



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

AUDIT REPORT

**SUPPORTING DOCUMENTATION FOR
OPERATORS PARTICIPATING IN THE
STRIPPER OIL WELL PROPERTY
ROYALTY RATE REDUCTION PROGRAM,
BUREAU OF LAND MANAGEMENT AND
MINERALS MANAGEMENT SERVICE**

**REPORT NO. 00~I-300
MARCH 2000**

EXECUTIVE SUMMARY

**Supporting Documentation for Operators Participating in
the Stripper Oil Well Property Royalty Rate Reduction Program,
Bureau of Land Management and Minerals Management Service
Report No. 00-I-300
March 2000**

BACKGROUND

The Stripper Oil Well Property Royalty Rate Reduction Program, initiated by the Bureau of Land Management (BLM), became effective on October 1, 1992. The Program was to provide an economic incentive for operators to maintain or restart production of marginal or uneconomic oil wells on Federal onshore leases by drilling new wells, by reworking existing wells, and/or by implementing enhanced oil recovery projects. The regulatory requirements for the Program are in the Code of Federal Regulations (43 CFR 3103.4-2). The Secretary is required by 43 CFR 3103.4-2(5) to evaluate the effectiveness of the Program, and this provision allows the Secretary to terminate any or all royalty rate reductions granted under the Program upon a 6-month notice any time after September 10, 1997. On February 18, 1998, the Department of the Interior extended the Program for an indefinite period.

The operator is required to submit a "Stripper Royalty Rate Reduction Notification" form, which includes the operator's lease or agreement number, qualifying period, and reduced royalty rate. The operator is required to calculate the reduced royalty rate using information reported on the "Monthly Report of Operations" form. The operator calculates the average production of oil per well per day by dividing the total oil production during the qualifying period by the total number of producing or injecting well days. The reduced royalty rate becomes effective on the first day of the month after the Minerals Management Service (MMS) receives the notification. The operators of the properties included in the Program are allowed to pay Federal royalty rates ranging from 0.5 to 11.7 percent of the value of a barrel of oil. These rates are below the standard onshore rate of 12.5 percent. As of September 30, 1999, approximately 850 operators and 4,100 properties were participating in the Program. Royalty rate reductions during the period of October 1, 1992, through December 31, 1998, totaled more than \$139 million.

Both BLM and MMS are responsible for the Program. BLM is responsible for promulgating the Program regulations; establishing policies and procedures; conducting all on-the-ground inspections to verify producing volumes and producing days; and reviewing production anomalies that are identified by MMS, which are unexplained differences between reported production from the operator's monthly reports and the notification. MMS is responsible for confirming the reduced royalty rate information provided by the operator on the notification form.

OBJECTIVE

The objective of the audit was to determine whether BLM provided effective oversight of well classification and production rates used in determining eligibility for the Program.

RESULTS IN BRIEF

We found that the "Monthly Report of Operations" form prepared by operators and used to support reduced royalty rate determinations for the Program showed production days that were inaccurate or that often could not be supported with operator documentation. Operators are required by 43 CFR 3 162.4-3 to accurately disclose all operations conducted on each well during each month. However, BLM (1) did not provide sufficient oversight of operators to ensure that information on the production days was correct and (2) did not establish Program policies and procedures to enable participating operators to accurately compute their reduced royalty rates and for MMS Program staff to accurately review and confirm the reduced royalty rates provided by the operators. For the 14 Program properties reviewed, we found that 5 properties had inaccurate rates, which may result in underpaid royalties of about \$1.27 million, and that 7 properties had unsupported rates, which may result in underpaid royalties of \$3.22 million. In addition, we found that reviews were conducted by state auditors from the States of California, New Mexico, and Oklahoma on six additional properties. Of the six properties, four had inaccurate rates, which resulted in underpaid royalties of about \$847,000, and one property had an unsupported rate, which may result in underpaid royalties of \$25,000. Of the 20 properties, 17 had inaccurate or unsupported rates, which resulted in actual or potential underpaid royalties totaling about \$5.36 million (30.8 percent). If the 30.8 percent potential underpaid royalty error rate is representative of the \$139.7 million in total reduced royalty Program benefits received, the total potential for underpaid royalties could be as much as \$43.02 million, which is attributable to inaccurate rates (\$16.90 million) and unsupported rates (\$26.12 million).

RECOMMENDATIONS

We recommended that BLM and MMS develop a plan which ensures that operators of the largest benefiting properties are audited and develop a policy for operators that do not have sufficient records to support their reduced royalty rates. We also recommended that they develop a policy and procedures on how to address certain issues when reviewing or preparing Program notifications and that they develop and implement a procedure for reviewing supporting documentation for future Program notifications submitted by operators.

AUDITEE COMMENTS AND OIG EVALUATION

Both BLM and MMS concurred with the report's four recommendations. Based on the bureaus' response and subsequent information, we considered two recommendations resolved and implemented and two recommendations resolved but not implemented.



United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20240

MAR 27 2000

AUDIT REPORT

Memorandum

To: Director, Bureau of Land Management
Director, Minerals Management Service

From: Roger La Rouché *Roger LaRouche*
Acting Assistant Inspector General for Audits

Subject: Audit Report on Supporting Documentation for Operators Participating in the Stripper Oil Well Property Royalty Rate Reduction Program, Bureau of Land Management and Minerals Management Service (No. 00-I-300)

INTRODUCTION

This report presents the results of our self-initiated audit of the supporting documentation for operators participating in the Stripper Oil Well Property Royalty Rate Reduction Program. The objective of the audit was to determine whether the Bureau of Land Management (BLM) provided effective oversight of well classification and production rates used in determining eligibility for the Program. This is the second report that we are issuing on the Program. The first report, entitled "Processing of Notifications for the Stripper Oil Well Property Royalty Rate Reduction Program, Minerals Management Service" (No. 99-I-782), dated August 1999, determined whether the Minerals Management Service (MMS) effectively processed and verified royalty rate reduction notifications. (This report is synopsized in the Prior Audit Coverage section of this report.)

BACKGROUND

The Secretary of the Interior is required by the Federal Oil and Gas Royalty Management Act of 1982 (30 U.S.C. § 171 l(a)) to "establish a comprehensive inspection, collection and fiscal and production accounting and auditing system to provide the capability to accurately determine oil and gas royalties, interest, fines, penalties, fees, deposits, and other payments owed, and to collect and account for such amounts in a timely manner."

The Mineral Leasing Act of 1920 (30 U.S.C. § 209) allows the Secretary to adjust royalty rates on Federal onshore leases to encourage the maximum amount of oil or gas to be removed. Further, to promote development on leases that cannot be operated economically under the existing lease terms, the Secretary may waive, suspend, or reduce the royalty on

all or any portion of the leasehold. Both BLM and MMS have responsibilities for Federal onshore leases. BLM's responsibilities include issuing onshore leases and monitoring production on the leases. MMS's responsibilities include ensuring the proper determination, collection, and distribution of royalties.

The Stripper Oil Well Property Royalty Rate Reduction Program,' initiated by BLM, became effective on October 1, 1992. The Program was to provide an economic incentive for operators to maintain or restart production of marginal or uneconomic oil wells on Federal onshore leases by drilling new wells, by reworking existing wells, and/or by implementing enhanced oil recovery projects. The regulatory requirements for the Program are at 43 CFR 3 103.4-2. The Secretary is required by 43 CFR 3 103.4-2(5) to evaluate the effectiveness of the Program, and this provision allows the Secretary to terminate any or all royalty rate reductions granted under the Program upon a 6-month notice any time after September 10, 1997. On February 18, 1998, the Department of the Interior extended the Program for an indefinite period.

The operator is required to submit a notification of Program participation on Form MMS-4377, "Stripper Royalty Rate Reduction Notification," which includes the operator's lease or agreement number, qualifying period, and reduced royalty rate. The operator is required to calculate the reduced royalty rate using production and injection information reported on the "Monthly Report of Operations" (Form MMS-3160).² The operator calculates the average production of oil per well per day by dividing the total oil production during the qualifying period by the total number of producing or injecting well³ days. The resulting average is rounded down to the nearest whole barrel regardless of the amount. The reduced royalty rate becomes effective on the first day of the month after MMS receives the notification. The operators of the properties included in the Program are allowed to pay Federal royalty rates ranging from 0.5 to 11.7 percent of the value of a barrel of oil (see Appendix 2). These rates are below the standard onshore rate of 12.5 percent.

To qualify for the Program, eligible wells must either produce oil or serve as an injection well for any period of time during the initial 12-month qualifying period, a preceding period, or a subsequent 12-month period. The qualifying period is used to determine the amount of production and the royalty rate that would be effective on or after October 1, 1992. In

¹According to 43 CFR 3 103.4-2, a stripper well property is "any Federal lease or portion thereof segregated for royalty purposes, a communitization agreement, or a participating area of a unit agreement, operated by the same operator, that produces an average of less than 15 barrels of oil per eligible well per well-day for the qualifying period." Also, 43 CFR 3105.2-2 states, "When a lease or portion thereof cannot be independently developed and operated in conformity with an established well-spacing or well-development program, the authorized office may approve communitization or drilling agreements for such lands with other lands whether or not owned by the United States, upon a determination that it is in the public interest."

² The "Monthly Report of Operations" contains monthly production data reported by operators for individual leases and wells, including data on lease identification; well location; well production of oil, gas, and water; number of days during the month that each well produced or injected; and other data about well site conditions and operations.

³According to 43 CFR 3103.4-1(c)(4), an eligible injection well is a "well that injects a fluid for secondary or enhanced oil recovery, including reservoir pressure maintenance operations."

calculating the royalty rate, operators are required to use either the initial qualifying period, which was August 1, 1990, through July 31, 1991, or if shut-in⁴ during this period, the 12-month production period immediately prior to the shut-in. Further, properties not qualifying during or prior to the initial qualifying period are required to use the first consecutive 12-month qualifying period beginning after August 31, 1990. In addition, participating operators can submit notifications for further reduced royalty rates subsequent to their initial participating rate if production levels continue to decline (these subsequent periods are referred to as outyears). After the first outyear notification is filed, a notification is required thereafter for each subsequent 12-month period or the royalty rate reverts to the initial reduced royalty rate. Each outyear notification is due within 60 calendar days after the applicable 12-month period.

Both BLM and MMS are responsible for the Program. BLM is responsible for promulgating the Program regulations; establishing policies and procedures; conducting all on-the-ground inspections to verify producing volumes and producing days; and reviewing production anomalies that are identified by MMS, which are unexplained differences between reported production from the operator's monthly reports and the notification. MMS is responsible for confirming the reduced royalty rate information provided by the operator on the form "Stripper Royalty Rate Reduction Notification." In confirming the reduced royalty rate, MMS compares information submitted in the notification with production and well status data previously submitted in the "Monthly Report of Operations." The information confirmed by MMS includes the following: the Federal mineral interest in the property, the identification and the proper description of the property, and the operator's status as the current operator of the property. MMS also confirms that wells meet the Program definition of a producing oil or injection well, that reported production is complete, and that the corresponding reduced royalty rate is accurate. Upon completion of this review, MMS notifies the operator that the calculated rate has been confirmed, adjusted, or disqualified.

As of September 30, 1999, approximately 850 operators and 4,100 properties were participating in the Program. Royalty rate reductions during the period of October 1, 1992, through December 31, 1998, totaled more than \$139 million (see Appendix 3). Stripper oil properties included single leases, communitization agreements, and units and ranged in size from a single well to more than 1,300 wells per property.

SCOPE OF AUDIT

Our audit fieldwork was conducted during March through July 1999 at MMS's Royalty Management Program office in Lakewood, Colorado, and BLM's Fluid Minerals Office in Washington, D.C. In addition, we contacted or visited BLM, state, and industry officials at the offices and locations listed in Appendix 4. To meet our audit objective, we selected 8 New Mexico and 6 Wyoming properties (see Appendix 5) from a list of the 100 largest benefiting properties in 1997. The properties were selected based on the number of producing days per well and the number of wells included on the operators' monthly reports.

⁴ Shut-in wells are wells from which the lease operator has temporarily stopped producing oil and gas because of economic or other considerations but for which production may be restarted by opening a valve or turning on a switch.

Our objective was to determine whether the error of overreported production days identified by the Comptroller of the State of California (see Prior Audit Coverage) was a systemic problem. For these properties, we examined BLM and MMS records and contacted operators or performed site visits to the offices of 5 of the 10 operators that were responsible for the 14 properties reviewed. We obtained information from participating operators supporting the monthly reports such as daily production logs, water injection records, and well-production test records.

Our audit was made 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 to accomplish our objective. We also reviewed the Department of the Interior's Accountability Report for fiscal year 1998, which includes information required by the Federal Managers' Financial Integrity Act of 1982, and BLM's annual assurance statement on management controls to determine whether any reported weaknesses were within the objective and scope of our audit. Neither the Accountability Report nor BLM's assurance statement addressed BLM's involvement in the Program. In addition, we evaluated BLM's system of internal controls related to the Program. The internal control weaknesses we found are discussed in the Results of Audit section of this report. Our recommendations, if implemented, should improve the internal controls in the areas reviewed.

PRIOR AUDIT COVERAGE

During the past 5 years, the General Accounting Office has not issued any audit reports on the Program. However, in August 1999, the Office of Inspector General issued the report "Processing Notifications for the Stripper Oil Well Property Royalty Rate Reduction Program, Minerals Management Service" (No. 99-I-782), which addressed the second part of our audit objective. The report stated that MMS did not timely confirm notifications it received and did not timely input the confirmed reduced royalty rates or review differences in the royalty rates confirmed with the royalty rates paid for properties participating in the Stripper Oil Well Property Royalty Rate Reduction Program. The report made two recommendations for MMS to develop and implement a plan to (1) eliminate the Stripper Oil Well Property Royalty Rate Reduction Program notification processing and data entry backlog and to approve future notifications in a timely manner and (2) review Program exceptions generated by the automated matching process and collect underpaid royalties from operators. Based on MMS's response, we considered the first recommendation resolved and implemented and the second recommendation resolved but not implemented.

As discussed previously (see Scope of Audit), the Controller of the State of California issued an October 30, 1998, audit report on royalties reported by a production company for its Program leases located in California for the period of January 1, 1993, through December 31, 1995. The report said that the company overstated well-production days on its "Monthly Report of Operations" during the qualifying period for the Stripper Oil Well Property Royalty Rate Reduction Program. According to the State auditors, a primary factor causing the misreporting was that the company's automated system reported all days of a month as producing unless adjustments were made based on manually generated reports showing when a well was inactive (well downtime). Adjustments for well downtime often

were not input into the automated system. The report also stated that overstated well-production days were the main factor for the royalty rate to be adjusted from 2.1 percent to 2.9 percent, which resulted in royalty underpayments of more than \$500,000. The company agreed with the conclusions and subsequently paid the underpaid royalties.

RESULTS OF AUDIT

We found that the "Monthly Report of Operations" (Form MMS-3 160) prepared by operators and used to support reduced royalty rate determinations for the Stripper Oil Well Royalty Rate Reduction Program showed production days that were inaccurate or that often could not be supported with operator documentation. Operators are required by 43 CFR 3 162.4-3 to accurately disclose all operations conducted on each well during each month. However, BLM (1) did not provide sufficient oversight of operators to ensure that information on the production days was correct and (2) did not establish Program policies and procedures to enable participating operators to accurately compute their reduced royalty rates and for MMS Program staff to accurately review and confirm the reduced royalty rates provided by the operators. For the 14 Program properties reviewed, we found that 5 properties had inaccurate rates, which may result in underpaid royalties of about \$1.27 million, and that 7 properties had unsupported rates, which may result in increased royalties of \$3.22 million (see Appendix 5). In addition, we found that reviews were conducted by state auditors from the States of California, New Mexico, and Oklahoma on six additional properties. Of the six properties, four had inaccurate rates, which resulted in underpaid royalties of about \$847,000, and one property had an unsupported rate, which may result in increased royalties of \$25,000. Of the 20 properties, 17 had inaccurate or unsupported rates, which resulted in actual or potential underpaid royalties totaling about \$5.36 million (30.8 percent). If the 30.8 percent potential underpaid royalty error rate is representative of the \$139.7 million in total reduced royalty Program benefits received, the total potential for underpaid royalties could be as much as \$43.02 million, which is attributable to inaccurate rates (\$16.90 million) and unsupported rates (\$26.12 million).

Participating Program operators are required by 43 CFR 3 103.4-2 to calculate reduced royalty rates using production data, including well-production days as reported on the monthly reports. Monthly reports are required by 43 CFR 3 162.4-3 to disclose accurately all operations conducted on each well during each month. Specifically, 43 CFR 3 162.4-3 states that "it is particularly necessary that the report show for each calendar month: ... The number of days each well produced, whether oil or gas, and the number of days each input [injection] well was in operation." According to 43 CFR 3 16 1, BLM is responsible for all operations conducted on Federal onshore leases, including the approval, inspection, and regulation of oil and gas operations.

Record maintenance and retention requirements are established in Section 103 of the Federal Oil and Gas Royalty Management Act of 1982. The Act requires records to be maintained for 6 years after the records are generated unless the Secretary notifies the record holder that he has initiated an audit or an investigation involving such records and requires such records to be maintained for a longer period. The Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 amended sections of the Federal Oil and Gas Royalty Management Act of 1982. Section 115 of the 1996 Act established a 7-year period for the retention of records

from the date an obligation becomes due. This 7-year period (30 U.S.C. §1724(f)) applies to oil and gas produced after September 30, 1996.

Our audit was designed to determine whether the error of over-reported production days identified by the Controller of California (see Prior Audit Coverage) was systemic. We determined that California, New Mexico, and Wyoming properties received more than 9 1 percent of the royalty rate reductions provided through the end of calendar year 1998 (see Appendix 3). Based on our review of the 14 properties (see Appendix 5), we found that only 2 properties had accurate and supported Program rates. Of the remaining 12 properties, 9 properties had deficiencies related to inaccurate or unsupported production days. Three of the nine properties had inaccurate rates with sufficient records for recalculation, one property had an inaccurate rate with insufficient records for recalculation, and five properties had no records to support their Program rates. The remaining three properties had deficiencies related to insufficient Program policies and procedures.

Production Days

BLM did not provide adequate oversight to ensure that operators participating in the Program accurately reported well-production days on their monthly reports used in their reduced royalty rate determinations. Because reduced royalty rates were based on the average production per day per well during the qualifying period, the number of producing days reported was a critical part of the reduced royalty rate calculations. BLM officials stated that producing days reported on the "Monthly Report of Operations " were normally not verified by BLM oil and gas inspectors because production days were not considered to be an essential factor when production totals were verified. In addition, BLM did not have Program policies and procedures to ensure that operators retained records supporting their claimed reduced royalty rates. These deficiencies are detailed in the paragraphs that follow.

Sufficient Records for Recalculation. We identified three properties for which well-production days were misreported during the qualifying period and for which records were sufficient for us to recalculate the proper reduced royalty rates. Based on our recalculations, we found that royalties were underpaid by \$1,037,953 for the three properties as follows:

- In September 1992, an operator of a New Mexico property submitted an initial notification claiming a reduced royalty rate of 1.3 percent effective in October 1992. The claimed rate was confirmed by MMS in March 1993. The rate calculation was based on the monthly reports, which showed only one producing oil well that produced 61 barrels of oil during 52 well-production days. In March 1999, we obtained daily production logs from the operator for this property in support of the monthly reports. Our review of these records indicated that the well was producing oil for between 4 and 6 days during the qualifying period. The operator agreed with our findings and acknowledged that the production days shown on the monthly reports were incorrect, which resulted in a reduced royalty rate that was also incorrect. Further, a BLM Washington Office Program official reviewed the operator's field records and concluded that the records supported only 4 well-production days. Consequently, using the 4 production days and the 61 barrels of oil, we determined that the property averaged more than 15 barrels of oil per day, which made it ineligible for a reduced royalty rate. Based on our recalculation of the royalties that were paid for the

period of October 1, 1992, through December 31, 1998, we determined that the operator underpaid royalties by \$888,416.

- In September 1992, an operator of a Wyoming property submitted an initial notification claiming a reduced royalty rate of 11.7 percent effective in October 1992. The claimed rate was confirmed by MMS in October 1994. The rate calculation was based on the monthly reports, which showed three producing oil wells and two water injection wells that produced 20,178 barrels of oil over a period of 680 producing and 672 injecting days (1,352 total days). In March 1999, we obtained oil well-production test records from the operator for this property that purportedly supported the production data shown on the monthly reports. Our review of these production rate tests indicated that the reported volumes were produced in 1,194 days, which was 158 fewer days than the 1,352 days reported on the monthly reports. Consequently, using 1,194 producing days and 20,178 barrels of production, we determined that the property produced more than 15 barrels of oil per day and was therefore ineligible for a reduced royalty rate. The operator agreed that a discrepancy existed between the operator's well test records and the reported monthly production and said that he would provide us with additional information to explain the discrepancies. However, we had not received the information as of October 1999. Based on our recalculation of the royalties paid for the period of October 1, 1992, through December 31, 1998, we determined that the operator underpaid royalties by \$76,935.

- In September 1992, the same Wyoming operator in the previous example submitted a notification for another property. Our review disclosed similar reporting discrepancies. We performed the same recalculation and determined that for the same period, the operator underpaid royalties by \$72,602 on this property.

Incomplete Records. One property for which well-production days were misreported during the qualifying period had records that were not sufficiently adequate for us to accurately recalculate the proper reduced royalty rate for the property. However, based on available information, we determined that royalties were underpaid by as much as \$672,384 for the property. Specifically, in September 1992, an operator of a New Mexico lease submitted an initial notification claiming a reduced royalty rate of 6.1 percent effective in October 1992. The claimed rate was confirmed by MMS in January 1993. The rate calculation was based on the monthly reports, which identified 46 producing oil wells and 8 water injection wells with production of 143,796 barrels of oil over a period of 16,637 producing and 2,920 injecting days (19,557 total days). In March 1999, we obtained daily tank gauging reports from the operator for this lease in support of production data that were reported on the monthly reports. Based on our review, we found that the operator had reported all 19,557 possible elapsed calendar days for the producing and injecting wells during the qualifying period. Based on discussions with BLM personnel, we determined that it was not reasonable for the 54 wells to produce or inject every day of the year. The operator stated that its reporting system is automated and contains a default which reports all days during each month as producing unless the system is changed manually. In addition, the operator stated that field personnel would make written notes of well downtime but that these records were not retained. The president of the operating company stated that "there is not a stripper well in New Mexico that would operate 365 days a year." Regarding water injection records, we noted that 240 days were reported as injecting when meter readings

indicated that injection had not occurred. The operator also concurred that these data may have been misreported. The operator was able to provide only one well test record for a single well of the 46 producing oil wells. The record for the one well showed oil production of 76 barrels over 8 days (average production of 9.5 barrels per day) versus production of 92 barrels over the full 31 days reported on the monthly report for this well. Based on the well test average production of 9.5 barrels per day, we concluded that the reported production of 92 barrels would be produced in about 10 days. Based on our conclusion that the wells could not have been operating for every day during the qualifying period, on documentation obtained on water injection well meter readings and one well test record, and on statements made by the president of the property's operating company, we considered this rate to be unsupported. Consequently, we recalculated the royalties paid for the period of October 1, 1992, through December 31, 1998, using the standard onshore 12.5 percent royalty rate and concluded that the operator did not support royalty reductions of \$672,384.

Lack of Records. The current operators of five properties could not provide documentation supporting the eligibility of their properties for royalty rate reductions. These operators all stated that they had purchased the participating property from a previous qualifying Program operator and that records supporting the reduced royalty rate were not provided at the time of sale. We attempted to contact the previous operators of these properties and were able to contact two of them, who also stated that they were unable to locate the records. However, one previous operator told us that records such as well test records, pumper logs, downtime reports, and tank gauging reports are normally given to the purchaser when a property is sold.

Each of the five properties for which we requested records had reported high numbers of producing days during the qualifying period. Specifically, production days reported on the monthly reports during the qualifying periods averaged 96.2 percent of the total number of days in the year (the range was from 84 percent to 100 percent of the available days). As stated in the section "Incomplete Records," BLM officials and an operator told us that stripper and associated injection wells are frequently down for reasons such as workovers (cleaning out a well that has sanded up, pulling tubing, washing out the bottom of the well with mud or acid, or using explosives to dislodge sand or silt); maintenance activities (such as hot oiling to remove paraffin wax buildup); and work on pumps, motors, pipelines, and oil storage tanks. Wells may also be down for regularly scheduled periods of time to allow oil or gas to migrate to areas of low pressure, such as the area surrounding the well bore of a producing well. Consequently, because records were lacking and the number of reported producing days was high, we concluded that the five properties should not qualify for the reduced rates claimed by the four operators. We determined that reduced royalties for these five properties totaled \$2,395,865 for the period of October 1, 1992, through December 31, 1998.

Program Policies and Procedures

BLM did not establish Program policies and procedures for participating operators and for MMS Program staff to ensure the accuracy of reduced royalty rate determinations. Specifically, policies and procedures were not established to address certain situations that would impact the operators' calculation of reduced royalty rates related to (1) the use of load

oil in **fracturing**;⁵ (2) multiple completions,⁶ commonly known as down hole commingling and multiple completion wells;⁷ and (3) water injection in a nonproducing formation on that property. We determined that the failure to consider these situations resulted in inaccurate Program royalty rate determinations. For the 14 sampled properties, we identified 3 properties with these situations that required technical interpretation and guidance by BLM officials. These officials acknowledged that these situations had not been anticipated when the Program was established. Based on our discussions and recalculations, we determined that royalties were underpaid for the three properties by \$383,131, as described in the paragraphs that follow.

Fracturing. In November 1994, an operator of a Wyoming property submitted an initial notification claiming a reduced royalty rate of 6.1 percent effective in December 1994. The claimed rate was subsequently recalculated and confirmed by MMS at 5.3 percent. The rate calculation was based on the monthly reports that identified two oil wells with production of 4,090 barrels of oil over 648 producing days. In March 1999, we obtained well-production test records from the operator for this property in support of the monthly reports. Our review of these records revealed large production volume reporting discrepancies between the well-production test volumes and the volumes reported on the monthly reports. For example, in October 1993, the operator reported production of 326 barrels of oil over 31 claimed production days, while the well test records showed production of 716 barrels of oil over just 18 test days. Similarly, in December 1993, the operator reported no oil production over 31 claimed production days, while the well test records showed production of 209 barrels of oil over just 10 test days. The operator told us that the reporting discrepancies were due to recovering oil used on the property for fracturing the formation. In this case, the operator was using load oil⁸ to fracture the formation. For the subsequent recovery of this oil, the operator appropriately did not report the load oil as production but did report the number of days it took to recover the load oil as producing days. While BLM had no formal policy and procedure on fracturing with load oil as it relates to calculating reduced royalty rates for the Program, BLM Program officials have taken the position that

⁵According to "Oil and Gas Terms" (by Howard R. Williams and Charles J. Meyers, Matthew Bender, New York, 1997), fracturing refers to "a process of opening up underground channels in hydrocarbon-bearing formations by force, rather than by chemical action such as acidizing." Load oil may be utilized in hydraulic fracturing, which is defined as "a mechanical method of increasing the permeability of rock, and thus increasing the amount of oil and or gas produced from it. The method employs hydraulic pressure to fracture the rock."

⁶According to "Oil and Gas Terms" (by Howard R. Williams and Charles J. Meyers, Matthew Bender, New York, 1997), multiple completion refers to "the completion of a single well into more than one producing horizon. Such a well may produce simultaneously from the different horizons, or alternately from each."

⁷According to "Oil and Gas Terms" (by Howard R. Williams and Charles J. Meyers, Matthew Bender, New York, 1997), multiple completion well refers to "a well producing from two or more formations by means of separate tubing strings run inside the casing, each of which carries crude oil from a separate and distinct producing formation. The separate tubing strings distinguish this form of well from a commingled well, which produces from two or more oil bearing formations through a single tubing string in the common well casing."

⁸According to "Oil and Gas Terms" (by Howard R. Williams and Charles J. Meyers, Matthew Bender, New York, 1997), load oil refers, in part, to "oil injected into a well as part of a fracturing operation."

neither recovered load oil nor days spent recovering load oil for fracturing should be considered for reduced royalty rate calculations. As with the preceding examples, we used the well test records to calculate the expected number of well-production days. This calculation resulted in a decrease of qualifying days from 648 to 358. At 358 production days and 4,090 barrels of production, the property qualifies for a reduced royalty rate of 9.3 percent rather than the 5.3 percent claimed. Based on our recalculation of the royalties paid for the period of November 1, 1993, through December 31, 1998, we determined that the operator underpaid royalties by \$39,671.

Multiple Completions and Multiple Completion Wells. In September 1992, an operator of a New Mexico property submitted an initial notification claiming a reduced royalty rate of 5.3 percent effective in October 1992, and the rate claimed was confirmed by MMS in March 1993. The rate calculation was based on the monthly reports that identified 13 producing oil wells with production of 31,432 barrels of oil over 4,501 well-producing days. In March 1999, we obtained daily production logs from the operator in support of the monthly report. Based on our review of the monthly report, we found that 8 of the 13 oil wells reported were multiple completions with down hole commingled production¹⁰ which was produced from only 3 oil wells. According to BLM Program officials, BLM has no written policy for the Program on multiple completions that are commingled down hole. However, these officials told us that multiple completions with commingled production should be counted as only one well. Accordingly, the eight wells reported on the operations report should have been reported as only three wells. We recalculated the well-production days based on 8 wells instead of 13 wells, which reduced the well-producing days to 2,684. At 2,684 producing days and 31,432 barrels of production, the property qualifies for a reduced royalty rate of 9.3 percent instead of the 5.3 percent rate claimed. Based on our recalculation of the royalties paid for the period of October 1, 1992, through December 31, 1998, we determined that the operator underpaid royalties by \$190,927.

BLM also did not have a written policy and procedure for calculating reduced royalty rates for properties containing multiple completion wells. BLM Program officials stated that in the case of a multiple completion wells, each producing tubing string¹⁰ should be counted as an individual well. MMS Program officials who reviewed and confirmed the operator's reduced royalty rate said that they had not received guidance on how to count multiple completions or multiple completion wells and had assumed that multiple completions should be counted as multiple wells regardless of commingling.

Water Injection in a Nonproducing Formation. In September 1992, an operator of a Wyoming lease submitted an initial notification claiming a reduced royalty rate of 2.9 percent effective in October 1992. Subsequent to MMS's review of that rate, the operator submitted amended monthly reports, and MMS confirmed a 2.1 percent rate. The

"According to "Oil and Gas Terms" (by Howard R. Williams and Charles J. Meyers, Matthew Bender, New York, 1997), commingled production refers to "production from two or more wells or leases or oil-bearing formations commingled by an operator."

¹⁰Tubing strings are explained in footnote 7.

rate calculation was based on the amended monthly reports, which showed two producing oil wells and three water injection wells with production of 3,902 barrels of oil over a period of 535 producing and 994 injecting days (1,529 total days). In March 1999, we obtained well-production test records from the operator for this lease in support of the monthly reports. Based on our review of these records, we found large reporting discrepancies between the well-production test volumes and the volumes reported by the operator on the monthly reports. For example, during May, June, and July 1991, the operator reported no oil production over 74 claimed production days; however, the well test records identified production of 806 barrels of oil over just 28 tested days. In addition, based on our review of the amended monthly reports, we determined that the operator claimed 446 injecting days during the period of December 1990 through July 1991 for injection to a formation which produced no oil from the formation on that property. BLM's petroleum engineer for that area said that this injection was either for the benefit of another lease or was a water disposal well with no benefit to production and should not be counted as an eligible Program well. In April 1999, the operator agreed that a discrepancy existed between the operator's well test records and the reported monthly production. Although the operator agreed to provide us with additional information to explain the discrepancies, we had not received this information as of August 1999. Based on the reporting discrepancies noted and the absence of records to support the operator's amended monthly reports and the operator's claimed rate, we considered this rate to be unsupported. Based on our recalculation of the royalties paid for the period of October 1, 1992, through December 31, 1998, we determined that the operator had underpaid royalties by \$152,533.

During this audit, we discussed our findings with BLM and MMS officials and with state audit agency officials, including discussions with these officials during our participation in the April and June 1999 State and Tribal Royalty Audit Committee² meetings, since some state audit agencies are responsible for auditing Federal onshore leases within their boundaries. BLM and MMS officials agreed that there was a lack of policies and procedures. Further, some state officials agreed to amend their annual audit plans to include audits of significant Program properties. To assist in this effort, MMS officials agreed at the April Committee meeting to identify the top 100 properties that benefited from the Program since the Program's inception. BLM officials subsequently agreed to request records supporting the reduced royalty rates for these properties. Officials of California, New Mexico, and Wyoming told us that they will begin auditing these properties. As previously stated, the Program's properties in these states received more than 91 percent of the royalty rate reductions provided through the end of calendar year 1998. We have provided copies of our applicable working papers to audit officials in New Mexico and Wyoming.

The 14 audited properties that we reviewed (see Appendix 5) received reduced royalty Program benefits totaling about \$6.94 million, and we identified 12 properties that had inaccurate or unsupported rates, which resulted in actual or potential underpaid royalties totaling about \$4.49 million (64.7 percent). Specifically, five properties had inaccurate rates with approximately \$1.27 million in underpaid royalties, and seven properties had unsupported rates with \$3.22 million in reduced royalties in which some or all of the

²"The State and Tribal Royalty Audit Committee is an organization composed of states and Indian tribes that have audit agreements with MMS.

royalties may be underpaid. In addition, the States of California, New Mexico, and Oklahoma reviewed six additional properties that had received reduced royalty Program benefits totaling about \$10.48 million. Of the six properties, five had inaccurate or unsupported rates, which resulted in potential underpaid royalties totaling about \$872,000 (8.3 percent). Specifically, four properties had inaccurate rates with \$847,000 in potential underpaid royalties, and one property had an unsupported rate with \$25,000 in reduced royalties. The combined 20 properties reviewed had reduced royalty Program benefits totaling about \$17.42 million. Of the 20 properties, 17 had inaccurate or unsupported rates, which resulted in actual or potential underpaid royalties totaling about \$5.36 million (30.8 percent). If the 30.8 percent potential underpaid royalty error rate is representative of the \$139.7 million in total reduced royalty Program benefits received, the total potential for underpaid royalties could be as much as \$43.02 million, which is attributable to inaccurate rates (\$16.90 million) and unsupported rates (\$26.12 million).

We believe that BLM and MMS, in consultation with the states which have Federal properties participating in the Program, should develop an overall audit strategy for participating properties other than the largest benefiting properties. Smaller properties could be audited along with the largest benefiting properties having the same operator, especially when systemic errors are found. For example, erroneous information for all of an operator's leases may occur because the automated production reporting systems automatically report production days equal to the number of days in the month unless the number of production days is manually changed to reflect actual producing days.

In addition, BLM and MMS need to develop policy and procedures for instances where the operators say that records prior to 1993 are no longer available. Such policies and procedures are essential because while the program is entering its eighth year, a B-year records retention requirement applies to production occurring prior to September 1, 1996. For example, State of New Mexico royalty auditors told us that they had initiated a review on one stripper property but were unable to obtain the supporting records. The auditors subsequently notified the operator by issue letter that the reduced rate would not be allowed unless supporting documentation was provided. The operator responded that it could not locate the records and that it was required to maintain those records for only 6 years after the records are generated. Based on our review of the top 100 benefiting properties, we found that 57 properties had rates based on the original qualification period of August 1990 through July 1991. However; operators had filed for subsequent outyear rate reductions on the remaining 40 properties; thus, the supporting records for these reductions should be less than 6 years old. At a minimum, we believe that operators who cannot provide documentation to support their reduced royalty rates should be required to requalify for the Program.

Further, we believe that BLM and MMS need to develop and implement policies and procedures for reviewing supporting documentation on future and existing notifications that MMS has not confirmed. Our prior audit report (see Prior Audit Coverage) noted that MMS had a backlog of 589 notifications that it had not confirmed. Because of the 85 percent error or unsupported rate (17 of the 20 properties reviewed) identified by this review and in state auditors' reviews, we believe that supporting documentation should be reviewed before MMS confirms that a reduced royalty rate is warranted.

Recommendations

We recommend that the Directors of BLM and MMS:

1. Develop and implement a plan, in coordination with the states, which ensures that the largest benefiting stripper oil well properties are audited. The plan should also identify smaller properties (other than the largest benefiting properties) for audit and/or properties that can be audited in conjunction with the largest properties.
2. Develop a policy for participating Program operators which do not have records prior to 1993 supporting their qualifying information on the "Monthly Reports of Operations." In addition, consideration should be given to requiring requalification of operators that cannot provide documentation to support their reduced royalty rates.
3. Develop Program policy and procedures which address the issues of using load oil in fracturing, multiple completions and multiple well completions, injecting water in a nonproducing formation, and other issues for reviewing and confirming the reduced royalty rate notifications provided by the operators.
4. Develop and implement a procedure to review supporting records for future Program notifications submitted by operators and existing notifications that MMS has not confirmed.

BLM and MMS Response and Office of Inspector General Reply

In the January 27, 2000, response (Appendix 6) to the draft report, the Acting Director, BLM, and the Director, MMS, agreed with the report's four recommendations. Subsequent to the response, officials from BLM and from the Assistant Secretary for Land and Minerals Management's office provided additional information regarding Recommendations 2 and 4. Based on the response and the additional information, we consider Recommendations 2 and 3 resolved and implemented and Recommendations 1 and 4 resolved but not implemented. Accordingly, the unimplemented recommendations will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation (see Appendix 7).

Regarding Recommendation 2, officials stated, in March 3, 2000, electronic correspondence, that MMS will make referrals to the states "for pursuit at their discretion" those cases in which "operators claim that they have no documentation beyond the statutory records retention period " and in which MMS "has reasonable basis to doubt either the claims or the veracity of their stripper royalty rate notifications." The electronic correspondence further stated that MMS "will incorporate alternative compliance techniques to be used for such cases into its routine compliance training programs" as appropriate.

Regarding Recommendation 4, the officials stated that BLM would propose a rule or revised regulations by December 29, 2000, for retaining supporting records for future notifications and subsequent periods.

Since the report's recommendations are considered resolved, no further response to the Office of Inspector General is required (Appendix 7).

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*

<u>Finding Area</u>	<u>Potential Additional Revenues*</u> (In millions)
Royalties underpaid because of:	
- incorrect royalty rates	\$1.56** to \$16.90
- unsupported royalty rates	<u>\$3.25 to \$26.12</u>
Total	<u>\$4.81” to \$43.02</u>

“These amounts are exclusive of the \$3.5 million audit exception reported in the August 1999 audit report “Processing Notifications for the Stripper Oil Well Property Royalty Rate Reduction Program, Minerals Management Service” (No. 99-I-782) (see Prior Audit Coverage).

**This amount is exclusive of an underpayment of more than \$500,000 identified by the State of California that the operator subsequently paid (see Prior Audit Coverage).

**ROYALTY RATES FOR THE
STRIPPER OIL WELL PROPERTY ROYALTY RATE
REDUCTION PROGRAM**

<u>Average Barrels of Oil Produced Per Well Per Day</u>	<u>Reduced Royalty Rate Percent*</u>
0	0.5
1	1.3
2	2.1
3	2.9
4	3.7
5	4.5
6	5.3
7	6.1
8	6.9
9	7.7
10	8.5
11	9.3
12	10.1
13	10.9
14	11.7

*The standard onshore Federal royalty rate as of December 1999 was 12.5 percent for 15 or more average barrels of oil produced per well per day.

**SCHEDULE OF ESTIMATED ANNUAL
STRIPPER OIL WELL PROPERTY ROYALTY RATE
REDUCTIONS PROVIDED BY STATE**

STATE	1992	1993	1994	1995	1996	1997	1998	Total
Alabama	\$672	\$2,359	\$2,146	\$1,974	\$1,574	\$1,876	\$1,072	\$11,673
California*	569,181	1,685,248	1,693,639	1,740,660	2,148,081	6,195,428	3,351,905	17,384,142
Colorado*	83,493	207,191	249,630	362,120	325,791	314,448	185,249	1,727,922
Illinois	1,309	10,478	8,500	7,116	6,707	12,696	8,178	54,985
Kansas	1,012	87,256	104,839	92,756	87,769	98,380	53,028	525,040
Kentucky	2,825	31,971	35,770	31,872	28,739	26,247	13,829	171,253
Louisiana*	1,052	7,250	8,981	8,021	9,657	19,906	10,763	65,631
Michigan	0	0	2,977	12,343	5,782	8,000	1,382	30,485
Mississippi	10,740	42,659	38,806	27,262	25,701	31,894	15,923	192,985
Montana*	43,245	226,169	198,564	231,954	189,920	219,736	118,629	1,228,216
Nebraska	0	459	836	782	1,071	6,763	29,824	39,735
New Mexico*	2,167,788	8,030,576	9,282,295	10,512,819	11,516,695	15,122,579	9,643,011	66,275,763
Nevada	0	0	0	0	0	1,895	5,374	7,269
North Dakota*	16,217	39,288	42,350	44,890	40,888	49,819	1,046	234,499
Ohio	1,105	6,910	8,781	8,763	10,817	44,594	26,248	107,217
Oklahoma*	59,158	65,429	55,984	56,253	70,471	83,806	43,592	434,692
Pennsylvania	0	0	0	0	0	2,366	1,027	3,393
South Dakota	474	2,262	407	5,791	4,556	3,959	302	17,752
Texas	15,446	72,814	66,918	60,612	62,661	83,100	63,947	425,498
Utah*	138,446	693,100	999,760	1,097,454	1,092,823	1,298,732	970,115	6,290,430
Wyoming*	<u>1,912,577</u>	<u>7,417,172</u>	<u>7,792,807</u>	<u>8,000,065</u>	<u>7,549,482</u>	<u>7,503,793</u>	<u>4,318,587</u>	<u>44,494,483</u>
TOTALS	<u>\$5,024,740</u>	<u>\$18,628,591</u>	<u>\$20,593,990</u>	<u>\$22,303,507</u>	<u>\$23,179,185</u>	<u>\$31,130,017</u>	<u>\$18,863,031</u>	<u>\$139,723,063</u>

*States with Section 205 agreements authorized by the Federal Oil and Gas Royalty Management Act. Although the State of Alaska also has a Section 205 agreement, no Federal oil properties in the State participate in the Program.

OFFICES AND SITES VISITED AND/OR CONTACTED

<u>OFFICES AND SITES</u>	<u>LOCATION</u>
Department of the Interior	
Bureau of Land Management	Washington, D.C.
Division of Fluid Minerals	Carlsbad, New Mexico
Carlsbad Resource Area	Hobbs, New Mexico
Hobbs Resource Area	Roswell, New Mexico
Roswell District Office*	Cheyenne, Wyoming
Wyoming State Office*	Casper, Wyoming
Casper District Office	Pinedale, Wyoming
Pinedale Field Office	Rawlins, Wyoming
Rawlins District Office	
Minerals Management Service	
Royalty Management Program Office	Lakewood, Colorado
State of California	
Oil and Gas Unit, Division of Audits	Sacramento, California
State of New Mexico	
Bureau of Oil and Gas	Santa Fe, New Mexico
State of Wyoming	
Mineral Audit Division	Cheyenne, Wyoming
Program Operators	
Amoco Production Company	Bair Oil, Wyoming
Conoco*	Ponca City, Oklahoma
Devon Energy Corporation	Artesia, New Mexico
Enron Oil and Gas	Big Piney, Wyoming
Marathon Oil Company'	Cody, Wyoming
Mack Energy Corporation*	Artesia, New Mexico
Marbob Energy Corporation	Artesia, New Mexico
North Finn, LLC'	Casper, Wyoming
Plains Petroleum Operating Co.*	Midland, Texas
Texaco Exploration and Production	Hobbs, New Mexico

*Contacted only.

RESULTS OF PROPERTIES REVIEWED

<u>Property Number</u>	<u>Rate Paid</u>	<u>Audited Rate</u>	<u>Audited Royalty Amount</u>	<u>Royalties Paid</u>	<u>Additional/ Unsupported Royalties Due</u>
PRODUCTION DAYS					
Sufficient Records for Recalculation					
1	1.3%	12.5%	\$991,536	\$103,120	\$888,416
2	11.7%	12.5%	626,553	549,618	76,935
3	5.3%	6.1%	303,592	230,990	<u>72,602</u>
Subtotal					<u>\$1,037,953</u>
Incomplete Records					
4	6.1%	12.5%	\$1,018,708	\$346,324	<u>84*2.3</u>
Subtotal					<u>\$672,3 84</u>
Lack of Records					
5	6.1%	12.5%	\$2,320,429	\$1,132,369	\$1,188,060*
6	6.1%	12.5%	1,175,620	476,012	699,608*
7	1.3%	12.5%	361,414	37,587	323,827*
8	10.9%	12.5%	297,493	211,589	85,904*
9	8.5%	12.5%	<u>33 1,869</u>	<u>233,403.</u>	<u>98,466*</u>
Subtotal					<u>2,395,865</u>
Subtotal (Production Days)			<u>\$7,427,2 14</u>	<u>\$3,321,012</u>	<u>\$4,106,202</u>
PROGRAM REGULATIONS					
Fracturing					
10	5.3%	9.3%	\$92,235	\$52,564	\$39,671
Multiple Completion and Multiple Completion Wells					
11	5.3%	9.3%	\$443,907	\$252,979	\$190,928
Water Injection Into a Non-Producing Formation					
12	2.1%	12.5%	<u>\$183,342</u>	<u>\$30,810</u>	<u>\$152,532*</u>
Subtotal (Program Regulations)			<u>\$719,484</u>	<u>\$336,353</u>	<u>\$383,131</u>
Total			<u>\$8,146,698</u>	<u>\$3,657,365</u>	<u>\$4,489,333</u>
NO PROGRAM EXCEPTIONS					
13	6.9%	6.9%	\$625,653	\$625,653	0
14	2.9%	2.9%	\$436,007	\$436,007	
Total			<u>\$1,061,660</u>	<u>\$1,06 1,660</u>	<u>0</u>
Grand Total			<u>\$9,208,358</u>	<u>\$4,7 19,025</u>	<u>\$4,489,333</u>

*Unsupported royalties due.



United States Department of the Interior

BUREAU OF LAND MANAGEMENT
Washington, D.C. 20240
<http://www.blm.gov>

Memorandum

To: Assistant Inspector General for Audits

Through: *for* Sylvia V. Baca *Shaunda Freeman Simmons* JAN 27 2000
Assistant Secretary, Land and Minerals Management - Designate

From: Tom Fry
Acting Director, Bureau of Land Management *Tom Fry* JAN 21 2000
Thomas R. Kite, Acting, *for* JAN 24 2000
Walt Rosenbusch
Director, Minerals Management Service

Subject: Response to Draft Audit Report on Supporting Documentation for Operators Participating in the Stripper Oil Well Property Royalty Rate Reduction Program, Bureau of Land Management and Minerals Management Service (Assignment No. C-IN-MOA-001-98(C))

Thank you for the opportunity to provide this joint response to the December 1999 draft audit report on the Stripper Oil Well Property Royalty Rate Reduction Program, which is the second report issued on this program. We appreciate the *rime* and effort put into producing the document and plan to use it, where appropriate, to aid in our continual improvement of the program.

Attached are our general comments on the audit findings and responses to the recommendations. If you have any questions, please contact Ms. Kamilah Rasheed, BLM Audit Liaison Officer, on 202-452-5 161 or Ms. Bettine Montgomery, MMS Audit Liaison Officer, on 202-208-3976.

Attachments

JOINT RESPONSE BY
THE BUREAU OF LAND MANAGEMENT AND
THE MINERALS MANAGEMENT SERVICE

DRAFT AUDIT REPORT
“SUPPORTING DOCUMENTATION FOR OPERATORS PARTICIPATING IN
THE STRIPPER OIL WELL PROPERTY ROYALTY RATE REDUCTION
PROGRAM, BLM AND MMS”

Audit Agency: Office of Inspector General (OIG)

Audit Number: C-IN-MOA-001-98(C)

GENERAL COMMENTS

BLM and MMS appreciate the opportunity to comment on this draft report. We have met together and with the Office of the Solicitor to determine how to best resolve the deficiencies pointed out in the recommendations.

COMMENTS ON RECOMMENDATIONS

1. Develop and implement a plan in coordination with the states, which ensures that the largest benefiting stripper oil well properties are audited. The plan should also identify smaller properties (other than the largest benefiting properties) for audit and/or properties that can be audited in conjunction with the largest properties.

Response: AGREE - MMS and BLM, in coordination with affected States, will prepare a written plan for auditing and verifying the royalty rate for the largest properties benefiting from the stripper oil royalty rate reduction program. MMS has provided affected States with a listing of the 100 properties benefiting the most from the program, and the States have incorporated audits of many of these properties in their FY 2000 audit workplans. For the remainder of those 100 properties that are not audited by the States, BLM will develop a plan for verifying production data reported by the operators considering the effective use of resources, taking into account expected costs and benefits as well as the availability of records. BLM will transmit any errors affecting the royalty rate to MMS, who will be responsible for issuing bills and collecting the additional royalties.

The written plan will be completed by June 1, 2000.

Responsible Officials: Assistant Director, Minerals Realty and Resource Protection, BLM; Deputy Associate Director for Royalty Management, MMS.

2. Develop a policy for participating Program Operators who do not have records prior to 1993 supporting their qualifying information on the “Monthly Reports of Operations.” In addition, consideration should be given to requiring requalification of operators that cannot provide documentation to support their reduced royalty rates.

- **Response:** AGREE – With respect to stripper properties currently benefiting from royalty rate reductions, representatives from BLM, the Solicitor and MMS developed a letter to be mailed to the operators of these 100 properties, requiring submittal of existing records upon which the royalty rate reduction is based. Where operators have records, they will be required to produce them. Where operators respond that they do not have the records, BLM and MMS will consider appropriate actions, including issuing subpoenas in cases where BLM and MMS believe that the records exist. Where records do not exist and where there is no requirement that the records be kept (i.e., where the B-year record retention period has expired), BLM and MMS do not believe that any further actions are appropriate. BLM will issue the letters by February 4, 2000.

With respect to properties for which operators may apply for royalty relief in the future, BLM plans to consider proposing revised regulations that would require retention of records for the initial qualifying period and any subsequent period that resulted in a further reduction in the royalty rate. For example, the regulations may require that the records for such periods be retained for as long as the property is benefiting from the royalty rate reduction. The regulations also will address sanctions for failure to maintain these records, including the possibility of requiring the operator to requalify. BLM will consider how to issue the regulation on an expedited basis, including the possibility of an interim final rule. BLM plans to have a final decision on its course of action by February 11, 2000.

Responsible Official: Assistant Director, Minerals Realty and Resource Protection, BLM.

3. Develop Program policy and procedures which address the issues of using load oil in fracturing, multiple completions and multiple well completions, injecting water in a nonproducing formation, and other issues for reviewing and confirming the reduced royalty rate notifications provided by the operators.

Response: AGREE – BLM issued Instruction Memorandum No. 2000-060 on January 4, 2000, to all BLM Fluid Minerals offices addressing these issues (see attached copy). MMS will evaluate the limitations of the automated system (CRAFTS) to ensure that the clarifications to the policies can be realistically administered.

4. Develop and implement a procedure to review supporting records for future Program notifications submitted by operators and existing notifications that the MMS has not confirmed.

Response: AGREE – MMS will develop guidelines for its technicians to identify anomalies in the reporting of production days on applications for royalty rate reductions. In cases where MMS finds anomalies in royalty rate reduction applications, MMS will refer these to BLM for follow-up and review of company records. BLM and MMS will meet no later than February 2000 to develop a Memorandum of Understanding, which will be completed by June 1, 2000.

Responsible Officials: Assistant Director, Minerals Realty and Resource Protection, BLM; Deputy Associate Director for Royalty Management, MMS.

UNITED STATES DEPARTMENT OF THE INTERIOR
BUREAU OF LAND MANAGEMENT
WASHINGTON, D.C. 20240

January 4, 2000

In Reply Refer To:
3100 (310) P

EMS TRANSMISSION 01/05/2000
Instruction Memorandum No. 2000-060
Expires: 09/30/2001

To: All State Directors

From: Assistant Director, Minerals, Realty and Resource Protection

Subject: Policy for the Stripper Oil Royalty Rate Reduction Program

Program Area: Fluid Minerals

Purpose: This Instruction Memorandum (IM) is written to provide guidance for the stripper oil royalty rate reduction (RRR) program.

Timeframe: The guidance in this IM is effective upon receipt.

Budget Impact: This should have a positive impact on the budget by helping ensure the program is clear and consistently applied across the Bureau.

Background: The Inspector General conducted an audit to evaluate the effectiveness of the RRR program. While the program is highly effective in encouraging production from stripper wells, the audit identified the need to develop policy and guidance for the program regarding accounting for frac/load oil; counting multiple completions and downhole commingling; and injecting water into a formation which is not producing on the property. To address these issues we are issuing the following guidance.

The operator shall not count any production until all frac/load oil is recovered and also shall not count any producing days until all the frac/load oil has been recovered. For example, if an operator uses 700 barrels of oil to frac a formation and it requires 25 days to recover 700 barrels of oil the operator should start counting the 26th day as the first producing day and the production from the 26th day. This frac or load oil production and the number of producing days should be broken out and noted separately on the Monthly Report of Operations.

Multiple completions that are commingled downhole shall be counted as one well because the operating expenses for this well would be for one well (even though there is more than one producing formation).

Multiple well completions with separate production strings for each zone shall be counted as separate wells. In this situation the operator would be paying increased operating expenses (closer to the expenses of separate wells) and so should be allowed to count each completion as an eligible well.

Wells injecting into a formation which is nonproducing on the property will not count as an injection well (for the purposes of this program) and so the injecting days will not be counted because by definition this is not an injection well for secondary/enhanced recovery [based on definition at 43CFR 3103.4-2(a)(4)].

Manual/Handbook Sections Affected: 43CFR 3103.4-2

Coordination: This IM was coordinated with the Field Offices and Minerals Management Service.

Contact: If you have any question about this guidance please contact, Rudy Baier at (202) 452-5024.

Signed by:
Carson W. Culp
Assistant Director
Minerals, Realty and Resource Protection

Authenticated by:
Robert M. Williams
Directives, Records
& Internet Group, WO540

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, DC. 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
4 15 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. 20240-000 1

Toll Free Numbers

1-800-424-508 1

TDD 1-800-354-0996

FTS/Commercial Numbers

(202) 208-5300

TDD (202) 208-2420

