

applied to production from shallower wells. Then assume that the lessee drills a successful qualified deep well to a depth of 19,000 feet TVD SS and thereby earns a royalty suspension volume of 25 BCF. Finally, assume that the successful qualified deep well produces only three BCF of gas. In this situation, the lessee still has 22 BCF of royalty suspension that may be applied to other deep gas production from the lease. Then assume that economic conditions change, resulting in deep gas production through the originally unsuccessful wellbore—the same wellbore originally used to qualify for the royalty suspension supplement. If enough production emerges from that wellbore it could be responsible for the five BCF of royalty suspension supplement already used, plus the 22 BCF of royalty suspension volume remaining from the successful qualified deep well. The total relief of 27 BCF exceeds the amount we allow from a single wellbore drilled to this depth.

Proposed § 203.44(c)(2) is designed to avoid this result. Under this provision, the lessee could use only 20 BCF of the royalty suspension volume remaining from the successful qualified deep well, resulting in a total of 25 BCF of royalty relief derived from that wellbore. This stipulation applies the same principle reflected in proposed § 203.44(c)(1). If the originally unsuccessful wellbore shares the incentive earned by a successful qualified deep well, the lessee subtracts whatever portion of the royalty suspension supplement has been applied to other production from the royalty suspension volume used by the originally unsuccessful well that later produces.

Price Thresholds

Another component of the proposed deep gas provisions is the stipulation of a \$5.00 per million Btu price threshold, adjusted from year 2000 for inflation, as described in proposed § 203.47. When average market gas prices remain above this threshold amount for an extended time, which we define as one calendar year, deep gas projects will benefit significantly more from favorable market conditions than generally expected. No royalty relief will typically be necessary during such periods, because market price alone offsets the need for royalty relief and should be sufficient reward for attaining the desired increase in exploration and development activities related to deep depth drilling. In times of prices above the threshold, relief in the form of royalty suspension supplements or volumes would no longer be needed. Lessees would then pay appropriate

royalties and that same production would count against the royalty suspension supplements and volumes. If this production were not to count against the royalty suspension volume or supplement, the only offset would be a delay in benefits from royalty relief—hardly enough to justify using a price threshold mechanism.

If the market price of natural gas later falls below the prevailing price threshold, royalty relief would be reinstated, up to the remaining suspension volume. That feature serves to keep marginal fields profitable and to accelerate production of additional gas supplies.

We employ the price threshold specified as a dollar value, escalated for inflation. Other types of price thresholds, such as a sliding scale or a continuous function, were considered but not chosen, primarily to be consistent with past practices. Our relief programs in the GOM region have used the same price threshold approach. When this type of threshold is exceeded, relief is lost only for that year and the lessee more than offsets the loss of relief by the gain in revenues received from the higher market price.

The proposed \$5.00 per million Btu price threshold is higher than natural gas thresholds set in other royalty relief programs because the focus of this program is to accelerate deep gas drilling and production. This short-term focus contrasts with inducing investment in new infrastructure such as platforms and pipelines and developing marginal properties, which is the longer-term goal of our deepwater program. The greater volatility of recent gas prices has raised uncertainty about price expectations over the next several years. In light of this increased price uncertainty, we believe it prudent to elevate the price level that would interrupt this royalty relief. Thus, raising the threshold price level would provide greater assurance that royalty relief will be realized and so would encourage timely exploration and earlier production from discoveries.

We found that the anticipated increase and acceleration of drilling induced by the relief program is similar to the effect that would occur without relief if gas prices rose from \$3.50 to \$5.00 per million Btu. So, during periods when market gas prices reach \$5.00 per million Btu, adjusted for inflation, we can safely eliminate royalty relief without adversely affecting the attainment of program goals. In contrast, our deepwater program targets long-term development and infrastructure incentives for which short-term price fluctuations are less

likely to affect decisions. The deep gas program is short term—thus economically justifying a higher natural gas price threshold before royalty relief

Transition Option for New Leases Issued in Sales Held after January 1, 2001

In § 203.48, we propose to allow leases issued in sales held after January 1, 2001 (post-2000 leases), but before the effective date of the final rule, to exercise a one-time transition option. The transition option would be the opportunity to replace the royalty relief provided for in the original lease instrument, if any, relating to deep depth drilling with the alternative terms that would be offered to all pre-2001 leases in shallow water under this proposed rule. The leases must be located in the GOM wholly west of 87 degrees, 30 minutes west longitude. This one-time option would have to be exercised within 180 days after the effective date of the final rule. Note that some elements of the deep gas royalty relief, such as the volume suspensions for the 15,000- to 18,000-foot TVD SS wells, are more favorable for at least some post-2000 leases than for pre-2001 leases. Yet other elements, such as price threshold levels and the royalty suspension supplements, are more favorable to pre-2001 leases than to at least some post-2000 leases. Each individual lessee could determine the most favorable set of terms for its particular post-2000 lease. Nevertheless, the option would be irrevocable, and once exercised, the lease would be subject to all the requirements for royalty suspension applicable to a pre-2001 lease. In particular, if the lease produced oil or gas from a well that commenced drilling in deep depths before the publication date of this proposed rule, then no suspension volumes or supplements would be available upon conversion.

While the option to change deep gas incentive terms may give some of the post-2000 leases a benefit for which the lessees did not fully bid, the leases issued before 2001 will receive the full deep gas benefit for which the lessees did not bid at all. Therefore, we feel that, in fairness, those lessees of post-2000 leases who may have paid some premium for the deep gas incentive in their lease terms should have the opportunity to get at least as favorable terms as those lessees who paid nothing for the incentive. Thus, allowing lessees of post-2000 leases with some deep drilling royalty relief to substitute in their lease terms the alternative terms for pre-2001 leases under this proposal would ensure consistency and fairness.