Columbia | SIPA
Center on Global Energy Policy

POSITIVE SIGNS FROM THE RECENT GULF OF MEXICO OFFSHORE OIL AND GAS LEASE SALE

BY TOMMY P. BEAUDREAU
APRIL 2018

Last fall the Department of the Interior (DOI) announced a region-wide lease sale scheduled for the spring of 2018 that would be "the largest oil and gas lease sale ever held in the United States," offering about 77 million acres in federal waters in the Gulf of Mexico (GOM). Interior Secretary Ryan Zinke called the sale a bellwether for offshore development, trumpeting it as "part of our strategy to spur local and regional economic dynamism and job creation and a pillar of President Trump's plan to make the United States energy dominant" in a press release that included statements from ten members of Congress and two Gulf state governors.[1] Lease Sale 250, held on March 21, 2018, drew bids on only 148 lease tracts covering about 815,400 acres – approximately 1% of the acres offered – and took in just under $125 million in high bids. Despite the hype going into the sale, the results were described as "tepid" and "modest."[2] But it is worth questioning whether the lease sale was indeed a flop and if it tells us anything about the future of the offshore industry in the United States.

The answer is that the results of the recent GOM lease sale were, for the reasons discussed below, relatively healthy and reflect trends in offshore development strategies and market conditions that have taken hold over the past several years and likely will continue, even as oil prices recover. The extent to which the lease sale was portrayed as a disappointment appears more a factor of the Administration's amped-up rhetoric as opposed to anything surprising or negative about the actual results.

Even the administrative change in the way DOI conducts GOM lease sales, which accounts for the record 77 million acres offered in Sale 250, predates the Trump Administration. Beginning in the early 1980s, DOI divided the GOM into three planning areas – the Western, Central and Eastern – and conducted lease sales separately for each of those planning areas. Specifically, DOI traditionally held an annual Central GOM lease sale in the spring and an annual Western GOM lease sale in August, as well as periodic lease sales for available areas in the Eastern GOM that were held either separately or in combination with a Central GOM sale.

In its five-year program scheduling offshore oil and gas lease sales for the period 2017-2022, the Obama Administration revised the traditional model to provide for holding region-wide lease sales offering all available acreage across the entire GOM twice each year. The purpose of this administrative change was to allow the industry greater flexibility in making strategic planning and leasing decisions across the entire basin, as well as for administrative efficiency and cost savings. Obama's offshore oil and gas leasing program, including the new region-wide approach to leasing in the GOM, is still in effect and currently is being implemented by DOI while the Trump Administration is in the process of developing its own leasing plan, which is targeted for completion next year. Accordingly, Sale 250 is actually the second region-wide lease sale conducted by DOI under the plan finalized during the previous Administration. The first of the new region-wide GOM lease sales (Sale 249) was held last August, offered approximately 76 million acres, and garnered $121 million in high bids – very similar results to Sale 250. While both of these region-wide sales offered all available acreage in the GOM, last month's sale included somewhat more due to the natural turnover in acreage through the expiration or relinquishment leases, rather than any significant "new" areas being made available.

With that background helping to explain how Sale 250 came to be the "largest" GOM offshore oil and gas sale in history (in terms of acreage offered, not the amount of acreage bid upon or the total of high offers), it is worth looking at the factors underlying the results of the lease sale and discussing how they should be interpreted.

First, the industry only recently has begun to emerge from several years of low oil prices that took a heavy toll on capital expenditures, including leasing, devoted to the offshore in the GOM. Moreover, while the GOM remains a prolific basin with mature infrastructure and a sophisticated support industry, it faces heightened competition for capital investment from lower-cost opportunities with shorter lead times to production (and, therefore, revenue), most notably from onshore shale. This competition did not exist a decade ago when the GOM accounted for a significantly higher proportion of U.S. domestic oil and gas production.[3]

Second, in light of these economic realities that have taken hold in recent years, the offshore industry has been laser-focused on controlling and reducing costs and lowering the break-even point at which a barrel of oil can be economically produced from the GOM. This has been a challenging and sometimes painful exercise for the offshore industry as a whole, but one that has yielded dramatic results in terms of improved engineering solutions, process efficiency, and cost management throughout the supply chain. All of this effort has made the offshore industry healthier and more competitive.

Third, in light of those hard-fought gains in efficiency, cost reduction and competitiveness, as oil prices recover and companies continue to evaluate their global portfolios and capital expenditure budgets, the industry is now focusing on discipline. The strides companies have made in reducing their break-even points present enormous opportunities for profitability and competitiveness if discipline on the cost and expenditure side can be maintained as commodity prices recover and operating and contracting costs, such as rig rates, creep upward. In short, the offshore industry needs to retain its focus on efficiency and value, and avoid the temptation to return to its freer-spending (including on leases) history.

All of which leads to a final point about a clear trend in bidding and leasing patterns that has developed in GOM lease sales over the past several years, and that is reflected in the Sale 250 bids. Consistent with the industry's overall focus on obtaining value through its leasing strategies, the offshore industry has mostly moved away from bidding speculatively on acreage in the GOM. This more strategic, value-driven approach to leasing decisions also has contributed to the decline in recent years in the number of tracts that receive bids, as well as the number of tracts that receive multiple bids. Companies are focusing on lease blocks that are in prospective areas, fit well with their portfolio, and are close to existing, accessible infrastructure and facilities. When the combination of these factors indicates that a particular tract makes strategic sense and offers value, companies still will spend millions for a single lease block. In Sale 250, nine individual lease blocks received high bids of more than $2 million, and the highest bid on a single block was more than $7 million.

For all of these reasons, while Sale 250 might not have lived up to DOI's hype as a bellwether of energy dominance, it should not be viewed as a disappointment or sign that the GOM is not attractive for industry investment. On the contrary, last month's region-wide GOM lease sale reflects an industry that evaluates the GOM in the context of a diverse set of global opportunities, remains disciplined in managing costs even as commodity prices have ticked upwards, and is focused on making strategic investments in pursuit of value. Those are all positive signs.

Notes

[1] U.S. Department of the Interior. "Secretary Zinke Announces Largest Oil &Gas Lease Sale in U.S. History," doi.gov, 24 Oct. 2017, https://www.doi.gov/pressreleases/secretary-zinke-announces-largest-oil-gas-lease-sale-us-history.

C. Passut, "Zinke Tells Senate Panel First Draft of OCS Drilling Plan Coming in Fall," Natural Gas Intelligence, March 14, 2018, http://www.naturalgasintel.com/articles/113685-zinke-tells-senate-panel-first-draft-of-ocs-drilling-plan-coming-in-fall.

[2] See, for example: R. Valdmanis, "Drillers give tepid response to record U.S. offshore lease sale," Reuters, March 21, 2018, https://www.reuters.com/article/us-usa-drilling-gulfmexico/drillers-give-tepid-response-to-record-u-s-offshore-lease-sale-idUSKBN1GX18D;

S. Spencer, "US Gulf of Mexico Lease Sale 250 results modest, but raise hopes," Platts, March 21, 2018, https://www.platts.com/latest-news/oil/houston/us-gulf-of-mexico-lease-sale-250-results-modest-21611161;

C. Davis, "A Bellwether? GOM-Wide Lease Sale, with Lower Royalty Rate, Generates $124.8M in High Bids," Natural Gas Intelligence, March 21, 2018, http://www.naturalgasintel.com/articles/113772-a-bellwether-gom-wide-lease-sale-with-lower-royalty-rate-generates-1248m-in-high-bids.

[3] In 2003, 27% of the crude oil produced in the United States was from the GOM; today that share is about 17%. https://www.eia.gov/todayinenergy/detail.php?id=22712#; https://www.eia.gov/special/gulf_of_mexico/

About the Author

Tommy Beaudreau is a nonresident fellow at the Center on Global Energy Policy and a partner at Latham & Watkins in Washington, DC. Previously, he served in numerous senior roles in

the Department of the Interior under President Obama, including as the first Director of the Bureau of Ocean Energy Management, Acting Assistant Secretary for Land and Minerals Management, and Chief of Staff.

The views represented in this commentary represent those of the author.

This work was made possible by support from the Center on Global Energy Policy. More information is available at http://energypolicy.columbia.edu/about/mission.

ABOUT THE CENTER ON GLOBAL ENERGY POLICY

The Center on Global Energy Policy provides independent, balanced, data-driven analysis to help policymakers navigate the complex world of energy. We approach energy as an economic, security, and environmental concern. And we draw on the resources of a world-class institution, faculty with real-world experience, and a location in the world's finance and media capital.

Visit us at www.energypolicy.columbia.edu

@ColumbiaUenergy

ABOUT THE SCHOOL OF INTERNATIONAL AND PUBLIC AFFAIRS

SIPA's mission is to empower people to serve the global public interest. Our goal is to foster economic growth, sustainable development, social progress, and democratic governance by educating public policy professionals, producing policy-related research, and conveying the results to the world. Based in New York City, with a student body that is 50 percent international and educational partners in cities around the world, SIPA is the most global of public policy schools.

For more information, please visit www.sipa.columbia.edu