Drilling for Dollars

The New and Improved Federal Oil Lease Program

Abraham E. Haspel

The story of the Federal Onshore Oil and Gas Leasing Reform Act of 1987 represents a modest victory for the marketplace and competition. It describes how the Department of the Interior abandoned its traditional bureaucratic methods for leasing public lands for oil and gas exploration and chose to rely instead on market forces. Although dissatisfaction with deregulation in other sectors has somewhat tarnished decontrol and marketplace competition, there have been no calls for reregulation of the onshore oil and gas leasing program. The fraud, abuse, and inefficiencies that plagued the earlier system have all but disappeared, and participants agree that the new market-based system is functioning well.

Onshore Leasing and the Lottery

Congress first passed legislation in 1920 to institute the leasing of onshore federal lands for oil and gas exploration and development. The system included both competitive and noncompetitive elements. Lands that lay within the bureaucratically drawn boundaries of a "known geologic structure" of a producing oil and gas field were leased competitively to the highest bidder. Lands that lay outside these boundaries were leased noncompetitively on a first-come, first-served basis. Before 1988 less than 5 percent of federal lands in this program were leased competitively.

This system functioned well enough until the 1950s. But leases for land outside boundaries of a producing field were potentially valuable, and competition for them did develop. Unfortunately, this competition did not occur in an organized marketplace. Rather it surfaced in illegal practices, such as the destruction of government land records; if other oilmen did not know the lands were available, they would not know to apply for them. Intimidation, including fist fights, was also used to prevent other oilmen from being first to arrive and apply to lease potentially valuable land from the Department of the Interior's Bureau of Land Management.

To restore order to the noncompetitive elements of the leasing program, the Bureau of Land Management introduced a lottery in 1959, the basic mechanics of which survived until 1987. All U.S. citizens of full legal age were eligible to apply for a lease for a nominal fee of $10 per application or filing; this filing fee was raised to $75 in 1982. Although each applicant could file only one application for a lease on any particular parcel of land, he could file on as many parcels as he chose. All filings accepted during a specified ten-day period were deemed to have been filed simultaneously, and a drawing was held to determine the winner of the

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lease. Many times the winner of the noncompetitive lottery won nothing of value. But when the lease was valuable, it was often sold or assigned to an oil company in a secondary assignment market at a price many times what the lottery winner had paid to pay.

To restore order to the noncompetitive elements of the onshore oil leasing program, the Bureau of Land Management introduced a lottery in 1959. Both the independents and the majors supported this lottery system, but the lottery encountered problems of its own in the forms of abuses by middlemen, filing agents, and 40-acre merchants.

Both the independent oilmen and the major oil companies suported this lottery system. The independents felt that the lottery helped them to overcome the handicap created by their relative lack of financial resources. Often independents were in a better position than the majors to identify potentially valuable property and to move quickly to obtain a lease through assignment. When the majors did participate in lotteries, the independents had an equal chance of winning the leases offered. And in the end, if a major really wanted a particular lease, the larger company could buy the lease from the independent. Thus, the independents viewed the system as a means of creating a "level playing field" with the majors. The majors supported the system as a means of getting potentially productive lands out of government control and into private hands.

Noncompetitive Problems Arise. But the lottery soon encountered problems of its own in the form of abuses by middlemen, filing agents, and 40-acre merchants. In 1980 it was discovered that signatures on many lottery applications and future assignment papers had been obtained by middlemen for a small payment, a drink, or the promise of continued employment. Middlemen thus built stockpiles of applications signed by U.S. citizens but with other specifics (such as the information identifying a particular land parcel) left blank. These applications could be filed wherever and whenever an order was placed by an oil company hoping to obtain exploration and development rights on a particular parcel. Using the assignments obtained with the signed applications, the middlemen could help skew the chances of winning specified leases in favor of their clients.

The second abuse involved filing services, boiler-room type operations that promised unsuspecting citizens great wealth through participation in the government-run oil and gas lottery. For a fee these filing services entered individuals in various lotteries. While they often did not violate the letter of the law, the filing services did violate its spirit and led a number of individuals to invest their life savings in lotteries that returned nothing of value. Several of these operations are now being investigated on charges of fraud by state attorneys general and the Federal Trade Commission.

The third set of problems were created by the so-called 40-acre merchants. These were the winners of worthless leases who subdivided their tracts into 40-acre parcels and sold these smaller leases to an unsuspecting public. The imprimatur of a federally obtained oil and gas lease lent credibility to these deals. This scam proved very lucrative for the merchants and troubling for the Interior Department and Congress when those purchasing the leases realized that they had been duped.

While the scandals revolving around the lottery system were disturbing, they did not generate any strong movement toward change. What did spur action was the "give-away" appearance of the noncompetitive system, an image that was the direct result of the inability to ensure that no valuable parcels lay outside boundaries requiring competitive bids.

A review of the leasing program in mid-1983 made it apparent that, despite proposed changes, the existing system provided no stability or predictability. It was impossible to eliminate the likelihood that lottery winners would receive more for their leases than the government had collected, and this generated calls for discontinuing the program. As 1983 drew to a close, it had become evident at the Interior Department that this was no way to run a leasing program. A change was needed, and incoming Interior Secretary William Clark called for an overall review of the onshore leasing program.

The Winds of Change

In each Congress after 1980, Sen. Dale Bumpers proposed eliminating the noncompetitive elements of the onshore oil and gas leasing program. At times Rep. George Miller put forth similar proposals, but the Interior Department demurred from considering any changes that were more than cosmetic. Before 1984, steps toward increasing the role of competition were limited to trying to devise broader regulatory definitions of a known geologic structure. Anything more meant revising the Mineral Leasing Act of 1920, and this would expose the onshore oil and gas program to the whims of Congress and political pressure groups.

In early 1984, however, the Interior Department's Office of Policy Analysis and the Bureau of Land Management began to seriously consider substantive change. In addition to receiving a fair return for onshore leases, the Interior Department had five other objectives: maintaining incentives to explore for oil and gas reserves by making unproven lands available to applicants intent on exploring for and developing these resources; promoting the orderly and timely development of oil and gas resources; minimizing the administrative burden of the leasing program while maintaining its integrity; maintaining low barriers to entry so that small firms could participate in the program; and leasing environmentally suitable lands in a manner compatible with other uses, including the retrieval of other minerals.

To maximize revenues it appeared critically important to differentiate between desirable tracts and other tracts. The proposed method established two sequential tiers. First, all tracts would be offered competitively at oral auction. Those that did not receive the minimum acceptable bid would be offered noncompetitively in the next lottery.

Although the economists within the study group recommended leasing all federal lands on a competitive basis, such a response was believed to have little political support except from Sen. Bumpers' office. Consequently, a number of other ideas were advanced including requiring competitive leasing of a congressionally mandated minimum percentage of lands, requiring companies to include with their bids a commitment to a specified amount of work on the leased land, using the lottery to determine the lessee but then appraising the land to determine the price the winner would have to pay to exercise his lease, and charging different rents based on the geological potential of the leased land.

Meanwhile, in 1983 Wyoming, the state in which 50 percent of the Bureau of Land Management lottery activity occurred, changed its leasing program for state lands from one that was all noncompetitive to one that was all competitive. After two sales, it was clear that Wyoming was losing money on its decision. Because there were two kinds of tracts—the desirable or "cream" tracts and everything else—Wyoming could have raised more money by offering the cream tracts competitively and the rest noncompetitively through a lottery.

To maximize revenues it appeared critically important to differentiate between the two kinds of tracts. Work began on a market-based system within the Interior Department's Office of Policy Analysis, but rather than using a geologically based test of value as the known geologic structure system attempted to do, an economic test was devised.

The proposed method established two sequential tiers. Initially, all tracts were to be offered competitively at an oral auction. Any tracts that received a bid at or above a specified minimum bid (initially $35 per acre was suggested) were to be awarded to the high bidder without any further evaluation. Tracts that did not receive the minimum acceptable bid, including those that received no bid, were to be offered noncompetitively in the next lottery. The vast majority, 90 percent or more, of the land would still be awarded noncompetitively, but most of the money would be collected competitively. All of the Interior Department's major objectives were met by this two-tier proposal. After a series of studies by the Interior Department, on May 17, 1985, Secretary Donald P. Hodel selected the two-tier, market-based approach to reforming the onshore oil lease program.

Despite their traditional opposition to changing the system, many independent oilmen were privately beginning to rethink their position. In meeting with the leadership of several indepen-

dent petroleum associations to sell them on the need for change, the Interior Department learned that the independents were not a monolithic political force speaking with one voice. Some feared competition; others welcomed it. One fear voiced by the independents would prove to be real, however. There was concern that opening the Mineral Leasing Act to amendment would create an opportunity for the environmental community to raise issues above and beyond the narrow question of leasing mechanics. In particular, environmentalists might press for new criteria defining which federal lands, if any, should be leased. It was feared that the Interior Department might end up with a better leasing system but no lands it could lease. And the Interior Department recognized that the prospect of additional centralized, bureaucratic land-use planning could neutralize, if not overwhelm, the benefits of a more market-oriented leasing program.

The Legislative Battles Begin. The reform of the onshore oil and gas leasing program became an important political agenda item early in the 99th Congress. Legislation introduced in both houses early in 1985 would have required the oil and gas exploration and development rights on all federal lands to be leased competitively. As representatives from the Interior Department continued to work closely with the staffs of Sen. Bumpers, Rep. Morris Udall, and Rep. Nick Joe Rahall, the two-tier, market-based approach favored by the Interior Department became increasingly viewed as a viable alternative to the all-competitive system initially favored by Bumpers and others.

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"I KNOW IT'S NOT MUCH TO LOOK AT NOW, BUT THINK OF THE POTENTIAL!"
Drawing by Cullum; Copley News Service.

On July 30, 1986, the Senate Energy and Natural Resources Committee passed a bill setting the minimum acceptable bid for competitive leasing at $20 per acre. The only reference to the environment was a note that the National Environmental Policy Act applied to virtually all aspects of the program. Despite the hearings on onshore leasing reform held by the House Subcommittee on Mining and Natural Resources, no bill was reported out of the full committee. Although the Senate sent the onshore leasing reform bill to the House twice in the waning hours of the 99th Congress, Congress adjourned without leasing reform.

The Environmental Issue Comes to a Head. When the 100th Congress convened in January 1987, leasing reform bills were introduced in both houses. The bill that emerged from the Senate committee in July 1987 represented a compromise, reducing the minimum acceptable bid for competitive leasing from the $35 per acre favored by the Interior Department to $10 per acre. This change dramatically increased the amount of federal land that would be leased competitively. The bill passed by the House included a two-tier system with a minimum bid of $2 per acre for competitively awarded leases and a five-year lease term. Any lands that did not receive this minimum bid were available noncompetitively on a first-come, first-served basis, but the lease term was increased to ten years.

In early 1987 it became evident that environmental concerns would play an important role in debates over reform of the onshore oil and gas leasing program. Despite admonitions from the Interior Department that additional environmental requirements beyond those of the Federal Land Policy and Management Act, the For-

est and Rangeland Renewable Resources Act, and the National Environmental Policy Act would add "to the administrative burden and costs" and would require "unsupported judgments beyond what can be reasonably predictable," the House version of onshore leasing reform included considerable land-use planning restrictions, requiring not only descriptions of the oil and gas potential, but also "an analysis of the most likely social, economic, and environmental consequences of exploration and development for oil and gas recovery, . . . an identification of those specific protective stipulations to be applied to oil and gas leases, and the specific areas to which each such stipulation shall apply."

The environmental sections now dominated everyone's interest. The Interior Department and the oil and gas industry were concerned that extensive environmental restrictions would effectively stop the leasing of onshore federal lands. There was general agreement that leasing reform was not worth the environmental costs the House bill would impose.

In September 1987 Secretary Hodel wrote Reps. Udall and Rahall: "This bill, if passed as currently constructed, will impede the orderly and timely exploration and development of the public lands for oil and gas by seriously undermining the leasing process. Should this bill, or one very similar to it, be enacted by both houses of the Congress, I will recommend in the strongest terms to the President that it be vetoed." Rep. Richard Cheney noted that "all of the oil and gas drilling that has ever taken place on federal lands since the passage of the Mineral Leasing Act of 1920 has yet to disturb even *one-tenth of one percent* of the lands underlying the federal mineral estate."

A Reform Act Emerges. In both houses of Congress the reform legislation was attached to the respective budget reconciliation bills. The conference committee established to work out a compromise on onshore oil and gas leasing reform met on December 16 and 17, 1987.

In a December 15 letter to the conferees, Secretary Hodel reiterated his strong objections to additional environmental requirements and asked that the conference committee accept the Senate language setting the minimum bid for a competitively awarded lease at $10 per acre. On this latter point Hodel argued, "By setting the minimum bid at $2 per acre, little incentive is left for anyone to uncover heretofore unleased lands or to participate in a simultaneous drawing."

Although Sen. Bumpers assured officials at the Interior Department that he would support the $10 minimum bid to the bitter end, it soon became clear that reform would not occur unless he compromised on this position. The conference came down to a trading session between Sen. Bumpers and Rep. Miller. Bumpers accepted the House's $2 minimum bid with the proviso that it could be raised after two years if a report to Congress by the Interior Secretary (prepared by the Bureau of Land Management) established that raising the minimum required for a competitive lease was in the public interest. Miller conceded the environmental planning section, accepting instead congressionally mandated studies by the Government Accounting Office and the National Academy of Sciences addressing the issues raised in the land-use planning section of the House bill. With these two major stumbling blocks removed, the remaining issues were quickly dealt with and the conference concluded. On December 22, 1987, the Omnibus Budget Reconciliation Act was passed by both houses. Title III is the Federal Onshore Oil and Gas Leasing Reform Act of 1987.

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Epilogue

Passage of the onshore oil and gas leasing reform legislation marked the end of the legislative process and the beginning of the regulatory process. The first auction under the new law was held in Wyoming on March 30, 1988. The *Casper Star Tribune* reported the next day that a Government Accounting Office spokesman and the Bu-

reau of Land Management leasing section chief concluded, "It appears the auction method did generate much more money than comparable sales under the previous combined system of lottery distribution and sealed competitive bids on prime tracts." This first auction under the new leasing program drew more than 200 bidders, leased 336 of the 867 parcels offered, and raised $7.8 million. All involved agreed that the mechanics of the auction method worked well. Noncompetitive leasing followed for tracts that did not receive bids.

The 1987 reform bill requires the Bureau of Land Management to provide annual reports to Congress on the performance of the new system. The first report, released May 2, 1989, noted that for acreage leased in fiscal year 1987 the government received an average of $8.49 per acre from bonuses and fees. In 1988, acreage leased before the new regulations were put in place received only $2.39 per acre, as potentially valuable land outside the known geologic structure of a producing field was held back until the competitive bidding system was started. Acreage leased under the reform act in 1988 received $9.96 per acre.

These trends continued in fiscal year 1989, the first full year under the reform act. Almost 7,400 parcels, covering more than 6.1 million acres, were leased. Bonuses and fees collected by the federal government amounted to $87.8 million. Although all acreage was first offered competitively, only 56 percent of the parcels and 45.4 percent of the acreage were ultimately leased through competitive bidding. It is instructive to compare onshore leasing experiences in 1989 and 1987. Under the competitive bidding program in 1989, the Bureau of Land Management leased 80 percent more acreage than in 1987, and its revenues from the program increased by 138 percent. The average return from leased land rose to $14.35 per acre. Thus, the government realized almost $6 more per acre than the pre-reform-act 1987 average. Furthermore, the independents have found themselves able to continue to compete effectively. In Wyoming, for example, independent oilmen won 85 percent of the federal leases awarded in fiscal year 1988 after the new system was in operation, and they captured almost 70 percent of the leases that went for $500,000 or more.

In short, the Interior Department seems to have accomplished its goals. The leasing program now in place relies heavily on the marketplace to establish a fair financial return for the federal government. Meanwhile, the system continues to make lands available for exploration and development. Still, there remain nagging concerns over the environmental reports of the National Academy of Sciences and the General Accounting Office.

The National Academy of Sciences' report was issued in January 1990. It found that the planning processes employed generally "have proven adequate to deal with issues related to oil and gas exploration on most Federal lands." The academy concluded, however, that controversies involving lands that are valuable both for their oil and gas potential and for their surface resources "are casting doubt on the efficacy of the planning process and threaten to bring leasing to a halt in some areas."

In its report, the academy's committee also made several controversial recommendations. The report echoed the House bill's call for forecasting reasonably foreseeable consequences of oil and gas exploration and development at the land-use planning stage. It asked that in areas that are valuable for both their surface resources and their gas potential, only exploration rights be leased, with development rights leased subsequent to exploration. The report recommended that the Bureau of Land Management and the Forest Service determine whether lands are suitable for oil and gas exploration and development and suggested that a stipulation preserving the government's right to revoke a lease become standard. The academy's report encouraged the government to control more closely the configuration and timing of leases in an area, to consider shortening the term of a noncompetitive lease, to improve public participation in de-

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cisions to waive, suspend, or modify lease stipulations, and to improve inter- and intraagency coordination. Finally, the academy's report suggested that the committee's recommendations be applied retroactively to existing leases to the extent possible.

The oil and gas industry is naturally concerned that recommendations such as these will limit their ability to lease federally owned lands for oil and gas exploration. While the act seems to have solved problems in the way lands are leased, it may have created another set of difficulties by restricting which tracts the federal government can lease and under what conditions.

Lessons Learned. There are several lessons to be learned from the passage of the 1987 Federal Onshore Oil and Gas Leasing Reform Act. An important step in bringing about change was the outreach program initiated by the Interior Department to discuss the proposed changes with the independents. This effort not only eased some fears about revisions under consideration, but it also demonstrated to Interior Department and congressional staffs the significant diversity of opinions among independent oil and gas producers.

It is also worth noting that the final form of the legislation was unexpected by the principal participants when the process began. Both the Interior Department and the industry had initially taken the position that a two-tier system in which noncompetitive leasing continued to play a dominant role was necessary to assure a continued role for the independent oilmen. It was generally argued that only the cream of the parcels ought to be leased competitively. While Sen. Bumpers supported this two-tier proposal, he often commented that it offered only "half a loaf." In the end, Bumpers managed to obtain almost the whole loaf.

The system introduced by the reform legislation is still two-tier, of course. But the low $2 per acre minimum bid on competitively issued leases has led to a much greater percentage of lands being leased competitively than was originally envisioned, although changed lease terms have resulted in active noncompetitive leasing too. Analysts who believed that an all-competitive solution was the efficient answer—but not a politically viable one—were pleasantly surprised at the outcome. The sequence of events that led to this result demonstrates the value of compromise, of avoiding all-or-nothing positions. A willingness to listen to the concerns of other groups and to make concessions in developing a proposed solution brought the independents to the table, allowed the notion of reform to be seriously debated, created the opportunity for dialogue, and ultimately resulted in competition for the majority of federal onshore oil and gas leases. The initial compromise broke the retaining wall that prevented change, and from it came reform legislation.

The potential for problems remains, however, even outside the concerns about the impact of proposed environmental restrictions. On May 20, 1990, the *Baltimore Sun* advertised a Wyoming oil "lottery": "Hundreds of individuals will win oil and gas lease rights in the upcoming public drawings conducted by the Bureau of Land Management. Tremendous cash gains may be realized by selling those rights to oil companies who pay lump-sum cash plus life-long royalties on all oil and gas production. Incredibly some will risk no more than a tax-deductible $45 to participate in this little-known program that allows each individual the right to compete equally with the giant oil companies for leases on public lands that may produce a fortune in oil and gas income." The initial flush of success with the Federal Onshore Oil and Gas Leasing Reform Act of 1987 must be tempered with the recognition that this story is not finished. We can only hope that future problems will not be so troublesome as those addressed by this legislation.

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