



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

AUDIT REPORT

**DRAINAGE PROTECTION PROGRAM,
BUREAU OF LAND MANAGEMENT**

**REPORT NO. 99-I-358
MARCH 1999**



United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20240

MAR 26 1999

AUDIT REPORT

Memorandum

To: Director, Bureau of Land Management

From: Robert J. Williams 
Assistant Inspector General for Audits

Subject: Audit Report on the Drainage Protection Program, Bureau of Land Management
(No. 99-I-358)

INTRODUCTION

This report presents the results of our review of the Bureau of Land Management's drainage protection program. The audit objective was to determine whether the Bureau, which is responsible for managing the program, identified all potential drainage situations and required lessees to drill wells and produce the oil or gas necessary to prevent drainage or pay compensatory royalties for the drained resource.

BACKGROUND

Drainage is the gradual removal of oil and gas from beneath a specified property by a producing well on an adjoining property. Oil and gas are found in subsurface reservoirs and tend to flow to areas of reduced pressure that surround a producing well, thus enabling the oil and gas to be removed and drainage to occur. The rule of capture established by court decisions protects the producer that removes oil and gas which have migrated across property lines from any liability as long as the well itself does not trespass. Furthermore, the owner of a tract of land acquires title to all oil and gas produced from that tract of land regardless of whether such oil and gas migrated from adjoining lands.

The Code of Federal Regulations (25 CFR 211 and 212 and 43 CFR 3100) requires the Bureau to ensure that Federal and Indian leases are protected from drainage of oil and gas and to obtain compensation from the lessees for drainage losses. Specifically, the Bureau can require a lessee of Federal or Indian lands to drill a protective well and produce oil or gas to protect leased lands from drainage and to pay compensatory royalties for lost oil or gas

from the time drainage was known until protective measures are implemented. Any royalty revenues related to the unleased lands are lost until the lands are leased. The standard Federal and Indian lease agreements provide for drainage protection and require compensation from the lessees for drainage losses.

Bureau Instruction Memorandum 93-287, "Application of the Statute of Limitations to Oil and Gas Drainage Cases," requires the Bureau to initiate collection action on compensatory royalties related to drainage of leased lands within 6 years of the Bureau's becoming aware of the drainage to prevent the Bureau from losing the royalties because of the statute of limitations.⁹ The Bureau's drainage protection program procedures are described in Appendix 1. During October 1992 through April 1998, the Minerals Management Service collected compensatory royalties of \$7.4 million that were specifically attributable to the program.

The funds to manage the program are included in the Bureau's Oil and Gas Management subactivity, which is within the Energy and Minerals Management activity. The fiscal year 1997 budget for the subactivity was \$52.1 million and included funding for 8 10 full-time-equivalent positions. The program has no separate budget or accounting line item, and many of the program staff also have other duties. Consequently, the Bureau could not account for, and we could not identify, specific program expenditures.

SCOPE OF AUDIT

This review was conducted in accordance with the "Government Auditing Standards," issued by the Comptroller General of the United States. Accordingly, we included such tests of records and other auditing procedures that were considered necessary under the circumstances. We reviewed the Departmental Report on Accountability for fiscal year 1996, which includes information required by the Federal Managers' Financial Integrity Act, and the Bureau's annual assurance statement on management controls for fiscal year 1997 and determined that no material weaknesses were included in the reports which directly related to the objective and scope of our review.

Our review, which consisted of auditing data from October 1993 through August 1998 and other years as appropriate, was performed during May through September 1998 at the Bureau offices in **Lakewood** and Durango, Colorado; Farmington, New Mexico; and Casper, Wyoming. October 1993 was selected for review because it was the beginning of the last fiscal year for which cases could be opened and still be within the 6-year statute of limitations. We interviewed Bureau personnel responsible for administering the program and conducted telephone interviews with various other Bureau offices (see Appendix 2). We obtained, analyzed, and evaluated program statistical data from the 14 Bureau offices that had drainage protection responsibilities for October 1993 through August 1998 (see Appendix 3).

⁹Instruction Memorandum 93-287 expired on September 30, 1996. However, Bureau officials said that the Bureau continues to follow the requirements.

PRIOR AUDIT COVERAGE

During the past 5 years, the General Accounting Office has not issued any reports concerning the Bureau's drainage protection program. However, the Office of Inspector General issued the September 1993 report "Followup of Recommendations Pertaining to the Drainage Protection Program, Bureau of Land Management" (No. 93-I-1642), which was a **followup** review of the seven recommendations contained in the September 1990 report "Drainage Protection Program, Bureau of Land Management" (No. 90-100). The **followup** report stated that the Bureau had satisfactorily implemented six of the seven recommendations and had kept the Department of the Interior informed **on the** progress of its implementation of the remaining recommendation. The unimplemented recommendation required the Bureau to revise the drainage regulations in the Code of Federal Regulations (43 CFR 3 100) to change drainage protection responsibility **from** the operating rights owner to the lessee. Transfer of responsibility from the operating rights owner to the lessee will enable the Bureau to effectively track responsibility for drainage requirements, since operating rights are easily and frequently transferred, making enforcement of the drainage requirements difficult. The proposed rule making was expected to be published in the "Federal Register" in October 1993 but was not published until January 1998.

RESULTS OF AUDIT

We found that the Bureau of Land Management generally managed its drainage protection program effectively. Specifically, in fiscal year 1990, the Bureau had an estimated backlog of 25,000 unresolved drainage cases at the 16 offices² that had drainage protection programs. To address the backlog, the Bureau issued new guidance for the program in November 1992 and increased the resources for the program. Consequently, the Bureau reduced the backlog of unresolved drainage cases to 3,200 cases by September 30, 1994, and to 1,700 cases as of March 31, 1998 (see Appendix 3). We also found that potential drainage situations were effectively identified and evaluated and that corrective measures were implemented. As a result, revenues estimated at \$36 million were generated by the program during fiscal years 1995 to 1998 (through April 1998). However, we found that the Farmington (New Mexico) Field Office did not collect all compensatory royalties or interest related to its drainage program and that it reduced the priority of drainage cases on Indian lands. Bureau Instruction Memorandum 93-287 requires that collection action begin within a 6-year time period from the determination of drainage to preclude compensatory royalties from being lost because of the statute of limitations. In addition, Bureau Instruction Memorandum 96-1 80, "Bureauwide Interim Guidance Replacing the Oil and Gas Manual 3 160-2 - Drainage Protection After August 23, 1996," requires the field offices to submit drainage data to the Minerals Management Service for the Service's determination of royalties and interest owed. Further, Bureau guidance requires that drainage cases related to Indian lands be given high

²As of September 1998, the Bureau had 14 offices that had drainage protection responsibilities. The responsibility for the Bureau's Wyoming drainage protection program, which was previously delegated to individual field offices, was consolidated as a Wyoming State Office function at the Wyoming Reservoir Management Group in Casper during 1993.

priority within the drainage program. However, when coal bed methane drilling activity increased significantly in the Farmington area, the only area within the Bureau where extraction of coal bed methane is a significant activity, the Bureau did not allocate sufficient resources to effectively manage the work load, and a backlog of drainage cases developed that was approaching the 6-year limit. Farmington Office officials said that they realized that the normal process would not allow the timely processing of the drainage cases. Therefore, to accelerate the royalty collection process and prevent the complete loss of compensatory royalties, the Field Office entered into drainage settlement agreements,³ which were not in compliance with the Bureau's normal procedures to have the Minerals Management Service determine and collect the royalties owed. While this procedure did result in royalties and interest of \$242,000 being collected, royalty revenues of \$24,530 were not collected because of the statute of limitations. Furthermore, interest on royalties estimated at \$83,000 on the three settlement agreements we reviewed was not collected because the Farmington Office did not pursue the collection of interest owed, and at least 23 Indian drainage cases had not been processed timely.

Settlement Agreements

Farmington Office officials said that they used settlement agreements because Federal income tax incentives associated with drilling wells for the extraction of coal bed methane gas deposits in the Farmington area caused the number of drainage cases to increase. Specifically, the Crude Oil Windfall Profit Tax Act of 1980 (26 U.S.C. 29) provided a tax credit for production of nonconventional fuels, which include coal bed methane gas. The tax credits were due to expire in December 1992. Consequently, there was significant activity up to that time, and the resultant production from those wells created the Farmington Office's backlog. For example, the Farmington Office's drainage work load increased from 279 cases in 1994 to 423 cases⁴ in August 1998. Of the 423 drainage cases, an estimated 133 drainage cases were approaching the end of the 6-year period for initiating collection action. The ability of the Farmington Office to manage this increased work load was affected by two factors. First, because there was no uniform industry process for precisely determining the extent of coal bed methane deposits, development of a process by Farmington Office engineers was time consuming. Second, Farmington officials told us that because of budgetary constraints, they were not able to hire the additional staff necessary to manage the backlog.⁵ Accordingly, the Farmington Office implemented the drainage settlement agreement process to expedite the processing of these older cases. The settlement agreements eliminated forwarding the cases to the Minerals Management Service for calculation of royalties and interest due by the lessee, which a Farmington Office official

³ Drainage settlement agreements are negotiated between the Farmington Field Office and the lessee for a fixed amount that generally covers all compensatory royalties due up to the time the lessee drills protective wells.

⁴ Of the 423 cases, 354 cases involved potential coal bed methane drainage.

⁵ We did confirm that in August 1998 the New Mexico State Office advertised for a petroleum engineer for the Farmington Office, and State Office officials said that the individual hired would be assigned to the drainage program.

stated would take 2 or more years to process and that the statute of limitations would have expired⁶ during this time period.

During January through July 1998, the Field Office entered into three settlement agreements involving 16 drainage cases. While the settlement process prevented the complete loss of royalties, we found that it did not ensure that all revenues were collected. Specifically, although the Farmington Office collected revenues of \$242,000 (royalties of \$206,016 and partial interest of \$35,984⁷ on the royalties) on these three settlement agreements, one settlement agreement did not include estimated royalties of \$24,530 because the statute of limitations had expired. In addition, the three settlements excluded estimated interest of \$83,000 on the royalties for drainage that occurred during 1987 through 1996.

The Farmington Field Office drainage protection program petroleum engineer stated that the determination of coal bed methane reservoirs is “a new technology which few engineers understand” and that only one individual in the Farmington Office had the knowledge and expertise to reasonably estimate coal bed methane drainage. The engineer further stated that he had developed the procedures and data used for determining drainage for coal bed methane which were not reviewed and approved by Bureau management. Consequently, when the Farmington Office entered into the agreements, the amounts did not include all interest owed on the compensatory royalties. According to Farmington Office officials, the full amount was not requested to make the agreements more favorable to the lessee, which would reduce the possibility of appeal and facilitate an expeditious settlement.

We found that only one employee, a petroleum engineer, was responsible for all aspects of the settlement, including identifying the drainage amounts, estimating the royalties due, and negotiating with the lessee the final amount to be paid. Regarding technical reviews of drainage cases, the Bureau’s Instruction Memorandum No. 96-180 states that “a sufficient number of Quality Control Reviews must be conducted to ensure that program objectives are being met.” The memorandum further provides that these reviews may be performed by peers who have the expertise in “petroleum evaluations as applied to the Reservoir Management Program.” However, the engineer’s work on the three settlement agreements we reviewed, including the technical determinations related to the drainage amounts, had not been reviewed. According to Farmington Office officials, the work was not reviewed because of the lack of resources and of individuals who had the expertise to perform the reviews and because of time constraints. Farmington Office officials said that they were aware of the lack of separation of duties but that they wanted to complete the settlements before the statute of limitations expired and all of the revenues were lost. In our opinion, the lack of a technical review of the engineering estimates used to calculate the royalty amounts

⁶ We reviewed the only three coal bed methane assessments that were sent by the Farmington Office to the Service in October 1995 and determined that the Service took more than 2 years to process and collect one assessment and had not processed the other two assessments as of August 1998.

⁷ The Farmington Office used an average annual interest rate of 8 percent when it calculated the interest owed on the royalty amount.

and the lack of separation of duties with regard to the preparation and negotiation of the agreements did not provide adequate assurance that the amounts of drainage and related royalties were determined adequately. In addition, the petroleum engineer stated that there would be increased activity in the development of coal bed methane gas in other areas of the country. In that regard, we believe that the personal knowledge of the program's petroleum engineer relating to determining coal bed methane drainage should be documented. Documenting this process would allow the Farmington Office to train other engineers in the process, thereby providing additional resources to its backlog and minimizing the recurrence of backlogs in other Bureau offices.

Furthermore, the policies and procedures followed by the Farmington Office in negotiating the settlement agreements, including the decision to forego interest, were not documented and, as such, had not been reviewed and approved by Bureau management or the Solicitor's Office. According to Farmington Office officials, the Farmington Office will need to continue to use settlement agreements until the backlog is reduced to a maintenance level. After the Farmington Office documents the coal bed methane agreement policies and procedures, we believe that the Bureau should review these policies and procedures and make the changes necessary to ensure that all potential revenues are collected through the settlement process.

Indian Lands Drainage Cases

The Farmington Office did not effectively process cases related to drainage **from** Indian lands. Specifically, we found that the Indian lands' drainage cases were not assigned a high priority in the Farmington Office, as was required by Bureau procedures. Procedural Note 5 of the Bureau's Instruction Memorandum No. 93-287 states that "all Indian drainage cases **are** to be pursued regardless of their financial 'significance,' and Indian drainage cases normally will continue to receive top priority over Federal cases." Also, Instruction Memorandum No. 96-180 requires that the Bureau of Land Management (1) establish a priority classification method which would "ensure that royalty is not permanently lost, due to, for example, unleased lands" and (2) notify the Bureau of Indian Affairs to initiate leasing or negotiate an agreement that would afford protection for the lease "if the administrative and technical reviews indicate unleased Indian tribal or allotted lands are subject to drainage." (Emphasis added.) Bureau of Land Management officials stated that because the statute of limitations does not apply to Indian lands, royalties associated with leased lands are never completely lost.

However, we concluded that the Farmington Office was not timely performing all of the technical reviews necessary to ensure that drainage on Indian lands was properly identified and that drainage protection was pursued. Specifically, of the 56 active drainage cases for Indian lands, 23 cases were established before or during fiscal year 1994. Of the 23 cases, 13 related to leased lands and 10 related to unleased lands as follows:

- **Leased Lands.** Of the 13 cases related to leased lands, we reviewed 11 and found that at the time of our review, there was no documentation in the files to support that

preliminary technical reviews to determine whether drainage was occurring had been performed for 9 cases. However, documentation supported that the required reviews had been performed for two cases.

- **Unleased Lands.** Of the 10 cases related to unleased lands, we reviewed 8 cases and found that at the time of our review, there was no documentation in the files to support that preliminary technical reviews to determine whether drainage was occurring had been performed for 7 cases. However, documentation supported that the required reviews had been performed for one case.

As a result of the delays in processing the Indian drainage cases, the Farmington **Office** did not timely assess and collect revenues associated with drainage from leased Indian lands and did not recover compensatory royalties **for** drainage occurring on unleased Indian lands prior to the lands being leased and protective wells being drilled.

Farmington **Office** officials said that the priority on Indian lands was lowered because drainage from the Indian lands was marginal, the Indian entities had not responded to the **Office's** initial drainage notifications, the Indian entities did not always inform the Bureau when associated lands had been leased, and the Farmington Office was using its limited resources to process high-revenue cases.

Recommendations

We recommend that the Director, Bureau of Land Management, ensure that the New Mexico State Director:

1. Documents the settlement agreement process and has it reviewed by Bureau management and the Solicitor's **Office**.
2. Develops and implements internal controls to provide technical quality assurance for drainage calculations and to provide for the separation of duties for the Farmington Field **Office's** drainage settlement process.
3. Develops and provides coal bed methane drainage training to other petroleum engineers at the Farmington Field **Office** to ensure that more than one individual has expertise in this area.
4. Develops and implements a plan to eliminate the Farmington Field **Office's** current backlog of Indian drainage cases, as well as the backlog of Federal cases. This plan should include provisions to maintain the drainage program at a maintenance level after the current backlog has been eliminated.

Bureau of Land Management Response and Office of Inspector General Reply

In the February 24, 1999, response (Appendix 4) to the draft report from the Acting Director, Bureau of Land Management, the Bureau concurred with all four recommendations but did not present **sufficient** information for us to consider the recommendations resolved. However, subsequent to the response, the Bureau provided additional information regarding Recommendations 1 and 3. Based on the response and the additional information, we consider Recommendations 1, 2, and 4 resolved but not implemented. Accordingly, these recommendations will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation. Also based on the response and the additional information, we consider Recommendation 3 resolved and implemented (see Appendix 5).

Regarding Recommendation 1, Bureau **officials** told us subsequent to the response that the Bureau's Washington Office will issue an instruction memorandum by June 1, 1999, regarding the settlement agreement process and that instruction memoranda are routinely reviewed by the Solicitor's Office. According to Bureau officials, the Assistant Director, Minerals, Realty, and Resource Protection, is responsible for implementation of this recommendation.

Regarding Recommendation 3, Bureau officials stated subsequent to the response that the coal bed methane training had been provided to Farmington Field Office staff.

Additional Comments on Audit Report

The Bureau also provided additional comments on our audit report. The Bureau's comments and our responses are as follows:

- The Bureau stated that two Farmington officials, rather than one individual as stated in our report, had the expertise to evaluate coal bed methane drainage cases. However, the data we reviewed and the information obtained during our review in the Farmington Office indicated that only one official was involved in making coal bed determinations for the drainage program. Furthermore, Farmington **Office** officials stated that an additional petroleum engineer was needed for the program to assist with the backlog and that the State Office had begun to recruit for such an individual. If the Farmington Office had other officials capable of performing these evaluations and eliminating the backlog, they were not assigned to these duties.

- The Bureau disagreed that the settlement process eliminated the forwarding of the drainage cases to the Service for calculation of royalties and interest due by the lessee. The Bureau stated that Minerals Management was an "active participant" in the settlement process. However, the Bureau also said that there was no documentation in the files to support that statement. The statement in the report referred to the Bureau's procedures for processing drainage cases as required by Bureau Instruction Memorandum No.90- 180, which requires that the Service calculate the royalties due and send a bill for collection to the lessee

for the amount calculated (see Appendix 1). We concluded that the settlement process was created primarily to bypass this portion of the program's procedures because, according to Bureau officials, involving the Service would result in more time being expended and therefore more royalties and interest being lost because of the statute of limitations.

- The Bureau stated that the report indicated that the settlement process had not been reviewed and approved by Bureau management. The Bureau **further** stated that the Farmington Field Office Manager had the authority to approve such agreements and that the agreements were approved by the Manager. Our concern regarding approval was that the settlement process was not documented and, as such, could not be reviewed by Bureau Headquarters to ensure that the process adequately protected the Government's interests. We did not question that the Farmington Field Office Manager had the authority to enter into such agreements.

- The Bureau stated that our report indicated that the Farmington Field Office did not recover compensatory royalties for drainage occurring on unleased Indian lands. The Bureau further stated that the Field Office, in accordance with Bureau guidelines, properly notified the Bureau of Indian Affairs of potential drainage situations and that, as such, the Bureau of Land Management was not required to take **further** action until the lands were leased.

Bureau of Land Management guidelines require that the Bureau of Indian Affairs be notified of potential drainage situations after the administrative and technical reviews have been completed. Our review of the drainage files indicated that the Bureau of Indian Affairs was being notified before a technical review was completed. Consequently, the Bureau of Indian Affairs was being tasked with leasing lands that may not have had potential drainage situations. Accordingly, we believe that the Bureau of Land Management needs to take additional actions to provide the Bureau of Indian Affairs with more information on drainage situations that is based on completed technical reviews.

Since the report's recommendations are considered resolved, no **further** response to the Office of Inspector General is required (see Appendix 5).

The legislation, as amended, creating the Office of Inspector General requires semiannual reporting to the Congress on all audit reports issued, actions taken to implement audit recommendations, and identification of each significant recommendation on which corrective action has not been taken.

We appreciate the assistance of Bureau of Land Management personnel in the conduct of our audit.

BUREAU DRAINAGE PROTECTION PROCEDURES

The Bureau of Land Management's drainage protection procedures for addressing potential drainage situations as required by Bureau Instruction Memorandum No. 96-180, "Bureauwide Interim Guidance Replacing the Oil and Gas Manual 3 160-2 - Drainage Protection After August 23, 1996," are as follows:

1. To identify potential drainage situations, the responsible Bureau office performs an initial well and administrative review of well activity to identify any well that, because of its proximity to Federal or Indian lands and level of production, may present a potential drainage situation. Once a potential drainage situation has been determined, the Bureau establishes a drainage case and notifies the offended Federal or Indian lessee of the potential drainage situation and drainage protection obligations and requests protective action or technical data regarding the lessee's evaluation of the drainage situation.

2. The drainage case is subjected to technical--geologic and engineering--reviews to determine the nature and extent of the drainage. When these reviews indicate that drainage may be affecting unleased land, the Bureau of Land Management takes action to initiate leasing activity for Federal lands or notifies the Bureau of Indian Affairs for Indian lands that the land is subject to drainage and recommends that protective measures be taken. When these technical reviews indicate that drainage may be affecting Federal or Indian leased lands, the Bureau of Land Management issues a demand letter that informs the lessee of the lessee's responsibilities to protect the lease from drainage, defines the lessee's options that will resolve the drainage situation, and requires the lessee to submit a plan for protecting the lease from drainage. At this time, the lessee may disagree as to whether the drainage is occurring or that an economic protective well could have been drilled and may also disagree on the extent to which the drainage is occurring.

3. The Bureau then performs final technical analyses--geologic and reservoir engineering/economic--to compare the Bureau's data with the lessee's submitted data. Consequently, there may be technical-related negotiations with the lessee to arrive at a mutually agreeable amount of drainage. Thereafter, a quality control technical review is conducted, and a decision letter is sent to the lessee that informs the lessee of drainage protective actions, if any, that are required.

4. When the decision involves assessment of compensatory royalties, a copy of the decision letter is sent to the Minerals Management Service's Royalty Compliance Division, which then calculates the royalties due **from** the lessee and sends a bill for collection to the lessee for the royalty amount calculated. When the Service receives payment of the compensatory royalties, it calculates the late payment interest due **from** the lessee and sends a bill for collection to the lessee for the amount of interest calculated.

BUREAU OFFICES VISITED OR CONTACTED

<u>Office</u>	<u>Location</u>
Headquarters*	Washington, D.C.
Alaska State*	Anchorage, Alaska
California State*	Sacramento, California
Colorado State	Lakewood, Colorado
San Juan Resource Area	Durango, Colorado
Montrose District *	Montrose, Colorado
Eastern States*	Minneapolis, Minnesota
Jackson Field*	Jackson, Mississippi
Milwaukee Field*	Milwaukee, Wisconsin
Montana State*	Billings, Montana
Dickinson Field*	Dickinson, North Dakota
New Mexico State*	Santa Fe, New Mexico
Farmington Field	Farmington, New Mexico
Roswell Field*	Roswell, New Mexico
Tulsa Field*	Tulsa, Oklahoma
Utah State*	Salt Lake City, Utah
Wyoming State*	Cheyenne, Wyoming
Wyoming Reservoir Management Group	Casper, Wyoming

*Contacted **only**.

**DRAINAGE PROTECTION PROGRAM CASE WORK LOAD
AT OFFICES THAT HAVE PROGRAM RESPONSIBILITIES**

<u>Office</u>	<u>Location</u>	<u>1990</u>	<u>1994</u>	<u>1998</u>	Percent of Decrease/Increase* From <u>1990 to 1998</u>
Alaska State	Anchorage, Alaska	**	7	7	**
Bakersfield Field	Bakersfield, California	10,000	184	81	99%
Colorado State	Denver, Colorado	59	36	40	32%
Dickinson Field	Dickinson, North Dakota	587	257	96	84%
Farmington Field	Farmington, New Mexico	974	279	423	57%
Jackson Field	Jackson, Mississippi	67	0	0	100%
Lewistown Field	Lewiston, Montana	806	162	99	88%
Miles City Field	Miles City, Montana	215	62	51	76%
Milwaukee Field	Milwaukee, Wisconsin	488	414	520	7%
Roswell Field	Roswell, New Mexico	3,000	126	33	99%
San Juan Resource Area	Durango, Colorado	383	222	63	84%
Tulsa Field	Tulsa, Oklahoma	3,105	1,073	168	95%
Utah State	Salt Lake City, Utah	573	0	0	100%
Wyoming Reservoir Management Group	Casper, Wyoming	<u>4,580</u>	<u>349</u>	<u>84</u>	<u>98%</u>
Total		<u>24,837</u>	<u>3,171</u>	<u>1,665</u>	<u>93%</u>

* Denotes increase in percentage.

**Work load data for Alaska were not available for 1990.



United States Department of the Interior

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

In Reply Refer To:
1245 (WO-310)

FEB 24 1999

MEMORANDUM

To: Assistant Inspector General for Audits

Through: Sylvia V. Baca *Sylvia V. Baca* MAR 1 1999
Acting Assistant Secretary, Land and Minerals Management

From: Tom Fry *Tom Fry*
Acting Director, Bureau of Land Management

Subject: Response to Draft Audit Report on the Drainage Protection Program, Bureau of Land Management (Assignment No. C-IN-BLM-002-98-D)

Thank you for the opportunity to respond to the subject draft audit report on the drainage protection program of the Bureau of Land Management (BLM). We agree with the finding resulting from the Office of the Inspector General (OIG) audit that the BLM has managed its drainage protection program effectively. We also appreciate the assistance the OIG provided through this audit to assist in our effort toward developing and managing an effective program. However, we do have some concerns about how the BLM Farmington Field Office's (FFO) program was portrayed in the draft report. Our staff commented on many of these concerns during the audit exit conference on December 17, 1998, and in subsequent correspondence to the OIG.

During the past three years, the FFO program triggered the drilling of eight protective wells with future royalty revenue generating potential of over \$15 million. During the last year alone, over \$1 million has been collected as a result of compensatory royalty assessments. The FFO staff has also committed resources to reducing its drainage case backlog to maintenance levels since the audit was conducted in 1998. However, we realize that improvements can be made and appreciate the OIG's suggestions to make this an even better program.

Our specific comments on the draft audit report are offered as follows. The OIG states in its draft audit report "only one individual in the Farmington Office had the knowledge and expertise to reasonably estimate coal bed methane drainage." Actually two out of three FFO staff members have expertise in the evaluation of coal bed methane drainage cases. The draft report

states that FFO “did not collect all compensatory royalties or interest related to its drainage program,” as it relied heavily on the use of settlements. The decision to pursue settlements was based on several factors to prevent potential royalty losses. In each settlement, the FFO was able to get compensatory royalties and partial interest payments for the time periods in excess of the period BLM provided actual drainage notification.

The draft audit report states “the settlement agreements eliminated forwarding the cases to the Minerals Management Service (**MMS**) for calculation of royalties and interest due by the lessee.” To the contrary, the MMS was an active participant in all settlements through its Office of Collection and Enforcement. That office researched the issue and determined that drainage settlements are not based on waiving any part of the principal or interest, but are accepted based on the technical merits of the case, where issues like complexity of the reservoir, inconclusive geology, new technology, and notification are questionable and subject to dispute. Although no documentation of **MMS’s** involvement in the settlement process was evident in some of the cases **that** the OIG reviewed during its audit, the FFO is implementing action to ensure that drainage settlements are documented through signatures of officials representing parties to the settlement.

The draft report states the settlement process “had not been reviewed and approved by Bureau management.” However, as provided for in BLM guidance, the authority to approve settlement agreements has been delegated to the FFO Manager by the State Director. **In** most cases, prior to signing a drainage settlement, the FFO Manager requires that a review of the settlement agreement be conducted by New Mexico State Office (**NMSO**) **officials** and the MMS. No settlement agreement becomes final unless it is signed by delegated officials from the BLM.

The report states that “the Indian lands’ drainage cases were not assigned a high priority in the Farmington Office.” The BLM’s guidelines provide for the processing of Federal drainage cases which have a high potential for collecting significant revenue on an equal basis with Indian drainage cases. Since the OIG completed its 1998 audit of the drainage protection program, the FFO has been focusing on reviewing Indian drainage cases and the backlog for those cases has been reduced by over 75 percent.

The report also states that the FFO “did not recover compensatory royalties for drainage occurring on unleased Indian lands.” The FFO properly followed BLM guidelines to identify potential drainage situations on unleased Indian lands and forwarded those cases to the Bureau of Indian Affairs for leasing action. No further action by the BLM is required until the lands have been leased.

All BLM field **offices** with fluid mineral functions are doing an effective job in ensuring the Federal and Indian oil and gas resources are being protected from drainage. The suggestions provided in this draft audit report are being addressed as appropriate. Once more, we would like **to** express our appreciation to the OIG for the tremendous effort it dedicated to conducting this

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audit. The implementation of the audit recommendations will provide valuable assistance in ensuring that Federal and Indian oil and gas resources are protected **from** drainage.

If you have any questions, please contact Donnie Shaw, Geologist, at (202) 452-0382 or Gwen Midgette, BLM Audit Liaison Officer, at (202) 452-7739.

Attachment

RESPONSE TO DRAFT AUDIT REPORT
DRAINAGE PROTECTION PROGRAM, BUREAU OF LAND MANAGEMENT
JANUARY 1999
(C-IN-BLM-002-98-D)

(We recommend that the Director, Bureau of Land Management, ensure that the New Mexico State Director:)

Recommendation 1:

Documents the settlement agreement process and has it reviewed by Bureau management and the Solicitor's Office.

Response: The BLM concurs with this recommendation in part. We agree that the settlement process should be documented and reviewed by Bureau management. An Information Bulletin will be issued on the settlement process by the BLM's NMSO by May 3, 1999.

However, since settlements are most often negotiated on the basis of interpretation of technical data and procedures and not on legal issues, we do not believe **that** the Solicitors have to be involved in this process unless there is a significant legal issue.

Responsible Official: Michelle Chavez, State Director, New Mexico State Office

Recommendation 2:

Develops and implements internal controls to provide technical quality assurance for drainage calculations and to provide for the separation of duties for the Farmington Field Office's drainage settlement process.

Response: We concur with this recommendation. Appropriate management oversight and quality control will be provided for through the Information Bulletin referenced in Recommendation 1.

Responsible Official: Michelle Chavez, State Director, New Mexico State Office

Recommendation 3:

Develops and provides coal bed methane drainage training to other petroleum engineers at the Farmington Field Office to ensure that more than one individual has expertise in this area.

Response: We concur with this recommendation. Expertise at this level of complexity requires hands on experience. The FFO Manager will ensure that appropriate technical staff is provided with the necessary experience to work coal bed methane drainage cases in coordination with senior technical staff.

Responsible Official: Michelle Chavez, State Director, New Mexico State Office

Attachment 1 - 1

Recommendation 4:

Develops and implements a plan to eliminate the Farmington Field Office's current backlog of Indian drainage cases, as well as the backlog of Federal cases. This plan should include provisions to maintain the drainage program at a maintenance level after the current backlog has been eliminated.

Response: We concur with this recommendation. Although the majority of the backlog of unresolved drainage cases has already been eliminated, the Farmington Field Office expects to eliminate all of its backlog of Indian drainage cases by March 1, 1999. The New Mexico State Director will submit an action plan to the Washington Office's Assistant Director, Minerals, Realty, and Resource Protection, also by June 1, 1999, that provides for maintaining the drainage program at a maintenance level **after** the current backlog has been eliminated.

Responsible **Official:** Carson W. Culp, Assistant Director, Minerals, Realty, and Resource Protection

STATUS OF AUDIT REPORT RECOMMENDATIONS

Finding/ Recommendation Reference	Status	Action Required
1, 2, and 4	Resolved; not implemented.	No further response to the Office of Inspector General is required. The recommendations will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation.
	Implemented.	No further action is required.

**ILLEGAL OR WASTEFUL ACTIVITIES
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