U.S. Department of the Interior
Office of Inspector General

AUDIT REPORT

SMALL REFINERS PROGRAM, MINERALS MANAGEMENT SERVICE

REPORT NO. 00-I-279
MARCH 2000

EXECUTIVE SUMMARY

Small Refiners Program,
Minerals Management Service,
Report No. 00-I-279
March 2000

BACKGROUND

An estimated 50 small refining companies operate in the United States and account for about 11 percent of the Nation's crude oil refining capacity. Small refiners produce a variety of products, such as motor gasolines, diesel and jet fuels, and asphalt for road construction. However, because small refiners generally are independent companies that do not have their own oil production capabilities, the potential exists for these refiners to face economic adversity, including possible shutdowns of operations, when oil supplies are low or oil prices are high. To assist small refiners, the Department of the Interior takes a portion of the Federal Government's royalties "in-kind" from oil companies and sells the oil to eligible refiners to ensure that they have a constant supply. The Minerals Leasing Act of 1920 and the Outer Continental Shelf Lands Act of 1953 govern the sale of royalty-in-kind oil originating from onshore leases and offshore leases, respectively.

The Small Refiners Program is administered by the Royalty-in-Kind Section, within the Accounting and Reports Division of the Minerals Management Service's Royalty Management Program. The Small Refiners Program costs about $1.2 million to operate each year, and the Section has seven full-time positions. In administrating the Program, the Service conducts periodic sales of Government royalty oil and negotiates contracts with the participating small refiners for the purchase of the oil, which generally run for a period of 3 years. Prior to a royalty oil sale, Program regulations require the Service to conduct a study (known as a Determination of Need) to determine whether small refiners would benefit from the sale. The Service's regulations also require that the costs of operating the Program be recovered through administrative fees assessed on the participating refiners.

OBJECTIVE

The objective of our audit was to determine whether the Service had an effective strategy to correct deficiencies in the Small Refiners Program that were identified by Service, state government, and industry officials in a formal study completed in 1997.

RESULTS IN BRIEF

We concluded that the Minerals Management Service had made satisfactory progress in correcting the deficiencies in the Small Refiners Program that were identified in a formal study conducted by Service, state government, and industry officials. For example, the Service improved the process for determining the value of royalty oil and was redesigning the Program to ensure that refiners paid royalties for oil volumes received. We found, however, that the Program had weaknesses that had not been addressed. Specifically, the Service did not address the anticipated increase in demand for oil from the refiners, did not conduct royalty oil sales on a frequent or regular basis, and did not recover the full costs of administrating the Program. Program regulations (30 CFR 208.4) require that the Service conduct an analysis of the crude oil market prior to a royalty oil sale to determine whether small refiners have adequate access to supplies of oil at equitable prices. In addition, 30 CFR 208.4(b)(4) and Office of Management and Budget Circular No. A-25, "User Charges," require that the Service recover the full administrative costs of the Program. The identified weaknesses occurred because the Service's crude oil market analysis did not include potential oil available to small refiners under the 20 percent set-aside provision in offshore leases and because Program officials, in attempting to reduce the financial impact on the refiners, recovered only a portion of the administrative costs incurred to operate the Program. We found that the Service had not recovered administrative costs of about $1.9 million since fiscal year 1997.

RECOMMENDATIONS

We recommended that the Minerals Management Service require Small Refiners Program officials to ensure that the Determination of Need considers all sources of oil available to the small refiners and to conduct the Determination of Need on a regular and more frequent basis. We further recommended that the Service ensure that it recovers the full costs of administrating the Program from the small refiners.

AUDITEE COMMENTS AND OIG EVALUATION

The Service concurred with the recommendation to conduct the Determination of Need on a regular and more frequent basis but did not concur with the recommendations to consider all sources of available oil when conducting the Determination and to recover all costs of administrating the Program. As to the Determination, the Service indicated that its failure to consider the 20 percent set-aside provision was not relevant to the process. We believe, however, that the Determination cannot be valid if this potentially significant source of oil is disregarded. Although the Service held a sale in October 1999, which resulted in smaller than expected volumes of oil sold, we do not believe that the small refiners necessarily exhibited a reduced interest in Government royalty oil. Rather, the manner in which the sale was conducted may have resulted in fewer small refiners participating, in that the "established reasonable price thresholds" were greater than expected for prospective small refiners. Regarding cost recovery, the Service stated that it was recovering costs in accordance with Program regulations and that it should recover only the costs of administrating leases active in the Program. We believe that the Service should recover the full administrative costs associated with both active and terminated leases. Accordingly, the Service was requested to reconsider its responses to the report's remaining two recommendations, which are unresolved.

United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20240

MAR 27 2000

AUDIT REPORT

Memorandum

To: Director, Minerals Management Service

From: Robert J. Williams Roger LaRouche
Assistant Inspector General for Audits

Subject: Audit Report on the Small Refiners Program, Minerals Management Service (No. 00-I-279)

INTRODUCTION

This report presents the results of our audit of the Small Refiners Program of the Minerals Management Service. We initiated this audit as part of our audit workplan for fiscal year 1998. However, at the request of the Service, we agreed to reschedule the audit for fiscal year 1999 to allow the Service sufficient time to complete certain Program improvements. The objective of our audit was to determine whether the Service had an effective strategy to correct deficiencies in the Small Refiners Program that were identified by Service, state government, and industry officials in a formal study completed in 1997.

BACKGROUND

An estimated 50 small refining companies operate in the United States and account for about 11 percent of the Nation's crude oil refining capacity. Small refiners produce a variety of refined products, such as motor gasolines, diesel and jet fuels, and asphalt for road construction. However, because small refiners generally are independent[1] companies that do not have their own oil production capabilities, the potential exists for these refiners to face economic adversity, including a possible shutdown of operations, when oil supplies are low or oil prices are high. In that regard, the Energy Information Administration of the Department of Energy reported on its Web site (http://www.eia.doe.gov/emeu/cabs/usa.html) in May 1999 that "[t]he United States has experienced a steep decline in refining capacity since 1981." The report further stated that in the 1980s, the number of operating refineries

[1]Independent refiners are involved primarily in the refining of oil. In contrast, major integrated oil companies participate in additional aspects of the oil business, such as exploration, production, transportation, and marketing.

decreased from 324 to 204 and that "[s]ince 1992, about 34 additional, mainly small U.S. refineries have shut down."

To assist small refiners, the Department of the Interior takes a portion of the Federal Government's oil royalties "in-kind"[2] and sells the portion to eligible refiners to ensure that they have a constant oil supply. The Minerals Leasing Act of 1920, as amended, and the Outer Continental Shelf Lands Act of 1953, as amended, govern the sale of royalty-in-kind oil originating from onshore leases and offshore leases, respectively. The implementing regulations for the Small Refiners Program are contained in the Code of Federal Regulations (30 CFR 208).

In administrating the Small Refiners Program, the Service conducts periodic sales of Government royalty oil and negotiates contracts with the participating small refiners for the purchase of the oil. The contracts are generally for a period of 3 years. The number of refiners participating in the Program, along with the associated values and quantities of oil since fiscal year 1997, is shown in Table 1.

Table 1. Program Summary Data

	FISCAL YEARS		
	1997	1998	1999
Participating small refiners at start of year	11	6	5
Number of purchase contracts at start of year	13	8	6
Contracts covering offshore leases	9	6	6
Contracts covering onshore leases	4	2	0
Number of leases at start of year	549	212	148
Volumes of oil sold under the Program (Millions of barrels)	26.8	17.4	12.7 *
Value of oil sold under the Program (Millions of dollars)	$483.4	$237.6	$151.4*
Estimated percentage of Federal royalty oil production	32%	22%	16% *

*Amounts projected based on actual data from October 1998 through August 1999.

The reduction in the size of the Program was caused in part by refiners leaving the Program for market-related reasons, such as the availability of oil from non-Federal sources. In addition, the size of the Program was also reduced because, according to some refiners, the

[2]Under the terms of most Federal oil leases, the Federal Government may choose to receive its royalty share of oil production either in-kind (receiving a physical share of the production) or in-value (receiving a cash payment).

Service did not manage the sale and valuation of the royalty oil in a manner consistent with normal industry trade practices.

In September 1996, the Service initiated a formal study to address the deficiencies in the Program that were identified by the Royalty Policy Committee, which is composed of Service, state government, and industry officials. These deficiencies consisted of discrepancies between the oil volumes reported by the lease operator and the volumes delivered to the refiner, inconsistent oil measurement points for offshore leases, uncertainty in the valuation of the royalty-in-kind oil, and a 1-month delay in the Service's receiving payment from the refiner compared with receiving payments on royalty-in-value leases. In the report issued by the Service in September 1997 on the results of the formal study, the Service made three recommendations to correct the problems identified and established a strategy to test the planned corrective actions in a demonstration pilot. The pilot was conducted in 1998, and the Service concluded in its preliminary draft report on the results of the pilot, issued in May 1999, that the recommendations in the September 1997 report should be implemented. Service officials said that they expected to implement the improvements to the Program in time for the next sale of royalty oil to the refiners, which was scheduled for October 1999.

The Small Refiners Program is administered by the Royalty-in-Kind Section, within the Accounting and Reports Division of the Service's Royalty Management Program. The Small Refiners Program costs about $1.2 million to operate each year, and the Section has seven full-time positions. The Service requires, under its regulations (30 CFR 208), that the costs of operating the Program be recovered by administrative fees assessed on the participating refiners.

SCOPE OF AUDIT

Our audit scope consisted of a review of the Service's Program activities conducted from October 1996 through August 1999. The audit fieldwork was conducted primarily at the Service's Royalty Management Program offices in Lakewood, Colorado, where we interviewed cognizant Program officials and examined relevant records. We also interviewed cognizant officials at the Service's Policy and Management Improvement offices in Lakewood. We visited or contacted 13 small refiner companies: the 5 refiners currently in the Small Refiners Program, 5 former Program participants, and 3 small refiners that had not previously participated in the Program. Additionally, we visited or contacted the Service offices, state government offices, oil companies, and oil industry trade organizations listed in Appendix 2.

Our audit was conducted in accordance with the "Government Auditing Standards," issued by the Comptroller General of the United States. Accordingly, we included such tests of records and other auditing procedures that were considered necessary under the circumstances. As part of the audit, we reviewed the internal controls to the extent considered necessary to accomplish our audit objective. We also reviewed the Secretary's Annual Statements and Reports to the President and the Congress for fiscal years 1993 through 1995, which were required by the Federal Managers' Financial Integrity Act; the Departmental Reports on Accountability for fiscal years 1996, 1997, and 1998, which include information required by the Act; and the Service's annual assurance statements on management controls for fiscal years 1996, 1997, and 1998. We determined that none of the reported weaknesses were directly related to the objective and scope of this audit.

PRIOR AUDIT COVERAGE

Neither the Office of Inspector General nor the General Accounting Office has issued any audit reports during the past 5 years concerning the Small Refiners Program. However, during this period, the Office of Inspector General has issued two reports and the General Accounting Office has issued one report that related to the royalty-in-kind concept of collecting Federal oil and gas royalties as follows:

- In May 1996, the Office of Inspector General issued the report "Royalty Gas Marketing Pilot, Minerals Management Service" (No. 96-I-786), which stated that the Service had effectively administered the 1995 Royalty Gas Marketing Pilot and had demonstrated the feasibility of taking gas royalties in-kind as an alternative to the royalty-in-value system. The report noted, however, that there were weaknesses in the areas of pilot design, revenue collections, marketing strategies, and administrative controls. We also concluded that the 1995 pilot was too limited in scope to accurately represent gas operations in the Gulf of Mexico. Although the report contained no recommendations, it did contain suggestions for the Service to consider in the design of future royalty-in-kind pilots, such as conducting larger scale pilots with mandatory lease holder participation.

- In March 1999, the Office of Inspector General issued the report "Royalty-in-Kind Demonstration Pilots, Minerals Management Service" (No. 99-I-371), which stated that the Service was successfully managing the three royalty-in-kind pilots. However, we determined that the limited geographic coverage and products examined by the pilots would not result in a conclusive in-kind feasibility assessment for all Federal oil and gas production. The report contained no recommendations but made suggestions that we believe will enhance the effectiveness of the pilot program, such as that the Service should expand the scope of the pilots to cover additional oil- and gas-producing regions and take both oil and gas from the same leases.

- In August 1998, the General Accounting Office issued the report "Federal Oil Valuation, Efforts to Revise Regulations and an Analysis of Royalties in Kind" (No. GAO/RCED-98-242) in response to a Congressional request to address the following: "(1) the information used by MMS [the Minerals Management Service] to justify the need for revising its oil valuation regulations; (2) how MMS has addressed concerns expressed by the oil industry and states in developing these regulations; and (3) the feasibility of the federal government's taking its oil and gas royalties in kind, as indicated by existing studies and programs." The report stated that the Service (1) "relied heavily" on an interagency task force report to justify revising its oil valuation regulations and (2) solicited public comments on its proposed regulations in five "Federal Register" notices and revised its proposed regulations three times in response to the comments received. The report further stated that available information

> . . . indicates that it would not be feasible for the federal government to take its oil and gas royalties in kind except under certain conditions. These conditions include having relatively easy access to pipelines to transport the oil and gas, leases that produce relatively large volumes of oil and gas, competitive arrangements for processing gas, and expertise in marketing oil and gas. However, these conditions are currently lacking for the federal government and for most federal leases.

The report did not contain any recommendations.

RESULTS OF AUDIT

We concluded that the Minerals Management Service had made satisfactory progress in correcting the deficiencies in the Small Refiners Program that were identified in a formal study conducted by Service, state government, and industry officials. For example, the Service improved the process for determining the value of royalty oil and was redesigning the Program to ensure that refiners pay royalties for oil volumes received. We found, however, that the Program had weaknesses that not been addressed. Specifically, the Service did not address the anticipated increase in demand for oil from the refiners, did not conduct royalty oil sales on a frequent or regular basis, and did not recover the full costs of administrating the Program. Program regulations (30 CFR 208.4) require that the Service conduct an analysis of the crude oil market prior to a royalty oil sale to determine whether small refiners have adequate access to supplies of oil at equitable prices. In addition, 30 CFR 208.4(b)(4) and Office of Management and Budget Circular No. A-25, "User Charges," require that the Service recover the full administrative costs of the Program. The weaknesses identified occurred because the Service's crude oil market analysis did not include potential oil available to small refiners under the 20 percent set-aside lease provision and because Program officials, in attempting to reduce the financial impact on the refiners, recovered only a portion of the administrative costs. Because the Service did not conduct a complete analysis of the oil market, the oil volumes in the next royalty sale will not likely be sufficient to satisfy the expected increase in demand from the small refiners. Further, the Service has not recovered administrative costs of about $1.9 million since fiscal year 1997 (see Appendix 1).

Program Improvements Completed or In Progress

We concluded that the Service was making progress in correcting the deficiencies in the Small Refiners Program identified by the formal study. As part of this effort, the Service has held discussions with Program participants since 1996 to create what they consider to be a commercially oriented Program that operates more efficiently and is more responsive to the oil industry. The small refiners that we contacted generally agreed that this objective was being achieved and indicated that they were interested in purchasing the royalty oil. Although they attributed this interest in part to the fact that the Program represented a rare source of supply that can be secured for long-term periods at reasonable prices, the refiners also credited the Service with improving the Program significantly over the past 2 years.

The specific deficiencies and the actions that were implemented or were being considered to correct the deficiencies were as follows:

- Before fiscal year 1998, the small refiners' oil purchase contracts authorized the Service to review the validity of the valuation methodologies used for royalty payments and, if warranted, assess additional royalties up to 7 years after the initial payment. As a result, time-consuming and expensive disputes with the refiners occurred concerning the proper valuation of the oil. The Service, however, corrected this Program deficiency in fiscal year 1998 by negotiating price formulas into the oil purchase contracts, an action that prohibits any redetermination of the values. We believe that the price formulas provide the refiners with a simple methodology to value the royalty oil, and compliance is readily verifiable by the Service. Service officials said that they were satisfied that this approach did not result in reduced royalty collections and that they intended to negotiate price formulas into future contracts with the small refiners.

- The Service has not adopted the standard industry practice of basing payments on the volume of oil delivered by the lease operator. Instead, the Program requires that royalty payments be based on the volume of oil that the refiner is contractually entitled to receive from the operator. As a result, small refiners paid royalties for undelivered oil. To illustrate, the volume of oil delivered to the refiner for a given month is based on an estimated production amount. However, the lease operator regularly produces a volume different from the estimate, creating an "imbalance." Because royalties are due on the volume of oil produced (the entitlement volume), the refiner may pay royalties on an oil volume that it did not receive. Service officials said that they bill the refiners based on entitlement volumes because these volumes "in theory" should equal delivered volumes. Although the lease operator corrects imbalances by overdelivering or underdelivering oil in future months or by making cash payments as necessary, this creates a burden for the small refiners that do not have sufficient financial resources. For example, one refiner stated that it had paid more than \$1 million of royalties for oil which had not been delivered and that after more than 1 year, the volume imbalance had not been fully corrected. At the time of our audit, the Service was reviewing options that would base royalty payments on delivered volumes. Service officials stated that this Program deficiency would be corrected before the October 1999 Government royalty oil sale to small refiners.

- The small refiners have been critical of the Program because it requires surety instruments to be posted for what they consider to be excessive periods of time. Program regulations (30 CFR 208.11) require a refiner to provide a surety at the beginning of a contract covering an amount estimated to be equal to a 99-day purchase of royalty oil and require the surety to be enforceable for 9 months after the contract terminates. We found that these time periods were longer than the industry standard of 50 to 60 days and resulted in less money available for refinery operations. The refiners stated that the Government did not benefit from its surety policy because the extra costs incurred by the refiners were passed on to the Government through lower prices offered for the oil. However, Service officials said that the Government should be fully insured against possible loss if a refiner does not pay for royalty oil and that the 99-day period for the surety represents the minimum time frame for the Service to terminate deliveries of oil under a purchase contract in the event of nonpayment by the small refiner. At the time of our audit, however, Service officials said that they might shorten the surety period to 60 days for future royalty oil sales.

Based on the actions implemented or under consideration, we believe that the Service has demonstrated that it can successfully manage a royalty-in-kind system with small refiners.

Program Improvements Needed

During our audit, we found that the Service had not adequately addressed the issues of oil volumes and the recovery of administrative costs, as discussed in the paragraphs that follow.

Oil Volumes. We found that the volume of royalty oil the Service plans to market in the October 1999 sale is not likely to be sufficient to meet the demands from the small refiners. The small refiners contacted said that they anticipate a decline in oil supplies in the open market and that they therefore are increasingly interested in obtaining Government royalty oil. For example, all 13 small refiners that we contacted supported continuation of the Program, and 3 of the 5 refiners in the Program said that they would like to purchase larger volumes of royalty oil. Additionally, Service officials said that they expect at least 20 refiners to participate in the October 1999 royalty oil sale, or at least four times the number currently in the Program. The Service, however, may be unable to substantially increase the amount of royalty oil in the sale because most of the remaining royalty oil that has not been dedicated to the Program has been committed to refilling the Strategic Petroleum Reserve.[3]

We found that the demand for royalty oil could exceed 136,000 barrels per day (based on 6,826 average barrels per day purchased by the five participants during fiscal year 1999 multiplied by the Service's estimate of at least 20 refiners), a number that is significantly more than the maximum of 80,000 barrels per day from the Gulf of Mexico that the Service plans to sell in October 1999.[4] Consequently, the Service may have to reduce the volume of oil to each refiner and/or exclude some refiners from the sale. However, we found that the Service had not considered that substantial oil volumes are potentially available for sale to small refiners under the "20 percent set-aside" provision contained in many offshore leases. Program regulations (30 CFR 208.4) require the Service, prior to a royalty oil sale, to conduct a study (known as a Determination of Need) to determine whether small refiners will benefit from the sale. Accordingly, the Service solicited comments from the oil industry

---

[3]The Strategic Petroleum Reserve, authorized in 1975 by the Energy Policy and Conservation Act, was established to provide the Nation with an emergency stockpile of up to 1 billion barrels of oil. In February 1999, the Departments of Energy and the Interior announced that approximately 28 million barrels of Government royalty oil would be transferred to the reserve. A maximum of 100,000 barrels of royalty oil will be delivered each day to the reserve, with an expected completion date for the transfer of March 1, 2000.

[4]Service officials stated on September 17, 1999, that the Government royalty oil sale in October 1999 will also include oil leases from the Pacific Region. The volume of oil to be offered for sale had not been determined at that time; however, the Government's royalty oil is approximately 17,000 barrels per day based on 1998 production data.

and relevant Governmental agencies in fiscal year 1999 to determine whether small refiners had adequate access to crude oil supplies at equitable prices. The Service's Accounting and Reports Division issued an analysis paper in April 1999 that concluded that small refiners had difficulty in obtaining crude oil supplies at fair market prices and recommended that the Service continue the Program and hold another sale of royalty oil "as soon as possible."

The Outer Continental Shelf Lands Act (43 U.S.C. §1337(b)(7)) provides that each offshore lease will contain a provision requiring the lessee to offer 20 percent of the oil production for sale to small or independent refiners. Our analysis of crude oil production data provided by the Service's Offshore Minerals Management regional offices in New Orleans, Louisiana, and Camarillo, California, disclosed that as of January 1999, approximately 160,000 barrels of oil subject to the provision were produced each day, consisting of 150,550 barrels per day from the Gulf of Mexico Region and 8,950 barrels per day from the Pacific Region.

While the Service does not monitor compliance or keep records concerning the amount of set-aside oil purchased by small refiners, cognizant Service officials stated that "few" small refiners acquired the oil. Our analysis disclosed that this oil supply was not fully accessed for various reasons, such as the set-aside provision was not well known in the oil industry, small refiners and lessees may have had difficulty in agreeing on the logistics for delivering the oil, and insufficient guidance existed on the implementation of the set-aside lease provision. Further, because the Service considers the provision to be "self-executing," it has not developed regulations or procedures for implementation except for a Notice of Interpretation issued in the "Federal Register" in 1983.[5]

In our opinion and consistent with Program regulations, the Service should consider the volume of oil that is available to refiners under the 20 percent set-aside provision and coordinate this information with the requirements of the Small Refiners Program. We estimate that the combined oil from these two sources should provide about 240,000 barrels per day (160,000 barrels from the 20 percent set-aside provision plus a minimum of 80,000 barrels from the Program) for the small refiners.

Frequency of Sales. The Service has conducted royalty oil sales on an infrequent and irregular basis, which impairs the ability of small refiners to rely on this supply source for planning purposes. Specifically, the most recent sales were held in 1983, 1987, and 1994, with the next sale scheduled for October 1999. Thus, the time frame between sales averaged about 5 years, which, in our opinion, is too long considering the dynamic and cyclical nature of the oil industry. Further, regulations (30 CFR 208) for the Program do not clearly specify when oil sales should be conducted, stating only that the crude oil market may be evaluated "from time to time." The Service has routinely extended the periods of the existing purchase contracts with the refiners because of the absence of regular oil sales. However, refiners said

[5]The Notice of Interpretation affirmed the policy of the Department of the Interior to enforce the Outer Continental Shelf Lands Act (43 U.S.C. §1337(b)(7)), which states that each lease issued after September 18, 1978, should "provide a requirement that the lessee offer 20 per centum of the crude oil, condensate, and natural gas liquids produced on such lease, at the market value and point of delivery applicable to Federal royalty oil, to small or independent refiners as defined in the Emergency Petroleum Allocation Act of 1973." The Notice also states that "the requirements of section 8(b)(7) can be achieved . . . without the intervention of Federal regulations."

that they would prefer that sales be held more frequently and regularly. We believe that the Service should accommodate the refiners by establishing a regular schedule of sales every 2 or 3 years. The Service should also consider conducting an interim sale between the scheduled sales, as allowed by Program regulations (30 CFR 208.4(d)), if sufficient volumes of royalty oil become available to attract competitive bids.

Recovery of Administrative Costs. The Service has not recovered the full amount of the Program's administrative costs, as required by applicable regulations. Regulations (30 CFR 208.4(b)(4)) for the Program require administrative costs to be allocated to the refiners on the basis of the "total number of leases under contract" (that is, active leases). Therefore, if total administrative costs remain constant but the number of leases in the Program decreases, the monthly administrative fee should increase because the same amount of costs will be distributed over a smaller base. However, since March 1997, the Service has documented the full cost of administrating the Program but has charged only the fee associated with leases active in the Program. According to Service officials, the lower fee assessment was charged because certain refiners had terminated leases from the Program and the remaining refiners objected that the resultant increase in the monthly fee from $180 to $450 (150 percent) would have forced them to resign from the Program. Consequently, the Service did not raise the monthly fee, and the refiners were assessed only about one-third of the administrative costs. However, 30 CFR 208.4(b)(4) provides that the Service "will recover the administrative costs of the RIK [royalty-in-kind] Program through the collection of administrative fees." Although Service officials said that they interpreted the regulations to support the collection of costs associated only with active leases, we believe that the regulations require the Service to collect the full administrative costs of the Program. Additionally, Office of Management and Budget Circular No. A-25, which provides guidance for the implementation of Title V of the Independent Offices Appropriations Act of 1952 (the User Charge Statute), states that agencies should assess user charges to recover the full costs of Federal activities provided to recipients of special benefits.

Because of its interpretation, the Service has not recovered administrative costs totaling about $1.9 million for the period of March 1997 through September 1999 and will not recover costs of approximately $813,000[6] for each additional year that this matter remains uncorrected. Further, state governments will be adversely impacted if the Service conducts a sale of royalty oil for onshore leases because, under the net receipts sharing[7] process, a portion of the unrecovered costs will be passed on to the states through reductions in their monthly royalty distributions.

---

[6]The annual unrecovered costs for future years were based on the average of the actual unrecovered costs of $825,800 for fiscal year 1998 and $733,900 for fiscal year 1999 (through August 1999). The unrecovered costs of $66,700 for September 1999 were estimated based on the prior 11 months' average costs for fiscal year 1999.

[7]Net receipts sharing is an administrative process in which Federal and state governments share the costs of managing the Federal onshore mineral leasing program. As the lead agency for the process, the Minerals Management Service computes the cost deduction for each state and subtracts the amount from each state's monthly distribution of mineral leasing receipts.

Recommendations

We recommend that the Director, Minerals Management Service, require Small Refiners Program officials to:

1. Ensure that the Determination of Need considers all sources of oil available to the small refiners, including the 20 percent set-aside lease provision.

2. Conduct the Determination of Need on a regular basis and increase the frequency of the analyses, such as every 2 or 3 years. The Service should also consider conducting interim Government royalty oil sales if the need for the oil is established and sufficient volumes of oil become available to attract competitive bids.

3. Ensure that the Service recovers the full costs of administrating the Program from the small refiners, as required by 30 CFR 208.4(b)(4) and Office of Management and Budget Circular No. A-25.

Minerals Management Service Response and Office of Inspector General Reply

In the January 5, 2000, response (see Appendix 3) to the draft report from the Director, Minerals Management Service, the Service concurred with Recommendation 2 but did not concur with Recommendations 1 and 3. Based on the response, we consider Recommendation 2 resolved but not implemented. Accordingly, the unimplemented recommendation will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation, and the Service is requested to reconsider its responses to Recommendations 1 and 3, which are unresolved.

Recommendation 1. Nonconcurrence.

Minerals Management Service Response. The Service stated that it would "consider all relevant information" when conducting a Determination of Need for future royalty oil sales and that "the failure to use the 20 percent set aside does not preclude a determination that there is a need to sell royalty oil to the small refiner." The Service further stated that it does "not believe it would be appropriate to implement" the recommendation.

The Service also disagreed with the report's statement that the volume of royalty oil the Service planned to market in the October 1999 sale would likely be insufficient to meet the demands from the small refiners. The Service further stated that in the October 1999 sale, which was held after the issuance of our preliminary draft report, the Service accepted bids for 16,600 of the 22,000 barrels of royalty oil from the Pacific Region but that "no acceptable bids" were received for the 80,0000 barrels of oil from the Gulf of Mexico Region because none of the bids met the Service's "established reasonable price thresholds." The Service stated that small refiners may have adequate access to sufficient amounts of oil from non-Federal sources.

Office of Inspector General Reply. Although the Service stated that it would "consider all relevant information" when conducting a Determination of Need for future royalty oil sales, the Service did not specifically affirm that an analysis of oil available under the 20 percent set-aside lease provision would be performed. To the contrary, the Service indicated that the 20 percent set-aside was not relevant to the Determination of Need process. We believe, however, that the results of a Determination of Need cannot be valid if this potentially significant source of oil available to small refiners is disregarded.

Regarding the Service's comments on the results of the October 1999 sale, we believe that the Service should not interpret the relatively small volume of royalty oil awarded as a lack of demand for oil by the small refiners. In our opinion, the fact that the bids did not meet the Service's "established reasonable price thresholds" could indicate that the small refiners have a different opinion of what constitutes a reasonable price. Our analysis, based in part on contacts with the small refiner companies and industry trade associations, disclosed a strong interest among small refiners to purchase Government royalty oil. The Service's own Determination of Need also reached this conclusion. Therefore, the results of the October 1999 sale should not be the basis to conclude that small refiners have sufficient access to oil from non-Federal sources.

Recommendation 3. Nonconcurrence.

Minerals Management Service Response. The Service stated that it was "properly recovering the costs of administering the program, as required by 30 CFR 208.4." The Service stated that it should recover only the costs of administrating leases active in the Program, stating that it "cannot support" our "contention that the costs attributable to terminated contracts should be borne by the current RIK [royalty-in-kind] program participants." The Service further stated that the Program regulations provide flexibility in determining the costs that may be recovered.

Office of Inspector General Reply. We disagree that the Service should recover only the administrative costs associated with the leases active in the Program. In our opinion, the Program regulations (30 CFR 208.4(b)(4)) provide for the recovery of total administrative costs. Moreover, as stated in the report, Office of Management and Budget Circular No. A-25 requires that agencies assess user charges to recover the full costs of Federal activities provided to recipients of special benefits. The Circular (Section 6) further requires that agencies choosing to make an exception to recovering full costs submit a request to the Director of the Office of Management and Budget. The Service has not requested such an exception, and without approval of such an exception, the Service should recover the full costs of administrative activities.

In addition, the Service should recognize that administrative costs, such as post-contract costs, are routine activities associated with both refiners that have terminated their contracts as well as refiners that have completed contractual obligations. As such, these costs are incurred for all small refiners participating in the Program. Accordingly, to recover the costs in compliance with the Circular, the Service should base the monthly administrative fee on the full $1.2 million cost of operating the Program.

Other Matters

The eligibility of a company to qualify as a small refiner depends on whether the royalty oil originates from offshore leases or onshore leases. This situation exists because the laws that authorize the Program for onshore lease sales (Minerals Leasing Act, as amended in 1946) and for offshore lease sales (Outer Continental Shelf Lands Act, as amended in 1978) contain different eligibility criteria. For example, the eligible small refiner for onshore lease sales must not have total refinery capacity of more than 175,000 barrels per day, while the offshore eligible small refiner must not have total refinery capacity of more than 75,000 barrels per day. As a result, if royalty oil produced from both offshore and onshore leases becomes available for sale, the Service must conduct separate royalty oil sales. We did not locate, nor did the Service provide, documentation supporting the different qualification criteria. Although Service officials stated that amending the applicable laws would be time consuming, we believe that a single eligibility criterion would result in more efficient royalty oil sales.

In accordance with the Departmental Manual (360 DM 5.3), we are requesting a written response to this report by May 8, 2000. The response should include the information requested in Appendix 4.

Section 5(a) of the Inspector General Act (5 U.S.C. app. 3) requires the Office of Inspector General to list this report in its semiannual report to the Congress. In addition, the Office of Inspector General provides audit reports to the Congress.

CLASSIFICATION OF MONETARY AMOUNTS

Finding	Lost Revenues
Unrecovered Administrative Costs* (Fiscal years 1997 through 1999)	$1.9 million

*Beginning with fiscal year 2000, we estimate that unrecovered administrative costs will increase by $813,000 annually if this matter remains uncorrected.

OFFICES VISITED OR CONTACTED

OFFICE	LOCATION
Minerals Management Service	
Royalty Management Program	
Accounting and Reports Division	Lakewood, Colorado
Royalty-in-Kind Section	Lakewood, Colorado
Royalty Valuation Division	Lakewood, Colorado
Policy and Management Improvement*	Lakewood, Colorado
Offshore Minerals Management	
Gulf of Mexico Outer Continental Shelf Region*	New Orleans, Louisiana
Pacific Outer Continental Shelf Region*	Camarillo, California
State Governments	
Colorado Department of Revenue*	Denver, Colorado
New Mexico Taxation and Revenue Department*	Santa Fe, New Mexico
North Dakota Office of the State Auditor*	Bismarck, North Dakota
Wyoming Office of Lands and Investments and Department of Audit	Cheyenne, Wyoming
Small Refiner Companies	
Berry Petroleum*	Kilgore, Texas
Calcasieu Refining Company*	Houston, Texas
CENCO Refining Company	Santa Fe Springs, California
Farmland Industries*	Coffeyville, Kansas
Gary-Williams Energy Corporation*	Denver, Colorado
Giant Refining Company	Scottsdale, Arizona
Huntway Refining Company	Wilmington, California
Kern Oil & Refining Company	Long Beach, California
Paramount Petroleum	Paramount, California
Placid Refining Company*	Port Allen, Louisiana
Tenby, Inc.	Oxnard, California
U.S. Oil & Refining Company	El Segundo, California
Wyoming Refining Company	Denver, Colorado
Other Oil Industry Contacts	
American Petroleum Institute*	Washington, D.C.
Council of Petroleum Accountants Societies*	Ponca City, Oklahoma
Exxon Company, U.S.A.*	Houston, Texas
Mobil Business Resources Corporation*	Dallas, Texas

* Contacted only.

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Washington, DC 20240

JAN -5 2000

Memorandum

To: Assistant Inspector General for Audits

Through: Sylvia V. Baca
Acting Assistant Secretary, Land and Minerals Management

From: Walt Rosenbusch
Director, Minerals Management Service

Subject: Office of Inspector General Draft Audit Report, "Small Refiners Program, Minerals Management Program" [C-IN-MMS-001-99]

Thank you for the opportunity to respond to the draft audit report on our Small Refiners Program. We are providing to you our general comments on the audit findings and specific ones on the recommendations.

Please contact Bettine Montgomery at (202) 208-3976 if you have any further questions.

Attachment

MINERALS MANAGEMENT SERVICE RESPONSE TO DRAFT AUDIT REPORT "SMALL REFINERS PROGRAM, MINERALS MANAGEMENT SERVICE"

Audit Agency: Office of Inspector General (OIG)

Audit Number: C-IN-MMS-001-99

General Comments

We appreciate the opportunity to comment on this draft report and are pleased with OIG's observation that we have made satisfactory progress in correcting deficiencies in the Small Refiners Program. We plan to fully implement the second of the three recommendations; however, we do not believe it would be appropriate to implement the other two as discussed below.

We cannot agree with OIG's statement supporting its first recommendation that the volume of royalty oil we planned to market in our October 1999 sale would be insufficient to meet the demands from small refiners. While two successful bids were received for 16,600 of the offered 22,000 barrels per day of Offshore Pacific oil, no acceptable bids were received for the offered 80,000 barrels per day of Gulf of Mexico oil. In general, the bids were below our established reasonable price thresholds, suggesting that oil from non-Federal sources was available to refiners in the open market at prices equal to or less than that threshold. Further, the draft report acknowledges that the reduction in the size of the program was caused, in part, by refiners leaving the program for market-related reasons, such as the availability of oil from non-Federal sources. The refiners have even requested shorter-term contracts, perhaps 6 months, which more accurately reflect industry practices and allow for changes in the market conditions.

We also believe that we are properly recovering the costs of administering the program, as required by 30 CFR 208.4. The administrative fee charged to current Royalty-in-Kind (RIK) small refiner participants includes the full cost of administering current RIK small refiner contracts. However, OIG states in its third recommendation that the costs attributable to *terminated* contracts should also be recovered from the current participants. We believe it is inappropriate to escalate the fee for costs associated with former participants who have terminated their contracts, e.g., audit and post-contract reconciliations which are incurred to ensure the Government's interests are protected. Moreover, the regulatory language uses the term "recoverable administrative costs," indicating we have flexibility in determining what costs fall into that category.

The report further suggests, but does not actually recommend, that we seek to amend the laws authorizing RIK sales to eliminate the differing eligibility criteria. While it might be easier to manage a single criterion program, we do not believe that benefit would outweigh the resources required for such an initiative. Gains in efficiency are a likely outcome of our ongoing RIK pilots which may compensate for the differing criteria.

COMMENTS ON RECOMMENDATIONS

1. Ensure that the Determination of Need considers all sources of oil available to the small refiners, including the 20 percent set-aside lease provision.

We will consider all relevant information, but the failure to use the 20 percent set aside does not preclude a determination that there is a need to sell royalty oil to the small refiner.

2. Conduct the Determination of Need on a regular basis and increase the frequency of the analyses, such as every 2 or 3 years. The Service should also consider conducting interim Government royalty oil sales if the need for the oil is established and sufficient volumes of oil become available to attract competitive bids.

Beginning in 2001, MMS will perform Determinations of Need on a biennial basis and will conduct sales as frequently as indicated in those analyses.

Responsible Official: Deputy Associate Director for Royalty Management

3. Ensure that the Service recovers the full costs of administrating the Program from the small refiners, as required by the Code of Federal Regulations (30 CFR 208.4(b)(4)) and Office of Management and Budget Circular A-25.

As explained above, we cannot support OIG's contention that the costs attributable to terminated contracts should be borne by the current RIK program participants.

STATUS OF AUDIT REPORT RECOMMENDATIONS

Finding/ Recommendation Reference	Status	Action Required
1 and 3	Unresolved.	Reconsider the recommendations, and provide action plans for implementing the recommendations. The plans should include target dates and titles of the officials responsible for implementation.
2	Resolved; not implemented.	No further response to the Office of Inspector General is required. The recommendation will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation.

ILLEGAL OR WASTEFUL ACTIVITIES SHOULD BE REPORTED TO THE OFFICE OF INSPECTOR GENERAL

Internet Complaint Form Address

http://www.oig.doi.gov/hotline_form.html

Within the Continental United States

U.S. Department of the Interior
Office of Inspector General
1849 C Street, N.W.
Mail Stop 5341 - MIB
Washington, D.C. 20240-0001

Our 24-hour
Telephone HOTLINE
1-800-424-5081 or
(202) 208-5300

TDD for hearing impaired
(202) 208-2420

Outside the Continental United States

Caribbean Region

U.S. Department of the Interior
Office of Inspector General
Eastern Division - Investigations
4040 Fairfax Drive
Suite 303
Arlington, Virginia 22203

(703) 235-9221

Pacific Region

U.S. Department of the Interior
Office of Inspector General
Guam Field Office
415 Chalan San Antonio
Baltej Pavilion, Suite 306
Agana, Guam 96911

(671) 647-6060

HOTLINE

U.S. Department of the Interior
Office of Inspector General
1849 C Street, NW
Mail Stop 5341- MIB
Washington, D.C. 20240-0001

Toll Free Number
1-800-424-5081

FTS/Commercial Numbers
(202) 208-5300
TDD (202) 208-2420