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The Latest on Outer Continental Shelf (OCS) Oil and Gas Exploration

On January 29, 2015, the Bureau of Ocean Energy Management (BOEM) announced the availability of the Draft Proposed Outer Continental Shelf (OCS) Oil and Gas Leasing Program for 2017–2022, or **DPP**. BOEM you may remember was formerly known as the Minerals Management Service and is one of the agencies within the U.S. Department of the Interior. Section 18 of the OCS Lands Act require the Secretary of the Interior to prepare and maintain a schedule of proposed OCS oil and gas lease sales determined to "best meet national energy needs for the 5-year period following its approval or re-approval." Hence the 2017-2022 DPP is intended to supersede the current 2012-17 Leasing Program. The 2017-2022 DPP schedules 14 potential lease sales in 8 OCS planning areas - ten sales in the three Gulf of Mexico (GOM) planning areas; one sale each in the Chukchi Sea, Beaufort Sea, and Cook Inlet Planning Areas, offshore Alaska; and one sale in a portion of the combined Mid and South Atlantic Planning Areas. Obviously the potential lease sale in the Atlantic is relevant to Carteret County and public comments are due on March 30, 2015.

Specifically, the DPP proposes one sale late in the Program for an area at least 50 miles offshore the coasts of Virginia, North Carolina, South Carolina, and Georgia as depicted in Figure 1. The lease sale schedule identifies this area as "Sale 260" to be offered in 2021. The DPP will need to be approved (i.e., finalized) and each lease sale will go through a prelease evaluation and decision process considering reasonable alternative lease sale configurations, reductions, and/or restrictions within that area. Leases are traditionally offered in blocks that are nine square miles (3 miles on a side), so expect the final sale to have a checkerboard type of appearance in map view.

So what happens if a lease is sold? First the lessee typically initiates a reconnaissance phase for oil and gas accumulations, which includes a formal Exploration Plan that must be submitted to BOEM for approval. Leasing and operational activities on the OCS are subject to the requirements of some 30 federal laws administered by numerous federal departments and agencies. This process in itself can take several years in order to secure permissions, environmental clearances, and to acquire and interpret the seismic data, which is akin to taking an "x-ray" of the subsurface. The next phase of exploration involves drilling a test well(s) that discretely targets an interpreted oil or natural gas trap(s) to determine if this resource exists, and in quantities considered to be economically favorable.

Once deemed economically favorable, delineation wells may be drilled to help constrain the extent of the petroleum hydrocarbon reservoir and amount of extractable resource. Delineation and actual production wells are collectively termed as development wells. If a lessee wishes to develop a well(s), a Development and Production Plan must be also submitted to BOEM for analysis and approval. And lastly, assuming petroleum hydrocarbons are discovered, delineated, and can be economically extracted; a production facility may be installed at the site. Of course oil and gas are brought to market via a system of pipelines and processing facilities or probably more likely for our situation, via a floating system creating a vast oil and gas service industry in the process.

Hence the full development of the final lease area is easily 10 to 15 years from now considering; (a) the lease sale is not scheduled until 2021, (b) the years involved with developing and implementing an Exploration Plan, and (c) the additional years formulating and implementing a Development and Production Plan. Historically speaking, this is not the first time a lease sale has been executed along the Atlantic seaboard – there have been 10 federal lease sales in all with the most recent held in 1983. There have been no active leases since the mid-1990s and obviously no production from the Atlantic OCS.

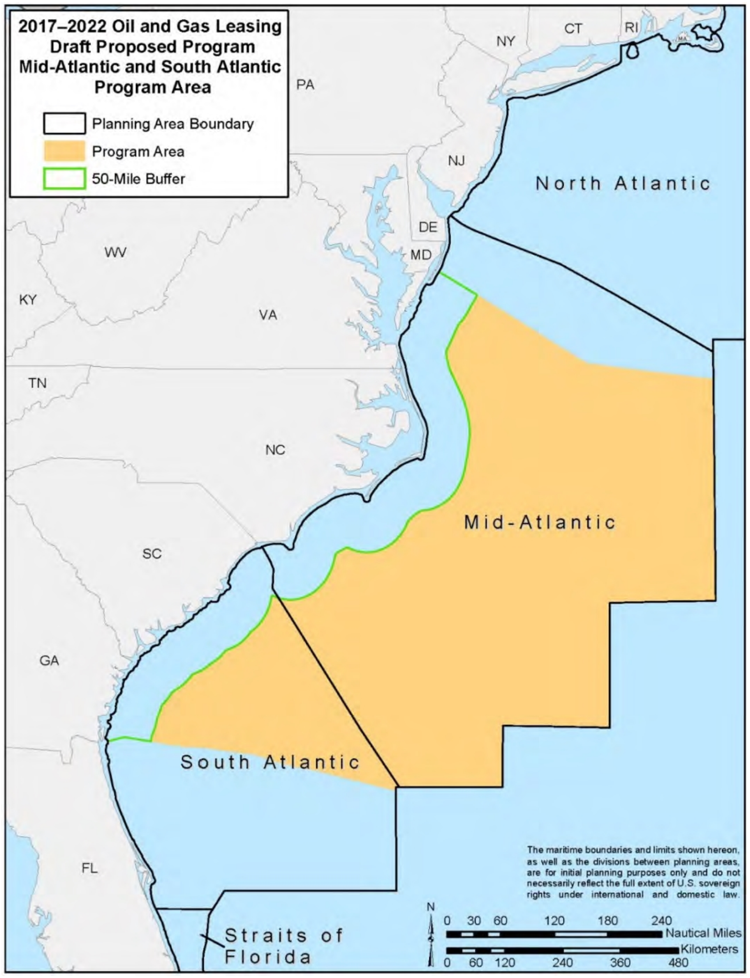

Figure 1 – Map from BOEM's 2017-2022 DPP depicting the areal extent of Lease Sale Number 260, tentatively scheduled for 2021. This area could be reduced, possibly significantly, once the Draft Lease Program is finalized.

On a very related note, Spectrum Geo Inc. and GX Technology are proposing to conduct separate seismic surveying within the North Carolina portion of the OCS in 2015. These surveys will be used by BOEM and the industry to identify discrete areas of petroleum hydrocarbon reservoirs which in turn will aid BOEM with constraining the lease area and developing reasonable market price for the lease sale. For the industry, the seismic surveys will go into their decision-making process concerning if the purchase of a lease and pursuit of an Exploration Plan is economically feasible. Based on the historical exploration records, the geology, and proposed seismic survey grid; it appears the most favorable areas to explore are within the "50-mile buffer" included in the 2017-2022 DPP. We're not sure of the exact mechanisms for shifting the lease sale landward. In theory, the 2017-2022 DPP could be delayed or a new lease sale within the 50-mile buffer could be included in the next Program (2022-2027).

Lease Terms and Conditions (Rentals and Royalties)

A lease grants the exclusive right to explore, develop, and produce oil and/or natural gas for an initial period from a specific block of OCS land – a minimum of five and maximum of ten years. If a discovery is made within the initial term of the lease, the lease is extended for as long as oil and/or natural gas is produced in paying quantities or approved drilling operations are conducted. The lease is a contractual agreement and details the requirements for surety bonds, royalty payments, rental payments, and assignment or other transfers of the lease or any partial interest. **Rental payments** are paid by the lessee on an annual basis and a portion thereof can (but not always) be assigned to the State and/or local government unit. **Royalties** on the other hand are based on a prescribed rate of production and likewise a portion thereof can be assigned to States/local governments. Royalties yield significantly higher dollars than rental payments – generally $100,000,000s per year compared to $100,000s per year. There is also a significant difference in royalty payments when comparing oil and natural gas production within and near State waters (0 – 6 miles offshore) to that purely in federal waters (6 – 200 miles offshore).

(1) State Water Royalties - Section 8(g) of the Outer Continental Shelf Lands Act (OCSLA) applies to <u>all</u> Coastal States adjacent to current or potential areas of OCS development and provides for Coastal States and the federal government to share revenues earned from OCS leases in federal waters between the state's submerged lands and three nautical miles seaward. BOEM shares 27% of these bonuses, rent and royalty revenues with the adjacent states. This 6-mile area is known as the "8(g) zone." However, the 2017 -2022 DPP lease sale is not in or near State waters so let's look at OCS royalties.

(2) OCS Royalties - The Gulf of Mexico Energy Security Act of 2006 (GOMESA) provides that the four Gulf of Mexico (GOM) producing states (Alabama, Mississippi, Louisiana and Texas) will receive a 37.5% share of OCS revenues from selected areas in the Eastern and Central GOM Planning Areas. ***North Carolina (and local governments within N.C.) will <u>not</u> receive any royalties from offshore production in federal waters unless Congress specifically authorizes revenue-sharing with the state*.**

Governor McCrory is the Chairman of the OCS Governors Coalition, consisting of the Governors of Virginia, North Carolina, South Carolina, and Georgia; and this coalition is pressing the federal government to provide the Mid and South Atlantic States the same share (37.5%) of potential royalties as the Gulf States. Senators Burr and Tillis also attached an amendment (S. Amdt 102) to the Keystone XL Pipeline Bill requiring BOEM to share revenues from offshore N.C. development in the same way (the Senate passed the Keystone XL Pipeline Bill, but they did not vote on S. Amdt 102). Governor McCrory has said most recently in his "State of the State" address to the General Assembly, that he will not support offshore oil and natural gas development unless the revenues are shared with the States. He added these revenues would be shared by the State with local communities along the coast for infrastructure development, beach nourishment, and other projects. The General Assembly has yet to specifically address how these "shared" revenues from the OCS would be allocated within the State.

And lastly, time is of the essence with respect to securing a royalty program for North Carolina and local governments. A revenue sharing program needs to be passed into law well before the lease sale and well before the Congressional Budget Office and/or the Presidential Administration considers the entire royalty payment as wholly their own and begin to use this in their budget projections. Notice we haven't discussed the merits or the shortcomings of oil and gas OCS exploration – that's a discussion for another day and involves a myriad of subjects. However if North Carolina willingly or even apathetically assumes the environmental risk and infrastructure demands associated with land-based processing/distribution and the service industry in general; then it's only fair one would presume to have a share in the royalties to accommodate these demands. It would be disturbing to say the least if this was not the case.