



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

SPECIAL REPORT

BIENNIAL REPORT ON THE FEDERAL ROYALTY MANAGEMENT SYSTEM FOR FISCAL YEARS 1996 AND 1997

**REPORT NO. 98-I-708
SEPTEMBER 1998**



United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20240

SEP 30 1998

Memorandum

To: The Secretary

From: /s/ Richard N. Reback *Richard N. Reback*
Acting Inspector General

Subject: Biennial Report on the Federal Royalty Management System for Fiscal Years 1996 and 1997 (No. 98-I-708)

This is the seventh biennial report issued by the Office of Inspector General. This report was prepared in accordance with Section 302(b) of the Federal Oil and Gas Royalty Management Act of 1982, which requires the Office of Inspector General to conduct a biennial audit of the Federal Royalty Management System and report the results to the Congress and the Secretary of the Interior. We prepared this report based on the results of eight audit reports, one evaluation report, and one investigative initiative completed by the Office of Inspector General and one audit report issued by the General Accounting Office.

Based on our reviews of the Royalty Management System, we concluded that the Minerals Management Service and the Bureau of Land Management had made improvements in collecting mineral lease revenues. Specifically, the adequacy of minimum bonus bids and annual rental fees was evaluated before each lease sale to ensure that the Federal Government received fair value for offshore oil and gas leases. We estimated that this improvement will result in increased lease revenues during 1998 through 2001 of about \$194 million.

However, to adequately protect mineral resources and further enhance royalty collections, the Service needs to make improvements in cost sharing deductions from states' mineral leasing receipts and in operating, testing, supporting, and controlling automated information systems.

In terms of revenues, the Department of the Interior collected royalties, rents, and bonuses of \$4.7 billion in fiscal year 1996 and \$6.2 billion in fiscal year 1997. Some of these revenues were generated from Service, state, and tribal audits of royalty payors. Specifically, Service audits of royalty payors resulted in the collection of royalties and the denial of refund requests totaling \$39.7 million (\$38.7 million in audit collections and \$1 million in denials of refund requests) in fiscal year 1996 and \$40.1 million in audit collections (there were no denials of refund requests) in fiscal year 1997. State and tribal audits of royalty payors

resulted in the collection of an additional \$9.5 million in fiscal year 1996 and \$9.5 million in fiscal year 1997.

This report does not make any new recommendations because each of the 10 audit and evaluation reports contained recommendations to the appropriate Departmental officials at the time each report was issued. The Department generally has been responsive to the audit recommendations and has made the improvements to the Royalty Management System that were suggested. In addition, the Service provided a synopsis (Appendix 4) that it prepared of its Royalty Management Program accomplishments during this biennial period. The Service and the Bureau, through the Assistant Secretary for Land and Minerals Management, also provided comments on the report in August 17 and September 14, 1998, memoranda, which we considered and incorporated into this report as appropriate.

cc: Assistant Secretary for Land and Minerals Management
Assistant Secretary for Indian Affairs

CONTENTS

	Page
INTRODUCTION	1
BACKGROUND	1
OBJECTIVE AND SCOPE	1
RESULTS OF BIENNIAL REVIEW FOR FISCAL YEARS 1996 AND 1997	3
A. IMPROVEMENTS MADE IN THE ROYALTY MANAGEMENT SYSTEM	3
B. IMPROVEMENTS NEEDED IN THE ROYALTY MANAGEMENT SYSTEM	5
C. ADDITIONAL ROYALTY MANAGEMENT SYSTEM ISSUES	6
APPENDICES	
1. AUDIT AND EVALUATION REPORTS ISSUED	8
2. ESTIMATED DOLLAR IMPACT OF REPORTS INCLUDED IN THE BIENNIAL REPORT FOR FISCAL YEARS 1996 AND 1997	9
3. STATUS OF PRIOR REPORT RECOMMENDATIONS	10
4. SYNOPSIS OF ACCOMPLISHMENTS OF THE MINERALS MANAGEMENT SERVICE'S ROYALTY MANAGEMENT PROGRAM FOR FISCAL YEARS 1996 AND 1997	11

INTRODUCTION

BACKGROUND

The Federal Oil and Gas Royalty Management Act of 1982 requires the Secretary of the Interior to establish comprehensive inspection, fiscal and production accounting, collection, and auditing systems. These systems are required to provide the capability to accurately determine oil and gas royalties, interest, fines, penalties, fees, deposits, and other payments owed and to collect and distribute such amounts in a timely manner.

To accomplish this requirement, the Secretary established the Royalty Management System and assigned specific responsibilities to the Minerals Management Service, the Bureau of Land Management, and the Bureau of Indian Affairs. The Minerals Management Service is responsible for monitoring oil and gas production from Federal leases on the Outer Continental Shelf, the Bureau of Land Management is responsible for monitoring oil and gas production from onshore Federal and Indian leases, and the Bureau of Indian Affairs distributes mineral revenues to individual Indians and tribes. Most of the royalty management functions were assigned to the Service's Royalty Management Program. The overall mission of the Program is to ensure proper determination, collection, and distribution of bonuses, rents, and royalties from Federal and Indian lands in a manner that maximizes incentives to the efficient management, production, and use of oil, gas, coal, and other mineral resources consistent with public health and safety, environmental, and public land use requirements.

The policies and procedures for the Royalty Management System are delineated in public laws and Departmental regulations, including the Allotted Indian Land Leasing Act of 1909, as amended; the Mineral Leasing Act of 1920, as amended; the Indian Mineral Leasing Act of 1938; the Minerals Leasing Act for Acquired Lands of 1947, as amended; the Outer Continental Shelf Lands Act of 1953, as amended; the Geothermal Steam Act of 1970; the Combined Hydrocarbon Leasing Act of 1981; the Indian Mineral Development Act of 1982; the Federal Oil and Gas Royalty Management Act of 1982; the Federal Oil and Gas Leasing Reform Act of 1987; and the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996.

OBJECTIVE AND SCOPE

The Federal Oil and Gas Royalty Management Act of 1982, Section 302(b), requires the Office of Inspector General to perform a biennial audit of the Federal Royalty Management System and to submit the results of such audit to the Congress and the Secretary. This biennial report of the Royalty Management System is the seventh of such reports and covers the biennial period of October 1, 1995, through September 30, 1997 (fiscal years 1996 and 1997).

The overall objective of this biennial review was to determine the Department's compliance with the Federal Oil and Gas Royalty Management Act of 1982. This was accomplished by the Office of Inspector General through its conduct of one evaluation and eight audits, seven on the Minerals Management Service and two on the Bureau of Land Management, and through a joint investigative initiative involving both the Service and the Bureau. Since the Royalty Management System consists of various components such as leasing, inspection, production and royalty accounting, royalty collection and distribution, and auditing, we selectively reviewed activities of these components. We considered factors such as materiality, degree of risk, prior audit coverage, and current information regarding the activity in selecting the specific activities to be reviewed in this biennial period. We also considered the results of a General Accounting Office audit of costs for onshore minerals leasing programs. The reports included in this biennial report are listed in Appendix 1.

RESULTS OF BIENNIAL REVIEW FOR FISCAL YEARS 1996 AND 1997

Based on a review of eight Federal Royalty Management System audits, one evaluation, and one investigative initiative conducted during the biennial period, we concluded that the Minerals Management Service and the Bureau of Land Management had made improvements in the System since the last biennial report that should increase mineral lease collections and enhance payor/producer compliance with existing regulations. However, additional improvements are needed to adequately protect mineral resources and further enhance royalty collections. Specifically, improvements are needed in the following areas: (1) computation of cost sharing deductions from states' mineral leasing receipts, (2) operation of automated information systems, (3) application software testing and support, and (4) general controls over automated information systems.

Office of Inspector General audit and evaluation reports issued on the Royalty Management System during this period identified a total monetary impact of about \$2 17.9 million, which was classified as potential additional revenues (\$214.7 million) and funds to be put to better use (\$3.2 million) (see Appendix 2).

Regarding the nine reports issued by the Office of Inspector General during this biennial period, one audit report and one evaluation report identified improvements made in the Royalty Management System, four audit reports presented opinions on the annual financial statements of the Service and the Bureau, and three audit reports identified areas needing improvement in the Royalty Management System. These reports contained 33 recommendations for improvement, of which 3 remain unresolved (see Appendix 3). These reports are synopsized in Sections A and B. Additionally, synopses of additional Royalty Management System issues regarding the Office of Inspector General's underpayment of royalties initiative and the General Accounting Office's review of costs for onshore minerals leasing programs are presented in Section C.

A. IMPROVEMENTS MADE IN THE ROYALTY MANAGEMENT SYSTEM

Peer Review

In our report "External Quality Control Review of the Audit Divisions, Minerals Management Service" (98-I-398), issued in April 1998, we concluded that the Service was performing audit work that was generally in compliance with the Service's Audit Procedures Manual and with the "Government Auditing Standards," issued by the Comptroller General of the United States. Further, we found that the Service's audits were conducted professionally, audit conclusions were adequately supported, and auditors were usually current in their continuing education requirements. Although we found minor deficiencies in the areas of audit management, such as supervisory review of the auditors' assessment of compliance with laws and regulations, quality control, supervision, timeliness of report

products, and working paper quality, we did not find that these weaknesses adversely affected the Service's audit findings and conclusions. The report did not contain any recommendations.

Followup of Offshore Minerals Leasing Activities

In our March 1998 evaluation report "Followup of Offshore Minerals Leasing Activities" (No. 98-I-385), which was a followup review of recommendations contained in our audit report "Offshore Minerals Leasing Activities, Minerals Management Service" (No. 94-I-179), issued in December 1993, we found that the Service had acted expeditiously to implement the recommendation to evaluate the adequacy of minimum bonus bids and annual rental fees before each lease sale to ensure that the Federal Government received fair value for offshore oil and gas leases. The Service's implementation of the recommendation resulted in increased rental fees per acre that generated an additional \$141 million in lease revenues between September 1993 and August 1997, which was \$20.7 million more than the estimate contained in Audit Report No. 94-I-179. In our followup review, we estimated that leases issued between September 1993 and August 1997 will generate an additional \$194 million in increased lease revenues during the period of 1998 through 2001. The followup report did not contain any new recommendations.

Financial Reporting

Based on four audits of the financial statements of the Service and the Bureau, we concluded that the combined financial statements and accompanying notes presented fairly the results of financial operations for both the Service and the Bureau for this biennial review period.

Our audit reports "Minerals Management Service Financial Statements for Fiscal Years 1995 and 1996" (No. 97-I-445), issued in February 1997, and "Minerals Management Service Financial Statements for Fiscal Years 1996 and 1997" (No. 98-I-382), issued in March 1998, presented an unqualified opinion regarding the financial operations of the Service. The audits found that the internal control structure in effect at year-end was sufficient to safeguard assets against loss from unauthorized use or disposition; ensure that transactions were executed in compliance with laws and regulations; ensure that transactions were properly recorded, processed, and summarized; and provide reasonable assurance that any losses, noncompliance, or misstatements that are material to the financial statements would be detected. The reports did not contain any recommendations.

Our January 1997 report "Bureau of Land Management Combined Comparative Financial Statements for Fiscal Years 1995 and 1996" (No. 97-I-319) and our January 1998 report "Bureau of Land Management Consolidated Comparative Financial Statements for Fiscal Years 1996 and 1997" (No. 98-I-234) presented an unqualified opinion on the Bureau's financial statements. We found that the Bureau's financial statements were presented in conformity with the accounting standards and policies described in the notes to the financial statements and that supplemental financial statements were fairly stated in relation to the financial statements taken as a whole. Additionally, we found that the Bureau's internal

control structure in effect at fiscal year-end was sufficient to safeguard assets against loss from unauthorized use or disposition; ensure that transactions were executed in compliance with laws and regulations; ensure that transactions were properly recorded, processed, and summarized; and provide reasonable assurance that any losses, noncompliance, or misstatements that are material to the financial statements would be detected. The reports did not contain any recommendations.

B. IMPROVEMENTS NEEDED IN THE ROYALTY MANAGEMENT SYSTEM

Three Office of Inspector General audit reports indicated that improvements were needed in the Federal Royalty Management System as follows:

- The Service and the Bureau need to improve the methodologies used in computing cost sharing reductions to promote an equitable proration of mineral leasing program cost recovery. In our October 1997 report "Costs Recovered Through Net Receipts Sharing Deductions, Minerals Management Service and Bureau of Land Management" (No. 98-I-79), we found that the cost sharing deductions were computed efficiently and deducted from the states' mineral leasing receipts on a timely basis. However, we noted inconsistencies in the methods used to compute cost sharing deductions, which resulted in the inequitable distribution of mineral leasing program costs. As a result, the costs deducted from states' mineral leasing receipts during fiscal years 1994 through 1996 were overstated by \$8.8 million, or about 11.6 percent. We recommended that the Service and the Bureau establish consistent policies and procedures to guide the net receipts process and to improve communication with the states. The Service responded to our recommendation by stating that it had requested and received Congressional approval to use one cost pool for the states' computations and that this would help to prevent the overcharging of cost deductions to the states. We further recommended that the Bureau obtain a Solicitor's opinion on whether preleasing costs were allocable deductions to the states. Regarding the preleasing costs, the Bureau subsequently obtained a Solicitor's opinion dated April 14, 1998, which stated that preleasing costs are deductible. Regarding the cost pool, the Service, in an August 17, 1998, memorandum, stated that it had completed the project of consolidating and updating its policies and procedures, had provided copies to the Bureau of Land Management and the Forest Service, and had presented the revised procedures to the State and Tribal Audit Committee at a June 1998 meeting.

- The Service needs to improve the efficiency of its automated information systems by applying modern designs and processes, and the Service needs to ensure that application software is adequately tested and documented. In our July 1997 report "The Royalty Management Program's Automated Information Systems, Minerals Management Service" (No. 97-I-1042), we found that the Service was using outdated and inefficient data structures which were difficult to change and improve. Additionally, the Service did not test its application software programs sufficiently to ensure the operational effectiveness of the software programs. We also found that the Royalty Program's automated systems were not adequately documented in accordance with established standards. As a result of these

deficiencies, the Program unnecessarily incurred about \$3.2 million annually for contractor support of the automated systems and for added work to detect and correct errors and problems in application processing. Our report contained seven recommendations to improve the Service's automated information systems processing. We considered one recommendation resolved and implemented and six recommendations resolved but not implemented. The unimplemented recommendations were referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation.

- The Service needs to improve the general controls over its automated information systems. Our March 1998 report "General Controls Over the Automated Information System, Royalty Management Program, Minerals Management Service" (No. 98-I-336) stated that the Service had established general controls over its automated information systems but that these controls were inadequate in the areas of risk assessment; security policies, procedures, and awareness; logical access controls; software change control practices; separation of duties; use of available mainframe security software; and inclusion of appropriate hardware and software systems in the Program's disaster recovery plans. These weaknesses increased the risk of unauthorized access, modification, and disclosure of Program data; theft and destruction of software and sensitive information; and potential loss of Program system and function capability in the event of a disaster or system failure. Our audit report contained 23 recommendations to the Service to improve the controls over the Program's automated information. While the Service strongly disagreed with the "characterizations" that general controls over automated systems were inadequate as presented in the report, the Service agreed to at least partially implement 20 of the 23 recommendations. The three unresolved recommendations concerned security-related personnel policies and procedures and classifications of sensitive computer resources. The Service stated that existing controls and classifications were adequate. The three recommendations have been forwarded to the Assistant Secretary for Policy, Management and Budget for audit resolution.

C. ADDITIONAL ROYALTY MANAGEMENT SYSTEM ISSUES

Underpayment of Royalties Initiative

In a major initiative undertaken by the Office of Inspector General, in conjunction with the Fraud Section, Civil Division, U.S. Department of Justice, and various U.S. Attorneys' offices throughout the United States, the Office of Inspector General has identified and investigated fraudulent royalty underpayments on Federal mineral leases.

For example, the Office of Inspector General, the Bureau of Land Management, and the Minerals Management Service joined forces during 1997 with the U.S. Attorney's Office, Civil Division, District of New Mexico, Albuquerque, New Mexico, in a joint investigation into allegations that a Texas oil company defrauded the Service by not paying royalties due on condensate produced on land leased from the Bureau in southeastern New Mexico between 1988 and 1994. The production of the unreported condensate was discovered by a Bureau inspector who was responding to an oil pipeline break on the Bureau lease. An

Office of Inspector General investigator and Bureau and Service personnel subsequently conducted reviews of oil production and purchasing records that verified that more than \$40,000 in condensate had been produced and sold. However, the company reported to the Service that no production of condensate had occurred and that therefore no royalties were due the Service.

Based on the results of the investigation, the U.S. Attorney's Office took action against the company under the Affirmative Civil Enforcement program, which provides for treble damages under the False Claims Act in civil false claims against the Government. The U.S. Attorney's Office notified the oil company that the Government would seek civil recoveries and treble damages in Federal district court if the company did not reach a settlement agreement with the Government. In April 1997, the oil company, while admitting no wrongdoing, agreed to a civil settlement to pay \$200,000 to the Government. Additionally, the company agreed to file corrected production reports for the leases affected.

Costs for States' Onshore Programs

The Congress asked the General Accounting Office to determine whether the costs borne by Wyoming, New Mexico, and California for managing Federal minerals were comparable to the costs for these states' own minerals programs.

The General Accounting Office's February 1997 report "Minerals Management, Costs for Onshore Minerals Leasing Programs in Three States" (No. GAO/RCED-97-31) stated that states received about half of the \$936 million generated by the development of Federal onshore leaseable minerals nationwide in fiscal year 1996. According to the report, the Federal Government spent nearly \$114 million to administer its onshore leaseable minerals program in fiscal year 1996, and the states will repay the Federal Government \$22 million (about 19 percent) of that amount. The report further stated that in fiscal year 1996, Wyoming, New Mexico, and California received almost \$358 million in revenues from Federal onshore leaseable minerals and that those states have paid almost \$14.6 million (about 4 percent) of the Federal Government's fiscal year 1996 onshore minerals leasing program costs. The report also stated that onshore development on land owned by the three states generated combined revenues of \$148 million in fiscal year 1996 and that the states' combined costs for managing onshore mineral development, which included development of private lands, totaled about \$19 million (about 13 percent).

The report stated that because of differences between Federal and state programs and because the states reviewed did not have similar land use planning processes, the program costs of the three states could not be "meaningfully compared." The report did not contain any recommendations.

AUDIT AND EVALUATION REPORTS ISSUED

Report Number	Title	Issue Date
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OFFICE OF INSPECTOR GENERAL

MINERALS MANAGEMENT SERVICE

98-I-398	External Quality Control Review of the Audit Divisions	April 1998
98-I-385	Followup of Offshore Minerals Leasing Activities	March 1998
97-I-445	Minerals Management Service Financial Statements for Fiscal Years 1995 and 1996	February 1997
98-I-382	Minerals Management Service Financial Statements for Fiscal Years 1996 and 1997	March 1998
98-I-79	Costs Recovered Through Net Receipts Sharing Deductions	October 1997
97-I-1042	The Royalty Management Program's Automated Information Systems	July 1997
98-I-336	General Controls Over the Automated Information System, Royalty Management Program	March 1998

BUREAU OF LAND MANAGEMENT

97-I-319	Bureau of Land Management Combined Comparative Financial Statements for Fiscal Years 1995 and 1996	January 1997
98-I-234	Bureau of Land Management Consolidated Comparative Financial Statements for Fiscal Years 1996 and 1997	January 1998

GENERAL ACCOUNTING OFFICE

MINERALS MANAGEMENT SERVICE

RCED-97-3 1 Costs for Onshore Minerals Leasing February 1997
Programs in Three States

**ESTIMATED DOLLAR IMPACT
OF REPORTS INCLUDED IN THE
BIENNIAL REPORT FOR FISCAL YEARS 1996 AND 1997**

<u>Report Number</u>	<u>Report Title</u>	<u>Funds To Be Put To Better Use</u>	<u>Potential Additional Revenues</u>
98-I-385	Followup of Offshore Minerals Leasing Activities		\$2 14.7 million*
97-I- 1042	The Royalty Management Program's Automated Information Systems, Minerals Management Service	\$3.2 million	

* Multiyear. Of this amount, \$20.7 million was identifiable to a recommendation made in Audit Report No. 94-I- 179. issued in December 1993. This additional revenue was derived based on data obtained during our **followup** evaluation (Report No. 98-I-385, issued in March 1998) in which we found that the Minerals Management Service's implementation of the recommendation resulted in increased revenues.

STATUS OF PRIOR REPORT RECOMMENDATIONS

<u>Addressee of Recommendations</u>	<u>Recommendations Made</u>	<u>Recommendations Concurred With/ Resolved</u>
Director, Minerals Management Service	31	28
Director, Bureau of Land Management	2	<u>2</u>
Total	<u>33</u>	<u>30</u>

**MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM (RMP)
FISCAL YEARS 1996 AND 1997
Synopsis of Accomplishments**

OVERVIEW

The RMP collects, verifies, and distributes mineral revenues from Federal and Indian lands. In 1997, we distributed \$6.2 billion mineral revenues from about 112,000 leases to 38 states, 42 Tribes, about 20,000 Indian allottees, the U.S. Treasury, and other Federal agencies. During fiscal year 1997 and 1996 disbursements totaled \$6.2 billion and \$4.9 billion respectively. Our goal is to provide timely, accurate, and cost effective revenue collection and disbursement services to our customers. To accomplish this goal, we:

- Assist and encourage royalty payors to submit royalty reports and payments correctly the first time.
- Streamline and simplify royalty collection and disbursement processes whenever possible.
- Use modern information management tools to improve the royalty collection and disbursement processes.
- Involve stakeholders in decision-making, and make decisions by consensus whenever possible.

ASSISTING ROYALTY PAYORS

As part of our efforts to improve reporting, we continued to provide on-site reporter training to oil, gas, and solid mineral companies in cities where their offices are located. To concentrate on reporter assistance rather than assessments, we stopped issuing bills to companies for filing royalty and production reports late or erroneously during fiscal year 1996. On August 13, 1996, The Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 (RSFA) extended the assessment moratorium through March 1, 1998.

Royalty and production reporting accuracy

We review royalty and production report lines with a series of critical system edits. These edits assure reported information is consistent with key reference data to permit correct disbursement of revenue. Lines rejected by system edits must be corrected manually before disbursement functions can resume. For example, if the reported lease number is invalid, our system rejects the line. Correct disbursement of lease revenue is impossible without a valid lease number. Lower error rates indicate reporters are better at meeting data requirements. The 1997 and 1996

error rates were 3.0 and 2.4 percent for royalty, and 3.0 and 2.9 for production, respectively.

Compliance Verification and Audit

An effective compliance program provides incentives for payors to “do it right the first time.” Our compliance verification and audit programs meet this need by providing reporting reviews and collections of under-payments we detect. As payors improve their first time payment and reporting, collections for these follow-up activities will decline. During 1997 and 1996 we collected \$36.4 million and \$33.2 million, respectively, from researching production and sales volumes, late payments, lease financial terms, allowances and adjustment variances.

Our auditors conduct on-site studies of payors’ accounting records for underpayment discovery. During 1997 and 1996 RMP auditors collected \$40.1 million and \$39.7 million in additional revenues and denied refund requests.

Disbursements to States

During 1996 and 1997, we timely disbursed 99 percent and 93 percent of States dollars, respectively. State disbursements were delayed during 1996 by the Federal Government shutdown. Less interest paid to States for late disbursements indicates more timely disbursements. For 1997, RMP paid \$62,000 interest to States, and for 1996, \$164,000.

STREAMLINING AND SIMPLIFYING PROCESSES

Royalty Policy Committee

To obtain timely and constructive advice on collection policies and procedures, the Department of the Interior established the RPC as part of the Minerals Advisory Board in 1995. MMS believes it can best reinvent its activities and serve the needs of its customers by working closely with constituents. Accordingly, RPC includes representatives from States, Tribes, Indian allottees, industry, Federal Agencies and the public. Six subcommittees reported to the RPC on issues including audit; report streamlining; disbursements to the States, Tribes and allottees and net revenue sharing; appeals, settlements and Alternative Dispute Resolution; phosphate, trona, and other leasable non-energy minerals; coal; and alternatives to conventional royalty collection methods. MMS began implementing most of the recommendations and is studying the feasibility of the others in conjunction with the work underway to implement RSFA.

RSFA Implementation

On August 13, 1996, the President signed RSFA into law. This legislation provides the framework for 1) additional delegations of royalty functions to States subject to Secretarial discretion, 2) enforcement definitions, 3) certainty for royalty payors with a 7-year statute of limitations for all royalty collections with liability limitations and a 33-month limit on all administrative appeals, 4) equity by requiring payment of interest on overpayments, 5) cost effective audit and collection activities, and 6) repeal of the outdated offshore refund requirements. MMS has identified several “critical events” that will be required to fully implement RSFA within the expected 3 years. Implementation is a very complex process

involving numerous rulemakings, computer systems modifications, reporting changes with accompanying payor guidance, and new operational processes.

Using insight gained from outreach sessions and issue-specific workshops with our State and industry constituents, MMS has made significant progress in implementing RSFA. We published the final rule for delegating functions to States on August 12, 1997, and with new software, began paying overpayment interest in April 1997 and accepting interest reporting in September 1997. On August 5, 1997, MMS published an Interim Final rule to match lessees and designated royalty payors, and the RPC formed a subcommittee to address related issues. Many other changes will be implemented through reengineering royalty management business processes and computer systems with cost-effective operational strategies and organizational structures for the future.

Program Reengineering Efforts

Reengineering is focusing on long-range plans to substantially improve timely and accurate reporting, payment and verification of Federal and Indian mineral lease revenues. We established the Program Reengineering Office (PRO) to focus on long-range plans to substantially improve timely and accurate reporting, payment and verification of Federal and Indian mineral lease revenues. The PRO is maintaining continuous communication and coordination with all customers, stakeholders, and other interested parties to gain consensus on key decisions and assure continued participation and support. A Reengineering Technical Assistance Contract was awarded to Performance Engineering Corporation (PEC) on July 15, 1997 to conduct a technical assessment of the current system environment (report issued December 1997), and develop systems options to support redesigned business processes (report issued March 1998). PEC is assisting the reengineering team in establishing, operating and maintaining an automated environment where the new processes and technology can be rapidly prototyped and evaluated. The PRO issued a report presenting its preliminary design concepts for future business processes in March 1998, and is currently prototyping future technologies that will lead to a final design concepts report in the summer of 1998.

USING MODERN INFORMATION MANAGEMENT TOOLS

Electronic Commerce Technology Development and Implementation

The Royalty Management Program's (RMP) target date for receiving 100 percent of its reports electronically is the end of Fiscal Year 1998. To assist reporters the RMP provides free reporting software and many electronic reporting options that require minor conversion commitments. To encourage conversion, the RMP is drafting a proposed rule to require electronic reporting, which will include an exception for hardship cases.

INVOLVING STAKEHOLDERS

Federal Gas Valuation

The Federal Gas Valuation Negotiated Rulemaking Committee (Committee), chartered by the

Secretary in June 1994, completed its work and published its final report in March 1995. The Committee reached agreement on using an index-based methodology as a valuation option for

gas sold under **arm's-length** nondedicated contracts and non-arm's-length contracts in geographic areas that meet certain criteria.

In light of the comments received from 44 entities, MMS reconvened the Committee on June 12- 14, 1996, and asked the Committee to provide input into five options for proceeding with further rulemaking. At the same time, MMS reopened the public comment period and asked for public comment on the five options. The reopened comment period closed August 19, 1996. The MMS performed a cost benefit analysis on three viable options for proceeding with gas valuation regulations. Given the results of the cost benefit analysis (\$20 million annual loss in royalties) and changes occurring the gas market, MMS withdrew the proposed rulemaking in April 1997.

Indian Gas Valuation

The Indian Gas Valuation Negotiated Rulemaking Committee was established on February 7, 1995, with a goal to publish regulations that will maximize royalty revenues for Indian Tribes and allottees consistent with the Secretary's discretion to establish value. The Committee agreed on a formula to value gas produced from Indian lands (in areas with a valid index) using publicly available spot market index prices and a discount factor. The **formula-**derived price will be applied to the **wellhead** Mcf volume and will satisfy the gross proceeds and major portion calculations required by lease terms. Under this scenario, filing of forms for transportation allowances will not be necessary. Dual accounting requirements can be satisfied in its current form or applying a percentage increase to the index formula value. For Indian lands with no valid spot market index, lessees will continue monthly reporting of gross proceeds under the 1988 regulations. The MMS will calculate and provide the major portion value to lessees.

The MMS published a proposed rule in the Federal Register on September 23, 1996, with a comment period ending December 3, 1996 and reopened for 30 days on March 6, 1997. The Indian Valuation Negotiated Rulemaking Committee reconvened on March 26, 1997. Industry generally supports valuation based on the index-based formula and the optional alternative dual accounting method. Industry strongly opposes the use of a safety net for non-dedicated sales and to the establishment of a "minimum value" for gas plant products in actual dual accounting situations.

Federal Crude Valuation Oil Rule

The current Federal oil valuation rules rely heavily on posted prices, which many believe substantially understate market value. On December 20, 1995, MMS published an Advance Notice of Proposed Rulemaking asking for comment on whether postings still represent market value, and suggestions on alternative valuation bases. The comment period ended in March 1996. Based on these comments, on January 24, 1997, MMS published a proposed rule in the Federal Register, with the comment period ending May 28, 1997. The intent of the proposed rule

is to reduce reliance on posted prices for royalty valuation, reflect true market value, provide certainty to all involved, and provide maximum flexibility to adapt to changing market conditions.

On July 3, 1997, MMS published a supplementary proposed rule responding to the many comments received that the restrictions on what transactions could be considered arm's length were too severe. The supplementary proposed rule limited some of those restrictions. The comment period closed August 4, 1997. On September 22, 1997, MMS published a notice requesting comments on five alternative proposals that were suggested in the comments received by MMS during the earlier proposals. Seven workshops involving States, industry, and the public were held during the comment period.

Indian Oil Royalty Valuation Rules

Due to the unique terms of Indian leases, MMS is developing a separate proposed rulemaking for valuing crude oil produced from Indian leases. On February 12-14, 1997, MMS met with Indian representatives to discuss initial proposals. MMS also arranged presentations by NYMEX and crude oil marketing expert Benjamin Johnson at the meeting. Based on MMS's initial proposals and input received at the February meeting, MMS drafted a proposed rule published in the Federal Register on February 12, 1998, that would require payors to use the higher of 1) the average of the five highest daily NYMEX settle prices for the prompt month for that month's production, adjusted for location and quality differentials, 2) the higher of the lessee's or its affiliate's arm's-length gross proceeds less appropriate allowances, or 3) a major portion value calculated by MMS after the reporting month. The major portion value would be the price at which 75 percent (by volume) of the oil (starting from the lowest price) is bought or sold in the designated area--usually a reservation. Lessees initially would report royalties based on the higher of the NYMEX or gross proceeds value. If the subsequent MMS major portion value is higher, lessees would have to adjust their initially-reported value to that level.

Differentials and refiner purchase prices would be derived from published data and information collected by MMS on a new form. Location differentials would be allowed from the reservation boundary to the index pricing point (Cushing, Oklahoma). The proposed rule also deletes the option for lessees in non-arm's-length transportation situations to request use of their FERC tariffs in lieu of actual costs.

OTHER ACCOMPLISHMENTS

Performance Measurement Team

In the Spring of 1996, MMS developed and issued its first MMS-wide long term strategic plan. During the development of the strategic plan, RMP formed a team to develop a performance measurement plan, as required by the Government Performance and Results Act (GPRA) for implementation at the beginning of fiscal year 1998. The RMP also participated in the GPRA pilot performance measurement program.

The strategic plan includes performance objectives and measurement indicators linked directly to RMP's mission goal, which is to "Provide timely, accurate, and cost-effective mineral royalty collection and disbursement services." The performance objectives are:

- improve the timeliness and accuracy of payments to States, Indian tribes, Bureau of Indian Affairs offices, and other Federal agencies;
- improve the cost effectiveness of mineral royalty collection and disbursement services;
- improve reporters' compliance with lease terms, rules, regulations, and laws;
- provide Indian tribes with increased opportunities for education and for assuming functional responsibilities with respect to the Royalty Management Program; and
- improve customer service and communication.

California Undervaluation

In June 1994, the DOI commissioned an interagency team to address possible under-payments of royalties on federal crude oil produced in and offshore California. The team issued its report on June 1996, and concluded that companies often received gross proceeds higher than the posted prices used as a basis for calculating royalties. This resulted in estimated underpayments including interest of \$856 million. The MMS re-estimated the underpayment amount to be \$440 million. The reduction in estimate was primarily due to removing the volumes the federal government took as RIK and those volumes included in previously negotiated settlements.

In late July 1996, The MMS initiated audits of the top 20 producers in California. This accounted for 97 percent of the oil producers in and offshore California, for the period from 1980 through 1995. The MMS divided the producers into two groups; integrated - those who produced and refined oil; and non-integrated - those who only produced and sold oil. The valuation criteria used for the integrated producers was to apply ANS oil value, as adjusted for transportation and quality at Los Angeles, for the period through early 1988 and gross proceeds thereafter. The non-integrated producers oil was valued at the total gross proceeds for the entire period instead of the posted prices commonly used for royalty value. Total amount originally billed during this project equals \$43 1.1 million. Reductions of \$174 million for adjustments and other corrections leave a net outstanding balance of \$257.1 million. All bills issued have been appealed. Two complaints have been filed by companies in the U.S. District Court, Northern District of Oklahoma, challenging the Government's access to records and the validity of orders for additional royalties.

Contract Settlements

During the past 10 years, many gas (a few coal) purchasers, particularly pipeline companies,

negotiated with mineral producers to rescind, terminate, limit, or otherwise modify sales contracts containing unrealistic purchase prices and/or volumes. In return, mineral producers frequently received monies in settlement of the contractual obligations. Since these settlements resulted in mineral producers receiving additional proceeds, audit determinations are necessary to verify that, to the extent the payments were attributable production, appropriate royalties are paid by the Federal and Indian leaseholders.

On August 27, 1996, a three judge panel of the U.S. Court of Appeals for the District of Columbia Circuit ruled against DOI in a contract settlement case. However, on April 14, 1997, the Sixth Circuit, U.S. Court of Appeals, ruled in DOI's favor on the same general issue, thus we continue to believe that payments, made in settlement of contract disputes, are linked to production and should be subject to royalty. Since many cases are nearing the 6-year record retention period, contract settlements are an audit priority.

Our audit goal is to achieve a high level of coverage, auditing at least 90 percent of contract settlement proceeds. This is consistent with historical coverage provided by contemporaneous audits.

**ILLEGAL OR WASTEFUL ACTIVITIES
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