U.S. ENERGY AND CLIMATE ROADMAP · CHAPTER BRIEF

# Ensuring Americans Receive Fair Value for U.S. Oil and Gas Resources

**Thomas Covert**, *Assistant Professor, Booth School of Business*
**Ryan Kellogg**, *Professor and Deputy Dean for Academic Programs, Harris School of Public Policy*

Several administrative and legislative changes to the federal mineral leasing process would better protect the environment and public health and also deliver more attractive financial returns to taxpayers. These changes would make the leasing process more similar to those already used in state and private markets, and include increasing the royalty rate, eliminating deductions and using a transparent price index, shortening primary terms, increasing the minimum bid and eliminating the non-competitive leasing program, and strengthening bonding requirements.

## The Challenge

Six percent of total U.S. oil production and 8 percent of natural gas production comes from federal lands. The federal mineral leasing process is a critical stage that governs whether, where, and when these oil and gas resources are developed, the revenue the government takes in, and the extent to which the local environment is protected. These mineral leases contain both a primary term that dictates how many years a firm has to drill and complete a well, and a royalty that dictates the share of the revenue that the government receives. Leases are auctioned, and the government sets a reserve price that specifies the lowest bid. The terms around these lease agreements, however, are not delivering a fair return for taxpayers and put the environment and public health at risk.

## Policy Context

Through the Federal Land Policy and Management Act (FLPMA) of 1976, the Bureau of Land Management (BLM) is statutorily obligated to: develop the country's natural resources, ensure fair value for taxpayers, and preserve the natural environment. Its leasing procedures are governed under FLPMA and the Mineral Leasing Act (MLA) of 1920, last amended in 1987. BLM uses a 10-year primary term, a 12.5 percent (one-eighth) royalty, and a reserve price of $2 per acre. BLM's 10-year primary term allows firms to "sit on" land far longer than do terms set by major oil and gas producing states. On top of this, BLM's royalty and reserve price are at the statutory minima and fall well below norms set by states and by the private leasing market. The shortcomings of these overly generous terms are exacerbated by the fact that many of the tracts auctioned by BLM do not even attract a large number of competitive bidders. For instance, in the fourth quarter of 2019 (the last full quarter before the COVID-19 pandemic began) only 36 percent of tracts auctioned received any bids at all, and of those 34 percent were won with just the minimum bid of $2 per acre. Additionally, prior to drilling, firms must pay a bond to cover part of the future decommissioning of the well. The bond amounts required by BLM have not changed since the 1960s, are below benchmarks used by states, and are insufficient to conduct full reclamation.

6% / 8%

**SEGMENT OF U.S. OIL AND NATURAL GAS PRODUCTION, RESPECTIVELY, FROM FEDERAL LANDS**

$25B

**COLLECTIVE WORTH OF FEDERAL OIL AND GAS RESOURCES PRODUCED IN 2019**

99.5%

**SEGMENT OF WELLS THAT DID NOT HAVE BONDS LARGE ENOUGH TO COVER ANTICIPATED RECLAMATION COSTS IN 2019**

## Recommendations

There are several steps that policy makers can take to better protect the environment and public health, and to deliver a fair return to taxpayers.

- **Increase the federal onshore royalty rate.** With a royalty rate at 12.5 percent, BLM gets as little as half as much as state or private landowners for every dollar's worth of oil and gas produced from its lands. Such a low rate is consistent with a desire to emphasize resource development rather than taxpayer value—a prioritization out of sync with other major oil and gas producing states.
- **Simplify royalty valuation by eliminating deductions.** With the royalty based on a firm's revenue, the value firms choose to place on production and the deductions firms take—such as transportation or processing costs—can lower the revenue the government receives and impose a substantial auditing burden. Instead, the Office of Natural Resources Revenue should eliminate deductions and use a transparent price index such as West Texas Intermediate or Brent for oil, or Henry Hub for natural gas.
- **Increase the rate of tract development by shortening primary terms to no more than five years, aligned with state agencies and private markets.** Establishing a short primary term, which can be accomplished through an amendment to the MLA, promotes timely resource development.
- **Increase the minimum bid per acre to match policies adopted by state agencies, and terminate the non-competitive leasing program.** Requiring firms to pay a robust initial fee to lease federal land will raise federal revenues, help ensure that lands are leased by the most productive firms, and reduce the burden of administering leases for marginal parcels. Increasing the minimum bid can be accomplished through administrative rulemaking, and eliminating the non-competitive leasing program can be accomplished through an amendment to the MLA.
- **Strengthen bonding requirements to protect the environment and public health.** BLM requires that firms post a single $25,000 bond to cover reclamation for all the wells that they operate in a single state. This amount falls well short of realistic estimates of reclamation costs. Economic research shows that stronger bonding requirements improve environmental outcomes. For example, when Texas increased its bonding requirements in the early 2000's, many small operators with poor environmental records left the industry, "orphaned" wells decreased by 70 percent, and water violations dropped by 25 percent. BLM could achieve similar results on federal lands by raising its bond amounts via administrative rulemaking.

*"Across the board, the terms of BLM oil and gas leases favor oil and gas production companies over U.S. taxpayers. They allow firms to capture the lion's share of oil and gas resources' value, while at the same time letting them avoid liability for environmental harm."*

**FURTHER READING**

### Relinquishing Riches: Auctions vs. Negotiations in Texas Oil and Gas Leasing

**National Bureau of Economic Research Working Paper**

Oil and gas extraction leases allocated via centralized auctions pay the owners of such extraction rights 67 percent more and produce 44 percent more output than informally negotiated leases.

**FURTHER READING**

### The Economics of Time-Limited Development Options: The Case of Oil and Gas Leases

**National Bureau of Economic Research Working Paper**

Primary terms can benefit the landowner and increase the total value that the landowner and firm receive together because they accelerate drilling activities.