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COLLECTION AND DISPOSITION OF FEDERAL OIL AND GAS ROYALTIES TAKEN IN-KIND

OVERSIGHT HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES

OF THE

COMMITTEE ON RESOURCES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

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COLLECTION AND DISPOSITION OF FEDERAL OIL AND GAS ROYALTIES TAKEN IN-KIND

Tuesday, June 12, 2001
U.S. House of Representatives
Subcommittee on Energy and Mineral Resources
Committee on Resources
Washington, DC

The Subcommittee met, pursuant to notice, at 10:05 a.m., in Room 1324, Longworth House Office Building, Hon. Barbara Cubin [Chairman of the Subcommittee] presiding.

STATEMENT OF THE HONORABLE BARBARA CUBIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MYOMING

Mrs. CUBIN. The oversight hearing by the Subcommittee on Energy and Mineral Resources will come to order.

The Subcommittee is meeting today to hear testimony on collection and disposition of Federal oil and gas royalties taken in-kind. Under Rule 4(G), the Chairman and the Ranking Member are the only ones that can make opening statements, and so I wonder if Ron would mind if I made his. In this hearing, I think it would probably be okay, but he will be here later. He is on a flight back to Washington and I am sure he will be able to make it for part of the hearing.

This hearing will continue to focus on the Subcommittee's inquiry on issues relevant to our energy supply for the nation from public lands and the outer continental shelf. But we are not today here to decry the lack of access to potential reservoirs of oil and gas, or seams of coal, or geothermal resources on our public land. Nor are we here today to ponder ways to get those energy reserves into production and thence to consumers more quickly than the current regulatory regime has allowed. Rather, the topic for today's discussion is about whether the Federal Government ought to consider greater use of in-kind collections for oil and gas royalties owed on producing leases.

The Subcommittee has a history over the past several Congresses of debating the problem of valuing oil and gas for royalty purposes in those instances where no arm's length transaction exists at the wellhead. Royalty in-kind, or RIK, is simply the exercise by the Secretary of Interior of her existing authority to demand that a Federal lessee surrender to the government his or her royalty obli-

gation, not in a cash payment but rather as a fraction of the oil and gas volume that is produced.

In this manner, the morass of calculating the wellhead value of the commodity from a downstream price with a net-back formula for processing, transportation, and marketing deductions is eliminated. Auditing of the volume of oil and gas produced must still occur, but this has to happen with in-value royalty payments, as well, so what it amounts to is checking the flow meters and seals against tampering, which would be a far easier job than calculating value.

But what happens then? The Secretary must dispose of these volumes in some manner. In the Wyoming crude oil pilot MMS project, royalty oil was aggregated (and oil from State leases, as well) and they were bid out at semi-annual auctions. This appears to have been a success in terms of demonstrating an ability to receive an uplift for the Federal Government and the State of Wyoming compared to those leases which did not participate in the RIK project.

On the outer continental shelf of the Gulf of Mexico, natural gas royalties have been targeted for in-kind pilot programs. As I have noted in previous hearings, MMS has transferred gas to the General Services Administration, which has used it to heat Federal facilities, including the Longworth House Office Building, which we are now in—In fact, I wish they would use a little bit more of it, John, to get the air conditioning a little cooler in here, please.

This is as far as the General Services Administration has used RIK so far, but in what other ways is it possible that RIK might provide flexibility to fill another governmental need?

Well, President Bush's National Energy Policy report recommends that the Secretary of Interior work with the Secretary of Health and Human Services to draft legislation to bolster the Low-Income Home Energy Assistance Program, or LIHEAP, through the dedication of oil and gas royalties. While this could be done with royalty dollars rather than royalty gas molecules, is there a reason to explore the latter approach? I think there is.

Could a pilot program be established to test the benefits of directing Federal royalty natural gas volumes to a utility with experience in delivering energy to low-income households? If so, would OCS leases be the better choice for a pilot, or would onshore public land leases?

These are several of the questions that we shall pose to our witnesses today to begin to flesh out, or put some flesh on the bones of the President's recommendation.

And lastly, I would like to thank all of our witnesses for coming to educate us on this issue. The RIK idea has engendered passionate debate in the past about whether the oil and gas industry is trying to escape its proper obligation to pay royalty based on a fair market value of the production. I think at this time it is demagoging to portray the industry as "cheats." Yes, we all acknowledge that large sums have been proffered by companies in settlements of lawsuits, and a recent judgment in an Alabama court levied a huge award against one major oil company. But a jury in California a few years ago rebuffed claims that this same energy company had cheated on its State lease obligations.

One point should be obvious, that had the Federal lessees paid these disputed royalties, in-kind, the U.S. taxpayer would have been the immediate beneficiary because there would have been no delay in collecting the proper value. My position continues to be that each and every lessee is obligated and must pay every single penny that it owes in royalties, whether it is in cash or in-kind, no more and no less. But they have to be held responsible for that.

Within the context of all of this, now let us turn to the issue of whether RIK can provide a benefit to our less fortunate citizens on a cold winter's night or a hot summer's day, like today.

[The prepared statement of Mrs. Cubin follows:]

Statement of The Honorable Barbara Cubin, Chairman, Subcommittee on Energy and Mineral Resources

This hearing will continue the Subcommittee's inquiry on issues relevant to energy supply for our Nation from public lands and the outer continental shelf. But we aren't today to decry the lack of access to potential reservoirs of oil and gas, or seams of coal, or geothermal resources.

Nor are we here today to ponder ways to get those energy reserves into production and thence to consumers more quickly than the current regulatory regime has allowed.

Rather, the topic for today's discussion is about whether the Federal Government ought to consider greater use of in-kind collections for oil and gas royalties owed on producing leases.

The Subcommittee has a history over the last several Congresses of debating the knotty problem of valuing oil and gas, for royalty purposes, in those instances when there is no arm's-length transaction at the wellhead. Royalty-in-kind, or R–I–K, is simply the exercise by the Secretary of the Interior of her existing authority to demand that a Federal lessee surrender to the government his or her royalty obligation not in a cash payment but rather as a fraction of the oil and gas volume produced.

In this manner, the morass of calculating the wellhead value of the commodity from a downstream price with a net-back formula for processing, transportation, and marketing deductions is eliminated. Auditing of the volume of oil and gas produced must still occur, of course, but this must happen with in-value royalty payments, too, and it amounts to checking the flow meters and seals against tampering - a far easier job than calculating value.

But, what happens then? The Secretary must dispose of these volumes in some manner. In the Wyoming crude oil pilot MMS has aggregated its royalty volumes (and those of State leases as well) and bid them out at semi-annual auctions. And this appears to have been a success in terms of demonstrating an ability to receive an "uplift" for the feds and the State of Wyoming compared to those leases which did not participate in the R–I–K pilot.

On the outer continental shelf (OCS) of the Gulf of Mexico, natural gas royalties have been targeted for in-kind pilot programs. As I have noted in previous hearings, MMS has transferred gas to the General Services Administration which has used it to heat Federal facilities - including the Longworth House Office Building in which we sit.

This is fine as far as it goes, but in what other ways might R–I–K provide flexibility to fill a governmental need?

Well, President Bush's National Energy Policy report recommends that the Secretary of the Interior work with the Secretary of Health & Human Services to draft legislation to bolster the low income home energy assistance program, or LIHEAP, through the dedication of oil and gas royalties. While this could be done with royalty dollars rather than royalty gas molecules, is there a reason to explore the latter approach?

Could a pilot program be established to test the benefits of directing Federal royalty natural gas volumes to a utility with experience in delivering energy to low-income households? If so, would OCS leases be the better choice to pilot or would onshore public lands leases? These are several questions we shall pose to our witnesses today to begin to put flesh onto the bones of the President's recommendation.

Lastly, I'd like to thank all of our witnesses for coming to educate us on this issue. The R–I–K idea has engendered passionate debate in the past about whether the oil & gas industry is trying to escape its proper obligation to pay a royalty based

upon a fair market value of the production. I believe that demagoging the industry as "cheats" is unproductive. Yes, large sums have been proffered by companies in settlements of lawsuits and a recent judgment in an Alabama court levied a huge award against one major oil company. But a jury in California a few years ago rebuffed claims that this same company had cheated on its state lease obligations.

One point should be obvious - had the Federal lessees paid these disputed royalties in-kind, the U.S. taxpayer would have been the immediate beneficiary because there would have been no delay in collecting the proper value. My position continues to be that each and every lessee is obliged to pay every penny of royalty owed in-cash or in-kind. No more and no less.

Within this context let us now turn to the issue of whether R–I–K can provide a benefit to our less fortunate citizens on a cold winter's night, or a hot summer's day.

Mrs. CUBIN. Since the Ranking Member is not here, I would be happy to recognize Mr. Inslee, if he would like to make an opening statement.

Mr. INSLEE. I will defer, Madam Chair. Thank you very much.

Mrs. CUBIN. I would like to introduce the first panel of witnesses and welcome them and thank them very much for being here with us today. Mr. M. Brian McMahon, McMahon and Spiegel; Mr. L. Poe Leggette, Fulbright and Jaworski, on behalf of API, IPAA, IPAMS, EPC, and USOGA.

The Chair now recognizes Mr. McMahon. I would like to remind you that your verbal testimony is limited to 5 minutes, but your entire testimony will be put in the record, and point the timing lights out to you.

STATEMENT OF M. BRIAN McMAHON, McMAHON AND SPIEGEL

Mr. MCMAHON. Thank you, Madam Chairman. I would like to thank you for inviting me to appear today to this hearing, and I would like to thank specifically Carolyn Maloney, Representative from New York, who personally invited me to talk at this hearing Friday afternoon.

In May 1998, I appeared before—

Mrs. CUBIN. Well, that was quick work and good work to get here.

Mr. MCMAHON. I got little sleep. In May 1998, I appeared before this Subcommittee to support MMS's efforts to adopt new valuation regulations for Federal royalty oil. At that time, we discussed the use of RIK sales. These are important issues for California. We have a large amount of Federal oil production in California and California's share of royalties goes directly to support its educational system.

California is concerned that the recent Wyoming RIK experience not be misinterpreted and used to justify unwise or costly RIK policies. As we pointed out in 1998, California has decades of experience in conducting RIK sales. We made the following points then in 1998 and we make them today.

First, Long Beach and California have been conducting royalty in-kind sales since the early 1970's.

Second, RIK sales achieve prices consistently higher than posted prices for California crudes.

Third, major oil companies, with rare exceptions, will not bid on RIK sales. The reason is that if they bid higher than their posted prices, they would undermine their posted prices. They use posted

prices as the basis of their royalty obligations for non-Federal oil and for many of their purchases of crude oil from producers and non-working interest owners.

Fourth, although RIK sales prices are consistently above posted prices, they are consistently below fair market value. We noted then and note now that the price of Alaska North Slope crude oil, ANS crude oil, sold in Long Beach is consistently above the royalty in-kind's prices that we receive in California. Attached to my written testimony, you will see a bar chart which compares posted prices, RIK sales in California, and ANS prices as quoted in Long Beach.

For these reasons, we supported MMS's efforts to base Federal royalties on readily available and competitive market prices, such as the spot price of ANS on the West Coast and the reported spot market prices for West Texas sour crude and West Texas intermediate crude.

The observations we made before the Committee 3 years ago about Long Beach's and California's RIK sales are still true today. Major oil companies, with rare exception, still do not bid on RIK sales, but when we do get RIK sales, non-majors bid on RIK sales and their prices are higher than postings.

One preliminary observation: MMS published their new regulations on April 15 of last year and they were to go into effect June 1 of the year 2000. MMS, as far as I know, has no reliable data on the prices they have received under the new regulations. I am not faulting MMS for doing this, but when they did their study of the Wyoming RIK sales, they did not compare the prices received under those sales with the prices they are to receive under the new regulations. There is no reason to ignore the impact of the new regulations, even though we still do not have any results yet. Much less is there any reason to abandon the new regulations in favor of an all-out RIK program on the basis of this pilot study.

Let me look now to the Wyoming study itself. As shown in the report that I have prepared and attached to my testimony, its striking feature is that it is consistent with California and Long Beach's experience. First, only 15 companies ever bothered to submit comments. Only one of those, Exxon, was a major oil company. Only seven companies were winning bidders and none of them was a major oil company. Most of them were marketers or brokers, not refiners, which suggests that these firms would be reselling the oil to refiners at even higher prices.

Second, as in the California experience, the accepted bids were higher than the prices posted by the major oil companies.

And third, as discussed below, the RIK sales prices were lower than market prices. We are going to use Canadian crude oil prices to measure the effectiveness of the RIK sales in Wyoming.

Fourth, the sales constituted 1.6 million barrels over an 18-month period, and that represents less than 1 percent of the total crude production of the Rocky Mountain area.

I guess I am out of time already?

Mrs. CUBIN. You are out of time, if you could just sum it up.

Mr. MCMAHON. Okay. What we did, in brief, Madam Chairman, was we compared Canadian crude prices, we adjusted for transportation to Wyoming, and as three charts show that are attached in

a study we commissioned on the RIK sales in Wyoming, they show that in all cases, the prices that—we will call this market prices for Canadian crude—are higher than the RIK sales prices.

That does not mean that we believe that MMS did not conduct the sales correctly. We approve of the way MMS conducted the RIK sales. But what this shows is that unless major oil companies are willing to participate in RIK sales, that is, bid on oil and bid prices higher than their postings, you are going to continuously find, even in the future, that the prices received in RIK sales are less than true market prices. That is why we recommend that the MMS new regulations, which do depend on market prices, are continually used in the future.

I think at some appropriate time, when MMS gets more data on the new regulations and how the costs of the new regulations compare with the RIK sales and the prices received under the new regulations, then I think we are in a more appropriate position to be determining the effectiveness of the RIK program. Thank you very much.

Mrs. CUBIN. Thank you, Mr. McMahon.

[The prepared statement of Mr. McMahon follows:]

Statement of M. Brian McMahon, for the City of Long Beach as Trustee for the State of California

Madam Chairman and members of the Subcommittee:

Thank you for your invitation to appear today to testify in this hearing on the collection and disposition of Federal oil and gas royalties taken in kind.

Introduction

In May 1998, I appeared before this Subcommittee to support MMS's effort to adopt new valuation regulations for Federal royalty oil. At that time, we discussed the use of royalty-in-kind (RIK) sales. These are important issues for California. We have a large amount of Federal oil production in California, and California's share of royalties goes directly to support its educational system. California is concerned that the recent Wyoming RIK experience not be misinterpreted and used to justify unwise and costly RIK policies.

As we pointed out in 1998, California has decades of experience in conducting RIK sales. The points we made then are still valid today:

- Long Beach and California have been conducting royalty-in-kind sales since the early 1970's.
- RIK sales achieve prices consistently higher than posted prices.
- Major oil companies, with rare exceptions, will not bid on RIK sales. The reason is that if they bid prices higher than posted prices, they would undermine their posted prices. They use posted prices as the basis for their royalty (non-Federal) obligations, and for many of their purchases of crude oil from producers and non-working interest owners.
- Although RIK sales prices are consistently above posted prices, they are consistently below fair market values. We noted that Alaska North Slope (ANS) crude prices in Long Beach are consistently above the RIK prices in sales by Long Beach and California, as shown by the attached bar chart.

For these reasons, we supported MMS's efforts to base Federal royalties on readily available and competitive market prices, such as the spot price of ANS on the West Coast and the reported spot market prices for West Texas sour crude and West Texas Intermediate crude.

The observations we made before this subcommittee three years ago about Long Beach and California's RIK sales are still true today: major oil companies still do not bid and RIK sales prices continue to be higher than posted prices, but lower than market values.

One final preliminary observation must be made: MMS published the new pricing regulations on March 15, 2000 to go into effect on June 1, 2000. Thus, MMS does not yet have any reliable data concerning the amount of royalties collected under the new regulations. MMS has not been able to compare the prices received in RIK sales of Wyoming crude oil with the prices they receive under the new regulations.

Nonetheless, that is no reason to ignore the impact of these regulations in evaluating a pilot RIK program. Much less is there any reason to abandon the new regulations in favor of an all out RIK program on the basis of a very small pilot study.

The MMS Wyoming Study

This brings us to the Wyoming study itself. As shown by the attached report, its most striking feature is that it is consistent with Long Beach's and California's experiences in RIK sales. First, as to participants, only 15 companies ever bothered to submit comments on the proposed program and only one, Exxon, was a major oil company. Only seven companies were winning bidders. None of the winning bidders was a major oil company. Most winning bidders were marketers or brokers, not refiners, which suggests that these firms could resell the oil to refiners at even higher prices.

Second, as in the California experience, the accepted bids were higher than the prices posted by the major companies.

Third, as discussed below, the RIK sales prices were lower than market prices.

Fourth, these sales of 1.6 million barrels over an 18 month period represent less than 1% of the total crude oil production in the Rocky Mountain area.

Canadian Crude Oils are a proper Benchmark to Evaluate the RIK Prices

Contrary to MMS claims, Canadian crude prices are the appropriate standards for evaluating the Wyoming RIK program. The Rocky Mountain area is a crude deficit area, i.e., it produces less crude oil than it refines. Canadian crude oils are the marginal supply for refineries in the Rocky Mountain area. Canadian crude oils are refined in Colorado, Wyoming, Montana and Utah and constitute about one third of the crude oil refined in the Rocky Mountain states. Canadian crude oil is an appropriate pricing benchmark for the Rocky Mountain area.

The RIK Prices are below Market Value

We compared spot prices for both sweet and sour Canadian crude oils that are shipped into the United States with the three Wyoming RIK crude types. The RIK prices for Wyoming sweet crude were compared with the spot price of Edmonton Par crude (a sweet crude) after adjustment for transportation into Wyoming. See Figure 1 of the study by our consultant, which shows that the spot prices of Edmonton Par crude were significantly higher than the RIK prices for the relevant time period. The difference was $2 to $3 per barrel. Put another way, the RIK prices were $2 to $3 per barrel below market value.

The RIK prices for Wyoming General Sour crude were compared with the spot prices for Canadian Bow River Crude oil (a sour crude oil). (See Figure 2). In the early months of the pilot program, the Canadian Bow River spot price exceeded the RIK price for Wyoming General sour crude by as much as $4.50 a barrel, although in the last five months of the program, the prices fell much closer in line.

We also compared the RIK prices for Wyoming Asphaltic crude with the spot prices for Canadian Bow River crude (see Figure 3). The RIK price was considerably below the Canadian crude price during the first pilot sale and then was not as much below the Canadian crude price in the other two pilot sales. RIK prices for Asphaltic crude reached near parity with the spot prices of Canadian Bow River crude oil in the second half of the third sale.

The fact that Canadian crude oils were generally priced above the RIK pilot prices is evidence that the RIK sales prices usually did not equate to market value.

MMS was wrong to reject Canadian Crude Oils as Benchmarks

MMS alluded to three reasons why Canadian crude oils should not be used as a benchmark for the RIK sales prices. First, not all Wyoming crude oils compete with Canadian crude oil at Billings (Montana). Second, Canadian crude production is less mature than Wyoming crude production. Third, Canadian crude is transported to both Midwest refineries and Rocky Mountain refineries. None of these is a valid reason to reject Canadian crude oils as benchmarks for RIK sales of Wyoming crude oils. None of these considerations is sufficient to reject Canadian crude as a benchmark with which to compare the Wyoming RIK prices.

First, whether Canadian crude oils compete with Wyoming crude oils at Billings is irrelevant. They do compete with Wyoming crude oils generally in the Rocky Mountain area. Second the fact that Canadian crude oil production is less "mature" than Wyoming crude oil production is similarly irrelevant. Presumably, MMS means that crude oil is cheaper to produce in less mature areas than in mature areas. Although that fact may be important to the profits of crude oil producers in both areas, that is no reason why it should have anything to do with how much refiners should be willing to pay for crude oils. Therefore, the maturity of crude oil producing areas does not affect the market values of crude oils.

Finally, both Canadian crude oils and Rocky Mountain crude oils are refined in both the Rocky Mountain area and the Midwest. These crudes compete with one another in both areas.

Other alleged Benefits of RIK Sales

MMS admits that, because it is still developing its processes for managing RIK, it is unable to document cost savings at this time. Just as the costs of the RIK program are uncertain so are the costs of using the new MMS valuation regulations. In analyzing the possible benefits of the RIK program, MMS has compared the RIK prices with posted prices and not with the prices established by the new valuation regulations. The proper comparison is with the prices established by the new valuation regulations. So, too, in documenting any cost savings achieved by RIK sales, the cost of the RIK program should be compared to the cost of implementing the new valuation regulations. Those regulations, like the RIK program, are designed to reduce the costs of auditing.

In short, because the costs of auditing under the new MMS valuation regulations are uncertain at this time, no legitimate estimate of any cost savings using RIK sales can be made at this time.

Congress should not take money from the states

The probable losses from the Wyoming pilot underscore that Interior needs to experiment and evaluate the pros and cons of an RIK program further before Congress begins legislating. The need for legislation is, indeed, doubtful. The right to take in kind exists under current law. The respective obligations of the lessee and lessor are set out in the lease and in long held interpretations of leases. Neither the government nor industry has demonstrated a need for an additional authority to operate an RIK program. Moreover, other than speculation, no evidence has been offered that the additional authority requested will result in enhancing, rather than decreasing, royalty revenues to the public beneficiaries. It is noteworthy that the former Chairman of this Committee exempted his own State of Alaska from the RIK legislation then under consideration.

Under current law, states receive a percentage of the United States' "royalty interest." A royalty interest is a cost free interest. It is unlike, for example, a working interest, under which the owner of that interest shares in the costs of exploring, developing and operating the lease. The cost of those obligations that a lessee is required to perform are not deductible from a royalty interest.

The oil industry, however, seeks to allow Interior to use royalty revenues to pay for performing certain services—services that are not deductible from the United States' interest when royalties are paid in value.

Clearly, industry is supporting this added authority as an adjunct to its claims that Federal lessees are not required to pay for these types of costs. Their assertion of a need for Interior to have funds to pay "downstream" costs is but a euphemism for post-production and marketing costs. Their claims for deducting those costs from royalties, however, were rejected repeatedly during the lengthy rulemaking leading to the 1988 regulations, and during the more recent rulemaking on the new oil rules. Interestingly, industry prohibits deducting those same type of costs when it is the royalty owner.

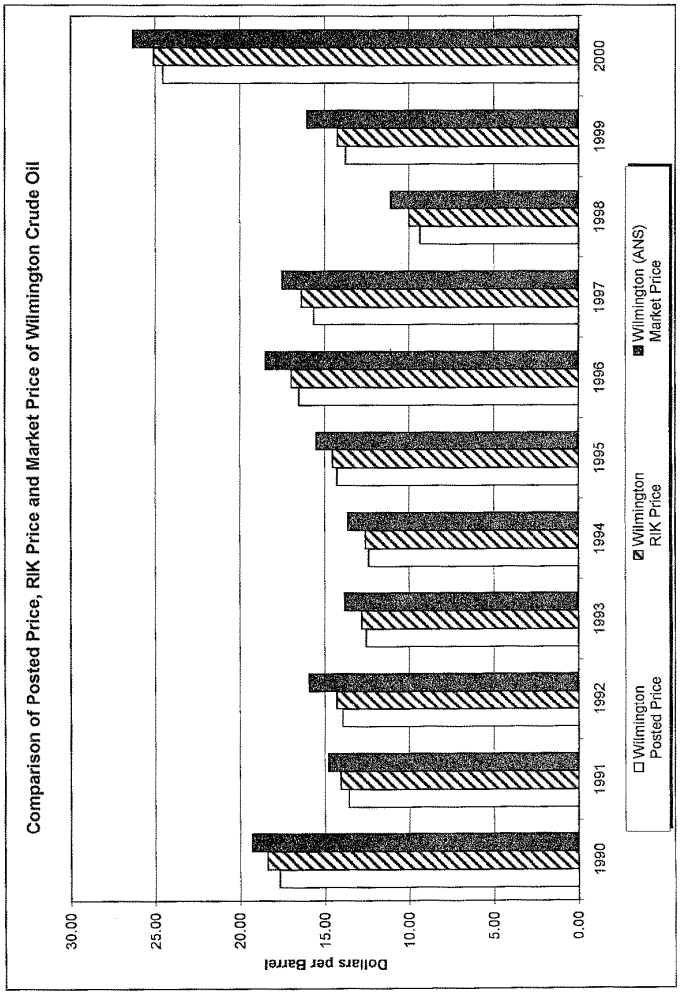
The oil industry advocates allowing Interior to use royalty revenues to pay for such matters as the hiring of independent brokers or marketers to sell production taken in kind. Let's be honest: if the government feels that it is inadequate to the task of marketing—that privatization will be of assistance—it should continue to take royalty in value. Taking royalty in value is the essence of "privatization". Moreover, such "privatization" can only reduce the "royalty interests" of states like Wyoming and California by forcing them to assume costs that currently do not reduce their royalty revenues.

Last year, Congress finally passed legislation to end the Net Receipts Sharing program, under which the costs of Interior's administration of the mineral leasing laws were deducted from the states' share of royalties. As the Chair will surely recall, the Net Receipts Sharing program resulted in substantial disputes between the states and Interior because the Federal Government could not justify and account for its costs. Indeed, Wyoming was at the forefront of the Net Receipts sharing battle. The authority that industry seeks for Interior is simply Net Receipts Sharing in a different form.

If Congress wants the government to be in the oil business, it should appropriate the money to do so through the annual appropriations process, where its performance can be evaluated and budgeted on a yearly basis. What it should not do, however, is transform the very nature of the public's royalty interest into a working interest through the guise of making the in-kind program "permanent." If Congress

wants Interior to stand in the shoes of a lessee, without the express consent of the royalty beneficiaries, the Federal Government should assume those costs that lessees assume today, leaving the states' and the public's cost free royalty interest intact.

I will be happy to answer any questions the Committee may have.



Sources: Texaco and Equiva Posted Price Bulletins, Platt's, Price of RIK Sales by City of Long Beach and State of California
Market value based on ANS spot price in Long Beach adjusted for gravity using the CA posted price gravity differential.

MEMORANDUM

April 24, 2001

TO: Report to the City of Long Beach, Trustee for State of California

FROM: Innovation & Information Consultants, Inc.

SUBJ: MMS Report in RIK Pilot Program in Wyoming

At your request we have reviewed the draft MMS report, "Wyoming Oil Royalty in Kind Pilot" to determine whether the claims made by MMS that this program has been highly successful are warranted and whether it could be used as a justification for extending an RIK program to California.

Based on our review of the report and certain other data, we have come to the following conclusions:

- The RIK sales appear to have generated bids and prices that were above posted prices and may have in fact reflected prices consistent with those reported for royalty and severance tax purposes. Nevertheless, these royalty and tax values were computed under the old royalty rule that MMS itself has recognized did not necessarily lead to market value, and thus one cannot conclude based on this evidence that the RIK sales prices equate to market value.

- The evidence indicates that these RIK sales did not result in the realization of market value. Of critical importance is the fact that the criteria applied by MMS in this study did NOT stipulate that RIK sales prices result in market value, but only result in prices as high or higher than royalty in value prices. A more appropriate criterion would be to evaluate the RIK prices against a measure of market value as we do in this memo.

- Much of the analysis contained in the MMS report has not been validated, however, MMS appears to be using the results of this study to expand the program in Wyoming and perhaps elsewhere. Further data and study are required, but at this point we do not see this study or the results of the RIK pilot as justification for expansion of the program to other areas in the country.

Summary of the MMS Report

MMS has evaluated the first three sets of sales from the Wyoming RIK pilot program covering the period October 1998 through March 2000. Each sale covered six months and included various leases in Wyoming that produce one of three types of crude oil: Sweet, Sour or Asphaltic Sour. Total volumes sold in each sale ranged from 2,516 barrels per day (B/D) in the first sale to 3,425 B/D in the second sale and 3,249 B/D in the third sale. A maximum of seven companies bid on these sales and four were winning bidders. Not all leases offered were sold, although by the third sale, trucked properties were removed from consideration, and 100 percent of the leases offered for sale received bids considered high enough to permit a sale.

MMS observes in its report that this time frame was one of extreme crude oil price volatility with general (WTI) crude oil prices ranging from $11 to $31 per barrel. MMS claims this volatility affects producers' decisions to explore and expand (or cut back) on production, but it is not clear how it would affect the prices received in an RIK program vs. a value-based program.

MMS applies three criteria to its evaluation of the pilot program and based on these criteria concludes that the program has been a success. The three criteria are:

1. Simplicity, accuracy, certainty for lessees and government;
2. Revenue neutral or better for government; and
3. Reduced administrative burden for lessees and government.

MMS states that RIK has "reduced the period of value uncertainty . . . from years to months, royalty receipts exceeded comparable in value royalties by approximately $810,000, and RIK streamlined processes . . . established a foundation for administrative savings." (p. 2)

We do not necessarily agree with the benchmarks used to evaluate these criteria, particularly with respect to the second criteria relating to value. The appropriate criteria should be whether the RIK program produces prices that reflect market value, not how it compares to existing prices. Existing prices, i.e., in-value may also not reflect market value[1] and so the conclusion that the RIK prices exceeded the in-value prices by $810,000 (which is less than $.50 per barrel) is not necessarily a very compelling justification for the program. Also MMS notes that some of these properties were subject to reduced royalties (stripper, heavy oil), and therefore comparison to existing royalty values may be misleading.[2]

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[1] This was prior to the implementation of the new royalty rule and thus it is highly likely that royalty in-value did not equate to market value.

[2] It is likely that in-value royalty or severance tax prices were tied to Wyoming postings which do not reflect market value, and the mere fact that the RIK prices exceeded these prices only validates the conclusion that postings do not reflect market value, not that RIK prices achieved market value.

Another relevant point raised in the MMS report is the fact that there were a relatively limited number of bidders for this crude oil. The maximum number of bidders was seven for the first and third sale, and six for the second sale, and we do not know whether all seven bid on each type of crude oil. Although either 4 or 5 companies did submit winning bids, this may be insufficient to generate prices reflective of market value. Recall the sell-offs for Long Beach's oil that attracted a similar number of bidders, but typically no majors. Much the same can be said for these sales. Not a single integrated major was a winning bidder, and those that did submit winning bids were primarily traders and brokers, i.e., companies that would resell the oil at a profit.

With regard to the other two criteria, we agree that an RIK program will likely establish values sooner in time, although under the new royalty rules that may not always be the case. However, if the RIK values are no higher than what is established under an in-value program, then what is the difference in knowing sooner what the value is? Finally, MMS presents a series of calculations intended to show that the RIK pilot will likely reduce MMS' administrative costs as well as lessees' costs. These calculations, however, acknowledge that they are preliminary and cannot be fully verified until a permanent RIK program is established. We see that as an inadequate basis for then proposing a permanent program. Nevertheless, there do appear to be some administrative savings involved.

Analysis of Values Received in RIK Pilot Sales

The MMS RIK report does not provide the actual average sales prices received for each type of Wyoming crude oil, but rather only presents a series of graphs from which one may estimate the sales prices. We have attempted to make such an inference, but we can only be confident that the actual prices received are accurate to within plus or minus $0.50 per barrel. Nevertheless, we have made some additional comparisons with the RIK prices to determine their reasonableness. We obviously would like the actual data on sales prices, as well as the data on in-value prices and the basis for the severance tax payments. These data have been requested, but we are unsure when or if we will receive such data.

It is important to put these sales into perspective. Total volume sold was 1.6 million barrels over an 18-month period, or about 3,000 barrels per day. Total Rocky Mountain production was about 525,000 barrels per day in 1999, so that these sales represented less than 1 percent of daily production in the area.

MMS notes that this was a period of extreme price volatility and that the Rocky Mountain area is a complex market area. We agree with both of these facts, but that does not mean that analysis of the prices received cannot be performed. MMS examines and discounts comparisons of RIK prices with prices for Wyoming Sweet spot, WTI, WTS and Canadian crude oils. We compared the Wyoming Sweet spot price, adjusted for transportation and gravity, with the RIK sweet prices and found that the prices were generally were in line with one another. MMS discounts the relevance of the Wyoming Sweet spot price indicating that the market was thin and these spot prices were not

necessarily reliable market values. No spot sour prices are quoted for Rocky Mountain crude oils so we then looked to the other crude oil that competes in this market area.

MMS claims Canadian crude oils are not appropriate benchmarks even though (unlike WTI or WTS) Canadian crude competes directly with Wyoming and Rocky Mountain crude oils. MMS states that not all Wyoming crude competes with Canadian crude at Billings, Canadian crude is less "mature" and considerable Canadian crude also flows to the Midwest. Based on these assertions, MMS discounts any price comparisons between Canadian crudes and the RIK prices, stating that "Canadian benchmarks are not a reliable price for purposes of comparison with the values received under the RIK pilot" (p. 12). We believe that MMS's logic is faulty.

The Rocky Mountain area is a crude deficit area and operates in a manner similar to the West Coast. Canadian crude oil is the marginal supply for refineries in the Rocky Mountain area and represents about 33 percent of the crude oil refined in PAD IV during 1999 and 2000.[3] Canadian crude oil functions in a similar manner to ANS on the West Coast. It serves the Rocky Mountain market as the marginal supply (as ANS has served the West Coast market), and as with ANS, also serves other markets including the Midwest (as ANS served the Gulf market). In addition, ANS was a less "mature" production reservoir than California crude, just as MMS claims is the case for Canadian crude compared to Wyoming crude. Therefore, Canadian crude should establish the pricing benchmark in the Rocky Mountain area just as ANS has for years on the West Coast.

A comparison of Canadian crude oil prices with RIK prices reveals a very different story than what the MMS would believe. Spot prices for both sweet and sour Canadian crude oils shipped into the U.S. were compared with the three Wyoming RIK streams. Figure 1 compares the estimated RIK prices for Wyoming Sweet with the Edmonton Par crude (sweet) adjusted for transportation into Wyoming. This figure clearly shows that the Canadian crude price was significantly higher than the RIK prices throughout the relevant time frame when sweet crude oils were sold under the RIK pilot. The differences were on the order of $2-3 per barrel.

Figure 2 presents a similar comparison between the average RIK price for Wyoming General Sour and the spot price for Canadian Bow River (sour) adjusted for gravity and transportation. In the early months of the pilot, the Canadian crude price exceeded the RIK pilot by as much as $4.50 per barrel, although over the last five months of the pilot program, the prices fell much closer into line. A similar trend in seen for Wyoming Asphaltic crude in Figure 3, which shows the RIK price was considerably below the Canadian price during the first pilot sale, and then lagged below the Canadian price by considerably less in the other two pilot sales, reaching near parity in the second half of the last sale.

[3] Canadian crude was refined in all Rocky Mountain states including Utah which is logistically the farthest point away from Canada. It was also refined in refineries in Colorado, Wyoming, and Montana. Further, some Wyoming and Montana crude oils do move east to the Midwest and compete there with Canadian crudes in that market as well.

These price comparisons certainly call into question whether MMS received market value for its RIK pilot sales, even if the prices were equal to or greater than postings or in-value prices. We certainly would expect the prices to exceed postings, particularly the companies' postings used by MMS which were typically lower tier posters. Nevertheless, there is a real question as to whether the RIK pilot sales achieved prices that equated to market value. The Canadian crude spot prices provide the best measure of market value during this time frame as Canadian crude was the marginal supply and competed directly with Wyoming and other Rocky Mountain crude oils for refiners' demand in that area. The fact that Canadian crude oils were generally priced above the RIK pilot prices is evidence that the RIK sales prices did not equate to market value.

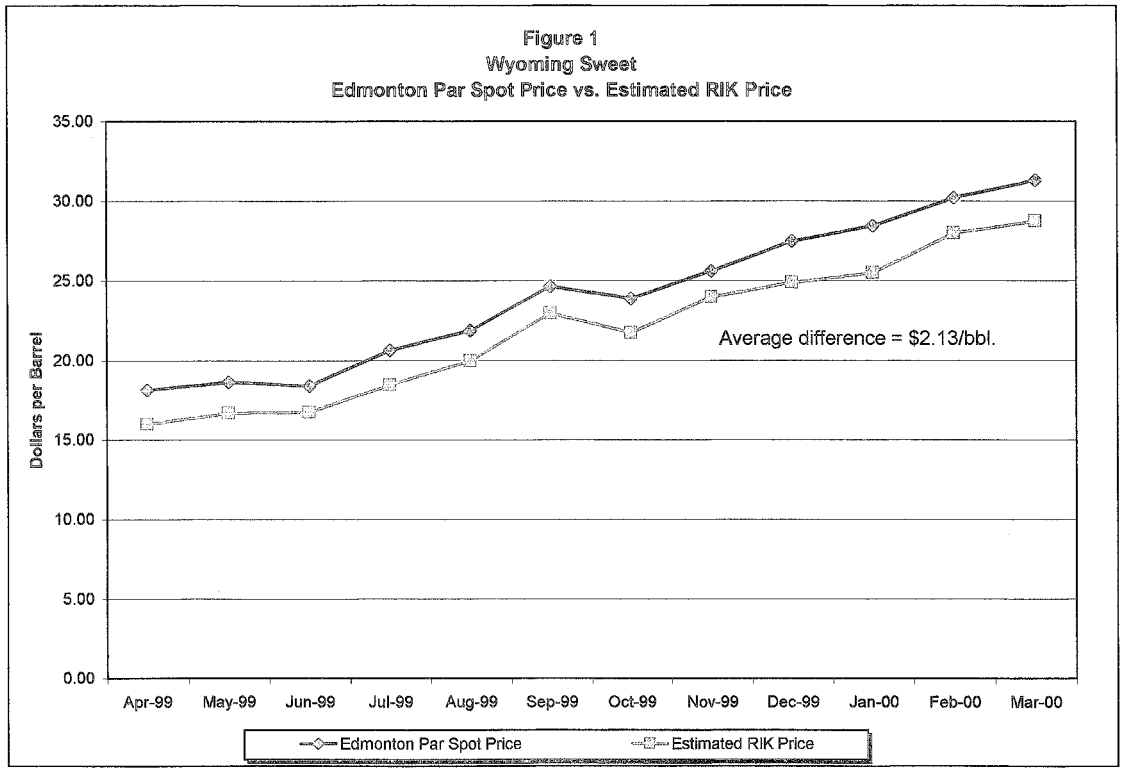
Other Alleged Benefits of the RIK Program

MMS claims that there were other benefits from the RIK program, including early payment (5 days), cost of administration, and cost of compliance. We have not evaluated the administrative or compliance cost aspects, although we suspect the administrative costs are not much different from an in-value program. The calculations made by MMS, however, are preliminary and cannot be fully verified until a permanent RIK program is established. We see that as an inadequate basis for proposing a permanent program.

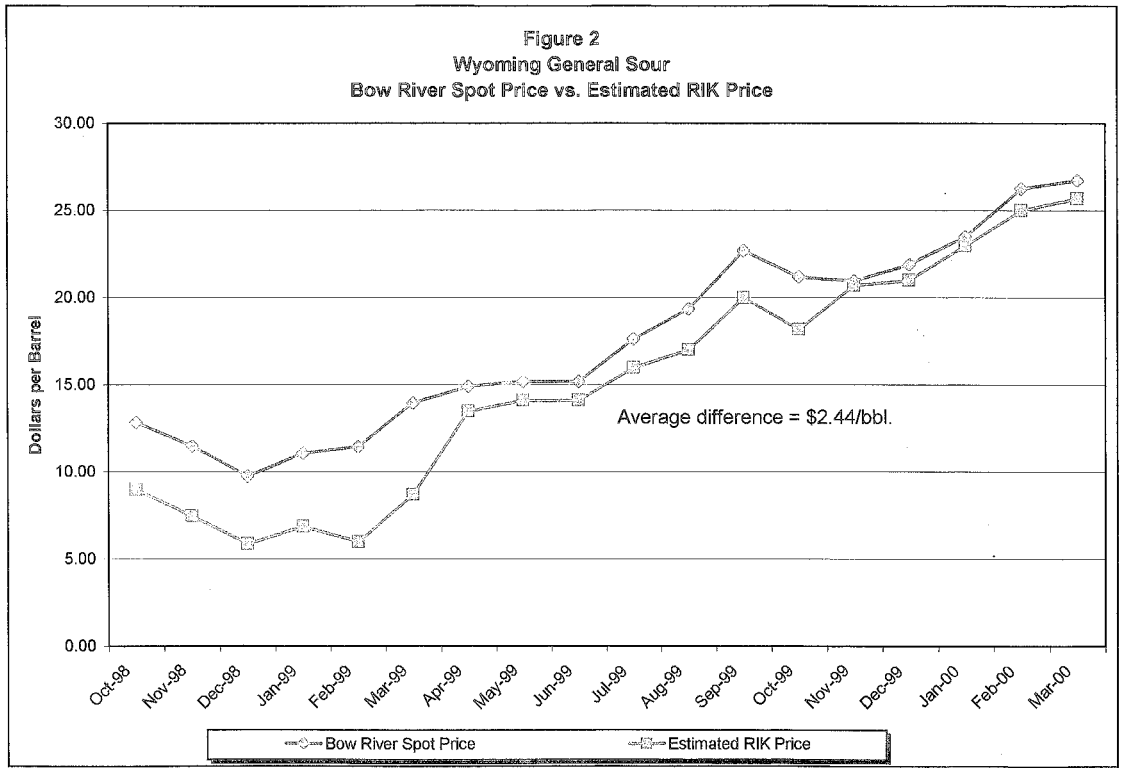
Although the RIK program may involve lower compliance (audit) costs, that does not mean the program might not be "gamed" by its participants, particularly given the limited number of bidders. Indeed, the ability to monitor and audit RIK sales is more limited than under an in-value royalty program that over the long run may be harmful to the government's interests in monitoring industry trends. Again the experience of Long Beach with its successful annual audits under the Contractor's Agreement helped develop the detailed knowledge required to understand the widespread nature of underpayments in California.

The early payment "benefit" amounts to a penny per barrel and need not be unique to the RIK program. If MMS desired earlier payment of in-value royalties, it could simply mandate such, and therefore we see no real added value here.

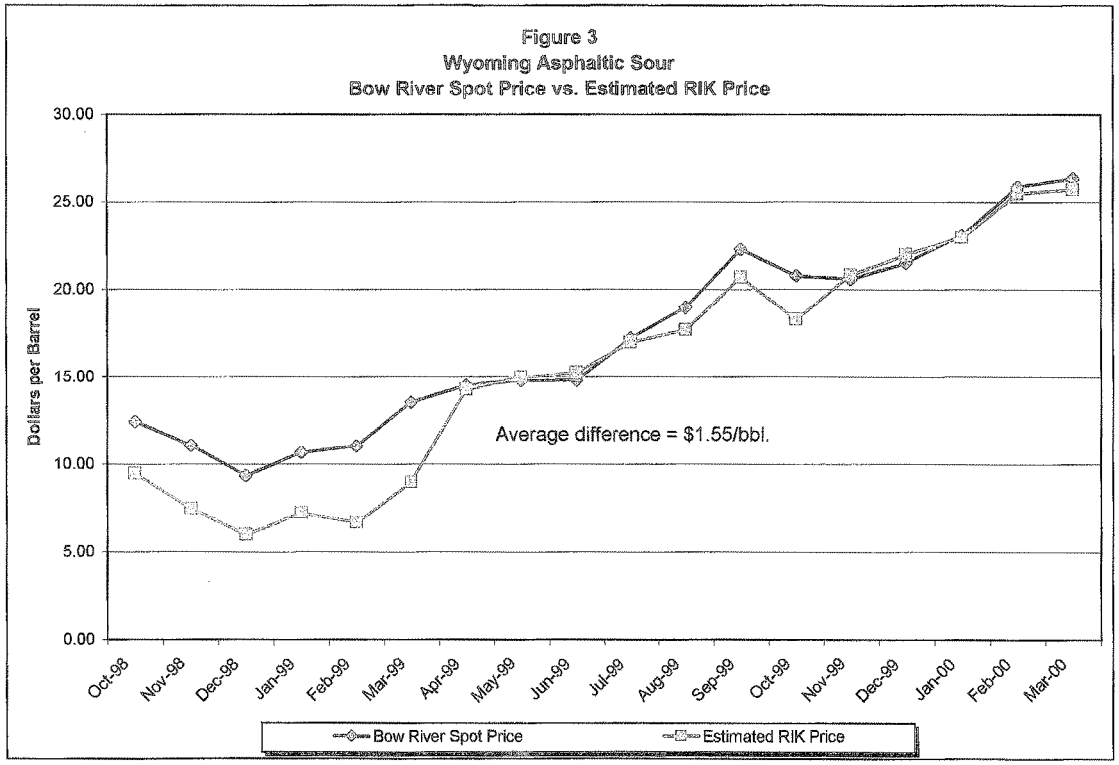
We believe that it is too soon to use the results of the Wyoming RIK pilot as a basis for more widespread application of an RIK program, particularly as it might be applied in California. MMS has broadened the RIK program in Wyoming so that it now involves upwards of 7,000 B/D of production. Further analysis of the results of these sales (April 2000-September 2001) is necessary before proceeding with the expansion of this program to other areas.



Sources: Platt's, MMS Wyoming Oil Royalty in Kind Pilot, Express Pipeline tariffs, Interprovincial Pipeline tariffs
Par crude adjusted to 40 degrees and $1.45 for transportation from Edmonton to Guernsey



Source: Platt's, MMS Wyoming Oil Royalty in Kind Pilot, Express Pipeline tariffs and Interprovincial Pipeline tariffs
Bow River adjusted to 23.7 degrees and $1.47 for transportation from Hardisty to Guernsey



Sources: Platt's, MMS Wyoming Oil Royalty in Kind Pilot, Express Pipeline tariffs and Interprovincial Pipeline tariffs
Bow River spot price adjusted to 20.3 degrees and $1.60 transportation from Hardisty to Guernsey

Mrs. CUBIN. The Chair now recognizes Mr. Leggette.

STATEMENT OF L. POE LEGGETTE, FULBRIGHT AND JAWORSKI, ON BEHALF OF AMERICAN PETROLEUM INSTITUTE (API), INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA (IPAA), INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES (IPAMS), DOMESTIC PETROLEUM COUNCIL (DPC), AND U.S. OIL AND GAS ASSOCIATION (USOGA)

Mr. LEGGETTE. Madam Chairman, Mr. McMahon went over by a minute and 20 seconds, so I will make up for it by going under by a minute and 20 seconds.

Mrs. CUBIN. And we will appreciate that very much.

Mr. LEGGETTE. Madam Chairman, the associations on whose behalf I appear today want to thank you for the leadership that you have shown in prodding the Federal Government into taking more of its royalties in-kind. As the record of this hearing will show, your efforts are beginning to pay off. MMS is beginning to find that it can, at least in many cases, make more money with less administrative expense than it can when taking royalty in-value. It is beginning to find that it can manage RIK with fewer personnel than is needed to manage royalty in-value.

Madam Chairman, you are right to continue to press MMS to pursue RIK. The reason is simple. Members of this Subcommittee know that all claims that RIK is bad financial business for the government boil down to a debate over one of two things, either the so-called duty to market production at no cost to the Federal Government, or a debate over whether comparison of the oil that is being sold, such as Wyoming oil or oil from the San Joaquin Valley in California, can fairly be compared with other oil, such as Alaskan North slope crude oil or Canadian crude oil, with multiple adjustments to try to make it equivalent.

Now, on the duty to market point in particular, if members believe that lessees have such a duty, then they are likely to think that the government will be worse off if it takes royalties in-kind. Let me explain why that position hurts the Treasury.

Even the prior administration agreed that no lessee is required to sell production downstream. It said so repeatedly in legal briefs. If the duty to market does exist, MMS cannot be sure that it will capture the benefit of value added downstream if it relies on royalty in-value. The lessee always has the option of selling at the lease. The only way the government can be sure to gain value added downstream is to take the royalty in-kind and sell it itself.

Furthermore, we have litigated with the government over this so-called duty. So far, we have won. If we continue to win in IPAA v. Armstrong, the government will never get more than the value at the lease if it takes royalty in-value, even when the lessee markets downstream. Again, the only way the government can be sure to gain value added downstream is to take royalty in-kind and sell it itself.

The most important issue today, however, is not the value of gas at the wellhead, it is the high cost of gas at the burner tip, in the homes of low-income families. Using RIK gas to benefit LIHEAP, the Low-Income Housing Program, is a brilliantly creative idea. Some have introduced legislation to take Federal royalty revenues

from royalty in-value and help fund LIHEAP, a good idea, perhaps, but let me suggest a better one. Use RIK. Why? For the reasons that you gave yourself at the start of this hearing.

A unit of gas is a unit of gas. When I produce six units of gas in the Gulf of Mexico, I owe the government one of those units. All reasonable people can agree on that. But people will disagree over whether the unit that I owe the government is worth $3, $3.25, or $4. In short, if Congress funds LIHEAP through royalty in-value, it will import into that program years of controversy over what the value of production really is. If it supports LIHEAP through RIK, it dramatically reduces the controversy. Better yet, as the next panel will explain, it can reduce the administrative costs of running the LIHEAP program itself.

If Congress decides to pursue RIK for LIHEAP, our associations stand ready to help the Committee prepare legislation to make the concept work. The LIHEAP concept is an exciting new use of the RIK program, a program that recent MMS experience shows can equal or exceed the value obtained from royalty in-value, take fewer personnel to administer, and increase the certainty for all stakeholders.

Again, we thank you, Madam Chairman, and all members of this Subcommittee who continue to support a program where everyone wins. Thank you.

Mrs. CUBIN. Thank you, Mr. Leggette.

[The prepared statement of Mr. Leggette follows:]

Statement of L. Poe Leggette, Partner, Fulbright & Jaworski

Introduction

Good afternoon, Madame Chairman and members of the subcommittee. My name is Poe Leggette. I am a partner at the law firm of Fulbright & Jaworski, LLP. I am grateful for the opportunity to appear here before you today on behalf of the American Petroleum Institute (API), the Independent Petroleum Association of America (IPAA), the Independent Petroleum Association of Mountain States (IPAMS), the Domestic Petroleum Council (DPC) and the U.S. Oil and Gas Association (USOGA).

My testimony will discuss the advantages of royalty–In-kind (RIK), for both the industry and the government. We applaud the committee for holding a hearing to explore the potential efficiencies available to the Federal Government and to industry if the use of in-kind royalty collections is broaden beyond current practice, and to compare and contrast this with the more typical practice of in-value collections. The entire oil and gas industry believe RIK provides the government numerous opportunities to creatively provide energy to in-need end-users while at the same time efficiently ensuring that the Country is receiving each royalty molecule of gas or oil due to the government. In fact Madame Chairwoman, it is this very committee that has led the way for encouraging RIK since the 104th Congress. We appreciate your efforts, including the RIK appropriations language contained in fiscal year 2001 Interior Appropriations, which gave MMS limited flexibility to do more with RIK.

For several years, there has been and remains today widespread support for RIK in the oil and gas industry. So much so, in fact, that in 1997 the trade associations mentioned above, which represent substantially all of the U.S. oil and natural gas industry, united to organize a multi-association committee to work in conjunction with the Minerals Management Service (MMS) and other stakeholders to formulate and promote a workable system through which Federal royalties might be taken in-kind.

I am pleased to be able to report to you today that MMS has made great strides in this arena through the establishment and continuing operation of its RIK pilot projects. The industry applauds the MMS RIK management team for the creativity and flexibility it has demonstrated in putting together these RIK pilots. While problems have inevitably arisen, industry views none of these as being intractable so long as the agency maintains its demonstrated commitment to cooperatively searching for the best and most efficient solutions.

Despite the successes of these RIK pilots, industry believes much work remains to be done. The pilots can only go so far, given certain legislative barriers. We encourage Congress to provide MMS the legislative RIK tools needed to fully expand the volumes of oil and gas royalties it takes in kind, it Congress and the Administration deem appropriate, to provide energy to in need consumers.

Complexity of the Royalty In–Value Process

RIK offers the most logical and efficient means of avoiding the kinds of disputes over oil and gas valuation that have arisen in recent years. The markets for oil and gas are extremely volatile, and their rapidly changing nature renders the determination of product value at various points of sale a very complex, labor-intensive exercise which all too often results in protracted, costly disputes. Any set of regulations designed to capture value in such an uncertain atmosphere must of necessity be vague and open to interpretation by the various players in the process. Interpretations lead to disagreements, disagreements to disputes, disputes to litigation.

Capturing volume is a very simple process by comparison. A barrel of oil is a barrel of oil. A cubic foot of gas is a cubic foot of gas. So long as the measuring devices used are accurately calibrated, there is no room for interpretation, and no need to estimate the value of the production. For example, if a lessee in the Gulf of Mexico produces six barrels of oil, he satisfies his royalty obligation by delivering one barrel to the government. Simple as that.

With RIK, the accounting is simplified. There is no need to estimate the value of production. The auditing is simplified; all that needs to be verified is the volume of production and the volume delivered as royalty. Disputes are fewer.

This simplicity of process is the main reason for the industry's support of the RIK process. Lessees have a business need for certainty in the royalty payment process, but simplicity should be appealing to every stakeholder; the lessee, who produces the oil and gas and pays the royalties; the Federal Government, who collects the royalties; and the beneficiaries who share in the royalty revenues, states like Wyoming, New Mexico, Colorado and California.

We urge the Federal Government to take full advantage of RIK and make it the standard method for collecting royalties, with royalty in-value becoming the exception rather than the rule. A permanent RIK program would greatly enhance government flexibility by offering several options for disposing of its royalty share: selling the royalty production on the open market or to small refiners; making available the royalty production for use in government/public facilities; filling the strategic petroleum reserve; or providing cheaper energy to pre-approved low-income families. For example, satisfying low-income heating needs via RIK versus sending royalty payments, ensures that every molecule is delivered in a timely fashion and provides the government and utilities an opportunity to provide further advantage to low income families by participating in the market place.

We were pleased that RIK was referenced in the Administration's National Energy Policy as a way to accommodate the strategic petroleum reserves. Additionally, the National Energy Policy proposes the use of royalty payments for LIHEAP. As you will hear today, by taking this payments in-kind, many benefits will occur to both the government and the recipients under the LIHEAP program.

Need for Legislative Action

The governing mineral leasing statutes already allow the Secretary to take royalties in-kind. The pilot projects thus far conducted by MMS demonstrate that RIK works. However, some enhancements to the current statutory language would make RIK work even better.

It is important to note that the RIK concept had its germination and grew rapidly during the last years of the Clinton Administration. Clinton Administration officials were resistant to the idea at first, but commendably were willing to explore the idea through the conduct of a series of pilot projects. Over time, these pilots evolved and became better tests of RIK as experience was gained. The pilot projects now demonstrate that RIK can increase revenues to the Treasury and reduce administrative costs. The pilot projects also show that the Secretary is handcuffed in some instances by existing statutory language and by budgetary constraints that prevent the department from fully exploiting the concept. MMS and industry joined together last year to endorse language that would have corrected some of these roadblocks, but much of that language was unfortunately struck on the floor of the House.

We urge Congress to work together with the Administration to craft solutions to eliminate or avoid unnecessary obstacles to optimization of an already proven RIK program. . Industry does believe the current statutes provide MMS much flexibility to enter into creative RIK programs, but to eliminate any uncertainty legislative language should:

- Clearly delineate producer and government obligations
- Provide the government use of in-value proceeds to cover any expenses downstream of the lease
- Provide for reports to congress
- Allow disposition to Federal agencies or entities designated by the Federal Government

In closing, let me again thank you for this opportunity to appear before you today on behalf of the industry trade associations

The industry also wishes to commend you, Madame Chairman, and this Committee for all the hard work you and your staff members have put in over the years, encouraging the creation and growth of the Federal RIK program. Working together, this Committee, the Congress, MMS and industry have demonstrated that RIK is a very useful tool to optimize MMS's royalty collection efforts. Working together, we can ensure that RIK ultimately achieves its maximum effectiveness.

I would be happy to answer any questions the committee may have.

Mrs. CUBIN. I will begin the questioning. I would remind the members and have them remind me if I go over that our questioning is limited to 5 minutes.

I wanted to ask you, Mr. McMahon, your testimony seemed to be more about RIK in general than its application to LIHEAP, which is really what the subject of this hearing is. So I would just like to know what your opinion about royalty in-kind being used for LIHEAP, what is your opinion for that?

Mr. MCMAHON. To tell the truth, I have not had a lot of time to think about that, but I will share with you some experiences we have had in California recently.

Mrs. CUBIN. Well—

Mr. MCMAHON. And I am going to tie it in to LIHEAP.

Mrs. CUBIN. Okay, because your testimony focused just really pretty much on RIK in general—realizing you had such a short time to prepare.

Mr. MCMAHON. Right.

Mrs. CUBIN. So please do not think in any way I am being critical about that. But I would really sort of like a broader picture, because the question that I would like to have answered is, is RIK for LIHEAP a reasonable option, especially in times when we are in a situation where we have energy problems? Would gas from the outer continental shelf or from the public lands be better used if we channeled that to a utility to distribute it?

It seems to me common sense that when you eliminate the audits, you eliminate the lawsuits from royalty, or for the value, and you eliminate the middleman, that you could deliver more energy to the houses of poor people if you did that. So if you would just respond to that, that is what I am trying to get at.

Mr. MCMAHON. Sure. But our California experience is this. Where we get gas is from the Gulf Coast area and New Mexico. Let us suppose that the government does have production of gas in that area and we use some of that gas. It has to go through a pipeline which is owned by a company called El Paso. El Paso, as far as I know, does not own the production. So some arrangement would have to be made to go through El Paso pipeline—

Mrs. CUBIN. Sure. There would be transportation costs, right.

Mr. MCMAHON. And more than that. Because there is a constriction in the pipeline now, it is not clear now much of the extra gas can go through. The next step is the utilities in California, like

Southern California Gas Company, PG&E. Again, what obligation do they have to ship Federal gas over their lines?

Mrs. CUBIN. I would think that it would be ludicrous to assume that gas would be coming out of California to take care of this proposal, or at least this idea that we are entertaining. No, California needs everything it has got, so that would not be it.

I would like to ask Mr. Leggette, you have been working, as you said in your statement, on royalty in-kind issues and talking about this issue for a long time. Could you please describe to me the problems that there are with the administration of a royalty in-kind program? And what I am specifically talking about are the accurate volumes being recorded and those kind of things and what you would do to go about making sure that the correct volumes were reported and that the government got its correct share?

Mr. LEGGETTE. For Federal production, production from Federal leases, lessees are required to submit plans to the government for approval in advance of installing their production equipment. The government is entitled to veto those plans or require alterations if it feels it necessary to make sure that oil or gas will be accurately measured. MMS then conducts, or onshore, the Bureau of Land Management, periodic site inspections to check the meters, and companies are required routinely to check the meters and provide the results of those checks to the Federal Government.

Now, this regulatory hand is in addition to the incentive in the private sector between producer and purchaser to make sure that these instruments are working correctly. But it is, compared with determining what royalty value is, it is a relatively simple process.

Mrs. CUBIN. And certainly, it seems that there is room for mischief there, measuring volumes.

Mr. LEGGETTE. Oh, absolutely.

Mrs. CUBIN. But that same mischief is available when you measure the volumes when they are going to be charged in-value, the royalties in-value, because it has to come out of the well and the volume has to be measured correctly and that is when the arguments start. So RIK is not any more vulnerable to this sort of tampering, or mischief, if you will, than royalty in-value, would you agree with that?

Mr. LEGGETTE. That is exactly right.

Mrs. CUBIN. And could you explain to me how you think the duty to market issue would play out under RIK?

Mr. LEGGETTE. Well, it would be addressed because the government would be fulfilling its obligation to market its production and to get the best return it can for the taxpayers, or alternatively, to serve alternate purposes that reduce the cost of government or other government programs, such as heating this building or perhaps benefitting a program like LIHEAP.

Mrs. CUBIN. Or preferably cooling it today.

Mr. LEGGETTE. Point well taken.

[Laughter.]

Mrs. CUBIN. The Chair now recognizes Mr. Inslee.

Mr. INSLEE. Thank you. I may ask some fairly low-level questions here, but I hope you will appreciate this is a relatively new issue, at least to me.

I would ask both gentlemen to comment. As I understand the proposals for universal RIK, its intent is to reduce litigation, reduce uncertainty, and the like. But it would seem to me if we go that route, it is going to set up a whole new level of responsibility for the Federal Government, both as to merchandising, marketing, transporting, storing, insuring, a whole new system of the Federal Government for handling this product as a marketing agent. Is that a fair assessment, and if so, what are the challenges and how would that be done? I just ask both gentlemen to comment on that.

Mr. LEGGETTE. Mr. McMahon yields.

Mr. MCMAHON. For the time being.

Mr. LEGGETTE. For the moment. Yes, he reserves the right to rebut.

There is no reason why the Federal Government would have to create a large new marketing department to make royalties in-kind work. Experience in Alberta, Canada, indicates just the opposite, and I believe, if you were to ask that question of the MMS witnesses coming after me, they would say that the early indication is that they can manage a large volume of Federal production with far fewer people when promoting it in-kind rather than claiming it in-value, and the reason is that the Federal Government, even without the aid of help from outside marketers, enjoys a very important position in the marketplace. It has access to substantial volumes in every field in which there is a Federal lease.

And so companies can come to MMS with creative proposals, unusual transportation arrangements that can beat the market and give the government better value than other producers can get. More importantly, one change that we would hope the Congress would consider would be to allow MMS to contract with the expertise of private marketers to further enhance its position in the market.

Mr. MCMAHON. Let me respond. Right now, as far as we can tell, MMS does not have the qualifications to market crude oil. The option would be, if all the oil is sold in-kind, if you do not want MMS marketing Federal production, then MMS is subject to being passive and let oil companies come in and tell MMS what price they are willing to pay.

Obviously, in my mind, you are going to have to set up a bureaucracy to deal with marketing. Marketing is complicated; not a simple matter, and you simply cannot let oil companies dictate the processes that will be used to market the crude oil. You have to go out and market it aggressively. So I think there is a large cost involved in RIK which is not involved in an intelligent, comprehensive evaluation procedure.

I emphasize again, I think the major issue here is unless you have competition, true competition among major oil companies for RIK sales, you are not going to get competitive prices. We have yet to see that happen, either in Long Beach or California or even in the Wyoming experience. You do not have majors coming in to bid, and if they do not come in and bid, then you are only going to have a small segment of the market that is bidding on the crude oil. So far, we have not had the experience of the major oil companies bidding on RIK sales.

Mr. INSLEE. When you say bid, do you mean bid for purchase from the government?

Mr. MCMAHON. Correct. We have not seen that. In 30 years in California, only one major oil company has ever won a bid, and that is Texaco, and Texaco is about to disappear because it is being purchased by Chevron. Chevron, Mobil, and Exxon, even though they have large presence on the West Coast, have never bid on royalty crude oil, and we do not see any majors in Wyoming bidding on Federal royalty crude oil. What you see are the marketers, the middlemen, and the only sense that that makes is that they are going to resell it at a higher price. I mean, why else would you be a middleman if you did not think you could get a higher price from a refiner?

Now, why do the refiners not go out and bid for royalty crude oil? Because then they would have to turn to their royalty owners and say, well, we did bid this price which is higher than what you are getting for your crude. So you see the conflict they would be in. So they would rather have the middlemen come in, do the bidding, do the dirty work, and then purchase from then, so then they can turn to their royalty owners and say, we did not buy the crude at the lease and so, therefore, we do not have to pay you the higher price. So they are in a conflict situation regarding the royalty in-kind and that is why, as far as we can tell, they will never bid on the royalty in-kind oil.

Mr. INSLEE. Mr. Leggette, do you want to respond to that concern?

Mr. LEGGETTE. Well, in the time remaining, probably the most effective thing I can do is to defer to the answer that the Minerals Management Service people will give you. They have the experience not only with the Wyoming project, but with a gas pilot project in the Gulf of Mexico. My impression is that some very heavy-duty players in the gas market are bidding on those programs, but they have the details.

Mr. INSLEE. Thank you.

Mrs. CUBIN. The Chair now recognizes Mr. Otter.

Mr. OTTER. Thank you very much, Madam Chairman, and gentlemen, I apologize for being late. If I cover some ground that has already been plowed, I sincerely apologize for it.

One of the things that is always of interest to me in a marketplace is what is the next generation going to look like. Perhaps, and I do not know if you are willing to speak for the industry or your segment of that industry, but what I would really like to know is where do we go from where we are today? My question centers to how much of the industry profit today is actually being spent on alternate forms of energy, research and development, alternate forms of drilling and recovery, proving up an oil field, blocking new oil bodies or ore bodies? How much of the industry profit or cash flow is going into the next generation of energy needs?

Mr. LEGGETTE. I will only be able to give you a most general answer. It, of course, varies from company to company, but my impression is that for most companies, it is quite a lot. Many—

Mr. OTTER. What is quite a lot?

Mr. LEGGETTE. Money is going back into looking for new reserves, but also exploring alternative forms of energy. Some of the

majors have established whole new business units that focus on alternative forms of energy. Shell and British Petroleum come prominently to mind, but they are hardly alone. And the independents that IPAA and IPAMS represent are very active in plowing the money that is currently being made in the prevailing price regime back into new exploration, to enhancement of declining fields, to new drilling in existing fields to further enhance the ability to deliver through the existing pipeline infrastructure.

Mr. OTTER. Mr. McMahon?

Mr. MCMAHON. I am really not qualified. I will make two observations, though. One is that the major oil companies are pulling out of California. For example, Chevron turned back some leases they had offshore which were already being developed. They appear to be sending their money overseas because they make higher overseas profits.

The second point is, the L.A. Times reported just this past week, the opposition of the oil companies against the use of ethanol in California as a way of cleaning up the gasoline. So at least on that issue, they appear to be opposed to that kind of alternative energy source. But generally speaking, I am not in a position to answer the question.

Mr. OTTER. Well, gentlemen, what I am concerned about, as we see the consolidation of energy resources and energy production, I know 20 years ago when I was drilling oil wells in the Knox zone of Kentucky, Tennessee, and Ohio, there was an awful lot of folks that were interested in the development side of it, and today, we were at five and now it looks like we are going to be at four with the Texaco and Chevron merger. I am as concerned about that consolidation and what that consolidation can do to our dependence on those consolidated efforts, and I am well aware that not all the consolidation is purely marketplace driven. But I am concerned that where our next generation of energy is going to come from along the line I just asked on energy production and the research and development for the future.

How about on the conservation side, and if you could give me a percentage. Now, if you were telling me, for instance, Mr. Leggette, that 15 or 20 percent of the cash flow or 35 or 40 percent of the profits that the industry is generating is going in to develop the next generation, is that too high? Is 35 to 40 percent of the profit going into the next generation, is that too high? Let me ask you that question first.

Mr. LEGGETTE. I would be guessing wildly, although I would be happy to try to get that information for you.

[The information referred to follows:]

Members of the Independent Petroleum Association of America are largely non-integrated oil and gas exploration and production companies whose focus is the development of oil and gas reserves. It is estimated that these companies put nearly all of their profits back into exploration and production activities. These companies typically do not allocate funds to the pursuit of alternative or renewable energy sources.

Mr. OTTER. How about you, Mr. McMahon?

Mr. MCMAHON. I would have no idea.

Mr. OTTER. Along that same line, how much research and development is going into conservation? When are we going to see 70 miles a gallon for an internal combustion engine? When are we

going to see more kilowatts produced per 250 megawatt hydropower plant now on X-number of cubic feet per second? And I am not exactly sure what that figure is, but it seems to me that if the lowest-hanging fruit here in this whole thing is conservation, or getting a larger bounce for our buck, that is where we ought to be spending our profits for the future. If you could just review that—I am out of time, but if you could just quickly embrace that for me for a minute, I would appreciate it.

Mr. MCMAHON. All I could tell you, Congressman, is that in California, the electricity-generating facilities are not owned by major oil companies. They are owned by much smaller companies. It appears that the major oil companies have figured they cannot make money generating electricity, so they are not devoting their resources to more efficient electrical generating facilities.

Mr. LEGGETTE. Questions about car fuel efficiency really will have to be addressed to Detroit, not to Houston, and about kilowatt hours to the Edison Electric Institute and not the American Petroleum Institute or the IPAA.

But plainly, as I think the President's plan recognizes, we have to attack both sides of the equation. The NRDC issued a report earlier this year indicating that if two steps were taken, increasing the CAFE standards for cars and imposing requirements on replacement tires, the nation could save 50 billion barrels of oil over the next 50 years. That is about a billion barrels a year.

The Department of Energy, however, projects that increase in demand domestically for crude oil between now and 2020 will be two billion barrels of oil a year, meaning even if we did everything that the NRDC was proposing, that would only reduce the increase in our demand for petroleum. Plainly, both sides of the equation need to be addressed, production and conservation.

Mrs. CUBIN. The Chair now recognizes Mrs. Napolitano.

Mrs. NAPOLITANO. Thank you, Madam Chairman. I am very much interested in the statements, and I, too, also was a little bit late in getting here, so I am assuming some of the information might have been covered.

Part of what really troubles me, and I have been in government long enough to know that private industry normally says, government, stay out of business. You are not in the business to do business. You are in the business to do government policy, et cetera. So to buy into an idea that the government can begin to have in their hands, and as Mr. McMahon was indicating, to set up another infrastructure, another bureaucracy to deal with the sale and the proceeds and everything that goes with it just does not quite make sense. To me, I would think industry would be saying, government, stay out of it. We will take care of it.

One of the questions that I have is the industry itself is asking that the government take in-kind?

Mr. LEGGETTE. Yes, ma'am.

Mrs. NAPOLITANO. And the reason is?

Mr. LEGGETTE. Unlike proposals in the 1970's, where the Federal Government was considering forming its own oil and gas company to drill offshore and install its own production platforms, this is a much more limited role for Federal Government in the marketplace. The government is not taking on the geologic risks of drilling

and the safety risks and operational risks of installing and operating platforms.

Mrs. NAPOLITANO. But it is taking other risks, sir.

Mr. LEGGETTE. Certainly, it is taking some market risks, like other entities in the marketplace. The reason that the industry supports that move is that, in the long run, it is more efficient both for the government and for industry to let the government make its money on its own, because the alternative is to have companies exposed to endless rounds of lawsuits under the False Claims Act and investigations and criticisms by Members of Congress.

Mrs. NAPOLITANO. How would those be avoided, sir, because right now, from what I am reading in some of the information given to us, is there are already several—a few suits against some of the major oil companies, as well as some of the minor companies, in regard to the False Claims Act. It seems to be there is a serious issue in underreporting.

Now, if we were able to bring that into compliance somehow, and I do not understand why the oil companies would be not happy to do what is naturally requested of almost any business, is adequately report, and they are trying to overturn that law, it just does not make sense for us to say, on one hand, it is okay to go ahead and start having the government set up its own, we will take care of it, when they are not even providing fully adequately reported sales, if you will.

Mr. LEGGETTE. There is only one lawsuit of which I am aware where someone is claiming that companies have underreported the volume of natural gas. That is a case where the government took its royalties in-value, not in-kind, the Chairman's point earlier. That case was investigated by the Department of Justice, which has declined to intervene. But under law, the relator is entitled to go forward, and that matter is in litigation and we will see what comes of it. But that is a problem that is a possibility that can occur whether you take royalty in-value or in-kind. If you take it in-value, you have two potential sources of dispute. If you take it in-kind, you only have one.

Mrs. NAPOLITANO. But it would be very expensive for the government for me. How could an RIK program be designed that would minimize the pitfalls?

Mr. LEGGETTE. To minimize the pitfalls?

Mrs. NAPOLITANO. Right. In other words, be able to do away with that second pitfall you were just talking about, the thicken problem.

Mr. LEGGETTE. The value pitfall?

Mrs. NAPOLITANO. Right.

Mr. LEGGETTE. Well, by taking royalty in-kind, the government is then putting the production out for bidding and we think the best way to make sure that the government does the best job it can is to allow the government to hire outside marketing expertise to advise it. Let me assure you that it is a whole lot cheaper for the government to hire a marketing consultant than it is to pay millions of dollars in royalties to False Claims Act private relators in these cases. There would be a big savings for the government there alone.

Mrs. NAPOLITANO. Well, I am afraid that government does not do things expediently, so I would be prone to challenge that a little bit.

Mr. McMahon, your comment?

Mr. MCMAHON. Yes, a couple of comments. One is that you are absolutely correct that in order to market properly, you have to have a bureaucracy to do it. You do not want people that are not sophisticated trying to market the crude and getting a good price for the Federal Government. Some of the oil is in out-of-the-way places, for example, offshore, California for one place, and in order to bring it to a market center where there are competitive prices, you need someone that is sophisticated to be able to do that.

The second point I will make is that we have heard a lot here today about litigation, and why was there litigation? There was litigation because, in the past, what the oil companies did was they reported the value of crude oil in terms of their own prices. That is, oil companies like Chevron, Mobil, Exxon would say, this is what the crude is worth and this is, therefore, what we are going to pay you. There was no check on them.

What we found, and throughout the country this was happening, was that the oil companies were setting up affiliated oil companies in which they were selling the production at posted price to an affiliate and the affiliate would then turn around and sell at a higher price. That was clearly an unfair situation.

Now, what MMS has done, it took them 4 years because of oil industry objections, they went to market-based criteria for value. When you are hearing in the news every day the price of West Texas crude is X-amount of dollars, it is because that is a market that is recognized throughout the oil industry. The price is not dependent on a single oil company. It is like the stock market. The reported price of West Texas crude oil is the result of lots of buyers and sellers coming together. That is a great indication of what the value of the crude is, and there cannot be a dispute about what the value of West Texas crude oil is. So we will expect fewer disputes under the new regulations, and that is what we would like to see actually put in place and look at it maybe in a year or two as to whether it is working or not.

Mrs. NAPOLITANO. Thank you very much, Madam Chairman.

Mrs. CUBIN. I would like to thank the witnesses for their testimony and answers to the questions. Thank you, Mr. McMahon, for coming on short notice. We appreciate your being here.

Mr. MCMAHON. Thank you, Madam Chairman.

Mrs. CUBIN. Likewise, Mr. Leggette.

Mrs. CUBIN. The Chair now would like to recognize the second panel, Mr. Walter Cruickshank, the Associate Director of Policy and Management Improvement of the Minerals Management Service, who has been a regular visitor with this Committee. He is accompanied by Mr. Milt Dial, the Assistant Program Director for Royalty In-Kind; Mr. John Harpole, the President of Mercator Energy; and Mr. James Jacob, Manager of Consumer Advocacy, KeySpan Corporation.

I would like to also welcome all of you gentlemen and thank you very much for being here. We always appreciate hearing from Mr. Cruickshank, who has been, as I said, a regular person here in

front of this Committee, and so now I will recognize him for 5 minutes. I point out again that the timing lights will be there on the table.

STATEMENT OF WALTER CRUICKSHANK, ASSOCIATE DIRECTOR OF POLICY AND MANAGEMENT IMPROVEMENT, MINERALS MANAGEMENT SERVICE, ACCOMPANIED BY MILT DIAL, ASSISTANT PROGRAM DIRECTOR, ROYALTY IN-KIND, MINERALS MANAGEMENT SERVICE

Mr. CRUICKSHANK. Thank you, Madam Chairman. Good morning to you and members of the Subcommittee. Thank you for the opportunity to testify this morning about the MMS's royalty in-kind program. I have submitted written testimony for the record, and given your background on this issue, I will just briefly provide an overview of the current status of our RIK projects and a summary of our findings of our initial evaluation of the Wyoming oil RIK pilot.

Turning first to Wyoming, MMS and the State have been cooperatively developing an oil RIK program since 1998. MMS has been taking up to 6,000 barrels per day of RIK crude oil and competitively selling that production in the open market. The State of Wyoming has also included RIK oil from the State lands in this program. Currently, we are selling approximately 2,000 barrels per day of Federal RIK oil in Wyoming.

In March of this year, MMS issued its initial evaluation of the Wyoming pilot for the first 18 months of operations. The report concludes that the Wyoming pilot demonstrates that in some, but not all, circumstances, taking oil royalties in-kind and selling it through a competitive bidding process is a viable alternative to the historical method of collecting royalties in-value. We used the following criteria as the basis for evaluating success: Revenue neutrality for the government; reduced administrative burdens for both lessees and the government; and simplicity, accuracy, and certainty for all parties.

To summarize, the main findings of the report, first, selective use of RIK can be revenue neutral. We received an average premium of about 45 cents per barrel over the value reported to the State for royalty and severance tax purposes. And I would note that the State's regulations for royalty and severance tax, in essence, are the same as the requirements for value under the new oil valuation rule. However, at the time of the evaluation, the payments to the State had been largely unaudited.

Second, lessees benefit from a reduced administrative burden, from both the dramatic reduction in reporting to MMS as well as the avoided costs of audits and valuation disputes.

Third, there is greater certainty for both lessees and the government. Not only are the valuation disputes avoided, but the potential exists for completing the volume reconciliation process in 90 to 120 days, allowing us to close the books on royalty obligations in months rather than years.

However, RIK does not work across the board. One of the things we found in Wyoming is that a number of properties served only by trucks were not drawing competitive bids or purchaser interest, and, therefore, we stopped offering those properties in the State.

Currently, we are working with the State in planning the next phase of competitive sales of Wyoming RIK oil, with deliveries commencing this fall.

In 1998, MMS also started working with the State of Texas General Land Office on a second RIK pilot involving natural gas production from Federal leases in the 8(g) zone, offshore Texas. The primary activity under this pilot was to mutually explore ways to market Federal RIK from 8(g) leases, building on GLO's experience with their own successful RIK program. Competitive sales began in June 1999 and initially focused on monthly spot market sales of natural gas. Total sales volumes reached 75,000 MMBTUs per day, with deliveries to both Federal facilities and private purchasers.

For reasons of administrative simplicity, this pilot was merged this fiscal year with our broader OCS gas pilot. We have started work on our evaluation of the Texas gas pilot and expect to complete that by the fall.

In November 1999, MMS began our third RIK pilot involving natural gas from OCS leases across the Gulf of Mexico. Much of this initial gas was sold to the General Services Administration for use in managing its program of supplying natural gas to Federal facilities. As previously mentioned, we did combine the two gas pilots together and today we are selling approximately 380,000 million BTUs per day of natural gas at offshore and onshore delivery points.

An important feature of this pilot is that with the authority provided in the fiscal year 2001 appropriations bill, we have begun entering into agreements for transportation of the RIK gas to pooling points and market centers away from the lease. Because of our strong presence across the Gulf, we have found this authority to be a cost effective means for shipping the government's share of production. In some cases, we have been able to negotiate better rates than other shippers along the pipeline. We have also used the new authority to pay processing costs, and that has proven beneficial in situations where pipeline companies have issued operational flow orders requiring gas to be processed. We feel the continuation of this authority beyond fiscal year 2001 is critical for testing alternative approaches to selling production at market centers removed from the lease.

In August of 2000, we commenced our fourth pilot for RIK crude oil in the Gulf of Mexico. We are currently selling about 7,600 barrels per day and planning the next sale with deliveries in October.

Finally, I would note that we are continuing to operate our small refiner RIK program, currently providing five small refiners with a total of 70,000 barrels of RIK oil per day from the Gulf of Mexico and the Pacific.

In closing, I would like to say that we are continuing to study RIK as a possible business approach for managing oil and gas royalties. Pilots are founded on the premise that oil and gas royalties are a revenue-generating asset for the public and the decision whether to take royalties in-kind or in-value would be based on the best way to manage that asset.

Your Subcommittee is now considering whether to broaden RIK beyond this current practice. MMS is prepared to provide technical assistance to you as you proceed. We also expect to work with all

stakeholders as the administration implements the recommendation from the President's National Energy Policy to bolster LIHEAP funding using a portion of oil and gas royalty payments.

I thank you, Madam Chairman, and I would be happy to answer any questions.

Mrs. CUBIN. Thank you, Mr. Cruickshank.

[The prepared statement of Mr. Cruickshank follows:]

Statement of Walter Cruickshank, Associate Director, Policy and Management Improvement, Minerals Management Service

Madam Chairman, I wish to thank you and the members of your Subcommittee for the invitation for the Minerals Management Service (MMS) to be here today to present testimony regarding its royalty in kind (RIK) activities.

Introduction

As you are aware, MMS's mission consists of two major programs: Offshore Minerals Management and Minerals Revenue Management (MRM). The leasing and oversight of mineral operations on the OCS and all mineral revenue management functions for Federal (onshore and offshore) and American Indian lands are centralized within the bureau. In 2000, OCS oil and natural gas production accounted for roughly 25 and 26 percent, respectively, of our Nation's domestic energy production—oil production was over 500 million barrels and natural gas production was over 5 trillion cubic feet. The amount of oil and natural gas production in 2000 was the most ever produced on the OCS. In addition, in fiscal year 2000, MMS collected and distributed about $7.8 billion in mineral leasing revenues from Federal and American Indian lands.

By provisions of law and lease terms, Federal oil and gas royalties can be paid by the lessee either as a share of cash proceeds realized by the lessee (in value) or with a share of production (in kind). The decision as to whether royalties will be paid in value or in kind is solely the lessor's (the Government). Historically, the MMS collected royalty payments in value, except for its Small Refiner Program whereby the Government receives oil royalty payments in kind on selected leases and in turn sells the production to qualified small refiners at fair market value.

RIK Feasibility Study

In 1997, the MMS formed an RIK Study Team to investigate the feasibility of the U.S. Government taking its oil and gas royalties from Federal leases in kind rather than in value. The Study Team concluded that under the right circumstances, RIK could be workable, revenue neutral or positive, and administratively more efficient for MMS and industry. The Study Team also recommended the following:

- Development of a long-term OCS RIK pilot program with input from the States of Texas and Louisiana for the marketing of substantial volumes of U.S. royalty gas.
- Establishment of a joint MMS/Wyoming team to examine the viability of an oil RIK program in Wyoming.
- Establishment of a joint MMS/Texas team to identify and assess a range of possible RIK programs involving OCS 8(g) leases offshore Texas.
- Evaluate the potential for additional RIK pilot programs upon the successful implementation of any pilot project.

In response to the recommendations of the Study Team, MMS aggressively initiated a series of pilot projects with the following goals:

- To determine the circumstances (market conditions) in which RIK makes sense and identify those key success factors.
- To determine if the government (and industry) can save money by reducing the administrative cost and burden of collecting and verifying royalties.
- To determine if RIK can provide accurate, simple and certain royalty collection.
- To determine if RIK can create value (revenue enhancement or neutrality) for the taxpayer.
- To conduct evaluations, which will include the criteria listed above, of each of the pilots and share with all interested parties.

RIK Pilot Program

The RIK pilot program commenced in 1998 with the initiation of its first pilot with the State of Wyoming involving crude oil. Since then, the pilot program has continued to expand in Wyoming and on the OCS in the Gulf of Mexico for both oil and gas. Each of the pilot projects is designed to test a variety of approaches

to utilization of the RIK option for managing the Federal royalty asset. Pilot evaluations are being conducted to ascertain pilot successes and lessons learned that are incorporated into succeeding pilot activities. I would like to briefly address each of MMS's RIK pilots and the evaluation work that has been completed to date.

The Wyoming Oil RIK Pilot

Under the Wyoming pilot, the MMS and the State of Wyoming's Office of State Lands and Investments have been cooperatively developing an oil royalty in kind program. Since 1998, MMS has been taking up to 6,000 barrels per day of RIK crude oil produced from Federal leases in the Powder River Basin and Big Horn Basin of Wyoming and competitively selling the production in the open market under 6-month term contracts. The State of Wyoming has also included State lands RIK oil in the pilot sales. Currently approximately 2,000 barrels per day of Federal RIK oil are being sold under the Wyoming Pilot.

In March 2001, MMS issued its evaluation of the Wyoming Pilot for the period October 1998 through March 2000. The report concludes that the Wyoming Oil RIK pilot successfully demonstrates that in some but not all circumstances, taking oil production in kind and selling it through a competitive bid process is a viable alternative to the historical method of taking royalties in value. The following criteria were established as the basis for evaluating its success:

- Simplicity, accuracy, certainty for lessees and government.
- Revenue neutral (or better) for government;
- Reduced administrative burdens for lessees and government.

To summarize the main findings of the report, the Wyoming oil RIK pilot demonstrated:

- Selective use of RIK can be revenue neutral—MMS received an average premium of 45 cents per bbl over the values reported to the State for royalty and severance tax purposes.
- Lessees benefit from a reduced burden—an 80% decline in the number of lines reported and the avoided costs of valuation disputes.
- Greater certainty for both lessees and the government—valuation disputes are avoided and the potential exists for completing the volume reconciliation process in 90–120 days.
- RIK does not work across the board—MMS stopped offering trucked properties because of the lack of competitive bids and purchaser interest.

The Wyoming pilot also provided the MMS and the State with valuable experience in operating an ongoing RIK program. In several areas, experience from the three sales allowed the MMS and State to review previous results and improve processes for the next cycle. Reviewing the bidding mechanisms and the properties which were receiving bids led to the expansion of the possible bidding and pricing mechanisms and to the elimination of trucked properties from subsequent sales. Feedback from sale participants provided impetus to eliminating burdensome and unnecessary qualification requirements. On the pricing side, MMS gained valuable insights into the complexities of the Wyoming oil market and discovered the need for MMS and the State to further investigate alternative pricing mechanisms and different sales terms. Although the overall value received in kind was at or above the comparable in-value number, this was not the case for every month for every property.

MMS and the State of Wyoming are currently in the planning phase for the next competitive sale of Wyoming RIK oil for deliveries commencing in the Fall 2001.

The Texas 8(g) Gas Pilot

In 1998, MMS in partnership with the State of Texas General Land Office initiated the second RIK pilot project involving OCS natural gas production from Federal leases in the Texas 8(g) zone of the Gulf of Mexico. The 8(g) zone refers to leases within 3 miles of State waters and from which Texas receives 27 percent of the revenues. The primary activity under this pilot was to mutually explore ways to cost-effectively market both Federal RIK gas from the 8(g) zone and State leases. Sales began in June 1999, and initially focused on monthly spot market sales of about 25,000 mmbtu/day of natural gas. Total sales volumes reached 75,000 mmbtu/day with deliveries to both Federal facilities and private purchasers. For reasons of administrative simplicity, the pilot was merged in fiscal year 2001 with the OCS pilot for non–8(g) gas. Sales of 8(g) gas to Federal facilities and other purchasers continues under the overall Gulf of Mexico gas pilot.

The MMS has commenced its evaluation of the Texas 8(g) gas pilot and expects to complete its analysis in the Fall 2001.

The Gulf of Mexico Gas Pilot

In November 1999, MMS began a third RIK pilot, involving non–8(g) Federal offshore leases in the Gulf of Mexico. Initial activities centered around competitively-

offered contracts with successful bidders taking approximately 200,000 mmbtu/day of royalty natural gas from specified offshore locations and delivering natural gas volumes and qualities of equivalent value to a specified onshore location. Much of this gas was sold to the General Services Administration for use in managing its program of supplying natural gas to Federal agencies. As previously mentioned, for reasons of administrative simplicity, the MMS merged the OCS Texas 8(g) and the non–8(g) gas into one pilot in fiscal year 2001. Under the merged gas pilot, the MMS is today selling approximately 380,000 mmbtu/day of natural gas at offshore and onshore delivery points.

An important feature of this pilot is that, with the authority provided in the fiscal year 2001 appropriations bill, MMS began entering into agreements for the transportation of RIK natural gas to pooling points and market centers away from the lease. Because of the strong presence of MMS royalty production throughout the Gulf, the MMS has found this authority to be a cost-effective means for shipping the Government's share of production. In some instances, MMS has been able to negotiate better rates than other shippers along the pipeline. Authority for the payment of processing costs has also proved beneficial for operating this pilot, particularly in situations where MMS was forced to process its royalty share due to operational flow orders. Continuation of this authority beyond fiscal year 2001 is critical to the RIK pilots for testing alternative approaches to selling production at market centers removed from the lease.

The Gulf of Mexico Oil Pilot

In August 2000, the MMS commenced a fourth pilot for the competitive sale of RIK crude oil from Federal offshore leases in the Gulf of Mexico. Under this pilot, MMS is currently selling about 7,600 barrels of crude oil per day through September 2001. We are now in the planning phase for the next sale with deliveries beginning October 2001.

Small Refiner RIK Program

Beyond the RIK pilot program, the MMS continues to operate its existing Small Refiner RIK Program. The objective of the Small Refiner Program is to help assure adequate supplies of crude oil at equitable prices are available to eligible small refiners. The business processes followed in operating the program have historically been complicated and labor intensive. The MMS has worked with parties affected by the Small Refiner Program in the last several years to bring about a number of improvements including:

- introduction of a competitive bidding process that increases price certainty for the small refiner and MMS.
- establishment of a volume nomination process for MMS to manage operators' deliveries of oil to small refiners thereby reducing monthly imbalance problems
- changes in MMS payment requirements to have small refiners pay on actual oil deliveries rather than estimated volumes, thereby reducing problems with small refiners having to pay for oil they did not receive, and
- streamlined information collection by no longer requiring operators to report RIK sales on the MMS royalty report.

Today, MMS is providing three small refiners in the Gulf of Mexico and two small refiners in the Pacific with a total of about 70,000 barrels of RIK oil per day.

Managing MMS's RIK Activities

To provide the needed management focus and visibility to RIK activities for the future, the MMS established through its October 2000 reorganization of the Royalty in Kind Office within the MRM. The RIK Office is the focal point and accountable for the management and coordination of all MMS activities related to the operation of the RIK pilots, the Small Refiner Program, and other RIK activities. The RIK Office is staffed with employees experienced in the pilot program and the Small Refiner Program. The Assistant Program Director for RIK reports directly to the Associate Director for the MRM.

Evolving MMS's RIK Activities

In January 2001, MMS published its RIK Road Map to the Future. The Road Map outlines a 3-year business plan for further development and operation of MMS's RIK pilots and Small Refiner Program, and integration of the RIK option into the overall asset management strategies of the MMS.

Closing Remarks

We at the MMS are striving to adopt a balanced approach in developing the RIK option as a viable tool for the management of the Nation's royalty assets. We have been deliberate in exploring new opportunities for optimizing value and gaining

market insight, yet have remained cautious to proceed slowly and build upon the lessons learned through experience.

This MMS is continuing to study RIK as a possible business approach for managing oil and gas royalties. MMS is evaluating experiences to date and will continue to explore the potential of RIK through pilot projects and long-term projects.

Madam Chairman, this concludes my prepared remarks. However, I will be pleased to answer any questions Members of the Subcommittee may have.

Mrs. CUBIN. The Chair now recognizes Mr. John Harpole to testify.

STATEMENT OF JOHN HARPOLE, PRESIDENT, MERCATOR ENERGY, LLC

Mr. HARPOLE. Thank you, Madam Chairman and members of the Committee. I am John Harpole, President of Mercator Energy. I would just like to thank you all for having me here today. I come from a big family. I am the eighth child of nine and I am really not used to people wanting to hear what I have to say, so thank you for this opportunity.

Mercator Energy is a natural gas services consulting company based in Denver that provides marketing services to natural gas end users and producers. During my 20-year career in the gas industry, I have purchased gas for most of General Electric's industrial facilities and also marketed gas for producers such as McMurry Oil Company located in Casper, Wyoming. Those varied experiences have provided me with an extensive view of the natural gas industry, from the wellhead to the burner tip.

Today, I am here representing myself. My goal is to help author an efficient solution for low- and fixed-income individuals who have been and continue to be hurt by rising natural gas prices. I would like to describe the efficiencies of a novel concept to expand existing low-income energy assistance programs by taking Federal royalty gas in-kind and allocating that gas directly to prequalified low-income energy assistance needs.

This Committee is certainly aware of the dramatic increase in natural gas prices during the last 12 months. I have prepared an illustration that shows the average gas prices from 1991 to 2001. You can see that just in the 2001 time period as compared to the 10-year average, we have got a 126 percent increase.

All three sectors of the natural gas customer base have been dramatically impacted by the price increase. Residential customers, the largest consumer sector, have naturally screamed the loudest. Most residential customers are what natural gas derivative traders refer to as "naked the forward price" for natural gas. While commercial and industrial customers have the option to lock down forward prices to ease the impact of volatile pricing, residential customers remain exposed. The financially naked residential natural gas customer is too often the one turning off the thermostat and throwing on the extra blankets.

The irony of all this is apparent in this illustration. In sheer numbers, the 58 million residential customers are those that vote, and as a result, they can drive public policy on an issue that they rarely have control over. Of those 58 million residential customers, 24 percent, nearly 13.8 million people, qualify for LIHEAP assistance. LIHEAP assistance is available to households whose income

is 150 percent of the Federal poverty level, or 60 percent of the State median income. Administrative expenses for LIHEAP organizations are required to stay at or below 10 percent of total monies funded.

Now, how can royalty gas help? It is simple. As an owner of royalty interests in all Federal lands, the Federal Government is the largest natural gas producer in the U.S. In 1999, the Federal Government received $2.1 billion in revenue for natural gas. In 2001, based on the price increase, the Federal Government should receive nearly $6 billion, a $4 billion increase as compared to 1999.

Why not incorporate those dollars in a solution for the needy? I would like to walk you through one possible solution. KeySpan Corporation, the largest gas utility in the Northeast, serves about 2.4 million customers in three States. KeySpan consumes about one million MMBTU of gas per day in their New York service territory. One of their many long-term supply contracts calls for the purchase of gas from an offshore Gulf of Mexico producer in the amount of 60,000 MMBTU per day, so 60,000 a day as compared to the million a day that they consume in New York City. That volume is then transported a distance of 1,400 miles on Transco pipeline to KeySpan service territory in New York City. In January of 2000, KeySpan's 54,000 low-income customers burned about 8,200 MMBTU per day. That is, the low-income used about 8,200 MMBTU per day.

Under the proposed solution, the offshore producer could change the price for that 8,200 a day—that is the portion of that 60,000 MMBTU sale to KeySpan—to $2 or whatever the Secretary of Interior deems an appropriate price for the price transfer to the LIHEAP folks. This one transaction, one transaction, could lower the natural gas price for 54,000 low-income customers in New York City. Under this solution, the utility simply transfers the price benefit directly to the low-income recipient via their monthly utility bill. LIHEAP incurs no additional administrative burden because it has already qualified the recipient for assistance.

Additionally, a number of other flexible royalty in-kind to LIHEAP approaches can be pursued that help address issues raised by various industry participants. This concept is not meant to be a long-term social welfare entitlement program. Rather, when natural gas spot market prices return to levels near the 10-year average, the program could be reviewed on a seasonal basis. We need enabling legislation to see this thing happen.

The benefits are three-fold, at least beyond helping the low-income. The proposed program could provide an additional benefit to the low-income in addition to increasing LIHEAP funding. The LIHEAP program, and this is a quote from the Chair of the National Fuel Funds Network, "The LIHEAP program may be nearing its administrative capacity in terms of delivering significantly more dollars. Additional delivery mechanisms," and I quote, "such as utilities, would expedite delivering dollars to people in need."

Producers, pipelines, and utilities could work in collaboration in pursuit of the solution, and the diversity of this approach would allow residential customers perhaps to better understand how the molecule of gas gets to the burnertip.

In conclusion, we are requesting this Subcommittee's assistance in putting together the required enabling legislation. That is my reason for appearing here today. The efficiencies of this proposal and the benefits to all parties involved should motivate us to move forward. Thank you for your time.

Mrs. CUBIN. Thank you, Mr. Harpole.

[The prepared statement of Mr. Harpole follows:]

Statement of John A. Harpole, President, Mercator Energy LLC

Introduction

Madam Chairwoman and members of the Committee: I am John Harpole, President of Mercator Energy. Mercator Energy is a natural gas services consulting company based in Denver, Colorado that provides marketing services to both natural gas end-user and natural gas producing customers. In the mid–1980's, the Federal Energy Regulatory Commission (FERC) created open-access transportation on interstate natural gas pipelines via FERC Order 436. At that time, I was employed by an oil and gas production company owned by General Electric. As a result of FERC Order 436, I was put in charge of supplying natural gas to 55 General Electric industrial plants behind 34 utilities and 18 interstate pipelines. It may also be of interest to you, Madam Chairwoman, to note that my company marketed all of the natural gas production out of the Jonah Field in Sublette County, Wyoming, for McMurry Oil Co. from 1992 to 2000. Those varied experiences have provided me with an extensive view of the natural gas industry—from the wellhead to the burnertip.

Additionally, I have served as Vice–Chairman of the Natural Gas Committee of the Independent Petroleum Association of America and on the governing boards of two regional producer trade associations, the Colorado Oil and Gas Association and the Independent Petroleum Association of Mountain States. Over the last twelve years, I have authored articles about a number of timely issues affecting the natural gas industry for such publications as American Oil & Gas Reporter, Oil and Gas World, Hart's Energy Markets, and Natural Gas Focus. Although I have testified before FERC, this is my first opportunity to testify before Congress.

I am here representing myself and my company, an independent, regional natural gas consulting firm, not an industry organization or political entity. My participation is the result of my interest in seeing the idea that I will describe further herein, reach fruition. While the resulting program should provide opportunities for positive public relations and increased public awareness of how the natural gas industry "works", my true goal is to help author an efficient solution for low- and fixed-income individuals who have been and continue to be hurt by rising natural gas prices.

Last month, President Bush's National Energy Policy Development Group specifically recommended that the President "take steps to mitigate impacts of high energy cost on low-income consumers", including "directing the Secretaries of the Interior and Health and Human Services to propose legislation to bolster LIHEAP [Low Income Home Energy Assistance Program] funding by using a portion of oil and gas royalty payments" and "redirecting royalties above a set trigger price to LIHEAP, whenever crude oil and natural gas prices exceed that trigger price, as determined by the responsible agencies." (Chapter 2, page 2–12)

Today, I appear before you to describe and explain the efficiencies of a novel concept to expand existing low-income energy assistance programs by taking Federal royalty gas in-kind and allocating that gas directly to pre-qualified low-income energy assistance needs. On February 7, 2001, Colorado Governor Bill Owens sent a letter to Vice President Cheney's office outlining the general terms of the concept. That letter resulted in press coverage from a number of natural gas industry trade publications. I have attached copies of the letter from Governor Owens and the response from Vice President Cheney's office as exhibits to this testimony.

After the effort that a number of parties contributed to this concept, it was gratifying to see the National Energy Policy Development Group select it for inclusion in the policy document that was released last month. As evidence of the bi-partisan support this concept has received, a variation of this idea was introduced in the House of Representatives on March 8, 2001 by Carol Maloney, (D–NY) as HR962, and a similar bill in the Senate by Charles Schumer (D–NY) and Hillary Rodham Clinton (D–NY).

The Need

This Committee is certainly aware of the dramatic increase in natural gas prices during the last 12 months. Most experts agree that the two major driving forces behind the price increase were the following:

1. A wholesale shift from coal to natural gas as the fuel of choice by electric utilities. This change is a result of stricter Federal air quality standards for coal-fired power plants; and
2. The exploration and production communities' inability to keep pace with increases in demand which has been exacerbated by more restrictive Federal land access and right-of-way regulations.

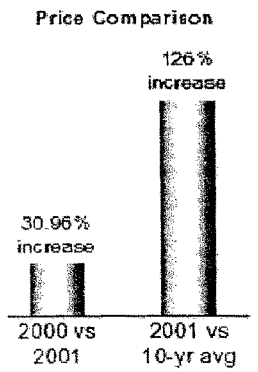
We, as a country, cannot simultaneously restrict coal-fired electric generation emissions, access to Federal lands, waters, and right-of-ways, and not expect a resultant increase in natural gas prices. Recent Federal policy and regulations have contributed significantly to the recent surge in gas prices. If the Federal Government decides to pursue the concept I am proposing, the irony of a Federal solution that would address the needs of those individuals most severely impacted,—that is, those with low or fixed incomes—might not be lost on the American public.

In an effort to convey the dramatic price increase, I have prepared an illustration that shows the average gas prices from 1991 to 2001.

NYMEX Natural Gas Prices

	Average $/MMBtu
1991	$1.543
1992	$1.779
1993	$2.155
1994	$1.916
1995	$1.626
1996	$2.546
1997	$2.631
1998	$2.137
1999	$2.271
2000	$3.882
2001	$5.084*

10-year average: $2.248/MMBtu



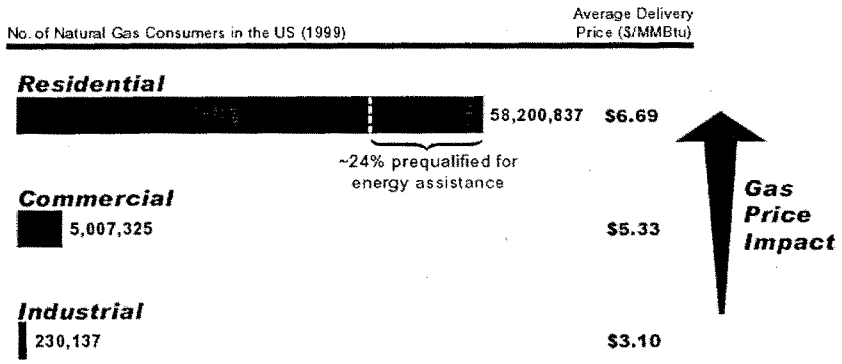
* Based on actuals for January June and July December NYMEX futures as of 6/6/01.

All three sectors of the natural gas customer base have been dramatically impacted by the price increase. Unlike their industrial and commercial counterparts who can lock down gas prices either physically or financially, residential customers—the largest consumer sector—who rely on utilities to supply their natural gas, do not have access to individually-negotiated fixed-price contracts or any other type of long-term, fixed-price hedging tools. In fact, as a result of various state public utility commission rulings, regulated utilities generally are allowed to pass through the actual cost of natural gas to residential customers, regardless of what the price may be. However, the utilities are not allowed to earn a rate of return on the commodity portion of those pass-through gas charges. If they were allowed to do so, simple logic would dictate that the more they paid and charged for gas, the higher the utility's rate of return would be.

Furthermore, most utilities have no incentive to try to predict or "outguess" the forward price for natural gas by locking down long-term, fixed-price contracts for their residential customer base. Utilities face the 20–20 regulatory hindsight of state public utility commissions whenever commodity prices increase. Many of those utilities, instead, buy gas for their residential customer base under contracts that are tied to a monthly spot-price index. Utilities have found themselves in a no-win situation. There is no incentive to pursue the absolute lowest prices available, and their purchasing strategy is constantly second-guessed when higher prices occur. This situation results in a purchasing methodology relegated to a laissez-faire monthly spot-market price. Many public utility commissions are now rethinking purchasing policies as a result of the recent dramatic natural gas price increase.

Because of the trend toward spot-market purchasing, most residential customers are what natural gas derivative traders refer to as "naked the forward price" for natural gas. The spot market purchasing strategy provides tools for commercial and industrial customers to mitigate the impact of volatile pricing, but residential customers remain vulnerable. The financially "naked" residential natural gas customer is too often the one turning off the thermostat and throwing on the extra blankets.

The irony of all this is apparent in the illustration below. Residential gas consumers in this country total about 58 million, more than ten times the number of commercial customers and 250 times the number of industrial customers. Yet residential customers are those most severely impacted by gas prices. In sheer numbers, the 58 million residential customers are the voting public, and consequently, they can drive public policy on an issue that they rarely have control over. Of those 58 million residential customers, 13.8 million qualify for LIHEAP assistance.



Source of data: U.S. Department of Energy, Energy Information Administration, *Summary Statistics for Natural Gas in the United States, 1995-1999.*

LIHEAP

"The Low Income Home Energy Assistance Program (LIHEAP) was created under the Omnibus Budget Reconciliation Act of 1981 (OBRA) to help low and fixed income households pay their fuel and utility bills. LIHEAP funding is allocated by the Department of Health and Human Services (HHS) and administered by the states, with the states having maximum flexibility in directing program funds.

"LIHEAP is one of the original seven block grants authorized by OBRA. Over the last decade, the LIHEAP program has evolved from providing only financial assistance to low-income households to today's efforts that include residential weatherization and home-energy repair. "[under the program] states are given the flexibility to direct program funds as needed, allowing individual states to tailor programs according to the needs of its low and fixed income residents. In addition, states are required to maintain administrative expenses at or below ten percent [of the total allocated dollars], ensuring that most of the monies go directly to needy households.—Finally, LIHEAP serves as discretionary, in many cases one-time, assistance providing a bridge that helps the working poor and avoiding dependence on welfare programs." (LIHEAP Issue Brief 1998–04)

According to the qualification criteria set forth by the Federal LIHEAP program, approximately 24% of the country's 58 million residential customers qualify for energy assistance. LIHEAP assistance is available to households whose annual income is 150% of the Federal poverty level or 60% of the state median income. As you can well expect, the number of applicants increased dramatically in conjunction with the natural gas price increase over the last heating season. Nearly 70% of the households receiving LIHEAP assistance in 1995 survived on an annual income of less than $8,000. Nearly 34% of those households had at least one member 60 years of age or older. In addition to low-income households, senior citizens and individuals on fixed-incomes have been especially impacted by high natural gas costs.

The Source

The Federal Government is the largest natural gas producer in the United States. When royalty volumes from every onshore and offshore well are aggregated, the volume of daily production owned by the Federal Government exceeds that of the country's largest commercial natural gas producer. In 1999, the Federal Government received $2.1 billion in total revenues from onshore and offshore natural gas royalty payments paid individually each month by each natural gas "wellhead operator". Based upon actual NYMEX natural gas settlement prices for the first six months of 2001 and the projected NYMEX futures prices for the remainder of this year, the Federal Government should receive nearly $6 billion in royalty payments in 2001.

The Federal Government, through the Minerals Management Service (MMS), currently takes in-kind approximately 400,000 MMBtu per day of its total 2.5 million MMBtu per day of offshore royalty gas. That is, the Federal Government sells the gas itself rather than relying on a sale by the wellhead operator. The administration of this program and its associated costs and benefits represent a true success story within the Department of Interior. Fewer than 14 employees at the MMS sell the 400,000 MMBtu per day of gas in the open market on a monthly basis. The Federal Government also manages a successful onshore oil royalty-in-kind program in the state of Wyoming.

By any standard, the royalty revenues received in 2001 by the government can be considered a windfall for the Federal treasury and for the onshore states that receive a 50% share of these onshore royalty revenues. Rather than see that windfall "disappear" into Federal and state treasuries, why not incorporate those dollars in a solution for the needy?

One Approach

Most, if not all, utilities in the eastern United States have arranged for long-term natural gas supplies from producers in the Gulf of Mexico. As you are aware, the Federal Government, under the terms of Federal leases granted to exploration and production companies, has the option to receive a one-sixth royalty payment on production located in offshore waters or take the equivalent volume of gas in-kind.

Nearly every utility in the western half of the country acquires a portion of its natural gas supplies from production located on Federal lands in the Rocky Mountains. On those lands, the Federal Government receives a one-eighth royalty payment and also retains, under its lease agreements, the option to receive its royalty in-kind.

In the majority of cases, whenever a utility purchases gas from producers with production on Federal lands, the utility utilizes its own transportation contracts on interstate pipelines in order to effectuate the transportation of gas "from the water" (Gulf of Mexico) or from "The Rockies" to their utility's front door, the "citygate.

As an example, KeySpan Corporation, the country's fifth largest gas utility and the largest gas utility in the Northeast, serves 2.4 million customers in three states. On an average January "peak" usage day, KeySpan consumes 1,100,000 MMBtu in its New York City service territory alone.

In January of 2000, in KeySpan's New York City service territory, 54,000 prequalified residential low-income customers accounted for a "low-income average daily demand" of 8200 MMBtu per day. Obviously the 8200 MMBtu per day of usage related to low-income demand is just a fraction (seven-tenths of one percent) of the total volume of gas consumed in New York City by KeySpan customers. The "low-income volume" was calculated by identifying the LIHEAP recipients by account number and totaling the daily usage for each account. That aggregate demand volume obviously changes each month. Note that the "low-income volume" for KeySpan's New York City service territory of the largest gas utility in the northeast amounts to less than three-tenths of one percent (0.3%) of the Federal Government's total offshore royalty gas volume.

One of KeySpan's many purchase contracts calls for delivery of gas from an offshore Gulf producer in the amount of approximately 60,000 MMBtu per day. That volume is then transported by KeySpan under a firm transportation agreement with Transcontinental Gas Pipe Line Corp. a distance of 1400 miles to KeySpan's service territory in New York City. As a result of this transaction, the offshore producer/wellhead operator, pays the Federal Government a monthly royalty equal to one-sixth of the Gulf Coast sales price arrived at with KeySpan. The producer remits payment to MMS with MMS Form 2014.

Under this proposed program, KeySpan, in conjunction with the offshore producer, could change the price for the 8,200 MMBtu per day of the total 60,000 MMBtu per day to $2.00 per MMBtu (or whatever "set trigger price" might be determined by the Secretary of Interior). This one transaction could lower the natural gas price for 54,000 LIHEAP and other prequalified low-income customers in New York.

This solution adds no net administrative burden or cost to either the offshore producer, the utility or the state LIHEAP administrator. The producer could simply indicate on the required Federal royalty paperwork (a simple redesign of Form 2014 would be required) that a specified portion of the royalty gas was sold in-kind at the predetermined LIHEAP set trigger price to the producer's utility customer, who verifies the sale volume and price for audit purposes. The utility then transfers the price benefit directly to the pre-qualified low-income recipients via their monthly utility bills. LIHEAP incurs no additional administrative burden because it has already qualified the recipient for assistance.

Under this approach, the producer handles the sales transaction of in-kind royalty gas. The only additional administrative burden is MMS's audit of the transaction. By not having to add special purchase contracts, the utility can simply transport the gas under existing long-term arrangements.

The above approach is not the only solution to moving royalty in-kind gas to low-income recipients. A number of flexible options can be pursued that help address the concerns of various industry participants. For example, some utilities may not have the information systems infrastructure necessary to allow them to identify specific recipients and pass through the lower-priced royalty-in-kind gas. Additionally, it may make more economic sense to have the government purchase firm transportation directly from the pipelines or pipeline shippers in those few instances where short-term "released-capacity" transportation may be cheaper than the utility's underlying firm transportation agreements.

Enabling Legislation and Pilot Projects

This novel concept is not meant to become a long-term social welfare entitlement program. Rather, when spot market prices return to levels near the ten-year average (which could be calculated on either a NYMEX, regional, or citygate basis), the need for the program could be reviewed on a seasonal basis.

Enabling legislation is, however, needed to address the Mineral Leasing Act and the Outer Continental Shelf Lands Act to allow the Secretary of Interior to accept a price that benefits the low-income.

We must move quickly in order to implement a pilot program that will address the high natural gas prices that are anticipated for this coming winter's heating season. Utilities could be selected for pilot programs in which each utility could tailor the concept to its own needs and requirements.

More than enough Federal royalty gas exists to satisfy all of the low-income demand nationwide. The nation's top 25 natural gas utilities serve 52.5% of all residential consumers in the United States. Under the above-described "KeySpan" approach, one "deal" alone can "cover" the low-income needs behind one of the largest gas utilities in the country utilizing only 3/10ths of one percent of the available offshore Federal royalty gas volumes. Imagine what 25 "deals" a month could do for other low- and fixed-income consumers! Auditing 25 transactions a month would be a nominal task for the MMS given the measure of benefit it would provide to recipients. MMS's cost to audit would be minuscule compared to the "up-to-ten-percent" cost of LIHEAP administration.

The Benefits

Important collateral benefits to this program are apparent beyond lowering the price of natural gas for low- and fixed-income households.

1. The proposed program could provide an additional benefit to the low-income in addition to increasing existing LIHEAP funds. This is best described by Karen Brown, current Chairman of the National Fuel Funds Network, who says in a letter (copy attached) that, "Additionally, in times of such crisis as last year, simply increasing dollars to be delivered through a finite and, in some cases, much outdated delivery structure such as LIHEAP is not fully effective. The LIHEAP program may be nearing its administrative capacity in terms of delivering significantly more dollars—especially without investing more dollars to improve such an infrastructure. Additional delivery mechanisms such as utilities would expedite delivering dollars to people in need.
2. By working in collaboration, producers, pipelines and utilities can direct more dollars to the needy by avoiding the "up-to-ten percent" administrative cost inherent in the LIHEAP program. As an example, if this Federal royalty-in-kind (RIK) solution results in $1 billion in benefits to LIHEAP customers, eliminating the 10% administrative charge adds another $100 million to the bottom line for low- and fixed-income customers.
3. LIHEAP and similar programs could redirect a larger pro-rata share of their funds to conservation efforts as a result of the base cost of natural gas being addressed by this program.

4. The diversity of this approach allows for a greater level of understanding about how a "molecule of gas" travels from the wellhead to the burnertip. For example, utilities could provide informative leaflets with their bill that describe the program in simple, everyday terms, thereby helping to educate and raise the level of awareness among those customers who know the least amount about our industry and yet are impacted the most by price volatility.

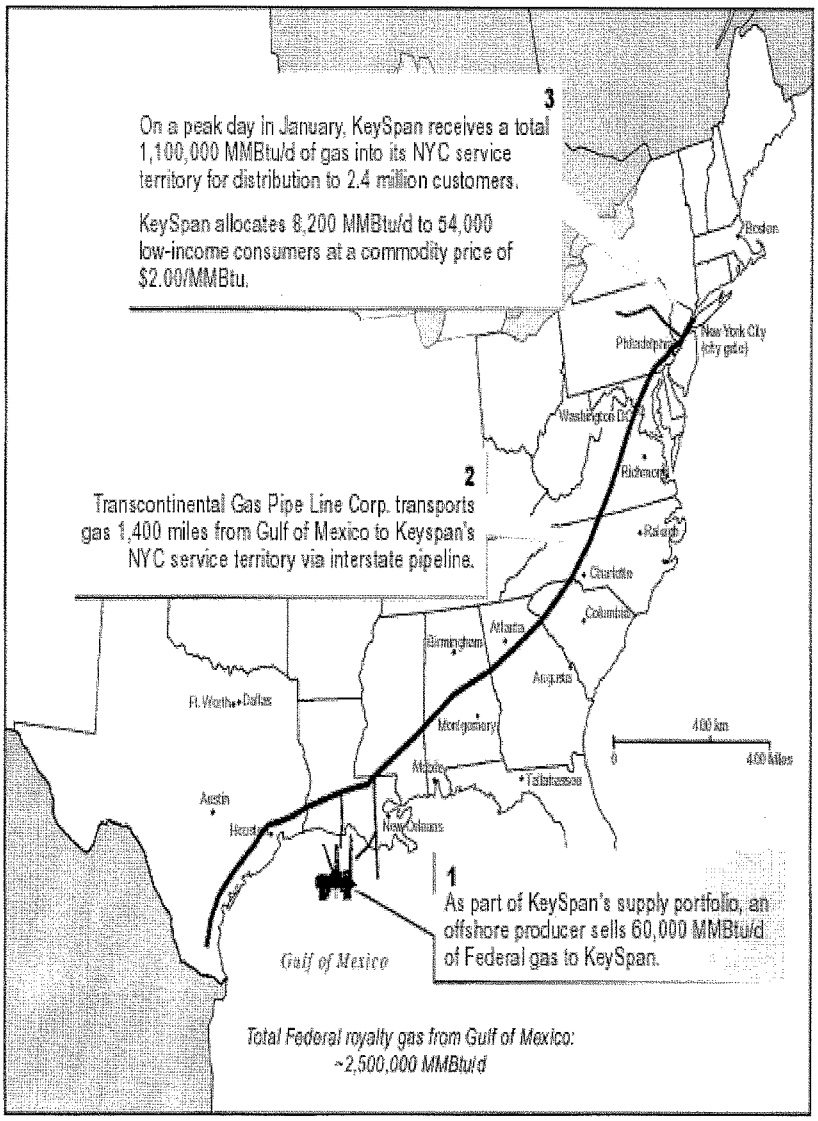
Conclusions

If, as many industry experts indicate, natural gas prices continue to remain 30% higher than just one year ago, more and more individuals on low or fixed incomes will continue to seek energy assistance from state and Federal programs. Under this proposed program, the Secretary of Interior has the option to decide if and when natural gas prices become high enough to warrant allocation of royalty in-kind gas to LIHEAP programs. If the Secretary so designates, producers, utilities and state LIHEAP organizations will not need to scramble to introduce new programs overnight, but will have the flexibility to reduce the price of gas supplies designated for LIHEAP recipients.

While LIHEAP offers other energy assistance programs that can benefit from any additional dollars the Federal Government may allocate to them in times of high energy prices, 100% of the benefit of low-priced, in-kind royalty gas is passed on to LIHEAP recipients free of any additional administrative fees.

Requesting this Subcommittee's assistance in putting together the requisite enabling legislation is my reason for appearing here today. The efficiencies of this proposal and the benefits to all parties involved should motivate us to move forward.

[A map and letters attached to Mr. Harpole's statement follow:]


3
On a peak day in January, KeySpan receives a total 1,100,000 MMBtu/d of gas into its NYC service territory for distribution to 2.4 million customers.
KeySpan allocates 8,200 MMBtu/d to 54,000 low-income consumers at a commodity price of $2.00/MMBtu.
2
Transcontinental Gas Pipe Line Corp. transports gas 1,400 miles from Gulf of Mexico to Keyspan's NYC service territory via interstate pipeline.
1
As part of KeySpan's supply portfolio, an offshore producer sells 60,000 MMBtu/d of Federal gas to KeySpan.
Gulf of Mexico
Total Federal royalty gas from Gulf of Mexico:
~2,500,000 MMBtu/d
Boston
New York City
Philadelphia
Washington DC
Richmond
Raleigh
Charlotte
Columbia
Atlanta
Birmingham
Augusta
Montgomery
Mobile
Tallahassee
New Orleans
Houston
Austin
Ft. Worth
Dallas
400 km
0
400 Miles

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June 8, 2001

The Honorable Barbara Cubin
Chairwoman, House Subcommittee on Energy and Mineral Resources
1114 Longworth, HOB
Washington D.C., 20515

Dear Chairwoman Cubin:

On behalf of the National Fuel Funds Network, I am writing to support the Royalty-In-Kind program as described by John Harpole. Such a program would allow low-income consumers, in times of extraordinary need, to have access to lower priced gas delivered directly to them via their own utility.

The distinct benefits of such a program are twofold. By providing a program delivered through utilities, this provides direct access for people who need help. This diversification of delivery mechanisms is important, as there are many individuals and families who will not go to the Low Income Home Energy Assistance Program because they consider it welfare - yet would accept support through their utility.

Additionally, in times of such crisis as last year, simply increasing dollars to be delivered through a finite and some cases much outdated delivery structure such as LIHEAP is not fully effective. The LIHEAP program may be nearing its administrative capacity in terms of delivering significantly more dollars - especially without investing more dollars to improve such an infrastructure. Additional delivery mechanisms such as utilities would expedite delivering dollars to people in need.

NFFN supports this program IN ADDITION to supporting the existing LIHEAP program and its funding base.

Thank you for the opportunity to submit this letter in support of the Royalty In Kind program.

Sincerely,

Karen M. Brown

Karen M. Brown

Chairman
National Fuel Funds Network

Executive Director
Colorado Energy Assistance Foundation

THE VICE PRESIDENT
WASHINGTON

April 24, 2001

Dear Bill,

Thank you for your letter about a pilot program to direct RIK natural gas to low-income households at discounted prices. I sincerely appreciate you contacting me about this matter and I look forward to examining your idea further.

In January of this year President Bush established the National Energy Policy Development Group, of which I am Chair. Included in this group are the Secretaries of Agriculture, Commerce, Energy, Interior, Transportation, Treasury, and the Administrator of the Environmental Protection Agency, as well as the Director of the Federal Emergency Management Agency. The State Department has also been participating.

It is our mission to develop a national energy policy to help the private sector, and as necessary and appropriate, Federal, State and local governments, to promote dependable, affordable and environmentally sound production and distribution of energy. In developing our final report, we will be sure to keep in mind your thoughts and suggestions.

Again, thank you for your letter. We have a significant undertaking ahead of us but I am confident we will be able to develop a national energy policy that meets the energy needs of our country in a dependable, affordable and environmentally sound manner.

Sincerely,

The Honorable Bill Owens
Governor, State of Colorado
136 State Capitol
Denver, Colorado 80203-1792

STATE OF COLORADO

EXECUTIVE CHAMBERS
136 State Capitol
Denver, Colorado 80203-1792
Phone: (303) 866 2471

Bill Owens
Governor

February 7, 2001

Vice President Richard Cheney
Old Executive Office Building
Washington, DC 20501

Dear Mr. Vice President:

As America grapples with its current energy crisis, I am writing to suggest a federal pilot program to reduce home heating costs for low-income families. As you may know, the federal government currently collects royalties on natural gas extracted on federal lands through the royalty-in-kind (RIK) program. The aggregate total of the royalties—both onshore and offshore—makes the federal government the largest producer in the country.

The monthly royalty payments, which can be received either as cash or as natural gas, are split between the federal and state governments. Under my proposal, the federal government's Minerals Management Service would establish a pilot program to claim its royalties as gas volumes and, with the cooperation of local utilities and energy assistance programs, direct RIK natural gas to low-income households at discounted prices. The royalty gas could also be used to produce less expensive electricity in California.

I have already signed legislation authorizing $10 million in state severance tax money for low-income energy assistance. I would suggest that the federal government partner in this effort by using its royalty gas to help those who are most vulnerable to the price increases. In Colorado alone, such a program would assist almost 60,000 households. This program could commence with the approval of the Secretary of the Interior, and no authorizing legislation would be necessary.

I believe that this program will help address the immediate impacts of the current crisis.

Sincerely,

Bill Owens
Governor

cc: Gale Norton
Spencer Abraham

Mrs. CUBIN. The Chair now recognizes Mr. James Jacob to testify.

STATEMENT OF JAMES JACOB, MANAGER OF CONSUMER ADVOCACY, KEYSPAN CORPORATION

Mr. JACOB. Good morning, Madam Chairman and members of the Committee. KeySpan is the largest gas company in the Northeast and the fifth largest in the country. We serve 2.4 million gas customers in three States. We are also the largest privately-owned power producer in New York State, with 6,200 megawatts of generation.

Since 1998, KeySpan, formerly known as the Brooklyn Union Gas Company, has grown from one of the most respected local gas distribution companies in the country to a diversified energy company with a footprint in the Northeast. KeySpan also provides management services for the electric transmission and distribution services owned by the Long Island Power Authority. In addition to our natural gas customers, KeySpan serves 1.1 million electric customers on Long Island.

KeySpan is committed to providing assistance to low-income and special needs households. We have over many years established partnerships with State and local government social service agencies and community-based organizations to maximize the use of the limited resources available to serve this at-risk population. KeySpan is an active participant in the New York State HEAP Block Grant Advisory Council. We take an active role in promoting, advertising, and enrolling eligible customers in this vital program.

Recognizing our corporate obligation to the communities we serve, KeySpan has supported urban renewal initiatives through our Cinderella program, now in its 31st year. In 1983, we created a fuel fund in New York City that we call the Neighborhood Heating Fund. This fuel fund has been a critical part of KeySpan's response to the need for public and private partnerships to supplement LIHEAP funding. We have created or support similar fuel funds in all of our service territories.

This winter was extraordinary in the Northeast because of two main factors, the cold weather lasting for longer than average and the high price of gas used in heating homes. Understanding the incredible burden faced by low-income customers, KeySpan responded by adding additional funds to their heating fund. To date, KeySpan has contributed more than $7.4 million to these energy assistance programs. As there was an increased demand for energy assistance, this money quickly made its way to the households desperately in need of assistance.

In the early 1990's, KeySpan created two targeted low-income assistance programs. The first is On Track, a comprehensive behavioral modification program focused on energy and financial management that serves 1,700 customers per year in New York State. The second is the Residential Reduced Rate. This program helps make energy more affordable for our low-income customers in New York City by providing a discount on their basic service charge.

I would like to focus on our New York City operation today as I ask for your support in piloting a natural gas royalties in-kind program for low-income customers. KeySpan Energy Delivery of

New York serves 1.1 million customers in three counties within New York City. We currently have identified over 120,000 special needs households in this area. Studies we have conducted tell us that over 43 percent of our payment trouble customers have incomes at or below 150 percent of the Federal poverty level. Census data and other income studies conducted for our service territory support the findings of our research.

Every year, KeySpan works with thousands of low-income households struggling to meet their energy expenses. These are good people and they are facing hard times. Many are having difficulty with their bills for the first time. We see families that have had their income reduced by catastrophic illness, senior citizens adjusting to the loss of a spouse and the associated change in their financial status, and single-parent households struggling to keep their families together, and many of our neighbors who, because of loss of employment, are facing a crisis.

Recognizing that a large number of households are facing difficult choices, KeySpan implemented a discount rate for low-income customers in 1993. We currently have 54,000 households enrolled in this program. The special needs customers enrolled in this program receive a 30 percent reduction in their basic service charge.

As we develop the proposals I am supporting today, we approached our regulatory agency, the New York State Public Service Commission, and we are pleased to report that they are supportive of this undertaking. While this project was underway, the price of natural gas has increased substantially. We believe that the timing for a new public-private partnership to assist low-income households is critical.

In our residential reduced rate, we have a self-identified group of low-income and special needs customers who have asked us for the lowest possible residential rate. Our proposal would not mandate participation, but offers the lower-priced commodity based on program eligibility criteria. We believe that the voluntary enrollment provision is critical since we support the right of customers to choose and to make informed decisions in the emerging competitive marketplace. As these customers are already aggregated for our discount rate, they are the group that would benefit the most from the commodity discounts associated with royalties in-kind. This group has a better bill payment history than our normal residential customers and this has been a multi-year experience, and we are concerned that with the growing energy crisis, that these customers will face additional terminations for non-payment in the near future unless we come up with a mechanism to reduce energy burden.

With your support, the Department of the Interior can arrange for the delivery of natural gas as royalties in-kind. In the program that we are proposing, KeySpan would need an average of 8,200 decatherms of natural gas per day for these customers during January. When this has been accomplished, KeySpan could supplement the already discounted transportation rate with a much lower commodity cost. We would continue to provide all the customer care functions for these customers and we would use our existing capacity to transport the natural gas. We would also seek to reduce

or eliminate any associated demand charges related to this new supply.

This partnership would reduce the energy burden for low-income households, helping them to reach the elusive goal of energy affordability. We ask that you support the proposal for natural gas royalties in-kind as a direct and meaningful method of addressing the energy burden of low-income households. LIHEAP and royalties in-kind are essential to the well-being of a major segment of our population. Thank you very much.

Mrs. CUBIN. Thank you very much, Mr. Jacob.

[The prepared statement of Mr. Jacob follows:]

Statement of James M. Jacob, Manager of Consumer Advocacy, KeySpan Corporation

Introduction

Madame Chairman and members of the committee: I am James Jacob, Manger of Consumer Advocacy for the KeySpan Corporation. KeySpan is the largest Gas Company in the Northeast and the 5th largest in the country. We serve 2.4 million gas customers in three states. We are also the largest privately owned power producer in New York State with 6,200 Megawatts of generation. Since 1998, KeySpan formerly known as The Brooklyn Union Gas Company has grown from one of the most respected local gas distribution companies in the country to a diversified energy company with a footprint that spans the Northeast. KeySpan also provides management services for the electric transmission and distribution services owned by the Long Island Power Authority. In addition to our natural gas customers, KeySpan serves 1.1 Million electric customers on Long Island.

KeySpan is committed to providing assistance to low income and special needs households. We have, over many years, established partnerships with State and Local Government social service agencies and community based organizations to maximize the use of the limited resources available to serve this "at risk" population. KeySpan is an active participant on the New York State HEAP Block Grant Advisory Council. We take an active role in promoting, advertising and enrolling eligible customers in this vital program. Recognizing our corporate obligation to the communities we serve, KeySpan has supported urban renewal initiatives through our "Cinderella" program now in its 31st year. In 1983, we created a fuel fund in New York City that we call the Neighborhood Heating Fund. This fuel fund has been a critical part of KeySpan's response to the need for public/private partnerships to supplement LIHEAP funding. We have created or support similar fuel funds in all of our service territories. This winter was extraordinary in the northeast because of two main factors, the cold weather lasting for longer than average and the high price of gas used in heating homes. Understanding the incredible burden faced by low-income customers, KeySpan responded by adding additional funds to their heating funds. To date, KeySpan has contributed more than $7.4 Million to these energy assistance programs. As there was an increased demand for energy assistance, this money quickly made it's way to the households desperately in need of assistance.

In the early 1990's, KeySpan created two targeted low-income assistance programs. The first is "On Track" a comprehensive behavioral modification program focused on energy and financial management that serves 1,700 customers per year in New York State. The second program is the Residential Reduced Rate. This program helps make energy more affordable for our low-income customers in New York City by providing a discount on their basic service charge for qualified customers.

I would like to focus on our New York City operation today as I ask for your support for piloting a Natural Gas Royalties in Kind program for low-income customers. KeySpan Energy Delivery of New York serves 1.1 Million customers in three counties within New York City. We currently have identified over 120,000 special needs households in this area. Studies we have conducted tells us that over 43% of our payment troubled customers have incomes at or below 150% of the Federal poverty level. Census data and other income studies conducted for our service territory support the findings of our research. Every year KeySpan works with thousands of low-income households struggling to meet their energy expenses. These good people are facing hard times. Many are having difficulty with their bills for the first time. We see families that have had their income reduced by catastrophic illness, senior citizens adjusting to the loss of a spouse and the associated change in their financial

status, single parent households struggling to keep their families together and many of our neighbors who because of the loss of employment are facing a crisis.

Recognizing that a large number of households were facing very difficult energy choices, KeySpan, implemented a discount rate for low-income customers in 1993. We currently have 54,000 households enrolled in this program. KeySpan's Residential Reduced Rate offers a discounted transportation rate or basic service charge that includes the first 6 therms of natural gas. The special needs customers enrolled in this program receive a 30% reduction on their basic service charge.

In order to qualify for the Residential Reduced Rate, a customers must be currently receiving Medicaid, SSI, Public Assistance, LIHEAP, Food Stamps, Child Health Plus (New York State health insurance for uninsured children), Veteran's Disability Pension or Veteran's Surviving Spouse Pension.

Four years ago, as part of our ongoing advocacy program, we initiated research into a mechanism to deliver lower priced natural gas to this identified special needs population. Traditional utility rate setting mechanisms do not have a provision for directing the lowest priced commodity to a sub-set of customers. As we developed our proposal, the Company approached our regulatory Agency, the New York State Public Service Commission, and we are pleased to report that they are supportive of this undertaking. While this project was underway, the price of natural gas has increased substantially. We believe that the timing for a new public/private partnership to assist low-income households is critical.

In our Residential Reduced Rate, we have a self-identified group of low-income and special needs customers who have asked us for the lowest possible residential rate available. Our proposal would not mandate participation but offers the lower priced commodity based on program eligibility criteria. We believe that the voluntary enrollment provision is critical since we support the right of customers to choose and to make informed decisions in the emerging competitive marketplace. As these customers are already aggregated for our discount rate, they are the group that would benefit from commodity discounts associated with the Royalties–In–Kind proposal. Our Residential Reduced Rate customers as a group have demonstrated a better bill paying history when compared to the general residential customer population. This multi-year collection experience shows the direct results of affordable energy for low-income consumers. However, current collection forecasts project a somewhat darker future as low-income consumers react to higher energy prices. We have already seen growth in the amount of our past due accounts. We expect that delinquency and subsequent terminations of service for non-payment will grow if a mechanism for reducing energy burden is not found.

Many of the customers in our program were recipients of Public Assistance. We believe that additional targeted energy education materials including the use of bill inserts, coupled with affordable energy, will assist these households in the transition to self-sufficiency.

With your support, the Department of the Interior can arrange for the delivery of natural gas as royalties in kind. In the program that we are proposing, KeySpan would need an average of 8,200 dth of natural gas per day for these customers during the month of January. When this has been accomplished, KeySpan could supplement its already discounted transportation rate with a much lower commodity cost. KeySpan would continue to provide all of the customer care functions for these customers and would use its existing transportation capacity for this program. We would seek to reduce and or eliminate any associated demand charges related to this new supply with our existing natural gas suppliers.

This new public/private partnership would reduce the energy burden for these low-income households helping them to reach the elusive goal of affordable energy.

Conclusion

We ask that you support the proposal for using Natural Gas Royalties in kind as a direct and meaningful method of addressing the energy burden of low-income households. In today's uncertain economic climate with energy costs rising, there are more people in need of help than ever before. In the face of daily announcements of layoffs, industry restructuring, and downsizing, programs such as LIHEAP and Royalties in Kind are essential to the well being of a major segment of our population.

Mrs. CUBIN. I will begin the questioning. I would like to start with Mr. Cruickshank. Rumor has it that Joe Skeen's Subcommittee markup of the fiscal year 2002 appropriation for Interior

has the same RIK language that it had last year. Is that sufficient or do you think Secretary Norton needs more authority?

Mr. CRUICKSHANK. I think that that language will be sufficient for us continuing what we are doing now. If the Secretary wanted to consider taking the program in a different direction, then we would have to see if the authority was sufficient for those decisions.

Mrs. CUBIN. So to use RIK gas for LIHEAP, you would think that it would be necessary for Congress to take action or not?

Mr. CRUICKSHANK. It might. I think we would have to work through the specific proposal and see how it fit with our existing authorities. Some things we would be able to do, some we might not, and we would need to really work through specific proposals on that.

Mrs. CUBIN. Okay.

Mr. CRUICKSHANK. But as you have noted, the President's energy plan does call for us to propose legislation to use royalties to bolster LIHEAP, so I am sure we will be considering those authorities in that context.

Mrs. CUBIN. How would an RIK LIHEAP program actually work?

Mr. CRUICKSHANK. Do you want to handle this one, Milt?

Mrs. CUBIN. I mean, I have been working with royalty in-kind ever since I have been here, and so has Mr. Thornberry, but the other members of the Committee have not, and so I think what I would like you to describe is the collection, the distribution, the offset of the value or just how a program works, how an RIK program works and how we would get it out to the people that we are trying to take care of.

Mr. DIAL. In answering that question and making reference to Mr. Jacob's proposal, basically, from an RIK perspective, if we were dealing with outer continental shelf leases in the Gulf of Mexico and we were dealing with natural gas, typically, what would occur would be an identification of properties where a royalty obligation exists, or a royalty collection is occurring. That collection, if it were currently in-value, would be converted at the discretion of the Secretary to an in-kind collection, basically, a one, for most leases, a one-sixth of total production coming off a lease be converted to an in-kind take of royalty, and that in-kind take of royalty, that physical production, would be delivered to a central aggregation point.

What I heard Mr. Jacob describe would be that KeySpan would either itself or through intermediaries arrange for the physical movement of that gas to New York. That is the physical aspects of how, I guess, we would envision, just in the short discussion that we have had, of this particular proposal.

Mrs. CUBIN. So in other words, the gas itself would go to the utility. The utility would deliver the gas to the homes and that would replace an additional appropriation that the Congress would make. Would that be a shortcut to it? Mr. Harpole?

Mr. HARPOLE. Can I try to answer your first question, and then I will try to clarify the second? Deanna, can you put up the map, please? The concept that I have discussed with KeySpan is that they hold firm transportation on Transco right now that actually picks up gas in the Gulf Coast. And so one of their purchases—they may have 40 different packages of gas that they buy on a daily basis, but one of their purchases is directly with the producer on

the Gulf Coast. That accounts for about 60,000 MMBTU per day, 60,000 of the million that they use behind their New York City service territory.

And so if you imagine there is a one-sixth royalty on all that gas, 10,000 of that, if the producer did not do it in-kind, 10,000 of that MMBTU would be paid to the Federal Government on a 2014 Form. What I am saying is, instead of doing that, let us have KeySpan identify the volume that they need under the existing contract. KeySpan says, I need 8,200 of that 60,000 at the Secretary of Interior's price, but I will transport it. I will transport it even though my transportation value is probably—the value of that transportation that they hold in the winter is four to five times less than what the market could charge for that similar transportation quantity.

So it is kind of a seamless transaction. You do not have to buy new gas to cover those people, and I would love to kind of address the California question that was asked earlier, but it is a pretty seamless transaction that would cover 54,000 people with one deal.

One thing I would like to point out is that only three-tenths of 1 percent of the available royalty gas offshore, only three-tenths of 1 percent would cover all of KeySpan's New York City service territory.

Mrs. CUBIN. I realize my time is out, and rather than going to a second round of questioning, I wanted to ask one question of Mr. Cruickshank. It has been alleged or suggested here today that MMS would have to establish a huge new big bureaucracy to market this gas. I would like your response to that.

Mr. CRUICKSHANK. I do not think that would necessarily be the case, Madam Chairman. Right now, our operating principle is to collect the royalties in-kind and get them to a pooling point or a market center that is close to the producing area. It is not the most complicated of transactions to do and selling gas at a market center is also fairly straightforward. I think if we were to get ourselves heavily involved with going downstream from there, then we would have to pick up a lot of additional skills and that would become more complicated. But the way we are operating right now, I do not think we need to build up too big a bureaucracy to do so.

Mrs. CUBIN. In conjunction with that statement was the statement that MMS does not have the expertise to do this. Would you agree with that or not?

Mr. CRUICKSHANK. We have been developing the expertise, and that is part of the reason for the pilots. I think that the folks that have been working the pilots since 1998 have developed a lot of that expertise and are operating very well and doing things that all the other marketers do out there very successfully. That is only a small number of people, and if we were to grow the program by a large amount, we would certainly need to train more people and acquire additional expertise over time. But it is the folks doing the work now that have developed that expertise.

Mrs. CUBIN. Thank you very much.

The Chair now recognizes Mrs. Napolitano.

Mrs. NAPOLITANO. Thank you, Madam Chairman. First, I would like to put into the record Representative Maloney's statement, Madam Chair. She has not been able to be here.

Mrs. CUBIN. Without objection.
[The prepared statement of Mrs. Maloney follows:]

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MALONEY CAUTIONS AGAINST REPUBLICAN PLANS TO BOLSTER OIL INDUSTRY

WASHINGTON, D.C. – Today, Rep. Carolyn B. Maloney (D-NY) testified before the Energy and Mineral Resources Subcommittee hearing on collection and disposition of federal oil and gas royalties taken in-kind.

"Apparently, my Republican colleagues would like to replace a state-run program with an unspecified, expensive, federal bureaucracy whose job it would be to transfer oil royalties taken in kind to low-income consumers," **Rep. Maloney said today before the Energy and Mineral Resources Subcommittee.** "Republicans would sooner walk over hot coals than support federal bureaucracies for something as important as our children's education system. But, boy, do they change their tune when it comes time to help the oil industry," Maloney added.

In her testimony, Rep. Maloney stated that before a new MMS rule was established last year, numerous major oil companies were paying royalties based on prices that were far lower that the market value of the oil they were buying and selling. Mrs. Maloney cited a draft review produced by MMS of the Wyoming royalty-in-kind pilot project. The report illustrated that accurate data reflecting the true administrative costs of royalty in kind programs is also unreliable at this time. The Wyoming report concedes that Minerals Revenue Management (MRM) is "still developing a process to manage royalties taken in kind" and that "the estimated costs for the new RIK process cannot be made at this time because the process is not final." In her testimony, Rep. Maloney asked: "Since when has Congress considered creating massive new Federal bureaucracies when we have little idea what they may cost?"

Congresswoman Carolyn Maloney, a long-time critic of waste, fraud, and abuse in government programs, has been a leader in efforts to revise the Interior Department's oil-valuation rules. At her urging, the House Subcommittee on Government Management, Information and Technology has held two hearings into MMS's royalty-collection efforts which were instrumental in getting MMS to re-write its oil-valuation rules. In 1999, she issued a report demonstrating that several major oil companies used a variety of schemes to deliberately underpay royalties throughout the 1980s. Consequently, in March of 2000, the Interior Department's Minerals Management Service (MMS) released a new oil-valuation rule that determined the royalties paid by companies that produce oil on federal lands. This rule will save taxpayers $67.3 million dollars each year, according to MMS estimates.

(Testimony attached)

Rep. Carolyn Maloney (D-NY), Opening Statement
Energy and Mineral Resources Subcommittee Hearing, June 12, 2001

I would first like to thank Congresswoman Cubin and the Committee for inviting me to appear today. I have worked actively on royalty issues for many years, and I am grateful for the opportunity to be here.

Through my work on the Government Reform Committee, I have been heavily involved in efforts to get the Federal government to do a better job collecting debt that it is owed.

It was as part of these efforts that I discovered that numerous major oil companies were paying royalties based on prices that were far lower that the market value of the oil they were buying and selling. They kept two sets of books, one for themselves and one for the people of America. And guess who was making the record profits? The oil companies.

Rep. Steve Horn and I held two hearings to investigate money that major oil companies apparently owed the Federal government.

Our hearings showed that many of these companies were underpaying royalties, costing the American taxpayer nearly $100 million a year. As you know, many companies were sued by the Federal government for deliberate underpayment of royalties. Most have elected to settle and, to date, over $425 million has been collected. Combined with States and private royalty owners, the oil industry has reluctantly paid close to $5 billion to settle these claims. Now I know that these settlements are not technically admissions of guilt, but they are the closest thing to them that you'll ever get out of companies like ExxonMobil, BP Amoco, and Chevron.

The Interior Department's new oil valuation rule -which was announced last year - will save taxpayers at least $67 million each year by ensuring that oil companies pay the fair market price for the oil they take from Federal lands.

Now that we have finally put a stop to the industry's shenanigans and are collecting the fair amount of royalties for the American taxpayer, we are being asked to examine an entirely new system of royalty collection.

The Minerals Management Service has conducted a draft review of their Wyoming royalty-in-kind pilot project. I applaud MMS for attempting to examine the performance of this new initiative, but I am concerned that this report fails to include many of the most important cost considerations for these projects. As a result, the report's conclusions that Royalty in Kind generated approximately $810,000 more revenue than royalty in value appear seriously flawed.

The MMS Review claims that the project has generated $810,000. But that assumes that royalties would have been calculated using the old royalty rules.

Independent analyses of the report show that in almost all cases, the government actually would have lost revenue compared to actual market prices. In fact, the government actually **LOST almost $3 million** when you compare what was received via RIK with what would have been gained for the government if royalties had been paid based on market prices.

I have brought a number of charts with me that illustrate this point. The bottom green line shows posted prices, the middle red line shows the revenues earned from royalties taken in kind and the top blue line shows the actual market rates for the oil being sold.

As you can see, market prices were almost always higher than the revenues gained from oil taken in kind. I would be interested to hear from MMS why their review of the pilot does not include this essential information.

I should also point out that the overall cost-benefit analysis of the program does not consider any of the costs associated with running the Royalty-in-Kind program including processing, transportation, pipeline fees, and other program costs. Given the relative lack of experience that the Minerals Management Service has in these areas, it seems likely that these costs could be considerable.

Apparently, accurate data reflecting the true administrative costs of royalty in kind programs is also unreliable at this time. The Wyoming report concedes that Minerals Revenue Management (MRM) is "still developing a process to manage royalties taken in kind" and that "the estimated costs for the new RIK process cannot be made at this time because the process is not final."

In other words, the possible costs of administering an RIK program are completely unknown. Since when did this Congress consider creating massive new Federal bureaucracies when we have little idea what they may cost?

Ladies and gentleman, RIK puts the Federal government in the oil business. Not because it will save taxpayers money–it will actually cost them more. Not because it is more efficient– that hasn't been shown. No, we are asking the Federal government to enter into the oil business because big oil can no longer get away with cheating taxpayers out of their fair share of royalties received in value. What's the best reason for this program??? Apparently because it will save big oil money. That is the only reason I have seen to support significant expansion of this program.

I would also like to remind everyone here that the General Accounting Office has already extensively examined Royalty-in-Kind. In their report of August 1998, they concluded that "it would not be feasible for the federal government to take its oil and gas royalties in kind except under certain conditions."

These conditions included access to pipelines, significant volume at the lease, competitive arrangements for processing, and marketing experience. The report further concluded that "these conditions are currently lacking for the federal government and for most federal leases." The Wyoming pilot confirms the GAO's conclusions.

I have asked the GAO to re-examine RIK now that the Federal government has become more involved in the oil business. I would hope that Congress would consider waiting for their nonpartisan analysis of RIK before moving forward with any expansion of this expensive and inefficient government program.

I was also asked today to discuss the possible use of royalty revenues for low income energy assistance. Earlier this year, I introduced HR 962, the Low Income Energy Reinvestment Act which would direct five percent of onshore royalties to LIHEAP, the Low Income Home Energy Assistance Program. I was delighted last month when President Bush included my idea in his energy package and I look forward to working with him to pass HR 962 this year.

I am somewhat surprised that the invitation to appear today mentioned that I should be prepared to discuss whether the government should use royalty dollars or royalties taken in kind to benefit low income consumers. After all, under my bill and the President's energy plan, royalty *dollars* could be directly applied to the LIHEAP program.

Now ladies and gentlemen, LIHEAP has existed for 20 years. It is a proven, state-run program funded by federal block grants. It helps thousands of seniors and low-income consumers each year. Apparently, my Republican colleagues would like to replace this state-run program with an unspecified, expensive, federal bureaucracy whose job it would be to transfer oil royalties taken in kind to low-income consumers. Now- I understand that they would have the help of the oil industry in this effort. Thank God.

I am glad that we will be leaving the energy needs of low-income Americans to an industry that has already settled for over **$5 billion dollars** for cheating taxpayers out of their fair share of oil royalties. Madame Chairwoman, I am grateful that this committee is anxious to help low income Americans who are hurting the most from high energy prices.

But I would advise this Committee and this Congress to avoid creating new federal bureaucracies to address these problems and instead work toward passing common-sense, bipartisan legislation like HR 962 that will use existing, state-run programs to help those in need.

Madame Chairwoman, President Bush and I may not agree often, and there are many aspects of his energy plan that I seriously question, but on this issue, there is little debate. I hope you will consider supporting my legislation, without controversial amendments to attach this sensible bill to the unproven and expensive royalty-in-kind program.

Thank you.

Mrs. NAPOLITANO. It is with great interest that I am listening to the actual process by which we could accomplish the assistance to the low-income, and that is of great interest to me, but I still have concerns whether or not the system will be able to function. Mr. Cruickshank, you indicate that there are some pilots.

Mr. CRUICKSHANK. We have been operating pilots where we have been taking royalties in-kind and selling them at the market centers. There has not been a pilot yet to deliver royalty in-kind to the LIHEAP program.

Mrs. NAPOLITANO. So we are just speculating that that would work. What would you think would be the most, I would not say onerous, but what would be the biggest obstacle to be able, to any of you gentlemen, to be able to put a program that would actually serve the low-income and still be able to have the government be able to maintain a fairly good process that would not endanger future programs, because if you realize, once you set it in place, all you have to do is keep adding to it, and we want to be sure that there is something that is going to be there for a good number of years, that is going to be adequate to serve the people that it is meant to serve, and that it does not infringe upon either the business sector, i.e., the gas companies, or that it does not impact other areas that will eventually be impacted, because you are going to have a rise and fall of prices much as you have in gasoline, and you have seen that increase. In 10 years, you have had a 100 percent increase almost. How would you be able to keep that?

I mean, there are all kinds of questions that come into my mind, because people on fixed income do not have, generally, a doubling of their income within a certain period of time. So you are talking about being able to provide those folks with adequate sources of gas and still maintain a price that is not going to affect both the government and private industry. Gentlemen?

Mr. HARPOLE. Can I take the first swing at that?

Mrs. NAPOLITANO. Please.

Mr. HARPOLE. It is a good question, several different questions in there.

Mrs. NAPOLITANO. A lot of them.

Mr. HARPOLE. A couple come to mind.

Mrs. NAPOLITANO. In my mind, there are more.

Mr. HARPOLE. I will try my best. This, in no way, shape, or form, is meant to upset the marketplace. In fact, the royalty gas that is purchased by a marketer or a utility right now is inherent in the 8(a) production that they buy from a producer. So when you think about it, when they buy that gas and take it to the utility, they are not allowed to earn a rate of return on the commodity portion of their gas cost. They have to pass that through. Utilities earn a rate of return based on their cost of service. If they are allowed to earn a rate of return on $20 gas, they would buy $40 gas. So it is a pass-through and so there is no inherent impact on the marketplace from that standpoint.

It is not meant to be a social or a welfare-type program. If the alternative is to buy gas—if the alternative is to transfer monies to LIHEAP, LIHEAP can spend up to 10 percent of those monies on administrative cost. So in my mind, if the top 25 utilities cover 52 percent of the residential customer base and we just solved New

York City's KeySpan service area problem with one deal, imagine what 25 deals could do in terms of solving 52 percent of the residential customers' exposure to low-income high heating bills.

And then, in addition, think about what it does when LIHEAP can reschedule other funds to go to conservation and other programs. It is meant to kind of augment the LIHEAP program and the ease and efficiency of it is such that if you just took $1 billion of royalty gas—just $1 billion of royalty gas—but if you took $1 billion of royalty gas in-kind and gave the money to LIHEAP, $100 million of that could be spent on administrative costs. It would not cost a fraction to audit this program, where you see where the utility says, this is how much I need for my low income. I cannot imagine a utility overstating that so that they can make more money. This is one where we are kind of all helping—the entire industry is helping that person lower their energy cost, and the efficiency is, in part, is the elimination of the administrative overhead.

Mrs. NAPOLITANO. That is great, and Madam Chair, may I just stress one point, is that I have heard the utilities would not want to make a profit, but let me tell you, I have had utilities tell me they have to make a profit for their investors, and I told them I do not get that kind of assurance from my stockbroker. So it is kind of like, do we allow it? How much of it? Is it a fair return? Look at what is happening with the price increases, both in the energy and electricity and also in gas. So to me, it is very open. It is like anybody can do anything they want until we begin to close the gaps and the loops. Your statement that the transporter will not charge because it is a seamless thing, they will make some money somewhere.

Mr. HARPOLE. They are allowed to earn their cost of service rate of return on the transportation.

Mrs. NAPOLITANO. That is what we heard of energy, too.

Mr. HARPOLE. But honestly, for me, I would hate to be a utility, because you are allowed to earn a rate of return, but there is no incentive for you to go out there and buy gas at a cheaper price, because if you guess wrong, you cannot pass through that cost to your customer base. And so they live in a box. These folks from KeySpan—

Mrs. NAPOLITANO. In other words, it is—

Mr. HARPOLE. Right. It is a no-win situation and there is constant 20/20 regulatory hindsight.

Mrs. NAPOLITANO. But you understand from our vantage point is we have our constituents saying to us, take care of it. How? And so we need to find out, how do we best work with the industry to be able to be sure that we are doing the right thing for them.

Mr. HARPOLE. I think what you have before you, Congresswoman, today is a producer group, an interested party in myself, and a utility group that are saying, this is a great solution. It is a seamless-type solution. And the utility is willing to allow their transportation that is worth a lot more in the marketplace to be utilized to save money for the low income.

Mrs. NAPOLITANO. Thank you, gentlemen, and I have gotten that message.

Mrs. CUBIN. The Chair now recognizes Mr. Otter.

Mr. OTTER. Mr. Harpole, I am interested in your comment that this was not meant to be a welfare program. What was it meant to be, then?

Mr. HARPOLE. It is definitely a transfer of wealth right now. This is—

Mr. OTTER. What would you call it? If you did not call it a welfare program, what would you call it?

Mr. HARPOLE. It is the Federal Government helping step in to solve a problem that they helped create.

Mr. OTTER. That they helped create?

Mr. HARPOLE. The higher natural gas prices, in my opinion, are a direct result of more air emissions standards. Now, I am from the natural gas industry and when I see every utility out there choosing natural gas as a generation of source, I feel like the dog that was chasing the car and I caught it. So every utility out there—of the 250 projects, electric generation projects, that are proposed, all but five are natural gas fired right now nationwide. And so we have seen the shift, and you can blame it on the Federal Government or just blame it on people that want to try to reduce emissions, but we have seen a shift in the fuel of choice to natural gas. But at the same time, as a third generation native of Colorado, we see access to Federal lands where a lot of those unknown and undeveloped reserves, or the undeveloped reserves, are situated.

And so from my perspective, having seen this from the wellhead to the burnertip, those two Federal issues have helped create a price increase. We cannot be surprised by the fact that gas prices have increased when we increased the demand and then also reduced access. At the beginning of the hearing today, the Chair recognized that we do not want to go into issues about why prices have increased and why we need more access to Federal lands, but I think that issue is a direct—the pricing that we are realizing today is a direct result of several different conflicting policies, restrict air emissions, restrict access to Federal lands.

Mr. OTTER. Well, given your enthusiasm for this kind program, then why would not the Federal Government, why would not this Committee also include the rights-of-way across Federal ground for pipelines, for instance, as in-kind as well? Why not allow the use of Federal lands for rights-of-way and the transmission of pipelines and use that as sort of a toll. Say, well, we are going to toll you X-number of dollars per cubic foot and that is going to go into the in-kind, as well. I can see a tremendous new bureaucracy being built up in order to keep track of all these little accounts that would absolutely delight those who believe that government ought to be the one that is dividing up scarcity.

Why would we not include all these other things? Say, in low-cost housing, if you are going to harvest forests off of Federal land, then out of every 1,000 feet, say 100 feet of that has got to go to low-cost housing. Where would we stop?

Mr. HARPOLE. Congressman Otter, I am about as right-wing a Republican as you will ever find. The gentleman to your left actually is my Congressman and he knows that for a fact.

Mr. TANCREDO. I can attest to that.

Mr. HARPOLE. There was a time when the Federal Government, to create an incentive to expand the nation actually awarded every other section on either side of the railroad.

Mr. OTTER. Yes.

Mr. HARPOLE. We have a problem right now. We have an energy crisis. It is hitting the people that do not understand the issue the most, the 58 million residential customers, and we need to come up with some creative solutions to solve that problem.

What I would like to do, in coming up with this idea, let us release the pressure valve on the people that are the most affected, and that is the low-income portion of those 58 million customers that really do not understand the flow of the molecule of gas from the wellhead to the burnertip. This is a program that you could dial up and down. If the gas prices return to a 10-year average, the program is terminated and the—

Mr. OTTER. And the bureaucracy goes away?

Mr. HARPOLE. The bureaucracy goes away. And it is not the bureaucracy that you create in the LIHEAP program. It is a much more efficient approach.

Mr. OTTER. We have got to have some institutional memory here, and the institutional memory that I can recollect is that I have never seen one go away, but that is a subject probably for a different day.

Mr. Cruickshank, have you audited any of these pilot projects for success?

Mr. CRUICKSHANK. We have done an evaluation of the Wyoming oil pilot.

Mr. OTTER. Is that an audit?

Mr. CRUICKSHANK. It is not an audit. That would, in essence, be auditing ourselves in a sense. We are taking the production. We do use our auditors from the royalty program to verify that the volumes delivered are the correct volumes. But we are selling the product under contractual obligations with private companies or with the General Services Administration, and as we verify the volume, since the price is written in the contract, we are able to tell without a full-scale audit whether we are being paid the right amount.

Mr. OTTER. I see. What would be wrong with the government just assuming a working interest in an ore body, or not in an ore body, but in a gas field? Why would we not just assume a working interest like if we were the landowner, which I think we are?

Mr. CRUICKSHANK. In a sense, when we take royalties in-kind, the operators are treating us as a working interest in terms of delivering the production to us and giving the information that one needs to manage the production one takes off of a lease. We are not a full working interest in the sense that we are not at the table to help decide how the oil and gas reservoir is going to be developed and what investment decisions to make, and I think that that would be the big issue with your proposal. Should the government be there with the lessee deciding exactly what sorts of investments to make and when to make them?

Mr. OTTER. But is that not what happens? If Butch Otter owns a chunk of ground and there is a gas reserve underneath it, there is a gas deposit underneath it and they drill down and I maintain

a one-eighth working interest in that well or in that whole field, do I not then come to the table and say to the folks who would develop it, who are actually getting the resource as a result of their development and their ability to accommodate the money necessary, the investment and exploratory funds necessary in order to develop the field, I make those decisions, and the decisions that I would make, Mr. Cruickshank, would be based upon how much more return am I going to get for my one-eighth, right?

Mr. CRUICKSHANK. The fundamental difference between a working interest and a royalty interest is that role in the decision making about the operations on the lease.

Mr. OTTER. One more question, then. Are we not the landowner?

Mr. CRUICKSHANK. Yes, we are.

Mr. OTTER. Thank you.

Mrs. CUBIN. The Chair now recognizes Mr. Rehberg.

Mr. REHBERG. Thank you, Madam Chairman. You will note that I sit to the right of the entire Committee. There is a reason for that on the conservative meter.

I do not have a problem with your idea. In fact, I think we do need a short-term solution and we have to be very creative without masking what created the problem, and that is supply and demand.

As I look at your map, that is a nice pipeline, but it does not do anything for Montana, and over the course of the testimony, we have heard that there is a bottleneck at the pipeline. Can it work in areas where there are, in fact, the inability to get our gas into the pipeline?

Mr. HARPOLE. Yes. I was hoping someone would ask that question to clarify a statement that Mr. McMahon made earlier. He indicated that it would require additional transportation volumes to get to California. In anticipation of that question, I pulled down the list of parties that transport gas on the El Paso pipeline and Trans-Western pipeline from the San Juan Basin, predominately Federal lands, from the San Juan Basin into California, and SoCal has 500,000 MMBTU a day of gas transportation. Similar in concept to the offshore idea, they could take advantage of that.

As you well know, Montana Power sources gas from all over Montana. In addition to doing this on Federal lands, that is gas that is brought in from Montana, you could do it on State lands, also, but that would be left up to the individual States to solve that problem. But Montana, as you well know, is surrounded by Federal lands and one-eighth of that royalty gas would be available. Now, remember, one-eighth of that royalty gas is transferred to the State once it is received and one-eighth goes to the Federal Government.

There may be some people in New Mexico that do not want 50 percent of their share going to California to solve a problem, but in my estimation, the Federal Government has more than ample volumes of gas to cover the low-income heating needs in Southern California. You will not be using 80 to 100 MMBTU a day in Southern California for the low-income just because of the temperature difference there.

Mr. REHBERG. Let us assume I am with you, then. By creating an opportunity for people to become dependent upon Federal sources for their natural gas, do we, in effect, then leverage them

into supporting our additional, not only construction of pipelines, but also taking land out of production in places like the Missouri Breaks, which they most recently did under the President's Executive Order?

Mr. HARPOLE. That was not the initial thought. That was not the motivation behind the idea. But for once, we might have what I would characterize as non-producing States. You might finally have even a Republican that has never voted for lands access issues, his constituents might finally be impacted by access to Federal lands by virtue of the royalty gas that is available from Federal lands that helps his constituents. And so it is a terrific link in the sense that, again, we just need to educate people as to where the gas resource comes from.

If you want to know where natural gas is consumed, look at a population density map of the U.S. If you want to know where it is produced, look at a pipeline map of the U.S. They are not the same. And so I think, honestly, all Americans need a better appreciation of where we source natural gas and how critical it is for us to maintain our own domestic energy policy to continue to source that gas in U.S. waters and on U.S. lands.

Mr. REHBERG. I tried to follow the conversation with Congressman Otter. Do you think there is an opportunity—let me use as an example Montana again. A lot of our natural gas comes in from Canada, and so that is clearly not a Federal gas, but it is mixed with Federal gas, but the pipeline does, in fact, go across Federal properties. Could we, in fact, then make a connection between the pipeline going across the Federal properties and use some of the Canadian gas that is in that line if it is a higher percentage than would be available under your pilot program?

Mr. HARPOLE. Yes. I actually did some expert witness work on a case involving Montana Power several years ago and Colorado Interstate Gas has an interconnection south of Billings that sources gas in the Powder River Basin and also in the Green River Basin, and at that time, I think it was responsible for about 20 percent of the gas volumes delivered into Montana Power. About 80 percent does come in off of Caraway, the connection in Canada.

But as you saw in New York City, 80 to 100 MMBTU a day, I mean, honestly, my father was born in Deer Lodge. What is the usage in Billings? We are not talking about a lot of gas volume there. So there should be plenty, I mean, in order of magnitude of 100 times more than what you might actually need for the low income.

Mr. REHBERG. Thank you.

Mrs. CUBIN. The Chair now recognizes Mr. Thornberry.

Mr. THORNBERRY. Thank you, Madam Chairman. As you mentioned a few minutes ago, you and I have been dealing with royalty in-kind issues since we have been here, partly out of a frustration of trying to put a value on gas and then figure out what that is so that proper payments can be made to the Federal Government, and then the continual lawsuits that seem to go on forever after that is made.

And so we have talked about royalty in-kind as far as figuring out a way to take the Federal share of gas and selling it on the market and receiving the money that way. We have also looked at

ways to use the Federal share of gas to heat Federal facilities. There, of course, is a little of that going on. There is a State program that does that in Texas, run by the General Land Office. And we have explored the possibility of military bases or other Federal facilities that could use this gas in a more direct way.

I think this suggestion kind of takes it even to the next step and tries to get around all of the difficulties in putting a value on what that is worth but making some good use. I think you are right. I think it is creative and it is interesting to me.

Mr. Harpole, I am still trying to understand, and I am sure it is just me, on the transportation side of this, obviously you have gas that these utilities will just pass along to the low-income folks. What is the motivation for them to provide the transportation, or is that something that we, the Federal Government or the LIHEAP program, has to pay to get transported?

Mr. HARPOLE. I would like to take a crack at this and then turn it over to Jim Jacob for KeySpan, if I can, to further answer the question. But there is in most States, and I would say 95 percent of the States, State utility commissions require public utilities to hold upstream firm transportation on interstate pipelines in adequate volumes to cover a peak day need on their system. Now, there are a lot of thoughts in that one sentence. But again, the only utility that I know of in the country that has relinquished firm transportation to the marketplace is Atlanta Gas Light, and if you have read any paper in the last 3 years, you realize that that was not necessarily the best program in the country.

Yesterday, I asked some gentlemen from KeySpan how many utilities on the East Coast have firm transportation all the way to the Gulf Coast in order to satisfy some of their supply and they said—they did not hesitate—they said 100 percent, 100 percent. And so that is transportation that is already in the queue because those are the customers that they have to cover. They are the last supplier of resort for that customer base. And so those utilities will always be able to cover the residential customer base. They will be required to by their State utility commission.

I do not know, Jim, if you have something to add to that.

Mr. JACOB. I would just like to add that in New York State, we do have an obligation to serve all customers who ask us for service, and even in recent hearings for providers of last resort in the emerging competitive marketplace, it has been determined that somebody, even if it was not a utility, and that is several years downstream, it would have to be an entity within the State, either a marketer or a utility company, who will have that capacity to supply natural gas and electricity to customers as needed. So I think that certainly in New York State, utilities will be the provider of last resort for the next several years, and we can certainly benefit low-income customers in New York State by using a royalties in-kind program at this time.

Mr. THORNBERRY. But you have to be compensated to transport that gas from production areas up to New York, because it costs you something to do that, right?

Mr. JACOB. We would already be transporting gas for these customers. This would simply be a lower-price commodity that we could pass on to consumers. So our cost, and I am not an expert

on our contract, certainly, but we already have supply contracts, as John noted, in the Gulf region, and so we would simply be passing this through the same pipeline system, through our city gate at the beginning of our territory and to our customers who were enrolled in this low-income initiative. So for us, it would simply be a mechanism that we could show on their utility bill as a reduction, along with some of the education programs that we would like to do with these same customers to help them to understand this changing competitive marketplace that is the energy world today.

Mr. THORNBERRY. So it would not cost you anything additional to transport this gas, more than it already costs to get the gas to each residential home?

Mr. JACOB. It is my understanding that there would not be any change in those structures. We are already transporting gas from that region to the New York City gate.

Mr. HARPOLE. And if I could add something to kind of help toot KeySpan's horn here, KeySpan is one of the few utilities, if you unbundle the cost of gas to residential customers, say there is a commodity cost, there is an interstate pipeline transport cost, then there is a cost to transport across the utility grid to get it to the residential customer, that last piece, they have actually cut that cost for the low-income by 30 percent. No other utility in the country has ever even offered something that large in terms of percentage cuts. And so this is one where they would benefit by the lower commodity cost, they pass through the same interstate transport costs under their costs of service, but then again, they even give that set of customers, the low-income, a 30 percent discount on what they charge to transport across their pipe.

Mr. JACOB. And if I could just add, as I said in my testimony, these customers who have benefitted from this 30 percent discount to date pay much better than the average residential customer base that we serve, so that once we have addressed an affordability issue, it really makes a difference in their lives and many of them have transitioned from public assistance and they are still on the food stamp program and still categorically eligible for LIHEAP, but it makes a real difference and we have seen that.

Now, the higher energy costs of the last year are starting to affect that. This program would allow us to reduce that burden by the commodity cost. We would still retain our discount rate of 30 percent and these customers would benefit and learn about the process of gas supply and competition at the same time.

Mrs. CUBIN. The Chair now recognizes Mr. Tancredo.

Mr. TANCREDO. Thank you, Madam Chairman, and I apologize for, first of all, being late and then having to run in and out here. As a result, I probably will not ask a question that may, in fact, end up being redundant. I would just say that your particular leadership in this area, Madam Chairman, has been very helpful to me and elucidative, and although I have not spent the same amount of time in the Congress or on this issue as Mr. Thornberry and you, I have come to the conclusion that royalty in-kind is a far better way of determining the exact value of the royalty that the Federal Government should be obtaining from the industry than is the present process that leaves so much up to—that causes so much

confusion about whether we are talking about wellhead prices or downstream prices upon which that valuation is determined.

So I have somewhat reluctantly come to the conclusion that royalty in-kind is the best way to go. The only thing I have ever heard as a major sort of argument against it from a philosophical standpoint is that it puts the Federal Government into the position of being one of the world's largest oil and gas brokers if the program is fully implemented. But it seems to me that if we could direct a portion of these direct payments to LIHEAP and the Strategic Petroleum Reserve, as has been recommended by the National Energy Policy, that we could diffuse some of that criticism, and appropriately so.

Along with that, of course, the program does eliminate the middleman that costs all energy consumers additional money, and oil and gas producers must provide exhaustive accounting, as has been attested to—I did hear that—valuation paperwork costing millions of dollars. The Federal Government must process that paperwork. In a way, we could, I guess, present this as being an energy savings plan, not have to cut down so many trees to produce so much paper.

But I must say that my added support for this concept is brought to bear as a result of Mr. Harpole's analysis and participation in it. I think he is one of the most knowledgeable individuals in this field. He has been a leader and a pioneer of the concept in Colorado, and, in fact, I know that Governor Owens, our governor, is strongly supportive of the RIK to the LIHEAP concept, and his confidence in that, by the way, I am sure, comes to a large extent from his support and confidence in you, Mr. Harpole. So I think we can all learn a great deal from your testimony and I look forward to reading the various testimonies that have been provided for the record, and I thank you all.

[The prepared statement of Mr. Tancredo follows:]

Statement of The Honorable Thomas G. Tancredo, a Representative in Congress from the State of Colorado

Thank you Madame Chairman. Your leadership on this Royalty in Kind concept for oil and gas leases is so strong and well developed, and I applaud you for holding a hearing which adds a new, and logical, twist to the royalty-in-kind program.

The only criticism I've heard regarding royalty-in-kind that holds any weight is the assertion that the Federal Government would, itself, become one of the world's largest oil and gas brokers when the program is fully implemented. If we could direct a portion these royalty-in-kind payments to LIHEAP and the Strategic Petroleum Reserve, as recommended by the National Energy Policy report, we could certainly diffuse some of that criticism. Not to mention the fact that royalty-in-kind programs should eliminate the "middleman" that costs all energy consumers additional money, as oil and gas producers must provide exhaustive accounting and valuation paperwork costing millions of dollars, and the Federal Government must process that paperwork. Who knows? With royalty in kind, we could probably save a few trees.

No one commands more knowledge on this topic, and the LIHEAP "twist", than Mr. John Harpole a constituent and friend of mine who is here today. He has been a leader and pioneer of the concept in Colorado. In fact, I know that Governor Bill Owens is strongly supportive of the royalty-in-kind-to–LIHEAP concept, and his support comes largely from his confidence in Mr. Harpole. I think we should all learn a great deal from his testimony.

Again, thank you Madame Chairman for holding this hearing today

Mr. TANCREDO. I guess I should say one other thing. If there is something that we have not asked you that we should, anyone can go ahead and respond, and this is the time to do it.

Mr. HARPOLE. I think the one that I would just like to reiterate, would this work for California utilities? Yes, it would. Would this idea work to maybe perhaps lower electricity costs by taking royalty gas to electric generators? Yes, it possibly could. I really believe in this idea. You can probably tell, I speak about it so passionately. I think it is a concept that is terrific because all the different parties work together. It really would be the Federal Government, the pipelines, the producers, the utilities, kind of working in conjunction and coming up with a solution for people that are most impacted by our commodity, and perhaps at the same time help educate them.

Mr. JACOB. And if I could just add that the LIHEAP delivery network is strained to capacity. It is difficult to administer programs. In New York State, we only serve 50 percent. We have 12 percent of the national allocation of funds and we are only able to serve 50 percent of the eligible households. This mechanism, using utilities, takes that burden off. It allows us to bring direct assistance to the low-income households who are LIHEAP-eligible or members of other low-income programs and it does so while allowing the network to redirect its sources to help other fuels, to help other people in crisis, maybe to mitigate some emergencies, to reduce the number of terminations for non-payment, and perhaps to allow some additional dollars from LIHEAP to go to weatherization and conservation efforts to solve the longer-term initiatives.

So I think that this is a wonderful opportunity to use the natural gas that currently goes for valuation as royalties in-kind that would help low-income customers directly. As a consumer advocate, that is the piece that I see. This is not to replace the LIHEAP program. Certainly, it needs to be funded and funded appropriately. But this is a wonderful way to supplement that, particularly during this time of crisis.

Mrs. CUBIN. Thank you. The Committee thanks the witnesses for their testimony and for the answers, the good answers to the questions. I think we have had a great discussion here today. I also thank the members for their thoughtful questions.

I would like to include a statement from Congressman Ron Kind in the record, without objection.

[The prepared statement of Mr. Kind follows:]

Statement of The Honorable Ron Kind, Ranking Democrat, Subcommittee on Energy and Mineral Resources

This morning we meet to review and discuss the Federal oil and gas "royalties-in-kind" or R–I–K program in preparation for Committee consideration of a national energy bill.

The witnesses today have been asked to focus on the pilot projects currently underway at the Minerals Management Service. And, also to comment on a proposal sponsored by our colleague, Representative Carolyn Maloney, to utilize royalties-in-kind in the Low Income Home Energy Assistance Program.

Let me state at the outset that the proposal to explore using Federal royalty oil and gas in a pilot with LIHEAP has merit.

This in no way means we would support a proposal to convert the current Federal oil and gas royalty system from cash payments to a wholesale marketing scheme. Under current law, the Secretary of the Interior has the option to take royalties-

in-kind at her discretion. Studies by the GAO and CBO have concluded that a nationwide, mandatory RIK system would not be in the public's best interest.

The oil and gas industry's abysmal record on underpayments has rendered their support of a national mandatory RIK system highly suspect. As an April 6, 2001, editorial in USA TODAY stated, "By assorted estimates, the industry has shorted the government on oil-royalty payments alone by about $100 million a year through a variety of price-fixing and record-fiddling games. That's almost 10% of the government's $1.1 billion annual collections.

However, to the extent that we can merge the extraction of our Nation's natural resource base with positive social goals, such as providing low-income energy assistance, we are open-minded and interested in hearing the testimony of our witnesses today.

Mrs. CUBIN. The hearing record will be held open for 10 days in case there are some other questions that the members come up with and we would appreciate your response in writing.

So if there is no other business before the Subcommittee, I again thank all of you for being here and the Subcommittee is adjourned.

[Whereupon, at 11:48 a.m., the Subcommittee was adjourned.]

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