CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

March 15, 2006

Honorable Ron Wyden
United States Senate
Washington, DC 20510

Dear Senator:

At our meeting on March 7, 2006, you requested more information about how the Congressional Budget Office (CBO) estimates the cost of legislative proposals involving oil and gas leases on federal land. Specifically, you asked CBO to contrast the budgetary effects of legislation to amend the terms of future oil and gas leases on federal lands, such as S. 2314, the Royalty Relief Act of 2006, with the estimated effects of the Administration's 2007 budget proposal to allow oil and gas leasing in the Arctic National Wildlife Refuge (ANWR). CBO's general approach to such legislative proposals is to evaluate how they would increase or decrease federal receipts relative to CBO's baseline estimates of receipts under current laws and policies.

Income from Federal Oil and Gas Leasing Programs

The Department of the Interior (DOI) administers oil and gas leasing programs on federal land, including submerged lands on the Outer Continental Shelf (OCS). Those programs generate three types of income from lessees: bonus bids, rental payments, and royalties. Oil and gas companies compete for leases through a process of sealed bidding. Each lease is awarded to the bidder that offers the highest bid. The bid, known as a bonus bid, is paid up front for the lease at the time of sale, regardless of whether the property ever produces any oil or gas. After securing a lease, the lessee pays annual rent until production begins, at which time royalties are due. Royalties are collected by the government from the lessee as a fixed percentage of the net value of oil and gas produced from the leased area. The terms of the lease typically specify the royalty rate that applies to future production from that area (on average, about 15 percent for OCS gas leases), as well as conditions under which the lessee may qualify for a lower royalty payment to the federal government (known as royalty relief).

When deciding how much to offer as a bonus bid, oil and gas companies consider the potential profitability of the lease as a long-term investment. Bonus bids are based on companies' expectations of long-term prices, the amount of oil and gas they might produce, and expectations of future costs, including royalty payments to the federal government. Generally, firms will be willing to pay a higher bonus bid for a lease that offers the possibility of greater royalty relief because it will be viewed as more profitable than a similar lease that offers less potential for royalty relief.

CBO's Baseline Estimates of Federal Oil and Gas Receipts

DOI has permanent authority to continue leasing certain federal lands, including specific parts of the OCS. Since 1980, DOI has offered leasing in the central and western Gulf of Mexico on an annual basis. Thus, CBO's 10-year baseline projection of federal spending and revenues includes estimates of rents and royalties from existing leases as well as bonus bids, rents, and royalties from leases we expect to be sold over the next 10 years in those areas and other areas where leasing is currently allowed.

The Deficit Control Act specifies that, in general, CBO's baseline assume that current laws and policies remain unchanged over the next 10 years. As a result, CBO's baseline estimates for bonus bids and royalties take into account the likelihood that future OCS leases may receive royalty relief, as authorized by current law, under certain market price conditions. Over the 2006-2010 period, CBO expects that annual receipts from OCS leases will average about $750 million for bonus bids, $75 million for rents, and $8.4 billion for royalties.

In the case of ANWR, current law prohibits DOI from leasing any part of that area for oil and gas development. Therefore, CBO's baseline for oil and gas leasing proceeds does not include receipts from leasing in ANWR. In order to open ANWR to oil and gas leasing, the Congress must enact new legislation.

Estimates for Legislative Proposals

CBO's baseline estimates of spending and revenues serve as benchmarks for measuring the effects of proposed changes to current law. Our approach to estimating legislative proposals to change royalty provisions of future OCS leases and to open ANWR to oil and gas leasing are described in the following paragraphs.

Changing Royalty Provisions of Future OCS Leases. CBO's baseline estimates of royalties from OCS leases assume that current programs to provide royalty relief under certain conditions remain unchanged. Accordingly, our estimates of bonus bids assume that bidders will take those programs into account when bidding on leases.

Legislation such as S. 2314 would change the terms of future OCS leases. Specifically, S. 2314 would require the Secretary of the Interior to end royalty relief under certain circumstances. Relative to the baseline, such a change would increase royalties from affected leases once they begin to produce oil or gas—typically five to seven years after the lease sale.

But, by reducing the likelihood or amount of royalty relief, the legislation would lessen the expected future profitability of affected leases. Bidders would take this fact into account in formulating their bids. As a result, under S. 2314, we expect that bids for future OCS leases would be lower than they would be under current law, starting in 2007 when the new policy would take effect. Relative to the CBO baseline, which assumes that current policies governing royalty relief continue, we expect that such legislation would reduce receipts from bonus bids in each future year.

To summarize, proposals to reduce royalty relief for future OCS leases would increase future royalty receipts once production began on new leases, but they would also result in lower bonus bids. Over the long run, net receipts to the government might not change much. However, because of the delay between the time when a lease is sold (and a bonus bid received) and when production begins, such proposals could result in a net loss of receipts over the next five years.

Oil and Gas Leasing in ANWR. The President's budget request for fiscal year 2007 includes a proposal to allow oil and gas leasing in certain areas of ANWR. Because, consistent with current law, the baseline now assumes ANWR will not be leased, implementing the President's proposal would generate new receipts to the Treasury.

Under that proposal, CBO assumes DOI would hold lease sales in 2009 and 2011 and estimates that bonus bids paid in those years would total $6 billion. We also expect that winning bidders would pay small amounts in rent over the 2009-2016 period but that production—and royalty payments—would not begin until after 2016. Under the President's plan, half of ANWR receipts would be paid to the state of Alaska, resulting in net federal proceeds of $3 billion over the 2009-2016 period.

I hope that this information is helpful to you. If you have further questions about these matters, we would be pleased to assist you. The CBO staff contacts are Megan Carroll (for ANWR) and Lisa Driskill (for OCS leasing).

Sincerely,

Donald B. Marron
Acting Director

cc: Honorable Dianne Feinstein

Honorable Pete V. Domenici
Chairman
Committee on Energy
and Natural Resources

Honorable Jeff Bingaman
Ranking Member