Committee on Resources

Subcommittee on Energy & Mineral Resources

Statement

TESTIMONY OF
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Department of the Interior
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House Resources Subcommittee on Energy and Mineral Resources
Committee on Resources
House of Representatives
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Madam Chairman and Members of the Subcommittee, I appreciate the opportunity to appear before you today to testify on H.R. 3432--a bill to direct the Minerals Management Service (MMS) to grant the State of Louisiana and its lessees a credit in the payment of Federal offshore royalties to satisfy the authorization for compensation contained in the Oil Pollution Act of 1990 for oil and gas drainage in the West Delta field.

The Department believes that the 1986 amendments to section 8(g) set forth a straightforward resolution of the drainage issue, and by doing so, allow the Federal government and States to avoid the necessity of debating, on a case-by-case basis, the possibility and extent of drainage when a Federal lease lies adjacent to a State's seaward boundary--a lengthy and complicated process which is usually subject to various interpretations given the complexity of a field's geology. Therefore, we do not support H.R. 3432.

In general, the bill proposes to:

, compensate State of Louisiana lessees by allowing them to withhold Federal royalty payments for leases in the Outer Continental Shelf due to MMS under the Outer Continental Shelf Lands Act;

, compensate the State of Louisiana by requiring the State lessees to pay the State of Louisiana 44 cents for every dollar of royalty withheld;

¨ allow the State lessees to retain the remaining 56 cents of every dollar withheld; and

, allow the withholding of Federal royalty payments to begin 60 days after enactment of the bill and to continue until the total royalty withheld is equal to $18,115,147 plus simple interest at 8 percent per year from March 21, 1989, or about $42 million. The amount $18,115,147 is the total value of the drainage identified in Senate Report 101-534 accompanying P.L. 101-512, Fiscal Year 1991 Department of the Interior and Related Agencies Appropriations Act.

In addition, the bill provides that:

, payments from the State lessees to the State of Louisiana would be done in a manner mutually agreed to by the State of Louisiana and the State lessee. The bill provides that any dispute between the State of Louisiana and the State lessee over the method of payment to the State would be resolved by the Secretary of the Interior, acting through the Director of the Minerals Management Service; and

¨ eligible State lessees are those companies or individuals, and their successors and assigns, that, on the date of enactment of the Oil Pollution Act of 1990, held lease rights in the State of Louisiana leases SL10087, SL10088, and SL10187 but did not hold lease rights in adjacent Federal leases.

The Department has carefully reviewed the legislation, and as I have previously stated, has concerns with the bill. However, prior to discussing those concerns, I would like to provide you with a somewhat abbreviated background of the West Delta issue--an issue with a long and complex history whose origins date back to the early 1980s.

OVERVIEW OF THE WEST DELTA ISSUE

On May 23, 1983, MMS issued two leases in Federal waters offshore Louisiana that were designated West Delta Block 17 (lease OCS-G 5668) and West Delta Block 18 (OCS-G 5669). These leases were located in the "8(g)" zone directly adjacent to leases in State of Louisiana waters and designated as State leases SL100087, SL100088, and SL100187. The first discovery was made in 1982 from State lease SL 10087. Subsequently, the adjacent Federal lessees and the other State lessees also discovered commercial quantities of hydrocarbons on their leases.

Our understanding of the situation was that production was delayed to wait for a marketing pipeline to be built and operated by the Federal and State lessees. In August of 1985, production began from the field from Federal leases OCS-G 5668 and OCS-G 5669, and from State leases SL100087 and SL100088. The Federal and State lessees voluntarily agreed that each would have equal access to the pipeline (i.e.; the lessees for the two Federal leases would collectively be guaranteed access to half of the capacity of the pipeline and the lessees of the three State leases would collectively be guaranteed access to the other half of the capacity of the pipeline). Further, they agreed that a lessee could exceed its guaranteed access capacity only if the other lessees used less than their guaranteed access.

Consequently, when the Federal lessees produced enough to use their full pipeline access, the State lessees were prohibited, by their own agreement, from increasing production to counter Federal production. This pipeline contract--voluntarily entered into by the State and the Federal lessees--was the underlying factor limiting the State lessees' ability to protect themselves from potential drainage.

In November, 1987, one of the State lessees made a request to MMS to unitize the entire field. Subsequent to that request, MMS followed its normal procedures and obtained comments from the other affected lessees. Of note, in the West Delta 17/18 situation, the Federal and State lessees were not the same companies, as is the case in the vast majority of unitization requests. Since the Federal lessee did not agree to voluntary unitization, the State and its lessees alleged that drainage was occurring and then requested that MMS force the Federal lessee to unitize the field to address the drainage issue.

Under section 5(a) of the OCS Lands Act, the MMS has the authority to establish regulations necessary and proper in order to provide for the prevention of waste, conservation of natural resources and the protection of correlative rights. Historically, MMS has used this authority to compel a Federal lessee to join a unit when the action is consistent with the objectives of the Act. However, based on MMS's geologic analysis of the West Delta field, the agency did not believe that requiring the Federal lessees to join a unit would promote conservation or prevent waste, and thus, did not require them to unitize. In addition, preventing drainage was not a basis for compelling unitization.

Thus, MMS's position on the West Delta unitization request, as conveyed to the State of Louisiana, was that MMS's authority to compel unitization was limited to Federal lessees and when required to prevent waste, conserve resources, or protect correlative rights. In April, 1986, the State of Louisiana and the State lessees filed a motion for a temporary restraining order and a preliminary injunction. They alleged that the Federal lessee was draining gas reserves from beneath State lands and that physical waste of natural resources was occurring. The suit also claimed that the Secretary of the Interior had a statutory obligation to unitize the field.

Around this same time (April 1986), Congress passed amendments to Section 8(g) of the OCS Lands Act. Section "8(g)" refers to the zone of Federal waters that is 3-miles wide and lies directly adjacent to a State's seaward boundary. As you may recall, this section was included in the Act in 1978 and was specifically designed as a means to compensate States for any revenues lost through drainage of their oil and gas resources by adjacent Federal leasing and development. Specifically, section 8(g) provided for a "fair and equitable" division of revenues produced by Federal lessees from oil and gas reservoirs common to both Federal and State waters. This was to be accomplished by the Secretary offering the Governor of an affected State the opportunity to enter into an agreement concerning the disposition of such revenues. In the event that an agreement could not be reached, the Secretary was required to deposit in a separate account "all bonus, royalties and other revenues attributable to oil and gas pools underlying both the OCS and submerged lands subject to the jurisdiction of any coastal State" until such agreement could be reached.

In many cases, affected coastal States could not reach agreement with the Secretary on the equitable division of these revenues, and from 1978 to 1986 monies from leases in the 8(g) zone were set aside in a special escrow account with the principal and interest on the account totaling about $6 billion by 1986. The division of these revenues was finally decided in 1986 as part of the Omnibus Budget Reconciliation Act (P.L. 99-272). In general, section 8(g) was amended such that: 1) the Federal government was directed to share prospectively with affected coastal States 27 percent of all revenues generated from the leasing and development of the 8(g) zone; 2) certain coastal States were entitled to a one-time payment from funds held in escrow; and 3) certain coastal States were entitled to another payment to be made in installments over 15 years beginning in Fiscal Year 1987. Those States included Alaska, Alabama, California, Florida, Louisiana, Mississippi, and Texas.

In response to the State of Louisiana's lawsuit, the Federal District Court issued an opinion in December 1986 holding in favor of the Secretary of the Interior (656 F. Supp. 1310 (W.D. La. 1986). In December 1987, the Fifth Circuit Court of Appeals upheld that decision (832 F. 2d 935 (5^{th} Cir. 1987)), cert. den., 485 U.S. 1033. In summary, the decision held that section 8(g) of the OCS Lands Act (as amended in 1986): 1) did not require the Secretary to unitize; 2) 27 percent of the revenues from the 8(g) zone was intended to compensate the States for Federal OCS activity, including any drainage losses; and 3) the State of Louisiana and its lessees failed to provide material evidence that "waste" had occurred.

In Fiscal Year 1989, as part of the Department of the Interior Appropriations Act (P.L. 100-446), Congress directed the Department to appoint a Third Party Factfinder to make appropriate findings concerning drainage along the Louisiana State/Federal boundary. On March 27, 1989, the Ryder Scott Company submitted the *Third Party Factfinder Louisiana Boundary Study* concerning six significant areas of drainage, including the West Delta area. Overall, the study found that drainage had occurred in both directions. Specifically with regard to the West Delta 17/18 leases, the study found that net drainage of gas resources had occurred in favor of the Federal government and its lessee. In response to that study, the Secretary of the Interior issued findings which concluded that the 27 percent compensation to the State under section 8(g) included compensation for any drainage that had occurred across the Federal/State boundary.

In 1990, Congress included in the Oil Pollution Act of 1990 (P.L. 101-380) a provision that, among other things, would "authorize such sums as may be necessary to provide compensation, including interest, to the State of Louisiana and its lessees for drainage of hydrocarbons as determined by the Third Party Factfinder"(section 6004 (c)). Subsequent to that authorization, in FY 1991 Congress appropriated $4 million as a down payment on compensating the State of Louisiana and its lessees. However, of note, the Conference report accompanying the Department's FY 1991 Appropriations Act (S. Rpt. 101-971) prevented MMS from obligating the funds until the Committee had an opportunity to conduct a full hearing on the subject and agree to the use of the funds. That report also required MMS to follow established reprogramming procedures prior to releasing the funds.

During FY 1991, neither the House nor the Senate Appropriations Committee held a hearing on the issue. Late in FY 1991, MMS requested that the funds be reprogrammed for other uses. The House Appropriations Committee notified MMS in a letter of September 30, 1991, that they had approved the reprogramming and noted that MMS had not used the funds for West Delta 17/18 because the Committee had not held hearings and released the funds. Since FY 1991, the Appropriations Committee has not appropriated funding for West Delta leases under the authorization provided for in section 6004 of the Oil Pollution Act.

Finally, in the Department's FY 1998 Appropriations Act (PL 105-83, specifically, Title IV--the "Environmental Improvement and Restoration Fund"), Congress set up a fund in the Treasury of the United States to be derived from one-half of the amounts awarded by the Supreme Court to the Unites States in the case of *United States of America v. State of Alaska* (117 S.Ct. 1888). The interest from the Fund could be used for certain activities, subject to appropriation. One of those activities was for "payment to the State of Louisiana and its lessees for oil and gas drainage in the West Delta field." However, no appropriation has been enacted.

DEPARTMENT OF THE INTERIOR VIEWS ON H.R. 3432

With this background, I would now like to discuss our concerns with the bill.

As I mentioned previously, 1986 amendments to section 8(g) of the OCS Lands Act were intended, among other things, to compensate States for drainage of oil and gas resources that lie along the State/Federal boundary. Further, by setting forth a straightforward resolution of the issue, the amendments obviated the need to debate, on a case-by-case basis, the possibility and extent of drainage. The State of Louisiana has benefited substantially from a resolution of this issue. From 1986 through 1999, the State has received about $867 million in revenues from activities associated with section 8(g) leases, including $8 million in revenues specifically associated with West Delta 17/18 leases. However, H.R. 3432 does not recognize that payment, and thus would treat the State and the West Delta leases differently from the way all other section 8(g) leases are treated. At a minimum, the legislation should take into consideration the compensation provided to the State for those leases under section 8(g). If not, this disparity would result in compensation at a rate higher than occurs with any other leases in the section 8(g) zone.

Further, we are concerned that the bill--by mandating that lessees be given a royalty credit on a specified dollar amount of Federal offshore royalties owed--proposes to establish a direct spending obligation on the part of the Federal government and therefore, has PAYGO implications. A direct spending obligation is a very different approach from that found in section 6004(c) of P.L. 101-380, which is simply an authorization for appropriations to the State and its lessees.

Finally, we are troubled by the provision in the bill that requires the Federal government to directly compensate a State lessee for drainage. It is our understanding that the State lessees limited their ability to prevent the drainage of gas resources from their leases by their own business decisions (i.e.; by failing to obtain access to transportation facilities in a timely manner). Those were business decisions that were made solely by the company without any interference from the Federal government.

As you know, oil and gas companies, whether on Federal leases, State leases, or private land, are faced every day with business decisions that involve both risk and reward. A decision to drill is a risk that the money may be spent for a dry hole. A decision not to drill may result in loss of oil or gas to an adjacent lease if the adjacent lessee or owner spent the money to drill. Similar business decisions involve choosing to invest or not to invest in future transportation facilities.

On OCS leases, MMS takes action to protect the Federal government's mineral interests or to protect correlative rights when one of the lessees does not have the opportunity to exercise its rights to drill and explore. When all lessees have the opportunity to explore and produce, then MMS allows the companies to produce at their own pace. Within the limits of MMS's diligence regulations, the timing of the company's activities becomes the prerogative of the company. In many cases, lessees across a State/Federal boundary have voluntarily formed a unit or entered into a production agreement. The process of forming a voluntary unit, naturally, is simplified when the lessee is the same on both the State lease and Federal lease.

The right of each company to produce what is under its leases as well as what it drains from an adjacent lease is a principle that has been part of both the onshore and offshore oil and gas tradition. Therefore, to propose to compensate a lessee for the repercussions associated with an individual business decision sets a very troubling precedent and runs counter to existing practice and law.

CONCLUSION

Madam Chairman, the West Delta issue not only has a complicated history but has also inspired significant discussion and debate. While we appreciate the fact that the issue is unusual in some respects, it is important to note that it is also representative of the myriad issues that arise when developing oil and gas resources along the State/Federal boundary. MMS has and will continue to work cooperatively with the State of Louisiana and other affected States on these issues as important OCS resources are developed. We firmly believe that these actions, along with the provisions of section 8(g) of the OCS Lands Act, provide a sound basis for ensuring that an affected State's interests are not jeopardized as a result of any Federal oil and gas activities along the State/Federal boundary.

This concludes my prepared statement. However, I would be pleased to answer any questions you or other Members may have regarding any aspect of my testimony.

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