

**GETTING ROYALTIES RIGHT:  
RECENT RECOMMENDATIONS  
FOR IMPROVING THE FEDERAL  
OIL AND GAS ROYALTY SYSTEM**

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**OVERSIGHT HEARING**

BEFORE THE

SUBCOMMITTEE ON ENERGY AND  
MINERAL RESOURCES

OF THE

COMMITTEE ON NATURAL RESOURCES  
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

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**OVERSIGHT HEARING ON GETTING ROYALTIES RIGHT: RECENT RECOMMENDATIONS FOR IMPROVING THE FEDERAL OIL & GAS ROYALTY SYSTEM.**

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**Tuesday, March 11, 2008  
U.S. House of Representatives  
Subcommittee on Energy and Mineral Resources  
Committee on Natural Resources  
Washington, D.C.**

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The Subcommittee met, pursuant to call, at 10:04 a.m. in Room 1324, Longworth House Office Building, Hon. Jim Costa, [Chairman of the Subcommittee] presiding.

Present: Representatives Costa, Pearce, Hinchey and Smith.

**STATEMENT OF THE HONORABLE JIM COSTA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA**

Mr. COSTA. The oversight hearing of the Subcommittee on Energy and Mineral Resources will now come to order. The Subcommittee is meeting today to hear testimony on recent recommendations on the oil and gas royalty system, something that has been the subject of this Subcommittee and the Committee over on the Senate for some time now.

Under Rule 4[g], the Chairman and the Ranking Member may make opening statements, and then if any other Members wish to do the same, we will submit those statements into the record under unanimous consent. Additionally, under Committee Rule 4[h] additional material for the record should be submitted by Members or witnesses within 10 days.

That includes questions that Members may have but may not have had the opportunity to ask during the hearing. We obviously urge Members to submit those questions, and we ask for the witnesses to provide a timely response on the answers to the questions that have been submitted.

As Chairman, I spoke with the Ranking Member just a moment ago. It is our intention to conclude this hearing by around noon-time. We have a number of votes, and we have other meetings that we are compelled to participate in, and so we will try to get as much work done as we can in the next two hours.

Let me just make a brief opening statement. I want to begin by thanking the witnesses on Panel 1 and Panel 2 for your due diligence and for your testimony. I know you will do your very best

to answer the questions that we have for you. We are obviously here today, as I said earlier, to continue to focus on how the government collects royalties for oil and gas that is produced on Federal lands.

This is the third time that the Natural Resources Committee has examined the issue in Congress, and my guess is it won't be the last. In the past year and a half, there have been multiple reports of the problems with royalty collections, some are less significant, some I think are much more significant, and we will endeavor to find from the witnesses your own take on how we best do this job.

Three of the organizations involved in the reports that have written about the success or the level of effectiveness that the Minerals Management Service has done its job of collecting royalties are here today. Representatives from the Government Accountability Office, the Department of the Interior's Inspector General and the Royalty Policy Committee are first on our panel.

We look forward to hearing about the recommendations that first came out in the Senate hearing, the 100 or so recommendations that I understand the Minerals Management Service is in the process of implementing. We also have Assistant Secretary Stephen Allred and Director Randall Luthi here today so that we can find out how some of these recommendations are being implemented.

Dennis Roller from North Dakota is here to describe some of the issues from the state and tribal standpoint that also participate and are beneficiaries of the collection of these royalties. In addition, probably a first for this committee, we have a witness, you might be surprised, from the Internal Revenue Service, Acting Director Linda Stiff.

I only asked her to come here today because I have some questions about my own taxes. Not true. Of course, we have invited the IRS here because one of the recent reports that was done earlier discusses how the Internal Revenue Service could act as a good model for our oil and gas royalty collection system.

To the degree that there are comparisons, we would like to learn whether or not those comparisons make sense or are applicable in the case of the Minerals Management Service. I also am glad because I think that frames the issue well, in part, but the Internal Revenue Service, the IRS, of course can be maligned. They are respected for their responsibility in collecting money from the American taxpayer.

Meanwhile, the Minerals Management Service collects money for the American taxpayer. One collects it from the American taxpayer, the other collects it for the American taxpayer. I think we seem to do very well in the first case. Some of my constituents argue they do it too well.

I am not sure that we are doing quite as well in the second category with regard to the royalty collection, and that is obviously the purpose of today's hearing. The Minerals Management Service brings in a staggering amount of money, last year over \$11 billion, as a source of income for our nation's government, and it is expected to do more this year, in part because of the rise in oil prices and natural gas.

The reports we are here to discuss show that, in fact, honest folks believe the job could be done better. I believe that we have

a responsibility and need to ensure that we do the best job possible for getting America's taxpayers' dollars, our fair share, from our abundance of energy resources.

As I said, this won't be the last hearing on the subject. I look forward to taking the testimony today, and not just as it relates to the royalty program but how other efforts can be improved, and the issue of in-kind versus royalty collection, which is not a new discussion. Ranking Member Pearce and others have opined as to their thoughts on what is the best way that we can do this.

I think it is still an issue that we have to try to reach some consensus on, and I know there are many differences of opinion on that point. Let me conclude by saying that simply because we have always done things this way doesn't necessarily mean that it is the best way to do them.

Times change, technology changes. MMS is in the process of trying to institute this \$150 million new computerized program. I keep getting mixed reports on the success of it. I think that we need to make sure that we are adaptive to protect the American interests of these resources.

I now would like to, with a great deal of pride, recognize the Ranking Member, Mr. Pearce from New Mexico, for his opening remarks.

[The prepared statement of Chairman Costa follows:]

**Statement of The Honorable Jim Costa, Chairman,  
Subcommittee on Energy and Mineral Resources**

We are here today to discuss the way the federal government collects royalties for oil and gas produced from federal lands. There will be plenty of discussions about auditing and accounting and various other financial complexities, but this is not some esoteric topic that only a policy wonk could appreciate. This is about the one of the largest sources of revenue for the federal government outside the tax system, with over \$11 billion brought in last year. Projections are that revenues this year could top \$15 billion. And let no one forget—these are the natural resources that belong to the American people. Royalties are not a gift that oil and gas companies give back to the Treasury. They are the American people's fair share of the resources that they are allowing to be extracted and sold. And this fair share goes towards schools, it goes towards roads, it goes towards protecting wilderness, restoring historic buildings, managing water projects, and doing just about everything else that this country needs to do.

When an oil or gas company signs a federal lease, they're signing a contract with the American people, and they're promising to provide that fair share that the people rightfully deserve. But in order to get that fair share, the American people have to put their trust in the government. They have to trust that we will be good stewards of their resources; that we will make sure to hold the oil and gas companies accountable for that fair share. Anything less is a gross dereliction of our duty.

Unfortunately, it appears that the government has not been as diligent as it should. The past few years have seen one revelation after another about the sorry state of our royalty collection system. As the Inspector General of the Department of the Interior, Earl Devaney, says in his testimony, "the history here is rich and disconcerting." The Government Accountability Office sums the issues up in their testimony when they say, "ultimately the system used by Interior to ensure taxpayers receive appropriate value for oil and gas produced from federal lands and waters is more of an honor system than we are comfortable with." Certainly more than I am comfortable with as well.

The most recent report comes from the Subcommittee on Royalty Management, which was appointed by the Secretary of the Interior on March 22, 2007, and came back with 110 recommendations to improve the royalty system less than nine months later—that's about three recommendations a week. Mr. David Deal, Vice-Chair of that Subcommittee, is here to discuss some of these recommendations, although I don't know if we'll have enough time to get through them all.

But as I have already alluded to, that report is only the latest in a line of serious concerns surrounding the royalty system. Inspector General Earl Devaney, testifying here today, has completed three reports in the past fifteen months, each one detailing serious shortcomings in the Minerals Management Service. The audit of MMS' increased use of compliance reviews talks of data reliability problems and a lack of a proper strategy to identify which companies need to be looked at more closely. The investigation of why price thresholds were left off offshore leases in 1998 and 1999, which could cost the government upwards of \$9 billion, resulted in the discovery of a "jaw-dropping example of bureaucratic binging." And the investigation of cases filed by disgruntled auditors who claimed that MMS was not going after royalties it was entitled to uncovered "a band-aid approach to holding together one of the Federal Government's largest revenue producing operations," and a "profound failure" in the development of a crucial computer system, one which MMS has spent \$150 million on already.

The Government Accountability Office has also uncovered numerous fundamental problems with how the royalty program operates. Last year they testified that MMS didn't have the data to accurately assess whether the Royalty-in-Kind program, which has exploded in recent years, was a better deal for the government than taking royalties the traditional way, in value. Today, Mr. Frank Rusco of the GAO will testify that MMS cannot even verify that they're getting the royalties they should. Dennis Roller, an auditor with the State of North Dakota, will testify about on-going problems that he sees from his position in the trenches, where he fights to ensure that his state gets the share of royalties that is rightfully theirs. No one from the Department of Energy is here to testify to today, but earlier this year they reported that MMS could not account for 30,000 barrels of royalty oil that were supposed to be headed to the Strategic Petroleum Reserve—which is over \$3 million in today's prices.

There are far too many issues with the royalty program to address today. This is just one in what will be a continuing series of hearings this subcommittee will hold in order to get to bottom of these problems, and figure out what needs to be done better. The entire structure of the federal oil and gas leasing system is under scrutiny here. I am not satisfied to maintain the dysfunctional status quo simply because of historical factors or industry preference. I intend to listen carefully to what our witnesses have to say, and start trying to figure out what has to be done, by the Department of the Interior and by Congress, to ensure that we don't come back here every few years to hear the next list of 100 recommendations that need to be implemented to make sure the American people get their fair share.

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**STATEMENT OF THE HONORABLE STEVAN PEARCE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW MEXICO**

Mr. PEARCE. Thank you, Mr. Chairman. The hearing today we have titled "Getting Royalties Right." If I recall, last year we called it "Royalties at Risk." I would say that as we get into the hearing I would like to pause because the misperceptions that are being created is that there are lost royalties when real royalties are being lost because of the energy policies that are originating from San Francisco-type energy policies.

My question is when is the Subcommittee going to get royalties right? The dollar value is falling, our economy is slowing, the price of WTI Oil yesterday closed at a record \$107.87 per barrel, the spot price for natural gas closed at \$9.58 per TCF, the EIA is expected to forecast record high gasoline prices for the summer and there is an outcry for supply, but that outcry is falling on deaf ears.

This country keeps its potential revenue from royalties on energy supply off limits. The majority keeps its off limits by creating a misperception that we drill everywhere and all of the time. Of the 262 million acres of BLM land, less than five percent of that land is being used for oil and gas production.

The other 95 percent of BLM land has no oil and gas production. The resources are there; we just don't produce it. So when we talk

about the lack of stewardship for the American people, we should look in the mirror. Similarly, only 15 percent of the National Wildlife Refuge Systems has oil and gas activities.

Furthermore, not a drop, zero percent, of our park lands permit oil and gas activities. We learned last Congress that less than three percent of our outer continental shelf is being leased for oil and gas production, and this at a time when we are seeing prices of gasoline moving toward \$4 a gallon.

The majority keeps production off limits by convincing the American people that we don't have enough energy here in the U.S. To keep up the charade, they cut off two trillion barrels of shale oil in Colorado and Utah last year in our omnibus spending package. Two trillion barrels, that is double all of the world's oil. Endless royalties are being now bypassed because of a decision made by this Congress.

These are the royalties at risk if we continue to file these Democratic energy policies that will continue to be at risk. This hearing is a classic example of penny wise, pound foolish. There are billions of dollars of Federal royalties left on the table because more and more of our Federal lands, where much of the energy is, remains off limits.

I am looking forward to the testimony. For instance, Mr. Devaney says in his comments that four investigations remain ongoing.

I am going to ask Mr. Devaney, and I hope he deals with the question up front, what the Justice Department is telling him about those investigations because I am concerned that if the Justice Department doesn't see his reasons for continuing investigations, I am concerned about how we are doing those investigations.

Also, Mr. Rusco, I am interested, in your GAO report you state that the Interior lacks adequate assurance that it is receiving full compensation for oil and gas produced in Federal lands, and yet, when I read this comprehensive report with multiple qualified people on the panel that put that report together I see that MMS is an effective steward of the minerals revenue.

There is no middle ground between those statements. I am diametrically opposed, and I am looking forward to the testimony that is going to assure me that the GAO actually used the same kind of qualified people that I can find on the list here, so I will be asking about that in your testimony. How can we come to diametrically opposed opinions from two different oversight agencies?

So I am looking forward to the testimony today. Mr. Chairman, I am aware of the criticism of royalties in kind. The royalties in kind, every day the price of oil is different in a different piece of the country. Price of oil is depending on the quality of the amount that it is going to cost to produce it, and we have to figure out every single area and every single price in the country to see if we get our dollars.

Yet, if we simply did RIK, royalty in kind, we simply say you made that many barrels, we get a percent and we will take it here or we will take it there. Similarly, on gas, you just read a meter. You don't have to do the complex calculations with lawyers and auditors. In the way that we are processing right now, the non-roy-

alty-in-kind process attracts lawyers and auditors like sharks to blood.

Again, I look forward to the testimony and discussion today. I just ask that all things be put into perspective. Welcome to you all. I appreciate your coming here for your testimony, and we look forward to it. Thank you, Mr. Chairman.

Mr. COSTA. Thank you, Mr. Pearce. I appreciate your comments. I don't want to get in a debate with you at this point, but I would indicate in meetings I had last week with Shell folks who have done the most in oil shale in the areas that you made reference to that they are probably 5 or 10 years away even though they think there are tremendous prospects, as you noted, in terms of their ability to get the technological efforts to make it cost effective.

As it relates to energy offshore, you and I, I think, have closer agreement than we have on others, but under the Clinton administration with a Republican Congress record leases were given in the late 1990s. Those leases have continued in the Bush administration, and they are continuing to provide leases.

So we do have problems in states like Florida and California, which I represent, where folks don't want to drill offshore. It is a question, as you pointed out in your testimony, of wanting to have it both ways. I might add that those are not a circumstance of the majority or a minority because in both those cases we had Republican Governors who in Florida and California in a bipartisan Court chose not to seek that exploration development.

It is a problem that we have to come together with as a nation I think in a bipartisan fashion. I think I just want to point out that we have witnesses here who will tell us what we are doing and give us their opinion, and we will listen. Then the good, sharp questioning that you are always a part of I know will be a part of the record of this testimony, and I look forward to it.

Mr. Earl Devaney is the Inspector General of the Department of the Interior; Mr. David Deal is the Vice Chairman of the Royalty Policy Committee within the Department of the Interior; and Mr. Frank Rusco is the Acting Director of Natural Resources and Environment for the General Accounting Office.

The timing lights, gentlemen, on the table, you are familiar with I know, and I am sure you have properly focused that you will be within that timeframe.

I would like to now recognize Mr. Devaney to testify for five minutes, and we will go from there.

**STATEMENT OF EARL DEVANEY, INSPECTOR GENERAL,  
U.S. DEPARTMENT OF THE INTERIOR**

Mr. DEVANEY. Thank you, Mr. Chairman. Mr. Chairman and Ranking Member Pearce, I want to thank you for the opportunity to appear before you today to discuss the recommendations arising from some of my office's most recent work—

Mr. COSTA. Could you bring the mic a little closer so we could all hear you?

Mr. DEVANEY. Sure—in the oil and gas royalties collection program and my thoughts about how this program might be improved including a stepped up oversight effort on the part of the Office of Inspector General.

Mr. COSTA. I think you need to put that a little closer. We really want to hear you, Mr. Devaney.

Mr. DEVANEY. The past two years, is that good?

Mr. COSTA. Yes, that is better.

Mr. DEVANEY. OK. The past two years, the agency responsible for royalty collections on behalf of the Federal Government, the Minerals Management Service, has undergone intense scrutiny by my office and GAO.

As you know, I testified on these issues before the House Subcommittee on Energy and Resources in September of 2006, the full House Committee on Natural Resources in February of 2007 and the Senate Committee on Energy and Natural Resources in January of 2007.

The history here is both rich and disconcerting. Beginning with our audit of MMS's compliance review process, we found that while compliance reviews play a useful role in MMS's Greater Compliance Asset Management Program they do not provide the same level of detail or assurance that a traditional audit provides, nor were they being utilized in the context of a well-designed, risk-based compliance strategy.

Following this audit, we made recommendations for improving data reliability, strengthening compliance review tools and developing that missing risk-based strategy. This audit was followed by a complex investigation into the failure of MMS to include royalty price thresholds in offshore oil leases in the Gulf of Mexico in 1998 and 1999.

After this investigation we recommended that all policy decisions that significantly alter the terms and conditions of the offshore/onshore oil and gas leases be memorialized in the form of an internal memorandum compiled in one accessible place, establish one person that is responsible for the entire Notice of Sale document and prior to its final issuance, each lease should be legally reviewed by the Solicitor's Office.

Even while this investigation was ongoing, Secretary Kempthorne requested that we initiate another investigation into the Minerals Revenue Management, a program within MMS that had several qui tam cases filed by its own auditors. The results of this investigation presented examples of a systemic dilemma in MMS, that of the Bureau's conflicting roles and relationships with the energy industry.

It also hinted of a profound failure in the development of a critical IT system, it revealed a working environment with poor communication compounded by an element of distrust, and it demonstrated a band-aid approach to holding together one of the Federal Government's largest revenue producing operations.

This report included recommendations to, among other things, rescind the 1997 "hardship" guidance and develop clear guidance to industry on interest calculations, develop a strategy to eliminate the interest collection backlog on an expedited basis, clarify guidance to the industry on sub-sea transportation costs, foster better communications between MMS's auditors and program people and to develop an enhanced ethics program designed specifically for the RIK Program.

In addition, we discovered a number of other significant issues worthy of separate investigations including ethical lapses, such as DOI employees who were accepting gifts from oil and gas industry representatives. We currently have four investigations that remain ongoing. Because these four investigations involve potential criminal violations, I am currently precluded from discussing them in any detail.

Suffice it to say, Mr. Chairman, MMS has had more than its share of royalty management problems and consumed more than its share of my office's attention in the last two years. In addition to his request for a qui tam investigation, Secretary Kempthorne separately requested a study by the independent bipartisan panel, co-chaired by Senators Bob Kerrey and Jake Garn, which reported to the Royalty Policy Committee.

We shared with this panel a list of recommendations that had emanated from our efforts. The final report presented to the Royalty Policy Committee fundamentally incorporated all of the 22 recommendations made by my office thus far. We expect to build on these recommendations as our remaining investigations come to their conclusion.

Given the work we have been doing in the royalties arena, it might be reasonable to conclude that we drew on a corps of subject-matter experts familiar with the intricacies and nuances of royalty management. Rather, we grew our so-called "experts" from scratch and on the run. We recognized almost immediately that our office would soon need to develop a royalties oversight unit and build an expertise for the long term.

We are in the process of doing just that. In the near term, we are setting up a modest interspaced royalty oversight office. This group will soon complete an evaluation of MMS's Royalty-in-Kind Sales Program for oil, and then we will undertake an audit of MMS's process for verifying volumes, most importantly, oil destined for the Strategic Petroleum Reserve.

In the longer term, we intend to develop the capacity to oversee all minerals-related activities managed by DOI from initial leasing of Federal and Indian lands to the final determination of those leases which would include the management of those leases and the collection of royalty payments.

Of course this vision is attached to a very real need for continued funding, and I can assure the Committee that any monies that we receive for that funding will be put to good use. Mr. Chairman, I would be remiss if I failed to acknowledge the receptiveness and responsiveness of Secretary Kempthorne, Assistant Secretary Allred and MMS Director Luthi to our findings and recommendations.

The challenge, however, comes in the effective implementation of the recommendations and in holding accountable those responsible for MMS's many past failings. This concludes my opening remarks, Mr. Chairman, and I will answer any questions.

Mr. COSTA. Thank you very much, Mr. Devaney. We do appreciate your focus and due diligence as the Inspector General. It is probably a good segue that we now go to our next witness who was selected, in part, with some other folks, Secretary Kempthorne, to really look at the problems associated with the issue that we are

attempting to deal with here today and have been now for several years.

[The prepared statement of Mr. Devaney follows:]

**Statement of The Honorable Earl E. Devaney, Inspector General,  
U.S. Department of the Interior**

Mr. Chairman, members of the subcommittee, I want to thank you for the opportunity to appear before you today to discuss the recommendations arising from some of my office's recent work in the oil and gas royalties collection program, and my thoughts about how this program might be improved, including a stepped up oversight effort on the part of the Office of Inspector General (OIG).

For the past two years, the agency responsible for royalty collections on behalf of the Federal Government, the Minerals Management Service (MMS) of the Department of the Interior (DOI), has undergone intense scrutiny by the OIG and GAO, following revelations of systemic management and organizational failures. As you know, I testified before the House Subcommittee on Energy and Resources in September of 2006 and the full Committee on Natural Resources in February 2007; I have done the same before the Senate Committee on Energy and Natural Resources in January 2007. The history here is rich and disconcerting. Beginning with our audit of MMS' compliance review process, we found that while compliance reviews play a useful role in MMS' greater Compliance and Asset Management Program, they do not provide the same level of detail or assurance that a traditional audit provides, nor have they been utilized in the context of a well-designed, risk-based compliance strategy. Following this audit, we made recommendations for improving systems data reliability, strengthening the compliance review tools, and developing that missing risk-based strategy.

This audit was followed by a complex investigation into the failure of MMS to include royalty price thresholds in offshore oil leases in the Gulf of Mexico in 1998 and 1999. From this investigation, we recommended that all policy decisions that significantly alter the terms and conditions of the offshore and onshore oil/gas leases be memorialized in the form of an internal memorandum and compiled in one accessible repository, establish one person that is responsible for the entire Notice of Sale document, and prior to its final issuance, each lease should be legally reviewed by the Solicitor's Office.

Even while this investigation was ongoing, Secretary Kempthorne requested that we initiate another investigation into Minerals Revenue Management (MRM), a program within MMS that had had several qui tam cases filed against it by its own auditors. The results of this investigation presented examples of a systemic dilemma in MMS—that of the bureau's conflicting roles and relationships with the energy industry. It also hinted of a profound failure in the development of a critical MRM information technology (IT) system; it revealed a working environment in which poor communication, or no communication, compounded an already existing element of distrust; and it demonstrated a band-aid approach to holding together one of the Federal Government's largest revenue producing operations. This report included recommendations to, among other things, rescind the 1977 "hardship" guidance and develop clear guidance to industry on interest calculations, develop a strategy to eliminate the interest collection backlog on an expedited basis, clarify guidance to industry on sub-sea transportation costs, foster better communication between the MMS audit and programmatic functions, and develop an enhanced ethics program designed specifically for the RIK program.

In addition, we discovered a number of other significant issues worthy of separate investigations, including ethics lapses, such as accepting gifts from and fraternizing with industry, program mismanagement and process failures. We currently have four investigations that remain ongoing. Because these latter investigations involve potential criminal violations, I am currently precluded from discussing them in any detail. Suffice it to say, Mr. Chairman, MMS has more than its share of royalty management issues, and has consumed more than its share of the OIG's attention on these issues over the past two years.

In addition to his request for the qui tam investigation, Secretary Kempthorne separately requested a study by an independent bi-partisan panel co-chaired by Senators Bob Kerrey and Jake Garn, which reported to the Royalty Policy Committee. As our work regarding MMS concluded, we shared with this panel a compilation of recommendations that emanated from our efforts. The final report presented to the Royalty Policy Committee fundamentally incorporated the 22 recommendations made by the OIG thus far. We expect to build on these recommendations, as our remaining investigations come to conclusion.

Given the amount of work we have been doing in the royalties' arena, it might be reasonable to conclude that we drew on a corps of subject-matter experts, familiar with the intricacies and nuances of royalty management. Rather, we grew our so-called "experts" from scratch and on the run. We recognized almost immediately, that the OIG would need to develop a royalties' oversight unit, and build an expertise for the long term.

In December, Congress passed the Omnibus Spending Bill for FY 2008. Accompanying the bill was report language that instructed the OIG to develop a permanent capability to oversee MMS' royalty function. We are in the process of doing just that. In the near term, we are standing up a modest Denver-based Royalty Oversight Office, consisting of six employees—four of which have already been filled by current OIG Staff, including the position of Director. The remaining two positions are expected to be recruited and on-board by May 2008. The members of this small office must first develop an understanding of royalties-related activities in MMS; we are also identifying training opportunities to cultivate their expertise, including observation and participation in royalty audits conducted by States and Tribes. This group will soon complete the on-going evaluation of MMS' Royalty-in-Kind (RIK) sales program for oil, and will then undertake an audit of MMS' processes for verifying volumes delivered as RIK, including, most importantly, oil destined for the Strategic Petroleum Reserve. Eventually, this unit would also verify that the recommendations we have made and those issued by the Royalty Policy Committee have been appropriately implemented.

In the longer term, we intend to develop the capacity to oversee all minerals-related activities managed by DOI from initial leasing of Federal and Indian lands to the final termination of those leases, which would include the management of those leases and the collection of royalty payments. Ultimately, we would like to expand our oversight coverage beyond MMS to the energy and minerals programs at the Bureau of Land Management and Indian Affairs, including oil, gas, and solid minerals.

Of course, to this vision is attached the very real need for continued funding to keep this unit operating, and to expand its capacity as it develops. I am quite confident, however, that the results that will be derived from this unit will more than pay for any increase in appropriations that we receive.

Mr. Chairman, I would be remiss if I failed to acknowledge the receptiveness and responsiveness of Secretary Kempthorne, Assistant Secretary Allred and MMS Director, Randall Luthi to our findings and recommendations. The challenge, however, comes in the effective implementation of those recommendations and in holding accountable those responsible for MMS' many past failings.

As we conclude the remaining investigations, I would be surprised to see all of the involved DOI employees prosecuted. Any that are not, however, will be forwarded to Assistant Secretary Allred for corrective administrative action. This will be the accountability test, the results of which, I am sure, the Subcommittee and I both await with great expectation.

That concludes my prepared remarks, Mr. Chairman. I would be happy to answer any questions you or the members of the Subcommittee might have.

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**Response to questions submitted for the record by Earl Devaney, Inspector General, U.S. Department of the Interior**

- 1. Mr. Devaney, do you believe it is appropriate for MMS to be in charge of analyzing the success of the Royalty-in-Kind Program? It seems that they have a strong incentive to show how well it is working, so would it be better to have someone outside of MMS be doing this review? And if so, who might you suggest?**

Answer: I believe any program in the Federal Government has an obligation to critically assess its own performance, but I also recognize the difficulty of being completely objective in doing so. An additional challenge is to define "success" in a program that generates considerable revenue for the Federal Government. An analysis of the RIK program's success would probably be best conducted by an independent oversight entity, like the GIG. If such an analysis were to be undertaken, it would also be most effectively accomplished if a definition of "success" were agreed upon in advance among the program, Congress and the oversight entity.

- 2. Mr. Devaney, as an audit organization, would you state your thoughts about any conflicts of interest that MMS might have being both the agency in a contractual arrangement with oil and gas companies and the agency responsible for auditing those contracts and payments from those same companies?**

Answer: The appearance of conflict of interest for MMS as an organization cannot be ignored, since MMS enters into leases with the oil and gas industries, collects the royalties and also audits industry payments. However, it is important to note that MMS is a Federal Government revenue collecting agency—similar to the Internal Revenue Service (IRS) which also collects revenues and conducts audits.

- 3. Mr. Devaney, could you discuss your views of the usefulness of the State and Tribal Royalty Audit Committee, or “STRAC”? And do you see any way to improve the relationship between STRAC and MMS?**

Answer: The states and tribes have a vested interest in the audit and collection of royalty payments for the leases on their lands. As such, the STRAC provides a forum for those states and tribes to share information and communicate with MMS. I see this as a useful function. STRAC is also useful for getting input from the states and tribes to MMS on audit/oversight policies, procedures and regulations.

- 4. Mr. Devaney, I’m pleased to see your office is going to be opening this office in Denver to perform a more active watchdog role. Do you have enough funding to do what you think needs to be done, and what else would you look at if you had additional funding?**

Answer: As I explained in my testimony, we received direction, as well as funding from the Appropriations Committees of both the House and Senate, to develop a permanent capability to oversee MMS royalties. We have done that, and the unit is up and running.

Over the longer term, we would like to develop the capacity to oversee all minerals-related activities managed by DOI. Ultimately, we would like to expand our oversight coverage beyond MMS to the energy and minerals programs at the Bureau of Land Management and Indian Affairs, including oil, gas, and solid minerals.

In order to see our longer term goals through, however, we will have a very real need for continued funding to keep this unit operating, and to expand its capacity as it develops.

- 5. Mr. Devaney, have you looked at any of the issues that were raised in the Department of Energy’s Inspector General report that said that 30,000 barrels of oil headed for the strategic petroleum reserve could not be accounted for?**

Answer: We have reviewed the Department of Energy (DOE) OIG’s report and have discussed their findings with them. As a result, it appears that there are weaknesses on the part of both DOI and DOE in accounting for the volume intended for delivery to the strategic petroleum reserve. As soon as our evaluation of the RIK oil sales program is completed, we will be initiating an audit of oil volumes in the RIK program, including oil designated for the Strategic petroleum reserve.

**Minority Questions for Earl Devaney, Inspector General. U.S. Department of the Interior**

- 1. Mr. Rusco from the Government Accountability Office referred to Mineral Management Service’s (MMS’) internal controls in his testimony. In your testimony you reference several qui tam cases filed by MMS’ own auditors. In our last hearing on this subject we heard from Professor Pamela Bucy (an expert on False Claims Act Laws) that these auditor actions were illegal and that these plaintiffs should not have standing to file qui tam lawsuits because they are using accounting information that they received in the course and scope of their employment for personal gain rather than the taxpayer’s gain. Instead, these plaintiffs should have reported their concerns to you, as Inspector General, or internally within the Mineral Management Service (MMS). Have you done anything to improve your internal controls to make sure these cases are reported to you for investigation rather than filed as qui tam cases?**

Answer: Unfortunately, neither DOI nor OIG internal controls can ensure that DOI employees properly report concerns to either the OIG or Departmental management. The OIG has made efforts by way of outreach to inform and educate DOI employees of their obligation to report fraud, waste and mismanagement to the OIG; we have enhanced our “hotline” to include Internet reporting; and have placed post-

ers in most major DOI facilities. MMS has also conducted some education and outreach in this regard.

2. **One [of] your criticisms of the MMS' administration of the Royalty-In-Kind program is the initial lack of experience MMS employees had in marketing the products they were taking in kind. You go further to state that your office is setting up a Denver-based Royalty Oversight Office and the members of this office need to develop an understanding of royalty related activities within MMS. That's a very complicated issue and based upon your reasoning, it seems that this new office will have problems because of lack of experience and knowledge of the issues they have oversight responsibilities for. How useful will this office be and would it not be a better investment to hire additional people for MMS (Especially in light of the fact that many of the criticisms levied against MMS are due to budgetary constraints and the need for additional people to meet the increasing workload)?**

Answer: The OIG has been examining royalties' issues in various arenas for over two years straight. When, in 1986—well before my time as Inspector General—the royalty audit function was steered to MMS rather than the OIG, our oversight, and thus our expertise, diminished. When the present royalties' issues began to arise in January 2006, we drew upon the limited royalties' experience that we had remaining in the organization, but essentially were forced to grow our expertise anew. With over two years behind us, however, we are well on our way in building OIG expertise for the long term. The OIG Royalty Oversight Office is already staffed with our two most knowledgeable royalties' auditors, an auditor that we hired from MMS and an auditor from the Department of Defense with extensive leasing and contracting experience. We also have a strong pool of candidates with state and tribal royalties audit experience who submitted their applications in response to our vacancy announcements.

In addition, the first evaluation by this unit is being concluded, and has developed some very good information that should be quite useful to MMS management for improving the operations of the Royalty-in-Kind program. I am already pleased with the work that this unit has done, and expect that it will only improve with time and experience.

Finally, if the greater royalty audit function is to remain within MMS, then our new unit will also provide vital audit oversight similar to the oversight of the IRS' audit work provided by the Treasury Inspector General for Tax Administration.

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**STATEMENT OF DAVID DEAL, VICE CHAIR, ROYALTY POLICY  
COMMITTEE, U.S. DEPARTMENT OF THE INTERIOR**

Mr. COSTA. David Deal is the Vice Chair of the Royalty Policy Committee, and has been part of the Commission that Secretary Kempthorne put together to examine this carefully and closely with their experience and to provide a set of recommendations that was noted earlier, *Getting Royalties Right: The Recent Recommendations for Improving the Federal Oil and Gas Royalty System*.

So we with that introduction look forward to your testimony, Mr. Deal.

Mr. DEAL. Thank you, Mr. Chairman and Mr. Pearce. I appreciate the opportunity to appear today at this important and timely oversight hearing. As you requested, I will offer you an abbreviated summary of my written statement already submitted. I have over 30 years of experience on oil and gas royalty management policy matters.

In the mid-1980s, I served on the Secretary of the Interior's original Royalty Management Advisory Committee formed in the wake of the 1982 Linowes Commission Report and the landmark 1983 Federal Oil and Gas Royalty Management Act. I have been involved in Federal royalty management matters, legislation, rule-making, litigation ever since.

I now serve as Vice Chair of the Department of the Interior's Royalty Policy Committee. I also served as Vice Chair of its Subcommittee on Royalty Management, whose December 2007 report you have received and brings me here today.

Our subcommittee, co-chaired by former Senators Bob Kerrey and Jake Garn, was directed by the Secretary to undertake a careful evaluation of the Royalty Management Program to ensure that its procedures and processes were in order. The subcommittee was initially charged with reviewing three areas: reporting and accounting, audit compliance and review procedures and royalty in kind.

Later, a fourth area for our review was added, namely Secretary Kempthorne's February 2007 procedures to tighten Department review of offshore lease packages, which include but are not limited to, royalty provisions, such as price thresholds.

I am pleased to say that the subcommittee's final December 2007 report was accepted by the multistakeholder Royalty Policy Committee at its January 2008 meeting and without change transmitted to Secretary Kempthorne. Overall, we concluded that the Department's Royalty Management Program is not broken at all but does need a major tune up.

Indeed, we identified 110 recommendations. Technical policy as practical as possible, recommendations for change, improvements plainly needed to restore public confidence and ensure maximum value for the nation's taxpayers. As to our specific recommendations, they are quite varied. There are 110 of them.

The executive summary includes a summary of major recommendations. My co-chair's testimony before the Senate has another angle of attack listing 10 areas which involve one or more recommendations. Finally, many of the subcommittee's recommendations reinforced thoughtful recommendations already made by the Inspector General and the Government Accountability Office.

What I would like to do today is rather than reiterate those different listings, I would like to identify four connecting themes which I think might further illuminate our own recommendations, their underlying royalty issues and the path ahead.

1) There are major differences in onshore and offshore leases. Over 2,000 offshore leases, and over 20,000 onshore leases now generate oil and gas royalties. The sheer numbers and many other major differences described in my written statement, vintage, location, Bureau of Management, contribute to an asymmetrical regulatory picture and stretch staff resources, especially onshore.

Chapter 3 of the subcommittee report offers 36 diverse recommendations, many of which have an onshore tilt. Chapter 5, which deals with intrabureau coordination, has 10 more recommendations affecting onshore.

2) There are major differences in crude oil and natural gas. Oil and gas exhibit fundamental differences in physical properties, modes of transportation, end users and marketing, price reporting and even government regulation outside the Department of the Interior. These differences bear heavily on the calculation of royalties.

My written statement describes two central aspects of the calculation of royalties, allowances and marketable condition, that re-

flect the complications that can arise somewhat differently for oil and gas, but especially in connection with gas, which today accounts for most disputes. These differences and other matters are reflected in many of the measurement and valuation recommendations of Chapters 3 and 4 of our report.

3) Improved intra-agency coordination is imperative. Table 13 at page 78 of our report is as good a snapshot as I have seen of the different bureau responsibilities bearing on royalty management. Our report offers 10 recommendations for improving coordination, many of which address Indian lease related matters.

4) Key elements of the Royalty Management Program need to be implemented with more rigor, and more clarity. For example, and I will offer just three, in the audits, compliance and enforcement areas, that is Chapter 4 of our report, we include 26 recommendations, many of which are directed at clarifying the strategy for choosing among the wide range of available audit compliance and review options, most notably, audits versus compliance reviews.

In so many words, the subcommittee concurred with the DOI IG's December 2007 report, as you have already heard this morning, which concluded that compliance reviews can be an effective part of the MMS's CAM Program. It also concluded, that we concur with as well, weaknesses related to management information in the compliance review process and performance measures may keep it from being maximized.

MMS's adoption of these recommendations should make MMS audits compliance and enforcement efforts more cost effective, adaptable to changing circumstances and more transparent for review by Congress and other stakeholders. Our Chapter 4 recommendations notably also reflect the advice we sought rather aggressively of the Internal Revenue Service, which itself has adopted sophisticated risk-based models for choosing among its audit, compliance and enforcement options.

A second just as important option, RIK. RIK, as we all know, is an atypical government program with the MMS functioning first as a regulator and then as a commercial marketer. In this regard, in 2007 GAO expressed some concerns about the RIK Program's rapid growth and posed questions about the MMS's ability to adequately quantify and compare RIK and RIV revenues and administrative costs as required by statute.

Here again, the subcommittee shared similar concerns finding that the MMS had done a credible job managing the RIK Program and that RIK offered great royalty management advantages but that the RIK deserved, "more intense oversight and distinct program improvements." Chapter 6 of the subcommittee report lists no less than 31 diverse recommendations for clarifying and tightening RIK Program management.

Here again, more rigor and clarity should make the Royalty Management Program more cost effective and should enhance program transparency for oversight by Congress and other stakeholders. Last but not least, a final short but needless to say important example of price thresholds.

In a similar vein, the process, procedure and training recommendations of Chapter 7 of our report are centered on the need

for rigor to assure that OCS leases are issued fully consistent with the law and policies of the department.

Mr. Chairman, as an Attachment B to my written statement, I also mention that Attachment B is a simple, one page diagram which it was my attempt to perhaps cut through some of the complexity of the royalty revenue calculation process and linking the different parts of the process to our report. Hopefully this will illuminate our recommendations and the underlying royalty issues.

Mr. Chairman, Mr. Pearce, that completes my remarks. I would be glad to answer any questions that you might have.

Mr. COSTA. Thank you very much, Mr. Deal. We appreciate that concise and to the point testimony. Tune up, I like that. Maybe we can come together in a fashion that will provide that tune up. We all on occasion need a tune up.

[The prepared statement of Mr. Deal follows:]

**Statement of David T. Deal, President, Deal Consulting & Dispute Resolution, LLC, and Vice Chair, Royalty Policy Committee**

Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to appear today at this important and timely oversight hearing.

I have over 30 years of experience on oil and gas royalty management policy matters. In the mid-1980's I served on the Secretary of the Interior's original Royalty Management Advisory Committee formed shortly after publication of the Linowes Commission in 1982 and passage of the landmark Federal Oil and Gas Royalty Management Act in 1983. I have been involved in federal royalty management legislation, rulemaking and litigation ever since.

I now serve as vice chair of the Department of the Interior's Royalty Policy Committee (RPC), a federal advisory committee. I also served as vice chair of its Subcommittee on Royalty Management, established in November 2006, whose December 2007 report brings me here today.

Prompted by criticism of the Department's royalty management program from several quarters, Secretary Kempthorne and Assistant Secretary Allred directed our Subcommittee to undertake a careful evaluation of the program to ensure that its procedures and processes were in order. The Subcommittee was initially charged with reviewing three areas: reporting and accounting for Federal and Indian mineral resources; audit, compliance and review procedures; and, royalty in kind.

After our Subcommittee got underway in mid-2007, a fourth area for our review was added: Secretary Kempthorne's February 2007 procedures to tighten Department review of offshore lease packages to assure consistency with all applicable law and policies. This fourth area was prompted by the disturbing omission of royalty relief price thresholds for Outer Continental Shelf leases issued in 1998 and 1999.

I am pleased to say that the Subcommittee's final December 2007 report, "Mineral Revenue Collection from Federal and Indian Lands and the Outer Continental Shelf," was accepted by the parent Royalty Policy Committee at its January 17, 2008, and without change transmitted to Secretary Kempthorne. I am also pleased to say that the Department has energetically begun to address the 110 recommendations of the Subcommittee's Report. Indeed, some of the simpler recommendations have already been satisfied.

**Character of the Subcommittee Report and Its Deliberative Process**

As conceived by Secretary Kempthorne and Assistant Secretary Allred, the Subcommittee's task was to be forward looking with a heavy emphasis on process and procedures.

The Subcommittee was directed to address royalty bearing minerals, although the heavy emphasis was oil and gas, which lay at the heart of so much recent program criticism.

The Subcommittee was to be an independent panel. I served as vice chair and the link to the Royalty Policy Committee, but the Subcommittee's membership drew also on the skills of:

- Bob Kerrey and Jake Garn, two former Senators who served as co-chairs
- Bob Wenzel, former deputy commissioner, Internal Revenue Service
- Perry Shirley, Assistant Director, Minerals Department, Navajo Nation
- Cynthia Lummis, former State Treasurer, State of Wyoming
- Mario Reyes, Professor of Finance, University of Idaho.

Finally, from the outset Subcommittee members were advised that nothing was off limits for our review. Moreover, the Subcommittee did not limit itself to information within the Department but looked to comparable programs outside the Department, most notably, the Internal Revenue Service.

### **Key Recommendations**

Overall, we concluded that the Department's royalty management program is not broken but does need a major tune up. We concluded that the Minerals Management Service is an effective steward of the Minerals Revenue Management Program and that its seasoned, skilled staff was eager to explore program improvements. And, as our Report makes clear, many improvements are plainly needed to restore public confidence and ensure maximum value for the nation's taxpayers.

At 160 pages in length and including 110 specific recommendations, which address a mix of practical policy, management and technical concerns, the Report does not read like a novel. To understand the Subcommittee Report, our 110 recommendations can be sorted in several ways.

For example, the Executive Summary to the Report itself includes a Summary of Major Recommendations and separately identifies recommendations that address major issues, some recommendations that will require long-term support, other recommendations that can be easily implemented, and a few that would need legislation.

In addition, Subcommittee co-chairs Bob Kerrey and Jake Garn, in February 26, 2008, in a statement submitted to the Senate Appropriations Committee, and included here as Attachment "A," offered a more integrated approach by identifying ten key areas for which Subcommittee recommendations were formulated.

Finally, many of the Subcommittee's recommendations reinforce thoughtful recommendations made by the DOI Inspector General and the Government Accountability Office.

Today, I will attempt no detailed analysis of the Report's many recommendations. Nor will I reiterate the litany of major recommendations in the Subcommittee Report or the key areas already ably presented by my Subcommittee co-chairs. To complement that useful information, I offer four basic themes that suffuse the Report and might further illuminate the recommendations, their underlying royalty issues and the path ahead. Toward this same end, I also offer a simple one-page diagram, included here as Attachment "B," that lays out the basic royalty calculation formula with explanatory notes linking it to the major portions of the Subcommittee Report.

### **Connecting Themes**

**1. Major differences in onshore and offshore leases.** Whereas about 2,300 offshore oil and gas leases generate about \$6.5 billion in royalty revenues, about 23,000 onshore Federal leases generate about \$2.7 billion. Offshore leases are large, operated by large companies, alone or in combination, and often far offshore. Typically, offshore leases are relatively modern with highly concentrated production facilities and linked to a small number of MMS planning region offices.

In contrast, onshore federal leases are far more diverse, including many small properties often operated by small companies. Onshore leases are often of old vintage, scattered around the countryside in several states and linked with many BLM field offices. In addition, offshore leases are regulated in all respects by the MMS whereas onshore federal leases are regulated by the Bureau of Land Management (BLM) for site security, production verification, but regulated by the MMS for audits, compliance and enforcement.

These major differences contribute to an asymmetrical regulatory picture and stretched staff resources, especially onshore, and are reflected in Chapter 3 of the Subcommittee Report. Chapter 3 alone accounts for 36 of the Report's 110 recommendations: requiring electronic reporting; promoting remote data acquisition; upgrading gas plant efficiency reporting and compliance review; examining BLM and MMS staffing levels and training; and other matters.

**2. Major differences in crude oil and natural gas.** Under applicable lease terms crude oil and natural gas produced on federal and Indian leases generate royalty obligations. Moreover, crude oil and natural gas can both be sold at the wellhead or downstream. But there the similarities end.

These two commodities exhibit fundamental differences in physical characteristics, modes of transportation, end users and marketing, the reporting of prices, and government regulation. All of these bear heavily on the calculation of royalties. Consider, for example, two important elements in the calculation of oil and gas royalties, allowances and marketable condition, complex issue areas which lie at the heart of many royalty issues.

Allowances. Under federal mineral statutes, royalty is based on the “value of production” and producers are allowed to take deductions for certain post-production costs to arrive at the proper base for calculation of royalties. In arriving at this value of production for the calculation of oil and gas royalties, MMS regulations do not allow a producer to deduct the costs incurred for gathering production, or satisfying “marketable condition,” or achieving any other marketing purpose.

However, consistent with well-established oil and gas law, MMS regulations do allow deductions for transportation costs. Consistent with well-established oil and gas law, MMS regulations also allow a producer to deduct certain processing costs, costs incurred to extract after production trace amounts of natural gas liquids (NGLs) which, if removed, are royalty bearing and therefore generate extra royalty revenue for the U.S. Treasury.

Marketable condition. MMS regulations require that crude oil and natural gas must be in “marketable condition” before being valued for royalty purposes. For oil, this generally means simple elimination of water and sediment before it is shipped and sold. For gas, much more is required to satisfy pipeline specifications: acid gas removal to avert pipeline corrosion, dehydration and compression. Complicating matters here is that certain gas-related costs, otherwise not deductible, may be deemed deductible (e.g., supplemental compression).

Given these differences, calculating gas royalties tends to be much more complex and, not surprisingly, gas valuation continues to account for most royalty disputes. These differences, and other matters, are reflected in many of the measurement and valuation recommendations of Chapters 3 and 4 of the Subcommittee Report: improving gas plant efficiency information; upgrading gas measurement guidance; exploring anew the use of indexing for gas valuation; addressing the issue of cost-bundling to simply calculation of allowances; to name but a few.

**3. Intra-agency coordination.** In connection with Subcommittee’s four charges, the need for better coordination among the Department’s bureaus involved with royalty management (i.e., MMS, BLM and BIA) commands a free-standing Chapter 5 of the Report. Table 13 at page 78 of the Report is a good snapshot of the different bureau responsibilities bearing on royalty management.

While inter-bureau coordination, communication and information sharing is not the kind of issue that generates royalty headlines, the Subcommittee concluded early on that effective coordination is imperative if the Department’s sprawling, multi-stakeholder royalty program is to operate efficiently and effectively. The Report’s ten recommendations include, for example: establishing an inter-bureau Coordinating Committee; developing common data standards; and several Indian lease-related matters.

**4. Rigor and clarity.** Stated most simply, the Department needs to implement key elements of its royalty management program with more rigor and clarity. For example, in connection with audits, compliance and enforcement, the topic of Chapter 4 of the Report, the many of the 26 recommendations are directed at clarifying the strategy for choosing among a wide range of available audit, compliance and review options. In this regard, in his December 2007 report, the DOI Inspector General concluded that “compliance reviews,” which are basically desk audits, “can be an effective part of MMS’ CAM Program,” but recommended strongly that several weaknesses be addressed to maximize the benefits of compliance reviews. The Subcommittee concurred and we found that the MMS had already adopted an Action Plan that seeks to implement important corrective measures. Once adopted, these measures should make MMS audit, compliance and enforcement efforts more cost-effective, adaptable to changing circumstances, and more transparent for review by Congress and other stakeholders.

In addition, the Report’s Chapter 4 recommendations reflect the Subcommittee’s aggressive effort to seek the advice of the Internal Revenue Service, which itself has adopted sophisticated risk-based models for choosing among its audit, compliance and enforcement options. My understanding here is that the MMS has already sought out the IRS for further advice and consultation on best practices to improve its royalty collection responsibilities.

Another key area where the Subcommittee concluded that more rigor and clarity was needed is the MMS’ Royalty-in-Kind (RIK) Program. RIK is an option increasingly used in lieu of royalty in value (RIV) to satisfy royalty obligations. When the MMS takes its royalty in kind, it can bypass the complexities of valuation—which can be especially difficult for non-arm’s length transactions involving gas—and realize substantial administrative cost savings. Through sales of the production taken in kind MMS can then realize the dollar royalty revenues it is owed and also generate extra revenues for the U.S. Treasury. Crude oil taken in kind can also contribute to Strategic Petroleum Reserve fills if the Administration sees fit; by statute,

crude oil or gas taken in kind can also be used to support any Federal low income energy assistance program.

However, RIK is an atypical government program with the MMS functioning first as a regulator and then as a commercial marketer. In this regard, the Government Accountability Office (GAO) in 2004 made recommendations that the Department has implemented and that have improved RIK administration. However, in 2007 GAO expressed some concerns about the RIK program's rapid growth and posed questions about the MMS' ability to adequately quantify and compare RIK and RIV revenues and administrative costs as required by statute.

The Subcommittee shared similar concerns, finding that RIK offered great royalty management advantages but deserved "more intense oversight and distinct program improvements." Chapter 6 of the Subcommittee Report lists 31 diverse recommendations for clarifying and tightening RIK Program management: establishing an Royalty Policy Committee RIK Subcommittee to address performance benchmarks, volume verification and market positioning; publishing a guidebook of RIK processes and procedures; establishing exploring alternative organizational arrangements to optimize its performance in a commercial environment; seeking reimbursement for costs incurred for Strategic Petroleum Reserve transfers; discontinuing the small refiners' set aside program and suspending the onshore crude oil RIK program; publishing performance measures; maintaining a staff critical mass; securing dedicated legal support; emulating sound business practices to maintain a competitive marketing position; evaluating different auction types; and many others.

Here again, more rigor and clarity should make the royalty management program more cost-effective and should enhance program transparency for oversight by Congress and other stakeholders. In a similar vein, the process, procedure and training recommendations of Chapter 7 are centered on the need for rigor to assure that OCS leases are issued fully consistent with the law policies of the Department.

Mr. Chairman and members of the Subcommittee, I welcome any questions or comments on my statement or the Subcommittee on Royalty Management's Report that brings me before you today.

**Attachment B**

**Basic Royalty Revenue Calculation Formula and the December 2007 RPC Subcommittee on Royalty Management Report**

$$\text{Royalty Revenue}^1 = \text{Volume Produced}^2 \times (\text{Value of Production}^3 - \text{Allowable Deductions}^4) \times \text{Royalty Rate}^5$$

[ <-----Audit, Compliance and Enforcement<sup>6</sup>-----> ]

[ <-----MMS, BLM, BIA Coordination<sup>7</sup>-----> ]

<sup>1</sup> Where royalty is taken in value (RIV), the royalty revenue is dollars. Where royalty is taken in kind (RIK), the royalty is that percentage of the oil or gas production volumes corresponding to the applicable royalty rate. Valuation of the taken volumes can be determined by MMS sales or imputing the value if it is simply transferred and consumed. RIK is addressed in Chapter 6 of the Subcommittee Report.

<sup>2</sup> Production volumes include oil (bbi) and gas (mcf). For onshore leases BLM supervises measurement and reporting; for offshore leases MMS supervises measurement and reporting. Measurement and reporting of production volumes is addressed in Chapter 3 of the Subcommittee Report.

<sup>3</sup> "Value of production" is a statutory term underlying calculation of royalty obligation. Where the production is involved in an arm's length transaction, value is determined by the gross proceeds, usually the sales price, adjusted to reflect any other consideration received. Where the production is involved in a non-arm's length transaction, value is imputed by using benchmarks (e.g., comparable sales) or an index (e.g., NYMEX prices) adjusted for location and quality. Valuation issues are addressed in Chapter 4 of the Subcommittee Report.

<sup>4</sup> Allowable deductions are prescribed by MMS regulation and include transportation costs for oil or gas and processing costs for gas. Costs for production, getting the production in "marketable condition," and marketing are not allowable deductions. Some allowance issues (e.g., cost bundling) are addressed in Chapter 4 of the Subcommittee Report.

<sup>5</sup> Royalty rates vary appreciably, depending on lease location and vintage, and are specified in the lease. Where royalty relief applies the royalty rate is reduced. Royalty relief for deepwater oil and gas or shallow water deep gas employs a royalty rate of zero subject to applicable suspension volume or price threshold limits. Royalty rates per se are not addressed by the Subcommittee Report. Procedures to avert inadvertent omission of provisions like royalty relief price thresholds are addressed in Chapter 7 of the Subcommittee Report.

<sup>6</sup> Audit, compliance and enforcement functions are carried out by the MMS; for onshore leases, states and Indian tribes may be involved also. Audit, compliance and enforcement matters are addressed in Chapter 4 of the Subcommittee Report.

<sup>7</sup> Inter-bureau coordination involves three bureaus: MMS supervises offshore leasing and the overall royalty management process onshore and offshore, including distribution of royalties; BLM supervises onshore leasing, production measurement and reporting; BIA is involved in Indian land leasing. Coordination matters are addressed in Chapter 5 of the Subcommittee Report.

**Attachment A****Testimony of Senators Bob Kerrey and Jake Garn, Co-Chairmen,  
Subcommittee on Royalty Management**

The Subcommittee on Royalty Management was established by the Secretary of the Interior, Dirk Kempthorne, in March 2007. It was created as a consequence of concerns about lapses in ethical behavior and inadequacies in lease issuance, royalty collection, and auditing. These concerns have been expressed by the Congress and by the Department's Inspector General who has investigated allegations of ethical lapses of personnel in the royalty in kind (RIK) program.

As co-chairmen of this Subcommittee, we are pleased to provide this statement on the Subcommittee's report entitled "Mineral Revenue Collection from Federal and Indian Lands and the Outer Continental Shelf." The report was released on December 17, 2007, and is the result of nine months of data gathering and analysis by the Subcommittee. It presents a comprehensive analysis of the federal mineral resource management program in the Department of the Interior. The program is a major source of revenue to the U.S. Treasury, with revenues in excess of \$11 billion in 2007.

The Subcommittee members conducted an independent evaluation of the revenue collection and royalty management program within the Department of the Interior. In addition to ourselves, the Subcommittee includes an impressive group of professionals: David Deal, our vice chairman, an oil and gas expert, and a member of the Royalty Policy Committee to whom the Subcommittee reports; Cynthia Lummis, a former Treasurer of the State of Wyoming; Mario Reyes, a professor of finance at the University of Idaho; Perry Shirley, the Assistant Director for the Minerals Department of the Navajo Nation; and Bob Wenzel, a former Deputy Commissioner for the Internal Revenue Service (IRS).

The companies who lease the right to explore for and develop minerals on federal lands and offshore waters pay royalties on the minerals extracted from those lands and waters. Those royalties are either paid in cash, which is known as royalty in value, or in product, which is known as royalty in kind. The royalty in kind program has been quite cost effective, especially for natural gas production, and the program is expected to continue to grow. The Minerals Management Service (MMS) does not stockpile product "paid" through the RIK program. Rather, it sells the product through a closed bid auction procedure. We believe the RIK program is an extremely important component of the royalty management program and the RIK recommendations in the report are geared toward ensuring the program's survival.

The Subcommittee's report makes over 100 recommendations for improvements in the mineral resource management program. Most of these recommendations can be implemented administratively. Many can be done quickly. Some will require long term effort and continued vigilance. A few of the recommendations depend upon legislative action. The Federal employees who work in the mineral leasing and royalty collection program are conscientious, hard working, and concerned about the reputation of the program and of the Department of the Interior. We believe that implementing the recommendations in this report will greatly strengthen the management of the program, will restore public confidence, and will ensure maximum value for the U.S. taxpayer.

We support all the Subcommittee's recommendations. However, for the balance of this testimony, we focus on a limited number of recommendations in 10 key areas that we believe are critical to ensure continued improvements in the program. Most of the recommendations will require some additional resources from the House and Senate Committees on Appropriations. A relatively modest increase in appropriations should yield increased revenues that more than offset the additional funding.

1. Over the past few years, MMS has relied more heavily on compliance reviews rather than full audits of industry royalty payments for production on federal lands and offshore waters. It appears that the increased reliance on compliance reviews has been based on funding and personnel constraints rather than on documented data on benefits and risks. MMS needs to establish an auditing and compliance program that includes an appropriate balance of audits and compliance reviews, and the program needs to be based on reliable data.

Specifically, MMS should implement a risk-based strategy for identifying companies and properties for audits and compliance reviews. This effort will require developing, testing, and refining various strategies over the next several years. While this will be an evolving process, and MMS is instituting a pilot program in this area, MMS needs to take aggressive action to establish an initial program over the short term. MMS should work

- with the IRS to benefit from the lessons IRS has learned in this area over the years.
2. We believe that one recommendation, which requires legislative action, deserves very serious consideration by the Congress. We recommend that MMS explore the feasibility of establishing an interest-bearing trust fund within the Treasury. Interest from this fund could be used to fund Department of the Interior activities; primarily, but not necessarily limited to, royalty management activities.
  3. The Department of the Interior should strengthen and emphasize ethics training for all staff involved in royalty management. Training should include guidance on appropriate interaction with the private sector, prohibitions on the use of public office for private gain, and the handling of official and proprietary information.
  4. In addition to MMS, the Bureau of Land Management (BLM) and the Bureau of Indian Affairs (BIA) play significant roles in onshore royalty management. Program improvements in these bureaus are needed, as is better coordination among MMS, BLM, and BIA. In particular, improved communication and coordination among the various production accountability staffs needs to be addressed. Further, data entry in BLM and BIA, as well as compliance management information in MMS, should be automated to eliminate manual data entry to the maximum extent practicable.
  5. BLM has difficulty recruiting and retaining Petroleum Engineering Technicians and Petroleum Accountability Technicians. The number of Mining Engineers is also inadequate. The salaries for these positions need to be reviewed and training programs need to be improved. Also, the total number of positions needed should be determined based on workload in individual BLM field offices. For example, production accountability reviews are critical for accurate revenue collection. However, in 2006, BLM had only 20 Petroleum Accountability Technicians (PATs) nationwide and nineteen of the thirty-one BLM field offices with oil and gas responsibilities employed no PATs.
- Emphasis within BLM over the past several years has been on increased funding for the "front end" of the program: namely, additional leasing and processing of applications of permits to drill. As the program has expanded, there has not been sufficient attention to funding the workload associated with the "back end" of the process: namely, increased collections, production accountability, and auditing requirements.
6. The Indian oil valuation rule has been languishing within the Department of the Interior for more than 10 years. Indian Tribes are understandably frustrated by the delay. The Subcommittee believes that the Department should immediately finalize its "technical changes" to the Indian oil valuation rule and, by June 2008, MMS should propose a rule that values Indian oil based on a market index as is done for production from federal oil leases and from Indian gas leases.
  7. Improved oversight of the mineral revenue collection program is essential to ensure the problems that generated so much concern in the past are not repeated and new problems in the future are avoided. Therefore, we recommend the establishment of an RIK Subcommittee to the Royalty Policy Committee. The RIK Subcommittee should address such issues as performance benchmarks, volume verification, and market positioning. We also recommend the establishment of a Coordinating Committee, comprised of senior management officials in MMS, BLM, and BIA, to ensure that recommended improvements are implemented in these bureaus.
  8. The skills necessary to administer the RIK program are not typical for a government agency. RIK is basically an oil and gas marketing operation. The Subcommittee recommends that issues associated with hiring and maintaining staff with industry expertise and dedicated legal support should be addressed in the RIK program. Also, MMS should evaluate the benefits and costs of alternative auction types and should develop a pilot program to test alternatives that could improve net returns.
  9. We recommend eliminating programs that are no longer cost effective or large enough to support their continuation. These include the onshore RIK crude oil program and the small refiners' set-aside RIK program. Market conditions in the future may be conducive to reinstating these programs but such is not the case today.
  10. The Subcommittee's charter did not include a review of the situation surrounding the offshore oil and gas leases in the Gulf of Mexico issued in 1998 and 1999 without price thresholds. However, towards the end of our review, we were asked by the Assistant Secretary for Land and Minerals Manage-

ment, Steven Allred, to comment on offshore lease issuance procedures enumerated in a February 2007 memorandum to him from Secretary Kempthorne.

Our recommendations are that the Department continue its efforts to pursue voluntary royalty payment agreements with holders of the leases; that Congress and the Secretary continue to explore legislative options that would address the loss of royalties without violating legitimately signed contracts; and that MMS and the Office of the Solicitor develop procedures and guidelines to ensure effective implementation of the 8 enumerated items in the memorandum within 60 days of release of the Subcommittee's report.

Thank you for the opportunity to provide this testimony. We look forward to working with you to improve this important program.

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**Response to questions submitted for the record  
by David T. Deal**

**General Questions**

**1. Mr. Deal, did your subcommittee consider recommendations aimed at instilling more independence in the audit function within MMS?**

In our discussions of the audit function, the Subcommittee did not address independence per se but did address aspects of the overall audit process with an independence character. For example, Chapter 3 addresses several matters that would facilitate the verification of production reporting that bear on the efficacy of audit and compliance and the "self-reporting" concerns identified by the Government Accountability Office in its March 11, 2008 testimony. Likewise, Chapter 4 of the Subcommittee Report addresses the mechanics of the audit and compliance review process, notably the choice of appropriate review options.

The Subcommittee Report also includes a Royalty in Kind-related Recommendation 6-16 to assure that RIK personnel have a solid understanding of existing ethics guidelines and, perhaps most relevant, a generic Recommendation 7-6 which addresses training, inclusive of ethics training, for all staff involved in royalty management and inclusive of "guidance on public-private sector interactions, use of official and/or proprietary data, and prohibitions on the use of public office for private gain."

**2. Mr. Deal, could you discuss your views of the usefulness of the State and Tribal Royalty Audit Committee, or "STRAC"? And do you see any way to improve the relationship between STRAC and MMS?**

As direct beneficiaries of onshore production in their jurisdictions, States and Indian tribes are important stakeholders, underscored by the fact that they have important roles in cooperation with the MMS in the overall audit process. See 30 C.F.R. Parts 227-229. While STRAC seems like a logical forum for States and Indian Tribes to share issues of common concern, I have had no direct experience with STRAC and the Subcommittee did not address MMS-STRAC relationships. Therefore, I can offer no specific suggestions for improving STRAC-MMS relationships.

**3. Mr. Deal, in their testimony, Senators Kerrey and Garn discuss the difference in the so-called "front-end" and "back-end" of BLM's operations. Can you describe that in more detail?**

To my knowledge, the "front-end" and "back-end" labels used in the testimony of Senator Kerrey and Senator Garn are not terms of art but are useful to explain BLM staffing challenges in the royalty management arena.

As the Senators used these terms, "front-end" relates to tasks associated with new leasing of onshore lands and the start up activity that follows leasing, e.g., processing of drilling permit applications, although the multiple-use character of BLM lands creates non-mineral responsibilities as well. However, "back-end" relates to tasks associated with leases once production has commenced, which embraces a host of tasks, including, but not limited to, onshore royalty-related production and accounting.

While the Subcommittee had neither the time nor the resources nor the resources to undertake a careful assessment of BLM funding trends, or the panoply of demands on BLM resources, our sense was that BLM resources, in terms of staffing numbers and skill levels, fell short of that needed to do the royalty-related "back-end" job completely and competently, an area that is central to Chapter 3 of the Subcommittee Report.

**4. Mr. Deal and Mr. Finfer, could you provide more detail on the difference between a “royalty payor” and an “operating rights owner”, and why it would be better for MMS to be able to pursue the royalty payor (as per Recommendation 3-8). Please provide an example to demonstrate the difficulty in the current system.**

Recommendation 3-8 of the Subcommittee Report suggests that the Department of the Interior support Section 215 of H.R. 2337 introduced in the 110th Congress, which would restore the MMS’ ability to pursue a designated payor for royalty debts, an option that was expressly precluded by prior remedial royalty legislation, namely, the Royalty Simplification and Fairness Act of 1996, Public Law 104-185 (RSFA). As Chapter 3, page 23, of the Subcommittee Report notes, underlying this recommendation, was the fact that the MMS does not have in place a system for tracking operating rights owners, which can make enforcement costly and cumbersome.

This recommendation is appropriately intended to simplify the collection process and respond to the Debt Collection Improvement Act of 1996-related compliance concerns identified in the course of a 2006 Inspector General audit. Upon reflection, however, my personal view is that the Subcommittee Report or Recommendation 3-8 itself should have included some caveats reflecting of some important legal and operational concerns.

In oil and gas parlance, an “operating interest” or “working interest” is the exclusive right to explore for, develop and produce oil and gas on a lease. For example, as described in the BLM Manual (excerpt attached), the owner of operating rights or a working interest holds:

the interest or contractual obligation created out of a lease (such as a sub-lease) authorizing the holder of that right to enter the leased lands to conduct drilling and related operations, including production, which may include as consideration a share in revenues production. Operating rights may or may not be transferred through an operating agreement; however, transfer of operating rights on Federal leases must be filed and approved on the official assignment form.

BLM Manual, H-3100-1, Oil and Gas Leasing, “Glossary and Abbreviations/Acronyms,” at 1-14, September, 6, 1985.

In contrast, a “royalty payor” is a party making payments to the royalty owner, in this case, the Federal Government. Although a royalty payor can be a working interest owner, a royalty payor can be anyone (e.g., an operator, a lessee, an accounting firm, etc.) so designated by one or more working interest owners and, therefore, is not necessarily linked to the underlying royalty obligation.

My recollection is that in the mid-1990’s the MMS was already concerned with collection closure times and advanced a “designated payor” concept intended to simplify the compliance review process by making any party designated as payor principally liable for any royalty bills due. While industry did not oppose simplification, it balked at the particular designated payor concept then under consideration by the MMS, raising legal and fairness concerns.

At the heart of the industry concerns was the view that a designated payor was not as a legal matter inherently a surrogate for the working interest owners beyond the reporting of royalty information and, did not bear the royalty obligation of the working interest owners prescribed in the lease document, and should not be liable for the working interest owner obligations of other parties.

When Congress took up RSFA in the mid-1990’s, the designated payor issue was one of several issues considered. While I was not privy to the many stakeholder discussions on the pending legislation at that time, there was widespread acceptance of the shortcomings of the MMS’ expanded designated payor approach. Enactment of RSFA in 1996 eliminated this liability ambiguity by amending the Federal Oil and Gas Royalty Management Act to sharpen the 30 U.S.C. § 1702 definition of “lessee” and amending 30 U.S.C. § 1712(a) as follows:

**(a) Liability for royalty payments**

In order to increase receipts and achieve effective collections of royalty and other payments, a lessee who is required to make any royalty or other payment under a lease or under the mineral leasing laws, shall make such payments in the time and manner as may be specified by the Secretary or the applicable delegated State. A lessee may designate a person to make all or part of the payments due under a lease on the lessee’s behalf and shall notify the Secretary or the applicable delegated State in writing of such designation, in which event said designated person may, in its own name, pay, offset or credit monies, make adjustments, request and receive refunds and submit reports with respect to payments required by the lessee. Notwithstanding any other provision of this chapter to the contrary, a designee shall not be liable for any payment obligation under the lease. The per-

son owning operating rights in a lease shall be primarily liable for its pro rata share of payment obligations under the lease. If the person owning the legal record title in a lease is other than the operating rights owner, the person owning the legal record title shall be secondarily liable for its pro rata share of such payment obligations under the lease.

30 U.S.C. 1712 (a) (emphasis supplied).

Since passage of RSFA working interest owners and payors have plainly relied on the bright line distinction between payor and working interest owner royalty liability.

For examples of the problem MMS confronts when it pursues collections from several working interest owners represented by a designated payor, I believe the MMS itself is best positioned to offer that information. I have no direct information on this matter. However, I am confident that another oversight hearing witness, MMS Director Randall Luthi, and his MMS Minerals Revenue Management staff can offer examples to illuminate the collection process. Indeed, the agency may be able to offer approaches to collection simplification, other than its original designated payor approach, that could satisfy their collection concerns without creating other problems in its place.

In sum, I am unaware of anyone opposed to simplification of the collection process to reduce the MMS workload and better satisfy Debt Collection Act requirements. However, if legislation akin to Section 215 of H.R. 2337 were enacted, the legislation and/or any ensuing MMS regulation in fairness should apply prospectively only and eliminate any ambiguities regarding the respective legal roles and responsibilities of royalty payors and operating interest owners for royalty collection in the future. In addition, because working interest owners and designated payors have been able to rely on RSFA, they would need an opportunity to consider realigning their payor arrangements and respective responsibilities.

#### **Minority Questions**

##### **5. In your opinion, what is the attitude of people working at MMS in terms of their desire to fulfill their obligation to the American public?**

While my oversight hearing testimony observes that the federal royalty management program needs many important improvements, I fully subscribe to the Subcommittee's view:

In general, the Subcommittee concludes that the Minerals Management Service is an effective steward of the Minerals Revenue Management Program, and that MMS employees are genuinely concerned with fostering continued program improvements. The Subcommittee members unanimously agree that MMS is the Federal agency best suited to fulfill the stewardship responsibilities for Federal and Indian leases.

Subcommittee Report at ix.

In its Report the Subcommittee also observed that over the years the MMS managed several rulemakings, stoutly defended its final rules against court challenges, and generally prevailed. Subcommittee Report at 12, citing, e.g., *IPAA v. DeWitt*, 279 F.3d 1036 (D.C. Cir. 2002) (upholding categorical denial of deductibility of marketing costs, except for firm demand charges, under 1997 gas valuation rule) and the court's dismissal of industry's challenge of the 2000 oil valuation rule.

Moreover, two more recent, cases not addressed in the Subcommittee Report, illustrate MMS' aggressive advocacy. Both cases are non-rulemaking, coalbed methane cases addressing application of the "marketable condition" rule: *Amoco Production Company v. Rebecca Watson*, 410 F.3d 722 (D.C. Cir. 2005), cert. denied except for statute of limitations issue, sub nom. *BP America Production Company v. Watson*, 126 S. Ct. 1768, 164 L. Ed. 2d 515, 2006 U.S. LEXIS 2851 (U.S., 2006) (upholding Assistant Secretary's denial of deductions for the costs of removing excess carbon dioxide from natural gas produced in the San Juan Basin); and, *Devon Energy Corp. v. Norton*, No. 04-0821, appeal pending, (D.D.C. Aug. 3, 2007) (upholding Assistant Secretary's denial of deductions for many compression, dehydration, and transportation costs).

Indeed, some courts have found that the MMS was overzealous in its efforts to fulfill its obligation to the American public. See, e.g., the decisions in *Diamond Shamrock Exploration Co. v. Hodel*, 853 F.2d 1159 (5th Cir. 1988) (holding that gas take-or-pay payments are not royalty bearing) and *Fina Oil and Chemical Company v. Norton*, 332 F.3d 672 (rejecting MMS' use of gross proceeds to capture affiliate gas resale proceeds even though affiliate was not "marketing affiliate" under MMS gas rule).

- 6. In the Energy Policy Act of 2005 we included a provision to establish pilot offices in areas of increased oil & gas exploration and development to ensure environmental compliance and ensure timely processing of lease applications and Applications for Permits to Drill—it seems that maybe we were on to something and that this program should be expanded to include other aspects of the Nation’s oil & gas program, including the collection of royalties. Do you believe this would facilitate better communication between BLM, MMS and the BIA?**

Concentrating agency resources in areas of high activity makes sense as a general matter. Whether it would facilitate BLM, MMS and BIA communication, however, is unclear to me inasmuch as I have had little contact with BLM and BIA staff over the years. However, I would observe that further decentralizing BLM offices, especially without the staffing and training recommendations of the Subcommittee, might not improve BLM performance but deserves careful consideration. Moreover, locating extra pilot offices in area of high exploration and development activity might not address onshore problems that might be associated with older, less active areas.

- 7. Can you describe your subcommittee’s interactions with MMS and the Department of the Interior while you were working on the report? Was it truly independent from your perspective?**

The Secretary of the Interior conceived of the Subcommittee as an independent panel and the Subcommittee so operated.

At the very outset of the project, at the November 2006 Royalty Policy meeting, and before the panel had been filled out, I was personally assured by the former MMS Director, Johnnie Burton, that “nothing was off limits” for the Subcommittee’s examination. Soon thereafter, Assistant Secretary Allred confirmed that view. The Subcommittee proceeded on that basis and encountered no barriers whatsoever.

Once the Subcommittee panel was filled out in late March 2007 and got underway, the Secretary appointed a small, non-MMS staff group to support the Subcommittee. Given the geographic dispersion of the Subcommittee members, and the need to collect large quantities of information, set up meetings with cognizant MMS and BLM staff, access to some basic policy analysis input, and administrative support, this staff group was essential, but in no way interfered with Subcommittee deliberations.

In the course of our deliberations, Subcommittee members met with BLM and MMS staff via telephone or in person on many occasions, especially during the Summer of 2007. My personal experience was that on all occasions the MMS and BLM staff were open, prepared and forthcoming in all respects. At no point, however, were MMS and BLM royalty-oriented staff invited to comment on emerging Subcommittee recommendations nor did they tender any such comments. Likewise, I am not aware of any intervention at all by any Department political appointee. Nor am I aware of any stakeholder (i.e., industry, state or Indian) outside the Subcommittee seeking or being invited to opine on any recommendation.

**STATEMENT OF FRANKLIN RUSCO, ACTING DIRECTOR,  
NATURAL RESOURCES AND ENVIRONMENT, U.S. GOVERNMENT ACCOUNTABILITY OFFICE**

Mr. COSTA. Our next witness is, last but not least, Mr. Frank Rusco, is that the way you pronounce it, who obviously comes to the Committee with high recommendations. We look forward to your testimony. Mr. Rusco, please begin.

Mr. RUSCO. Thank you. Chairman Costa, Ranking Member Pearce and members of this Subcommittee, I am pleased to be here to discuss our ongoing work on royalty collections for oil and gas produced on Federal lands and waters.

Mr. COSTA. For the record, excuse me, Mr. Rusco, I did fail to note you are the Director of Natural Resources and the Environment within the General Accounting Office, and you testify this morning with that imprimatur.

Mr. RUSCO. Thank you. Interior’s Minerals Management Service collected almost \$10 billion last year in such royalties. MMS col-

lects royalties in two forms, as a percentage of oil and gas revenues paid in cash or royalties in value and as a percentage of actual oil or gas royalties in kind. Oil and gas production and royalty data are self-reported to MMS by oil and gas production operators and/or royalty “payors.”

Because of the large amount of money involved and the fact that the basic data used to determine royalties owed are self-reported, it is imperative that MMS have adequate IT and management systems to: 1) prevent and detect errors and omissions to production and royalty data; 2) ensure audit capabilities can reliably identify and collect additional royalties due as a result of errors or omissions; and 3) design and implement appropriate performance measures for MMS’s overall programs.

Based on our work to date, we must conclude that MMS’s IT and management systems are inadequate on all three counts. Therefore, we do not have assurance that royalties are accurately collected. Until late 2004, MMS’s IT and management systems lacked the ability to reliably identify missing oil and gas production reports.

As a result, MMS has identified a backlog of about 300,000 missing production reports which will now have to be reconciled. Worse, the system still lacks the ability to identify missing royalty reports, so MMS does not know if or how many such reports are missing. Finally, companies are allowed to go back in to MMS’s data system and change royalty data at any time for up to six years after an initial report is filed.

There is no requirement for companies making such changes to notify MMS, and the IT and management systems do not systematically flag these changes for MMS review. As a result of these and other deficiencies, MMS does not have reasonable assurance that data entered into its system are complete or accurate to begin with or that they remain so over time.

We have a number of concerns about MMS’s audit capabilities including: 1) the lack of systematic and complete collection and evaluation of third-party production data and other supporting documentation; and 2) increasing reliance on compliance reviews, which compared to audits are less rigorous checks of the reasonableness, accuracy and completeness of royalty reports; and finally, the fact that there is too much riding on audits and compliance reviews given that the primary royalty data are so unreliable.

MMS is currently revising its audit and compliance review process, and we will be evaluating these revisions in our ongoing work. However, based on our work to date, we are concerned about the ability of the audit and compliance review process to adequately detect or deter missed reporting of production and royalty data.

Finally, MMS lacks adequate performance measures for its royalty-in-kind program. First, MMS does not check self-reported royalty-in-kind gas volumes against third-party production data. As a result, MMS does not have reasonable assurance that it is even getting the correct volumes of gas, which raises questions about MMS’s claimed benefits of the royalty-in-kind program.

Second, MMS’s methodology for comparing the value of royalty-in-kind oil and gas with what it would have received had the royalties been paid in cash is subject to a lot of unreported uncertainty.

We found that even small changes in assumptions about prices that royalty and value “payors” receive for their oil and gas leads to large swings in the estimated benefits of the royalty-in-kind program and can even make these estimates negative.

These and other problems raise serious questions about MMS’s reported measures of the benefits of the royalty-in-kind program. I want to conclude by saying that we encountered hardworking and knowledgeable staff in all Department of the Interior offices we visited, and we have received great cooperation in conducting our audit work.

However, we also found profound and persistent problems with IT and management systems that are inadequately designed and do not contain common sense checks that could assist staff in: 1) detecting and correcting inaccurate or incomplete self-reported production and royalty data; 2) conducting efficient and effective audits and compliance reviews; and 3) appropriately measuring program performance.

Upon completing our audit we will make recommendations that will address these and other issues. This completes my oral statement. My colleague, Jeanette Franzel, and I will be happy to answer any questions you have. Thank you.

Mr. COSTA. Thank you, Mr. Rusco.

[The prepared statement of Mr. Rusco follows:]

**Statement of Frank Rusco, Acting Director, Natural Resources and Environment, Accompanied by Jeanette Franzel, Director, Financial Management and Assurance, U.S. Government Accountability Office**

Mr. Chairman and Members of the Subcommittee:

We are pleased to participate in the subcommittee’s hearing to discuss the Department of the Interior’s (Interior) oversight of the collection of royalties paid on the production of oil and natural gas (hereafter oil and gas) from federal lands and waters. In Fiscal Year 2007, Interior’s Minerals Management Service (MMS) collected over \$9 billion in oil and gas royalties and disbursed these funds to federal, state, and tribal accounts. The federal portion of these royalties, which totaled \$6.7 billion in Fiscal Year 2007, represents one of the country’s largest nontax sources of revenue. At the same time, oil and gas production on federal lands and waters represents a critical component of the nation’s energy portfolio, supplying roughly 35 percent of all the oil and 30 percent of all the gas produced in the United States in 2006. The Department of Energy’s (DOE) Energy Information Administration projects that over the next 10 years the portion of U.S. production from federal lands and waters will increase to 47 percent for oil and 37 percent for gas. In Fiscal Year 2007, MMS also transferred \$322 million worth of oil to DOE as part of its efforts to fill the nation’s Strategic Petroleum Reserve (SPR). The SPR currently holds nearly 700 million barrels of oil—equivalent to about 58 days of net oil imports—that can be released at the discretion of the President in the event of an oil supply disruption. Recently, both oil prices and the demand to drill for oil and gas on federal lands have increased dramatically. For example, the price of West Texas Intermediate—a commonly used benchmark crude oil—now exceeds \$100 per barrel, a price that, when adjusted for inflation, is the highest price since 1980. Moreover, Interior’s Bureau of Land Management (BLM) is projecting substantially increased numbers of drilling permit applications. It received 8,351 in 2005 and anticipates receiving 12,500 in 2008.

Companies that develop and produce federal oil and gas resources from federal lands and waters do so under leases obtained and administered by Interior—BLM for onshore leases and MMS’s Offshore Minerals Management (OMM) for offshore leases. Together, BLM and OMM are responsible for overseeing oil and gas operations on more than 28,000 producing leases to help ensure that oil and gas companies comply with applicable laws, regulations, and agency policies. Among other things, BLM and OMM staff inspect producing leases to verify whether oil and gas are accounted for as required by both the Federal Oil and Gas Royalty Management

Act of 1982<sup>1</sup> and agency policies. As a condition of producing oil and gas under federal leases, companies are required to self-report monthly production volumes to MMS (as part of their monthly production reports).<sup>2</sup> In some situations, several companies may be jointly involved in developing oil and gas from a lease or a number of adjacent leases, in which case the companies designate one of the companies to be the “operator.” The operator has sole responsibility for submitting production reports for all oil and gas produced from the leases.

Companies, or lessees, compensate the government for producing federal oil and gas resources either “in value” (royalty payments made in cash), or “in kind” (royalty payments made in oil or gas). In Fiscal Year 2006, 58 percent of the \$9.74 billion in oil and gas royalty payments were made in value, while 42 percent were made in kind. Under the royalty-in-value program, lessees responsible for paying cash royalties, also called “payors,” calculate the royalty payment they owe to the federal government using the key variables illustrated in the following equation:

**Royalty payment = (sales volume x sales price - deductions) x royalty rate<sup>3</sup>**

Cash royalty payors are required to submit monthly royalty reports to MMS specifying the royalty amount they owe the federal government for the production and sale of oil and gas, and generally make the cash payment via an electronic fund transfer to an account at the Department of the Treasury (Treasury).<sup>4</sup> In many instances, because leases are co-owned by multiple companies, multiple payors submit individual royalty reports for a single lease. However, in these situations a single company is designated the “operator” and is responsible for submitting the production report for that entire lease. As a result, MMS will often receive multiple royalty reports corresponding to a single production report. Royalty reports include the sales volume (amount sold), the sales revenue (the amount of revenue received from the sale), and the royalty payment due to MMS (royalty value less allowances taken for transportation and processing the gas into a marketable condition), prorated based on the share owned by each payor. Some of these data, as well as some of the deductible transportation costs, are also available from third-party sources. For example, individual royalty payor data on production and some transportation costs can be acquired from pipeline statements, which are essentially receipts from pipeline companies for shipping oil and gas. In contrast, documentation of sales revenue data, as well as data supporting allowable deductions, are generally available only from oil and gas company records. Royalty payors submit their monthly royalty reports through a Web-based portal. Once MMS reconciles the self-reported royalty payment data from the monthly royalty reports with the payments submitted to Treasury, MMS disburses the royalties from the Treasury account to the appropriate federal, state, and tribal accounts. The transaction information is recorded in MMS’s financial management system.<sup>5</sup>

As a check on the accuracy of the self-reported data the payors use when determining cash royalty payments, among MMS’s internal controls are audits and compliance reviews.<sup>6</sup> Audits are an assessment of the accuracy and completeness of the self-reported production and royalty data compared against source documents, such as sales contracts and oil and gas sales receipts from pipeline companies. By contrast, compliance reviews deal with reasonableness—a quicker, more limited check of the accuracy and completeness of a company’s self-reported data—and they do not include systematic examination of underlying source documentation. In addition, some states and tribes that receive a share of royalties collected by MMS have agreements with MMS authorizing them to conduct both audits and compliance re-

<sup>1</sup> Federal Oil and Gas Royalty Management Act, Pub. L. No. 97-451, §101(a) (1983).

<sup>2</sup> Companies are required to self-report monthly production volumes to MMS on an Oil and Gas Operations Report (OGOR) form.

<sup>3</sup> The royalty rate varies somewhat but is typically in the range of 12.5 to 18.75 percent. In other words, the federal government typically receives between 12.5 and 18.75 percent of revenues less allowable deductions for oil and gas produced on federal lands and waters. Allowable deductions include payments to pipeline companies and other shipping costs required to transport the commodity to a market center, as well as adjustments made for the costs of processing natural gas.

<sup>4</sup> Companies are required to self-report monthly royalty payments to MMS on the Report of Sales and Royalty Remittance Form, Form 2014.

<sup>5</sup> This system, also known as the Minerals Revenue Management Support System, is designed to store and support the collection, verification, and disbursement of royalty revenues from federal and Indian mineral leases.

<sup>6</sup> Internal controls are a series of management actions and activities that occur throughout an entity’s operations and include the procedures used to meet agency objectives.

views on federal and Indian producing leases within their jurisdictions.<sup>7</sup> MMS has an annual performance goal whereby it evaluates the compliance group's performance on the basis of whether the group has conducted compliance activities—either full audits or compliance reviews—on a predetermined percentage of royalty payments.

In contrast to royalties in value, when paying royalties in kind, a payor delivers a volume of oil or gas to MMS as determined by the following equation:

**Royalty volume = total production volume x royalty rate**<sup>8</sup>

Once it receives the oil or gas, MMS may either sell it and disburse the revenues received from the sales, or transfer it to federal agencies for them to use. For example, MMS can transfer oil to DOE and DOE, in turn, can trade this oil for other oil of specific quality to fill the SPR. Under the Energy Policy Act of 2005,<sup>9</sup> MMS is charged with ensuring that the revenues it receives when it sells oil and gas taken in-kind are at least as great as the revenues it would have received had it taken the royalties in value. Furthermore, MMS cannot sell oil and gas it takes in-kind for less than market value. As required, MMS routinely compares the estimated benefits of the in-kind program to the estimated benefits MMS would have received if the royalties had been taken in cash and annually reports these benefits to the Congress.

MMS estimates that from Fiscal Years 2004 through 2006 the royalty-in-kind program generated about \$87 million more in net value to the government than MMS would have collected had it received royalties in cash. Of this \$87 million, MMS estimates that (1) \$74 million came from selling royalty-in-kind oil and gas for more than it would have received in cash royalty payments, (2) \$5 million came from interest from receiving revenues from in-kind sales earlier than cash payments are due, and (3) \$8 million came from savings because the royalty-in-kind program costs less to administer than the in-value program.

Our testimony today is based on two ongoing efforts. The first focuses on MMS's royalty-in-value program and addresses (1) whether Interior has adequate assurance that it is receiving full compensation for oil and gas produced from federal lands and waters and (2) the extent to which MMS's compliance efforts provide an adequate check on industry's self-reported data.<sup>10</sup> The second, relating to MMS's royalty-in-kind program, addresses (1) the extent to which MMS has reasonable assurance that it is collecting the right amounts of royalty-in-kind oil and gas and (2) the reliability of the benefits of the royalty-in-kind program that MMS has reported.<sup>11</sup>

In addressing these issues, we reviewed documentation on MMS policies and procedures for collecting royalties; collected and assessed information on the sales of royalty oil and gas; and reviewed MMS procedures for preparing the administrative cost comparison between the royalty-in-value and royalty-in-kind programs. We also interviewed officials at offices selected from a nonprobability sample of five BLM field offices and the associated BLM state offices—the offices were selected based on the numbers of violations, oil and gas volume errors identified, and geographic location. In addition, we interviewed officials at MMS; toured oil and gas production facilities in Wyoming, Colorado, and the Gulf of Mexico; sent questionnaires addressing production and royalty data issues to the 11 state and 7 tribal members of the State and Tribal Royalty Audit Committee, of which 9 states and 5 tribes responded. We assessed the reliability of the royalty-in-kind sales and performance data by (1) reviewing the systems that MMS has in place to help ensure that the data were entered and calculated correctly, and (2) comparing the data to aggregate performance results that MMS reported to the Congress for Fiscal Years 2004 through 2006. We determined that the data were sufficiently reliable for the purposes of this testimony. Our work is ongoing and we are continuing to assess infor-

<sup>7</sup>Eleven states—Alaska, California, Colorado, Louisiana, Montana, New Mexico, North Dakota, Oklahoma, Texas, Utah, and Wyoming—and seven tribes—Blackfeet Nation, Jicarilla Apache Tribe, Navajo Nation, Shoshone and Arapaho Tribes, Southern Ute Indian Tribe, Ute Mountain Ute Tribe, and the Ute Indian Tribe—conducted compliance work under cooperative agreements with MMS in Fiscal Year 2007.

<sup>8</sup>In some cases, there may be deductions to the royalty oil given MMS as a result of costs incurred by the payor to transport the oil to the point at which MMS takes possession. In addition, there may be credits or deductions that adjust for different qualities of oil transported on a pipeline.

<sup>9</sup>Energy Policy Act of 2005, Pub. L. No. 109-58, § 342 (2005).

<sup>10</sup>This work is being done at the request of Senator Bingaman and Mr. Davis, Mr. Issa, Ms. Maloney, and Mr. Rahall, House of Representatives.

<sup>11</sup>This work is being done at the request of Senator Bingaman and Senator Wyden, and Mr. Issa and Mr. Rahall, House of Representatives.

mation related to the objectives and findings presented in this testimony. We conducted this work from April 2007 to February 2008 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

In summary, regarding the royalty-in-value program, our work to date has revealed the following:

- Interior lacks adequate assurance that it is receiving full compensation for oil and gas produced from federal lands and waters. For example, neither BLM nor OMM is meeting statutory obligations or agency targets for conducting inspections of meters and other equipment used to measure oil and gas production, which raises questions about the accuracy of oil and gas measurement. Further, MMS's systems and processes for collecting and verifying royalty data are inadequate and lack key internal controls. Specifically, MMS lacks an automated process to routinely and systematically reconcile all production data filed by payors (those responsible for paying the royalties) with production data filed by operators (those responsible for reporting production volumes).
- MMS's compliance efforts do not consistently examine data from third parties to verify whether self-reported industry payment data are complete and accurate. Combined with the inadequacy of MMS's systems and processes for collecting and verifying royalty data and the lack of key internal controls, the absence of a consistent check on self-reported data using third-party data raises further questions about the accuracy of royalty payments.

Regarding the royalty-in-kind program, our work to date has revealed the following:

- MMS does not consistently check the accuracy of self-reported gas collection data against available third-party data, putting the accuracy of gas royalty collections at risk. MMS's ability to detect gas production discrepancies is weaker than for oil because, unlike in the case of oil, MMS does not use third-party gas metering data to verify the operator-reported production numbers.

The methods and assumptions MMS uses to compare the revenues it collects in kind with what it would have collected in cash do not account for all costs and do not sufficiently deal with uncertainties, raising significant questions about the reported financial benefits of the in-kind program.

#### **Interior's Oversight Does Not Provide Adequate Assurance That the Government Is Being Fully Compensated for Oil and Gas Production on Federal Lands and Waters**

Interior lacks adequate assurance that it is receiving the full royalties it is owed because (1) neither BLM nor OMM is fully inspecting leases and meters as required by law and agency policies, and (2) MMS lacks adequate management systems and sufficient internal controls for verifying that royalty payment data are accurate and complete. With regard to inspecting oil and gas production, BLM is charged with inspecting approximately 20,000 producing onshore leases annually to ensure that oil and gas volumes are accurately measured. However, BLM's state Inspection and Enforcement Coordinators from Colorado, Montana, New Mexico, Utah, and Wyoming told us that only 8 of the 23 field offices in the 5 states completed both their (1) required annual inspections of wells and leases that are high-producing and those that have a history of violations and (2) inspections every third year on all remaining leases.<sup>12</sup> According to the BLM state Inspection and Enforcement Coordinators, the number of completed production inspections varied greatly by field office. For example, while BLM inspectors were able to complete all of the production inspections in the Kemmerer, Wyoming, field office, inspectors in the Glenwood Springs, Colorado, field office were able to complete only about one-quarter of the required inspections. Officials in 3 of the 5 field offices in which we held detailed discussions with inspection staff told us that they had not been able to complete the

<sup>12</sup> We excluded production inspection results from three BLM field offices where BLM state Inspection and Enforcement Coordinators could not validate production inspection numbers because they felt the data in BLM's Automated Fluid Minerals Support System (AFMSS), the database used to track production inspections, were unreliable. We excluded one additional BLM field office because it is implementing a pilot project inspection program using different selection and prioritization criteria; therefore it is not comparable with the other BLM field offices.

production inspections because of competing priorities,<sup>13</sup> including their focus on completing a growing number of drilling inspections for new oil and gas wells, and high inspection staff turnover. However, BLM officials from all 5 field offices told us that when they have conducted production inspections they have identified a number of violations. For example, BLM staff in 4 of the 5 field offices identified errors in the amounts of oil and gas production volumes reported by operators to MMS by comparing production reports with third-party source documents. Additionally, BLM staff from 1 field office we visited showed us a bypass built around a gas meter, allowing gas to flow around the meter without being measured. BLM staff ordered the company to remove the bypass. Staff from another field office told us of a case in which individuals illegally tapped into a gas line and routed gas to private residences. Finally, in one of the field offices we visited, BLM officials told us of an instance in which a company maintained two sets of conflicting production data—one used by the company and another reported to MMS.

Moreover, OMM, which is responsible for inspecting offshore production facilities that include oil and gas meters, did not inspect all oil and gas royalty meters, as required by its policy, in 2007. For example, OMM officials responsible for meter inspections in the Gulf of Mexico told us that they completed about half of the required 2,700 inspections, but that they met OMM's goal for witnessing oil and gas meter calibrations. OMM officials told us that one reason they were unable to complete all the meter inspections was their focus on the remaining cleanup work from hurricanes Katrina and Rita. Meter inspections are an important aspect of the offshore production verification process because, according to officials, one of the most common violations identified during inspections is missing or broken meter seals. Meter seals are meant to prevent tampering with measurement equipment. When seals are missing or broken, it is not possible without closer inspection to determine whether the meter is correctly measuring oil or gas production.

With regard to MMS's assurance that royalty data are being accurately reported by companies, MMS's systems and processes for collecting and verifying these data lack both capabilities and key internal controls, including those focused on data accuracy, integrity, and completeness. For example, MMS lacks an automated process to routinely and systematically reconcile all production data filed by payors (those responsible for paying the royalties) with production data filed by operators (those responsible for reporting production volumes). MMS officials told us that before they transitioned to the current financial management system in 2001, their system included an automated process that reconciled the production and royalty data on all transactions within approximately 6 months of the initial entry date. However, MMS's new system does not have that capability. As a result, such comparisons are not performed on all properties. Comparisons are made, if at all, 3 years or more after the initial entry date by the MMS compliance group for those properties selected for a compliance review or audit.

In addition, MMS lacks a process to routinely and systematically reconcile production data included by payors on their royalty reports or by operators on their production reports with production data available from third-party sources. OMM does compare a large part of the offshore operator-reported production data with third-party data from pipeline operators through both its oil and gas verification programs, but BLM compares only a relatively small percentage of reported onshore oil and gas production data with third-party pipeline data. When BLM and OMM do make comparisons and find discrepancies, they forward the information to MMS, which then takes steps to reconcile and correct these discrepancies by talking to operators. However, even when discrepancies are corrected and the operator-reported data and pipeline data have been reconciled, these newly reconciled data are not automatically and systematically compared with the reported sales volume in the royalty report, previously entered into the financial management database, to ensure the accuracy of the royalty payment. Such comparisons occur only if a royalty payor's property has been selected for an audit or compliance review.

Furthermore, MMS's financial management system lacks internal controls over the integrity and accuracy of production and royalty-in-value data entered by companies. Companies may legally make changes to both royalty and production data

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<sup>13</sup>To gain a balance of perspectives of how BLM field offices conduct production inspections, we chose a nonprobability sample of five field office locations—Meeker, Colorado; Vernal, Utah; Farmington, New Mexico; Buffalo, Wyoming; and Pinedale, Wyoming. We selected the field offices in each of these states through consideration of a number of criteria, ensuring that we visited BLM field offices that represented a range of BLM state office jurisdictional policies. While this nonprobability sample allowed us to learn about many important aspects of production inspections, it was not designed to be representative of all the BLM field offices production inspection activities. As such, the findings cannot be generalized to sites we did not visit.

in MMS's financial management system for up to 6 years after the reporting month, and these changes may necessitate changes in the royalty payment.<sup>14</sup> However, when companies retroactively change the data they previously entered, these changes do not require prior approval by, or notification of, MMS. As a result of the companies' ability to unilaterally make these retroactive changes, the production data and required royalty payments can change over time, further complicating efforts by agency officials to reconcile production data and ensure that the proper amount of royalties was paid. Compounding this data reliability concern, changes made to the data do not necessarily trigger a review to determine their reasonableness or whether additional royalties are due. According to agency officials, these changes are not subject to review at the time a change is made and would be evaluated only if selected for an audit or compliance review. This is also problematic because companies may change production and royalty data after an audit or compliance review has been done, making it unclear whether these audited royalty payments remain accurate after they have been reviewed. Further, MMS officials recently examined data from September 2002 through July 2007 and identified over 81,000 adjustments made to data outside the allowable 6-year time frame. MMS is working to modify the system to automatically identify adjustments that have been made to data outside of the allowable 6-year time frame, but this effort does not address the need to identify adjustments made within the allowable time that might necessitate further adjustments to production data and royalty payments due.

Finally, MMS's financial management system could not reliably detect when production data reports were missing until late 2004, and the system continues to lack the ability to automatically detect missing royalty reports. In 2004, MMS modified its financial management system to automatically detect missing production reports. As a result, MMS has identified a backlog of approximately 300,000 missing production reports that must be investigated and resolved. It is important that MMS have a complete set of accurate production reports so that BLM can prioritize production inspections, and its compliance group can easily reconcile royalty payments with production information. Importantly, MMS's financial management system continues to lack the ability to automatically detect cases in which an expected royalty report has not been filed. While not filing a royalty report may be justifiable under certain circumstances, such as when a company sells its lease, MMS's inability to detect missing royalty reports presents the risk that MMS will not identify instances in which it is owed royalties that are simply not being paid. Officials told us they are currently able to identify missing royalty reports in instances when they have no royalty report to match with funds deposited to Treasury. However, cases in which a company stops filing royalty reports and stops paying royalties would not be detected unless the payor or lease was selected for an audit or compliance review.

#### **MMS's Compliance Efforts Do Not Consistently Use Third-Party Data to Check Self-Reported Royalty-in-Value Payment Data**

MMS's increasing use of compliance reviews, which are more limited in scope than audits, has led to an inconsistent use of third-party data to verify that self-reported royalty data are correct, thereby placing accurate royalty collections at risk. Since 2001, MMS has increasingly used compliance reviews to achieve its performance goals of completing compliance activities—either full audits or compliance reviews—on a predetermined percentage of royalty payments. According to MMS, compliance reviews can be conducted much more quickly and require fewer resources than audits, largely because they represent a quicker, more limited reasonableness check of the accuracy and completeness of a company's self-reported data, and do not include a systematic examination of underlying source documentation. Audits, on the other hand, are more time- and resource-intensive, and they include the review of original source documents, such as sales revenue data, transportation and gas processing costs, and production volumes, to verify whether company-reported data are accurate and complete. When third-party data are readily available from OMM, MMS may use them when conducting a compliance review. For example, MMS may use available third-party data on oil and gas production volumes collected by OMM in its compliance reviews for offshore properties. In contrast, because BLM collects only a limited amount of third-party data for onshore production, and MMS does not request these data from the companies, MMS does not systematically use third-party data when conducting onshore compliance reviews. Despite conducting thousands of compliance reviews since 2001, MMS has only recently evaluated their effectiveness. For calendar year 2002, MMS compared the results of 100 of about 700 compliance reviews of offshore leases and companies with

<sup>14</sup>The Royalty Simplification and Fairness Act of 1996, Pub. L. No. 104-185, § 5(a) (1996), provides a 6 year adjustment window.

the results of audits conducted on those same leases or companies. However, while the compliance reviews covered, among other things, 12 months of production volumes on all products—oil, gas, and retrograde, a liquid product that condenses out of gas under certain conditions—the audits covered only 1 month and one product. As a result of this evaluation comparing the results of compliance reviews with those of audits, MMS now plans to improve its compliance review process by, for example, ensuring that it includes a step to check that royalties are paid on all royalty-bearing products, including retrograde.

To achieve its annual performance goals, MMS began using the compliance reviews along with audits. One of MMS's performance goals is to complete compliance activities—either audits or compliance reviews—on a specified percentage of royalty payments within 3 years of the initial royalty payment. For example, in 2006 MMS reported that it had achieved this goal by confirming reasonable compliance on 72.5 percent of all calendar year 2003 royalties. To help meet this goal, MMS continues to rely heavily on compliance reviews, yet it is unable to state the extent to which this performance goal is accomplished through audits as opposed to compliance reviews. As a result, MMS does not have information available to determine the percentage of the goal that was achieved using third-party data and the percentage that did not systematically rely on third-party data. Moreover, to help meet its performance goal, MMS has historically conducted compliance reviews or audits on leases and companies that have generated the most royalties, with the result that the same leases and companies are reviewed year after year. Accordingly, many leases and companies have gone for years without ever having been reviewed or audited.

In 2006, Interior's Inspector General (IG) reviewed MMS's compliance process and made a number of recommendations aimed at strengthening it. The IG recommended, among other things, that MMS examine 1 month of third-party source documentation as part of each compliance review to provide greater assurance that both the production and allowance data are accurate. The IG also recommended that MMS track the percentage of the annual performance goal that was accomplished through audits versus through compliance reviews, and that MMS move toward a risk-based compliance program and away from reviewing or auditing the same leases and companies each year. To address the IG's recommendations, MMS has recently revised its compliance review guidance to include suggested steps for reviewing third-party source production data when available for both offshore and onshore oil and gas, though the guidance falls short of making these steps a requirement. MMS has also agreed to start tracking compliance activity data in 2007 that will allow it to report the percentage of the performance goal that was achieved through audits versus through compliance reviews. Finally, MMS has initiated a risk-based compliance pilot project, whereby leases and companies are selected for compliance work according to MMS-defined risk criteria that include factors other than whether the leases or companies generate high royalty payments. According to MMS, during Fiscal Year 2008 it will further evaluate and refine the pilot as it moves toward fuller implementation.

Finally, representatives from the states and tribes who are responsible for conducting compliance work under agreements with MMS have expressed concerns about the quality of self-reported production and royalty data they use in their reviews. As part our work, we sent questionnaires to all 11 states and seven tribes that conducted compliance work for MMS in Fiscal Year 2007. Of the nine state and five tribal representatives who responded, seven reported that they lack confidence in the accuracy of the royalty data. For example, several representatives reported that because of concerns with MMS's production and royalty data, they routinely look to other sources of corroborating data, such as production data from state oil and gas agencies and tax agencies. Finally, several respondents noted that companies frequently report production volumes to the wrong leases and that they must then devote their limited resources to correcting these reporting problems before beginning their compliance reviews and audits.

#### **The MMS Royalty-in-Kind Program Is at Risk of Inaccurate Collection of Natural Gas Royalties because of Inconsistent Oversight**

Because MMS's royalty-in-kind program does not extend the same production verification processes used by its oil program to its gas program, it does not have adequate assurance that it is collecting the gas royalties it is owed. As noted, under the royalty-in-kind program, MMS collects royalties in the form of oil and gas and then sells these commodities in competitive sales. To ensure that the government obtains the fair value of these sales, MMS must make sure that it receives the volumes to which it is entitled. Because prices of these commodities fluctuate over time, it is also important that MMS receive the oil and gas at the time it is entitled

to them. As part of its royalty-in-kind oversight effort, MMS identifies imbalances between the volume operators owe the federal government in royalties and the volume delivered and resolves these imbalances by adjusting future delivery requirements or cash payments. The methods that MMS uses to identify these imbalances differ for oil and gas.

- For oil, MMS obtains pipeline meter data from OMM's liquid verification system, which records oil volumes flowing through numerous metering points in the Gulf of Mexico region. MMS calculates its royalty share of oil by multiplying the total production volumes provided in these pipeline statements by the royalty rates for a given lease. MMS compares this calculation with the volume of royalty oil that the operators delivered as reported by pipeline operators. When the value of an imbalance cumulatively reaches \$100,000, MMS conducts further research to resolve the discrepancy. Using pipeline statements to verify production volumes is a good check against companies' self-reporting of royalties due the federal government because companies have an incentive to not under-report their share of oil going into the pipeline because that is the amount they will have to sell at the other end of the pipeline.
- For gas, MMS relies on information contained in two operator-provided documents—monthly imbalance statements and production reports. Imbalance statements include the operator's total gas production for the month, the share of that production that the government is entitled to, and any differences between what the operator delivered and the government's royalty share. Production reports contain a large number of data elements, including production volumes for each gas well. MMS compares the production volumes contained in the imbalance statements with those in the production reports to verify production levels. MMS then calculates its royalty share based on these production figures and compares its royalty share with gas volumes the operators delivered as reported by pipeline operators. When the value of an imbalance cumulatively reaches \$100,000, MMS conducts further research to resolve the discrepancy.

MMS's ability to detect gas imbalances is weaker than for oil because it does not use third-party metering data to verify the operator-reported production numbers. Since 2004, OMM has collected data from gas pipeline companies through its gas verification system, which is similar to its liquid verification system in that the system records information from pipeline company-provided source documents. Our review of data from this program shows that these data could be a useful tool in verifying offshore gas production volumes.<sup>15</sup> Specifically, our analysis of these pipeline data showed that for the months of January 2004, May 2005, July 2005, and June 2006, 25 percent of the pipeline metering points had an outstanding discrepancy between self-reported and pipeline data.<sup>16</sup> These discrepancies are both positive and negative—that is, production volumes submitted to MMS by operators are at times either under- or overreported.

Data from the gas verification system could be useful in validating production volumes and reducing discrepancies. However, to fully benefit from this opportunity, MMS needs to improve the timeliness and reliability of these data. After examining this issue, in December 2007, the Subcommittee on Royalty Management, a panel appointed by the Secretary of the Interior to examine MMS's royalty program, reported that OMM is not adequately staffed to conduct sufficient review of data from the gas verification system.<sup>17</sup> We have not yet, nor has MMS, determined the net impact of these discrepancies on royalties owed the federal government.

#### **Significant Questions and Uncertainties Exist Regarding the Reported Financial Benefits of the Royalty-in-Kind Program**

The methods and underlying assumptions MMS uses to compare the revenues it collects in kind with what it would have collected in cash do not account for all costs and do not sufficiently deal with uncertainties, raising doubts about the claimed financial benefits of the royalty-in-kind program. Specifically, MMS's calculation showing that MMS sold the royalty oil and gas for \$74 million more than MMS would have received in cash payments did not appropriately account for uncertainty

<sup>15</sup> Onshore gas properties accounted for less than 1 percent of the revenue managed by the royalty-in-kind program from Fiscal Year 2004 through Fiscal Year 2006, but this area is expected to grow in the future.

<sup>16</sup> For purpose of this testimony, we used 4 months of data from the gas verification system. We chose these months (January 2004, May 2005, July 2005, and June 2006) because these are the months for which MMS has started to work to resolve the discrepancies identified between the production reports and pipeline data.

<sup>17</sup> Subcommittee on Royalty Management, Royalty Policy Committee, Report to the Royalty Policy Committee: Mineral Revenue Collection from Federal and Indian Lands and the Outer Continental Shelf (2007).

in estimates of cash payments. In addition, MMS's calculation that early royalty-in-kind payments yielded \$5 million in interest was based on assumptions about payment dates and interest rates that could misstate the estimated interest benefit. Finally, MMS's calculation that the royalty-in-kind program cost about \$8 million less to administer than an in-value program did not include significant costs that, if included, could change MMS's conclusions.

### **Sales Revenue**

MMS sold the oil and gas it collected during the 3 Fiscal Years 2004 through 2006 for \$8.15 billion and calculated that this amount exceeded what MMS would have received in cash royalties by about \$74 million—a net benefit of approximately 0.9 percent. MMS has recognized that its estimates of what it would have received in cash payments are subject to some degree of error but has not appropriately evaluated or reported how sensitive the net benefit calculations are to this error.<sup>18</sup> This is important because even a 1 percent error in the estimates of cash payments would change the estimated benefit of the royalty-in-kind program from \$74 million to anywhere from a loss of \$6 million to a benefit of \$155 million.

Moreover, MMS's annual reports to the Congress present oil sales data in aggregate and therefore do not reflect the fact that, in many individual sales, MMS sold the oil it collected in kind for less than it estimates it would have collected in cash. Specifically, MMS estimates that, in Fiscal Year 2006, it sold 28 million barrels of oil, or 64 percent of all the oil it collected in kind, for less than it would have collected in cash. The government would have received an additional \$6 million in revenue if it had taken these royalties in cash instead. These sales indicate that MMS has not always been able to achieve one of its central goals: to select, based on systematic economic analysis, which royalties to take in cash and which to take in kind in a way that maximizes revenues to the government.

According to a senior MMS official, the federal government has several advantages when selling gas that it does not have when selling oil, a fact that helps to explain why MMS's gas sales have performed better than its oil sales. For example, MMS can bundle the natural gas production in the Gulf of Mexico from many different leases into large volumes that MMS can use to negotiate discounts for transporting gas from production sites to market centers. Because purchasers receive these discounts when they buy gas from MMS, they may be willing to pay more for gas from MMS than from the original owners. Opportunities for bundling are less prevalent in the oil market. Because MMS generally does not have this, or other, advantages when selling oil, purchasers often pay MMS about what they would pay other producers for oil, and sometimes less. Indeed, MMS's policies allow it to sell oil for up to 7.7 cents less per barrel than MMS estimates it would collect if it took the royalties in cash. MMS told us that the other financial benefits of the royalty-in-kind program, including interest payments and reduced administrative costs, justify selling oil for less than the estimated cash payments because once these additional revenues are factored in, the net benefit to the government is still positive. However, as discussed below, we have found that there are significant questions and uncertainties about the other financial benefits as well.

### **Interest**

Revenues from the sale of royalty-in-kind oil are due 10 days earlier than cash payments, and revenues from the sale of in-kind gas are due 5 days earlier. MMS calculates that the government earned about \$5 million in interest from Fiscal Years 2004 through 2006 from these early payments that it would not have received had it taken royalties in cash.<sup>19</sup> We found two weaknesses in the way MMS calculates this interest. First, the payment dates used to calculate the interest revenue have the potential to over- or underestimate its value. MMS calculates the interest on the basis of the time between the actual date that Treasury received a royalty-in-kind payment and the theoretical latest date that Treasury would have received a cash payment under the royalty-in-value program. However, MMS officials told us that cash payments can, and sometimes do, arrive before their due date. As a result, MMS might be overstating the value of the early royalty-in-kind payments. Second, the interest rate used to calculate the interest revenue may either over- or understate its value because the rate is not linked to any market rate. From Fiscal Year 2004 through 2007, MMS used a 3 percent interest rate to cal-

<sup>18</sup> OMB Circular A-94, "Guidelines and Discount Rates for Benefit-Cost Analysis of Federal Programs," suggests that such sensitivity analysis be done and reported.

<sup>19</sup> While MMS calls this value "interest," it is not interest per se because the money does not go into an interest-bearing account. Rather, MMS argues that the government uses the early payments to cover expenses that it would otherwise need to borrow money to pay for. The interest, then, is the cost that the government avoids by deferring the need to borrow.

culate the time value of these early payments. However, during this time, actual market interest rates at which the federal government borrowed fluctuated. For example, 4-week Treasury bill rates ranged from a low of 0.72 percent to a high of 5.18 percent during this same period. Therefore, during some fiscal years, MMS likely overstated or understated the value of these early payments.

#### **Administrative Cost Savings**

MMS has developed procedures to capture the administrative costs of the royalty-in-kind and cash royalty programs and includes in its administrative cost comparison primarily the variable costs for the federal offshore oil and gas activities—that is, costs that fluctuate based on the volume of oil or gas received by MMS, such as labor costs. Although MMS also includes some department-level fixed costs, it excludes some fixed costs that it does not incur on a predictable basis (largely information technology [IT] costs). According to MMS, if it included these IT and other such costs, there would be a high potential of skewing the unit price used to determine the administrative cost savings. However, by excluding such fixed costs from the administrative cost comparison, MMS is not including all the necessary cost information to evaluate the efficacy of the royalty-in-kind program.

MMS's administrative cost analysis compares a bundle of royalty-in-kind program administrative costs divided by the number of barrels of oil equivalent realized by the royalty-in-kind program during a year,<sup>20</sup> with a bundle of cash royalty program administrative costs divided by the number of barrels of oil equivalent realized by that program. The difference between these amounts represents the difference in cost to administer a barrel of oil equivalent under each program.

MMS then multiplies the difference in cost to administer a barrel of oil equivalent under the two programs by the number of barrels of oil equivalent realized by the royalty-in-kind program to determine the administrative cost savings. However, MMS's calculations excluded some fixed costs that are not incurred on a regular or predictable basis from the analysis. For example, in Fiscal Year 2006, royalty-in-kind IT costs of \$3.4 million were excluded from the comparison. Moreover, additional IT costs of approximately \$29.4 million—some of which may have been incurred for either the royalty-in-kind or the cash royalty program—were also excluded. Including and assigning these IT costs to the programs supported by those costs would provide a more complete accounting of the respective costs of the royalty-in-kind and royalty-in-value programs, and would likely impact the results of MMS's administrative cost analysis.

#### **Conclusions**

Ultimately the system used by Interior to ensure taxpayers receive appropriate value for oil and gas produced from federal lands and waters is more of an honor system than we are comfortable with. Despite the heavy scrutiny that Interior has faced in its oversight of royalty management, we and others continue to identify persistent weaknesses in royalty collections. Given both the long-term fiscal challenges the government faces and the increased demand for the nation's oil and gas resources, it is imperative that we have a royalty collection system going forward that can assure the American public that the government is receiving proper royalty payments. Our work on this issue is continuing along several avenues, including comparing the royalties taken in kind with the value of royalties taken in cash, assessing the rate of oil and gas development on federal lands, comparing the amount of money the U.S. government receives with what foreign countries receive for allowing companies to develop and produce oil and gas, and examining further the accuracy of MMS's production and royalty data. We plan to make recommendations to address the weaknesses we identified in our final reports on these issues.

We look forward to further work and to helping this subcommittee and the Congress as a whole to exercise oversight on this important issue. Mr. Chairman, this concludes our prepared statement. We would be pleased to respond to any questions that you or other members of the subcommittee may have at this time.

#### **GAO Contact and Staff Acknowledgments**

For further information about this testimony, please contact either Frank Rusco, at 202-512-3841, or ruscof@gao.gov, or Jeanette Franzel, at 202-512-9406, or franzelj@gao.gov. Contact points for our Congressional Relations and Public Affairs may be found on the last page of this statement. Contributors to this testimony include Ron Belak, Ben Bolitzer, Lisa Brownson, Melinda Cordero, Nancy Crothers, Glenn C. Fischer, Cindy Gilbert, Tom Hackney, Chase Huntley, Heather Hill, Bar-

<sup>20</sup>A barrel of oil equivalent is an amount of natural gas or natural gas liquid that contains the same heating value as a barrel of oil.

bara Kelly, Sandra Kerr, Paul Kinney, Jennifer Leone, Jon Ludwigson, Tim Minelli, Michelle Munn, G. Greg Peterson, Barbara Timmerman, and Mary Welch.

March 11, 2008

## MINERAL REVENUES

### Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk

G A O  
Accountability Integrity Reliability

## Highlights

Highlights of GAO-08-560T, a testimony before the Subcommittee on Energy and Mineral Resources, Committee on Natural Resources, House of Representatives

#### Why GAO Did This Study

Companies that develop and produce federal oil and gas resources do so under leases administered by the Department of the Interior (Interior). Interior's Bureau of Land Management (BLM) and Offshore Minerals Management (OMM) are responsible for overseeing oil and gas operations on federal leases. Companies are required to self-report their production volumes and other data to Interior's Minerals Management Service (MMS) and to pay royalties either "in value" (payments made in cash), or "in kind" (payments made in oil or gas).

GAO's testimony will focus on whether (1) Interior has adequate assurance that it is receiving full compensation for oil and gas produced from federal lands and waters, (2) MMS's compliance efforts provide a check on industry's self-reported data, (3) MMS has reasonable assurance that it is collecting the right amounts of royalty-in-kind oil and gas, and (4) the benefits of the royalty-in-kind program that MMS has reported are reliable. This testimony is based on ongoing work. When this work is complete, we expect to make recommendations to address these and other findings.

To address these issues GAO analyzed MMS data, reviewed MMS, and other agency policies and procedures, and interviewed officials at Interior. In commenting on a draft of this testimony, Interior provided GAO technical comments which were incorporated where appropriate.

To view the full product, including the scope and methodology, click on GAO-08-560T. For more information, contact Frank Rusco at (202) 512-3841 or ruscof@gao.gov.

#### What GAO Found

Interior lacks adequate assurance that it is receiving full compensation for oil and gas produced from federal lands and waters because Interior's Bureau of Land Management (BLM) and Offshore Minerals Management (OMM) are not fully conducting production inspections as required by law and agency policies and because MMS's financial management systems are inadequate and lack key internal controls. Officials at BLM told us that only 8 of the 23 field offices in five key states we sampled completed their required production inspections in fiscal year 2007. Similarly, officials at OMM told us that they completed about half of the required production inspections in calendar year 2007 in the Gulf of Mexico. In addition, MMS's financial management system lacks an automated process for routinely and systematically reconciling production data with royalty payments.

MMS's compliance efforts do not consistently examine third-party source documents to verify whether self-reported industry royalty-in-value payment data are complete and accurate, putting full collection of royalties at risk. In 2001, to help meet its annual performance goals, MMS moved from conducting audits, which compare self-reported data against source documents, toward compliance reviews, which provide a more limited check of a company's self-reported data and do not include systematic comparison to source documentation. MMS could not tell us what percentage of its annual performance goal was achieved through audits as opposed to compliance reviews.

Because the production verification processes MMS uses for royalty-in-kind gas are not as rigorous as those applied to royalty-in-kind oil, MMS cannot be certain it is collecting the gas royalties it is due. MMS compares companies' self-reported oil production data with pipeline meter data from OMM's oil verification system, which records oil volumes flowing through metering points. While analogous data are available from OMM's gas verification system, MMS has not chosen to use these third-party data to verify the company-reported production numbers.

The financial benefits of the royalty-in-kind program are uncertain due to questions and uncertainties surrounding the underlying assumptions and methods MMS used to compare the revenues it collected in kind with what it would have collected in cash. Specifically, questions and uncertainties exist regarding MMS's methods to calculate the net revenues from in-kind oil and gas sales, interest payments, and administrative cost savings.

United States Government Accountability Office

### Response to questions submitted for the record by Dr. Rusco

#### Majority Question Responses

1. Mr. Rusco, do you believe it is appropriate for MMS to be in charge of analyzing the success of the Royalty-in-Kind Program? It seems that they have a strong incentive to show how well it is working, so would it be better to have someone outside of MMS be doing this review? And if so, who might you suggest?

**Answer:** Our review of the royalty-in-kind program raised significant concerns about the assumptions and methods that MMS uses to compare the revenues it col-

lects in kind with what it would have collected in cash payments. However, we believe that if MMS addresses these concerns, MMS could produce reliable information on this key aspect of program performance.

**2. Mr. Rusco, did GAO identify any specific instances of a breakdown in internal controls related to reporting?**

**Answer:** We identified several instances where internal controls were either absent or not working effectively. One instance of a missing internal control we identified was the inability of MMS's information technology (IT) system to effectively identify missing royalty reports, a critical piece of data used by MMS to determine whether royalties were paid. We also identified several instances where internal controls were ineffective. For example, while MMS's IT system now has the ability to identify missing production reports, it now has a significant backlog of production data that staff are spending considerable time and resources attempting to reconcile. Finally, MMS's interest IT module, which is used to calculate and charge interest payments to payors for late payments, never fully worked and is in the process of being re-designed, subject to funding.

We also identified several weaknesses in MMS's system for measuring and reporting the performance of the RIK program. Specifically, we determined that MMS does not appropriately measure or report: (1) the uncertainty of the benefits of taking royalties in kind or (2) the interest accrued from receiving royalty-in-kind payments earlier than cash payments. Further, we found that MMS's annual reports to Congress have not fully reported all the costs of administering the RIK program. These weaknesses make it unclear whether the benefits of taking royalties in kind have exceeded what MMS would have received had it taken royalties in cash instead.

**3. Mr. Rusco, what is needed for MMS to better ensure the accurate collection of royalties?**

**Answer:** We plan on issuing a product related to the ongoing work from which our testimony was drawn that will include recommendations on how MMS can better ensure accurate collections of royalties. Those recommendations will deal with improvements to help ensure the completeness and accuracy of royalty data and the related collections. Furthermore, we have additional ongoing work examining royalty collections and will include recommendations in our reporting as appropriate.

**4. Mr. Rusco, it seems that MMS relies heavily on the audit and compliance group to find errors in royalty and production reporting. Is that more efficient than having the financial management system be better controlled?**

**Answer:** We did not directly address the issue of whether MMS's financial management system with better controls would be more efficient than relying on audits and compliance reviews. Our work did identify that MMS currently uses both up-front edit checks to prevent erroneous data from being initially entered into the financial system—preventive controls—as well as after-the-fact audits and compliance reviews to detect incorrect royalty payments—detection controls. An effective internal control environment consists of both strong preventive controls in addition to detection controls. An appropriate balance between the two is also important in achieving effectiveness and efficiency of internal controls. For example, where there is a high volume of transactions, the lack of preventive controls significantly increases the risk of errors and accordingly increases the need for particularly sensitive detection controls. In the absence of preventive controls, a high number of errors can render detection controls not only inefficient but also ineffective in detecting and correcting errors in a timely manner.

**5. Mr. Rusco, in your testimony, you discuss what appear to be significant lapses in key internal controls. Would GAO agree that when controls are weak, particularly when surrounding a "checkbook" of billions of dollars, the risk of fraud goes up dramatically?**

**Answer:** While we did not perform specific tests that might have uncovered potential fraud, it is true that the risk of fraud increases in the absence of strong internal controls. However, internal controls, even when operating optimally, will not provide a 100 percent guarantee that someone cannot commit fraud. Because fraud is usually concealed, material misstatements due to fraud are difficult to detect. Nevertheless, certain events or conditions that indicate incentives or pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes and rationalizations to justify a fraudulent action may be present at MMS. Such events or conditions are referred to as "fraud risk factors." Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances

where fraud exists. During the course of our work, we found that at least two of the three key indicators of fraud—an incentive for someone to misappropriate assets (for example cash or gas and oil in this case), and the opportunity to do so (that is, a relatively low risk of being caught)—may exist in MMS’s environment of collecting the federal government’s fair share of royalties from oil and gas produced on federal properties. However, we have not uncovered any fraud during the course of our work so far.

**6. Mr. Rusco, in response to a question at the hearing, Mr. Finfer stated that one of the crucial elements to a risk-based compliance strategy is good data. Do you believe that MMS currently has data of sufficient quality to properly implement an effective risk-based compliance strategy?**

**Answer:** We agree that a crucial element of a risk-based compliance strategy is good data upon which to base management’s risk assessments and judgments. We have previously reported on data accuracy problems in limited sets of royalty data extracted from MMS’s financial management system. At this time, however, we are unable to comment on the full extent of the reliability of the underlying data used to assign risk as we did not assess many of the data elements that MMS has proposed to use in ranking both properties and payors. We are in the process of doing additional work in this area and will report out when that work is completed.

**7. Mr. Rusco, we constantly hear from MMS that the Royalty-in-Kind Program is performing well. Your testimony indicates the benefits are less certain. Do you think MMS’s reports are giving us the full story, and could you provide an example of this?**

**Answer:** MMS’s annual reports are not providing the Congress with the full picture regarding the performance of the royalty-in-kind program. By presenting oil sales data aggregated by major sales category, the reports do not reflect the fact that, in many individual sales, MMS has sold the oil it collected in kind for less than it estimates it would have collected in cash. For example, MMS estimates that, in Fiscal Year 2006, it sold 64 percent of all the oil it collected in kind, for less than it would have collected in cash.

**8. Mr. Rusco, could you discuss your views of the usefulness of the State and Tribal Royalty Audit Committee, or “STRAC”? And do you see any way to improve the relationship between STRAC and MMS?**

**Answer:** The State and Tribal Royalty Audit Committee (STRAC) works under authority granted in the Federal Oil and Gas Royalty Management Act. It performs compliance work through agreements with MMS and brings jurisdictional expertise and staff to MMS’s compliance activities. We are aware that there are many written communications between STRAC and MMS. However, we have not examined whether or how the relationship between STRAC and MMS could be improved.

**9. Mr. Rusco, in your testimony, you seem to say that if a company gets a compliance review or an audit, it can make an adjustment afterwards that MMS will never check? Is that true? Does the MMS “Adjustment Line Monitoring Initiative” help with that?**

**Answer:** A company can make adjustments to data after MMS has completed either an audit or a compliance review, and MMS does not have controls in place to assess the justification for each of those adjustments. In commenting on our draft testimony, MMS stated that staff are currently developing requirements for an IT initiative to be completed in Fiscal Year 2008 that will assist in monitoring adjustments. As of March 2008, MMS has not finalized the IT specifications for this module, so we are unable to determine the extent to which this would address our concerns. As planned, the new IT system module would monitor adjustments made after the module went on-line and would not address prior adjustments. Accordingly, unless MMS goes back and reviews past data, we will not be confident that all past adjustments have been warranted.

**10. Mr. Rusco, in their testimony, Senators Kerrey and Garn discuss the difference in the so-called “front-end” and “back-end” of BLM’s operations, saying that increased funding has been focused on additional leasing and processing of applications for permits to drill, but “there has not been sufficient attention” to collections, production accountability, and auditing requirements. Has GAO seen evidence of this in recent years?**

**Answer:** BLM field office staff tell us that many resources are dedicated to processing drilling permits. These staff and the official BLM inspection strategy guid-

ance, indicates that resources are prioritized for “front-end” activities, such as drilling inspections rather than “back-end” activities, such as production verification. Furthermore, we reported in *Oil and Gas Development: Increased Permitting Activity Has Lessened BLM’s Ability to Meet Its Environmental Protection Responsibilities* (GAO-05-418) that BLM’s ability to meet its environmental mitigation responsibilities for oil and gas development has been lessened by a dramatic increase in oil and gas operations on federal lands between 1999 and 2005. Since that time, permitting activity has continued to increase.

**11. Mr. Rusco, I understand that GAO is now looking at some of the issues with the Accenture computing system that the Inspector General brought up in September. Could you discuss your work on this issue?**

**Answer:** We agreed with the Department of the Interior’s Inspector General (IG) that we would examine key functionalities of the IT system, whereas the IG would examine the contract Accenture had with MMS to develop the IT system and determine whether the end product was what the contract specified. Accordingly, we spoke with MMS staff and STRAC users of the IT system and are doing further work to evaluate the quality of the data managed in that system. We will report on the results of this work when it is completed.

**12. Mr. Rusco, the Subcommittee on Royalty Management’s report says that “MMS’s processes for evaluating the feasibility of RIK vs. RIV appears to be rigorous and effective.” Do you agree with that statement?**

**Answer:** Before MMS decides to take royalties from a particular property or pipeline in kind, MMS compares the revenues it expects to receive by taking the royalties in kind to what it currently receives in cash. We did not evaluate the effectiveness of this prospective analysis. Rather, we evaluated the methods that MMS uses to retrospectively determine whether the benefits from taking royalties in kind were, in fact, better than taking royalties in value. Our review raised significant concerns about this retrospective analysis. MMS can use its retrospective analysis to help inform prospective decisions about which properties or portfolios to keep in the in-kind program. For example, MMS placed one portfolio of natural gas leases back into the in-value program after noticing that sales from these leases had performed poorly. Our concerns about the retrospective analyses also raise significant concerns about whether these analyses provide reliable information regarding which leases to keep in the in-kind program over time.

**13. Mr. Rusco, a footnote in your testimony says that certain BLM state officials believed the data in BLM’s Automated Fluid Minerals Support System (AFMSS) were unreliable. Have you assessed the AFMSS and the reliability of its data?**

**Answer:** We identified a number of discrepancies in the production inspection data stored in BLM’s Automated Fluid Minerals Support System (AFMSS) and determined that it was not sufficiently reliable for our reporting purposes. During the course of our work, we took a number of steps to assess the reliability of the production inspection data. These steps included requesting the Fiscal Year 2007 production inspection data from AFMSS from BLM’s AFMSS database manager for those field offices that we included in our review. We then asked field staff to validate the numbers we received from AFMSS. In several cases, field office staff stated that the numbers were not correct and subsequently revised the numbers in AFMSS. However, in two instances, BLM staff were unable to validate the AFMSS production inspection numbers because they lacked confidence in the data. Consequently, we were uncomfortable reporting the actual production inspection numbers in our testimony. In assessing the reliability of the data, we did not perform electronic testing, nor did we compare records kept in BLM’s paper files with data in AFMSS.

**14. Mr. Rusco, in your testimony you say that MMS lacks an automated process to reconcile payor production data with production data filed by operators. However, MMS reports that they have an automated Compliance Process Tool (CPT) which makes those reconciliations. How do these two statements square up, and how does the CPT compare to MMS’s old automated process?**

**Answer:** MMS’s prior IT system automatically compared all production reports and royalty reports within 6 months without human intervention. However, during the course of our work MMS officials told us that the that the new system only compared a portion of the production reports with the royalty reports through the compliance review process, which generally is done 3 years after royalties are reported. Furthermore, while this comparison is done via the Compliance Program Tool, it requires an analyst to manipulate the menus and query tools to complete the actual

comparison. The need for staff to perform this comparison, rather than its being done automatically, takes time away from other compliance efforts. MMS recently told us that it is in the process of changing its policies on comparing production and royalty reports. However, we have not yet assessed this process.

**15. Mr. Rusco, on page 8 of your testimony, you describe one instance of a bypass built around a gas meter and one instance of a company maintaining two sets of conflicting production data. What action was taken by BLM in these instances, and did the companies face any financial penalties?**

**Answer:** In the instance of the bypass, BLM staff told us that they issued the company an Incident of Non-Compliance. The company subsequently removed the bypass. Because the company removed the bypass within the allotted timeframe, the company was not issued a financial fine.

In the other instance, according to BLM Petroleum Engineer Technicians, the company kept two sets of books—the internal raw data and the data reported to MMS on the Oil and Gas Operations Report (OGOR). Although, the total volumes of oil and gas on those books were the same, the company altered production amounts at the well level that they reported to MMS on the OGOR. BLM subsequently asked the company to correct and resubmit the OGORs and did not issue the company a financial fine.

**16. Mr. Rusco, please describe whether the findings and recommendations of the Royalty Policy Committee report dated December 17, 2007 are consistent with findings reported by GAO in its testimony to the subcommittee on March 11, 2008, and point out any major differences that exist between the two reports.**

**Answer:** The findings reported by GAO in its testimony to the subcommittee on March 11, 2008 are generally consistent with the findings and recommendations of the Royalty Policy Committee (RPC) report dated December 17, 2007. This similarity is due to the fact that both GAO's and RPC's objectives focused on two common objectives—(1) to determine whether MMS collects the correct amount of federal and Indian mineral royalties, and (2) to assess whether the federal government is benefited by taking royalties in kind. To address these objectives, both GAO and RPC reviewed management's oversight activities, policies, procedures, systems and internal controls.

While RPC concluded that MMS is an effective steward for federal and Indian mineral interests, it also found a number of management activities requiring prompt, and in some cases, significant management attention, to ensure public confidence. Over 100 detailed recommendations to management were reported by RPC. For example, several of these recommendations were directed at MMS and BLM to improve production accountability and production measurement. GAO shares this concern and believes that without improvement in verification procedures, MMS cannot be assured that it is receiving full compensation for oil and gas produced on federal and Indian properties.

GAO and RPC also evaluated the RIK program and concluded that improvements are needed to increase transparency of reporting and clarity of management decision-making when determining whether to take royalties in kind or in value. For example, RPC recommended, and GAO suggested in its testimony, that MMS should report on the uncertainties surrounding the benefits of taking royalties in kind. However, there are a number of differences between the two reports with respect to the RIK program. For example, RPC concluded that MMS should explore the feasibility of establishing a trust fund, the interest from which could be used to fund royalty management activities. The RPC also concluded that MMS should study the use of various governance arrangements for the RIK program. GAO has not explored these issues. Moreover, GAO was not requested to examine outer continental shelf (OCS) royalty relief as part of this testimony, whereas RPC was charged with reviewing the Department's procedures established in response to the lack of price thresholds for certain deep water leases in the Gulf of Mexico. This additional examination by RPC resulted in six recommendations to improve management in offshore leases.

- 17. Mr. Rusco, please describe to what extent GAO considered the results of (1) audit reports issued by the Department of the Interior's independent public accountants, KPMG, and (2) an agreed upon procedures report issued by TCB&A, an independent accounting firm engaged by Interior, to examine its RIK cost methodology, in assessing and reporting on whether MMS's oversight provides adequate assurance that full compensation is being received from oil and gas produced on federal properties.**

**Answer:** GAO reviewed and assessed these and other relevant accountants' and auditors' reports (e.g. reports of Interior's OIG) in planning the scope of our work. We also considered other auditors' results during the course of developing our findings and conclusions in reporting our work to the subcommittee. However, key differences existed between our work and the scope of the work done by both KPMG and TCB&A. In addition, key limitations in the scope of work done by KPMG and TCB&A required us to perform additional test work to assess MMS's oversight and controls over its royalty collections.

Specifically, with respect to KPMG's audit of Interior's financial statements for 2007 and preceding years (a separate audit was not completed for MMS's financial statements in 2007), KPMG's report specifically stated that the audit of the financial statements was not designed to provide an opinion on internal controls over financial reporting or over reported performance information. Accordingly, GAO performed additional procedures to assess these internal controls.

Similarly, GAO found that TCB&A's agreed-upon procedures report, dated June 30, 2005, was limited to reviewing the RIK/RIV cost comparison methodology and certain underlying fiscal 2004 data. While the independent accountants reported MMS's methodology to be reasonable, they also found that many underlying data were based on undocumented estimates or were otherwise in error. Accordingly, GAO further analyzed the underlying data, including expenses through fiscal 2006, and found that key expense elements—principally information systems specifically used for the RIK program—had not been previously assessed and had not been included in MMS's cost comparison. Therefore, this earlier work supported GAO's conclusion that the RIK/RIV methodology may be improved and reported results may be made more transparent by including full and accurate costs.

- 18. Mr. Rusco, please describe the resources employed by GAO in its audits of MMS that led to the findings in its testimony. How many staff days and other resources were allocated and what were the qualifications of GAO staff who worked on these audits?**

**Answer:** The findings included in our recent testimony on mineral revenues were developed over the course of a year by GAO staff with a wide range of qualifications, including staff with a juris doctorate, doctorates in economics and social science, and master's degrees in public administration, public affairs, environmental science, social science and research methods, business administration, and geology. Team members also hold certifications in public accounting, software engineering project management, government financial management, information system auditing, and management accounting.

- 19. Mr. Rusco, please describe and point out any major differences between GAO's and MMS's estimates of potential losses resulting from royalty relief in the Gulf of Mexico.**

**Answer:** MMS's estimate for future losses from leases issued in the deep waters of the Gulf of Mexico in 1998 and 1999 compare favorably with scenarios that GAO developed to show the effect of different production levels and prices. In February 2007, MMS estimated that potential losses could be between \$6.4 billion and \$9.8 billion. In April 2007, GAO developed and reported the results of scenarios that showed the losses from these leases could range between \$4.3 billion and \$10.5 billion. In June 2007, MMS revised its earlier estimate to between \$5.3 billion and \$7.8 billion, based on oil and gas prices of \$60.78 per barrel of oil and gas prices of \$7.52 per thousand cubic feet. We plan to update our scenarios in the near-future.

GAO has not developed scenarios that illustrate potential losses from leases issued in the deep waters of the Gulf of Mexico in 1996, 1997, and 2000. In October 2004, MMS estimated that forgone royalties on these leases could be as high as \$60 billion should price thresholds not apply to these leases. While we reported in April 2007 that this estimate was made in good faith, much had been learned since then and we believed that MMS may have been overly optimistic about the amount of oil and gas production that would occur over the lifetime of these leases. MMS concurred and revised this estimate in February 2008 to between \$15.7 billion and

\$21.2 billion. We are currently reviewing this estimate and plan to develop scenarios that illustrate the effect of different production levels and prices.

**Minority Question Response**

1. **In our experience, when Congress requests the Government Accountability Office (GAO) to conduct a study or investigation, we find that GAO often comes back to negotiate the scope of the investigation. Oftentimes the reason underlying the negotiation is a lack of resources needed for the scope of the original request. In other words, GAO will try to prioritize the salient aspects of the study that they feel they can conduct within budgetary constraints. However, you appear to be criticizing the MMS for prioritizing hurricane recovery from the hurricanes that hit the Gulf in 2004 and 2005. Is that true? Wouldn't you agree that cleaning up after several severe and unprecedented storms should have priority over meter inspections? What MMS, Coast Guard, and the oil & gas industry achieved during those storms and their aftermath was remarkable. The fact that: (1) there were no major spills even though many platforms were lost and (2) all oil field personnel were safely evacuated—seems to be the bigger success story rather than whether an internal best practices inspection goal (that exceeds legal requirements) was met. Do you agree or disagree?**

**Answer:** One of the research objectives of our work was to determine whether MMS was completing the required meter inspections as required by agency policy and law. We did not consider or evaluate MMS's prioritization methodologies for hurricane safety, recovery, or cleanup activities. Therefore we cannot comment on the appropriateness of these decisions. However, MMS officials did explain to us that one reason they had not complied with their internal production inspection policy was that their limited resources were devoted to hurricane recovery and cleanup efforts, and we reported this in our testimony. An evaluation of what the Coast Guard, MMS, and the oil and gas industry achieved during and after Hurricanes Katrina and Rita was not within the scope of our work on the accuracy of royalties or the royalty-in-kind program.

Mr. COSTA. Now, let us get to the questions. To all three of you, does it make sense in looking at the track record of the Royalty-in-Kind Program, it seems to indicate that given the vagaries of the marketplace that there is incentive or seemingly that it is working, but that maybe someone outside of the Minerals Management Service should be doing the review.

Three of you, could you opine quickly on whether or not they are in the appropriate place to make the review?

Mr. DEAL. Let me take a—

Mr. COSTA. Please use the mic.

Mr. DEAL. I am sorry. Can you hear me?

Mr. COSTA. Yes.

Mr. DEAL. OK. Let me take a stab at that. My answer to that is no, that it is not wise to export this program outside the agency. That is an alluring possibility, but I really question whether or not that solves any problems that might be perceived, and all three of us have identified some shortcomings in the program.

You have heard both of my colleagues at the table here talk about the existing staff. They are energetic. More important than that, they are very knowledgeable. Royalty management involves not just strict accounting but a deep understanding of—

Mr. COSTA. I think you are responding to the entirety of the program. I was talking about the analysis of the program.

Mr. DEAL. OK. Maybe I don't understand the question. I am sorry, sir.

Mr. COSTA. Well, the point is that it is a complicated area. I understand they have about 50 people that deal with the review of

this in kind program, and they are dealing in a very complex marketplace in terms of trying to make these determinations, and whether or not that analysis is most properly done within that segment within the Minerals Management Service was my question.

Mr. DEAL. I see. Are you confining this to RIK?

Mr. COSTA. Yes.

Mr. DEAL. Yes, OK. Well, here again, I think my answer would be the same, although I would recognize RIK has a different character. MMS is still on the learning curve. They would be the first to admit that. However, in the last several years they have made great progress. The recommendations we have made have been to several very discreet recommendations to kind of better their game.

Mr. COSTA. We will look at those recommendations. I want to get the other response quickly. Mr. Devaney?

Mr. DEAL. OK.

Mr. DEVANEY. Mr. Chairman, I think they can do it. I think it is a matter of making sure that they have their policies and procedures in place. When we first went in there, there weren't too many written documents that described how the process was supposed to work. Also, I think they need the right people there, and I think they are making positive changes to make that happen.

Mr. COSTA. All right. Mr. Rusco?

Ms. FRANZEL. Hello, Mr. Chairman. I will answer on behalf of GAO. Our findings with regard to the program, we did not really detect any large governance issues that would cause us to say that it needs to be taken outside of the current environment, but rather internal control issues and data reliability issues which really would reflect the major tune up that Mr. Deal characterized as being needed.

Mr. COSTA. All right. Thank you. Mr. Devaney, you indicated that in your September 2007 report that other investigations might be forthcoming, a result of what you found. Are you guys moving ahead with those, and what are the topics?

Mr. DEVANEY. Yes. Those are the four cases, investigations, I mentioned that involve potential criminal violations. That is all we have left, and we are trying very hard to get those closed.

Mr. COSTA. All right. Mr. Deal, the whole panel talks about the concerns in the report of the lack of price thresholds in the infamous 1998-1999 lease sales which, combined with the Kerr-McGee case, threaten to impact the Federal Government—maybe to the tune of \$30 billion or more. In your report, you recommended to Congress and the Secretary to continue to explore legislative options.

Do you have any suggestions on what we can do, particularly if the case is lost?

Mr. DEAL. Well, this is a very tough nut to crack. You have heard testimony before from the Department, which I would agree with. You know, a contract is a contract. We did exhort, as other people have, the Department to continue to seek out visional companies, as several companies already have, to renegotiate their leases and take into account the price thresholds.

This is tough, though. It poses a very tough legal problem. The subcommittee did not spend a lot of time on that, not because we

were trivializing the issue but it had already been studied at great length.

Mr. COSTA. I think we understand it is difficult, and that is why we are looking for recommendations.

Mr. DEAL. Yes. Well, I wish I could shed more light on it. You know, of course the Kerr-McGee case may moot the whole issue if upheld, but it is on appeal so who knows what is going to happen. So I wish I could illuminate it more, but I can't.

Mr. COSTA. OK. Last question, quickly. Mr. Devaney, you know, when we look at the situation over collections that your office has brought in over \$700 million in the last 10 years I know the Justice Department now gets a small cut of the money on the cases they win, three percent I think, do you have any suggestion that a similar circumstance might apply in this instance?

Mr. DEVANEY. Well, naturally I think I would like to see a similar opportunity for any inspector general that investigates in this area. I think there are about 11 inspector generals that do qui tam work. I will speak for myself, we don't do as much as I would like to do and it is a resource issue.

I think you get a big bang for your buck when you do these cases, so I think it would be an interesting and fruitful idea to try to put maybe one percent toward the investigative efforts. I think the DOJ gets three percent.

Mr. COSTA. Yes. All right. Thank you very much. My time has expired. The gentleman from New Mexico is poised, waiting and ready with his questions.

Mr. PEARCE. Thank you, Mr. Chairman. Poised is never the word that I have found used with me much. Unpoised maybe. Mr. Rusco, if you remember the conversation in our office, we were talking about government take and a report that is coming up. I talked about the tendency of the reports coming from you all is to maybe use hyperbole.

So if I can get my staffer to hold up—the government take is, in your views, quite more simplistic, but government take in Russia is definitely higher than it is here, but you can't give a moral equivalence between the Russian system that allows this kind of thing to go on and our country where these cleanups occur. That is OK. Put it down. It is distracting even me.

You draw rather harsh conclusions I think in your report, and one of the things that you are critical of is that it relies heavily on self-reporting. That is a curious thing because what we did is compare it to IRS, and we even have IRS people here. If I am not mistaken, IRS depends on self-reporting, and so we find it OK with the mass of the public.

Always I am curious when people find other people's behavior suspicious and their own behavior above reproach. So when we say that the weakness of the system is self-reporting, I don't find in your report where you mention that we actually conduct 8.2 percent, where MMS examined 8.2 percent of the properties and 25.9 percent of the payors. IRS only looks at one percent.

I wonder if you had an IRS person on your team because this big report that comes from Mr. Deal's committee, there were two senators on that—by the way, I find people from state treasurers, professor of finance, Deputy Assistant Director of MMS, Bureau of

Land Management economist—and I wonder if you had this panel that was led by two senators to see that maybe this report came out with less hyperbole and more facts, as we are looking at a very complex thing there.

I wonder. I didn't see any list of people, and I had asked for that in my opening statement. I would hope that you would provide that for us at some point. Now, you are quick to say that the methodology that is calculating financial benefit is not good. I wonder in your own methodology, there is an independent accountant report that says methodology as reasonably and accurate, in your report, did you consider these outside sources?

Mr. RUSCO. Yes, we did.

Mr. PEARCE. You did. And so we have this report that says it is accurate, and your report says it is inaccurate. How many weeks did you spend on your report versus this report here?

Mr. RUSCO. Well, we have been auditing MMS on and off for years, but this particular job we have been at for about a year. On our team we have economists, accountants, data analysts, specialists, licensed IT auditors, oil and gas geologists, engineers and general auditor staff.

Mr. PEARCE. Your report considers this but says that this finding was inaccurate. We have independent accountants who find that it is OK, and your team says it is not OK and you were working for a year.

Now, I have the KPMG. KPMG is one of the big three if you are going to get somebody to be an accountant. KPMG for three years—three years—says we noted no deficiencies involving the design of the internal control over the existence, completeness, assertions related to any key performance measures, and yet, you find the lack of key internal controls, you spent a year on your report—was this the only report you were working on during the year?

Mr. RUSCO. No.

Mr. PEARCE. How many reports were you working on during this year period?

Mr. RUSCO. Personally, I probably worked on seven or eight.

Mr. PEARCE. OK, so you have seven or eight, so we can say that roughly maybe two months dedicated time, unless you are working overtime, and I am sure you did. Again, we go back to the KPMG reports that find no deficiencies and you find that there are lack of key internal controls.

I wonder if the discontinuity, I wonder if the hyperbole that we found—lift that chart up over here one more time—if the hyperbole and simplicity of what you have done is the same simplicity that said we collect fewer royalties than Russia and yet, that is Russia, that it is okay that exists and your committee did not, your findings did not include any of that.

I wonder why you came up with different substantive findings than people who audited for three years, two different major accounting reports that found exactly the opposite of what you found. Mr. Chairman, I will come back in my next round.

Mr. COSTA. Seems you were just getting warmed up.

Mr. PEARCE. If you would extend some time, I would go on.

Mr. COSTA. Well, I would be happy to do that except we have other Members who obviously would like to get their questions in as well. Mr. Hinchey, good to have you here this morning.

Mr. HINCHEY. Thank you very much, Mr. Chairman.

Mr. COSTA. You are up.

Mr. HINCHEY. Nice to be here with you. Good morning. Gentlemen, I just wanted to ask a couple of questions if I may. With regard to those leases that go back to 1998 and 1999, have you had a chance to look at the MMS cost estimates regarding the amount of money that we stand to lose if that situation isn't fixed?

Mr. DEAL. Is your question directed to all of us?

Mr. HINCHEY. Anyone who wants to take a crack at it. Mr. Deal, you may do so if you want to. You probably know as much as anyone.

Mr. RUSCO. We issued a correspondence last year in which we did an analysis ourselves of the expected costs of the lack of price thresholds on those and royalty relief.

Mr. HINCHEY. Could you speak a little louder?

Mr. RUSCO. I am sorry. In our work looking at the royalty relief we found similar dollar values to what MMS found in their analysis.

Mr. HINCHEY. Well, do you want to be more specific? What is the number? Is the \$21 billion estimate too low?

Mr. RUSCO. We have not updated the analysis after the recent Kerr-McGee ruling.

Mr. HINCHEY. When do you expect to do that?

Mr. RUSCO. Well, we have not yet been requested to do it. We will do it at some point when requested.

Mr. HINCHEY. Who are you expecting to request you to do it.

Mr. RUSCO. That is not up to us.

Mr. HINCHEY. Well, no, but who do you expect to request you to do it?

Mr. RUSCO. We will take a request from anyone in Congress who is interested in that.

Mr. HINCHEY. Would GAO accept this as a request to do it?

Mr. RUSCO. If the request is sent to us, we will accept it according to our usual protocol.

Mr. HINCHEY. OK. We will send you a specific request and ask you to do it because there is a lot of money at stake here.

You have a situation where the oil companies are making record profits, where the price of oil has gone up to \$109 a barrel, the price of gasoline has gone up very dramatically, and the fact of the matter is that property that is owned by the people of this country is not being addressed accurately, properly. They are not being paid properly.

Mr. Deal, I would like to ask you a question. You have a lot of experience with the oil industry as a former person who worked with the American Petroleum Institute, you were a representative for that operation. As a member of the Subcommittee on Royalty Management, one of your important recommendations was that MMS should continue to renegotiate those faulty 1998 and 1999 leases.

So are you also concerned that MMS has all but ceased bringing these leaseholders back to the negotiating table?

Mr. DEAL. Well, I have no information one way or the other on that. I have no information about further efforts by the Department.

Mr. HINCHEY. Well, you know the negotiations are not going on, right?

Mr. DEAL. I am not aware of them. You know, the early negotiations weren't very public either, so I am not privy to them.

Mr. HINCHEY. Do you believe that they have brought back to negotiating table to talk about the amount of money that is at stake here just in those two year leases?

Mr. DEAL. I have no information to show that, so I really don't know.

Mr. HINCHEY. Do you intend to look into that, to acquire information?

Mr. DEAL. Would I or did I?

Mr. HINCHEY. Do you intend to?

Mr. DEAL. If directed, I will.

Mr. HINCHEY. Pardon me?

Mr. DEAL. If directed, I will. I would be glad to.

Mr. HINCHEY. Who would you expect to direct you?

Mr. DEAL. This committee.

Mr. HINCHEY. Well, Mr. Chairman, would we ask him to do so?

Mr. COSTA. I think that is appropriate. We could put together a request in the form of a question to the Commission, and we will work on that.

Mr. HINCHEY. Good. I would like to help you with that.

Mr. COSTA. OK.

Mr. DEAL. Can I make one observation there?

Mr. COSTA. Certainly. Please, Mr. Deal.

Mr. DEAL. The Department is here today, and they can answer your question directly. So I will be responsive to any question posed to me, but the Department is here today.

Mr. COSTA. I am sure that Mr. Hinchey will direct that question to the Department.

Mr. HINCHEY. Do I have any time left?

Mr. COSTA. Yes.

Mr. HINCHEY. Just let me ask you one last thing. You have a lot of experience with the oil industry, so I am wondering if you have any specific recommendations for the Congress on how best to legislate the renegotiations that need to take place with the oil industry in order to get this royalty situation straightened out?

Mr. DEAL. I don't have any suggestions. This question has already been posed to me. I wish I could offer you a bright line. This is a tough nut to crack. You know, there are contracts on the table. Fortunately, you know, some companies have been willing to renegotiate, others haven't as yet.

As far as legislation, you know, a few ideas have been floated. They don't seem to have legs. I wish I could offer you some great suggestion here, but I don't have one.

Mr. HINCHEY. Well, I would think that the General Accounting Office would have some input into this. I think that we are all responsible to make sure that people who take public property pay for it appropriately. Thanks to the initiative of our Chairman here, we are overseeing this operation.

We would like very much for you to be more effectively involved in it. Is there any likelihood that you intend to do so?

Mr. DEAL. Well, the subcommittee, which was formed that resulted in the report you have, has been sunsetted. There is nothing on the agenda for that subcommittee to do anything at this point, but as before, you know, I am the Vice Chair of the Royalty Policy Committee. We have been and will be, continue to be responsive to the Secretary and respond accordingly. That is about all I can say.

Mr. HINCHEY. Well, that is fascinating because I can see that there is no real initiatives being taken here. Nothing really is being done effectively to try to straighten this mess out.

Mr. COSTA. The gentleman's time has expired, and we will get a chance to go back.

Mr. HINCHEY. Thank you.

Mr. COSTA. Thank you. The next member of the Committee is Mr. Smith from Nebraska, and you have five minutes.

Mr. SMITH. Thank you, Mr. Chairman. I would like to ask Mr. Rusco a couple of questions. In your testimony, you were critical of MMS because it relies heavily on self-reporting and honor system I guess, as described. Isn't it true that the IRS relies on self-reporting. Is that accurate?

Mr. RUSCO. It is accurate except that they also require employers to submit W-2s or 1099s and other third-party documentation.

Mr. SMITH. OK, and so I guess furthermore, the IRS has conducted audits of about one percent of the payors, and yet, MMS examined 8.2 percent of the properties and 25.9 percent of the payors, and was that included in your testimony?

Mr. RUSCO. Not specifically, but we do agree that there is an overreliance on compliance in audits in MMS, and that is because the quality of the data coming into the system and the integrity of that data are not up to par.

Mr. SMITH. So the integrity of the data is lacking?

Mr. RUSCO. If we could be sure that the self-reported data were accurate, and if third-party data were collected in a timely fashion and compared to those data and those problems were fixed in the IT and management systems up front, that would be a better way to do it than to rely more heavily on your audit system.

Mr. SMITH. And if we could meet the suggestions that you are making what do you think the net result would be?

Mr. RUSCO. I think the system would work much more efficiently. I think part of what MMS is doing in trying to implement a risk-based system is they are trying to touch fewer properties but do it more efficiently and closer to the model that the IRS uses.

Mr. SMITH. Would the amount due increase?

Mr. RUSCO. If the data could be assured of being accurate, then we would know we had the accurate collection of royalties. We don't know at this point, and we can't know because the data are not reliable or accurate enough.

Mr. SMITH. So maybe some folks are overpaying? Do I hear you saying that?

Mr. RUSCO. It is certainly possible. Likely? I can't comment on that.

Mr. SMITH. OK. Thank you. Mr. Deal, if we found the amount payable on the amount due to increase what do you think would be the impact in the marketplace?

Mr. DEAL. Well, I guess it is kind of hard to say. Depends on the impact. About the best way I could say it is the oil companies try to be good corporate citizens, they pay what is due. Sometimes they overpay and ask for a refund, sometimes they underpay and need to pay with interest. What difference would it have on the market?

I would say relative to existing oil prices and gas prices, you know, my guess is that it is not likely to have a big impact on the market, but, you know, we are kind of talking in the abstract here. It depends on the amounts we are talking about. There is no obvious big impact that tuning up the Royalty Management Program would have.

Mr. SMITH. OK. Thank you. I would yield the balance of my time to Mr. Pearce. Thank you.

Mr. COSTA. All right. Gentleman yields the balance of his time to Mr. Pearce. Mr. Pearce has one minute and 20 seconds.

Mr. PEARCE. Thank you. Mr. Deal, do the oil companies fill out any reports every year about how much production that they make and then how much they give? Are there any reports that are filed?

Mr. DEAL. Well, there are all kinds of annual reports, but on a regular basis they have to submit, you know, every month—

Mr. PEARCE. They have to submit something.

Mr. DEAL. Yes.

Mr. PEARCE. So when Mr. Rusco says there is a contrast between what IRS does and what MMS does, IRS demands a W-2 from every filer, and if I understand your testimony correctly, the oil companies have to turn in some similar document saying we produced this much and we pay this much, is that not accurate?

Mr. DEAL. That is accurate.

Mr. PEARCE. OK. Mr. Rusco, what was GAO saying the stakes were last year in this 1998, 1999 lease, the offshore leases? How much was going to be lost in the Kerr-McGee case?

Mr. RUSCO. I am sorry, I don't remember the exact figure. I will have to get back to you on that.

Mr. PEARCE. If I gave you a number would you verify it? Because I am going to give you a number. Sixty billion is what the GAO said last year. Publicly they said \$60 billion is at stake. How much is at stake this year in your opinion?

Mr. RUSCO. We have not updated that work since the recent Kerr-McGee ruling.

Mr. PEARCE. I am sorry, can you?

Mr. RUSCO. I am sorry. We have not updated our—

Mr. PEARCE. MMS is saying \$20 billion this year after a study, so you are 300 percent off, yet, you say these audit reports that declare—and KPMG can't say this stuff. They can't say that it is in conformity, and they do. They say it is in conformity. I wonder if your GAO report is 300 percent off like your estimate on the amount to be achieved.

Mr. COSTA. All right. The gentleman's time has expired. Mr. Rusco, this may be appropriate for you. In the Royalty-in-Kind Program there is an industry practice that I have learned about that is called swinging. My understanding is that when the price is low,

the industry provides more supply, and when the price is high, they provide less. I guess that is the definition more or less?

Do you think you could explain that practice and whether or not you think that is a problem with the royalty-in-kind payment?

Mr. RUSCO. The process would exist if a royalty-in-kind, and I will speak for gas producers in particular, because there has been a case that MMS identified of that going on in natural gas, this would be the case if MMS had contracted with someone to provide natural gas, royalty-in-kind, and then sold that to a buyer and then the deliveries would vary according to the price of natural gas.

The deliveries would be lower if the prices were higher and greater if the prices are lower. That is what swinging is. MMS did identify some of that going on.

Mr. COSTA. So you think it may be a problem?

Mr. RUSCO. The extent of which the problem, we don't know, but we do know that it has happened in the past. MMS has identified it. You would have to ask them.

Mr. COSTA. All right. OK. Before my time expires, Mr. Devaney, you have expressed concerns about the culture in your own testimony of the Royalty-in-Kind Program in the past, especially as it relates to ethics or potential ethics violations that are on.

Your investigations I know are now ongoing, and I know that you can't speak specifically about that, but I would like to get a general sense without talking about the specifics whether or not we are talking about petty types of crime or whether we are talking about wholesale criminal intent that could cost the American Treasury significant amounts of money?

Mr. DEVANEY. I think the way I would like to answer that, Mr. Chairman, is most of the continued investigations involve personal behavior, at a minimum, ethical lapses with potential criminal violations involved as well. I think that has stopped, and I think the Department has made some personnel changes that were very helpful.

I think at the end of the day if people are not prosecuted we are going to turn this matter over to Assistant Secretary Allred for administrative action, and I am confident that he will take that action.

Mr. COSTA. All right. Mr. Rusco and Mr. Devaney, there has been a recommendation from the Royal Policy Committee that Mr. Deal is dealing with that they establish a trust fund for MMS operations. What do both of you think about that, quickly?

Mr. DEAL. I will just say that I really don't have an opinion on that.

Mr. COSTA. Mr. Rusco?

Mr. RUSCO. We have not addressed that either.

Mr. COSTA. You haven't? OK. Mr. Rusco, you talked about the focus of the Minerals Management Service on compliance review versus audits, and I was inferring from your testimony that you were suggesting that they perform greater focus on audits than comparative compliance review. Would you like to speak a little more in detail about the problems and why you think so?

Mr. RUSCO. Yes. I think that in our work we found that the data coming in to MMS are unreliable, that there aren't enough controls on that data, there aren't enough verification with third-party data,

and, as a result of that, when MMS does compliance reviews or audits they frequently find that additional royalties are due.

We are concerned about the mix of compliance reviews and audits because compliance reviews are less rigorous than audits. However, we are not commenting on the precise mix because we have not evaluated that.

Mr. COSTA. Well, you know, when I talk to the Minerals Management Service, and I talk about how many auditors they have and whether or not they have the sufficient tools to do the job, and I think about the companies that they are engaged with and how sophisticated an operation it is, it just seems like a lot of manual paper entries are taking place.

Why can't a lot of this data be automated and transferred to the Minerals Management Service' computer with paper copies being kept for independent reviews? It just seems to me like so much of their effort, notwithstanding the \$150 million investment, has gone for naught. Quickly.

Mr. RUSCO. We agree that the IT systems are inadequately designed and there are many gaps that need to be filled.

Mr. COSTA. OK. Good. My time has run out. Do either of you have a quick comment on that? Do you concur? Disagree?

Mr. DEVANEY. I would concur. I think this IT system really needs to be fixed.

Mr. COSTA. All right. Very good. The gentleman from New Mexico is up to the plate again for five minutes.

Mr. PEARCE. Thank you, Mr. Chairman. Mr. Devaney, what is your definition of timely? In other words, we asked for timely responses back so if we have some questions today, what is timely to get an answer back?

Mr. DEVANEY. I will get it back as soon as I possibly can.

Mr. PEARCE. About how much?

Mr. DEVANEY. Two weeks.

Mr. PEARCE. Two weeks. Be aware that we asked you last year about why you excluded the letter from Carolina Calure out of your report. You said there was no smoking guns to say that the Clinton administration purposely left off, and so we brought the smoking gun, and we gave it to you and you never really responded to that.

So by your own definition, a couple of weeks, that is a month and 12 months, 13 months. I really appreciate you getting back with us on that, sir. In your testimony, you say that MMS is not using risk-based strategies for compliance reviews. Mr. Deal, did you find any evidence that risk-based strategies are being used?

Mr. DEAL. Well, we did.

Mr. PEARCE. That is all. You did or you didn't. Yes, you did. You did not?

Mr. DEAL. No. We did, but found a need for more rigor and clarity.

Mr. PEARCE. Well, you found some use of risk-based strategy?

Mr. DEAL. Yes, yes.

Mr. PEARCE. So, Mr. Devaney, your comments last year were that there was no risk-based strategy in your comments. Did you actually go to MMS and ask them if they had implemented? Because in the report I find that we have implemented significant risk-based strategies in the last 12 months. I again wonder about

your definition of timely. When is the last time you went to talk to MMS about that?

Mr. DEVANEY. Well, Mr. Pearce, I think that, you know, when we did that audit we didn't find that MMS was adequately using a risk-based strategy. Today, I think they are.

Mr. PEARCE. Yes, but your testimony today says they are not doing it. I am wondering if you did any more—no, we didn't do any more timely look on this than you did—

Mr. DEVANEY. I am sorry if you misunderstood my testimony. I was characterizing my prior report.

Mr. PEARCE. I understand you are characterizing your prior report, but people are going to use your words in this hearing today saying there is no risk-based strategy and come here using loose words.

I just think that you really should be aware that people are going to use your testimony today not to characterize what you were wanting to characterize a year ago, they are going to take your report today as if it were given today and as if you actually did something in between last year and this year, which you didn't answer my questions, and I have to assume, I hope that you actually talked to MMS before you came here today to make your assertions here that we are not doing our job when I find really dedicated public servants that are wrestling with a very complex issue.

Now, in your testimony last year you mentioned these four investigations. Have you turned that over to DOJ? That is pretty serious allegations of misconduct. Did you turn that over to DOJ?

Mr. DEVANEY. Yes. We have been working with them all along.

Mr. PEARCE. And so DOJ has had that information for 13 months?

Mr. DEVANEY. It is not a matter of turning the investigation over. We have been working with DOJ for 13 months.

Mr. PEARCE. But this is serious allegations you are making in front of this Committee, and has DOJ decided to prosecute or not?

Mr. DEVANEY. They have not made that decision yet.

Mr. PEARCE. They haven't made a decision. They have had it for 13 months, and, yet, you come here and you talk about—you mentioned the qui tam cases.

Mr. DEVANEY. Right.

Mr. PEARCE. We all remember Mr. Maxwell. He was in front of this talking about this same thing. What happened to his case in Court?

Mr. DEVANEY. I believe it was found in his favor in Court.

Mr. PEARCE. It was found in his favor.

Mr. DEVANEY. Right.

Mr. PEARCE. Can I check with staff? It was found not to have standing. He was found not to have standing, and I wonder about your internal processes when you write your report. He took his case straight to the Courts, you mentioned that in your testimony, and yet, he was thrown out of Court for not having standing, and yet, you talk today about it as if it was still a legitimate thing that he did, and Mr. Maxwell was pitched out of Court because he did bypass all.

I wonder what your internal controls are doing about people who will go outside the system to try to get personal gain. Now, this is

actually, Mr. Rusco, an actual document and circumstance of somebody's behavior that would say we ought to be suspicious, yet, we don't find that suspicion directed there, we find the suspicious stuff directed—I have a very complex report that states over and over that it is pretty good.

Yes, we have 100 assertions that could be dealt with, but overall, it is pretty good. Then I have Mr. Devaney's report, and I have Mr. Rusco's report that says diametrically opposed. I just wonder what facts were looked at. Thank you, Mr. Chairman. I appreciate your indulgence.

Mr. COSTA. Thank you, Mr. Pearce. We can agree to disagree, but you are correct, the gentleman was found on the qui tam case not to have standing because of the position he held. The Court did find his allegations to be correct.

Mr. Smith, you are closing this panel.

Mr. SMITH. I am——

Mr. COSTA. OK. Very good. Well, then let us move on to the next panel. Gentlemen, to be continued. I am sure that Mr. Pearce, and I—and maybe other members of the Subcommittee—will have questions that we will submit to you. We hope that you will respond in a timely manner. I think Mr. Pearce is correct.

If he didn't get an answer to last year's question, that is inappropriate, and I would hope that would be corrected. So with that understood, gentlemen, thank you, again, for your testimony. We look forward to continuing this discussion as we try to, as Mr. Deal said, tune up the deficiencies that exist within the Minerals Management Service.

The next panel involves the following witnesses. The Honorable Stephen Allred, who is the Assistant Secretary of Land and Minerals Management with the U.S. Department of the Interior. In addition, we have Mr. Dennis Roller, who is the Audit Manager for the North Dakota State Auditor's Office that will give us a state and tribal, a local perspective.

We also have Ms. Linda Stiff, who is also testifying, as I noted before, the Acting Commissioner for the Internal Revenue Service. Then the last two individuals that will testify are Mr. Randall Luthi from the Minerals Management Service, and Mr. Lawrence Finfer, who is the Deputy Director of the Office of Policy Analysis within the Department of the Interior.

So lady and gentlemen, we would like you to be focused on the five-minute rule.

Mr. COSTA. Let us begin with The Honorable Stephen Allred, Assistant Secretary for Land and Minerals Management within the Department of the Interior. Mr. Allred. Yes. You need to keep it close I think. Is it on?

**STATEMENT OF THE HONORABLE C. STEPHEN ALLRED, ASSISTANT SECRETARY, LAND AND MINERALS MANAGEMENT, U.S. DEPARTMENT OF THE INTERIOR**

Mr. ALLRED. Is it on now?

Mr. COSTA. Now, you have it.

Mr. ALLRED. Mr. Chairman, Mr. Pearce, members of the Committee, it is a pleasure to be here and to visit with you about what is a very important program to the United States. Our testimony,

and we are going to kind of tag team this between I and Director Luthi, but I am going to focus in early on the subcommittee and why we asked it to do the report and a little bit about the recommendations.

Mr. Luthi will talk a little bit later about what we are doing about those recommendations and how we are implementing them. As you know, we recently received the report that contained the recommendations developed by the Subcommittee on Royalty Management. What I would like to do very quickly is tell you why the committee was formed and the claim we made to ensure that it was an independent review.

As you know and as you have discussed here in the last panel reports from the Office of the Inspector and others had questions about the royalty program as to whether it was adequate to ensure that the public received the royalties that Congress had intended.

While at the time that I looked at this I concluded that there were not major programs, and I visited all of the Minerals Management Service's offices and talked to a lot of people when I first came onboard, I felt that there were no significant problems that threatened the viability of the program, but I also recognized that with anything as complex as the operations of the Minerals Management Service and the other agencies within Interior, that there were probably lots of opportunities for improvement.

I felt a comprehensive look across the board at those issues was warranted. The Secretary agreed and determined that a fully independent examination of the program was warranted, both to restore credibility to this important revenue generating program and to make sure that we were focused on the changes that were needed.

On my recommendation in March of 2007, the Secretary appointed the Subcommittee on Royalty Management to conduct that independent examination. Mr. Deal has already identified the three charges that we gave to the committee, so I won't repeat those. We made it clear from the onset that the Department would not direct, manage or influence the subcommittee's work.

The subcommittee was comprised of seven distinguished members, and while you have indicated already who those were, I think it is important to reiterate it.

They were, as Co-Chairman, U.S. former Senator and Nebraska Governor Bob Kerrey; and former U.S. Senator Jake Garn of Utah; Cynthia Lummis, who is a former Wyoming official and State Treasurer and who in that position had received, Wyoming receives the largest amount of the royalties that we distribute to the states; Mr. Perry Shirley, who is Director of the Navajo Nation's Mineral Department and who has been involved in these issues for some period of time; Mr. Robert Wenzel, who was from 1998 to 2003 the highest ranking career official in the Internal Revenue Service and who brought a great amount of expertise to this committee; Dr. Mario Reyes, who is Associate Dean and Director of the Business Economics Program at the University of Idaho; and David Deal, who has already testified in front of you.

We provided staff out of our Department Office of Policy Analysis and the co-chairs selected a staff member independently of the Department to assure the independence of the work that was being

done for them. The Minerals Management Service in that analysis played no role except to answer questions.

I want to really express my appreciation and that of the Department for the work that this committee did. They spent many long hours, traveled extensively and we think prepared an excellent report which was delivered to the Royalty Policy Committee on December 17, 2007. That, incidentally, became a public report while it laid before the Royalty Policy Committee.

The subcommittee concluded that the Minerals Management Service was an effective steward of the Minerals Revenue Management Program and that the MMS employees were generally concerned with fostering continuing program improvements. The subcommittee members unanimously agreed that MMS was the Federal agency best suited to fulfill the stewardship responsibilities for Federal and Indian leases.

However, as we expected and as you indicated, the report identified many areas that warrant management attention to improve operations and ensure the public confidence. There were 110 recommendations. Thirty-five related to collections and production accountability, 30 relate to the Royalty-in-Kind Program, 27 to audit compliance enforcement, 10 to coordination, and 5 to the OCS Royalty Relief Program.

We have developed an action plan that includes the three bureaus within the Department. It is an extensive action plan for those 110 recommendations. Most of those can be implemented without additional legislation. Some cannot, and we will bring back those recommendations to these committees. With that, Mr. Chairman, I would be most happy to answer at the appropriate time any questions you might have.

Mr. COSTA. All right. Thank you very much, Mr. Allred. We also want to thank you and the Department on behalf of the committee for the submission of the breakdown of the Royalty Policy Committee Report, and the recommendations by category and the charts that you provided. I think they are helpful.

On your last point, as it relates to the legislative changes, both Mr. Pearce and I are interested in looking at those, and we will talk about them and confer with the Department at the appropriate time.

Mr. COSTA. So my understanding is Mr. Luthi is here to provide back up, is that correct, or did you prepare testimony?

Mr. LUTHI. Of course I prepared testimony, Mr. Chairman.

Mr. COSTA. Well, we always like hearing from you. Mr. Luthi, you have five minutes.

**STATEMENT OF RANDALL LUTHI, DIRECTOR,  
MINERALS MANAGEMENT SERVICE**

Mr. LUTHI. Thank you, Mr. Chairman. Our Royalty Management Program today is not the same program as it was 15 years ago or even two years ago. In the last seven months, I have learned that the Royalty Management Program is the culmination of 26 years of ideas, findings and recommendations from many partnerships with the best and brightest, both internal and external, to our agency.

Our people are dynamic, resourceful and agile. We are ready to change when necessary to keep pace with an ever challenging business environment and changing legal mandates. Each month approximately 2,100 companies report and pay royalties associated with over 68,000 producing and nonproducing Federal and Indian leases.

In Fiscal Year 2007 alone, the 537 employees of the Minerals Management Program processed over 400,000 reports containing 7.7 million lines of data, closed 304 audits, completed 4,171 compliance reviews, held 10 RIK sales, conducted 81 Indian outreach sessions, distributed \$11.7 billion to the states, counties, Indian tribes, individual mineral owners and other Federal agencies including the U.S. Treasury, and that was before lunch.

Mr. COSTA. Sounds like you have been busy.

Mr. LUTHI. That represents the monitoring of approximately 5.7 trillion cubic feet of natural gas and 585 million barrels of oil from Federal and Indian leases. Since 2003, we have completed 59 internal control reviews, identified 713 recommendations for improvement and we have successfully implemented 612. The Royalty Management Program has been reviewed and analyzed by the GAO, OIG, annual CFO audits and external independent peer reviews.

Since Fiscal Year 2003, 24 external reviews have resulted in 195 recommendations of which at this time we have closed 124. Annual audits in our royalty management and financial statements are conducted by an independent firm, KPMG, under contract with the IG. We have received an unqualified, which is a good, clean audit, for the past six years with some minor findings.

We have worked to correct those findings to improve the overall processing of our system and to make these reports more useful to the public. In addition, the recent RPC subcommittee report contains 110 recommendations spanning the three bureaus: MMS, Bureau of Land Management and Bureau of Indian Affairs. Of the 110, we are responsible for 73. Twenty-two of these recommendations are going to require coordination.

As of February 11, 16 of the 110 are complete. Of the remaining 94, 29 are already under way. We have developed a Joint Action Plan with the other two agencies, and we have a plan to implement or evaluate all of the subcommittee's recommendations. Some of the recommendations we will need to consult with the state, and tribal and other stakeholders as well.

One of the common themes throughout the subcommittee's report is the need for the three royalty management bureaus to work as partners to make sure we are using the best practices available, and we are doing that. Internally, we already identified the need for better coordination and flow of communication between our Off-shore Minerals Program and minerals royalty management.

Those efforts are under way. The stovepipes are being breached and new connections are being forged. Our partnership and communications with our external reviewing organizations do not stop when we receive a report. Now, for example, subcommittee member, Mr. Bob Wenzel, and the subcommittee's efforts paved the way for us to establish an ongoing relationship with the IRS to compare

and contrast our risk-based compliance approaches and to learn from their experience.

This last fall we met with the U.S. Attorney's Office and the IG's office to strengthen our relationship regarding qui tam cases. This group meets every month now to discuss joint training on detecting and referring false claims and how best to work with the U.S. Attorney's Office. It wasn't a surprise to me when the RPC concluded that we are an effective steward for the Minerals Management Program and that we are generally concerned about its improvements.

I see this every day, but where much is given, much is expected. Like the IRS, we have targeted high revenue producers with compliance reviews and audits. As part of our evolution, we are now developing an in place, a risk-based strategy for compliance, that extends coverage to a greater number of companies and properties.

The IG and the RPC recommended we develop this strategy, and it will help us we believe in the future to help target those properties and lessees where audits and compliance reviews are warranted and where we need additional resources. I am very pleased with those efforts but recognize there is more work to be done. We will work quickly to implement the remaining recommendations concerning the GAO draft report.

It seems very clear to me that this is still clearly a work in progress and that the findings represented today may not be complete. We stand ready with additional data and to work closely with them to complete their analysis. In conclusion, Mr. Chairman, a director can have no greater goal than to leave an agency better when they arrived.

With the efforts of our MMS employees, you and your Subcommittee's willingness to work with us, and the other partnerships we have developed, that goal is clearly within reach. Thank you for your time.

Mr. COSTA. Thank you very much, Mr. Luthi.

[The prepared statement of Mr. Allred and Mr. Luthi follows:]

**Statement of C. Stephen Allred, Assistant Secretary Land and Minerals Management, and Randall Luthi, Director, Minerals Management Service, U.S. Department of the Interior**

Mr. Chairman and Members of the Committee, we appreciate the opportunity to testify today. This Committee has been instrumental in shaping our domestic energy program, particularly with regard to the sound development of our domestic oil and gas resources on the Outer Continental Shelf (OCS) and onshore Federal and Indian lands, and the management of mineral revenues from these lands. Our testimony will focus on the recently issued report from the Royalty Policy Committee's Subcommittee on Royalty Management and the Department of the Interior's (Department) subsequent implementation efforts, and the status of the Department's response to findings and implementation of the recommendations contained in the previous reports and audits from the Department's Office of Inspector General (OIG), the General Accountability Office (GAO), and internal reviews. As we are all aware, GAO is currently working on a similar analysis and report of the Department's royalty management program. I anticipate that GAO's findings will be similar to and support the findings and recommendations of the Royalty Policy Committee (RPC) Subcommittee.

**Background**

The Department and its agencies serve the public through careful stewardship of our Nation's natural resources. The Department also plays a vital role in domestic energy development. Approximately one-third of all energy produced in the United States comes from resources managed by the Department of the Interior.

The Bureau of Land Management (BLM) is charged with managing 700 million acres of our Nation's onshore subsurface mineral estate. The BLM issues onshore leases, establishes lease terms and conditions; and conducts on-the-ground inspections to ensure that unnecessary environmental impacts do not occur; that drilling operations are completed in accordance with an approved drilling plan; that measuring points for production of oil and gas are secure; and, that the onsite physical infrastructure for transporting oil and gas from a lease is secure so as to prevent theft of oil and gas. Furthermore, to supplement the on-the ground inspections, production reviews are performed to verify the production figures that operators have sent to the Minerals Management Service (MMS).

MMS is responsible for managing off-shore mineral resources and providing the American people with an accurate and transparent accounting of revenue that production from all Federally-owned minerals generates. In Fiscal Year 2007, MMS collected more than \$11.4 billion in revenues from Federal production, disbursing the revenue to states, American Indians, and the U.S. Treasury as directed by various statutes. Since its establishment in 1982, MMS has collected and disbursed more than \$176 billion in oil, natural gas and other mineral revenues. I am happy to point out that for the past five years, as part of its annual CFO audit, MMS consistently has received clean audit opinions from the Office of the Inspector General's contracted independent auditing firm.

In addition to the BLM and MMS roles, the Bureau of Indian Affairs (BIA) maintains ownership information for Indian lands that determines the distribution of revenue to tribes and individual Indians. Given these shared responsibilities, the success of the royalty program requires close coordination and sharing of information between these three bureaus. The roles that BLM and BIA play in the process are equally important and significantly impact the ability of MMS to successfully achieve its mission.

As you know, the Secretary recently received a report that contains recommendations developed by the Subcommittee on Royalty Management. We would like to discuss how the Subcommittee came to be established, its composition, areas of responsibility, and the current status of our efforts to implement the recommendations contained in the report.

#### **Establishment of the RPC Subcommittee**

On March 22, 2007, upon my recommendation, Secretary Kempthorne appointed the Subcommittee on Royalty Management ("the Subcommittee") to conduct an independent examination of the minerals revenue management program. As you are aware, reports from the Department's OIG and others questioned whether the Department's royalty programs were adequate to assure that the public received the royalties that Congress had intended. While I had concluded at the time that there were not major problems in the royalty program, I felt that there needed to be a comprehensive look at the royalty program and that there would be many opportunities to improve those operations. As a result, the Secretary determined that a fully independent examination of the program was warranted, both to restore credibility to this important revenue-generating program, and to focus on the improvements that were needed.

Specifically, we asked the Subcommittee to review:

- the extent to which existing procedures and processes for reporting and accounting for Federal and Indian mineral revenues are sufficient to ensure MMS receives the correct amount;
- MMS's audit, compliance and enforcement procedures and processes to determine if they are adequate to ensure mineral companies are complying with existing statutes, lease terms, and regulations as they pertain to payment of royalties; and
- the operations of the Royalty in Kind (RIK) Program to ensure that adequate policies, procedures, and controls are in place to ensure the decisions to take Federal oil and gas royalties in kind result in net benefits to the Federal government.

Subsequently, the Subcommittee was also asked to review procedures promulgated by the Department in response to the lack of price thresholds in Gulf of Mexico deep water leases from 1998 and 1999 sales to ensure that future leases with royalty suspension provisions include price thresholds.

The panel was organized as a Subcommittee of the Royalty Policy Committee (RPC), a Federal Advisory Committee Act (FACA) body that advises the Secretary on matters related to mineral revenues, and was comprised of seven distinguished members:

- Former U.S. Senator and Nebraska Governor Bob Kerry and former U.S. Senator Jake Garn, of Utah;

- Cynthia Lummis, a former Wyoming official who served as State Treasurer, and as a member of the Wyoming House and Senate, concentrating on natural resource and taxation issues;
- Perry Shirley, Assistant Director of the Navajo Nation's Minerals Department, who serves as the Principal Investigator responsible for administering a Cooperative Agreement between the Navajo Nation and the Minerals Management Service;
- Robert Wenzel, the highest ranking career official in the Internal Revenue Service from 1998 to 2003, whose responsibilities included the day-to-day operation and strategic management of the United States tax administration system;
- Dr. Mario Reyes, Associate Dean for Administrative Affairs and Director of Business Economics Programs in the College of Business and Economics at the University of Idaho; and
- David Deal, who serves as the vice-chair of the full Royalty Policy Committee, and served as the Royalty Policy Committee's representative on the Subcommittee.

To ensure independence, the Subcommittee staff came primarily from the Department's Office of Policy Analysis, but also included BLM staff and an independent staff member, Loretta Beaumont, who was selected by the co-chairs. MMS played no role in the Subcommittee's work beyond responding to requests for information.

I want to express my deep appreciation to each member of the Subcommittee and staff for their hard work in the preparation and completion of this thorough report.

#### **Royalty Policy Committee Report**

The Subcommittee issued its report on December 17, 2007, as a public document and in a public meeting on January 17, 2008, the RPC voted to accept the Subcommittee's Report. By letter dated January 25, 2008, the RPC Chairman transmitted the Report to the Secretary.

The Subcommittee concluded that MMS is an effective steward of the Minerals Revenue Management (MRM) Program, and that MMS employees are genuinely concerned with fostering continued program improvements. The Subcommittee members unanimously agreed that MMS is the Federal agency best suited to account for and distribute royalties that are paid for the production of oil and gas from Federal and Indian leases.

As we expected, however, the report identified many areas that warranted management attention to ensure public confidence.

The report contains 110 recommendations, including 35 recommendations related to collections and production accountability from both onshore and OCS operations; 30 regarding the royalty in-kind (RIK) Program; 27 on audits compliance and enforcement; 10 related to coordination, communication, and information sharing among MMS, BLM, and BIA; and 5 on OCS royalty relief and ethics (See Attachment #1). At least three of the recommendations would require legislative action. Notably, the Report concluded, "the advantages of including an RIK approach among MMS asset management options are clear and MMS's process for evaluating the feasibility of RIK versus royalty in-value (RIV) appears to be rigorous and effective. Nevertheless, in order to ensure the program's successful operation, a number of challenges must be addressed."

The Report's recommendations span the responsibilities of all three Departmental Bureaus involved in royalty management—MMS, BLM, and BIA (See Attachment #2). Examples of the roles of the three bureaus include:

- The results of Production Accountability Reviews performed by BLM and the MMS Offshore program are sent to the MRM program when there is a discrepancy of production reported to MRM and what is actually discovered by the accountability review. MRM then orders the operator to correct their production report and, if necessary, also orders the payor to pay additional royalties.
- BIA maintains ownership information for Indian lands that determines the distribution of revenue to tribes and individual Indians;
- Land title maintained by BLM for federal lands, i.e. classification of land, determines the distribution of revenue between the Treasury, States, and other funds;
- Lease terms and conditions established by BLM determine the royalty rate and provisions for royalty rate reductions for onshore leases;
- Authorizations and regulations control drilling of wells and construction of facilities, pipelines, and measurement equipment; and
- BLM inspections ensure the integrity of the facilities and the protection of the environment.

Of the 110 recommendations, MMS is solely responsible for 73 and BLM is solely responsible for 15. The remaining 22 recommendations require coordination among

the Bureaus. We are in the process of establishing a Production Coordination Committee with representatives from the BLM, MMS, and BIA whose task will be not only to coordinate and implement the cross cutting recommendations contained in the Report, but to also provide on-going coordination of issues related to the management of Federal and Indian mineral leases as suggested by one of the recommendations contained in the Report.

Secretary Kempthorne and I are grateful to the Subcommittee for the time and energy it devoted in its review. The Department is committed to working with our stakeholders to implement the recommendations contained in the Report. We agree with the statement of the Subcommittee that implementing the recommendations in this report will greatly strengthen the management of the program, restore public confidence, and ensure maximum value for the U.S. taxpayer.

Randall Luthi, Director of the MMS, is here today to provide the Subcommittee with an update on the work being done to implement the findings and recommendations of the RPC Subcommittee and other previous reviews.

The MMS's royalty management program of today is not the same program of 25 years ago when it was in its infancy, or even 5 or 2 years ago. The MMS royalty management program of today is the culmination of 26 years of ideas, findings and recommendations for program enhancements from the best and the brightest, both internal and external, to the agency. Since FY 2003, the MRM has completed 59 internal control reviews, identified 713 recommendations for improvement, and successfully closed 612 of the recommendations. Since FY 2003, 24 external reviews by the GAO and OIG, and annual CFO audits and external peer reviews have resulted in 195 recommendations, of which MMS has successfully closed 124.

Notably, many significant changes were identified through the internal review process and were ultimately supported in the findings and recommendations reported by the various external reviews. For example, as part of the MRM program-wide Strategic Business Planning process, the MMS royalty management program identified in June 2006 the need for a risk-based compliance approach that expands compliance coverage to a greater number of companies and properties. In its December 2006 audit of MMS's compliance review process, the OIG also recommended a risk-based compliance approach. MMS recently completed the pilot project for this initiative. Additionally, in February 2006, MMS identified the need for an automated adjustment line monitoring tool to ensure that companies' royalty adjustments are made within the allowed timeframes and in compliance with applicable laws and regulations. Funding was appropriated for this initiative as part of the FY 2008 budget. The royalty management program continues to make improvements. For example, in June 2006, as part of its strategic planning initiative, MMS began pursuing the development of a risk-based strategy for compliance that expands compliance coverage to a greater number of companies and properties. This strategy will allow us to rank companies and properties according to particular risk identifiers, to provide the detail needed to identify properties or payors where audits or compliance reviews are warranted, and to identify when and where we need additional resources. Also, MRM proposed to improve the timeliness and efficiency of the interest assessment to companies by implementing computer system enhancements. The President's Fiscal Year 2009 Budget includes a request for an additional \$3.7 million for these two initiatives.

#### **Implementation of Subcommittee Recommendations**

I would like to turn your attention to our progress to implement the RPC Subcommittee Report. In a memorandum dated January 14, 2008, Secretary Kempthorne asked the Department to review the Report, develop an action plan, and begin implementing the Subcommittee's recommendations. I am pleased to report that as of February 11, 2008, 16 of the 110 recommendations are already complete (See Attachment #3). Of the remaining 94 recommendations, 29 are underway. We have developed a Joint Action Plan to address all of the Report's recommendations.

The Plan identifies by recommendation the responsible Bureau, estimated timeframes for completion, and status. Points of contact are designated within each Bureau to monitor implementation and report on progress on a monthly basis. Many of the recommendations require further evaluation, and to that end, teams are being formed to determine appropriate actions and schedules. Likewise, many recommendations will need to be explored further through consultations with State and Tribal officials, and other organizations before they can be adequately implemented. We have developed a tracking system and have been and will continue to hold regular meetings to assess progress on the implementation of each action item.

Examples of the major focus areas contained in our Joint Action Plan include the following:

- Completing Production Accountability Reviews at BLM and MMS for producing leases to make certain that royalties are being paid on the correct volume and quality of oil and gas from Federal and Indian lands.
- Improving the coordination, collaboration, communication, and information sharing between BLM, MMS, and BIA.
- Requiring more reporting of data electronically and ensuring that bureaus have easy access to each other's systems.
- Implementing a risk-based compliance strategy and determining the extent to which a more flexible approach to audits, similar to that used by the IRS, is feasible.
- Ensuring the RIK program has the right personnel with the right skills to get the job done.
- Ensuring that all staff receives ethics training, including training focusing on public-private sector interactions.
- Ensuring that we have sufficient staff to support the Department's onshore and offshore royalty management activities.

The BLM has already taken measures to strengthen its Production Accountability Reviews by increasing funding in FY 2008 and FY 2009, and, for FY 2009, BLM plans to hire an additional 15 Production Accountability Technicians (PATs) to increase the number of reviews in order to verify production reported to MMS by oil and gas operators. In addition, as part of the Joint Action Plan, the BLM is examining issues and recommendations to lower the thresholds for production of oil and gas for which annual reviews will be given; revise its policy and regulations on evaluating the quality of oil (API gravity) and gas (BTU factor) when doing production verification, as inaccurate reporting of these values will impact royalty collections; consolidate its policy on oil and gas measurement and when gas can be used on a lease without paying royalties on that gas; and update and consolidate policy across the program for more effective implementation of the oil and gas inspection program, including production accountability. The BLM is also examining further increased staffing of Production Accountability Technicians, ensuring PATs are properly trained, and developing standardized position descriptions for PATs. Finally, BLM is working to develop better communications with MMS, including scheduling annual workshops on production accountability, and developing protocols for operators who have been identified as underreporting production.

Recently, Assistant Secretary Allred sent to Chairman Costa and Ranking Member Pearce, MMS's status update on the action MMS has taken to address the findings of the OIG in two of its most recent reports. I am pleased to report that as of February 29, 2008, MMS completed all of the 23 items in the action plan associated with the December 2006 audit report on MMS's compliance review process, and 12 of the 15 actions associated with the September 2007 OIG report on false claims allegations.

The OIG's December 2006 report on the compliance review process represents the culmination of an audit that the OIG performed of MMS's compliance review process. The objectives of the audit were to determine (1) whether compliance reviews are an effective part of the Compliance and Asset Management's (CAM) operation, and (2) whether MMS is effectively managing the compliance review process.

The OIG concluded in its audit that compliance reviews can serve a useful role as part of MMS's CAM program operations. The OIG further reported that compliance reviews are a legitimate tool for evaluating the reasonableness of company-reported royalties and allow a broader coverage of royalties, while requiring fewer resources than audits. While the OIG report concluded that compliance reviews are an effective part of MMS's CAM program operations, it made recommendations to strengthen policies and procedures to improve automated tracking and verification systems and improve the compliance review process.

MMS administers a royalty Compliance and Asset Management operation charged with ensuring that fair market value is received for the mineral assets removed from Federal and Indian lands. MMS is committed to the administration of a Federal and Indian mineral revenue compliance program of the highest quality and integrity. Our efforts are to ensure that Federal and Indian mineral revenues are timely and correctly reported and paid by the minerals industry in compliance with applicable laws, regulations and lease terms.

Our compliance strategies and activities are carried out through a nation-wide MRM field audit structure and partnership through delegated and cooperative audit agreements with 11 States and 7 Indian tribes. This strategy effectively utilizes a combination of targeted and random audits, compliance reviews, and royalty in kind property reconciliations. The strategy calls for completion of the compliance cycle within 3 years of the royalty due date. In Fiscal Year 2007, this strategy ensured reasonable compliance on \$5.8 billion in Federal and Indian mineral lease revenues,

64.7 percent of total mineral revenues paid for calendar year 2004 production. MMS's royalty compliance activities have yielded over \$3.4 billion in additional mineral revenues since program inception in 1982. The cost benefit analysis of compliance reviews and audits for Fiscal Years (FY) 2005 through 2007 shows that for every \$1 spent on compliance reviews, MMS collected \$5.49. In August of 2007, MMS reached a \$105.3 million settlement with Burlington Resources, resulting from complex, multi-year audit work. Without this anomaly being recorded in FY 2007, the cost benefit analysis for audits shows that for every \$1 spent on audits, MMS collected \$4.71 (See attachment #4). We agree with the OIG and the RPC Subcommittee that compliance reviews are a valuable management tool.

Through the implementation of MMS's compliance action plan we have taken steps to strengthen the compliance review process by establishing and implementing a pilot project to further develop and begin implementing risk-based compliance strategies, restoring MMS's access to BLM's Automated Fluid Minerals Support System that was interrupted by the Cobell litigation, amending production verification procedures, and ensuring state and tribal auditors have access to compliance tools.

The OIG's September 2007 report on the false claims allegations responded to Assistant Secretary Allred's request that they look into the qui tam lawsuits that were filed by some MMS employees (relators) against several energy companies alleging fraudulent activities. The OIG report indicates that 1) the relators did not follow MMS procedures, and 2) there was no evidence of retaliation by management against employees. The report also identified a number of areas for improvement that MMS embraced and moved aggressively to build upon.

As a result of this report, MMS analyzed its practices and, where applicable, identified opportunities to implement policy and procedural changes. These opportunities were outlined in the action plan containing 15 items, 12 of which have been completed.

Significant accomplishments include eliminating the backlog in interest billing; fully briefing decision makers on the interest calculation policy; updating manuals and other guidance on safeguarding proprietary and business confidential information and on procedures for reporting suspected fraud; and establishing policies to ensure mandatory training and performance management requirements are met. Of special note, in FY 2007, MMS billed more than \$66 million of interest on late royalty payments and is now regularly billing the lessees for any late payments on a monthly basis. The MMS will complete the remaining three action items this spring.

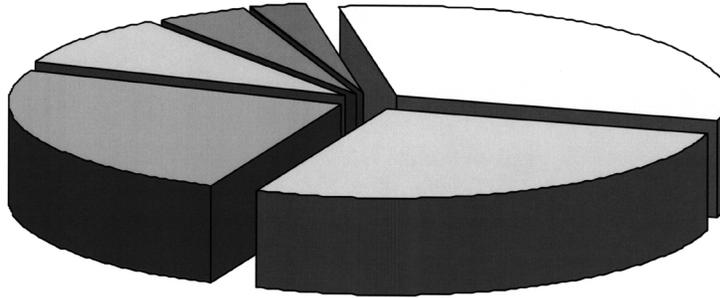
In addition, in October 2007, MMS met with the U.S. Attorney's Office (USAO) and the OIG to begin the process of strengthening our relationships regarding the referral and investigation of false claims cases. As a result of MMS's initiative, this group has begun meeting every month to discuss joint training on detecting and referring false claims and referral of potential royalty cases to the USAO.

### **Conclusion**

Each month, approximately 2,100 companies report and pay royalties associated with over 28,000 producing Federal and Indian leases. In FY 2007 alone, the 537 employees of the MRM program processed over 400,000 reports containing more than 7.7 million lines of data. The magnitude and complexity of this program requires that the Federal government work with all its partners to ensure the use of best practices, the best technology, and the most efficient use of available resources. We will continue to identify and respond to opportunities to improve our efficiency and streamlining our processes, within the confines of available resources. The Department's goal is to ensure that companies are in compliance with applicable laws, regulations, and lease terms and the Government is receiving fair market value. We are pleased with the results of MMS's efforts thus far, but recognize that there is much more work to be done. We can assure you that MMS will successfully implement the remaining recommendations of the OIG and that the three Bureaus will continue to work together to implement the RPC Subcommittee's recommendations.

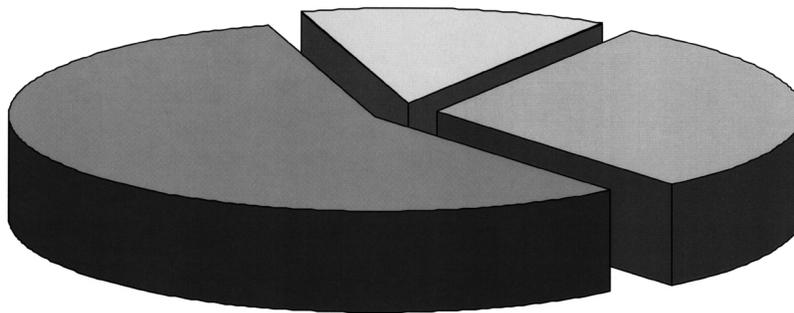
We welcome your input on all of these initiatives, and look forward to working with the Committee as we strengthen and improve the royalty management program.

**Attachment #1  
Royalty Policy Committee Report  
Recommendations by Category**



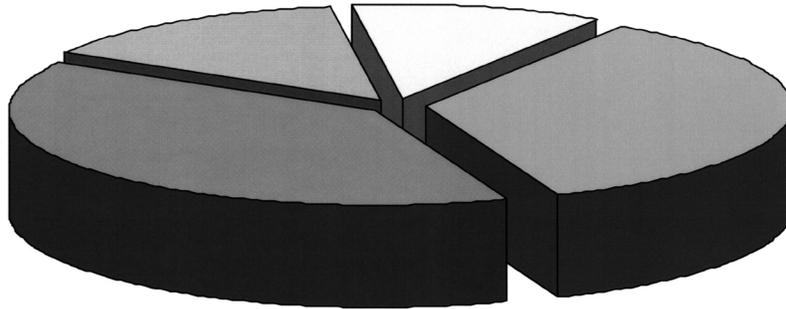
Recommendations by Category	
Collections and Production Accountability	35
Royalty In Kind	30
Audits, Compliance and Enforcement	27
Coordination, Communication, and Information Sharing	10
OCS Royalty Relief and Ethics	5
Legislative	3
<b>Total</b>	<b>110</b>

**Attachment #2  
Royalty Policy Committee Report  
Recommendations by Bureau**



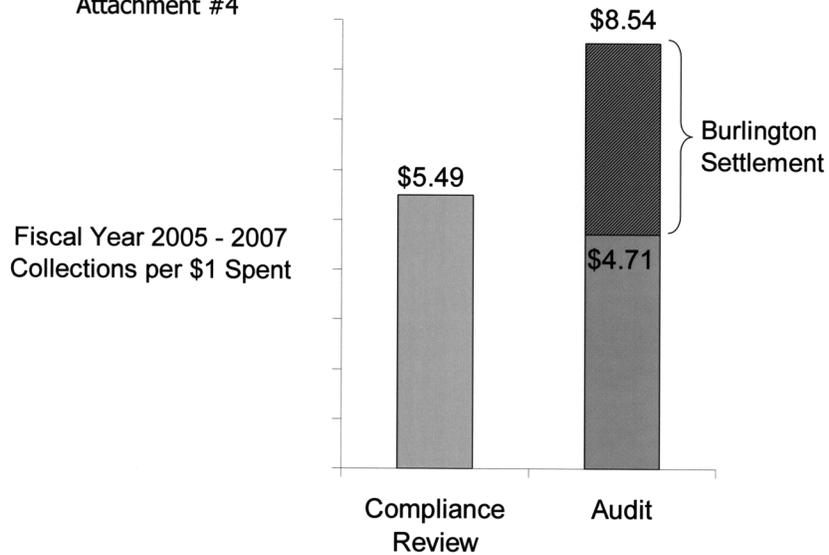
Recommendations by Bureau	
MMS	73
BLM	15
Multi-Bureau Recommendations (MMS, BLM & BIA)	22
<b>Total</b>	<b>110</b>

**Attachment #3  
Royalty Policy Committee Report  
Recommendation Timeframes**



Timeframe	
Completed	16
Short Term (< 6 months)	12
Medium Term (<1 year)	39
Long Term (>1 year)	43
<b>Total</b>	<b>110</b>

**Attachment #4**



**STATEMENT OF LAWRENCE FINFER, DEPUTY DIRECTOR,  
OFFICE OF POLICY ANALYSIS, U.S. DEPARTMENT OF THE  
INTERIOR**

Mr. COSTA. We will now move on to the next witness, Mr. Lawrence Finfer, is that correct? Mr. Finfer is the Deputy Director of

the Office of Policy Analysis for the Department of the Interior. Mr. Finfer, please.

Mr. FINFER. Thank you, Mr. Chairman, Mr. Pearce. I am Lawrence Finfer, Deputy Director of the Office of Policy Analysis, but I was also Staff Director to the Subcommittee on Royalty Management. As you know, our co-chairs, Senators Bob Kerrey and Jake Garn, submitted a statement for the record. I would like to briefly summarize that statement.

The subcommittee was formed in March 2007 to provide an independent examination of the royalty program and its proceeded over a nine month period. As mentioned, the subcommittee concluded that overall MMS was an effective steward of the royalty program.

The Senators, in particular, included the following statement, both in their statement for the record and in the announcement of the subcommittee's report, namely, "that the Federal employees who work in the mineral leasing and royalty collection program are conscientious, hard working and concerned about the reputation of the program and the Department of the Interior."

Nonetheless, the committee found many areas in which improvements were needed, and some of those improvements need to be substantial. Hence, the 110 recommendations provided by the subcommittee. I would like to just highlight a number of the ones that were included in the Senators' statements.

First, the subcommittee embraced the Inspector General's recommendation that compliance reviews are an appropriate tool but need to be used in conjunction with audits in a comprehensive, well thought out strategy. This means specifically the implementation of a risk-based approach.

In that light, the subcommittee consulted with what we regarded as the pros, namely the IRS, which has decades of experience in risk-based approaches, and we learned quite a bit, which we included in our report. Further, we recommended that MMS pursue an ongoing relationship with the IRS as it implements a risk-based approach.

My understanding, that it is doing just that at this point. That is absolutely critical to its success. Second, one recommendation which has been touched on before is the recommendation to establish a trust fund with royalty revenues. The subcommittee's recommendation was made because a number of these improvements will cost money, and a trust fund properly invested will yield interest, a small portion of which could help fund those improvements.

Third, building off of some of the recommendations of the IG, the subcommittee recommended ethics training for all employees involved in the royalty program, particularly the Royalty-in-Kind Program.

Government employees do receive ethics training, but the subcommittee believes that this particular ethics training should be targeted to the particular issues and situations faced by employees in this program so that they know what interactions are appropriate and which ones are not.

Fourth, as noted, better coordination needs to occur between BLM, and the MMS and the BIA in a variety of areas, production accountability and otherwise. This is essential in a variety of areas. We also made recommendations for improving some of the report-

ing, such as the MMS 2014, to include BPU values, and perhaps most important, to ensure that we go to an all electronic reporting format as soon as possible.

Without an all electronic reporting format it will be difficult to implement a risk-based approach. Also, as noted, the subcommittee spotlighted some of the problems BLM has in getting a sufficient number and a sufficiently well-trained production technician workforce. This significantly affects production accountability, and this is a situation that needs to be addressed.

The onshore program has grown rapidly, and frankly, this area needs some catch up work to ensure appropriate production accountability. Finally, with respect to the Royalty-in-Kind Program, the subcommittee concluded strongly that the RIK Program is a valuable program and should be continued. However, the program has grown rapidly from one that barely existed five or six years ago to the point where it is not a major facet of royalty collections.

That growth now needs to be accompanied by more structured procedures and better oversight. We recommended the establishment of a subcommittee on royalty in kind to the Royalty Policy Committee, among other things, and much more consistent application of procedures across the board, both in terms of auction, performance measures and so on and so forth.

That combination will produce greater transparency, which is essential for a program of this type. Simply put, the program has grown so quickly it is now time to catch up and give it the foundation that it needs and deserves. At the same time, however, while concluding that the Royalty in Kind Program was a valuable program there were certain areas we recommended that be discontinued.

These include the Small Refiner Program and the Onshore Oil Program. Mr. Chairman, this concludes my testimony, and I will be pleased to take questions.

[The response to questions submitted for the record by Mr. Finfer follows:]

**Response to questions submitted for the record by Larry Finfer**

**Question 1: Mr. Finfer, you stated that one of the crucial elements to a risk-based strategy is good data. Do you believe that MS currently has data of sufficient quality to properly implement an effective risk-based compliance strategy, given that both Mr. Rusco and Mr. Roller testified that there were problems with MMS data?**

Answer: The issues raised with respect to the quality of MMS's data do not necessarily bear upon whether data exist that are sufficient to implement a risk-based approach. As the risk-based approach is designed, those needs will be defined as will the systems support needed to apply the data to implementation activities. That will also inform the issue of whether existing systems can be readily adapted to use data for risk-based activities or whether a new and more tailored systems design effort is needed.

**Question 2: Mr. Finfer, did the committee ask whether or not MMS had enough staff to complete its audit and compliance tasks? They currently have about 126 auditors, far less than the nearly 170 they had at the beginning of the decade? Is that enough?**

Answer: The committee did review staffing issues and a number of recommendations address those concerns. In general, although a portion of the reduction is explicable given the efficiencies realized as a result of the Royalty-In-Kind program, it appears that the some of the reduction also reflected budget limitations as opposed to reduced needs. Some of the committee recommendations address this issue. For example, Recommendation 4-2 (Chapter 4, page 62 of the report) recommends a sys-

tematic review of staffing and budgetary needs related to anticipated compliance strategies. In particular, the development of the risk-based approach should further inform the effort to define appropriate staffing levels.

**Question 3: Mr. Deal and Mr. Finfer, could you provide more detail on the difference between a “royalty payor” and an “operating rights owner,” and why it would be better for MMS to pursue the royalty payor (as per Recommendation 3-8). Please provide an example to demonstrate the difficulty in the current system.**

Answer: The operating rights owner/working interest owner is defined in BLM manuals as: “The interest or contractual obligation created out of a lease (such as a sublease) authorizing the holder of that right to enter the leased lands to conduct drilling and related obligations, including production, which may include as consideration a share in revenues therefrom.” The lessee of record title is the owner of the lease, and there can be numerous lessees of a lease including individuals who acquire an interest as a passive investment. The payor can be the operator, purchaser, lessee, operating rights owner and the accounting service hired by the owner to report on and pay the royalties. There can be multiple payors on a given lease.

There are a number of problems with the current system that led to the committee’s recommendation. First, as noted in the report (Chapter 3, page 23), MMS does not have a system in place to track the identity of operating rights owners. Enforcing an obligation against a lessee could be costly and cumbersome and involve actions including hundreds of entities. Added complications arise because when MMS pursues nonpayments or underpayments against a payor, it must notify all operating rights owners and lessees (which, as noted above, MMS is currently unable to track). Further, under the Debt Collection Improvement Act, MMS has only 180 days to collect payments. Given the above circumstances, this has proved to be a near-impossible deadline. Accordingly, the committee concluded that restoring pre-Royalty Simplification and Fairness Act requirements was merited, and that is reflected in Recommendation 3-8. However, if MMS received such statutory authority, it would be important for it to work with industry in the implementation phase to ensure requirements were imposed in a reasonable and efficient manner.

Mr. COSTA. Thank you very much. We appreciate a number of the comments you made with regard to both risk assessment as well as to the computerization program. I know a number of us will have questions on a number of the points you raised.

**STATEMENT OF LINDA STIFF, ACTING COMMISSIONER,  
INTERNAL REVENUE SERVICE**

Mr. COSTA. Our next witness is Ms. Linda Stiff, the Acting Commissioner for the Internal Revenue Service, is that correct?

Ms. STIFF. That is right.

Mr. COSTA. Thank you, and we look forward to your testimony.

Ms. STIFF. Good morning, Chairman Costa, Ranking Member Pearce and members of the Subcommittee. Thank you for the opportunity to appear before you today. I have served as the acting Commissioner of the IRS since September. I am a career IRS employee having started as a revenue agent more than 27 years ago.

Mr. COSTA. Congratulations.

Ms. STIFF. While the IRS has no role relative to the Federal Oil and Gas Royalty Program, it is my understanding that you want me to review for the Subcommittee the IRS’s compliance procedures relative to the collection of Federal income taxes.

My written statement provides a detailed overview of the IRS compliance program, so what I would like to do this morning is highlight what I think to be the most important aspects of a strong compliance program. For the IRS, the most fundamental premise of our compliance efforts involve balancing taxpayer service with our enforcement programs.

Service is critical to sound tax administration because we know that some portion of noncompliance results from taxpayers failing to fully understand their tax obligations. The primary goal of our service program is to assist taxpayers in complying with their Federal tax responsibilities and to help them navigate the complexities in the Tax Code.

To accomplish this, we provide extensive outreach and education to individual and business taxpayers as well as to tax practitioners. The IRS taxpayer services programs ensure that taxpayers know their obligation, they understand how to meet them and we provide assistance when appropriate.

Our service programs mitigate compliance problems due to inadvertent errors and lack of understanding, particularly for taxpayers who are inclined to comply. At the IRS we believe that services with enforcement equals compliance. Enforcement programs are critical to verify compliance as reported and to ensure that all taxpayers can count on the system to be fair and be a system that requires everyone to pay their share and meet their tax requirements.

Additionally, our enforcement programs enable us to address those instances where the noncompliance is willful and intentional. The IRS employs a number of enforcement tools that includes notices, matching of third-party information to returns, audits and collection activities. In each of these cases, we integrate risk-based strategies to select what work will be done.

There are two critical factors that were actually mentioned earlier by the first panel that assist us in ensuring compliance with the tax laws. One is transparency. Simply put, the more transparent a transaction is, the easier it is to understand. Fostering greater transparency within this nation's administration system enhances compliance with the tax laws.

The second critical factor to ensure compliance actually flows from the transparency issue as well; it is third-party information reporting. Research and compliance studies confirm that compliance is greater in the presence of third-party reporting. In fact, for the tax system, compliance exceeds 95 percent where third-party reporting exists.

Where income is not subject to either withholding or third-party reporting requirements the misreporting percentage rises to as high as 54 percent. We continue to seek means of improving third-party reporting in transactions where it does not now exist. Another critical component of our compliance effort is balanced coverage or presence.

We know there is a ripple effect when we reach out and interact with the taxpayer through our enforcement programs. It is similar to the efforts of the police. They may not catch every speeder, but if a motorist sees them they do tend to slow down and abide by the law. Finally, from both a service and enforcement perspective, we understand that we operate in an environment where resources are limited.

We are challenged, just as our colleagues are, to find ways to improve processes and increase productivity. We are doing this by continuing to improve efficiency and productivity through process changes and streamlined business practices, and we are leveraging

technology to deliver both increased services and improve our enforcement efforts.

Mr. Chairman, I hope this overview has been helpful. I thank you, again, for the opportunity to appear this morning and will be happy to respond to any questions that you may have.

Mr. COSTA. Thank you. I appreciate your comments. How much of that is applicable in this sense we will try to determine, but we thank you for being here.

[The prepared statement of Ms. Stiff follows:]

#### **Statement of Linda Stiff, Acting Commissioner of Internal Revenue**

Chairman Costa, Ranking Member Pearce, and members of the Subcommittee, thank you for the opportunity to appear before you today. While the IRS has no role relative to the Federal oil and gas royalty program, it is my understanding that you want me to review for the Subcommittee IRS's compliance procedures relative to the collection of Federal income taxes.

#### **Background**

The IRS administers America's tax laws and collects the revenue that funds most federal government operations. Each year we collect more than \$2 trillion, or over 96 percent of the revenues that fund the federal government each year. This revenue comes from over 144 million Federal income tax returns filed by individuals and corporations throughout the U.S. In many ways, the IRS and its employees represent the face of U.S. government to more American citizens than any other government agency.

What is perhaps most impressive about our Federal tax collection system is that it is largely self-enforcing, and yet we collect what we estimate to be approximately 85 percent of the taxes owed each year. We are able to do this by maintaining a system that balances strong taxpayer service with an equally strong compliance program.

#### **Maintaining the Service and Enforcement Balance**

##### *Taxpayer Service*

Research has shown us that the complexity of the U.S. tax code is an important factor in the ability of many taxpayers to remain compliant with tax laws. It is important for us to differentiate between this type of noncompliance and willful noncompliance where the taxpayer fully understands their obligations but refuses to pay the taxes due. The primary goal of IRS service programs for individual taxpayers is to facilitate compliance with federal tax obligations.

We attempt to assist taxpayers through three primary means: the internet, the telephone and direct contact.

- The Internet—One of the most frequently visited websites in America is IRS.gov. In FY 2007 there were more than 215 million hits on the web site, a 10-percent increase over the previous year. IRS.gov:
  - Provides taxpayers information on the economic stimulus program enacted by Congress in February;
  - Assists taxpayers in determining whether they qualify for the Earned Income Tax Credit (EITC);
  - Assists taxpayers in determining whether they are subject to the Alternative Minimum Tax (AMT);
  - Allows more than 70 percent of taxpayers the option to file their tax returns at no cost through the Free File program. Free File is a public/private partnership that allows more than 97 million taxpayers to file their returns at no cost. In 2007, approximately 4 million taxpayers took advantage of the Free File service.
  - Allows taxpayers who are expecting refunds to track the status via the "Where's My Refund?" feature; and,
  - Allows taxpayers to calculate the amount of their deduction for state sales taxes.
- Telephone—Many Americans still prefer to pick up the telephone to have their questions answered. In FY 2007 the IRS customer assistance call centers answered 33.2 million assistor telephone calls and maintained an 82.1 percent level of service on the telephone with an accuracy rate of 91.2 percent on tax law questions. The agency reached a 95 percent customer satisfaction rating for its toll-free telephone service, up from 94 percent the year before.

- **Face to Face**—While we attempt to direct taxpayers to less costly, and in many ways more effective, means of assistance such as the internet, we understand that there will always be a number of people who prefer direct contact with an individual to have their questions answered. We continue to meet that need through our 401 Taxpayer Assistance Centers (TACs). These TACs are scattered across the country and act as walk-in sites for millions of Americans each year. Another important element of our face-to-face contact with taxpayers is the nearly 12,000 manned volunteer sites. These volunteer sites assist in the preparation and submission of income tax returns, primarily for low-income Americans. In FY 2007, over 76,000 volunteers prepared 2.63 million returns at these sites.

The overriding strategy that guides our taxpayer service program is the Taxpayer Assistance Blueprint (TAB). This collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate began in July 2005 in response to a Congressional mandate to develop a five-year plan that outlines the steps we should take to improve taxpayer services. This was in recognition of the critical role that taxpayer service plays in improving compliance.

TAB represents a significant milestone in a decade-long history of service enhancements by the IRS. During this period taxpayer satisfaction with IRS services has grown significantly, due in large part to the strength of our commitment to continual improvements. Increases in electronic filing and on-line service transactions, high levels of toll-free access and accuracy, extensive stakeholder engagement, and increasingly diversified efforts to reach taxpayers through local partners and community coalitions have all led to better taxpayer understanding and participation in the tax system.

Another critical component of our compliance program is a strong customer service focus toward the business community. A key component of this has been our outreach program. In FY 2007, we:

- Maintained relationships with business industry and tax-professional organizations and coordinated or participated in events across the country, sharing education and outreach messages and information to better enable their members to comply with the law.
- Engaged practitioners and payroll providers through national and local chapters of prominent organizations such as the American Institute of Certified Public Accountants (AICPA), American Bar Association (ABA), the National Association of Enrolled Agents (NAEA), the National Payroll Consortium (NPRC), and the Independent Payroll Provider Association (IPPA).
- Maintained a close working relationship with the Internal Revenue Service Advisory Council (IRSAC) and the Information Returns Program Advisory Committee (IRPAC) to address small business issues through their Small Business/Self-Employed Sub-Working Group. Currently, both groups are working to address issues to improve voluntary compliance.

#### *Enforcement*

Through a renewed focus on improving our enforcement efforts, we have been able to increase enforcement revenue from \$33.8 billion in FY 2001 to \$59.2 billion in FY 2007, an increase of 75 percent. This represents a 5.6 to 1 return on investment for all IRS activities in FY 2007.

In FY 2007, both the levels of individual returns examined and coverage rates have risen substantially. We conducted nearly 1.4 million examinations of individual tax returns in FY 2007, an 8 percent increase over FY 2006. This is over three-quarters more than were conducted in FY 2001, and reflects a steady and sustained increase since that time. Similarly, the audit coverage rate has risen from 0.6 percent in FY 2001 to 1 percent in FY 2007.

While the growth in examinations of individual returns is visible in all income categories, it is most visible in examinations of individuals with incomes over \$1 million. Audits of individuals with incomes of \$1 million or more increased from 17,015 during FY 2006 to 31,382 during FY 2007, an increase of 84 percent. One out of 11 individuals with incomes of \$1 million or more faced an audit in 2007. Their coverage rate has risen from 5 percent in FY 2004 to 9.25 percent in FY 2007.

In looking at our audit numbers for individual taxpayers, it is important to understand that we conduct two types of audits. The first is the traditional field audit where an auditor actually meets with the taxpayer to conduct an examination. The second is a correspondence audit. These occur in instances where we are unable to match the taxpayer's return with third-party documents that are filed with us. For example, a taxpayer's return that does not report income that is reported to us as part of an interest statement provided by the taxpayer's bank would raise a red flag. We would send a letter to the taxpayer assessing the additional tax as well as any

interest and penalties that may apply. The taxpayer is then provided an opportunity to dispute this assessment if they desire or they can send the corrected assessment directly to us.

In the business arena, we attempt to allocate resource to the areas where we think they will be most effective. In FY 2007 for example, the IRS continued efforts to review more returns of flow-through entities—partnerships and S Corporations. Our business statistics reflect that we have placed more emphasis in the growing area of these flow-through returns. We also increased our focus on mid-market corporations—those with assets between \$10 million and \$50 million.

Operating in an environment where resources are limited, we are challenged to find ways to improve processes and increase productivity. We are doing this by continuing to improve efficiency and productivity through process changes and streamlined business practices.

A critical component in ensuring the most productive use of compliance resources is a greater reliance on information technology (IT) modernization. The IRS strategic vision includes IT systems that would allow for identification of the cases to be worked, routing of those cases to the most appropriate workstream, and the availability of cost effective technology analytics to manage cases in the stream optimally.

The National Research Project (NRP), which analyzed some 46,000 individual income tax returns from Tax Year (TY) 2001, has provided us with significant data to help us facilitate the selection of the most productive returns to examine. It is envisioned that the case selection process will be further enhanced through automated classification processes, including expert systems, electronic database analysis, and leveraging e-filed data from corporations—efforts that are currently underway. Technology enhancements are also on track for more effective and efficient workload selection models within the non-filer population.

The FY 2009 Budget for the IRS includes \$51 million to expand our commitment to quality enforcement research. This enforcement initiative will support and expand ongoing research studies of filing, payment, and reporting compliance to provide a comprehensive picture of the overall taxpayer compliance level. Research allows the IRS to better target specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively to reduce the tax gap. Improved research data will refine workload election models reducing audits of compliant taxpayers.

We also use current audit information from “issue management” systems to improve case selection criteria and provide for immediate identification of emerging issues. For collection programs, we are using improved decision analytics to select cases and route them to the most appropriate collection enforcement stream. For large corporate returns, data is now available earlier due to the corporate e-file mandate, and we are using data from returns filed electronically, including the Schedule M-3, for risk assessment and issue identification.

Delivery systems are also being modified to move audit work into the system more effectively and efficiently. Return classification and delivery will be more automated and digital, eliminating the manual time-consuming and expensive process of ordering returns and sending examiners out to Campus locations for classification details. Additionally, the IRS will replace manual processes with electronic case building and instant access to multi-year tax return information.

Automated systems are also being deployed to allow more batched processing of high-volume examinations. Technology enhancements will allow employees to work cases in an online environment, where returns and case-related data can be downloaded, and actions can be tracked electronically. We will continue to link multiple internal and external databases to enhance overall effectiveness, allowing better identification, management, and performance monitoring for compliance workload. In utilizing these automated systems, IRS remains committed to protecting taxpayer data from being accessed inappropriately.

The large corporate entities monitored by the IRS are highly sophisticated, well-capitalized, well-organized, and adept at tax planning. Particularly in the case of public companies, they are driven to show high after-tax profitability to shareholders in a very competitive and complex economic environment. They have the resources and willingness to defend their reporting positions and contest proposed adjustments aggressively.

However, these taxpayers also face significant changes in corporate governance, including increased public disclosure and transparency. A number of these changes have been the result of legislative or administrative changes including:

- New requirements were imposed on corporate officers and directors by the Sarbanes-Oxley Act.

- There was increased scrutiny of outside auditors by the creation of the Public Corporation Accounting Oversight Board.
- Increased requirements of disclosure were included in the American Jobs Creation Act.
- New SEC/FASB (FIN48) rules limit the discretion companies can apply in determining their unresolved tax positions for financial accounting purposes.

For some corporations, these changes have created a desire for certainty regarding their tax liability as soon as possible. Tax certainty—or lack thereof—can have a real effect on a company's share price, because a more accurate picture of a company's finances is now required and publicly available.

We recognized long ago that our traditional approach to corporate tax administration, which centered on lengthy, detailed tax return examinations, was no longer viable. As a result, we developed a proactive approach to dealing with the challenges of effective tax administration in a global environment with an increasingly complex tax code. Overall, this strategy depends on making compliance checks, when possible, on a real-time basis, remaining current in our examinations, and having as much transparency to book-tax differences and other indicators of risk as possible. To that end, we have initiated several programs that foster transparency, currency, pre-filing compliance opportunities, and improved efficiencies in issue and risk identification.

First, to improve transparency on corporate tax returns, the IRS introduced a new Schedule M-3. The Schedule M-3 provides transaction-specific detail on book-tax differences, enabling the IRS to identify and focus more quickly and precisely on those tax returns and issues that present the highest potential compliance risk.

Second, our Large and Mid-Sized Business (LMSB) division has introduced the Compliance Assurance Program (CAP). The CAP program is designed to improve both currency and transparency. It is a real-time approach to compliance review that allows LMSB, working in conjunction with the taxpayer, to determine tax return accuracy prior to filing. CAP is more efficient than a post-filing examination, as it provides corporations certainty about their tax liability for a given year within months, rather than years, of filing a tax return. CAP is a pre-filing initiative designed to provide certainty for both the IRS and the taxpayer, that a return (in its entirety) is substantially compliant when it is filed. This win-win program greatly reduces taxpayers' compliance burden and their need for contingent book tax reserves, while increasing currency and allowing for more efficient use of IRS resources.

Third, the IRS is continuing the Pre-Filing Agreement (PFA) program to provide taxpayers an opportunity to request that revenue agents examine and resolve potential issues before tax returns are filed. This is distinguished from the CAP program as it provides certainty on a single issue(s), as opposed to certainty of a tax return (in its entirety). We continue to explore ways to improve and create additional pre-filing compliance opportunities that may limit the number of issues we need to examine in a post-filing examination.

Fourth, working with Treasury and Chief Counsel, LMSB identifies emerging high-risk issues as early as possible, issuing guidance to taxpayers and examiners on the proper treatment of these issues, and efficiently and vigorously examining those returns where taxpayers engage in that behavior.

Fifth, the IRS is mandating, in stages, the electronic filing of corporate returns (E-Filing) in order to improve issue identification and the selection for examination of high-risk returns. Large corporations are required now to file their tax returns electronically and this mandate will expand in future tax years. E-filing will provide more consistent treatment and data analysis for efficient, near real time identification of high-risk issues and taxpayers. E-filing and Schedule M-3 together also allow us to identify and exclude more efficiently lower-risk taxpayers from consideration for examination.

The approaches described above better position the IRS to address the rapid change of business in the domestic and global arenas in a timelier manner. The earlier we learn of emerging trends, the better positioned we will be to adjust resources to address compliance risks appropriately.

Increasing timeliness and reducing cycle time means that less time is spent on each audit. This has allowed us to continue to show improvement in enforcement results at the same time we are increasing our coverage of these taxpayers. We believe that the more compliance "touches" that occur (even if that does not include a full audit in the traditional sense), the better the direct and indirect enforcement benefits will be.

*Summary*

Any agency with limited resources must make difficult decisions on how to allocate those resources in the most effective way. It also must be accountable for those decisions, and so appropriate metrics must be established to measure the success or failure of the actions taken.

While we understand that we can still do some things better, we believe that our approach, which balances service and enforcement in an effort to improve compliance, is working effectively. We base that conclusion on the metrics that show how enforcement—particularly enforcement against high-income individuals and large corporations—have grown substantially in the last five years without any diminution in our taxpayer service levels.

Thank you for the opportunity to appear this morning, and I will be happy to respond to any questions.

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**Response to questions submitted for the record by Linda Stiff,  
Acting Commissioner of Internal Revenue**

**Questions for Ms. Linda Stiff, Acting Commissioner, Internal Revenue Service**

- 1. Commissioner Stiff, in a report issued last year by the Interior Department's Inspector General, a manager at MMS says that when companies file their royalty reports, they are allowed to take deductions and it's up to MMS to figure out whether or not those deductions are valid. Apparently, a company can never get in trouble for filing a false deduction, since they're not required to verify whether it is or isn't. Does the IRS operate that way with individual taxpayers?**

ANSWER: The IRS cannot comment on Mineral Management Services (MMS) rules regarding royalty reporting requirements. However, with regard to federal income tax returns, taxpayers are expected to maintain adequate records (such as a check or a receipt) to substantiate any deduction on their income tax return. Upon audit, a number of penalties—both civil and criminal—can be applied if false deductions are claimed on an income tax return. The IRS does not allow taxpayers to knowingly file “false deductions.”

Individual taxpayers who receive royalty income normally receive a Form 1099. The Form 1099 reports the gross royalty income received by the taxpayer. Generally, the taxpayer may be entitled to deduct depletion and production taxes from the income reported.

- 2. Commissioner Stiff, it seems to me that IRS would have similar problems that MMS is having in terms of retaining a trained workforce. You have highly trained accountants and tax experts who are in demand in the private sector. Are you seeing high turnover rates, and how do you attract and retain skilled individuals?**

ANSWER: The IRS takes a holistic approach to managing its human capital. We ensure that planning, recruitment and hiring, employee development, retention and the management of attrition are looked at as a continuum and not as individual processes. We are fortunate that we are not experiencing unusually high turnover rates among our Mission Critical Occupations (MCO) at this time. However, with the potential for increasing retirements, we are studying and implementing multiple programs to ensure we meet hiring goals and have a well trained workforce with the needed level of expertise. These programs include targeted recruitment, marketing and advertising, as well as integrating skills assessments into the hiring process. We are also expanding strategic use of reemployed annuitants to enhance our training efforts for newly hired MCO positions. Use of reemployed annuitants has proven to be very successful. However, use of this program continues to require special authority and/or legislative change to ensure there is no impact on the annuitant's retirement income.

The IRS continuously reviews its programs to market itself as an “employer of choice”. Relationships have been established with veteran's organizations such as Military.com, Operation Warfighters (DoD) and the Department of Veterans Affairs “Coming Home to Work Program”. In addition, a Service-wide recruiter cadre participates in targeted events at colleges and a video game-like tool is being developed to target high school students for a possible career with the IRS. Work life flexibilities, such as telework and alternate work schedules, are also touted as tools to provide/ maintain a work life balance and achieve business goals.

The IRS is currently challenged in the area of retaining some new hires. New hires in MCO positions, such as Revenue Agents, are being lost about one year ahead of the past trends. The trend is being monitored and addressed through the use of: exit interviews; a retention benefit index model; training and development studies; and continued analysis of workforce drivers. The IRS has also adopted a corporate incentive strategy that allows for recruitment, relocation and retention payments for hard to fill positions.

In addition, we are focusing efforts on identifying and moving employees into career paths for leadership. The IRS has established a comprehensive Leadership Succession Review program that provides a systematic approach to identify a leadership pipeline of high performers early in their career. We expect that these efforts will help us understand the causes of attrition and reduce the overall impact on the organization.

**Minority Question for Linda Stiff, Acting Commissioner, Internal Revenue Service**

**1. Can the Internal Revenue Service please estimate the impact on the federal treasury from corporate and personal income taxes over the life of an oil and gas lease?**

ANSWER: Perhaps the best approach to this request would be to develop a profile of a "typical" oil and gas property, with estimates of the costs incurred and revenues generated over the production life of that property. Then a set of assumptions would be made regarding the tax characteristics of the owner of that property and these characteristics would interact with the revenue stream and costs incurred to generate a set of estimates of income taxes due on the earnings from that property.

Unfortunately, the income tax return of an investor in an oil and gas property does not contain sufficient information for the Internal Revenue Service to estimate the revenues, costs, and ultimately the total amount of individual and corporate income taxes paid over the life of an individual oil and gas property. The Department of Energy, in conjunction with the Office of Tax Policy at the Department of Treasury, is probably in the best position to answer a request along these lines.

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**STATEMENT OF DENNIS ROLLER, ROYALTY AUDIT SECTION  
MANAGER, OFFICE OF THE STATE AUDITOR, NORTH DAKOTA**

Mr. COSTA. Our last witness is Mr. Dennis Roller, who is the Royalty Audit Section Manager for the Office of the State of North Dakota. I assume that when you testify this morning, Mr. Roller, that you also do so with the fact that you meet and confer with other auditors from other states throughout the country and with tribal groups, and that there is a general sense of the challenges you face.

Mr. ROLLER. Yes, sir.

Mr. COSTA. Yes, you do?

Mr. ROLLER. Yes, we do. Yes, I do.

Mr. COSTA. You like my statement. OK.

Mr. ROLLER. It is not STRAC's voted upon view, but there is general consensus, as I state, to my testimony and certain areas that need review or need a tune up.

Mr. COSTA. Thank you.

Mr. ROLLER. Mr. Chairman and members of the Committee, thank you for the opportunity to comment and share my views concerning the wide array of challenges faced by the Minerals Management Service and state and tribal compliance delegations.

The first major challenge we are facing is a state of misreporting of the oil and gas operations report, or OGOR, the production reporting document, and the MMS 2014s, as a payment reporting document. Many state and tribal delegations have expressed their concerns over the lack of correct reporting and additional compli-

ance hours used because of the incorrect reporting, as has the GAO earlier today.

This reporting issue goes to the core of having an effective and efficient Royalty Management and Compliance Program. Having complete and current OGOR data is one of the first steps in having an efficient and effective compliance system. The MMS does not have complete and current OGOR data.

The next step to have an effective Royalty Compliance Program is having correct and complete 2014 data. The FBMS states that overall, company 2014 reporting accuracy is around 97 percent, but that measure is based on the percentage of lines processed through the MMS acceptance system the first time.

This appears to be a good measure. The problem is that there are very few edit checks in the acceptance system, so very few lines are not accepted the first time. Because of the lack of correct and complete 2014 reporting our audits now entail a reconciliation of all 2014 payments made by a company for the review period in order to determine what the company intended to report and pay.

In my written testimony, I explained what is meant by reconciling every single 2014 payment. In general, it means that the lease number or agreement number was not reported correctly, and we have to try to determine what the correct lease number or agreement number is.

An IRS comparable scenario of this would be if I file my taxes under Friend A's Social Security number and Friend A files it under Friend B's Social Security number, et cetera. You can see the mess that would present for Social Security retirement benefits.

Comparing the OGOR data, what volume we expect to receive royalties on, to what was actually received, 2014 payments, is a must in order to have an effective and efficient compliance program. Another area of concern that has been expressed to me by several delegations is interest. The MMS reengineered system did not have an interest module to bill late payment interest until May 2003.

In a recent IG report, the MMS stated that interest will be caught up by the end of Federal Fiscal Year 2007, but based on the interest data the MMS has provided, there are many compliance royalty collections and late paid royalties for which interest has not been billed.

More importantly, we have determined that in many instances when a company pays the royalties late the system doesn't bill late paid interest and doesn't recoup the interest that was paid to the company on their estimate. In essence, the company is paid interest to pay their royalties late.

Another area of concern expressed by several delegations is MMS's unwillingness to accept STRAC input or make a STRAC suggested change. An example of this is STRAC's written request on January 15, 2003, to then director, R.M. Johnnie Burton to immediately withdraw the guidelines regarding statute of limitations for demands, orders and appeal decisions for Federal leases.

Under these guidelines, MMS required: 1) that the prospective only statute of limitations enacted under RSFA be applied retroactively to oil and gas production; and 2) that RSFA statute of limitations apply to solid minerals, although not covered under RSFA.

The result of the guidelines was that appeals were being lost, demands for payments were not issued, audits were closed and royalties uncollected.

The dollars lost is unknown because MMS never evaluated the impact of the guidelines before issuing them, making them binding on the state delegations. In 2007, the U.S. District Court for the District of Columbia, in a suit brought by the California State Controller invalidated the guidelines as arbitrary and capricious noting as grounds many of the arguments STRAC made to MMS in 2003.

In November of 2007, the MMS director issued a memorandum rescinding those guidelines, yet, MMS has done nothing to date toward collection of royalties impacted by the guidelines. Another area of concern, as expressed by several delegations, states mainly, as it does not affect tribes, is the net receipt sharing or the administrative provision which reduces by two percent the state's share of the royalties from public domain lands.

The two percent results in approximately a \$40 million decrease in royalty revenue to states from which the minerals are produced. However, every U.S. citizen benefits from the royalty revenue program because of the revenue generation of the program. If every U.S. citizen benefits from the program, then why is the cost of administering the program being unfairly applied to only the states that produce the Federal mineral.

The final area that I was asked to discuss is the RPC report on MMS. I was asked as STRAC's chair to discuss STRAC's opinion and views of the report. Unfortunately, due to the timing of this hearing and the report, STRAC has not had an opportunity to meet as a whole and discuss the report. However, several STRAC delegations have provided comments to me upon learning that Congress wanted STRAC's views of the report.

Those have been included in my written testimony. A general summation of those comments, as the report highlights, many important areas of concern, but STRAC delegations should have a voice in how those concerns are addressed and corrected. In closing, this is about giving the U.S. citizens what they deserve: an effective and efficient Royalty Management Program for their minerals.

Ultimately, it is about data management, and without good data, the program cannot be effective and efficient. This concludes my testimony. Thank you for the opportunity to appear before the committee today. I will be happy to answer any questions you may have and go into more details.

Mr. COSTA. Thank you very much, Mr. Roller. We appreciate your testimony.

[The prepared statement of Mr. Roller follows:]

**Statement of Dennis Roller, Audit Manager for the North Dakota State Auditor's Office—Royalty Audit Section, Minerals Management Service**

Mr. Chairman and members of the committee, I want to thank you for the opportunity for me to comment and share my views concerning the wide array of challenges faced by the Minerals Management Service and State and Tribal compliance delegations.

The North Dakota State Auditor's Office Royalty Audit Section (ND delegation) was created in 1982 under the authority of section 205 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA). For the past 25 years the ND delegation has performed compliance work on federal mineral royalties paid in North Dakota.

The ND delegation from 1982 through 2001 collected over \$26.6 million. During that same period, the costs of the ND delegation were less than \$4.2 million. That's over \$6 of revenue for every \$1 spent. For all States that had a 205 delegation for 1982 through 2001 the total collections were over \$296.5 million, while costs were under \$58.5 million.

Given the delegations success in the past, I would like to discuss some of the challenges the MMS and the delegations are currently facing.

Before I go into those challenges however, I would like to express that my testimony is not being given without some trepidation. I'm testifying in the hopes and beliefs that the royalty compliance program will be improved for the benefit of all U.S. citizens. However, my testimony about the challenges and ineffectiveness of the program may be viewed differently by the Department of Interior, who is in control of ND's delegation contract funding.

In fact, in October 2006, a now former high ranking MMS official advised several STRAC delegation managers (including myself) to not testify at the upcoming House and Natural Resources Subcommittee hearing that eventually took place on March 28, 2007. This official expressed to us that Congress only requests that you testify so you aren't obligated to testify and that it is best to keep any problems in house. I'm of the view that as a government employee we are to serve the people and accountability to the people is a priority.

That said the first major challenge is the state of misreporting for the MMS 2014s, payment reporting document, and the Oil and Gas Operations Report (OGOR), production reporting document. Many State and Tribal delegations have expressed their concerns to me and others over the lack of correct reporting and the additional compliance hours used because of the incorrect reporting.

With the re-engineered system that went into place on November 1, 2001, the MMS changed the property numbering system used by company's to report the 2014s. The MMS also stopped doing any automated comparison of the OGOR and the 2014. Without any automated check, company reporting accuracy has drastically deteriorated.

This issue goes to the core of having an effective royalty management program and an effective compliance program. Having correct and current OGOR data is one of the first steps in having an efficient and effective compliance system. Without complete and current OGOR reporting, the MMS does not know what they should be being paid royalties on. The ND delegation recently sent 48 different properties to MMS for which OGOR reporting was at least six months behind and in some cases OGORs had not been filed for over two, three or more years. In one case, the property started production in February 2002 and no OGORs had ever been filed. The ND delegation is aware there are even more properties in ND for which the OGOR filings are late or never been done, but has not had the time to complete this reporting project (the known unreported OGORs in ND are for CY05 or later—a period for which the ND Delegation has not done our automated comparison for—so when we do that period these unreported OGOR issues will be addressed). Having complete and current OGOR data is one of the first steps in having an efficient and effective compliance system and the next step is having correct and complete 2014 data.

Because of the lack of correct and complete 2014 reporting, our audits now entail a reconciliation of every single 2014 payment made by a company for the review period in order to determine what the company intended to report and pay.

Here's an example of a recently worked ND delegation case depicting this (with the well name, lease numbers and company name changed). Federal well #1 is a lease well on lease A (meaning that 100% of the wells production is attributable/payable to that lease). For January 2003 through July 2003, Company XYZ paid (2014 reporting) well #1's sales incorrectly to communitization agreement #410, and allocated 75% to lease A and 25% to lease B. For July 2003, Company XYZ paid 100% of the sales to lease B. For August 2003 through June 2004, Company XYZ again paid well #1's sales to communitization agreement #410, and allocated 75% to the lease A and 25% to lease B. For July 2004, Company XYZ paid 100% of well #1's sales to lease C. Finally, for August 2004 through December 2004, Company XYZ paid well #1's sales to unit #160, and allocated 58% to lease A, 2% to lease C, 16% to lease D and 24% to lease E. Net effect being that Company XYZ paid royalties on 100% of the production from well #1, so no additional royalties are due, but it was never once paid to the correct property on the 2014.

In this instance, the land types for all leases were the same (acquired lands) and thus there was not a land type issue. If the incorrect reporting crosses land types then the incorrect entity receives the royalties, public domain lease is distributed 48% to the State and 52% Federal Government, versus an acquired lease distribu-

tion of 75% Federal Government and 25% to the county from which the mineral was produced.

An IRS comparable scenario of this would be if I filed my tax return using friend A's social security number, and friend A filed his taxes under friend B, and so on. If you tried to file your taxes with the wrong social security number electronically the IRS would not even accept them, because the social security number did not match the name.

This "reconciliation" process (determining where the payments made by the company actually belong) has added a tremendous amount of hours and inefficiency to our audits. In order to combat this, the ND delegation requested the authority to perform volume and royalty rate automated verifications on October 1, 2005, as allowed for under the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 (FOGRSFA). The ND delegation was denied that request on January 20, 2006. However, the ND delegation later was granted by MMS the ability to perform limited scope compliance reviews using our comparison tool. The ND delegation has been performing limited scope oil volume and royalty rate compliance reviews (an automated comparison of the OGOR to the 2014 for oil) since October 1, 2006 and have discovered countless reporting issues, non payment issues, missing reporting documents issues and two company's that just quit paying their federal royalty obligation in ND. The ND delegation has taken on this comparison process at a time when ND's delegation funding has went from 6 FTE to 4 FTE and the audits we perform have become complicated by the misreporting, as already discussed.

The ND delegation efforts in this area for royalties paid for CY01 through CY02 resulted in identification of nearly \$200,000 of incorrectly paid royalties at a cost less than \$30,000. The automated comparison process that MMS used to perform was as successful too. Per the 2001 Minerals Management Service budget justification document, the last year such collection data was reported by the MMS, the AFS/PAAS automated comparison process collected \$56.2 million in additional FY98 paid royalties and per the 2000 budget justification document the AFS/PAAS comparison collected \$32.7 million for FY97 paid royalties.

Comparing the OGOR data (what volume we expect to receive royalties on) to what was actually received (2014 payments) is a must in order to have an effective and efficient compliance program.

This OGOR-2014 automated comparison process was a recommendation of the Fiscal Accountability of the Nation's Energy Resources of January 1982, commonly referred to as the Linowes Commission, which was the driving force for the creation of the MMS. Recommendation #5 of the internal controls section (Chapter 3) of the Linowes Commission report states "That the Federal royalty managers incorporate production data into the royalty management system in order to cross check the data with sales and royalty data for all leases each payment period." (emphasis added) The MMS did this automated comparison for years, commonly referred to as the AFS/PAAS comparison. However, since the implementation (11/1/01) of the re-engineered system this is no longer done.

Another area of concern that has been expressed to me by several delegations is interest. The MMS re-engineered system (implemented 11/1/01) did not have an interest module to bill late payment/collection interest until May 2003. In a recent IG report the MMS stated that interest will be caught up by the end of Federal Fiscal Year 2007 (9/30/07). However, based on the interest data the MMS provided the ND delegation through September 30, 2007 (the MMS has not yet provided any interest data information beyond September 30, 2007) there are many compliance royalty collections and late paid royalties for which interest has not been billed as of September 30, 2007.

In addition and more importantly, the ND delegation has determined that in many instances when a company pays their royalties late the system doesn't bill late paid interest and doesn't recoup the interest that was paid to the company on their estimate. An estimate is like a security deposit. It stays with the MMS until the company is no longer the payor and it allows the company to pay the royalties for the lease one month later than originally due.

For example, Company A has a \$10,000 estimate for lease 55555. Company A pays \$10,500 for January royalties on April 1, one day late since the January royalties are due the last day of February but because of the estimate they are due the last day of March. Because no royalties were paid by the due date (March 31) the system assumes no royalties are due and automatically calculates and pays interest to Company A for the entire month of March on the company's \$10,000 estimate. On April 1st, the system should determine that the January royalties of \$10,500 was paid late and bill Company A interest for 1 day on \$10,500 and also bill Company A interest on \$10,000 for the Month of March (recoup the interest paid on the estimate because the system assumed no royalties were due when in fact there were

royalties due that were just paid late). The ND delegation has discovered that the calculation and billing of this interest often doesn't occur. In essence, Company A was paid interest to pay their royalties late. Specific examples of this can be provided by me upon request.

Another area of concern expressed by several delegations is MMS' unwillingness to accept STRAC input or make a STRAC suggested change. A good example of this is MMS' Government Performance Results Act (GPRA) goals. MMS set the goals based on dollars voluntarily paid by the company (2014 payments). The delegations for years argued that is not a good way to set goals (what about the property for which nothing is paid on but there should be royalties paid—one that compliance work should be done on—but you accomplish \$0 toward the GPRA goals because \$0 was paid on the property—it moves the compliance efforts away from severely under paid properties because less of the goal is accomplished). MMS refused to change the goals until a recent Inspector General report stated the goals should be revised.

An even better example of this is STRAC's written request to then-Director R.M. "Johnnie" Burton to immediately withdraw the "Guidelines Regarding Statute of Limitations for Demand, Orders and Appeals Decisions for Federal Leases", which was approved on October 15, 2002. Under these Guidelines, MMS required: (1) that the prospective only statute of limitations, enacted under the Royalty Simplification and Fairness Act (RSFA), be applied retroactively to oil and gas production, and (2) that the RSFA statute of limitations apply to solid mineral royalties, although not covered under RSFA.

The result of the Guidelines was that appeals were deemed lost and royalties uncollected, although MMS could claim a reduction in the number of outstanding appeals. Also, demands for payments were not issued and audits were closed. The dollars lost is unknown because MMS never evaluated the impact of the Guidelines before issuing them and making them binding on the State delegations.

On January 15, 2003, STRAC warned MMS that the Guidelines were of doubtful legality and that they would most likely result in an unnecessary litigation, but STRAC's concerns were dismissed. In 2007, the U.S. District Court for the District of Columbia, in a suit brought by the California State Controller, invalidated the Guidelines as arbitrary and capricious, noting as grounds many of the arguments STRAC made to MMS in 2003.

On November 17, 2007, MMS Director Randall Luthi issued a memorandum rescinding the Guidelines. Yet, MMS has done nothing to date towards collection of royalties impacted by the Guidelines.

A final example of MMS not willing to accept input from STRAC is in the development of the recent Compliance Program Tool (CPT). CPT is a new MMS tool (STRAC delegations were provided training on the tool in mid CY07) used by MMS to perform their compliance reviews. In this instance, the MMS didn't even ask STRAC for input, even though they profess STRAC to be their partner. They developed the tool and they want all the delegations to use it, but unfortunately the tool is ineffective because the tool was built backwards. Instead of starting with production data (OGOR) and then comparing that to 2014 data, MMS used their GPRA philosophy of starting with dollars voluntarily paid (2104 payments) and then compared those to the OGOR. What this means, is that for all the OGORs that no payments were received (the ones that compliance should be looking at), the CPT tool doesn't show a difference (because there was no 2014 and thus there is no starting point). I refer you back to the earlier example of lease well #1's royalties being attributed 100% to lease A—but no payment was made as a lease well to lease A so the CPT would not show a difference. If MMS would have asked STRAC for input, this fatal tool error could have been avoided.

An IRS comparable scenario of this would be me not filing my taxes and the IRS never catching that I didn't file any taxes because there were no taxes filed by me in the universe that they looked at (taxes paid), even though the State of ND files with the IRS a w-2 showing that they paid me a salary.

Another area of concern as expressed by several delegations (States as it does not affect Tribes) is the net receipts sharing or the administrative provision which reduces by 2% the States share of the royalties from public domain lands as established under the Minerals Leasing Act. This was passed as part of the Federal Fiscal Year 2008 Interior Appropriation Bill (HR2764) and is again included in the Presidents Budget for Federal Fiscal Year 2009. The 2% results in approximately a \$40 million decrease in Mineral Leasing Act royalty revenue to the States from which the minerals are produced. However, every U.S. citizen benefits from the royalty revenue program because of the revenue generation of the program. If every State benefits from the program, then why is the cost of administering the program (2% reduction of States share) being unfairly applied to only the States that produce the Federal Mineral? Plus, it's applied by the States with the most production shoul-

dering the most administrative costs. Why should the States that produce the Federal Mineral, for the benefit of every U.S. citizen, solely bore the costs of administering that program?

Should the State of Montana bore most of the Core of Engineers costs associated with administering the dams on the Missouri River just because the majority of the water was originally produced from the mountains of Montana? No, the whole country benefits from those dams through electricity generation, barge traffic, water supply for cities, etc., so the cost should be bore by the country as a whole (Federal Government), not mostly by the State of Montana.

Should the State of Florida or Arizona pay more of the administration cost of the Social Security Benefit Program because they have more retirees in those states?

Secondly, the 50% State share as provided for originally under the Minerals Leasing Act was provided to the States because the States and Counties within the States were incurring large infrastructure and maintenance costs (road building, maintenance of roads costs, etc.) from development of the minerals on Federal Lands. However, the States and Counties did not receive any revenues from those lands (through taxation, royalties, agricultural use, etc.). So the Mineral Leasing Act provided the States 50% of the royalties to compensate for the loss of revenues from the Federal Lands (Bankhead Jones Act provided 25% to the Counties for acquired lands). Today the lack of revenue generation (other than the sharing of the royalties as provided for by the Mineral Leasing Act and the Bankhead Jones Act) from those Federal Lands is still the case, so why should the State's share to compensate for the lack of revenue be reduced by 2%?

The final area that I was asked to discuss is the Royalty Policy Committee (RPC) report on MMS. I was asked as STRAC's chair to discuss STRAC's opinion and views of the report. Unfortunately, do to the timing of this hearing and the report, STRAC has not had an opportunity to meet as a whole and discuss the report. However, several STRAC delegations have provided comments to me upon learning that Congress wanted STRAC's views of the report. See attachment 2 for a summary of those comments about the recommendations. Note that these are not STRAC views as a whole, just a summation of views as presented by several STRAC delegations to myself.

I would sum up the comments on the RPC report to be that the report highlights many important areas of concern, but STRAC delegations should have a voice in how those concerns are corrected and addressed.

In closing, the STRAC delegations have been very successful in the past at collecting additional royalties owed from Federal Lands. However, the MMS has consistently shown over the last several years that they are not interested in accepting STRAC's opinion or more recently even willing to ask for STRAC's opinion, despite the fact that they profess STRAC to be their partner. With the increase in oil and gas prices over the last two years bringing on a flurry of activity that hasn't been seen for over twenty years, now is not the time to be reducing audits and compliance activities and resisting improving a system that has many problem areas.

This concludes my formal testimony. Thank you for the opportunity to appear before the Committee today. I will be happy to answer any questions you may have and to go into more detail surrounding these issues.

## Attachment 1

### STATE AND TRIBAL ROYALTY AUDIT COMMITTEE

**State of Alaska • Blackfeet Nation • State of California • State of Colorado  
• Crow Tribe • Fort Peck Tribes • Jicarilla Apache Tribe • State of  
Louisiana • State of Montana • Navajo Nation • State of New Mexico • State  
of North Dakota • State of Oklahoma • Shoshone & Arapaho Tribes •  
Southern Ute Indian Tribe • State of Texas • State of Utah • Ute Indian  
Tribe • Ute Mountain Ute Tribe • State of Wyoming**

Jay Norman, Chairman (505) 827-0986  
Harold St. Goddard, 1st Vice Chair (435) 722-5141  
Inge-Lise Goss, 2nd Vice Chair (801) 297-4608

Former Ex Officio:  
Ellwood V. Soderlind  
(307) 777-6467

January 15, 2003

R. M. "Johnnie" Burton, Director  
Minerals Revenue Management  
Minerals Management Service

1849 "C" Street NW. Room 4212  
Washington, D.C. 20240

Dear Ms. Burton:

On behalf of the State and Tribal Royalty Audit Committee (STRAC), we are writing to request that you immediately withdraw the "Guidelines Regarding Statute of Limitations for Demands, Orders and Appeals Decisions for Federal Leases," which were approved by you on October 15, 2002. With all due respect, the "Guidelines" cannot be considered legally binding upon pending appeals and audits involving any minerals produced from Federal lands prior to September 1996. The "Guidelines" are inconsistent with the Royalty Simplification and Fairness Act (RSFA) and its legislative history.

Under RSFA, Congress set a 7 year statute of limitations on judicial actions and demands relating to oil and gas produced from Federal leases after August 1996. 30 U.S.C. '1724(b)(1). Under the "Guideline" the preclusive reach of '1724(b)(1) would be expanded, as a matter of MMS policy, to include the following additional categories of royalty matters:

- Orders to perform issued both before and after the '1724(b)(1) effective date;
- Pending administrative appeals of demands for royalties owed on oil and gas produced before the '1724(b)(1) effective date;
- Pending audits of royalties on oil and gas produced before the '1724(b)(1) effective date, including outstanding issue letters, draft demands or demand letters resulting from such audits;
- Audits, demands, orders to perform and appeals, related to minerals other than oil and gas produced from Federal lands either before or after the '1724(b)(1) effective date.

Under the terms of the "Guidelines," the Minerals Revenue Management and Appeals Division staff, as well as auditors under RSFA Section 205 audit agreements, are required to implement this guidance effective immediately. In short, through this policy statement, MMS has legislated its own 7 year statute of limitations applicable to audits, orders, demands and appeals not covered by RSFA '1724(b)(1).

As set out in the "Guidelines," the only way that an audit program can avoid application of this binding norm<sup>1</sup> to the royalty matters listed above is through retroactive application, often post-audit, of a fact bound compelling circumstance standard that has no known statutory origin. While MMS staff has informed us that all of the factual circumstances that may be considered compelling, are not set forth in the Guidelines, both that standard and the 7 year norm substantially limit audit judgment and discretion.<sup>2</sup> Moreover, the "Guidelines" are currently being applied by MRM/Lakewood to reduce State drafted demand orders without the benefit of any standards on what will be considered a compelling circumstance, other than the "Guideline" examples.<sup>3</sup>

The only legal justification for the policy set forth in the "Guidelines," is the legislative intent of RSFA not to pursue claims for royalties due more than 7 years before a demand or order to pay or to perform restructured accounting.(p.2) With regard to this justification, STRAC briefly notes the following:

- Through Section 11 of **RSFA, Pub. L. 104-185, 30 U.S.C. Sec.1701** note, Congress provided that RSFA amendments shall apply with respect to production of oil and gas after the first day of the month following the date of the enactment of this **Act [August 13, 1996]**, unless a particular provision specified otherwise. RSFA, including the 7year limitation period, was intended to be applied prospectively only. The statute of limitations established here [RSFA] is prospective only, meaning that obligations arising from production of oil or gas from Federal leases prior to enactment of this bill are not affected, House Report 104-667, p. 18, reprinted in 1996 **USCAN 1442, 1447-1448** [emphasis supplied]. Instead of being supported by RSFA's legislative intent, the policy set forth in the "Guidelines" is directly contrary to Congress's expressed intent under RSFA and contrary to standard principles of statutory construction. See e.g., 73 Am. Jur. 2d Statutes '245 (even where congress is silent, the presumption is that a statute is prospective only); *Chevron USA, Inc., v. NRDC*, 467 US. 837, 842-843 (1984) (agency must give effect to the unambiguously expressed intent of Congress).
- Under its plain language, RSFA's 7 year limitations period does not apply to orders to perform restructured accounting, whether those orders are issued before or after August 1996. Instead, RSFA's 7 year limitations period applies only to a judicial proceeding or demand. 30 U.S.C. '1 724(b)(1). A demand, as defined in RSFA Section 1, 30 U.S.C. '1 701 (22), includes only orders to pay, not any and all Administrative orders as stated in the "Guidelines"(p.1). Applying the 7 year limitation to orders to perform is inconsistent with the fact that the stat-

ute of limitations, if one exists, is tolled once audit is initiated<sup>4</sup>; limiting the scope to seven years prior to the date of such an order does not give the public credit for the tolled period.

- The expansion of the 7 year limitation to the categories of appeals, demands and audits listed above does not comport with the statute of limitations case law applicable to such matters. Representatives of the Solicitor's Office have repeatedly and publicly stated that the Department has not acquiesced in the decision in *OXY USA, Inc. v. Babbitt*, 268 F. 3d 1001 (10th Cir. 2001).<sup>5</sup> Even to the extent that the decision is controlling, however, it does not preclude all means of collection of royalty debts; it applies only to judicial actions initiated by the Department to collect royalty debts. As the 10 Circuit emphasized, 28 U.S.C. '2415 includes two narrowly drafted exceptions to the time-bar, permitting the government to defensively assert time-barred claims by way of offset or counter claim. 268 F.3dat 1106. Moreover, application of the statute of limitations, if any, is not an issue subject to administrative resolution. E.g. *Marathon Oil Co.*, 149 IBLA at 290-291.

Under RSFA 30 U.S.C. '1735 and its predecessor, any standards applicable to delegated state audits are required to be promulgated by rule, not agency proclamation. Cf. *IPAA v. Babbitt*, 92 F.3d 1248, 1256 (D.C. Cir. 1996) nothing in DOI's procedures vest authority in the Associate Director of MMS..., or even the Director to issue proclamations binding on the agency. RSFA also requires that standards be designed and implemented only after consultation with State authorities. E.g., 30 U.S.C. 7 735(d). The "Guidelines" were issued without notice to or consultation with States, and, thus, in this respect too, are directly contrary to congressional intent.

While MMS may have some enforcement flexibility with regard to individual royalty cases, it does not have unfettered enforcement discretion. See e.g., cases cited supra footnote 2. In fact, Interior shall give priority to those lease accounts identified by States and Tribes as having significant potential for underpayment. 30 U.S.C. '1711 (c)(1). This mandatory language limits any arguable power of MMS to unilaterally discriminate among issues or cases it will pursue. *Heckler v. Chaney*, 470 U.S. 821, 833 (1991).

In sum, the "Guidelines" are simply another instance of an advance MMS policy statement that, as in the past, will only serve to complicate and confuse the audit and collection process, and lead to unnecessary litigation. There is no identification of any statutory authorization and, to our knowledge, no Solicitor's or other legal opinion, government regulation or case law supporting what is, in essence, a waiver of royalty debts. Cf. *American Central Gas Companies, Inc.*, 156 IBLA 367, 371 (2002) (MMS has no authority to waive interest). Indeed, according to MMS staff, these guidelines were issued without any analysis of the potential revenue loss, either in terms of royalty income or wasted audit resources.<sup>7</sup>

What is even more unfortunate, in STRAC's view, is what the "Guidelines" suggest about Interior's current attitude toward State and Tribal participation in the royalty audit program. State and Tribal audit programs are not a subdivision of the Federal bureaucracy. Instead, each STRAC jurisdiction represents an independent and sovereign government. While there has always been some disagreements in the relationship between the MMS and STRAC jurisdictions, it is a working relationship that Congress sanctioned first in FOGRMA and then in RSFA by requiring MMS to, in effect give these jurisdictions a full seat at the table. Because of their expertise and more direct financial interest (and because of Federal mis-steps), Congress wanted the States and Tribes to be active participants and watchdogs over the federal collection of revenues owed to their jurisdictions, not passive subordinates of a Federal bureau or hapless recipients of whatever MMS determines. The issuance of the "Guidelines" was not only inconsistent with Secretary Norton's public commitment to Consultation, Communication and Cooperation, it was also a serious step backwards in over 20 years of slow but steady progress in forging mutually acceptable compromises and an amicable working relationship on royalty matters. It is particularly disheartening to see the legacy of Secretary James Watt being casually disregarded by today's Department.

The next STRAC/MMS meeting is scheduled for February 4-5, 2003 in Sacramento, California. We understand that you are currently scheduled to attend that meeting. Our hope is that you will have withdrawn the "Guidelines" before that meeting. If not, we request that you or someone designated by you, be prepared to respond in detail to the legal and administrative issues out lined above. We also ask that MMS disclose for STRAC's review all of the Departmental documentation that would explain the genesis of the "Guidelines". We trust that Interior is open to providing such information voluntarily, but nonetheless, as a formality, we will submit a request under the Freedom of Information Act.

If you have questions regarding this letter or the issues, please feel free to call me at 505-827-0986.

Sincerely,

Jay Norman STRAC  
 Chairman  
 State of New Mexico  
 Taxation and Revenue Department  
 Oil & Gas Bureau  
 1200 S. St. Francis Drive  
 Santa Fe, NM 87509  
 inorman@state.nm.us

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<sup>1</sup> Cf. *American Business Assoc. v. US.*, 627 F.2d 525,529 (D. C. Cir. 1980)

<sup>2</sup> Compare *Shell Oil Co. v. EPA*, 950 F. 2d 741, 763-764 (D. C. Cir. 1991); *Alliance for Bill Integrity v. Shalala*, 11 F. Supp. 2d 166, 171 (D.C. Cir. 7P97Xenforcement Discretion limited to decisions in individual cases; does not extend to broader policies imposed on categories of agency matter).

<sup>3</sup> The example set forth in the "Guidelines" (p-2) misstate the reality of MMS's pre-1996 audit program and enforcement practice. For example, prior to 1996, MMS and the Solicitor's Office simply refused to use its subpoena power, despite State/Tribal requests and lessee refusal to turn over documents. Indeed, according to MMS staff, there are no outstanding subpoenas relating to the pre-1996 time period. Moreover, MMS does not conduct fraud audits and never has. Thus the examples of compelling circumstances listed in the "Guidelines" are essentially administratively meaningless.

<sup>4</sup> E.g. *Phillips Petroleum v. Lujan*, 963 F.2d 1380 (10th Cir. 1992).

<sup>5</sup> E.g. *Marathon Oil Co.*, 149 IBLA 287, 291 (1999); *Amoco Production Co.*, 144 IBLA 135, 140 (1998) (Int'rior is not obligated to follow decisions of federal courts, especially if contrary decisions exist or are likely).

<sup>6</sup> Cf. *Opinion of Office of Legal Counsel, US. DOJ* (July 28, 1998).

<sup>7</sup> It was also disturbing to learn from MMS staff that, while issued under your and the Associate Director's signatures, the Guidelines were actually a product of a decision made elsewhere in the Department and with little, if any, input by MMS itself.

## Attachment 2

### RPC Report Comments/Key Recommendations

Report was released without any STRAC involvement or comments. As stakeholders we should have some say.

Report recommendations 4-1, 4-4, 4-5 and 4-9 which identify development of Risked Based audit and compliance strategies, tools and pilot projects. States and Tribes should be directly involved in this development as each State and Tribe is unique in nature as it relates to oil and gas production and valuation.

Recommendation 4-16 which identifies that the DOI should improve processes and procedures associated with calculating interest on royalty payments. This recommendation should go even further. DOI should work with Congress in deleting the requirement that the federal government pay interest on overpayments.

Recommendations 3-16 and 3-17 which identifies that the DOI/MMS should implement gas plant studies and periodic reporting. This recommendation, if implemented would strengthen the audit and compliance functions and would support recommendations 3-15 and 3-27.

Recommendations 3-15 and 3-27 which identifies development and implementation of new software to perform accounting comparisons between Production and Royalty reporting and enforcement of accurate reporting via written orders and civil penalties. If implemented, it also would support validating incorrect reporting and would ensure that the audit and compliance functions are working from accurate data.

Recommendation 5-5, 5-6 and 5-7 which identifies that the BLM/MMS should coordinate onshore production issues in conjunction with royalty reporting. This implementation should go beyond the Federal Government entities and incorporate shareholders from States and Indian Nations.

On page 57, E. Royalty Collections As a Result of Audit and Compliance Activities: It reinforces how good compliance reviews are because of the large increase in collections as summarized in Table 9 on page 58. Are there any new compliance review collections that wouldn't have existed through exception processing (auto-

mated), which includes AFS/PAAS comparisons (\$56 million in 1999), AFS exceptions (\$12 million in 1999) and allowance exceptions (\$101,000 in 1999)?

Recommendation 4-27 for revising regulations and guidance for calculating solid minerals prices especially for non-arms-length transactions. This has been discussed on numerous occasions at the RPC Coal Subcommittee. If MMS implements this recommendation it will enhance our solid minerals audits.

**Response to questions submitted for the record by Dennis Roller, Audit Manager for the North Dakota State Auditor's Office—Royalty Audit Section for the Minerals Management Service**

Mr. Chairman, I want to thank you for the opportunity to provide testimony at the hearing and the opportunity to provide further clarity and information for your additional questions.

**Question 1:**

Mr. Roller, if a company has an estimated payment on file, and they don't report their royalties by the due date, the system assumes that they didn't owe any royalties and pays them interest on the entire estimated payment?

**Answer 1:**

Yes, that is correct. The system does not do a check of the production report (Oil and Gas Operations Report - OGOR) to determine if there were actual sales that royalties have not been paid on. It just automatically pays interest on the estimate. Of course, with my testimony about the state of misreporting, the check I just mentioned would not be useful since the MMS doesn't have complete and accurate OGOR data. It all hinges on having complete and accurate data.

**Question 2:**

Mr. Roller, about two years ago, the House adopted an amendment to the Interior Appropriations bill that would have increased STRAC funding by \$1 million. It had bipartisan support, and showed our interest in making sure that STRAC was adequately funded. Has STRAC seen any additional funding recently?

**Answer 2:**

STRAC did see an increase of \$500,000 in the total STRAC FFY07 budgets—per MMS. I nor does any one STRAC delegation have all delegations budget levels to know that the total STRAC delegations budgets were increased. The reason STRAC was given by MMS that the increase was only \$500,000 rather than \$1 million is because of how MMS views the budget. MMS feels that the base budget for STRAC at that time was \$6.9 million—which is based on the 1996 DOI budget justification document (page 134). In the 1996 DOI budget justification document, \$6.9 million was requested as STRAC funding. Since 1996, MMS does not mention total STRAC funding in their budget justification document. Instead, the MMS tells STRAC that the base funding is \$6.9 million and any additional funding the MMS gives STRAC is out of the MMS budget. So for FFY06, the MMS funded STRAC at \$8.6 million (\$6.9 million base and then \$1.7 million out of the MMS budget). Then in FFY07 (the year Congress adopted an amendment for \$1 million more funding for STRAC), the MMS funded STRAC at \$9.1 million (\$6.9 million base, \$1 million amendment, and \$1.2 million out of the MMS budget).

**Question 3:**

Mr. Roller, I understand you have an example where a company reported a negative royalty by accident and got paid interest on that. Could you explain that situation?

**Answer 3:**

Because of the proprietary nature of the company 2014 reporting I will change the company name when I explain the situation. See Exhibit I for the detailed 2014 and interest lines and see below for a written explanation.

For the October 2001 oil sales on lease 2550898320, due November 30, 2001 (the company did not have an estimate), XYZ Company in May 2002 paid on document # ROY100011534 a negative \$928.11. The MMS paid XYZ company interest in the amount of \$22.41 (interest invoice #INT100015538)—interest calculated from the due date of November 30, 2001 until the paid date in May 2002. The interest was paid as the system assumed it was an over payment (since it was negative payment). Then in June 2002 on document #ROY100014923, XYZ Company paid \$928.11 making the royalty royalties paid for October 2001 to be \$0. The MMS then billed interest of \$3.56 (interest invoice #INT100036045) for the late paid royalties.

I have no clue how the interest was calculated as it should have been calculated from the due date of November 30, 2001 to June 2002 when paid—but that would be more than what was originally paid to XYZ of \$22.41. In fact one month's interest at the 6% rate applicable at the time on \$928.11 is over \$4.50, so I'm puzzled how the amount billed is only \$3.56. Finally, in May 2007 the company paid over \$7,300 (based on a ND OGOR to 2014 comparison finding) for the October 2001 royalties on document #ROY100154907. No interest to date has been billed on this collection (latest interest information MMS has provided is through December 2007). Although, today (3/27/08) in a conference call with States and Tribes the MMS director, Randall Luthi, assured us that interest billing was current. Net effect is that the company has been paid \$18.85 (\$22.41 paid to XYZ less \$3.56 billed to XYZ) to borrow money from the MMS for a month and to pay their \$7,300 of royalties owed over 5 years late.

I hope these additional answers and explanations help you to better understand my testimony and the challenges the delegations have and are currently facing.

All XYZ Company 2014 Information for lease 2550988320 for sales month October 2001

PR CO	Payor Name	Document Id	LEASE #	SALE DATE	REP DATE	Receipt Date	SALES QUANTITY	SALES VALUE	ROYALTY VALUE	Unit Price	Royalty Rate
01	XYZ Company	ROY100015538	2550988320	10/31/2001	5/31/2002	17-May-02	-364.79	(\$7,424.91)	-928.11	20.35593	0.124999
01	XYZ Company	ROY100014923	2550988320	10/31/2001	6/30/2002	28-Jun-02	364.79	\$7,424.91	928.11	20.35593	0.124999
01	XYZ Company	ROY100154907	2550988320	10/31/2001	5/31/2007	14-May-07	814.15	\$18,571.37	2071.42	20.3542	0.125
01	XYZ Company	ROY100154907	2550988320	10/31/2001	5/31/2007	14-May-07	2072.92	\$42,192.63	\$274.08	20.3542	0.125

Interest Invoiced Information XYZ Company for lease 2550988320 for sales month October 2001

Name	Invoice	Invoice Date	Doc	Access Code	Am. Due	Pay on Bill Ref ID	Lease	Site Month	State	County Name
XYZ	INT100015538	6/14/2007	18-Jul-07	LPROY	-22.04	ROY100011534	2550988320	10/31/2001	ND	Golden Valley
XYZ	INT100015538	6/14/2007	19-Jul-07	LPROY	-0.34	ROY100011534	2550988320	10/31/2001	ND	Golden Valley
XYZ	INT100015538	6/14/2007	18-Jul-07	LPROY	-0.03	ROY100011534	2550988320	10/31/2001	ND	Golden Valley
XYZ	INT100036045	6/14/2007	19-Jul-07	LPROY	18.85	ROY100014923	2550988320	10/31/2001	ND	Golden Valley

XYZ does not have an estimate for this lease.

Document ROY100011534 (red highlight) was 5 months late but also created a negative royalties paid balance (negative \$928.11). Interest on that document was paid to XYZ for \$22.41 (yellow highlight). A little over a month later on 6/28/02 XYZ corrected (document ROY100014923 - light blue highlight) the negative royalties balance to 50 royalties paid. The MMS system then calculated and billed interest of \$3.56 (green highlight) to XYZ. Not sure how the \$3.56 was calculated. Then on 5/14/07 (document ROY100154907 purple highlight) XYZ finally pays what is actually owed based on our work of over \$7,300 and interest has not been billed - up to 12/31/07 - the last point at which MMS provided our information with interest information.

Net effect is that XYZ was paid \$18.85 (\$22.41-\$3.56) interest to basically borrow money from the MMS for a month and to not pay the royalties owed for over 5 years.

Mr. COSTA. Director Luthi, in reference to the comments that Mr. Roller made, last year, as you know, a Federal Court ruled that the Minerals Management Service's guidelines about not pursuing certain unpaid royalties were unlawful.

About a week and a half ago I sent you a letter that was signed by some of my colleagues asking for details on how you were planning to follow up on the cases that you stopped because of the, as the Court said, unlawful guidelines. Can you provide any information yet, and what the follow-up is on these cases that were dropped?

Mr. LUTHI. Thank you, Mr. Chairman. I did receive your letter. We put it into our system, and I had asked to get a response as soon as possible. I would like to wait until that written response is available so I know it is accurate.

Mr. COSTA. All right. Well, speaking of your system, I understand that Accenture, the computer company or the company that was contracted with, received \$150 million on a program that it seems, based on the testimony here this morning, isn't working, at least to the expectation levels. Some have said it is a failure. Some said that, in part, because a new contract was awarded last fall.

When you awarded the new contract last fall, did you factor in the shortcomings of the previous contract, and are we going to be able to get beyond this, what I would refer to as green eye shade approach of accounting that the Department seems to be plagued with?

Mr. LUTHI. Mr. Chairman, appreciate the question. Accenture was the contractor that put together this system. As you might guess, this isn't an off the shelf system, and now, frankly, it has been a challenge to make it work. The award that you mentioned last fall is currently under review one more time because one of the

other contractors asked some questions, and we are going back and looking at the award.

I think in general the answer to your question is it is a system that has not been perfect, we have had to go in and make several changes to it, but it is to the point now where it is working and it is working I would say for the most part effectively. We are going to continue to work with it. I think it is going to make more financial sense to stay with the current program rather than try to throw it out and start all over again.

Again, it is not a system that you normally see. It has to be a system that can calculate interest, which was difficult for it to do, it has got to recognize different production values—

Mr. COSTA. I appreciate the complexity, but this is something that we will continue to follow obviously. It seems to frustrate a lot of us. Mr. Finfer, could you describe a little more detail what MMS could learn about how the Internal Revenue Service handles its compliance activities?

Mr. FINFER. Yes, sir. We consulted with the IRS on the risk-based approach. Again, they have 40 years more experience in this.

Obviously they are dealing with a much more complex universe, many more industries, many more layers and so on, but in meeting with a wide variety of their senior managers, and I must say IRS was very generous about affording us the time with them, one of the key things that came out was you have to have a very strong data support system and underlay.

Without good data, without reliable data and data system support it is very hard to implement a risk-based approach. Another thing was that you are never in a situation where you can set it and forget it. Your work is never done. What is today's big risk may not be a big risk tomorrow and vice versa, so you have to constantly evolve the system through constant evaluation, feedback, retooling and so on.

Third, that a fundamental objective of a risk-based approach isn't necessarily increasing collections, per se, but it is identifying behaviors which might not necessarily be costing the taxpayers a lot of money now but if they proliferated would cost a lot of money and getting on those quickly so that you don't create problems. Those were among the many key insights.

Mr. COSTA. No, and there were a lot of recommendations. My time is quickly going. I am really intrigued with this further development. I was talking with the Ranking Member on risk assessment versus risk management because, frankly, I think there is a lot to be gained in that area. I also believe, whether we are talking about in this instance or whether we are talking about health and safety, it is one of the areas that we in government generally perform poorly.

That is my opinion. Quickly, your reports mention the possibility of an alternative government structure for the Royalty-in-Kind Program. Could you describe what those are?

Mr. FINFER. Yes. Royalty in kind involves the government operating an enterprise pure and simple. Unless one is opposed to that, and some are, but if you are not opposed to that then obviously the goal needs to be to enable it to operate effectively as a business to get the greatest net returns for the taxpayers.

So we recommended a cost benefit analysis of potential alternative governance structures. This might include, for example, something comparable to what is called an FFRDC, Federally funded research and development center, like the National Labs. Those sorts of entities are tied to the respective departments, in that case, DOE, and in this case it would be tied to Interior and MMS.

The advantage of that structure is that they would be freed from some of the strictures that inhibit the ability of the program to operate like an enterprise. For example, some of the personnel requirements they would be free from so that they could compete to get high quality personnel, there wouldn't be any question about whether they had followed contracting procedures that other programs might have to follow.

However, we said at the same time that if an alternative governance structure is proposed to the legislation it would need to be balanced by heightened oversight. There is a trade off here. If you are going to get more freedom to operate, you also need to have heightened oversight.

In that case, we recommended the establishment of an independent oversight board which would have the power to make recommendations to the Secretary which the Secretary would have to respond to with a published finding as to why he or she accepted, modified or rejected the board's recommendations.

Mr. COSTA. All right. I have gone beyond my time, but I would like to ask unanimous consent that a statement from the Project on Government Oversight be entered into the record. Without objection.

Mr. Pearce will be the last questioner. With his indulgence, though, if you could give me a quick response, Mr. Roller, do you see any positive changes as a result of the recommendations MMS has already implemented? Quickly, because I have exceeded my time.

Mr. ROLLER. To be honest, I haven't had any experience in knowing what recommendations have been implemented that weren't discussed with STRAC or anyone.

Mr. COSTA. Well, obviously you can answer it very quickly then. I may follow up with you then on that question. The gentleman from New Mexico has his time, and when he completes his questioning we will conclude this hearing.

Mr. PEARCE. Well, we may not complete my questioning until 2:00 or 3:00 then. I am sorry to hear the gentleman say that.

Mr. COSTA. I won't be here until 2:00 or 3:00.

Mr. PEARCE. OK, thank you, Mr. Chairman.

Mr. COSTA. Godspeed.

Mr. PEARCE. Mr. Luthi you heard the testimony of Mr. Rusco feeling like all the oil and gas operators are out there to cheat the American government and the American people. What would it take to cheat on your royalties? Beginning at what level to be significant?

Mr. LUTHI. Thank you, Mr. Chairman.

Mr. PEARCE. Scoot it closer, if you would, and push the button. There we go.

Mr. LUTHI. There we go. To paraphrase your question a little bit, what would it take to cheat on the royalties? It takes quite a com-

plicated process as far as I can understand because your royalty is developed upon a basic formula of volume, value and the royalty that is set. The only set standard there is the royalty amount, rather, the 18 and three-quarters percent, 12.5 percent, whatever that is.

So then you go back and you look at the volume and the value of either the gas or the oil. The volume is normally run through at least one, if not several, meters, so there is an opportunity to——

Mr. PEARCE. So you would have to have meters that don't work that have been jimmed with, and then you would have to have complicity up and down. In other words, if the guy at the top, the CEO, says cheat, you have to have the mid-level say cheat, and then he has got to have a guy at the field level say cheat and they all have to kind of agree, but then you have different operators at the well.

So if I can get this guy over here on the ground that actually pumps and works that well to cheat, I have to also get every single guy out there at field level. CEO, you could get one guy that issues the instructions, then you get different mid-level people, but you have individuals on the ground.

If one of them says I am not going to do that, I am going to report, isn't that—I just find that absurd that we have a GAO report that begins to say that we have that sort of—have you all stumbled on any kind of complicity like that throughout the nation?

Mr. LUTHI. No, we haven't, Congressman.

Mr. PEARCE. OK. All right. The document that came out, actually, as we looked through it, it came up with a lot of findings and about 100 or more recommendations, but at the beginning it says the process is working well, but, yes, it could be tuned up a lot. How many of those findings had you already started implementing even maybe before the findings were given or since you have seen the report?

Tell me a little bit about the contrast of MMS today versus maybe the MMS of the Clinton years?

Mr. LUTHI. That is going back a few years, but, yes, many of the findings, especially those 16 that I referenced in my testimony, we actually had underway. A good example of that—or they were the easy ones to fix—one of those was the Indian Oil Valuation Rule. That particular one wasn't an easy fix.

It is a very complex rule, it is an important rule. What it does is help clarify how we value Indian oil. That is out, it is on the street, it is out there now. Other things that we did, we did recommend, and it has been done, we have the subcommittee now dedicated to RIK. We have increased some security, the easy stuff, on the computers, the passwords.

The coordination was a big factor, which I thought the subcommittee did an excellent job of identifying, and we have broken down some barriers. It is amazing to me, as coming from a small, you know, Wyoming I would say bureaucracy and a legislature, to see how we do get on our own stovepipe area.

We don't have a chance for those that are actually monitoring the meters, seeing the producers on a daily basis don't always have that coordination with those that are actually requesting the

money be paid. We have broken that down. We are very pleased with the progress—

Mr. PEARCE. Well, I think that is an important piece to know from this hearing today. One report says that you are doing fairly well and you are even implementing many of the findings before and during. By the way, you can go out to New Mexico. They spent almost \$200 million.

I was on the Appropriating Committee trying to work out this thing or trying to figure out the royalty payments, and New Mexico's budget at that time was maybe \$2 billion and we spent \$200 million, so you can imagine kind of how trying that was because it is very complex.

Mr. Finfer, if it is that complex to figure out the royalties because the wellhead prices are different every day, you have a floating price, and then you got people that got all these partners, and subpartners, and unit operators and unit members, tell me a little bit about the Royalty-in-Kind Program.

I continue to see it to be a fairly simple operation compared to the other operation that we spent billions, or millions, or whatever. Tell me a little bit about the RIK.

Mr. FINFER. RIK isn't foolproof, but, yes, it is simpler. It is a more cut and dried process. One of the ways in which it has an advantage is, as you know, there have been many disputes about valuation over the years. Just simply writing the valuation rules took 10 years or so. In the Royalty in Value Program there are many disputes about valuations, deductions and so forth that can take quite a bit of time to resolve.

Royalty in Kind has less of that sort of a problem, and so there is a significant advantage in that regard.

Mr. PEARCE. So, if I understand you correctly, it is not foolproof, but it might be damn foolproof, so, if you get it narrowed down. OK. Mr. Chairman, I see my time is up. We have come within one minute of your expectations of a noontime adjournment, so I would thank you for your indulgence all day long. I appreciate it.

Mr. COSTA. Thank you, Mr. Pearce, the gentleman from New Mexico. We will continue to work with the various parties on this issue, and we will look at the recommendations and see if we can figure out a way in a collaborative fashion that we can peruse those as I think Mr. Deal said tune up. I kind of like that term. Every once in a while I need a tune up.

So I want to thank all the witnesses for your testimony and your patience. We look forward to continuing to work with you. I have some comments I need to make here. We want to note for the members of the Subcommittee that if they have additional questions for witnesses, we will ask you to respond to these in writing.

The hearing record will be held open for 10 days to allow those responses to be submitted. If there is no further business before the Subcommittee, once again, I want to thank the members of the Subcommittee, and the staff and all those who worked to put this hearing together. The Subcommittee now is adjourned.

[Whereupon, at 12:03 p.m., the Subcommittee was adjourned.]

[Additional material submitted for the record follows:]

[A statement submitted for the record by The Honorable Adrian Smith, a Representative in Congress from the State of Nebraska, follows:]

**Statement of The Honorable Adrian Smith, a Representative in Congress  
from the State of Nebraska**

Good morning. There are a number of challenges facing domestic oil and gas production, and I thank you, Chairman, for holding this hearing today on the "Recent Recommendations for Improving the Federal Oil and Gas Royalty System."

As Congress continues to examine our energy needs, we must encourage and promote the development and utilization of domestic oil and gas production. We can sustain this goal while ensuring federal management practices meet the highest standards.

While oil and gas production on federal lands generates revenue from royalty payments, all domestic oil and gas production generates revenue from corporate and personal income taxes. As my home state of Nebraska has seen an increase in production on non-federal land, I am very interested in how this also contributes to the federal treasury.

I appreciate the Subcommittee for holding this hearing today on the recommendations for improving the Minerals Management Service. I look forward to hearing from the Department of the Interior, the Government Accountability Office, the Inspector General's office, the Internal Revenue Service, and all of our witnesses. What we learn here today will play a critical role for achieving the greatest possible benefit from our vital, irreplaceable natural resources.

Chairman, I look forward to working with you. Thank you.

[A statement submitted for the record by Danielle Brian, Executive Director, Project On Government Oversight, Washington, D.C., follows:]

**Statement of Danielle Brian, Executive Director,  
The Project On Government Oversight**

The Project on Government Oversight (POGO) has long worked for accountability and honesty within the federal government. By that standard, we applaud the Royalty Policy Committee's report shedding light on the many problems inherent within the royalty collection systems at the Department of Interior's Minerals Management Service (MMS) and encouraging reform, oversight, and transparency. However, much of what we know about the agency from its own Inspector's General reports, press reports, Congressional oversight, state and tribal auditors, and whistleblowers leads us to believe that the Committee's report does not go far enough.

Rather than depicting MMS as "an effective steward"<sup>1</sup> of the nation's oil and gas royalty collection program, the report is a damning picture of the inability of the program to effectively collect the taxpayers' money. Combined with a recent report by the Department of Interior's Inspector General that found that the agency was collecting the largest share of non-tax revenue within the government using a "band-aid" approach, it is easy to conclude that MMS and its revenue collection agency, Minerals Revenue Management (MRM), are failing to effectively collect taxpayer money.<sup>2</sup>

Despite having spent close to \$150 million over the last several years on information technology, the report finds that MMS' technology systems, as well as MMS strategies for using those systems are failing in a multitude of areas.<sup>3</sup> It is critical the agency have an effective strategy for determining which companies to audit.<sup>4</sup> It is also critical that the agency have information technology systems that collect

<sup>1</sup>Report to the Royalty Policy Committee, Mineral Revenue Collections from Federal and Indian Lands and the Outer Continental Shelf, Submitted by: the Subcommittee on Royalty Management, with staff support from the Department of Interior, Office of Policy Analysis (Office of the Secretary) and the Bureau of Land Management, December 17, 2007, page ix. (Referred to as Report to the Royalty Policy Committee from this point forward.)

<sup>2</sup>Department of Interior. Memorandum from Earl E. Devaney, Inspector General, to Secretary Kempthorne and C. Stephen Allred, Assistant Secretary, Land and Minerals Management, September 19, 2007, page 1.

<sup>3</sup>United States Department of Interior, Office of Inspector General, "Minerals Management Service: False Claims Allegations," Transmitted on September 19, 2007, page 38.

<sup>4</sup>Report to the Royalty Policy Committee, Recommendations 4-1, 4-9, 4-19.

the appropriate information.<sup>5</sup> It is critical that the agency know for certain how much royalty is owed to the government.<sup>6</sup>

The Committee's report recommends 110 ways that improvements should be made. Many of the Committee's recommendations are straightforward common sense strategies for good management. It is easy for POGO to support making manuals and procedures available to the public, increasing communication among agencies, enhancing performance measures, conducting more studies, and ensuring better reporting for all endeavors at the agency. For instance, mandatory electronic reporting for all lessees would reduce manual entry errors, speed up calculation, and ease auditing and compliance reviews.<sup>7</sup> Additionally, POGO always supports systems that encourage whistleblowers. We urge adoption of a whistleblower hotline combined with incentives to encourage whistleblowers to come forward.<sup>8</sup>

While these nuts and bolts recommendations are key to begin reforming the ailing systems within the agency, they fail to address important questions of independence, oversight, and transparency. The Committee was charged with determining if royalty collection and audit, compliance, and enforcement systems and procedures are adequate, as well as reviewing the operations of the program to take royalties in the form of product, rather than cash. While they may have discovered 110 ways to improve these systems, avoiding reforms that target larger systemic problems will only lead to continued skepticism of the agency's ability to effectively steward the program.

Following are the four larger issues connected to reforming the agency we believe the Congress should address, as well as two areas raised by the Committee to which we are vigorously opposed.

#### **Additional Reforms:**

1. Presidential appointment and Congressional confirmation for the Director of the Minerals Management Service would provide additional oversight and scrutiny of the agency, as well as elevate the status of one of the largest non-tax revenue operations within the federal government.
2. Moving the compliance and audit function out of MMS is a critical step to improving the independence of the agency from oil and gas companies and reducing conflict of interest within the agency. The same people responsible for working with companies to see that federal lands are used to their greatest leasing potential and working in partnership with those companies to sell royalty oil should not also be in charge of auditing those companies.
3. Transparency of MMS leases, contracts, documents, and procedures is paramount to reducing opportunities for fraud and increasing public confidence in the agency.
4. An independent and public study of the royalty in kind program and its use to fill the nation's Strategic Petroleum Reserve should be commissioned to determine if this is in the best interest of the taxpayers. While this program may have many benefits, evidence is mounting that it compromises the integrity of the agency and squanders taxpayer money through inefficiencies.

#### **Areas of Concern:**

1. POGO urges the Congress to reject the Committee's recommendation that a trust fund be established and the interest used to fund audit and compliance activities without Congressional approval.<sup>9</sup> Rather we urge the Congress to reign in all spending activities outside the annual Congressional appropriations process.
2. POGO urges that any consideration of moving to market indices for gas valuation, whether for affiliated transactions or not, be carefully considered in light of continuing court cases proving manipulation by oil and gas companies.<sup>10</sup>

While this list is by no means exhaustive, it represents significant opportunities to reform the agency by taking an expansive view on what it means to be an effective steward of federal lands and funds. We are preparing in-depth comments on our primary policy objectives and concern as well as on individual chapters of the Royalty Policy Committee report, and will supply the document to the Committee

<sup>5</sup> Report to the Royalty Policy Committee, Recommendations 3-6, 3-10, 4-10, 4-16, 4-17, 4-18, 4-22.

<sup>6</sup> Report to the Royalty Policy Committee, Recommendations 3-1, 3-14, 3-15.

<sup>7</sup> Report to the Royalty Policy Committee, Recommendations 3-7, 3-11, 3-13, 3-16, 4-8, 4-21, 4-22.

<sup>8</sup> Report to the Royalty Policy Committee, Recommendations 4-6.

<sup>9</sup> Report to the Royalty Policy Committee, Recommendation 6-6.

<sup>10</sup> Report to the Royalty Policy Committee, Recommendation 4-26.

when it is complete. We appreciate the Chairman's interest in this critically important area and trust you will find our comments helpful.

We would like to sincerely thank the Royalty Policy Committee for its thoughtful and expansive work on this critical issue. We believe this report, combined with others generated in the recent past, are an urgent call for reform of the royalty system. We hope that this report will be used to springboard the agency into action so that the taxpayers are assured of receiving their fair share from the nation's mineral rich lands.

