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

AUDIT REPORT

STRIPPER OIL WELL PROPERTY ROYALTY RATE REDUCTION PROGRAM, BUREAU OF LAND MANAGEMENT

REPORT NO. 01-I-297
MARCH 2001

United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20240

MAR 30 2001

Memorandum

To: Director, Bureau of Land Management

From: Roger La Rouche Roger La Rouche
Assistant Inspector General for Audits

Subject: Audit Report on the Stripper Oil Well Property Royalty Rate Reduction Program, Bureau of Land Management (No. 01-I-297)

This report presents the results of our audit of the Stripper Oil Well Property Royalty Rate Reduction Program. This is the third report that we are issuing on the Program.

In accordance with the Departmental Manual (360 DM 5.3), we are requesting a written response to this report by April 16, 2001. The response should include the information requested in Appendix 6.

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.

cc: Director, Minerals Management Service

EXECUTIVE SUMMARY

Stripper Oil Well Property Royalty Rate Reduction Program,
Bureau of Land Management
Report No. 01-I-297
March 2001

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 Secretary of the Interior is required by Program regulations 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 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.

We concluded that the goal of BLM's Stripper Oil Well Property Royalty Rate Reduction Program of increasing or restarting oil production on marginal or uneconomical wells on Federal leases has merit. Specifically, we believe that property operators who have already implemented enhanced or secondary recovery techniques but who were unable to produce economic quantities of oil and for whom reserves were near depletion could be encouraged to continue production by obtaining the Program's reduced royalty rates. BLM, however, did not determine whether all properties participating in the Program needed the reduced royalty rates to economically maintain or increase production. In addition, BLM's evaluation supporting the decision to extend the Program was limited in scope and did not adequately consider comments from BLM's field offices and the Minerals Management Service (MMS). Further, BLM did not consider a property's economic viability in connection with Program eligibility and did not provide for an increase in royalty rates if the property subsequently became economically viable. As a result, we believe that the Government is losing royalty revenues from Program properties which do not require reduced royalties to maximize production or promote development.

We also noted that BLM did not include a provision in the Program regulations for recovering costs of the Program from participating operators. MMS, which is responsible

for confirming the reduced royalty rates authorized under the Program, estimated that it costs an average of $180,000 annually to process Program notifications and to maintain an automated royalty rate exception processing routine, which is used to monitor royalty rates paid by royalty payors. We believe that the $180,000 annual cost should be recovered from the operators.

We recommended that BLM reevaluate the Program and make changes as appropriate and that it develop and implement a cost recovery fee for processing Program notifications.

AUDITEE COMMENTS AND OFFICE OF INSPECTOR GENERAL EVALUATION

BLM stated, "In the light of the policy focus on minerals and the change of Administration . . . . [i]t is our intention to present a full range of policy options from status quo to discontinuing the program to the new Assistant Secretary for Land and Minerals Management." BLM also stated that the recommendation to implement a cost recovery fee will be included in the policy options.

Because the response did not express specific concurrence or nonconcurrence with the report's two recommendations, the recommendations are considered unresolved.

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INTRODUCTION

BACKGROUND

The Secretary of the Interior is required by the Federal Oil and Gas Royalty Management Act of 1982 (30 U.S.C. § 1711) 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.

The Stripper Oil Well Property Royalty Rate Reduction Program,[1] 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 restart production of marginal or uneconomic oil wells and to increase production on Federal onshore leases by drilling new wells, by reworking existing wells, and/or by implementing enhanced or secondary oil recovery[2] projects. The Secretary is required by 43 CFR 3103.4-2(b)(5) to evaluate the effectiveness of the Program and is allowed, at any time after September 10, 1997, to terminate any or all royalty reductions granted under the Program upon 6 months notice. On February 18, 1998, the Department of the Interior extended the Program for an indefinite period.

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[1]According to 43 CFR 3103.4-2, 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 officer 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." Thus, a unit or communitization would include more than one lease.

[2]"The Illustrated Petroleum Reference Dictionary" (edited by Robert D. Langenkamp, Tulsa, Oklahoma, 1982) defines secondary recovery as follows: "The extraction of oil from a field beyond what can be recovered by normal methods of flowing or pumping; the use of waterflooding, gas injection, and other methods to recover additional amounts of oil." The "Dictionary" defines enhanced oil recovery as follows: "Sophisticated recovery methods for crude oil which go beyond the more conventional secondary recovery techniques of pressure maintenance and waterflooding."

To qualify for the Program, eligible wells must either produce oil or serve as injection wells[3] 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 average daily production and the royalty rate that would be effective on or after October 1, 1992. In 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-in[4] 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.

The operator is required to submit a notification of Program participation on the "Stripper Royalty Rate Reduction Notification" (Form MMS-4377), 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).[5] The operator calculates the average production of oil per well per day by dividing the total oil production produced from eligible wells during the qualifying period by the total number of producing or injecting well days. The resultant 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 the Minerals Management Service 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.

BLM has overall responsibility for the Program, including promulgating the Program regulations; establishing policies and procedures for the Program; 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

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[3]According to 43 CFR 3103.4-2(a)(4), an eligible injection well is a "well that injects a fluid for secondary or enhanced oil recovery, including reservoir pressure maintenance operations."

[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.

[5]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.

is responsible for confirming the reduced royalty rate information provided by the operator on the notification forms. 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's 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[6] agreements, and units[7] and ranged in size from a single well to more than 1,300 wells per property.

OBJECTIVE AND SCOPE

The objective of the audit was to determine whether BLM used accurate and effective data and appropriate methodology to identify Program benefits and costs to justify the Program's indefinite extension.

Our audit fieldwork was conducted 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, Department of Energy, and state government officials at the offices listed in Appendix 1. To meet our audit objective, we examined data relative to BLM's evaluation study of the Stripper Well Property Royalty Rate Reduction Program and BLM and MMS records pertaining to individual operators participating in the Program.

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 the assurance statement addressed BLM's involvement in the

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[6]"Manual of Oil and Gas Terms" (by Howard R. Williams and Charles J. Meyers, Matthew Bender, New York, 1997) states, "Where Federal lands are involved communitization is the agreement to combine small tracts for the purpose of committing enough acreage to form the spacing and proration units necessary to comply with the applicable state conservation requirements."

[7]"Manual of Oil and Gas Terms" (by Howard R. Williams and Charles J. Meyers, Matthew Bender, New York, 1997) states that a unit is "an area of land, deposit, or deposits of minerals, stratum or strata, or pool or pools, or part or parts thereof, as to which parties with interests therein are bound to share minerals produced on a specified basis and as to which those having the right to conduct drilling or mining operations therein are bound to share investment and operating costs on a specified basis."

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 Findings and Recommendations section of this report. Our recommendations, if implemented, should improve internal controls in these areas.

PRIOR AUDIT COVERAGE

During the past 5 years, the General Accounting Office has not issued any audit reports on this Program. However, the Office of Inspector General has issued two audit reports on the Stripper Oil Well Property Royalty Rate Reduction Program.

In August 1999, we issued the audit report entitled "Processing Notifications for the Stripper Oil Well Property Royalty Rate Reduction Program, Minerals Management Service" (No. 99-I-782). 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. We recommended that MMS develop and implement a plan (1) to eliminate the Stripper Oil Well Property Royalty Rate Reduction Program notification processing and data entry backlogs and to approve future notifications in a timely manner and (2) to review Program exceptions generated by the automated matching process and collect underpaid royalties from operators. Based on MMS's response to the two recommendations, we considered one recommendation resolved and implemented and the other recommendation resolved but not implemented.

In March 2000, we issued the audit report entitled "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). The report stated that BLM (1) did not provide sufficient oversight of operators to ensure that information on the production and injection 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. As a result, royalties may have been underpaid by as much as $43 million since inception of the Program through December 31, 1998. The report recommended that BLM and MMS (1) develop and implement a plan which ensures that the largest benefiting stripper oil well properties are audited, (2) develop a policy for participating Program operators that do not have records for periods prior to 1993 which support their qualifying information on their "Monthly Reports of Operations," (3) develop Program policy and procedures which address qualifying production and wells, and (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. Based on BLM's and MMS's responses to the four recommendations and subsequent information, we considered two recommendations resolved and implemented and two recommendations resolved but not implemented.

FINDINGS AND RECOMMENDATIONS

A. PROGRAM OPERATIONS

The goal of BLM's Stripper Oil Well Property Royalty Rate Reduction Program of increasing or restarting oil production on marginal or uneconomical wells on Federal leases has merit. Specifically, we believe that property operators who have already implemented enhanced or secondary recovery techniques but who were unable to produce economic quantities of oil and for whom reserves were near depletion could be encouraged to continue production by obtaining the Program's reduced royalty rates. BLM, however, did not determine whether all properties participating in the Program needed the reduced royalty rates to economically maintain or increase production. The Mineral Leasing Act of 1920 (30 U.S.C. § 209) permits the Secretary to reduce royalty rates in order to encourage maximum production and to promote development on leases that cannot be operated economically. The Code of Federal Regulations (43 CFR 3103.4-2) requires that the Program be evaluated for effectiveness after 5 years, at which time any or all royalty rate reductions granted under the Program could be terminated upon 6 months' notice. However, BLM's evaluation supporting the decision to extend the Program was limited in scope and did not adequately consider critical comments from BLM's field offices and MMS. Also, BLM did not consider a property's economic viability in connection with Program eligibility and did not provide for an increase in royalty rates if the property subsequently became economically viable. As a result, we believe that the Government is losing royalty revenues from Program properties which do not require reduced royalties to maximize production or promote development.

Program Extension

The Department of the Interior approved the indefinite extension of the Stripper Oil Well Property Royalty Rate Reduction Program on February 18, 1998. BLM recommended indefinite extension based on the results of a joint study conducted by officials from BLM, MMS, and the Department of Energy. The study's methodology consisted of (1) running a computer model that compared actual production on selected New Mexico Program properties with model estimates of production which might have occurred had the royalty rate remained at 12.5percent, (2) soliciting public and private sector comments, and (3) reviewing BLM and MMS production data relative to Program properties in other oil-producing states.

As discussed in the sections that follow, we believe that the scope of this study was insufficient to support BLM's recommendation for approving an indefinite extension of the Program without modification. In addition, BLM and MMS officials raised significant concerns about the adequacy of the study that were not resolved before the recommendation to extend the Program was made to the Assistant Secretary for Land and Minerals Management.

Scope of Study. The study did not determine why incremental production increased on existing wells or why new wells were completed on existing producing properties. In addition, the number and the locations of the properties used in the computer modeling were insufficient for results to be projected to the entire Program. These issues are discussed as follows:

- The recommendation to extend the Program relied primarily on the results of a Department of Energy computer model (Tertiary Oil Recovery Information System, or TORIS) that estimated incremental production from 603 sample Program properties in the State of New Mexico during the period of October 1992 through December 1996. As a result of the modeling, Department of Energy officials estimated that incremental production from the existing wells increased by 4.27 million barrels from October 1992 through December 1996 and was attributable to the royalty rate reduction. However, we questioned this attribution because in calendar year 1997, 88 percent of the production from the top 100 Program-benefiting properties was from properties that had enhanced or secondary recovery projects. According to industry, BLM, and MMS officials, operator decisions on these types of projects are based on economic factors such as estimated reserves, oil prices, production volumes, and production costs. The Department of Energy officials who participated in the model agreed that incremental production from enhanced or secondary recovery projects should not have been attributed only to reduced royalty rates when any of these other economic factors could have been the primary reason the enhanced recovery project was initiated.

- The Department of Energy sampled 603 Federal properties in New Mexico; however, its February 9, 1998, report stated that "to more fully assess the effectiveness of the royalty relief Program, the analysis should be expanded to include Federal lands in other states." In addition, the Department of Energy also noted that its evaluation did not consider the impact of oil price changes and "highly recommended that future analysis considers the impact of the oil price change once the 1997 and 1998 data become available."

- According to MMS comments on the study, 40 percent of the 6,807 stripper notifications received and logged involved New Mexico properties and 39 percent involved Wyoming properties. According to MMS, while the study showed an increase in production from New Mexico, Wyoming experienced a decline in production. MMS also said that Wyoming was more representative of a stripper oil state and New Mexico is more representative of a marginal gas state. According to MMS, many of the New Mexico wells that qualified under the Stripper Program were actually low-producing gas wells rather than oil wells. Except for the States of California, Colorado, Kentucky, and New Mexico, production volumes overall decreased on the stripper oil properties, according to MMS, when 1992 was used as the base year. MMS also stated that the losses in royalty dollars attributable to the Program were more than $89 million through 1996. According to MMS, this estimated royalty loss reflected the "worse case scenario of royalty losses" attributable to the Program and was based on the assumption that every barrel would have been produced in the absence of the Program. MMS acknowledged that the estimated royalty loss did not take into consideration incremental production and the economic impact attributable to shut-in wells if the Program had not been an effect.

Comments on the Program. The study's methodology also solicited comments and data from the public, industry, BLM, and MMS. Public and industry comments were received primarily from oil and gas organizations and operators that had properties participating in the Program. Respondents from the oil and gas industry favored continuing the Program and cited Program benefits such as extended life of industry's properties, consideration of secondary recovery processes, ability to drill new wells, and positive impact on local economies. However, none of the claims by oil property operators or oil producer associations relative to program benefits on individual properties or industrywide statistics were verified by BLM.

Fourteen BLM offices (seven state and seven field offices) and MMS's Royalty Management Program Office made specific comments about Program benefits and the need for continuing the Program. Although these comments were made by personnel connected with the Program, the final study report omitted the comments from BLM's field offices and attributed MMS's comments to "one respondent." In written responses, only 1 (a Colorado field office) of the 14 responding BLM offices attributed increased production to royalty rate reductions. Of the remaining 13 offices, 5 offices stated that increased production was not attributable to royalty rate reduction, 6 offices had no comments on the reasons for the increased production, and 2 offices did not identify increased production. In regard to continuation of the Program, four offices recommended termination, nine offices did not comment on Program extension, and the remaining office recommended specific Program modifications.

In its comments, MMS suggested that BLM consider evaluating the economics of the higher-producing properties to determine whether or not a royalty rate reduction was warranted. MMS agreed that the lower producing properties could benefit from continuation of the Program and also recognized that some of the higher producing properties may have had operating costs that would warrant some type of royalty reduction. However, MMS said that the loss of royalties is greatest with the higher volume producing properties. MMS suggested that BLM consider narrowing the scope of properties that could continue to receive a royalty rate reduction. MMS recommended that BLM consider a production cap under which properties could benefit from a royalty rate reduction and suggested that BLM consider redefining a stripper property as one that has an average daily production volume lower than the fewer than 15 barrels of oil per eligible well per well day cited in the regulation.

Economic Viability

According to 43 CFR 3103.4-2, operators of properties that produce an average of fewer than15 barrels of oil per eligible well per day may pay reduced royalties. The Code does not address situations in which properties are profitable or become profitable and do not need the reduced royalty subsidy in order to maximize production or promote development. Once a reduced royalty rate is approved for a property, the rate does not go up, even if production increases, but the rate can go down if production decreases. Stripper regulations allow many properties that have current production volumes well above BLM's qualifying level of 15 barrels per day to pay reduced royalty rates based on the qualifying period.

Average Production per Well. Operators of many of the largest benefiting Program properties have drilled new wells, reworked existing wells, or initiated enhanced recovery projects since qualifying for the Program and have increased production volumes well above the qualifying maximum level of an average of fewer than 15 barrels of oil per well per day. Of the top 100 benefiting properties in calender year 1997, 43 properties had increased production above 15 barrels of oil per day (see Appendix 4), and these properties accounted for $11.2 million, or about 36 percent, of the total reduced royalty allowed for 1997 of $31.1 million.

We selected 19 of the 43 properties with average production volumes above 15 barrels for review of income and expenditures. The 19 properties were selected based mainly on the availability of property enhancement information submitted to BLM by the operators. This information pertained to investments in the property that would require BLM approval, such as reworking or recompleting a well, drilling new wells, plugging old wells, or changing well status. We examined BLM and MMS records to determine the amount of revenues from oil sales, royalty rate reductions claimed, and total operator investment in improvements to increase production from the initial date the reduced royalty rate was claimed through September 1998. Because we did not have cost information on operator activities not requiring BLM approval, such as routine maintenance or normal operating expenses, we were unable to calculate a rate of return on capital investments or determine whether these properties needed a royalty rate reduction to operate economically. We believe that the operators of these properties would have invested in the improvements to increase production even if Program incentives were not available because of how quickly capital costs were recovered. The potential profitability of these properties is presented as follows:

- A property in New Mexico with one producing oil well and average daily production of three barrels of oil per day qualified for a reduction of its royalty rate to 2.9 percent in October 1993. In July 1995, the operator recompleted the well into a different producing formation at an estimated cost of $45,000. In calender year 1997, the property had increased average daily production to 109 barrels of oil per day. From October 1993 through September 1998, the property produced more than 137,000 barrels of oil with a sales value of more than $2.7 million, and the property's operator had received a reduction in its royalty payments of almost $260,000 (paying a 2.9 percent reduced royalty rate versus the standard rate of 12.5 percent).

- A property in Wyoming with four producing oil wells and three injection wells and an average daily production of six barrels of oil per day qualified for a reduction of its royalty rate to 5.3 percent in October 1992. BLM records show that since qualifying for the reduced royalty rate, the operator made no investments in the property to enhance production. In calender year 1997, the property had increased average daily production to more than 22 barrels of oil per day. From October 1992 through March 1998, the property produced more than 272,000 barrels of oil with a sales value of more than $5.2 million, and the property's operator had received a reduction in its royalties of more than $378,000 (paying a 5.3 percent reduced royalty rate versus the standard rate of 12.5 percent).

- A property in California with 376 producing oil wells and 12 injection wells and an average daily production of 2 barrels of oil per day qualified for a reduction of its royalties to 2.1 percent in October 1992. Since qualifying for the reduced royalty rate, the operator drilled 79 new wells and received BLM approval of 309 notices for additional investments in operations at an estimated cost of about $27 million. In calender year 1997, the property had an average daily production of more than 31 barrels of oil per day. From October 1992 through September 1998, the property produced more than 4.5 million barrels of oil with a sales value of more than $86 million, and the property's operator received a reduction in its royalties of almost $9 million (paying a 2.1 percent reduced royalty rate versus the standard rate of 12.5 percent).

Although increasing oil production of stripper oil well properties was a goal of the Program, we believe that operators of those properties which significantly increased production above the qualifying levels may have invested in the property without the Program incentives of reduced royalty rates. Accordingly, unless operators can justify, with specific economic data, that continued reduced royalty rates are required to maximize production or further promote development, we believe that Program benefits should be reduced or eliminated as production increases beyond qualifying levels.

Cumulative Production per Property. Properties are permitted by 43 CFR 3103.4-2 to qualify for reduced royalty rates based on average production per well, but the regulation does not distinguish between a small property with a few wells and low cumulative production and a large property with many wells and high cumulative production. During our audit, we found that 72 of the top 100 benefiting properties in calender year 1997 were enhanced or secondary recovery projects. The production from these 72 properties came from 7,200 wells and totaled 19.6 million barrels, resulting in royalty savings of approximately $19.4 million (81 percent of the reduced royalty allowed for 1997). In our opinion, the cumulative amount of production (these 72 properties averaged almost 273,000 barrels of oil each during 1997) provided the economic incentive to keep these properties producing, and the reduced royalty rate did not significantly affect the operators' decision to continue production on these properties. In 1997, MMS's Royalty Management Program and BLM State Offices in Wyoming and Utah provided written comments regarding the extension of the Program that raised concerns about allowing reduced royalty rates for secondary recovery properties. The comments from MMS and BLM are as follows:

- MMS expressed concern about qualifying properties that produced large quantities of oil, noting that the greatest loss in royalty dollars was incurred from these higher producing properties. MMS conducted a study of the Program's largest qualifying property, a water flood project in Wyoming that had more than 1,900 wells and produced more than 2 million barrels of oil per year. MMS records showed that the property's operator saved more than $3.4 million in royalties during calendar year 1997. In its comments, MMS further stated:

> We make the case that this property would have continued [without the reduced royalty rate] to produce high [oil] volumes because the water flood project has been in existence for many years. In addition, having the existing

> infrastructure and operations at economies of scale would almost guarantee that the property would continue to produce as long as the price of oil was not such that it made production uneconomical.

- BLM's Wyoming State Office stated that the economic significance of a royalty rate reduction was small when compared with the investments in enhanced and secondary recovery systems. The State Office recommended that these properties be analyzed on their individual merits for continued royalty rate reduction. The State Office further stated:

> An enhanced recovery unit project usually begins with an oil field that has produced oil through primary recovery that is at or near its economic limit. At this point in the life of the field, a RRR [royalty rate reduction] may have [been] obtained as the property continues to produce under primary recovery. Once the enhanced recovery unit is approved and enhanced recovery operations commence, the benefits of enhanced or secondary recovery result in oil wells that can produce at rates many times more than when they were under primary recovery [sometimes at higher rates than when the well was initially completed for primary reserves].

- Written comments from BLM's Utah State Office identified secondary recovery properties that had received reduced royalty rates with production of 2.5 million barrels of crude oil. However, the State Office also noted that other secondary recovery properties in the same area were undergoing similar development without the benefit of reduced royalty rates. The State Office further stated, "We feel the results would have been the same if the stripper policy was not in place."

BLM's Montana State Office stated in its written response:

> Overall, we do not believe the royalty rate reduction has served to extend the productive life of federal leases. It appears that most operators did not take action to drill new wells, work over existing wells, or attempt new technologies [horizontal drilling is considered to be a standard completion technique for many fields in North Dakota and eastern Montana]. We do not recommend renewal of the royalty rate reduction regulations.

We found that during calender year 1997, about 800 operators that had about 3,600 stripper oil well properties received about $31 million in royalty rate reductions (see Appendix 3). During this period, operators of five individual properties (less than 1 percent) received almost $11 million (35 percent) of the royalty rate reductions allowed (see Appendix 3). In addition, operators of the top 100 benefiting properties (less than 3 percent) received more than $24 million (77 percent) of the royalty rate reductions provided by the Program. While these large properties should not be excluded automatically from the Program based on their total production levels, we believe that these large properties may be profitable without the benefit of a reduced royalty rate and that taxpayers should not subsidize such operations. If large producing properties are allowed to be considered for the Program, we believe that the operators should be required to submit sufficient information to demonstrate that economic incentives are required to maximize production or promote development.

The Program has been in operation since October 1992. To ensure that only properly qualified properties receive program benefits, we believe that BLM should perform a more comprehensive evaluation that addresses the issues and concerns discussed in this report. For example, the uncertainties in the Department of Energy's modeling and the concerns of MMS and many of the BLM field offices need to be fully considered. In addition, BLM was not aware of the extent of operator misreporting, as noted in our audit report titled "Supporting Documentation for Operators Participating in the Stripper Oil Well Property Royalty Rate Reduction Program, Bureau of Land Management and Minerals Management Service" (see Prior Audit Coverage). The report stated that production reports, which are used to calculate reduced royalty rates, were improperly completed by the operators, which resulted in many operators receiving a royalty rate lower than the rate to which they were entitled. Of the 20 properties reviewed, 17 were found to be either improperly calculated or unsupported, and royalties may have been underpaid by as much as $43 million. We believe that the concerns noted in that report, along with the issues raised in this report, should be considered in a reevaluation of the Program. Finally, the recent increases in oil prices (the price per barrel increased from about $10 in February 1999 to about $31 in March 2000) have substantially increased the profitability of many of the Program properties and have also increased the royalty losses attributable to the Program.

Recommendation

We recommend that the Director, BLM, reevaluate the Stripper Oil Well Property Royalty Rate Reduction Program and make changes as appropriate. In the new evaluation, BLM should analyze production changes and the reasons for the production changes, such as enhanced or secondary recovery and the impact of oil price variations during the period reviewed, on a representative sample of properties participating in the Program; establish production ceilings for stripper oil properties above which operators would not receive reduced royalty rates unless they submitted sufficient economic data to demonstrate that they needed the reduction to maximize production or promote development; and establish guidelines for reduction of Program benefits when production levels on an average per well basis increase beyond an established level.

BLM Response and Office of Inspector General Reply

In the March 26, 2001 response (Appendix 5) to the draft report from the Acting Director, BLM, BLM stated, "It is our intention to present a full range of policy options from status quo to discontinuing the program to the new Assistant Secretary for Land and Minerals Management." Based on the response, we request that BLM specifically respond to the recommendation, which is unresolved (see Appendix 6).

B. RECOVERING PROCESSING COSTS

MMS did not recover its costs for processing notifications for the Stripper Oil Well Property Royalty Rate Reduction Program. The authority for Federal agencies to recover costs of providing services to beneficiaries is contained in the Independent Offices Appropriations Act of 1952. In addition, the Department of the Interior Manual and Office of Management and Budget Circular A-25, "User Charges," provide guidance on carrying out the authority contained in the Act. However, when BLM promulgated the Program regulations, it did not include a provision for recovering costs of the Program from participating operators. MMS officials estimated that it cost an average of $180,000 annually to process Program notifications and to maintain the automated royalty rate exception processing routine, which is used to identify exceptions in the royalty rates paid by royalty payors. During fiscal years 1995 through 1998, MMS received from 400 to 800 notifications annually. Based on these estimates, we determined that the average cost to process one notification would be from about $225 to $450. In addition, MMS estimated that it would cost about $145,000 to eliminate the notification processing backlog (see Prior Audit Coverage). As noted in our August 1999 audit report, MMS has not allocated the resources necessary to properly monitor this Program, primarily because of higher priorities and limited resources.

The Department of the Interior Manual (Part 346, "Cost Recovery") states that unless otherwise prohibited or limited by statute or authority, a fee that recovers costs should be imposed for services that provide special benefits or privileges to a non-Federal recipient. Circular A-25 requires that a user charge be "assessed against each identifiable recipient for special benefits derived from Federal activities beyond those received by the general public." Circular A-25 further states that a special benefit will be considered to accrue and a user charge will be imposed when a Government service "is performed at the request of or for the convenience of the recipient, and is beyond the services regularly received by other members of the same industry or group or by the general public." In addition, MMS regulations for offshore royalty relief contained in 30 CFR 203.56 require an application processing fee as follows:

> When you submit an application for royalty relief, you must include a payment to reimburse MMS for the costs it incurs in processing your application. The MMS will establish in a Notice to Lessees a schedule that will specify the fees that must be paid for each of the different types of royalty relief applications.

We believe that since the reduced royalty rate does not automatically apply to all producers, it is a special benefit to certain operators and meets this cost recovery criterion. Furthermore, since the regulations governing the Program are BLM regulations, we believe that the processing fees should be required by BLM but should be collected by MMS.

BLM has several options for determining how to recover costs associated with processing stripper notifications. For example, BLM could base fee amounts on the number of wells included in the notification. In that regard, some properties had only a single well, and MMS personnel said that the information on a single well notification takes only 1 to 2 hours to confirm. Therefore, billing an operator for the cost to review a single well notification might not be productive; thus, smaller operators could be exempt from the payment. However, billing an operator for reviewing data on multiple-well notifications, such as 10 or more wells, should be considered, since the amount of the reduced royalties would be significant and the operator would be less likely to end participation in the Program. BLM officials have expressed concerns that charging a processing fee for notifications could cause some of the smaller marginal operators to end their participation in the Program. Our review, however, found that since smaller operators typically had smaller properties, they had fewer wells.

Recommendation

We recommend that the Director, BLM, revise Program regulations to require a cost recovery fee for processing Program notifications.

BLM Response and Office of Inspector General Reply

In the March 26, 2001 response (Appendix 5) to the draft report, the Acting Director, BLM, did not express specific concurrence or nonconcurrence with the recommendation. BLM said that it would incorporate the recommendation into the policy options when the new Assistant Secretary arrives. Based on the response, we request that BLM specifically respond to the recommendation, which is unresolved (see Appendix 6).

OFFICES AND SITES VISITED AND/OR CONTACTED

OFFICES AND SITES	LOCATIONS
Department of the Interior	
Bureau of Land Management	
Division of Fluid Minerals	Washington, D.C.
Bakersfield Field Office*	Bakersfield, California
Great Falls Resource Area	Great Falls, Montana
Roswell District Office	Roswell, New Mexico
Royal George Resource Area	Canon City, Colorado
Wyoming State Office*	Cheyenne, Wyoming
Minerals Management Service	
Washington Office*	Washington, D.C.
Royalty Management Program	Lakewood, Colorado
U.S. Department of Energy	
National Petroleum Technology Office*	Tulsa, Oklahoma
State of New Mexico	
New Mexico Taxation and Revenue Department, Bureau of Oil and Gas	Santa Fe, New Mexico
State of Wyoming	
Minerals Management Division*	Cheyenne, Wyoming

*Contacted only.

SCHEDULE OF ROYALTY RATE REDUCTIONS

Average Number of Barrels Reduced of Oil Produced Per Well Per Day	Royalty Rate Percentage
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

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*	1,912,577	7,417,172	7,792,807	8,000,065	7,549,482	7,503,793	4,318,587	44,494,483
TOTALS	**$5,024,740**	**$18,628,591**	**$20,593,990**	**$22,303,507**	**$23,179,185**	**$31,130,017**	**$18,863,031**	**$139,723,063**

* These states have Section 205 agreements authorized by the Federal Oil and Gas Royalty Management Act.

SCHEDULE OF STRIPPER OIL WELL PROPERTIES WITH THE HIGHEST ESTIMATED ROYALTY SAVINGS FOR CALENDAR YEAR 1997

Property Rank[A]	Producing Oil Wells	Water Injection Wells	Oil Produced (Barrels)	Average Daily Production	Reduced Royalty Rate	Estimated Royalty Reductions
1[B]	715	586	2,011,718	5.01	0.037	$3,403,757
2[B,C]	222	36	1,352,577	15.28	0.021	2,813,360
3[B,C]	113	0	1,177,358	31.51	0.021	2,448,905
4[a]	147	81	578,317	10.23	0.021	1,202,899
5[BC]	75	38	920,119	59.38	0.069	1,030,533
6[C]	67	61	960,550	21.89	0.061	656,186
7[C]	106	33	980,693	26.24	0.093	627,644
8	172	139	1,058,278	9.97	0.037	528,839
9[C]	70	10	373,427	18.58	0.037	496,538
10	173	59	522,571	7.15	0.077	489,463
11	131	97	413,634	4.99	0.029	443,612
12	53	31	218,857	7.65	0.037	385,188
13	96	31	407,147	9.15	0.077	375,890
14[C]	23	0	167,971	56.54	0.021	349,380
15[C]	35	13	295,087	18.89	0.069	330,497
16	34	9	171,468	11.71	0.029	329,219
17	84	68	168,528	6.19	0.037	296,609
18	52	44	303,127	8.77	0.077	289,675
19	117	6	152,109	3.47	0.037	267,712
20	140	88	145,559	1.90	0.029	259,147
21	48	37	196,670	6.85	0.061	251,738
22[C]	9	1	133,830	54.63	0.037	235,541
23	18	15	101,563	9.34	0.021	211,251
24	62	14	145,252	6.34	0.029	209,768
25[C]	12	0	88,611	34.64	0.013	198,489
26	16	14	105,047	9.91	0.037	184,883
27	14	14	104,000	11.92	0.037	183,040
28[C]	9	0	74,618	39.23	0.013	167,144
29	72	45	290,909	7.39	0.053	159,288
30	53	20	123,818	5.45	0.061	158,487
31[C]	13	10	197,771	26.21	0.085	158,217
32	52	43	84,929	2.57	0.029	143,072
33	65	67	97,878	8.07	0.053	140,944
34	15	14	129,504	13.69	0.061	137,137
35[C]	14	3	77,918	15.24	0.037	137,136

A. Ranking based on highest estimated royalty savings.
B. Largest five benefiting properties received royalty reductions of $10.9 million.
C. Properties (total 42) with average daily production per well of more than 15 barrels of oil per day.

Property Rank[A]	Producing Oil Wells	Water Injection Wells	Oil Produced (Barrels)	Average Daily Production	Reduced Royalty Rate	Estimated Royalty Reductions
36	12	6	60,714	9.77	0.013	135,999
37	43	26	95,872	4.43	0.021	135,610
38	37	28	175,805	7.82	0.077	124,474
39	30	28	85,894	4.29	0.053	123,687
40	57	0	59,305	2.99	0.029	113,866
41[C]	30	21	422,544	48.11	0.069	112,633
42	12	12	53,669	6.20	0.013	111,631
43	71	62	152,822	3.40	0.037	108,634
44	19	9	94,841	9.65	0.069	106,222
45	32	0	59,642	5.18	0.037	104,970
46	42	32	281,217	10.95	0.093	104,208
47	19	15	88,116	7.8	0.069	98,690
48[C]	13	9	87,029	16.87	0.069	97,472
49[C]	14	0	80,402	17.87	0.061	93,241
50[C]	9	0	82,178	28.27	0.069	92,039
51	34	0	50,661	4.22	0.037	89,163
52	25	16	69,584	5.39	0.061	89,068
53	39	28	121,561	5.45	0.061	86,431
54	46	9	67,213	3.17	0.061	86,033
55	29	14	66,910	4.62	0.061	85,645
56	9	3	50,045	12.25	0.045	80,072
57[C]	8	0	44,806	34.46	0.037	78,859
58[C]	172	157	1,686,553	15.29	0.109	78,796
59	44	46	71,371	2.45	0.029	78,680
60	18	0	54,584	10.15	0.053	78,601
61	82	24	365,012	12.15	0.085	77,308
62[C]	8	0	69,015	25.38	0.069	77,297
63[C]	1	0	40,050	109.72	0.029	76,896
64[C]	4	0	38,928	27.08	0.029	74,742
65	41	8	68,601	4.22	0.037	70,831
66	52	7	187,909	8.91	0.077	70,696
67	37	23	219,879	10.46	0.109	70,361
68	35	0	114,851	5.46	0.053	68,339
69[C]	6	0	59,781	31.17	0.069	66,955
70	155	88	241,228	6.53	0.021	64,033
71[C]	4	0	24,308	16.64	0.005	58,339
72	18	1	50,946	8.71	0.069	57,060
73[C]	38	6	352,877	23.52	0.117	56,460
74[C]	5	1	34,714	22.49	0.045	55,542
75[C]	4	2	38,350	22.28	0.053	55,224
76	30	6	53,552	5.09	0.053	55,191
77	41	13	184,498	10.63	0.109	54,326
78[C]	9	0	39,032	18.00	0.061	49,961

Property Rank[A]	Producing Oil Wells	Water Injection Wells	Oil Produced (Barrels)	Average Daily Production	Reduced Royalty Rate	Estimated Royalty Reductions
79[C]	2	1	20,230	19.65	0.005	46,293
80[C]	4	2	92,065	48.50	0.037	45,370
81	15	13	61,219	6.18	0.061	44,655
82[C]	4	0	53,211	53.47	0.085	42,569
83[C]	2	0	43,868	63.66	0.077	42,113
84	136	14	230,656	9.04	0.117	36,905
85	11	0	51,213	13.87	0.093	32,776
86	27	25	58,230	4.56	0.045	32,484
87[C]	9	0	50,731	17.39	0.093	32,468
88[C]	4	0	49,476	45.47	0.093	31,665
89	60	51	276,193	7.42	0.077	31,658
90[C]	2	0	15,257	21.48	0.029	29,293
91	29	11	119,333	8.78	0.045	28,557
92	49	13	134,158	7.41	0.045	26,983
93[C]	1	2	12,761	15.39	0.021	26,543
94[C]	3	0	13,771	16.77	0.029	26,440
95	115	62	168,788	2.78	0.021	25,453
96[C]	3	0	17,557	21.2	0.053	25,282
97[C]	2	1	25,080	32.61	0.077	24,077
98[C]	2	0	13,375	18.47	0.037	23,540
99[C]	2	1	101,049	93.39	0.085	22,087
100[C]	2	0	8,700	47.54	0.005	20,880
TOTALS						**$24,053,563**

United States Department of the Interior

BUREAU OF LAND MANAGEMENT
Washington, D.C. 20240

MAR 2 6 2001

In Reply Refer To:
3100 (310)

MEMORANDUM

To: Assistant Inspector General for Audits

Through: Piet deWitt
Acting Assistant Secretary, Land and Minerals Management

Piet deWitt MAR 2 6 2001

From: Nina Rose Hatfield
Acting Director, Bureau of Land Management

Nina Rose Hatfield

Subject: Response to Draft Audit Report on the Stripper Oil Well Property Royalty Rate Reduction Program, Bureau of Land Management (Assignment No. C-IN-MOA-001-98 (B)-D)

Thank you for the opportunity to provide this response to the June 26, 2000, draft audit report on the Stripper Oil Well Property Royalty Rate Reduction Program. This is the third report issued on this program. We appreciate the time 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. Jean Fend, BLM Audit Liaison Officer, on (202) 452-5153.

Attachment

BUREAU OF LAND MANAGEMENT

DRAFT AUDIT REPORT
STRIPPER OIL WELL PROPERTY ROYALTY RATE REDUCTION
PROGRAM, BUREAU OF LAND MANAGEMENT

Audit Agency: Office of Inspector General (OIG)

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

GENERAL COMMENTS: The Bureau of Land Management (BLM) appreciates the opportunity to comment on this draft report.

RECOMMENDATION: 1. We recommend that the Director, BLM reevaluate the Stripper Oil Well Property Royalty Rate Reduction (RRR) Program and make changes as appropriate. In the new evaluation, BLM should consider analyzing production changes and the reasons for the production changes, such as enhanced or secondary recovery, on a representative sample of properties participating in the Program; establishing production ceilings for stripper oil properties above which operators would not receive reduced royalty rates unless they submitted sufficient economic data to demonstrate that they needed the reduction to maximize production or promote development; and, establishing guidelines for the reduction of Program benefits when production levels on an average per well basis increase beyond an established level.

RESPONSE: In the light of the policy focus on minerals and the change of Administration, we believe that it would be prudent to discuss significant changes in the RRR Program, such as suggested in this recommendation, with new policy level officials. We realize that royalty rate reductions for stripper properties were initiated to provide the oil industry with incentives to continue producing during periods of low oil prices and that there has been a significant increase in the price of oil. It is our intention to present a full range of policy options from status quo to discontinuing the program to the new Assistant Secretary for Land and Minerals management.

RECOMMENDATION: 2. We recommend that the Director, BLM, revise program regulations to require a cost recovery fee for processing program notifications. These fees should be collected and used by Minerals Management Service to offset the cost of receiving program notifications.

RESPONSE: This recommendation will be incorporated into the policy options presented to the new Assistant Secretary for Land and Minerals Management.

RESPONSIBLE OFFICIAL: Assistant Director, Minerals, Realty and Resource Protection, BLM.

STATUS OF AUDIT REPORT RECOMMENDATIONS

Finding/ Recommendation Reference	Status	Action Required
A.1 and B.1	Unresolved.	Provide a specific response to each recommendation. The response should state concurrence or nonconcurrence, including specific reasons for any nonconcurrence. The response should also provide information on actions taken or planned, including target dates and titles of officials responsible for implementation.

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

Internet Complaint Form Address

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