas liquids (NGL) produced in Montana, the Office of Natural Resources Revenues, or ONRR – a separate DOI sub-agency – collected $264 million in royalties over the last decade. Nearly half was shared with the state. Though sizable, the royalties collected by ONRR do not capture the "fair market value" of the taxpayer-owned oil and gas resources sold. The low royalty rate of 12.5% for federal leases generally does not capture as large a portion of resource proceeds as the market would bear.

In some cases, the same producers extract and sell the same quality oil and natural gas from wells on state lands just miles away from federal leases and pay the state of Montana 16.67% of those resources' sales value. The 12.5% royalty rate on federal lands was first set by Congress as the legal minimum almost 100 years ago, yet BLM has not raised it since. The rate not only lags behind those charged by most states with large oil and gas industries, like Texas, Oklahoma, Colorado, Wyoming, and Utah, it's also less than the 18.75% producers pay for oil and gas developed from federal waters.[2]

For comparison, if the prevailing federal offshore royalty rate of 18.75% had been imposed on the same quantity of onshore production over the last decade, ONRR would have collected over $432 million, an additional **$168 million** in Montana alone. Which means Montana taxpayers would have received an additional **$80 million** in disbursements from ONRR. And because the royalty rate would be comparable to state rates, shifts in production from federal to state lands

[1] Congressional Research Service, "Federal Land Ownership: Overview and Data," p. 10, March 3, 2017. **https://fas.org/sgp/crs/misc/R42346.pdf**

[2] The effective royalty rate is often measurably less than 12.5%. After transportation and processing deductions, ONRR typically collected only 10% on sales of NGL from federal lands over the last decade, for example. ONRR issued new rules that would have decreased those deductions and increased royalty collections in 2016, but they were repealed in 2017 under the new administration before taking full effect. A federal district court judge ruled in April 2019 that ONRR's repeal violated the Administrative Procedures Act and reinstated the 2016 rules, potentially increasing future oil and gas royalty collections.

would be minimal. Most federal production comes from leases issued decades earlier, so overhauling the royalty regime would yield little in the short-term, but beyond the next few years, taxpayers could see a notable increase in receipts.

Losses from Other Lease Terms

In addition to royalties, BLM also charges companies rent to capture the value of privileged access to federal land, and collects bonus bids that reflect the value of exclusive rights to develop certain parcels of federal land. Neither the annual rental rate nor the minimum acceptable bonus bid has been adjusted since 1987.

Congress first established a formal system for leasing federal land to develop oil, gas, coal and other resources through the Mineral Leasing Act (MLA) of 1920. For oil and gas leases attained by permit or through competitive bidding, the original MLA set the annual rental rate at "not less than $1 per acre per annum." Through later legislation, Congress enacted changes to the rental rate over time. In 1935, the rent due for oil and gas leases was reduced to $0.25 per acre. In 1960, it was increased to $0.50 per acre. Finally, in 1987, Congress set the current rates at, "not less than $1.50 per acre per year for the first through fifth years of the lease and not less than $2 per acre per year for each year thereafter."

Through these periodic amendments to the MLA, Congress had effectively accounted for inflation. For example, the rental rate increases in 1960 and 1987 approximately reflected the 1935 rate of $0.25/acre, adjusted for inflation in those years. By not updating the rates since 1987, however, Congress has neglected to account for inflation for longer than any period since the MLA was enacted in 1920. As a result, rent collection now yields roughly half of what it would have under inflation-adjusted rates.

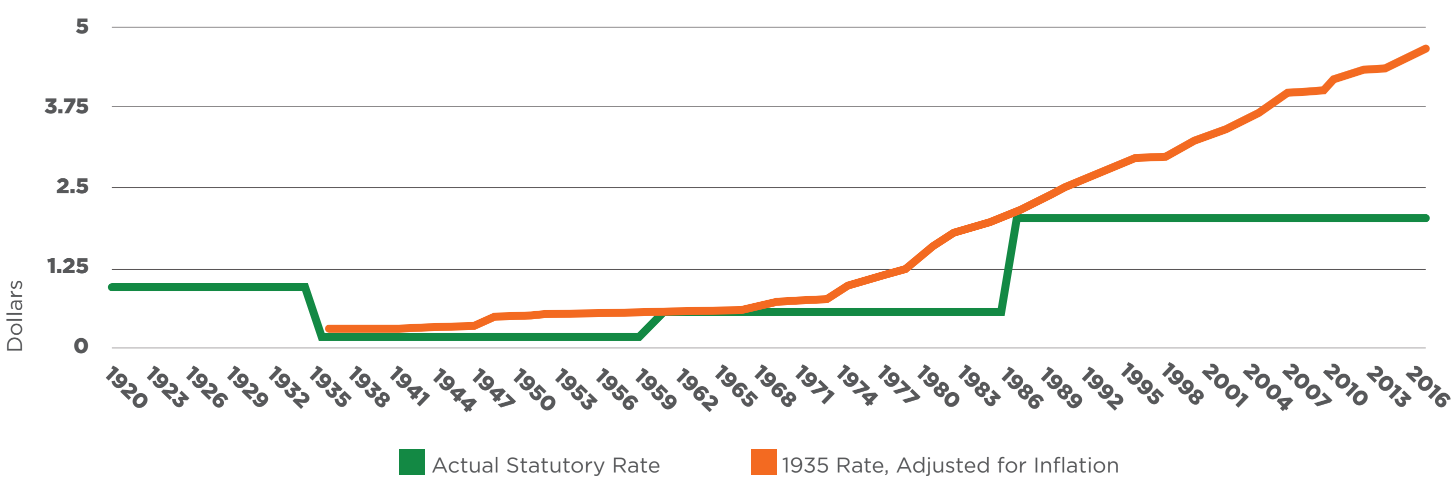
Over the last ten fiscal years, FY2009-2018, ONRR collected nearly $18 million in rent for oil and gas leases in Montana. If the 1987 rental rates had been annually adjusted for inflation, as measured by the Bureau of Labor Statistics, ONRR could have collected $74 million in rental payments over the decade. That is, taxpayers have lost approximately $56 million in rental revenue from rental rates that were set more than 30 years ago.

Lost Gas

With the advent of new technologies and techniques like fracking and horizontal drilling, production of natural gas and, in particular, oil has boomed in the U.S. over the last 10-15 years. As producers raced to drill more wells on federal lands, they began burning off – flaring, or simply releasing – venting, huge volumes of natural gas, which is mostly made up of methane, into the atmosphere.

Over the 10-year span FY 2009-2018, oil and gas operators reported wasting 17 billion cubic feet (bcf) of gas in Montana, that is about seven percent of all methane waste reported on all federal lands nationwide in that period. Montana wasted more gas

Figure 1. Federal Oil & Gas Lease Rental Rates, Actual vs. Inflation-Adjusted



Oil and Gas Rig. Source: BLM

in that ten-year period, than was produced by the state in all of 2018.

BLM's rules for waste on federal leases were written in 1979, long before fracking and horizontal drilling even existed. BLM's administration of the antiquated rules has not only failed to prevent prolific venting and flaring in Montana, it has allowed operators to largely avoid paying royalties on the wasted gas.

Of the 21 billion cubic feet of gas reported lost by operators on federal lands in Montana between 2008 and 2017, ONRR reported collecting royalties on just 8.4 million cubic feet, or 0.04 percent. That is, on the estimated sales value of the wasted gas, $112 million, ONRR collected just over $3,168 in royalties.

Oil and gas companies are required to pay royalties on the minerals they remove from private, state, or federal lands to compensate the owner of these resources. In 2016, the BLM issued new rules to curtail gas waste during drilling on federal leases and to collect more royalties on lost gas. The Trump administration rescinded these rules and issued a much weaker one in 2018 that removes any incentive for companies to capture valuable gas resources. As a result of the new rule, not only will fewer royalties be collected, but the increased emissions of methane – a potent greenhouse gas – will also create additional liabilities for taxpayers.

Conclusion

Federal lands and the vast resources they contain are limited but valuable assets for taxpayers and must be treated as such. The weight of the public trust, the current federal budget picture, and congressional mandate all demand that the Bureau of Land Management maximize fiscal returns for the federal taxpayer. By administering oil and gas development strategically on federal lands and modernizing its leasing system in Montana and across the country, the Bureau of Land Management has the ability and the obligation to realize greater returns for the US treasury.

Current policies have failed to realize the economic potential of these important resources and have led to large amounts of lost revenue from development in Montana and other western states over the last decades. In particular, continued losses from below market royalties and noncompetitive leasing prevent state and federal taxpayers from realizing the full benefit of oil and gas resources in Montana.

The Bureau of Land Management is not beholden to the decisions from decades past. The agency has the statutory authority to independently change each of the policies discussed here, including noncompetitive leasing, royalty rates, rental rates, and treatment of natural gas waste. By updating lease terms for federal oil and gas development now, the Bureau of Land Management can substantially increase the returns to the Treasury and the amounts disbursed to the state of Montana, placing additional revenues in the hands of both federal and state coffers.