STATEMENT
OF
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BEFORE THE
SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES
COMMITTEE ON NATURAL RESOURCES
U.S. HOUSE OF REPRESENTATIVES

GETTING ROYALTIES RIGHT: RECENT RECOMMENDATIONS FOR IMPROVING FEDERAL OIL & GAS ROYALTY SYSTEM

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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 Wentzel, 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.

<u>Allowances</u>. 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 <u>transportation costs</u>. Consistent with well-established oil and gas law, MMS regulations also allow a producer to deduct certain <u>processing costs</u>, 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.

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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.