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October 11, 2011

Walter Cruickshank
Deputy Director
Bureau of Ocean Energy Management
1849 C St. N.W., MS 5438
Washington, D.C. 20240

Dear Dr. Cruickshank:

On August 22, 2011 the Bureau of Ocean Energy Management, Regulation, and Enforcement ("BOEMRE") issued a Proposed Notice of Sale for Sale 218 in the Western Planning Area ("PNOS"), proposed to be held on December 14, 2011. *See* 76 Fed. Reg. 52344. In the Leasing Activities Information notice issued in conjunction with the PNOS, BOEMRE stated:

> **New Lease Form**
> The BOEMRE will use a new lease form to convey leases offered in this sale. The new lease form will be referenced in the Final Notice of Sale for WPA Lease Sale 218, and will be available to view at that time on the BOEMRE website. A list of proposed changes to the lease form may be viewed at: http://gomr.boemre.gov/homepg/lsesale/218/wgom218.html. The lease form will be amended to conform with the specific terms, conditions and stipulations applicable to the individual lease.

The American Petroleum Institute ("API") is a national trade association that represents over 480 members involved in all aspects of the oil and natural gas industry. API represents operators involved in the exploration and production of offshore federal oil and gas resources. The U.S. oil and natural gas industry supports 9.2 million U.S. jobs and more than 7.5 percent of the U.S. economy. The industry has paid more than 150 billion dollars in royalty revenues to the federal treasury. On behalf of its members, API submits the following comments on the Bureau of Ocean Energy Management's ("BOEM," the successor agency to BOEMRE following the reorganization effective October 1, 2011) "proposed" changes to the lease form to be used for leases issued in Lease Sale 218.

As an initial procedural matter, it is unfair and unreasonable for BOEM to unilaterally adopt numerous substantive changes to the standard lease form contract. Because this form is of general applicability and future effect for all prospective Outer Continental Shelf ("OCS") lessees, BOEM should pursue a formal notice and comment rulemaking process to adopt changes to the operative provisions of the standard lease form (other than changes to financial terms that may vary from sale to sale such as minimum bids, rental rates, royalty rates, and availability of royalty relief). If BOEM simply imposes changes to the basic operative provisions of the lease form without explanation of the reason and purpose for the changes, lessees will be required to invest hundreds of millions of dollars in new OCS leases without a clear understanding of the lessor's purpose in making changes to longstanding terms in the lease contract, and without the benefits of predictability and efficiency inherent in the lessor's otherwise longstanding lease terms.

Very recently, BOEMRE recognized the need to follow a public process to develop terms for the commercial lease form for renewable energy development on the OCS. *See* 76 Fed. Reg. 55090 (Sept. 6, 2011). It is puzzling, to say the least, why BOEM has not adopted a similar approach for oil and gas leases. Prospective OCS oil and gas lessees are entitled to no less of an administrative process than other OCS lessees. Therefore, API requests that BOEM engage in a formal rulemaking process before making the numerous proposed substantive changes to the operative provisions of the standard OCS lease form. At a minimum, BOEM should announce that it will consider comments submitted by API and others on the "proposed" changes to the lease form and publish an explanation of the basis and purpose for any changes adopted in conjunction with the Final Notice of Sale for Sale 218 so that prospective bidders may fully comprehend the terms of the revised lease contract.

Section-by-Section Comments

API provides the following comments to the proposed section-by-section strikeout and redline changes to Form MMS-2005 (October 2009) that were published on the website cited above.

API notes that the proposed changes to the lease form currently posted to the website referenced above are different than the changes originally posted. This "informality" on the part of the agency when addressing a subject as important as lease terms underscores why the agency should provide a formal notice and comment process before adopting any changes to the OCS lease form.

Title and Introductory Paragraph: References to the Minerals Management Service should be replaced by BOEM.

Sec. 1: BOEM proposes to change the terms of Section 1 of the standard OCS lease form to subject lessees to prospective unilateral changes in lease terms by providing that the lease is "subject to the [OCS Lands] Act, regulations promulgated pursuant thereto, and other statutes and regulations in existence upon the Effective Date of the lease, and those statutes enacted *(including amendments to the Act or other statutes)* and regulations promulgated thereafter, except to the extent *they explicitly conflict* with an express provision of this lease. *It is expressly understood that subsequent amendments to the Act, other statutes, and regulations which do not explicitly conflict with an express provision of this lease may be made and that such amendments may increase or decrease the Lessee's obligation under this lease*." (proposed changes in italics).

API opposes these proposed changes because they deprive lessees of any assurances that the rules governing their exploration and development activities will not materially change after they have acquired their leases and expended the significant resources required for lease acquisition, exploration, development and production. API objects to the proposed changes because they are unfair to lessees and are beyond BOEM's legal authority.

As highlighted in a March 16, 2010 letter from API to the Solicitor of the Department of the Interior providing comments regarding similar proposed changes to Section 1 (a copy of which is enclosed), for over thirty years, beginning in September 1978, Section 1 of all OCS leases provided (with minor variation) that an OCS lease is

> issued subject to the [Outer Continental Shelf Lands Act ("OCSLA")]; all regulations issued pursuant to such statute and in existence upon the Effective Date of the lease; all regulations issued pursuant to such statute in the future which provide for the prevention of waste and the conservation of the natural resources of the Outer Continental Shelf, and the protection of correlative rights therein; and all other applicable statutes and regulations.

The United States Supreme Court recently confirmed that this language protects lessees against post-lease acquisition statutory or regulatory changes beyond those specifically identified (*i.e.*, OCSLA statutory and regulatory changes that address prevention of waste, conservation of OCS natural resources, or the protection of correlative rights therein). See *Mobil Oil Exploration & Producing Southeast, Inc. v. United States*, 530 U.S. 604, 620 (2000).

The enormous investments necessary to obtain and develop an OCS lease give rise to the need for the specific, protective restriction on the government's right to change unilaterally the terms under which a lessee has agreed to develop a lease. First, an OCS lessee must pay a substantial bonus in order to acquire an OCS lease. A lessee must then invest significant sums to explore for and ultimately produce oil and gas, if it is found in

commercially viable quantities. It is not uncommon for these costs to be in excess of a billion dollars for a single lease. As the Supreme Court has acknowledged, under these circumstances, it is reasonable for lessees to expect to be able to know the rules that will apply to their exploration, development, and production efforts. *See Mobil Oil*, 530 U.S. at 530-31 ("if the companies did not at least buy a promise that the Government would not deviate significantly from those [preexisting] procedures and standards, then what did they buy?"); *see also Amber Res. Co. v. United States*, 538 F.3d 1358, 1372 (Fed. Cir. 2008) (stating that the Supreme Court's opinion in *Mobil Oil* "makes clear" that government's imposition, subsequent to lease issuance, of an overall change in the regulatory regime under which lessees had bargained for the right to explore for and extract oil and gas constituted a breach of the leases).

The proposed changes to Section 1 go even further than previous changes to eliminate the essential assurances to lessees that the "rules of the game" will remain consistent throughout the term of a lease. Those changes purport to allow Congress or BOEM to impose, nearly without limitation, additional obligations beyond those agreed upon by a lessee at any time during the term of a lease, including after a lessee has invested millions of dollars in the lease. Consequently, API opposes the proposed changes to Section 1 because they fail to provide the certainty necessary for potential lessees to invest the enormous sums involved in lease development.

In addition to being fundamentally unfair, the proposed changes to Section 1 also are beyond BOEM's legal authority and invalid as a matter of law. In 1978, Congress amended Section 5(a) of OCSLA, 43 U.S.C. § 1334(a), to make clear that the rules and regulations to which an OCS lease would be subject were those in existence at the time of lease issuance and, with respect to subsequently-enacted rules and regulations, only those "necessary and proper in order to provide for the prevention of waste and conservation of the natural resources of the Outer Continental Shelf, and the protection of correlative rights therein." Consequently, the agency changed the language of the lease form Section 1 to comply with the statutory amendment. *See* Outer Continental Shelf Lease Form, Department of the Interior, 43 Fed. Reg. 44893 (Sept. 29, 1978) (acknowledging that revision of lease form was "necessary in order to make the form consistent with the OCS Lands Act Amendments of 1978 (Pub. L. 95-372), signed into law by the President on September 18, 1978").

No subsequent legislative amendment has altered BOEM's obligation to comply with the 1978 amendment to Section 5(a) of OCSLA. Nor has any subsequent legislative action authorized BOEM to adopt a version of Section 1 that allows the government to require compliance with statutory or regulatory provisions beyond those identified in the version of Section 1 that became effective in September 1978. Because BOEM's proposed new Section 1 would allow the government to require compliance with statutory and regulatory provisions beyond what Congress authorized in the 1978 amendment to OCSLA Section 5(a), BOEM's proposal exceeds BOEM's authority under

that section and is unlawful. BOEM therefore should not make the proposed changes to Section 1.

Sec. 4: BOEM has changed the meaning of this section and made it extremely confusing. As revised, the section could be read as requiring two rental payments per year. The first clause requires a rental payment "on or before the *first* day of each year before the discovery of oil and gas on the lease…." The second clause requires a rental payment ". . . on or before the *last* day of each lease year in any full year in which royalties on production are not due…." No royalties can be due before there is a producible well on the lease. Therefore, the literal reading of the revised section is that two rental payments are due in years where there is no discovery of oil and gas and no royalties are owed. BOEMRE must amend this section to make its intent and effect clearer.

This language also would have the literal effect of imposing rental obligations on a producing lease with royalty relief because until the royalty suspension volume is produced, no royalties on production are due. BOEM must clarify that no rental is owed on a lease with royalty relief once production in paying quantities commences. When production of the royalty suspension volumes begins, the lease is subject to a minimum royalty obligation under Section 5.

Sec. 6(a): API prepared the following comment based on proposed changes to this subsection that were posted to the website when BOEMRE issued the PNOS. The original changes no longer are posted. API is uncertain whether the deletion of the originally proposed changes is intentional or inadvertent. Therefore, in the event BOEM intends to proceed with the originally proposed changes, API is providing the following comment.

The intent of the new language in this provision appears to be to provide the lessee with an alternative procedure for reporting royalty obligations in complex commingling situations, while eliminating any risk of underpaying royalties to the lessor. API supports this concept. However, this should not be an opportunity for the lessor to enhance the royalty obligation beyond that which could be due. As written, this section provides that the lessor may require a royalty rate higher than even the highest royalty rate for any contributing lease. To avoid this ambiguity, this section should state that the "higher royalty rate" in no circumstance shall be higher than the highest royalty rate of any lease contributing commingled production. For example, assume three leases are contributing commingled production. Leases A and B have a 12.5% royalty rate, and lease C has a 16.67% royalty rate. The lessee should never have to pay more than a 16.67% royalty rate for commingled production since that rate would completely protect the lessor under any circumstance from the risk of losing royalty on that production. In most circumstances a form of blended royalty rate would be reasonable.

Sec. 6(b): API is concerned that the proposed provision stating that the lessee "agrees" to pay royalty on the value established under Office of Natural Resources Revenue ("ONRR") regulations is intended to create a new standard by imposing a direct breach of lease risk on the lessee if it fails (even unintentionally) to properly pay its royalty in accordance with those regulations, no matter how insignificant the resulting royalty underpayment may be. This section should only continue the current purpose of stating *how* value will be determined and should not establish potential new consequences for non-compliance. ONRR has adequate enforcement authority to deal with lessees that underpay royalties: a minor infraction should not directly threaten the viability of the lease itself. This section should be reduced to one sentence that reads "…as determined by the Lessor [] under 30 CFR Chapter XII or applicable successor regulations."

Sec. 7: The phrase "or successor agency" should be added after "Office of Natural Resources Revenue."

Sec. 9: The proposed last sentence provides that "[t]he Lessee may depart from an approved plan only as provided by applicable regulations." Read literally, this section could be construed as a constraint on existing authority to grant departures. 30 C.F.R. §§ 250.141 and 250.142 already authorize departures for procedures and equipment that "provide a level of safety and environmental protection that equals or surpasses" the protections provided by otherwise applicable regulations. The proposed new language could be construed as limiting the ability to grant departures from approved plans only to the extent specifically authorized in a regulation addressing a particular operational issue. API opposes such a narrow construction and application of this provision because the existing departure authority provides the needed flexibility to address unexpected circumstances that occur during operations. Regulations take months or years to adopt, and even then cannot possibly cover the range of issues that might arise during operations.

If the new sentence is intended only as a reference to existing departure authority, it is unnecessary and should be deleted because of the ambiguity it creates. Alternatively, if BOEM retains the new sentence and explains that it is only a reference to existing regulatory authority to grant departures, API recommends that BOEM amend that sentence to provide for an automatic exception for a lessee that proposes alternate operational safety requirements more stringent than the existing requirements.

Sec. 10 (a): BOEM's proposed modifications require a lessee to "maximize the ultimate recovery of hydrocarbons from the leased area." However, OCSLA requires consideration of a variety of factors other than maximization in determining appropriate rates of production, including safety considerations. *See* 43 U.S.C. § 1334(g). BOEM must modify the lease language to conform to the statute.

Sec. 10(b): The proposed new subsection requires a lessee to "complete and produce all penetrated economic hydrocarbon bearing zones to conform to sound conservation practices." API is uncertain what this proposed language means. For example, it is unclear whether this requirement applies on a lease basis or to each well. Therefore, BOEM should fully explain the purpose and intent of this provision before adding it to the lease form.

Sec. 10(c): It is unclear why BOEM is proposing to add an express "diligence" requirement to OCS leases. Exploration and development of OCS leases, particularly in deep water and other frontier areas, is a lengthy and expensive process. Necessary infrastructure to support development is not always available, often requiring extension of lease terms. BOEM already has shortened the terms for OCS leases, and it is unclear what BOEM's reason might be for including this separate diligence provision. API is concerned that BOEM may use this new and undefined diligence requirement in the OCS lease form to deny requests for suspensions of operations and suspensions of production on the grounds that an operator failed to exercise "diligence" with respect to a particular lease. Under these circumstances, API opposes this new diligence provision until BOEM explains the purpose for its inclusion.

Sec. 10(d): BOEM proposes to add a last sentence to this subsection requiring that "[t]he Lessee must drill and produce wells necessary to protect the Lessor from loss due to drainage or pay Lessor compensatory royalty for drainage in the amount determined by Lessor." It is very expensive to drill OCS wells, particularly in deep water where drilling a well can cost in excess of $100 million. It is well-established that for onshore federal leases issued pursuant to the Mineral Leasing Act, the lessee is required to drill an offset well or pay compensatory royalty only in circumstances where drilling the well is economic. *See Forest Oil Corp.; Exxon Corp.*, 141 IBLA 295 (1997). BOEM should incorporate the "economic" standard into the proposed lease language to avoid any ambiguity as to its application offshore.

All federal leases on the OCS are issued by a single lessor. Therefore, drainage is an issue (1) along the state/federal boundary, or (2) where there may be disparate royalty rates among OCS leases producing from a single reservoir. API is particularly concerned that BOEM may seek to use this provision to force lessees to drill wells or pay compensatory royalty in certain royalty relief situations. For example, assume Lease A is subject to royalty relief and has a well producing from a common reservoir with Lease B. BOEM potentially could use this authority to require the lessee of Lease B to drill an otherwise uneconomic offset well, or pay compensatory royalty, only because the royalty relief on Lease A makes the royalty owed on Lease B production higher. This is another example of why BOEM should provide a full opportunity for public notice and comment and an explanation of its intent in adopting the new proposed provisions.

Sec. 22(c): This proposed section requires a lessee to remove platforms and other facilities within one year after lease or right-of-way termination unless "the Lessee receives approval to conduct other activities." This language must be expanded to also include situations where a third-party receives approval through a right-of-use and easement to conduct "other activities" on the lessee's platform or other facilities following lease or right-of-way termination.

API appreciates the opportunity to provide comments on the proposed changes to BOEM's OCS lease form and looks forward to BOEM's response. If you have any questions regarding these comments, please contact me at (202) 682-8273.

Sincerely,

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Erik Milito, Group Director
Upstream and Industry Operations

Enclosure

cc: Tommy Beaudreau, BOEM Director
Robert LaBelle, BSEE Deputy Director
Renee Orr, BOEM Strategic Resources Chief
Gregory Gould, ONRR Director
Hilary Tompkins, Solicitor, Department of the Interior