

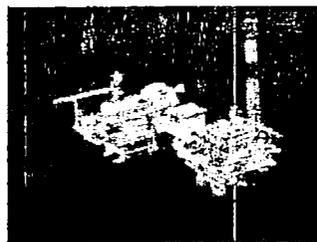
# Report of the Subcommittee on Royalty Management

David Deal – Vice Chair, Subcommittee on Royalty Management  
Larry Finfer – Staff Director, Subcommittee on Royalty Management

Royalty Policy Committee Meeting  
January 17, 2008

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## Mineral Revenue Collection from Federal and Indian Lands and the Outer Continental Shelf



Submitted by:

The Subcommittee on Royalty Management

with staff support from

U.S. Department of the Interior

Office of Policy Analysis (Office of the Secretary)

and the Bureau of Land Management

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## Background

- December 2006 IG report
- MMS "Action Plan"
- Subcommittee appointed March 22, 2007
- September 2007 IG report

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## Subcommittee Charge

- **Collections** - "the extent to which existing procedures and processes for reporting and accounting for Federal and Indian mineral revenues are sufficient to ensure that the Minerals Management Service receives the correct amount"
- **Audits, Compliance, and Enforcement** - "the audit, compliance and enforcement procedures and processes of the Minerals Management Service to determine if they are adequate to ensure that mineral companies are complying with existing statutes, lease terms, and regulations as they pertain to payment of royalties"
- **Royalty-in-Kind Program** - "the operations of the Royalty in Kind program to ensure that adequate policies, procedures and controls are in place to ensure that decisions to take Federal oil and gas royalties in kind result in net benefits to the American people"
- **OCS Royalty Relief** - lack of price thresholds in Gulf of Mexico leases from 1998 and 1999 sales

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## Subcommittee Members

### Co-Chairs:

Bob Kerrey former U.S. Senator  
Jake Garn former U.S. Senator

### Vice Chair:

David Deal Member, Royalty Policy Committee

### Members:

Cynthia Lummis former State Treasurer, State of Wyoming  
Mario Reyes Professor of Finance, University of Idaho  
Perry Shirley Assistant Director, Minerals Dept. Navajo Nation  
Bob Wenzel former Deputy Commissioner, IRS

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## Data Gathering

- Face-to-face meetings, numerous teleconferences
- Briefings
- Consulted with:
  - Various U.S. States and the Province of Alberta (on RIK issues)
  - Consultants with expertise in specific areas
  - The Department of Energy
  - The Internal Revenue Service
- Field visits
- Information from BLM on onshore minerals leases

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## Major Themes

- Transparency
- Offshore v. onshore; Oil v. gas
- Compliance tool kit
- Risk-based compliance
- Training
- Businesslike processes/procedures
- Electronic reporting/technological improvements

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## Chapter 2 - History of Royalty Management *Background*

- FY 2007 revenues - \$11.4 billion
- FY 2007 disbursements - \$11.7 billion
- Cumulative distributions - \$164.9 billion
- Minerals royalties → large source of non-tax revenue

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## Chapter 2 – Background, cont.

- Approx. 30,000 total leases
- Onshore (27,300 leases) - \$3.8 billion (37% of total royalty revenue)
- Offshore (2,335 leases) - \$6.4 billion (63% of total royalty revenue)

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## Chapter 3 - Collections and Production Accountability *Background*

- BLM → verifies onshore production
- MMS → verifies offshore production
- MMS → collects royalty revenue
- MMS → deals with discrepancies in production reporting

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## Chapter 3 - Major Findings

- Discrepancies in reported BTU value of gas impact sale value, royalty owed
- Gas analysis reports not consistently requested to verify BTU values
- RSFA single payor
- Efficiency improvements (data exchange; electronic payments; automated accounting tools; electronic reporting)

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## Chapter 3 - Major Findings, cont.

- Gas plant efficiency data is critical
- Training inadequate
- MRM staffing → backlogs in investigating and resolving discrepancies
- Unconsolidated, outdated production accountability guidance

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## Chapter 3 - Major Recommendations

- Amend MMS-2014 to record natural gas BTU values
- Modify GVS and LVS to compare BTU values and oil quality data to OGORs
- Amend RSFA to directly pursue “payor”

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## Chapter 3 - Major Recommendations, cont.

- Electronic submission of payments
- Training: assess needs, standardize, offer more frequently, certification process for solids inspectors
- BLM:
  - Improve production accountability records tracking system
  - Determine appropriate staffing levels

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## Chapter 4 - Audit, Compliance, Enforcement *Background*

- Compliance tools:
  - Informal efforts
  - “Issue letters”
  - Audits
  - Compliance reviews
  - Enforcement actions
- Different levels of detail, effort, and engagement
- Compliance efforts often initiated via “issue letters” or “orders”

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## Chapter 4 – Background, cont.

- Audits and compliance reviews validate companies' compliance with their royalty responsibilities
- Compliance reviews:
  - rely on existing information
  - used in conjunction with audits to increase coverage
  - less costly (but less detailed) than full audits
  - use increased recently to meet the increased workload

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## Chapter 4 – Background, cont.

*IRS Approach*

- “Soft notices,” full scale audits, “issue audits,” “math checks”
- Risk-based foundation, continually refined
- Whistleblower program

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## Chapter 4 – Background, cont.

*MMS Risk-Based Pilot*

- Payors with fewer variances or risks audited or reviewed less frequently
- Payors with a higher risk of error audited or reviewed more frequently
- Requires effective data systems

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## Chapter 4 - Major Findings

- MMS compliance staff:
  - 438 FTEs in 2000
  - 363 FTEs in 2006.
- Funding:
  - \$18.9 million in FY 2003
  - \$22.1 million in FY 2005
  - \$16.3 million in FY 2006
- State/tribal audit/compliance costs represent a significant proportion of total compliance costs
  - Funding does not reflect inflation or increases in staffing needs
  - States/Tribes allocation information not available

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## Chapter 4 - Major Findings, cont.

- IRS: sophisticated risk models
- MMS pilot: audit v. compliance review
- Compliance/production verification data entry and maintenance - inconsistent and insufficient for managing the workload
- Various methodologies used to value oil and gas and when applying transportation deductions

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## Chapter 4 - Major Recommendations

- Finalize the “technical changes” Indian oil valuation reg
- Implement risk-based approach
- Develop new GPRA goals/metrics

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## Chapter 4 - Major Recommendations, cont.

- Interest on royalty payments
- Consolidate duplicative databases
- Electronic submission to LVS, GVS
- Revise gas valuation regs
- Revise regs for calculating prices used in checking royalty compliance for solid minerals

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## Chapter 5 - Coordination Background

- Previous inter-bureau projects were intended to improve coordination
- Intra-bureau communication also critical
- Compliance staff are highly decentralized

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## Chapter 5 – Background, cont.

Function	Location of Mineral Resource			Information necessary for effective coordination
	Offshore	Onshore		
		Federal	Indian	
Develop and implement Management Plans	MMS	BLM	BIA	Land status, areas available for leasing, stipulations
Lease parcels	MMS	BLM	BIA	Lease terms and conditions, royalty rate, distribution of revenue
Permits/inspect operations/enforcement	MMS	BLM	BLM	Well/lease operating and production status, information on operations
Production verification	MMS	BLM	BLM	Production information generated by agency field measurements and inspections
Production reports	MMS	MMS	MMS	Operator reported production
Production accountability (compare measurements to reports)	MMS	BLM	BLM	Production information reported by operators, production information from agency information systems
Royalty payment compliance	MMS	MMS	MMS	Compliance status
Royalty collections/enforcement	MMS	MMS	MMS	Compliance status
Revenue distribution	MMS	MMS	MMS	Revenue distribution information

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## Chapter 5 - Major Findings

- Inadequate inter and intra agency coordination
- Inadequate coordination on permits for mineral activities in Indian Country
  - Inspections for environmental impacts or production accountability may not be conducted

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## Chapter 5 - Major Recommendations

- Strengthen inter and intra-Bureau coordination
- Improve access to the Indian lease system
- Reconnect Indian data systems
- Establish standards for geospatial data for Indian leases
- Review the decision classifying information as "Trust" information

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## Chapter 6 - RIK Background

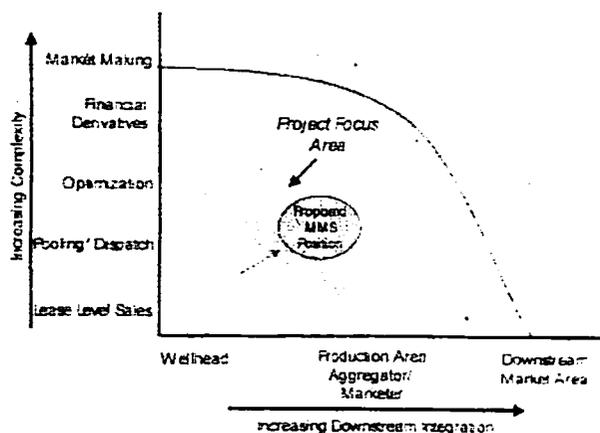
- Program expanded in recent years
- Systematic economic analysis prior to converting a property to RIK
  - Property returned to RIV if economics unfavorable
- Small Refiner program
- Role of SPR

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## Chapter 6 – Background, cont. Five-Year RIK Business Plan



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## Chapter 6 – Background, cont.

- FY 2006: RIK production → 72% of the crude oil royalty volumes and 45% of the natural gas royalty volumes produced in the GOM
- Pilot project with the State of Wyoming - 30,000 mmBTU per day

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## Chapter 6 – Background, cont.

### *RIK Sales and Revenues*

- FY04: 46.6 million BOE; \$1.5B
- FY05: 57.8 million BOE; \$2.5B
- FY06: 75.3 million BOE; \$4.1B
- RIK revenue as % of total royalty revenue
  - FY04: 23.8%
  - FY05: 32.6%
  - FY06: 42.0%

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## Chapter 6 – Background, cont. *RIK v. RIV Administrative Costs*

	FY 2004	FY 2005	FY 2006
RIK total administrative cost (\$ millions) <sup>1</sup>	\$9.7	\$10.2	\$14.4
RIK cost per BOE (\$/BOE) <sup>2</sup>	\$0.057	\$0.059	\$0.076
RIV administrative costs (\$/BOE) <sup>2</sup>	\$0.075	\$0.102	\$0.108

<sup>1</sup> RIK total administrative costs include direct RIK costs, overhead, and SPR related costs.

<sup>2</sup> In order to compare RIK and RIV costs on an equivalent BOE basis, MMS excluded the following cost categories from the unit cost administrative cost calculations: IT costs, RIK onshore direct costs, and overhead costs.

Source: MMS data.

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## Chapter 6 – Background, cont. *Strategic Petroleum Reserve*

- Current capacity = 727 million bbl
- Possible expansion to 1 billion bbl.
- Transfers to SPR
  - FY04/05 → 64.4 million bbl
  - FY06 → 0
  - FY07/08 → 27 million bbl
- Post 2009 requirements

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## Chapter 6 - Major Findings

- Growth of Program
- Market Position, Organization, Incentives
- Crude Oil Program
- Personnel Breadth, Depth
- Performance Measures
- Auction Procedures

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## Chapter 6 - Major Recommendations, cont. *Governance (short-term)*

- RIK Subcommittee to the RPC
- New or revised regs and/or guidelines
- Clarify application of FAR
- SPR cost reimbursement

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Chapter 6 - Major Recommendations, cont.  
*Governance (medium-term)*

- "Trust fund"
- Analysis of governance alternatives
- Independent oversight board
- Charter or mission statement
- Outreach (States, Tribes, industry)
- Discontinue onshore crude oil program
- Discontinue the small refiner set-aside

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Chapter 6 - Major Recommendations, cont.  
*Human Resources*

- Need personnel depth
- Personnel Plan
- Streamline process for filling vacancies
- Ethics guidelines
- Dedicated legal support

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## Chapter 6 - Major Recommendations, cont. *Performance Measurement*

- Opportunity costs of SPR oil
- Report on performance using range-of-values methodology
- Use of standard financial reporting tools
- Benchmark program costs
- Systematic procedure for handling bid documents

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## Chapter 7 – Price Thresholds

- Topic not included in the Subcommittee's charter
- Leasing issue rather than a royalty management issue

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## Chapter 7 - Major Recommendations

- Ensure that the Secretary's February 15, 2007 memorandum is implemented
- Incorporate into performance standards for key staff
- Additional ethics training

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