Reforming the Federal Oil and Gas Royalty Program

Romany Webb   August 4, 2015

The Department of the Interior (DOI) made headlines last week as it began the first of five listening sessions on the future of the federal coal program. The program – which allows companies to buy the right to develop federally-owned coal for as little as a dollar a ton – has long been criticized as inconsistent with national environmental goals. Responding to this criticism, Secretary of the Interior Sally Jewell recently called for a national conversation about the program, asking how it can be managed "consistent with our climate change objectives."

This conversation will play out in a series of meetings across the western U.S., where the vast majority of federal coal is mined. Most participants at the first meeting, held on Wednesday July 29, urged an increase in the federal coal royalty (i.e., the amount companies pay the federal government for coal extraction). This increase is, according to the participants, required to ensure to ensure a fair return to taxpayers and account for the social cost of coal development. These same arguments would also justify an increase in the oil and gas royalty rate.

Some background: The DOI's Bureau of Land Management (BLM) manages nearly 700 million acres of subsurface oil and gas resources owned by the federal government. BLM is authorized, under the Mineral Leasing Act (30 U.S.C. § 223), to lease federal land for oil and gas development. While such development has fallen in recent years, it remains significant. Indeed, 11 percent of the nation's gas and 5 percent of the nation's oil is currently produced on federal lands.

Under the Mineral Leasing Act, producers must pay the federal government a royalty, based on the value of oil and gas extracted from federal lands. This royalty is intended to provide the owners of the resource – U.S. taxpayers – with a share of the profits generated by its extraction. Royalties are paid to the U.S. Treasury and generally split 50:50 with the state in which the lease is located.

The Mineral Leasing Act declares that the royalty must be set at "not less than" 12.5 percent of oil and gas production. This effectively creates a floor or minimum royalty which BLM could, in its discretion, increase at any time. Notably however, since enactment of the Mineral Leasing Act in 1920, the royalty has never been increased above the floor.

Whereas BLM's royalty rate has remained unchanged for nearly a century, state governments and private landowners have updated their royalties time and again, as technological advances have increased the profitability of oil and gas development. Many western states, including Colorado, Montana, and Wyoming, now charge a 16.67 percent royalty rate on state leases. In New Mexico and North Dakota, royalty rates are set at 18.75 percent, while Texas rates are as high as 25 percent. That is double the rate charged by BLM.

A recent study by the Center for Western Priorities found that, due to the low royalty rate for oil and gas production on federal lands, taxpayers are losing out on over $750 million each year. This lost revenue is, in effect, a subsidy to oil and gas producers. Recognizing this, environmentalists and others have criticized the federal royalty policy, arguing that it is at odds with ongoing efforts to mitigate climate change (among other things). (Other concerns frequently raised include that the royalty program fails to ensure taxpayers are adequately compensated for the development of their resources and does not account for the social costs of such development).

As previously reported, oil and gas production is a major source of methane, a short-lived but potent greenhouse gas. The Environmental Protection Agency estimates that, in 2013, the oil and gas industry emitted over 7.3 million metric tons of methane (representing 43 percent of national emissions). Without action, industry emissions are expected to rise more than 25 percent by 2025.

Significant amounts of methane are emitted through the venting (intentional release) and flaring (intentional burning) of excess gas. This has been a particular problem on public lands. A 2010 Government Accountability Office study found that up to 5 percent of all gas produced on federal lands is vented or flared. More recent research suggests that this figure is increasing.

While research suggests that much of the gas vented and flared could be economically captured, many producers have elected not to invest in gas capture technologies. There are many reasons for this, including the high upfront cost of such technologies, as well as uncertainty over the payback period. Moreover, the investment decision is likely also be influenced by the federal royalty program.

Currently, under the federal program, royalties are only required to be paid on gas that is captured for sale. Producers can, therefore, vent gas without paying any royalty. Changing this policy, to require payment of royalties on vented gas, would strengthen incentives for investment in gas capture. This is because, by capturing and selling the gas, producers could recover the royalty cost.

Given the above, reforming the federal royalty program could help to mitigate climate change, by curbing methane emissions. Recognizing this, in the spring, BLM commenced a review of its royalty program. This review could, however, take several months or even years to complete. Some policy-makers are not willing to wait that long. House Democrats recently proposed new legislation that would require payment of royalties on all vented gas. That would be a good start.

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