

OPENING STATEMENT FOR SENATOR FEINSTEIN
Minerals Royalty Program Oversight Hearing
Tuesday, February 26, 2008

Good morning, ladies and gentlemen, and thank you for attending this oversight hearing on the Minerals Management Service and the minerals royalty program.

I'd like to welcome Stephen Allred, the Interior Department's Assistant Secretary for Lands and Minerals Management. Thank you, Mr. Allred, for joining us again this year. Joining Assistant Secretary Allred is the Director of the Minerals Management Service, Randall Luthi. We look forward to hearing your testimony.

The Minerals Management Service is responsible for managing the federal government's oil and gas royalty programs on public lands and waters.

I know for some that probably sounds excruciatingly dry, but the fact is that MMS, working on behalf of the American taxpayer, plays an important role in the overall finances of the U.S. government.

Last year, MMS collected \$11.4 billion in royalties and rents associated with 29,000 onshore and offshore oil and gas leases.

Of that amount, \$2.5 billion was distributed to state and tribal governments, while the federal share was used to fund the Land and Water Conservation Fund, the Historic Preservation Fund, and the Reclamation Fund, in addition to general government operations.

Mr. Allred, we've asked you to address three specific subjects this morning in your testimony.

First, we would like you to update the Committee on the status of your negotiations with the oil companies holding leases issued in 1998 and 1999 for which MMS is not collecting royalties due to the US. This is potentially a \$10 billion loss to the taxpayer and we need to know what the department is doing to make the treasury whole.

Secondly, we've asked you to address the ongoing litigation between Kerr-McGee, which is now Anadarko Oil, and the Interior Department over the legality of price thresholds for all 1996-2000 leases. We're aware of the recent District Court decision that went against the government, but the Committee is eager to hear the status of the case and the Department's outlook on its outcome. As I understand, this is another potential loss of \$21 billion should this case stand.

Finally, we've asked you to speak to the findings and recommendations contained in a December 17th report from the Royalty Policy Committee concerning mineral revenue collection on federal lands.

The report was authored by our former colleagues, Senators Bob Kerrey and Jake Garn, who co-chaired the special committee that investigated and reported on nearly every aspect of Federal performance in carrying out its oversight and revenue collection duties. Senators Kerrey and Garn, while unable to attend today's hearing, have submitted testimony that will be entered into the record of this hearing.

Before we hear from Mr. Allred and Mr. Luthi, I will turn to the Subcommittee's distinguished Ranking Member, Senator Allard, to make any opening remarks he may wish.

**STATEMENT OF
C. STEPHEN ALLRED
ASSISTANT SECRETARY, LAND AND MINERALS MANAGEMENT
AND
RANDALL B. LUTHI
DIRECTOR, MINERALS MANAGEMENT SERVICE
UNITED STATES DEPARTMENT OF THE INTERIOR
BEFORE THE
COMMITTEE ON APPROPRIATIONS
SUBCOMMITTEE ON INTERIOR AND RELATED AGENCIES
UNITED STATES SENATE**

FEBRUARY 26, 2008

Madame Chairman and Members of the Committee, we appreciate the opportunity to testify today. This Committee has been instrumental in shaping our domestic energy program, particularly with regard to the sound development of our domestic oil and gas resources on the Outer Continental Shelf (OCS) and the management of mineral revenues from the OCS and from onshore Federal and Indian lands.

Today's testimony will focus on three areas:

1. The OCS leases that were issued in 1998 and 1999 without price thresholds.
2. The recent District Court decision in the Kerr-McGee litigation.
3. The recently issued report from the Subcommittee on Royalty Management and our subsequent implementation efforts.

The Department of the Interior and its agencies serve the public through careful stewardship of our Nation's natural resources. The Department also plays a vital role in domestic energy development: Approximately one third of all energy produced in the United States comes from resources managed by the Interior Department. The Department, through MMS, is also responsible for managing and providing the American people with an accurate and transparent accounting of the revenue this production generates. For example, since 1982 MMS has distributed approximately \$176.6 billion to Federal, State, and Indian accounts and special funds, including the following:

- \$107.8 billion to the U.S. Treasury and other Federal agencies;
- \$22.6 billion to the Land and Water Conservation Fund;
- \$22.3 billion to States;
- \$14.7 billion to the Reclamation Fund;
- \$5.7 billion for American Indian Tribes and allottees; and
- \$3.5 billion for the Natural Historic Preservation Fund.

1998-1999 OCS Leases without Price Thresholds for Royalty Relief

The Deep Water Royalty Relief Act of 1995 (DWRRA) required deep water leases issued from 1996 – 2000 to include a royalty incentive that allowed companies to produce a set volume of oil and gas before they began paying royalties. Price thresholds, which limit royalty relief when oil and gas prices are high, were included in leases issued in 1996, 1997 and 2000. However, they were not included in leases issued in 1998 and 1999.

A recent Federal District Court decision has called into question MMS's authority to establish price thresholds under the authority of the DWRRA. In the *Kerr-McGee* case, the District Court for the Western District of Louisiana ruled that MMS did not have the authority to apply price thresholds to the royalty relief provided in the deepwater leases issued in 1996 – 2000. On December 21, 2007, the Department of Justice filed a timely notice of appeal with the 5th Circuit Court of Appeals to protect the interests of the United States in the *Kerr-McGee* litigation. The 1998-1999 lease issue and the question of price thresholds is a sub-issue of the larger *Kerr-McGee* case.

The question of whether the Department has the authority to include price thresholds in royalty relief provisions for leases issues after 2000 is not at issue in the *Kerr-McGee* litigation. All leases issued after 2000 that include royalty relief also include price thresholds, and there is no dispute that MMS has the authority to condition this relief on the prices of oil and gas.

In an attempt to address the missing price thresholds in the OCS oil and gas leases issued during 1998 and 1999, early in my tenure as Assistant Secretary, I met with several oil companies. As a result of those meetings, voluntary agreements were reached with six companies, each of which has been paying royalties consistent with the terms of the agreement. We remain open and willing to discuss agreements with the remaining companies that hold leases issued without price thresholds.

If the District Court's decision in *Kerr-McGee* is not reversed, whether the leases issued in 1998-1999 contain price thresholds becomes moot. While we have had at least preliminary discussions with all companies holding leases issued in 1998 – 1999, I do not believe that any additional lessees will agree to price thresholds until they see the outcome of the *Kerr-McGee* case.

Royalty Policy Committee Report

As you know, we recently received a report that contains recommendations developed by the Royalty Policy Committee's Subcommittee on Royalty Management. I would like to discuss how the Subcommittee came to be established, its composition, and areas of responsibility. Director Luthi will address the current status of our efforts to implement the recommendations contained in the report.

On March 22, 2007, upon my recommendation, Secretary Kempthorne appointed the Subcommittee on Royalty Management (“the Subcommittee”) to conduct an independent examination of MMS’s minerals revenue management program. As you are aware, reports from the Department’s Office of Inspector General and others questioned whether the Department’s royalty programs were adequate to assure that the public received the royalties that Congress had intended. While I had concluded at the time that there were not major problems in the royalty program, I felt there were many opportunities to improve those operations. As a result, the Secretary determined that a fully independent examination of the program was warranted, both to restore credibility to this important revenue-generating program, and to focus on the improvements that were needed.

Specifically, we asked the Subcommittee to review:

- the extent to which existing procedures and processes for reporting and accounting for Federal and Indian mineral revenues are sufficient to ensure MMS receives the correct amount;
- MMS’s audit, compliance and enforcement procedures and processes to determine if they are adequate to ensure mineral companies are complying with existing statutes, lease terms, and regulations as they pertain to payment of royalties; and
- the operations of the Royalty in Kind Program to ensure that adequate policies, procedures, and controls are in place to ensure the decisions to take Federal oil and gas royalties in kind result in net benefits to the Federal government.

Subsequently, the Subcommittee was also asked to review procedures promulgated by the Department in response to the lack of price thresholds in Gulf of Mexico leases from 1998 and 1999 sales to ensure that future leases include price thresholds.

The panel, which was organized as a Subcommittee of the Royalty Policy Committee (RPC), a Federal Advisory Committee Act (FACA) body that advises the Secretary on matters related to mineral revenues, was comprised of seven distinguished members:

- Former U.S. Senator and Nebraska Governor Bob Kerry and former U.S. Senator Jake Garn, of Utah;
- Cynthia Lummis, a former Wyoming official who served as State Treasurer, and as a member of the Wyoming House and Senate, concentrating on natural resource and taxation issues;
- Perry Shirley, Assistant Director of the Navajo Nation’s Minerals Department, who serves as the Principal Investigator responsible for administering a Cooperative Agreement between the Navajo Nation and the Minerals Management Service;
- Robert Wenzel, the highest ranking career official in the Internal Revenue Service from 1998 to 2003, whose responsibilities included the day-to-day operation and strategic management of the United States tax administration system;

- Dr. Mario Reyes, Associate Dean for Administrative Affairs and Director of Business Economics Programs in the College of Business and Economics at the University of Idaho; and
- David Deal, who serves as the vice-chair of the full Royalty Policy Committee;

To ensure independence, the Subcommittee staff came primarily from the Department's Office of Policy Analysis, but also included Bureau of Land Management staff and an independent staff member, Loretta Beaumont, who was selected by the co-chairs. MMS played no role in the Subcommittee's work beyond responding to requests for information.

I want to express my deep appreciation to each member of the Subcommittee and staff for their hard work in the preparation and completion of this thorough report.

The Subcommittee issued its Report on December 17, 2007, as a public document and in a public meeting on January 17, 2008, the RPC voted to accept the Subcommittee's Report. By letter dated January 25, 2008, the RPC Chairman transmitted the Report to the Secretary.

The Subcommittee concluded that MMS is an effective steward of the Minerals Revenue Management Program, and that MMS employees are genuinely concerned with fostering continued program improvements. The Subcommittee members unanimously agreed that MMS is the Federal agency best suited to fulfill the stewardship responsibilities for Federal and Indian leases. However, as we expected, the report identified many areas that warranted management attention to ensure public confidence.

The Report contains 110 recommendations, including 35 recommendations related to Collections and Production Accountability; 30 regarding the Royalty in Kind (RIK) Program; 27 on Audits Compliance and Enforcement; 10 related to Coordination, Communication, and Information Sharing among MMS, the Bureau of Land Management (BLM) and the Bureau of Indian Affairs (BIA); and 5 on OCS Royalty Relief (See Attachment #1). At least three of the recommendations would require legislative action. Notably, the Report concluded, "the advantages of including an RIK approach among MMS asset management options are clear and MMS's process for evaluating the feasibility of RIK versus Royalty in Value (RIV) appears to be rigorous and effective. Nevertheless, in order to ensure the program's successful operation, a number of challenges must be addressed."

The Report's recommendations span the responsibilities of all three Departmental Bureaus involved in royalty management - MMS, BLM, and BIA (See Attachment #2). Of the 110 recommendations, MMS is solely responsible for 73 and BLM is solely responsible for 15. The remaining 22 recommendations require coordination among the Bureaus. We are in the process of establishing a Production Coordination Committee with representatives from the BLM, MMS, and BIA whose task will be not only to coordinate and implement the cross cutting recommendations contained in the Subcommittee's report, but to also provide on-going coordination of issues related to the

management of Federal and Indian mineral leases as suggested by one of the recommendations contained in the Report.

Implementation of Subcommittee Recommendations

In a memorandum dated January 14, 2008, Secretary Kempthorne asked the Department to review the report, develop an action plan, and begin implementing the Subcommittee's recommendations. I am pleased to report that as of February 11, 2008, 16 of the 110 recommendations are already complete (See Attachment #3). Of the remaining 94 recommendations, 29 are underway. We have developed a Joint Action Plan to address all of the Report's recommendations.

The plan identifies by recommendation the responsible Bureau, estimated timeframes for completion, and status. Points of contact are designated within each Bureau to monitor implementation and report on progress on a monthly basis. Many of the recommendations require further evaluation, and to that end, teams are being formed to determine appropriate actions and schedules. Likewise, many recommendations will need to be explored further through consultations with State and Tribal officials, and other organizations before they can be adequately implemented. We have developed a tracking system and have been and will continue to hold regular meetings to assess progress on the implementation of each action item.

Examples of the major focus areas contained in our Joint Action Plan include the following:

- Ensuring collection of sufficient data to make certain that royalties are being paid on the correct volume of oil and gas from Federal and Indian lands.
- Improving the coordination, collaboration, communication, and information sharing between BLM, MMS, and BIA.
- Requiring more reporting of data electronically and ensuring that bureaus have easy access to each other's systems.
- Implementing a risk-based compliance strategy and determining the extent to which a more flexible approach to audits, similar to that used by the IRS, is feasible.
- Ensuring the RIK program has the right personnel with the right skills to get the job done.
- Ensuring that all staff receive ethics training, including training focusing on public-private sector interactions.
- Ensuring that we have sufficient staff to support the Department's onshore and offshore royalty management activities.

Secretary Kempthorne and I are grateful to the Subcommittee for the time and energy it devoted in its review. The Department is committed to working with our stakeholders to

implement the recommendations contained in the Report. We agree with the statement of the Subcommittee that implementing the recommendations in this report will greatly strengthen the management of the program, will restore public confidence, and will ensure maximum value for the U.S. taxpayer.

Conclusion

I am pleased with the results of our efforts thus far, but recognize that there is much more work to be done. MMS will continue to review and improve its royalty program. I have every confidence that MMS will successfully implement the Subcommittee on Royalty Management's recommendations which will assist MMS in ensuring that the American people receive a fair return from the important public resources the Department manages. I welcome your input on all of these initiatives, and we look forward to working with you.

Testimony of Senators Bob Kerrey and Jake Garn
(Submitted for the Record)
Co-Chairmen, Subcommittee on Royalty Management
Before the
Senate Committee on Appropriations
Subcommittee on Interior, Environment, and Related Agencies
February 26, 2008

The Subcommittee on Royalty Management was established by the Secretary of the Interior, Dirk Kempthorne, in March 2007. It was created as a consequence of concerns about lapses in ethical behavior and inadequacies in lease issuance, royalty collection, and auditing. These concerns have been expressed by the Congress and by the Department's Inspector General who has investigated allegations of ethical lapses of personnel in the royalty in kind (RIK) program.

As co-chairmen of this Subcommittee, we are pleased to provide this statement on the Subcommittee's report entitled "Mineral Revenue Collection from Federal and Indian Lands and the Outer Continental Shelf." The report was released on December 17, 2007, and is the result of nine months of data gathering and analysis by the Subcommittee. It presents a comprehensive analysis of the federal mineral resource management program in the Department of the Interior. The program is a major source of revenue to the U. S. Treasury, with revenues in excess of \$11 billion in 2007.

The Subcommittee members conducted an independent evaluation of the revenue collection and royalty management program within the Department of the Interior. In addition to ourselves, the Subcommittee includes an impressive group of professionals: David Deal, our vice chairman, an oil and gas expert, and a member of the Royalty Policy Committee to whom the Subcommittee reports; Cynthia Lummis, a former Treasurer of the State of Wyoming.; Mario Reyes, a professor of finance at the University of Idaho; Perry Shirley, the Assistant Director for the Minerals Department of the Navajo Nation; and Bob Wenzel, a former Deputy Commissioner for the Internal Revenue Service (IRS).

The companies who lease the right to explore for and develop minerals on federal lands and offshore waters pay royalties on the minerals extracted from those lands and waters. Those royalties are either paid in cash, which is know as royalty in value, or in product, which is known as royalty in kind. The royalty in kind program has been quite cost effective, especially for natural gas production, and the program is expected to continue to grow. The Minerals Management Service (MMS) does not stockpile product "paid" through the RIK program. Rather, it sells the product through a closed bid auction procedure. We believe the RIK program is an extremely important component of the royalty management program and the RIK recommendations in the report are geared toward ensuring the program's survival.

The Subcommittee's report makes over 100 recommendations for improvements in the mineral resource management program. Most of these recommendations can be

implemented administratively. Many can be done quickly. Some will require long term effort and continued vigilance. A few of the recommendations depend upon legislative action. The Federal employees who work in the mineral leasing and royalty collection program are conscientious, hard working, and concerned about the reputation of the program and of the Department of the Interior. We believe that implementing the recommendations in this report will greatly strengthen the management of the program, will restore public confidence, and will ensure maximum value for the U.S. taxpayer.

We support all the Subcommittee's recommendations. However, for the balance of this testimony, we focus on a limited number of recommendations in 10 key areas that we believe are critical to ensure continued improvements in the program. Most of the recommendations will require some additional resources from the House and Senate Committees on Appropriations. A relatively modest increase in appropriations should yield increased revenues that more than offset the additional funding.

1. Over the past few years, MMS has relied more heavily on compliance reviews rather than full audits of industry royalty payments for production on federal lands and offshore waters. It appears that the increased reliance on compliance reviews has been based on funding and personnel constraints rather than on documented data on benefits and risks. MMS needs to establish an auditing and compliance program that includes an appropriate balance of audits and compliance reviews, and the program needs to be based on reliable data.

Specifically, MMS should implement a risk-based strategy for identifying companies and properties for audits and compliance reviews. This effort will require developing, testing, and refining various strategies over the next several years. While this will be an evolving process, and MMS is instituting a pilot program in this area, MMS needs to take aggressive action to establish an initial program over the short term. MMS should work with the IRS to benefit from the lessons IRS has learned in this area over the years.

2. We believe that one recommendation, which requires legislative action, deserves very serious consideration by the Congress. We recommend that MMS explore the feasibility of establishing an interest-bearing trust fund within the Treasury. Interest from this fund could be used to fund Department of the Interior activities; primarily, but not necessarily limited to, royalty management activities.
3. The Department of the Interior should strengthen and emphasize ethics training for all staff involved in royalty management. Training should include guidance on appropriate interaction with the private sector, prohibitions on the use of public office for private gain, and the handling of official and proprietary information.
4. In addition to MMS, the Bureau of Land Management (BLM) and the Bureau of Indian Affairs (BIA) play significant roles in onshore royalty management. Program improvements in these bureaus are needed, as is better coordination among MMS, BLM, and BIA. In particular, improved communication and

coordination among the various production accountability staffs needs to be addressed. Further, data entry in BLM and BIA, as well as compliance management information in MMS, should be automated to eliminate manual data entry to the maximum extent practicable.

5. BLM has difficulty recruiting and retaining Petroleum Engineering Technicians and Petroleum Accountability Technicians. The number of Mining Engineers is also inadequate. The salaries for these positions need to be reviewed and training programs need to be improved. Also, the total number of positions needed should be determined based on workload in individual BLM field offices. For example, production accountability reviews are critical for accurate revenue collection. However, in 2006, BLM had only 20 Petroleum Accountability Technicians (PATs) nationwide and nineteen of the thirty-one BLM field offices with oil and gas responsibilities employed no PATs.

Emphasis within BLM over the past several years has been on increased funding for the “front end” of the program: namely, additional leasing and processing of applications of permits to drill. As the program has expanded, there has not been sufficient attention to funding the workload associated with the “back end” of the process: namely, increased collections, production accountability, and auditing requirements.

6. The Indian oil valuation rule has been languishing within the Department of the Interior for more than 10 years. Indian Tribes are understandably frustrated by the delay. The Subcommittee believes that the Department should immediately finalize its “technical changes” to the Indian oil valuation rule and, by June 2008, MMS should propose a rule that values Indian oil based on a market index as is done for production from federal oil leases and from Indian gas leases.
7. Improved oversight of the mineral revenue collection program is essential to ensure the problems that generated so much concern in the past are not repeated and new problems in the future are avoided. Therefore, we recommend the establishment of an RIK Subcommittee to the Royalty Policy Committee. The RIK Subcommittee should address such issues as performance benchmarks, volume verification, and market positioning. We also recommend the establishment of a Coordinating Committee, comprised of senior management officials in MMS, BLM, and BIA, to ensure that recommended improvements are implemented in these bureaus.
8. The skills necessary to administer the RIK program are not typical for a government agency. RIK is basically an oil and gas marketing operation. The Subcommittee recommends that issues associated with hiring and maintaining staff with industry expertise and dedicated legal support should be addressed in the RIK program. Also, MMS should evaluate the benefits and costs of alternative auction types and should develop a pilot program to test alternatives

that could improve net returns.

9. We recommend eliminating programs that are no longer cost effective or large enough to support their continuation. These include the onshore RIK crude oil program and the small refiners' set-aside RIK program. Market conditions in the future may be conducive to reinstating these programs but such is not the case today.
10. The Subcommittee's charter did not include a review of the situation surrounding the offshore oil and gas leases in the Gulf of Mexico issued in 1998 and 1999 without price thresholds. However, towards the end of our review, we were asked by the Assistant Secretary for Land and Minerals Management, Steven Allred, to comment on offshore lease issuance procedures enumerated in a February 2007 memorandum to him from Secretary Kempthorne.

Our recommendations are that the Department continue its efforts to pursue voluntary royalty payment agreements with holders of the leases; that Congress and the Secretary continue to explore legislative options that would address the loss of royalties without violating legitimately signed contracts; and that MMS and the Office of the Solicitor develop procedures and guidelines to ensure effective implementation of the 8 enumerated items in the memorandum within 60 days of release of the Subcommittee's report.

Thank you for the opportunity to provide this testimony. We look forward to working with you to improve this important program.