

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



Inspection Report: BLM and MMS Beneficial Use Deductions

Report No. CR-IS-MOA-0004-2009
March 2010



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United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, DC 20240

MAR 08 2010

Memorandum

To: Secretary Salazar

From: Mary L. Kendall 
Acting Inspector General

Subject: Inspection Report: BLM and MMS Beneficial Use Deductions
(Report No. CR-IS-MOA-0004-2009)

This memorandum transmits our report detailing the results of our inspection of beneficial use deductions for onshore and offshore oil and gas. Our review was prompted by two ongoing Office of Inspector General (OIG) investigations into allegations that companies claimed royalty deductions for beneficial use of gas as part of their lease agreements without meeting the requirements for claiming these deductions.

We found that the Bureau of Land Management (BLM) and the Minerals Management Service (MMS) failed to carry out effective oversight and management of the beneficial use program to ensure that all royalty income due to the Treasury was collected. As outlined in our findings, deficiencies in the beneficial use program as currently managed potentially cost the Government significant lost income. We found a substantial amount of gas claimed as beneficial use, although the use of oil was minimal. We estimated that the total value of royalty-free beneficial use gas in calendar year 2008 was \$1.16 billion, with a corresponding potential royalty value of \$145 million. We also found 43 instances in which companies claimed more than 100 percent of their production as beneficial use deductions.

Approvals are not usually required for beneficial use and, typically, beneficial use of oil and gas is estimated rather than measured. Both bureaus fail to coordinate approval requirements, and both lack a verification process also. We recommend five steps that BLM and MMS should take to reduce the risk of lost royalties associated with beneficial use deductions and improve the accuracy of recording and reporting.

We ask that you inform us of your course of action regarding our recommendations within 30 days. Should you have any questions about this report, please do not hesitate to contact me at (202) 208-5745.

cc: Deputy Secretary
Assistant Secretary, Land and Minerals Management
Director, Minerals Management Service
Director, Bureau of Land Management

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Executive Summary

The Department of the Interior (DOI) plays a key role in managing and ensuring the Nation's energy supply. Offshore and onshore operations on federal and Indian lands account for 26 percent of the natural gas and 32 percent of the oil produced annually in the United States. In fiscal year 2008, the sales value of oil and gas produced by companies with leases to operate on federal and Indian lands and offshore amounted to almost \$100 billion, generating royalties of \$12.6 billion to the Federal Government. These royalties along with other revenues collected by the Department's Minerals Management Service (MMS) constitute one of the largest non-tax sources of income to the United States Treasury. With energy demand, especially for natural gas, projected to increase steadily over the coming decades, MMS must perform strong, efficient, and consistent oversight to ensure that every royalty dollar owed to American taxpayers is accounted for and collected from the companies that extract valuable energy resources from public lands and the waters off the nation's coastline.

Unfortunately, in a practice involving onshore and offshore oil and gas production, MMS as well as DOI's Bureau of Land Management (BLM) have failed to carry out effective oversight and management to ensure that all royalty income due to the Treasury is collected. This practice, referred to as "beneficial use," is the subject of our inspection report. As outlined in our findings, the deficiencies in the beneficial use program are potentially costing the Government significant lost income. We previously notified BLM and MMS of the need for change



but, to date, no real action has been taken. Therefore, in this report, we outline five steps that MMS and BLM should take immediately to fix these deficiencies.

Beneficial Use: Practice and Concern

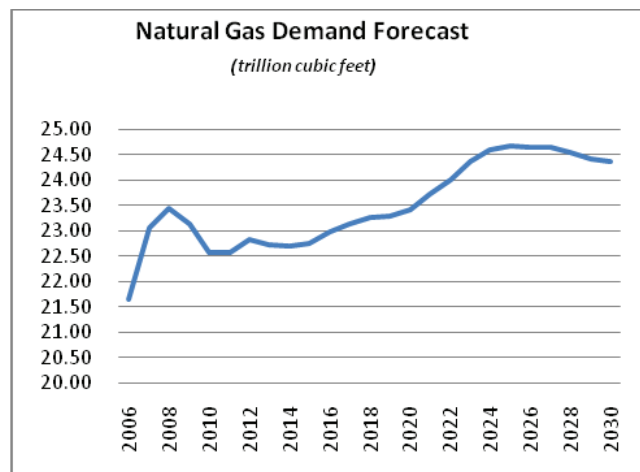
As part of their lease agreements, companies that drill on federal and Indian lands and offshore are allowed to claim royalty deductions on the portion of the oil and gas they produce to run their on-site operations, such as using natural gas to power drilling and pumping.¹ This use of royalty free oil and gas is referred to as “beneficial use.”

Recently, the Office of Inspector General (OIG) has been concerned about companies claiming beneficial use deductions without meeting the requirements for claiming these royalty deductions, or even receiving approval from the Department. Moreover, we have been concerned about the inability of MMS to determine whether companies have allowable beneficial use deductions.

Because of these concerns, we conducted an inspection of onshore and offshore oil and gas operations to determine the extent of beneficial use and to identify management controls over the practice. We performed our inspection work from July 2009 to October 2009,² and conducted data analysis on reported beneficial use information for the period January 1, 2009, to March 31, 2009.

From our work we estimated that in calendar year 2008, the total value of beneficial use gas

¹ The Mineral Leasing Act of 1920 and the Outer Continental Shelf Lands Act of 1953 both state that royalties are due when oil or gas is removed or sold from the lease. The Department of the Interior and the courts have interpreted this as allowing oil and gas to be used royalty free on a lease or agreement site to fuel production operations as long as eligibility requirements are met.



Data obtained from the Energy Information Administration <http://www.eia.doe.gov/oiaf/forecasting.html>. This data pertains to nationwide demand.

reported by lease operators was \$1.16 billion, with a potential royalty value of \$145 million. (Oil, on the other hand, was minimal, with an estimated total value of approximately \$22,000 and a royalty value of less than \$3,000.) The U.S. Energy Information Administration forecasts that demand for natural gas in the country will rise steadily, increasing by eight percent over the next two decades. This fact underscores the importance of strong and efficient oversight of beneficial use, particularly of natural gas.

Unfortunately, over the years the Department’s bureaus and programs responsible for overseeing leasing, production, operator compliance, and royalty collection have done a poor job of monitoring and verifying beneficial use deductions, and have failed to coordinate their oversight responsibilities, leading to the very real potential for significant amounts of lost royalties to the United States Government.

Three different Department programs are integral to the beneficial use process. The Offshore Energy and Minerals Management (OEMM) program, a part of MMS, oversees offshore oil

² We performed our work in accordance with the *Quality Standards for Inspections* issued by the President’s Council on Integrity and Efficiency.

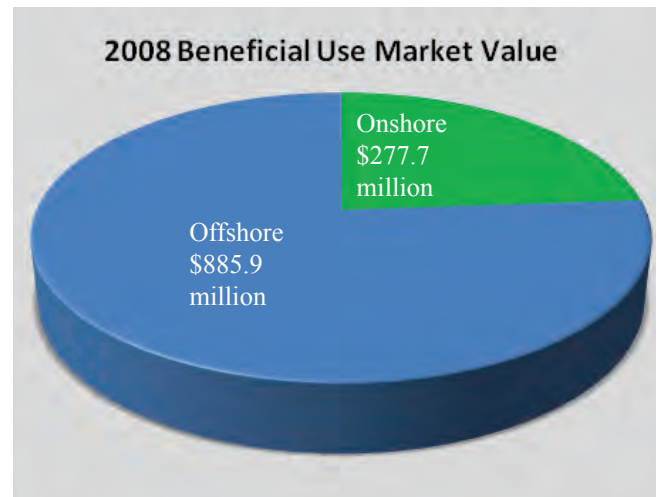
and gas leasing, production, and operator compliance. Onshore oil and gas leasing, however, is overseen by BLM, which also is responsible for monitoring onshore production and ensuring operator compliance. The collection of royalties – both for offshore and onshore operations – is the responsibility of the Minerals Revenue Management (MRM) program, also a part of MMS.

In an environment of divided duties and uncoordinated policies, and where beneficial use is employed widely by lessee companies, we found that BLM and MMS give little attention to ensuring accurate reporting of beneficial use by onshore and offshore oil and gas producers, or to verifying that deductions are claimed for legitimate purposes. We found that agencies do not: (1) provide adequate and consistent guidance among agencies or offices; (2) consistently require companies to obtain prior approval for beneficial use deductions; (3) ensure accurate measurement of beneficial use; or (4) require verification of reported beneficial use deductions.

With no measurement and verification process in place and a failure to coordinate between BLM and MMS, companies have the opportunity to exploit the vulnerabilities of the beneficial use program and potentially pay fewer royalties than they otherwise owe to the Treasury. This has been substantiated by ongoing OIG investigations into underpaid royalties by onshore companies that have claimed beneficial use for purposes not allowed by BLM.

Companies Claim Substantial Beneficial Use Deductions for Gas

The beneficial use of natural gas was substantial during our three-month sample period from January 1, 2009, through March 31, 2009. Lessees' beneficial use was claimed on 9,485 properties, amounting to 46.26 million



Information for this chart came from data obtained from MMS.

Mcf (thousand cubic feet) of gas during this period – enough natural gas to heat 650,000 homes in the United States for one year. We estimated the market value of that gas at \$201 million with a corresponding potential royalty value of \$25 million. Based on actual volume information for calendar year 2008, we estimated the total value of beneficial use gas for that year to be \$1.16 billion and the potential royalty value to the Government to be \$145 million.

As the pie chart illustrates, more than three-quarters of the market value was for offshore beneficial use. This is due to the substantially greater power needs of offshore platforms, which are self-sustaining cities, compared to smaller onshore production operations.

Overall, the beneficial use of oil was negligible in relation to gas, totaling only 127 barrels of oil during the three-month sample period. We estimate the market and royalty values of this oil to be \$5,000 and \$680 respectively. The annual value would be approximately \$22,000 with a royalty value of less than \$3,000. As a result, we focused primarily on beneficial use of gas.

Findings And Recommendations

Bureaus Fail to Coordinate, Causing Inconsistent Guidance

BLM and MMS are inconsistent on how to properly report beneficial use deductions. This leads to inadequate monitoring and weak or nonexistent oversight, and a potential loss to the Government of significant royalty payments. MRM's Minerals Production Reporter Handbook lists codes to standardize and facilitate lessee application reviews. The Handbook gives Disposition Code 20 as the code lessees should cite when reporting products used on, or for, the benefit of lease or agreement operations that have prior approval from BLM or OEMM. This requirement, however, is inconsistent with the practices of both BLM and OEMM, neither of which generally require prior approval for lessee companies as long as the companies comply with eligibility requirements.

BLM policy is that companies have automatic approval to use oil or gas for beneficial use for circumstances covered in the bureau's guidance, such as using the fuel to power drilling rig equipment. If a company wishes to claim beneficial use for a circumstance not covered in BLM's guidance, or for one specifically requiring prior approval – such as using natural gas as a drilling medium or reinjection of natural gas – it must apply for and receive prior approval from BLM. OEMM, on the other hand, does not require any approvals for beneficial use.

Without a written approval process signifying that either BLM or OEMM has agreed to the beneficial use, neither agency can quickly identify companies with leases and agreements taking beneficial use deductions. The agencies also are unable to ensure that companies are complying

with beneficial use requirements. Further, BLM's and OEMM's decision not to require prior approval leaves MRM with no way to verify that the beneficial use volumes the companies claim on their production reports are in fact allowable. For example, OIG investigations were conducted after allegations that companies claimed beneficial use without meeting BLM's requirements and without approval, thus resulting in lost royalties.

These investigations demonstrate that the bureaus are not consistently sharing information necessary to identify possible abuse of beneficial use deductions. BLM and MMS would both benefit from access to data documenting all prior written approvals for beneficial use. The OIG's Management Advisory of June 11, 2009 recommended that BLM and MMS jointly develop and implement a notice and verification process for the approval of deductions for beneficial gas used on leases. BLM and MMS agreed with this recommendation.

BLM's Notice to Lessee 4A, which defines beneficial use and the circumstances under which it may apply, is the primary guidance for onshore lessee beneficial use determinations. Some BLM state offices have issued additional supplemental guidance. The BLM Wyoming state office issued additional guidance that includes instruction memoranda and "Dear Operator" letters to clarify some beneficial use issues. This initiative addressed information gaps in the absence of a national policy, but it also highlights inconsistencies among the states.

Recommendation

- 1. BLM and MMS develop and implement clear, consistent, national beneficial use guidance and requirements, as detailed in the June 11, 2009 OIG Management Advisory. Such guidance should include a requirement for prior written**

approvals for all beneficial use that contain a description of the equipment involved, as well as an estimated volume of the gas and oil designated for beneficial use purposes.

Agency Guidance Contributes to Inaccurate Reporting

While lack of agency coordination has led to inconsistent federal guidance, such guidance also may lead to inaccurate reporting. In our sample period, we found 43 instances in which companies claimed more than 100 percent of their production as beneficial use deductions. Collectively, these instances accounted for 814,547 Mcf of gas with an approximate market and royalty value of \$3.5 million and \$440,000 respectively. The highest percentage claimed was 555 percent. The instances in which the companies reported more than 100 percent of their production as a beneficial use deduction raise serious concerns.

We informed MMS and BLM of these 43 instances. After researching the lessee companies, MMS responded that only 1 of the 43 instances was truly an instance of misreporting by an on-shore company. In 42 offshore instances referred to as “buy-back” transactions, companies purchased resources from a pipeline to be used to maintain lease productivity. One example of a buy-back transaction would be when a company stops production during a storm, closing down platforms and evacuating people, then needs to purchase gas from the pipeline to have sufficient power to restart on-site operations.

MMS instructs operators to identify these buy-back transactions by using the code for beneficial use. Although we found 42 instances in which the buy-back exceeded gas production, there may be many other situations in which buy-back is reported as beneficial use and yet is

not greater than the production. Identifying and reporting the buy-back as beneficial use is misleading and, as a result, MMS cannot accurately identify how much beneficial use is truly being used offshore.

Recommendations

- 2. MMS and BLM develop and implement controls to identify and research instances where companies report more than 100 percent of oil and gas production as beneficial use.**
- 3. MMS develop a separate code for buy-back volumes and require operators to use this code in order to promote accurate reporting of both beneficial use and buy-back volumes.**

Poor Controls and Lack of Verification Encourage Misreported Data

Since BLM and MMS do not require companies to measure the amount of gas or oil used for beneficial use, companies have the potential to misrepresent the amount of resources they claim as beneficial use. For example, a company could report only the volume of oil or gas required to run on-site lease equipment while actually taking more oil and gas to use for unallowable purposes. Because oil or gas required for beneficial use at a lease site is not measured, neither BLM nor MMS would have a way of detecting this potential misreporting. Currently, if beneficial use is measured it is only because the company chooses to do so on its own. Companies typically estimate their usage based on the equipment employed at the lease site.

Although BLM personnel in one state office said that beneficial use is a problem and has the

potential to be misused, no formal review or verification process exists to detect such problems. In the 43 instances in which companies claimed more than 100 percent of their production as beneficial use deductions, 42 were not actually beneficial use deductions. In the case of the one onshore instance, BLM informed us that the company is undergoing a production review for having misreported an entire year of oil and gas production. Any instance in which companies report more than 100 percent of their production as a beneficial use deduction should trigger a review. Although this may only indicate reporting errors, fraudulent activity could also be the case. There are no systems checks to detect and flag these instances for further review by BLM and MMS.

Since approvals generally are not required, MRM staff do not have a way to identify lessees who were denied beneficial use on their leases or agreements. As discovered during one OIG investigation, a company could be denied a beneficial use deduction by BLM but still report the deduction to MRM. This increases the risk that companies not allowed to take beneficial use deductions in fact may do so.

Recommendations

- 4. BLM and MMS develop and implement a joint verification process that includes a comparison of reported beneficial use volumes to actual measured volumes.**
- 5. BLM develop and implement a system to review all denied beneficial use applications to ensure that beneficial use deductions are not being claimed on those properties.**

Conclusion

Strong Controls Needed to Ensure Accurate Reporting of Beneficial Use

BLM officials informed us that the production verification inspections they conduct ensure that the amount of oil or natural gas reported as beneficial use is reasonable based on the equipment on site. We do not believe relying on such production inspections is adequate for monitoring and verifying onshore beneficial use. Based on our ongoing evaluation of BLM's Inspection and Enforcement program, we know that production inspections are conducted primarily on higher producing leases, and then typically only once a year. Lower producing leases, such as those only reporting enough production to run the lease operations, may not be inspected for several years.

Offshore companies are required to maintain records supporting beneficial use estimates for two years. In spite of this requirement, as OEMM officials informed us, offshore inspectors do not verify beneficial use estimates or review company records. OEMM also informed us that they believe theft or misuse of oil or gas offshore is highly improbable due to technological and logistical safeguards. Offshore gas would have to be transported either through metered pipelines or on a vessel employing technology that could convert the gas to a liquid for purposes of transportation. Such technology currently is not used on the Outer Continental Shelf.

We agree that there is higher risk of theft or misreporting in connection with onshore beneficial use. We believe, however, that in order to safeguard valuable public energy assets and to ensure that all royalties owed to American taxpayers are in fact paid, there must be strong controls in place for accurate recording and reporting of beneficial use by companies holding Federal oil and gas leases.

Summary of Recommendations

1. BLM and MMS develop and implement clear, consistent, national beneficial use guidance and requirements, as detailed in the June 11, 2009 OIG Management Advisory. Such guidance should include a requirement for prior written approvals for all beneficial use that contain a description of the equipment involved, as well as an estimated volume of the gas and oil designated for beneficial use purposes.

2. MMS and BLM develop and implement controls to identify and research instances where companies report more than 100 percent of oil and gas production as beneficial use.

3. MMS develop a separate code for buy-back volumes and require operators to use this code in order to promote accurate reporting of both beneficial use and buy-back volumes.

4. BLM and MMS develop and implement a joint verification process that includes a comparison of reported beneficial use volumes to actual measured volumes.

5. BLM develop and implement a system to review all denied beneficial use applications to ensure that beneficial use deductions are not being claimed on those properties.

Appendix

Objective, Scope And Methodology

The objective of this review was to conduct an inspection of the onshore and offshore oil and gas beneficial use deductions in order to determine the extent of beneficial use deductions and identify weaknesses in BLM or MMS' controls over beneficial use.

The initial scope included any leases or agreements taking the beneficial use deductions for the time period of January 1, 2009 – March 31, 2009. The scope was expanded to include any leases or agreements taking the beneficial use deductions for calendar year 2008. To accomplish our objective we did the following:

- Reviewed statutory and regulatory requirements.
- Reviewed MMS and BLM policies and procedures.
- Analyzed information reported by industry to the bureaus.
- Interviewed BLM and MMS personnel.
- Conducted a site visit at the BLM Buffalo Field Office.
- Selected a sample period of January 1, 2009 to March 31, 2009 and conducted data analysis on the reported beneficial use information which included:
 - Determining the volume of beneficial use claimed for our sample period.
 - Determining the number of leases that claimed 100 percent or more beneficial use.

- Identifying any trends in the reported information.
- Calculating the market values for both gas and oil by multiplying the beneficial use volume reported on the Oil and Gas Operations Report by the average monthly gas or oil market price for the three sample months as reported by the U.S. Energy Information Administration.
- Calculating the royalty values by multiplying the market value by the royalty rate of 12.5 percent.
- Selected an expanded sample period of January 1, 2008 to December 31, 2008 for gas and conducted an analysis to:
 - Determine the amount of onshore and offshore volumes.
 - Determine the volume of an entire year's worth of claimed beneficial use deductions.
 - Calculate the market values for gas by multiplying the beneficial use volume reported on the Oil and Gas Operations Report by the average 2008 gas market price as reported by the U.S. Energy Information Administration.
 - Calculate the royalty values by multiplying the market value by the royalty rate of 12.5 percent.

Bureau of Land Management

BLM manages more federal land than any other agency – 253 million surface acres as well as 700 million sub-surface acres of mineral estate. The BLM reviews and approves permits and licenses from companies to explore, develop, and

produce both renewable and nonrenewable energy on federal lands. The BLM ensures that proposed projects meet all applicable environmental laws and regulations. Once projects are approved, the BLM is responsible for ensuring that developers and operators comply with use authorization requirements and regulations. Although the Bureau of Indian Affairs issues mineral leases on Indian lands, the BLM approves and supervises mineral operations on these lands.

Minerals Management Service

MMS, a bureau in the U.S. Department of the Interior, is comprised of two major programs: Minerals Revenue Management (MRM) and Offshore Energy and Minerals Management (OEMM).

Minerals Revenue Management

The MRM collects, accounts for and distributes revenues associated with offshore and onshore oil, gas and mineral production from leased federal and Indian lands. Additionally, the MRM is responsible for ensuring that the Nation's federal and Indian energy and mineral revenues are accurately reported and paid in compliance with laws, regulations, and lease terms.

Offshore Energy and Minerals Management

The MMS plays a key role in America's energy supply by managing the mineral resources on 1.7 billion acres of the Outer Continental Shelf. This includes managing Renewable Energy Programs as well as offshore oil and gas leasing in federal waters. The OEMM's oversight and regulatory framework ensure production and drilling are done in an environmentally responsible manner, and done safely. OEMM is responsible for ensuring that the U.S. Government receives fair market value for acreage made available for lease.

ing and that any oil and gas activities conserve resources, operate safely, and take maximum steps to protect the environment.

Guidance

Notice to Lessees and Operators of Onshore Federal and Indian Oil and Gas Leases

(NTL-4A): Royalty or Compensation for Oil or Gas Lost is the BLM guidance that was signed January 1, 1980. The guidance states no royalty obligation shall accrue as to the produced oil or gas which (1) is used on the same lease, communitized tract, or same unitized participating area for beneficial purposes or (2) the Supervisor determines to have been unavoidably lost. The guidance defines beneficial use as oil or gas which is produced from a lease, communitized tract, or unitized participating area and which is used on or for the benefit of that same lease, same communitized tract or same unitized participating area for operating or producing purposes such as (1) fuel in lifting oil or gas (2) fuel in the heating of oil or gas for the purpose of placing it in a merchantable condition, (3) fuel in compressing gas for the purpose of placing it in a marketable condition, or (4) fuel for firing steam generators for the enhanced recovery of oil. Gas used for beneficial purposes shall also include that which is produced from a lease, communitized tract, or unitized participating area and which is consumed on or for the benefit of that same lease, same communitized tract or same unitized participating area (1) as fuel for drilling rig engines, (2) as the source of actuating automatic valves at production facilities, or (3) with the prior approval of the Supervisor, as the circulation medium during drilling operations.

Where the produced gas is processed through a gasoline plant and royalty settlement is based on the residue gas and other products at the tailgate of the plant, the gas consumed as

fuel in the plant operations will be considered as being utilized for beneficial purposes. In addition, gas which is produced from a lease, communitized tract, or unitized participating area and which, in accordance with a plan approved by the Supervisor, is reinjected into wells or formations subject to that same lease, same communitized tract, or same participating area for the purpose of increasing ultimate recovery shall be considered as being used for beneficial purposes; provided, however, that royalty will be charged on the gas used for this purpose at the time it is finally produced and sold.

Code of Federal Regulations 30 Sec. 250.1203

states that gas used on-lease [offshore] must be measured or estimated and the applicable documentation must be maintained at the field location for two years.

OIG Management Advisory of Investigative Results, June 11, 2009 advises that: “To enhance the ability of MMS and BLM to readily identify unapproved deductions for beneficial gas used on lease claimed by operators, we recommend that BLM and MMS work together to develop and implement a notice and verification process for the approval of deductions for beneficial gas used on lease. Implementation of this recommendation will ensure that MMS is made aware of BLM beneficial use approvals so that MMS can identify and reject unapproved deductions for beneficial gas used on lease.”

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