U.S. Department of the Interior
Minerals Management Service

Annual Financial Report
Fiscal Year 2004

MMS

*Securing Ocean Energy &
Economic Value for America*

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Message from the Director

It is my pleasure to submit to you the Fiscal Year 2004 Management Discussion and Analysis and Annual Financial Report of the Minerals Management Service (MMS). The financial and performance data it presents are fundamentally complete and reliable as outlined in Office of Management and Budget guidance. This report also presents the status of the Bureau's compliance with certain legal and regulatory requirements. The annual assurance statement required by the Federal Managers' Financial Integrity Act (FMFIA) concludes that MMS can provide reasonable assurance that its systems of management, accounting, and administrative controls, taken as a whole, meet the objectives specified in Section 2 of the FMFIA. These objectives are intended to ensure that: (1) programs achieve their intended results; (2) resources are used consistent with agency mission; (3) programs and resources are protected from waste, fraud, and mismanagement; (4) laws and regulations are followed; and (5) reliable and timely information is obtained, maintained, reported and used for decision making.

For over 20 years, MMS has been a leader in asset management for the Federal Government. Our mission includes managing the mineral resources on the Outer Continental Shelf (OCS), as well as Federal and Indian mineral revenues, to enhance both public and trust benefits, promote responsible use, and realize fair value. In pursuing this mission, MMS also supports the broader goals of the Department of the Interior, particularly:

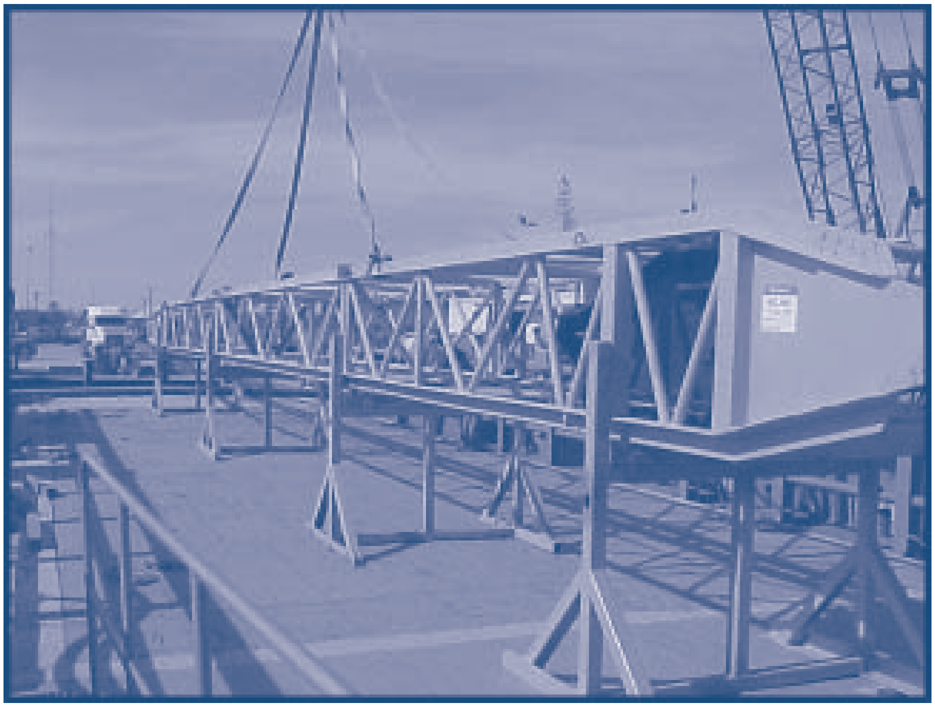
- The Department's Resource Use goal for managing resources to enhance public benefit, promote responsible use, and ensure optimal value in energy and non-energy areas.
- The Department's Serving Communities goal for fulfilling Indian trust responsibilities.

MMS contributes to America's energy supply by managing the mineral resources on 1.76 billion acres of the OCS. The approximately 40 million leased OCS acres account for 23 percent of America's domestic natural gas production and 30 percent of America's domestic oil production. MMS revenue collected from Federal and Indian gas and oil production is distributed to recipients such as the U.S. Treasury, states, American Indians and special purpose trust funds such as the Land and Water Conservation Fund

America currently relies on foreign sources for more than half our oil supply. Over the next two decades, our demand for oil is expected to grow by 35 percent and our demand for natural gas is expected to grow by more than 50 percent. Beyond our current energy production and supplies, MMS administers several initiatives designed to increase the domestic production of oil and natural gas, such as the Shallow Water Deep Gas Incentive Program, which provides royalty suspensions to encourage deeper exploration and development using existing shallow water infrastructure.

MMS is committed to serving our country in the best, most efficient manner possible. From ensuring value for America's mineral resources to protecting the environment and disbursing revenues, MMS manages a number of responsibilities with efficiency, care and precision. As a small bureau with a vast impact, we never stop looking for the most efficient means to ensure that the Nation receives the best value for its precious resources now and in the future.

R. M. "Johnnie" Burton
Minerals Management Service Director



Management's Discussion and Analysis

MISSION AND ORGANIZATION

The Minerals Management Service (MMS), a Federal bureau within the U.S. Department of the Interior (DOI), manages the Nation's natural gas, oil, and other mineral resources on the **Outer Continental Shelf** (OCS). The bureau also collects, accounts for, and disburses more than $6 billion per year in revenues from Federal offshore mineral leases and from onshore mineral leases on Federal and Indian lands. MMS's activities provide major economic and energy benefits to taxpayers, states, and the American Indian community.

MMS Mission Statement

Manage the mineral resources on the Outer Continental Shelf and Federal and Indian mineral revenues to enhance public and trust benefit, promote responsible use, and realize fair value.

MMS consists of two primary operating programs: *Offshore Minerals Management* (OMM) and *Minerals Revenue Management* (MRM), with support from the Directorate of Policy and Management Improvement, the Directorate of Administration and Budget, and the Offices of Public and Congressional Affairs. Additionally, MMS operates the Department's Interior Franchise Fund (IFF). The IFF provides acquisition and video services to customers throughout the federal government.

Mandate: The Outer Continental Shelf Lands Act of 1953 called for the Federal Government to manage the oil, gas, and other mineral resources of the OCS to ensure national security, reduce dependence on foreign sources, protect the Nation's environmental health and conserve the precious resources of the OCS. The MMS was created by Secretarial Order 3071 in January 1982 based on a recommendation, by the Independent Commission on Fiscal Accountability, that stated proper fiscal accountability and management of the public's mineral resources would best be served by a bureau devoted to minerals management. The Federal Oil and Gas Royalty Management Act of 1982 (as amended) mandates the manner in which royalties are collected on leasable minerals.

Securing Ocean Energy and Economic Value for America

Every American benefits from the work of MMS. From the gasoline that powers our cars and the natural gas that heats our homes to the benefits obtained through the disbursement of collected mineral revenues, the Nation and its citizens benefit from the efforts of MMS. A bureau of about 1,700 people across the United States, the MMS has distributed more than $135 billion dollars since its establishment in 1982.

"The MMS is helping secure America's energy future and quality of life, while protecting the environment and providing fair equity for the use of Federal lands."

- R. M. "Johnnie" Burton
MMS Director

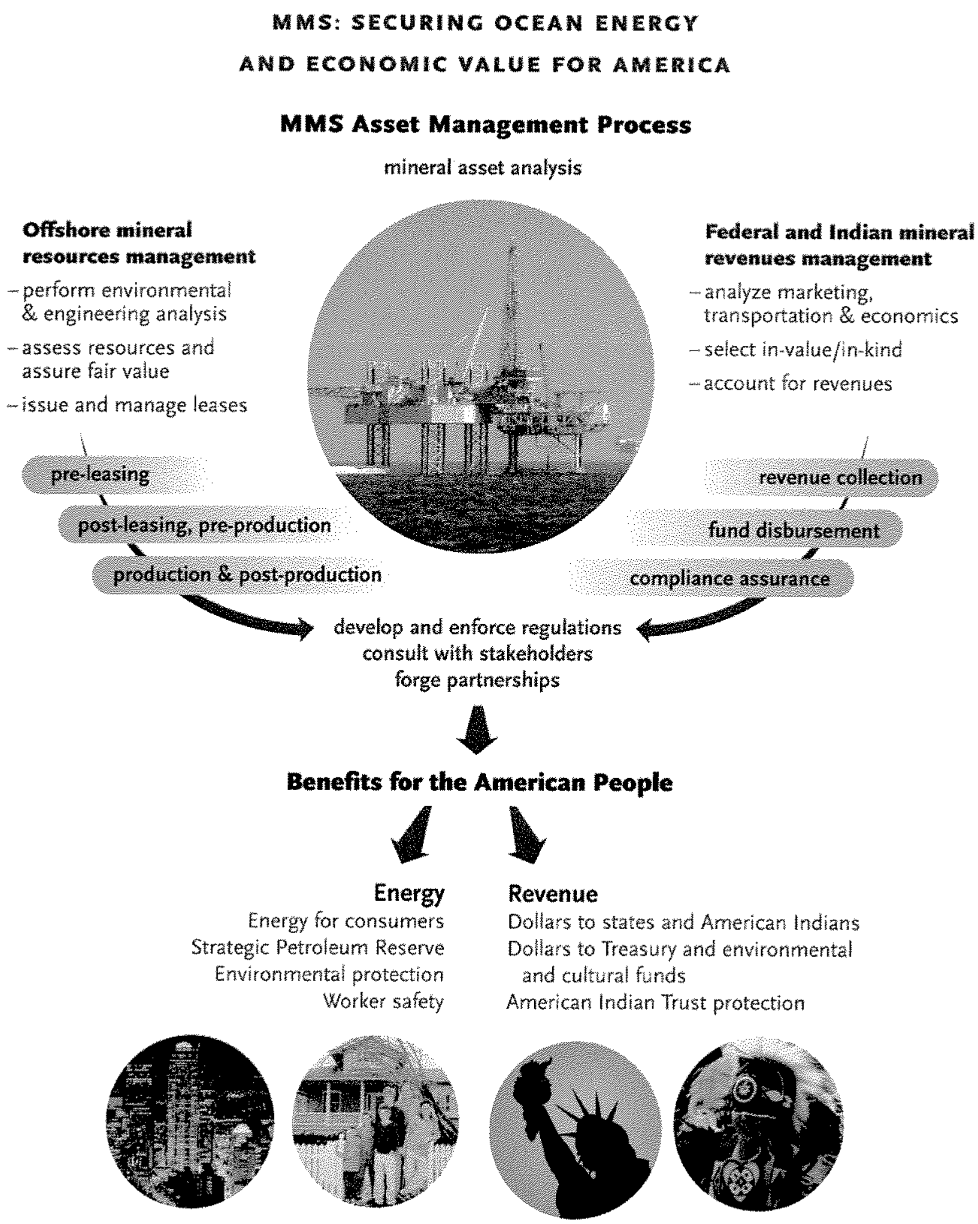
MMS Asset Management Process

> *"Reliable and affordable energy is critical to our economic security."*
>
> *-President George W. Bush*

MMS is one of America's leading mineral asset managers. Through the MMS Asset Management Process, MMS ensures optimal value for America's mineral resources, benefiting the American people, including states, tribes, and individual Indian allotees.

Within the MMS, the *Offshore Minerals Management* program (OMM) manages activities that range from the initial geological and geophysical analysis of OCS resource potential and the leasing process to monitoring the safety of offshore facilities and protecting our coastal and marine environments. In addition to oil and gas resources, the MMS provides access to state and local governments for the recovery of sand and gravel used to protect the Nation's coastal shores and wetlands. The OMM program is headquartered in Washington, D.C., and Herndon, Virginia, with regional offices in three locations: New Orleans, Louisiana; Camarillo, California; and Anchorage, Alaska.

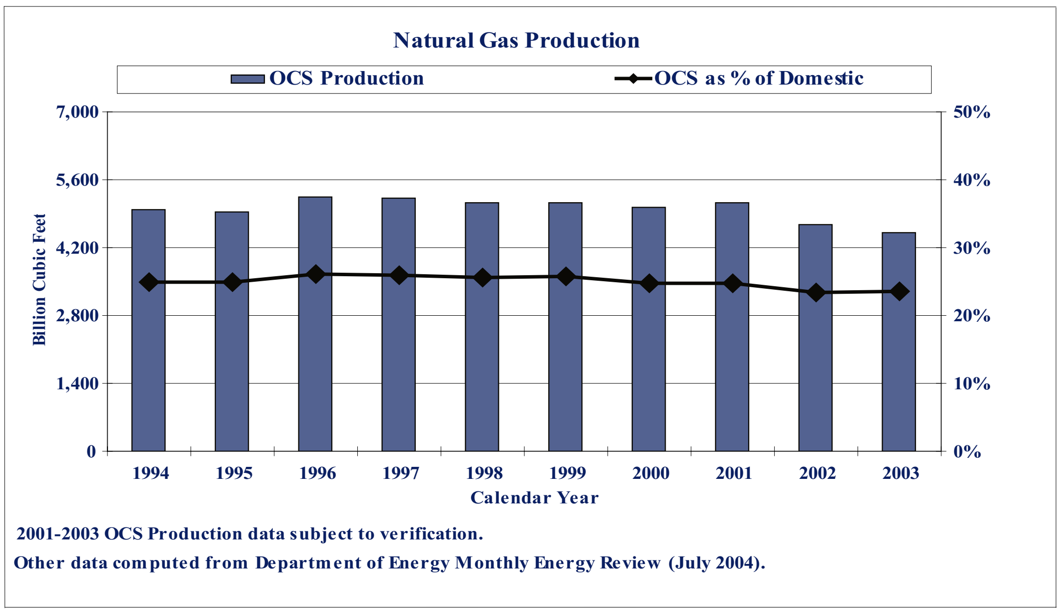
The *Minerals Revenue Management* program (MRM) collects, accounts for, and disburses revenues associated with mineral production from leased Federal and Indian lands. Revenues collected by MMS are one of the largest sources of non-tax revenue to the Federal Government. The MRM program is headquartered in Washington, DC, with major operations in Lakewood, Colorado and field offices located in Houston and Dallas, Texas; Tulsa and Oklahoma City, Oklahoma; and Farmington, New Mexico. MMS is committed to serving our country in the best, most efficient manner possible throughout all of our business activities.

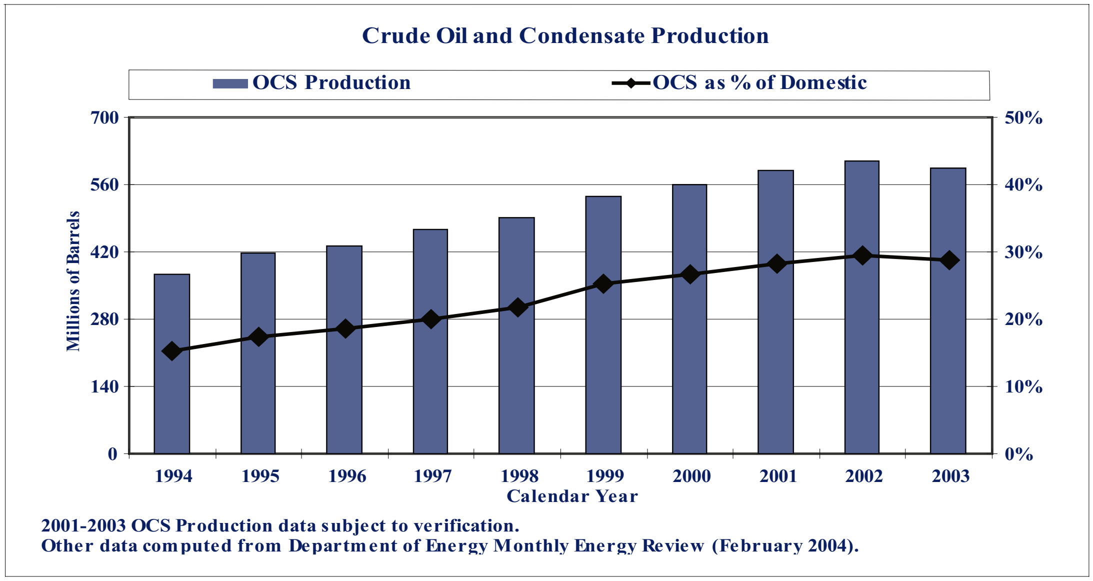

MMS: SECURING OCEAN ENERGY
AND ECONOMIC VALUE FOR AMERICA
MMS Asset Management Process
mineral asset analysis
Offshore mineral resources management
– perform environmental & engineering analysis
– assess resources and assure fair value
– issue and manage leases
Federal and Indian mineral revenues management
– analyze marketing, transportation & economics
– select in-value/in-kind
– account for revenues
pre-leasing
post-leasing, pre-production
production & post-production
revenue collection
fund disbursement
compliance assurance
develop and enforce regulations
consult with stakeholders
forge partnerships
Benefits for the American People
Energy
Energy for consumers
Strategic Petroleum Reserve
Environmental protection
Worker safety
Revenue
Dollars to states and American Indians
Dollars to Treasury and environmental and cultural funds
American Indian Trust protection

Helping Meet the Energy Needs of the Nation

One of the cornerstones of President Bush's National Energy Policy is the role MMS plays in securing ocean energy for the Nation. MMS oversees production of 23 percent of the natural gas and 30 percent of oil produced domestically. To date, the area known as the Outer Continental Shelf (OCS) has contributed about 14 billion barrels of oil and 150 trillion cubic feet of natural gas for U.S. consumption.

The offshore areas that MMS has designated for leasing under our current 5-year plan could yield as much as 22 billion barrels of oil and 61 trillion cubic feet of natural gas as additional energy for America. Looking forward, the OCS is estimated to contain more than 60 percent of the Nation's remaining undiscovered oil and as much as half of the Nation's undiscovered recoverable natural gas. MMS plays a vital role in providing safe and environmentally sound access to these domestic energy resources.

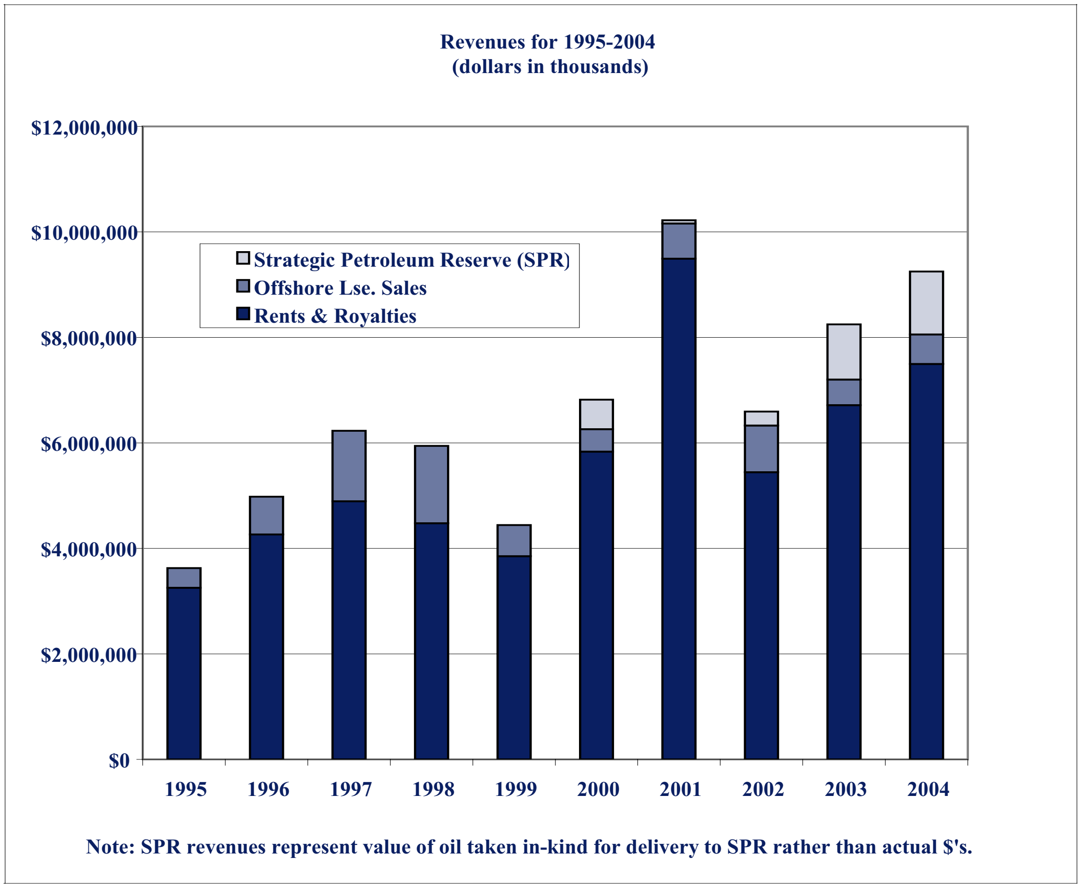




Providing Economic Value

Every American benefits from mineral resource development on Federal lands, whether it is from the energy produced from the lands, the revenues generated from the associated natural resources, or the various funds that benefit from those revenues. In FY 2004, MMS disbursed more than $9 billion in mineral revenues to states, Office of the Special Trustee for American Indians, other Federal agencies, and U.S. Treasury accounts. MMS is a leader in securing economic value for America by managing the natural resources and associated revenues generated on the Federal lands.

Mineral revenues over the last 10 years are shown in the chart below. In FY 2004, MMS collected $8 billion in mineral revenues. In addition, MMS delivered approximately 38 million barrels of in-kind oil to the Department of Energy (DOE) for the Strategic Petroleum Reserve (SPR), valued at $1.2 billion.



Interior Franchise Fund (IFF)

Established pursuant to the Government Management Reform Act (GMRA) of 1994, the IFF pilot program's objective is to reduce the cost of government by providing common administrative products and services to other Federal agencies on a competitive, fee-for-service basis. The IFF consists of two activities: GovWorks and US Film and Video Production.

GovWorks is a preferred provider of Acquisition and Federal Assistance services for Federal agencies. Full-service acquisition and Federal assistance support includes project planning (acquisition strategy), soliciting and evaluating offers, awarding and administering contracts, and monitoring agreements through closeout. Clients receive assistance with project management activities from the preparation of the statement of work through contract sourcing and expenditure tracking. Since its inception GovWorks has grown to a division of approximately 150 employees, with over $1.2 billion in annual revenue.

US Film and Video Production is a full service studio that produces film, video, new media and multi-media programs for other Government agencies. Through Partnering agreements with other external production facilities US Film and Video Production offers access to cutting edge techniques and developments found in the commercial world, while easing the procurement process.

PERFORMANCE GOALS AND RESULTS

The Government Performance and Results Act (GPRA) requires that Federal agencies formulate Strategic Plans, identify major strategic goals, and report performance and costs related to those goals. GPRA requires Federal agencies to revise and update strategic plans every three years. The Department of the Interior updated the Department-wide Strategic Plan in Fiscal Year 2004 and replaced the MMS mission goals applicable in Fiscal Years 2001 through 2003 with three new mission goals for Fiscal Year 2004 and thereafter. As a result of the revisions MMS has included trend data for the new 2004 performance goals only where reliable data are available.

During FY 2004, MMS conducted a data verification review on GPRA measures. The bureau's internal review found internal processes and documentation exist for all measures. The GPRA measure results are determined to be relevant and reliable. The following is a discussion of MMS's long-term goals, measures, and performance.

OCS Leasing Activities

DOI End Outcome Goal	Measure	FY 2000 Actual	FY 2001 Actual	FY 2002 Actual	FY 2003 Actual	FY 2004 Plan	FY 2004 Actual
Resource Use: Manage or influence resource use to enhance public benefit, promote responsible use and ensure optimal value – *energy*.	Number of lease sales held consistent with the Secretary's Five Year Program.	2	3	3	3	4	4

To facilitate mineral production on the OCS, the Department of the Interior prepares a five-year schedule of proposed oil and gas lease sales. The schedule includes lease sales in the available areas of the OCS (i.e. those areas not under congressional moratorium or executive withdrawal) that have the highest resource value and expected interest to industry while recognizing environmental values, economic conditions, and competing uses. There are 20 lease sales planned for the current five-year program (2002–2007) including three "special sales" in frontier areas offshore Alaska.

The MMS has developed a suite of economic incentives designed to stimulate industry interest in bidding for OCS leases. OCS production will help to ensure the Nation's economic security by providing a reliable domestic supply of energy resources. With Deep Water and Shallow Water/ Deep Gas royalty relief incentives in place for certain zones of the Gulf of Mexico, the Central and Western planning areas are seeing the highest level of bidding activity in six years.

During FY 2004, MMS conducted the following sales:

Eastern Gulf of Mexico Sale 189: The offshore oil and natural gas lease sale for a small area in the Eastern Gulf of Mexico attracted $8,376,765 in high bids on 14 tracts.

Central Gulf of Mexico Sale 190: This sale was characterized by strong competition and robust bidding. In all, 83 companies submitted 829 bids – 60 percent of these bids were on the shelf, reflecting industry interest in deep gas in shallow waters, at least partly in response to royalty relief offered by the MMS. MMS accepted high bids on 542 tracts for a net amount of $364,024,583. Of the 557 tracts receiving bids, MMS rejected 14 high bids totaling $4,537,449 as insufficient for fair market value. In addition, one high bid at $201,450 was deemed unacceptable by MMS because it was below the required minimum bid amount stated in the Final Notice of Sale.

Cook Inlet Sale 191: Consistent with the 5 year plan, MMS published a Federal Register notice offering tracts for lease; however, no bids were received. All MMS actions necessary to provide the opportunity for access were completed.

Western Gulf of Mexico Sale 192: The number of bids received for tracts in the "Deep Gas" royalty relief zone of the Western Gulf planning area increased by more than 20 percent over last year's sale. Interest in deepwater tracts was also high. In all, MMS received 421 bids on 351 tracts, with high bids totaling $171,387,285 off the coasts of Texas and western Louisiana. Bid analysis is ongoing to ensure receipt of fair market value for each of these tracts. After bid analysis is complete, leases will be awarded.

Ensuring Safe and Clean Operations

DOI End Outcome Goal	Measure	FY 2000 Actual	FY 2001 Actual	FY 2002 Actual	FY 2003 Actual	FY 2004 Plan	FY 2004 Actual
Serving Communities: Protect lives, resources and property.	Reduce from 5-year average (1999-2003) of 7 fatalities.	4	6	7	11	< 7 fatalities	3
Serving Communities: Protect lives, resources and property.	Reduce from 5-year average (1999-2003) of 25 serious injuries.	26	26	21	23	< 25 serious injuries	29
Resource Use: Manage or influence resource use to enhance public benefit, promote responsible use and ensure optimal value - *energy*.	Achieve an oil spill rate for offshore development of no more than .00001 barrel spilled per barrel produced.	.0000535	.000001	.00000058	.000004	.00001	NO DATA*
* MMS is unable to provide FY 2004 Oil Spill data for this measure, because of ongoing investigations into damage from Hurricane Ivan.							

Over the last 50 years, the safety and environmental record of the offshore industry has dramatically improved. The Nation has much to gain from excellent offshore safety and environmental performance because the production and consumption of energy are fundamental components of economic development, national security, and societal well-being. MMS's ongoing commitment to safe and clean operations is a prerequisite for all activity on the OCS.

In addition to making the mineral resources of the OCS available to the Nation, MMS is responsible for the protection of the environment as well as oil and gas workers offshore. MMS has a comprehensive program to ensure that mineral operations on the OCS are conducted in a safe and environmentally sound manner. MMS's approach includes: research programs to enhance understanding of technologies appropriate for the OCS environment, extensive environmental assessment and consultation, a regulatory program that includes review of operator plans and permits and inspection of OCS facilities and operations, and accident investigations and civil penalties. Ensuring safety is a top priority of the MMS. MMS has strict requirements for the proper use and testing of equipment in drilling and production operations. Workers must also receive the proper training.

The Offshore Minerals Management program conducts thousands of inspections each year to ensure the safety of the oil and gas workforce and the protection of marine coastal and human environments. Prevention is our most important safety strategy. Annual inspections examine safety equipment designed to prevent blowouts, fires, spills, and other major accidents. MMS inspectors have authority to shutdown an operation immediately if it is being conducted improperly or without proper equipment.

MMS closely monitors and analyzes incident-related data to understand the cause and occurrence of offshore accidents and spills. MMS uses this information to identify actions that can be taken to prevent reoccurrence of these incidents. Data for FY 2004 show 3 fatalities and 29 serious injuries reported by OCS operators. By comparison, the annual average over the previous 5-year period (the performance baseline) was 7 fatalities and 25 serious injuries.

The most significant factor in the reduction of fatalities from FY 2003 to FY 2004 has been the decrease in fatal helicopter incidents where the helicopter was either on approach to or taking off from an OCS facility, or impacted an OCS facility. There were none of these incidents in FY 2004 compared to 5 fatalities in such incidents during FY 2003. This is still an important area of concern for MMS because serious helicopter incidents have continued to occur while the helicopters are in-flight. These incidents are not counted in the performance measure because MMS has no direct or indirect regulatory function associated when helicopters are in-flight. Nevertheless, we continue to work with industry and other regulators on this important safety issue.

Data for FY 2004 shows 29 serious injuries reported by OCS operators. By comparison, the annual average over the previous 5-year period (the performance baseline) was 25. Many of the serious injuries involved material-handling equipment, pipe-handling equipment, and lifting operations associated with cranes. MMS has recently worked with the American Petroleum Institute to modify existing industry standards to include additional requirements for crane equipment and training. MMS has adopted these standards and has included the requirements of these new standards in our inspection program.

In addition, MMS is addressing these and other areas of safety concern by considering regulatory options for requiring operators to incorporate new procedures in their safety and environmental management practices. These procedures relate to five important areas — hazards analysis, operating procedures, management of change, safety analysis, and mechanical integrity. Incident investigations and data have shown these areas to be important areas to focus on for improved safety. These areas were the subject of a recent MMS/industry workshop, and MMS is preparing Advanced Notices of Proposed Rulemaking to request comments on the best way to address these and other important areas to enhance the safety of OCS operations.

Financial Management and Fulfilling Indian Trust Responsibilities

DOI End Outcome Goal	Measure	FY 2000 Actual	FY 2001 Actual	FY 2002 Actual	FY 2003 Actual	FY 2004 Plan	FY 2004 Actual
Resource Use: Manage or influence resource use to enhance public benefit, promote responsible use and ensure optimal value - *energy*.	Percent of revenues disbursed on a timely basis per regulation.	98.5%	98.4%	80%	92.6%	94%	95.5%
Serving Communities: Fulfill Indian fiduciary trust responsibilities: Improve Indian Trust ownership and other information.	Disburse X% of revenue to OTFM within 24 hours of receipt.	N/A New Measure	N/A New Measure	N/A New Measure	99.3%	99%	100%
Serving Communities: Fulfill Indian fiduciary trust responsibilities: Improve Indian Trust ownership and other information.	Provide lease data to BIA for X% of royalties by first semi-monthly disbursement.	N/A New Measure	N/A New Measure	N/A New Measure	N/A New Measure	60%	84%

MMS collects and processes reports and payments from bonuses, rents and royalties from about 3,700 reporters for about 26,000 producing leases each month. MMS distributes and disburses these revenues directly to states, the Office of Special Trustee for American Indians (OST), other Federal agencies and U.S. Treasury accounts. The distribution and disbursement function ensures that revenues are properly disbursed to the appropriate recipients. MMS achieved 95.5 percent timely disbursements, easily meeting its FY 2004 goal of 94 percent.

MMS contributes to DOI's ability to provide accurate and timely information and revenues to Trust beneficiaries. As an example, MMS transfers American Indian mineral revenues to the Office of Trust Funds Management (OTFM), a division within the OST, on a daily basis. OST in turn, deposits funds into interest-bearing accounts. MMS has established a measure to document the percentage of all Indian revenue received on a daily basis transferred to OST within 24 hours of identification, and in FY 2004, MMS achieved timely transfer of 100 percent of funds belonging to American Indians.

The Bureau of Indian Affairs (BIA) requires Financial Distribution Report (FDR) information in order to distribute funds to individual Indian mineral owners. MMS provides this lease distribution data to BIA twice each month. MMS is improving the timeliness of sending lease distribution data to BIA thus enhancing BIA's ability to provide revenues more quickly to the ultimate Trust beneficiaries. MMS exceeded its FY 2004 goal of 60 percent, disbursing 84 percent of American Indian royalty dollars by the first semi-monthly disbursement.

Mineral Revenue Compliance Activities

DOI End Outcome Goal	Measure	FY 2000 Actual	FY 2001 Actual	FY 2002 Actual	FY 2003 Actual	FY 2004 Plan	FY 2004 Actual
Resource Use: Manage or influence resource use to enhance public benefit, promote responsible use and ensure optimal value - *energy*	Royalties received for mineral leases are X% of predicted revenues, based on market indicators in the production year.	N/A New Measure	N/A New Measure	N/A New Measure	N/A New Measure	98% of predicted revenues (46% of 2001 royalty universe)	96.1%
Resource Use: Manage or influence resource use to enhance public benefit, promote responsible use and ensure optimal value - *energy*	Compliance work is completed within the 3-year compliance cycle for X% of royalties for production year X.	N/A New Measure	N/A New Measure	10.5% of 1999 royalties	46% of 2000 royalties	69% of 2001 royalties	69.4%

MMS mineral revenue compliance activities represent a large and critical part of MMS's operational strategy to ensure timely and correct payment for minerals produced on Federal and Indian leased lands. The MMS predicts expected revenues, analyzes variances, performs targeted and random audits, resolves valuation discrepancies, and negotiates settlements to ensure that optimal value is received by the American taxpayer and Indian recipients.

One of our compliance measures is a ratio comparing actual payments to predicted revenues. Predicted revenues include market indexes or other value indicators, such as spot prices, related to specific properties and product types. This measure provides us with an indication of how well the industry is initially complying with our regulations and reporting guidelines before we perform any compliance work.

Utilizing the results from this measure, MMS coordinates with select companies to resolve issues and improve timeliness and accuracy of future reporting. In FY 2004, we measured CY 2001 royalty payments and determined that company payments were 96.1 percent of predicted revenues (for properties representing about 75 percent of all CY 2001 royalties).

MMS performs analysis on variances between actual and predicted payments through our end-to-end 3-year compliance process. During the MRM reengineering effort, MMS established a goal to reduce the 6-year compliance cycle by half. MMS has demonstrated the feasibility of completing the compliance function in 3 years or less. MMS is continuing to expand compliance coverage within the shortened compliance cycle to ensure that the Government is realizing fair market value, and that companies are in compliance with applicable laws, regulations and lease terms. In FY 2004, MMS completed compliance work for 69 percent of the entire 2001 royalty universe.

Interior Franchise Fund

Goal*: Maintain a cost of contract dollars awarded that is less than the government-wide benchmark of 2 cents per dollar awarded.	**FY 2001 Actual**	**FY 2002 Actual**	**FY 2003 Actual**	**FY 2004 Plan**	**FY 2004 Actual**
	$0.02	$0.02	$0.01	$0.02	$0.02
*This measure is not a GPRA measure.					

In FY 2003 awarded contract dollars increased 157 percent to $1.385 billion from the FY 2002 base of $539 million. Since there was not a corresponding growth in costs, the cost per dollar awarded dropped to $0.01. For FY 2004, workforce was added to restore workload balance.

SIGNIFICANT ACCOMPLISHMENTS

Deepwater: America's Expanding Frontier

> *"The deepwater area of the Gulf of Mexico continues to rapidly unfold as the major domestic energy source for the United States."*
>
> - Chris Oynes
> MMS Regional Director

To meet the Nation's energy needs, America's oil and gas industry now produces energy resources in water depths greater than 7,000 feet and is exploring in record depths. In 2004, 12 new discoveries in deepwater have been announced and 18 projects are expected to come online—a trend MMS expects to continue. In November 2003, ChevronTexaco, using Transocean's *Discoverer Deep Seas* drillship, set a new world water-depth record for drilling in 10,011 feet of water in the Gulf of Mexico. Also in FY 2004, the Na Kika project came on line. The Na Kika facility sits atop six independent fields approximately 140 miles southeast of New Orleans in 5,800 to 7,600 feet of water. It hit the deepest water depth ever for a development well and installed the first pipe-in-pipe risers in the world. The world's first cell spar in a deepwater oil and gas project was installed in FY 2004, Kerr-McGee's "Red Hawk" project.

The growing deepwater investment indicates that the Gulf of Mexico will continue to be an integral part of this Nation's energy supply and remain one of the world's premier oil and gas basins.

Royalty in Kind

As part of mineral lease terms, the Government has the option to receive royalties in kind (RIK) or in-value. In 2004, MMS released a 5-Year RIK Business Plan for FY 2005-2009, including actions to further evolve RIK business activity in the areas of strategic principles and objectives, enhanced human resources and skill sets, focused organizational structure, establishment and routine use of performance metrics, and diversified marketing strategies. Implementing this plan will ensure MMS's ability to track, analyze, control, and manage the significant portfolio of oil and gas royalties taken in kind. It will also continue to enhance MMS's ability to assure the taxpayer of proper collection of royalty receipts and effective management of the RIK program. RIK is a viable asset management option where its application is at least revenue neutral or better than the Government would receive in-value. It promotes efficiency and cost effectiveness for both the Government and industry.

Strategic Petroleum Reserve

With almost 60 percent of the Nation's supply of oil coming from foreign sources, the Strategic Petroleum Reserve (SPR) provides a critical buffer for potential disruptions in oil supplies. In November 2001, President Bush directed the filling of the SPR to capacity using RIK crude oil. Through a Memorandum of Understanding, MMS partners with the Department of Energy (DOE) to deliver oil to the SPR. MMS has taken about 87 million of the 120 million Gulf of Mexico RIK wellhead barrels required to fill the SPR. When full in 2005, the SPR will contain approximately 700 million barrels of oil, providing a key link in the Nation's security network.

Overseeing Industry to Promote Responsible Development and Ensure Optimal Value

During FY 2004, MMS published three significant rules affecting the oil and gas industry, the Deep Gas Rule and two Valuation Rules.

> *"We believe significant gas resources exist, more than three miles deep, below existing shallow-water platforms in the Gulf of Mexico. This is a technological frontier, but can be accessed from existing infrastructure."*
>
> *-R. M. "Johnnie" Burton*
> *MMS Director*

Deep Gas Rule: For OCS lease sale offerings since March 2001, MMS has provided royalty relief incentives to increase natural gas production from deep zones beneath shallow waters of the Gulf of Mexico OCS. The Deep Gas Rule, published in 2004, provides similar royalty relief to shallow water leases issued prior to 2001 on production of natural gas from wells completed below 15,000 feet subsea. While the shallow waters of the Gulf have been actively explored, relatively few wells penetrated depths below 15,000 feet due to the high cost and risk associated with such wells. Since infrastructure—platforms and pipelines—is already in place in the shallow water Gulf, MMS anticipates that production could come online quickly from active leases. This rule makes lessees eligible for royalty relief on their existing leases if they are willing to drill for new and deeper prospects. The rule also provides royalty relief credits for "dry holes" drilled to depths below 18,000 feet subsea prior to any deep gas production being generated on the lease.

Valuation Rules: Amendments to the Federal Oil Valuation Rule, published in 2004, will reduce litigation, assure more timely compliance, reduce administrative costs to both lessors and lessees, and make Federal leases more attractive for development and leasing. The final rule, effective August 1, 2004, addresses primarily which published market prices are most appropriate to value crude oil not sold at arms-length and what transportation deductions should be allowed. In addition, MMS published a new proposed Federal Gas Valuation rule on July 23, 2004. The proposed changes would offer greater certainty, clarity, and consistency on natural gas valuation issues for oil and gas producers. The result would be more accurate royalty reporting, which ultimately helps MMS continue to assure economic value for America on these important resources.

Enhancing American Indian Services

Partnering with the Bureau of Indian Affairs (BIA) and the Bureau of Land Management (BLM), MMS has been instrumental in building a positive business environment for the Navajo allotments in the Farmington, New Mexico, area. Leading up to a June 2004 oil and gas sale, the Federal Indian Minerals Office (FIMO), composed of technical experts in oil and gas related disciplines from the BIA, BLM, and MMS, made key changes to lease terms and lease-approval requirements, making Indian leases more attractive to the energy industry. The result was a successful lease sale in June 2004, generating bids of more than $1.4 million, from which about 2,500 Navajo individual Indian mineral owners will receive benefits.

In 2004, MMS provided opportunities to tribes, under the Intergovernmental Personnel Act (IPA) Fellowship Program, to learn more about MMS business processes. Members of three tribes – Chippewa Cree, Hopi, and Navajo – are currently participating with MMS in IPAs to develop their auditing skills and enhance their knowledge of minerals and royalty management. This puts the Chippewa Cree and Hopi tribes on their way to performing their own audits. In addition, it enhances in-depth audit expertise for the Navajo Tribe, already under a cooperative agreement with MMS to perform their own audits. To date, MMS has entered into 10 IPAs and 8 cooperative agreements with tribes.

Improving Efficiency through Electronic Government

Working to find better ways to ensure efficiency, the Minerals Management Service has piloted a new electronic reporting system for lessees and operators to submit offshore well data for improved efficiency. The new permitting and reporting communication system, called "eWell," will streamline processes, reduce data redundancy, and improve the quality, timeliness, completeness, and compliance of the information exchange between MMS and industry.

> *"In addition to dramatically decreasing the number of steps involved in filing permits, the ability to electronically submit them eliminates the reliance on both internal and external mail, creating additional financial savings."*
>
> *- R. M. "Johnnie" Burton*
> *MMS Director*

MMS restructured six well permit and report forms and made them accessible electronically. The new system replaces paper versions of permits to drill, permits to modify wells, well activity reports, end of operations reports, and rig move notifications. Internet-based forms with automated help screens will aid the operator in completing the forms accurately. MMS has ensured security of company proprietary data, and industry has been a willing partner to help improve the design of the system. Operators volunteered to test the system over many months, and through their input, many facets of the application were modified to enhance the ease of operation. MMS analyses show the eWell permitting and reporting system could reduce processing time for the 20,000 applications each year by as much as 50 percent.

To improve citizen access to OCS-related information, the MMS also developed and initially deployed *Public Connect*. This is a public commenting system that provides secure online access to the regulatory programs of the Offshore Minerals Management program. The new system enables the public to find, view, and submit comments on MMS's proposed regulations, lease sale notices, environmental reports, and other related documents. The *Public Connect* system automatically associates and stores submitted comments with the appropriate projects and documents, streamlining MMS ability to track and manage public input.

MMS also completed Certification and Accreditation for all MMS systems, as required for full compliance with the Federal Information Security Management Act. This moves MMS from "red" to "green" on the Government scorecard for IT security.

Presidents Management Agenda Scorecard

During FY 2004 MMS improved performance in areas targeted by the President's Management Agenda (PMA). This progress is evident when comparing the bureau's self-assessment scorecards, for the 5 PMA areas for which it is responsible, for the periods of October 2003 and May 2004. MMS is responsible for monitoring performance within the areas of: Human Capital, Competitive Sourcing, Financial Management, E-Government, and Budget and Performance Integration. The following paragraph briefly describes MMS's performance status within each area.

MMS's performance achievements throughout the fiscal year resulted in a "green" rating, a score of 7-9 on a scale of 10, within each PMA area. Overall, MMS's performance status increased within 4 of the 5 areas. Performance status increased in the areas of human capital, financial management, and budget and performance integration (moving from a yellow rating in October 2003 to one of green in May 2004). MMS's maintained the same level of performance status in the E-Government arena (a green rating) throughout FY 2004. Although, the Competitive Sourcing performance status slightly decreased at the end of FY 2004, MMS maintained a green rating. MMS's scorecard ratings are depicted in the below table.

MMS FY 2004 PMA Scorecards

	October 2003	May 2004
Human Capital	7.5	7.6
Competitive Sourcing	8.0	7.9
Financial Management	7.6	8.6
E-Government	7.0	7.0
Budget and Performance Integration	6.8	8.0

Legend
= Green
= Yellow

Interior Franchise Fund

The rapid growth from FY 2002 to FY 2003 required the IFF to add staff. Management took aggressive action to bring the workload into balance through an aggressive training program, expanding the workforce and limiting the growth in new business. This was successfully accomplished during FY 2004. Consequently, while Contracts Awarded met the annual growth goal, Funds Received did not. FY 2005 goals are set at a 10 percent growth rate over the FY04 baseline.

The IFF goal is to achieve an annual growth rate of 10 percent in the dollar value of Contracts Awarded and Funds Received.

- The Value of Contracts Awarded measures productive output of the IFF.
- Funds Received is an indicator of the effectiveness of sales and marketing efforts to expand the business base.

IFF Measure	FY 2001	FY 2002	FY 2003	FY 2004	Change from FY 2003 to 2004
Contracts Awarded	$.295B	$.539B	$1.385B	$1.548B	12%
Funds Received	$.372B	$.824B	$1.732B	$1.615B	-7%

LOOKING AHEAD – MANAGEMENT CHALLENGES

Although the oil and gas industry is a globally competitive business, oil production from the federal OCS now accounts for 30 percent of total domestic production – more than double what it was just 12 years ago. With an eye on the future, MMS is actively involved in providing access to energy resources for the American people, from traditional sources such as oil and natural gas, as well as considering alternative sources of energy, such as unlocking the potential of methane hydrates.

Deepwater: America's Expanding Frontier

As industry strives to meet America's energy supply challenge, oil and gas exploration in deep water will very likely continue to experience activity levels at historic highs. Much of the future role of the OCS can be addressed by exploring in deep (1,000 feet and deeper) and ultra-deep (7,500 feet and deeper) waters. MMS has made available various economic incentives to stimulate production of offshore oil and gas in deep water. Industry is responding by developing the technology and practices required to tap these resources. The role played by the MMS in this major energy expansion has been critical — from ensuring the receipt of fair market value for the sale of the leases to the evaluation and approval of new technology. MMS will continue to work with industry and respond to new challenges in drilling, protecting the environment, worker safety and infrastructure to serve deepwater discoveries.

Ensuring the Safety of an Aging Infrastructure

The average age of all current OCS platforms is about 20 years. If not properly maintained, offshore oil and gas facilities and components age at an accelerated rate due to the corrosive salt-water environment. In order to have this infrastructure in safe and useful condition for years to come, it is important to properly protect and maintain wells, platforms, and pipelines through sound engineering standards and rigorous inspection. MMS is working closely with industry to ensure the continued safety of OCS facilities, protecting workers and the environment.

Managing Alternative Energy and Other Uses of the OCS

Increasingly, the Federal Government is advocating the use of renewable sources of energy and the private sector is considering non-traditional projects on the OCS. Managing access to the OCS is becoming more complicated with aquaculture, wind and wave power, hazard areas, artificial reefs, sand borrow sites, shipping, fishing, liquefied natural gas (LNG) ports and fiber optic cables competing for limited space. These projects will present MMS with increasingly resource domain remains accessible, that MMS-granted energy and non-energy rights are protected, and that OCS related activities continue to be conducted in a safe and environmentally sound manner.

> *"Although a number of different variables have to be taken into consideration in crafting a regime for other ocean uses, the scope and comprehensiveness of the OCS oil and gas program can be a model for the management of a wide variety of offshore activities".*
>
> *Pg. 290 USCOP Report*

Methane Hydrate Potential

Preliminary estimates by the United States Geological Survey (USGS) indicate potential natural gas from hydrates may be hundreds of times larger than current estimates of conventional offshore natural gas, and about 99.8 percent of this domestic hydrate potential is in the Federal offshore. The recent successful testing of gas flows from methane hydrates in the Arctic, and plans from the DOE-funded Joint Industry Project (JIP) to drill and core hydrate sites in the OCS, may indicate the feasibility of commercial offshore gas production from the hydrates within 10 to 15 years. The JIP, a 4-year collaborative effort to develop technology and collect data to characterize gas hydrates in the deepwater Gulf of Mexico, will commence drilling the first two wells to test hydrate production and evaluation methodologies in the spring of 2005. MMS will use this and other information to assess methane hydrates as part of the 2007-2012 5-Year Oil and Gas Leasing Program.

> *"The deepwater success story of the last decade has led to an increase of over 75 percent in the amount of crude oil produced from our offshore waters."*
>
> *- R. M. "Johnnie" Burton*
> *MMS Director*

Environmental studies are needed to characterize baseline environmental conditions in advance of commercial exploration and development of hydrate resources. Biological communities and their interactions with the physical and chemical conditions of the environment will be studied to ensure that proper environmental mitigation can be developed. New hydrate recovery technologies must be evaluated for reliability and safety.

MMS is developing a probabilistic, analytical methodology for the estimation of technically recoverable hydrate resources and tract-specific hydrate assessment to determine fair market value (FMV) once production is practical. MMS must be ready with proper policy and planning for future gas production from hydrates in the OCS, once the private sector is ready with the technology for offshore hydrate production.

Maximizing Revenues Through Optimal Use of Royalty in Kind

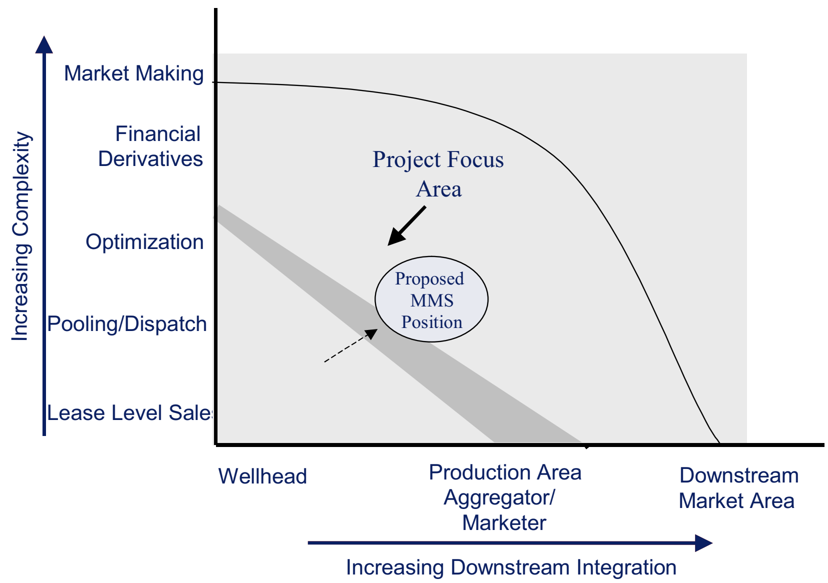
The Five Year Royalty-in-Kind (RIK) Business Plan for FY 2005-2009 is designed to develop and deploy full business capabilities to actively manage the Federal oil and gas royalty asset stream in a manner which optimizes returns for the taxpayer, while, at the same time, reducing administrative costs of this management activity. The Plan's focus for the first two years will be on finalizing implementation of performance measures, developing risk policy guidelines, and enhancing organization and human resource skill sets.

> *"The new MMS Five Year Royalty in Kind Business Plan provides the blueprint to successfully increase revenues and decrease administrative costs associated with managing our oil and gas royalty assets. We are applying proven private sector business practices to improve government efficiencies and effectiveness".*

Recommendations to be implemented in the latter three years of the Plan involve diversifying the conservative business model through enhanced marketing strategies, selected based on acceptable risk-return criteria. MMS has concluded that diversified marketing and sales strategies would likely result in net positive returns to the Federal Treasury.

MMS has targeted a cumulative net revenue enhancement of $50 million over 5 years, based on oil and gas volume projections for the 5-year period and also on historic RIK margins.

MMS will move its RIK business model to the more active position required to increase net revenues. For optimal portfolio performance, MMS will gain expertise to evaluate various marketing alternatives and continuously monitor historical and forward-looking market intelligence pertaining to the alternatives.



Integrating MMS Systems and Processes with DOI's Indian "To Be" Model

The MMS is participating with various Departmental agencies including the Office of the Special Trustee and the Bureau of Indian Affairs on the "To Be" Trust Business Model. This process is a continuation of our involvement on the predecessor "As Is" model team. The purpose of these teams is to fundamentally rethink how trust business is conducted and how trust services are provided to beneficiaries. The team's goals include standardizing fiduciary trust business processes and modernizing systems while maintaining a beneficiary focus and using accountability and performance based approach.

Interior Franchise Fund

While the IFF continues to refine its management activities and business process to meet the needs of continued growth and ever increasing customer expectations, the lack of permanent operating authority for the IFF complicates operations and planning. Uncertainty over the organization's long range existence undercut efforts to build long-term, stable customer relationships and hinders efforts to sustain and expand a staff capable of maintaining the IFF's reputation for quality service.

DISCUSSION AND ANALYSIS OF THE FINANCIAL STATEMENTS

MMS prepares annual Financial Statements as a tenant to help fulfill its responsibility to be publicly accountable, and to manage its programs economically, efficiently, and effectively. MMS's principal Financial Statements include the consolidated balance sheets, consolidated statements of net costs, consolidated statements of changes in net position, consolidated statements of financing, combined statements of budgetary resources, and statements of custodial activity.

To provide greater assurance on the integrity of financial operations and the accuracy of financial data MMS undergoes annual Financial Statement audits. MMS's goal is to obtain an unqualified audit opinion on its Financial Statements, eliminate findings related to the internal control environment, and ensure that the Bureau does not have instances of non-compliance with provisions of laws and regulations that have a direct and material impact on the Financial Statements. MMS obtained an unqualified opinion on its Financial Statements in Fiscal Years 2004 and 2003. While MMS has made significant progress in enhancing its overall control environment we have not been able to eliminate all instances of material weaknesses, reportable conditions or non-compliance with applicable laws and regulations.

Limitation of Financial Statements

Responsibility for the integrity and objectivity of the Financial Statements lies with MMS management. The Financial Statements and supplementary schedules included in the report reflect the financial position and results of operations of MMS pursuant to the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. While the statements have been prepared from the books and records of the Bureau in accordance with generally accepted accounting principles for federal entities and the formats prescribed by OMB, the statements differ from financial reports used to monitor and control budgetary resources that are prepared from the same books and records. The Financial Statements should be read with the realization that MMS is a bureau of the Department of Interior, an agency of the executive branch of the United States government, a sovereign entity. Accordingly, unfunded liabilities reported in the statements cannot be liquidated without the enactment of an appropriation and ongoing operations are subject to the enactment of appropriations.

General

Statement of Net Cost and the Strategic Plan

In accordance with OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, MMS has aligned its Statement of Net Cost directly to the goals and outcomes identified in the Department of Interior Strategic Plan. As required by the Government Performance Results Act (GPRA) the Department updated its department wide strategic plan in Fiscal Year 2004. As a result, the Fiscal Year 2004 Consolidated Statement of Net Cost is not comparable to Fiscal Year 2003. Under the updated Strategic Plan the mission goals and categories for MMS are as follows:

1. Resource Use
    a. Resource Use Energy
        i. Manage and Provide Incentives for Access and Development
        ii. Enhance Responsible Use Management Practices
        iii. Effective Lease and Permit Management
        iv. Improve Information Base, Resource Management and Technical Assistance
    b. Resource Use Non-Energy
2. Serving Communities
    a. Indian Trust Fulfillment
3. Reimbursable Activity, and Other
    a. Interior Franchise Fund
    b. Other

Interior Franchise Fund Legislation

The Interior Franchise Fund currently operates under temporary authorizing legislation that expires October 1st of each year. Section 632 of Title VI within the General Provisions of the President's 2005 budget extends the sunset date to October 1, 2005. While the existence of the sunset date creates uncertainties about the MMS's ability to continue as a going concern because of the dependency on the annual renewal of its authorizing legislation, Management has developed a plan to deal with the uncertainty. In a proposal to the FY 2006 appropriations language Management has sought language that would establish franchising as a permanent program. Should the proposal be unsuccessful MMS will continue to operate its reimbursable business lines under the Economy Act, and will restructure its pricing conventions to eliminate retained earnings. Additionally, MMS will continue to operate all of its other appropriated programs.

Operating Challenges

Fiscal Year 2004 presented a number of other important challenges that effected MMS's financial position and results of operations. The most significant of these were continued growth within the Interior Franchise Fund, and increased royalty and related collections and distributions caused by higher oil and gas prices and production volume.

Costs of Operations

As reflected on the Consolidated Statement of Net Cost, the total Fiscal Year 2004 cost of MMS operations was $2,992 million, an increase of approximately $772 million from the Fiscal Year 2003 cost of $2,220 million. The increase is primarily attributable to a $534 million increase in expenses related to royalty disbursements to the states, and a $212 million increase in reimbursable expenses related to increased contract costs within the IFF.

The increase in royalty disbursements to the states is the result of higher oil prices and increased production by producers. IFF activity increased because of an increased number and value of contracts awarded.

Revenues

In general MMS's strategic goals are intended to be funded by general government funds derived from tax receipts and other sources. However, other fees and collections support a number of MMS activities. As authorized by Congress, MMS retained approximately $132 million of royalties, rents, and bonus receipts as revenue from the public. Additionally, MMS collected approximately $1,354 million, an increase over FY 2003 of approximately $208 million from other federal entities for acquisition, personnel, and other technical services related to increased business within the IFF.

Assets

MMS's Consolidated Balance Sheet shows Fiscal Year 2004 assets totaling $4,007 million, an increase of $467 million from Fiscal Year 2003. The increase is primarily the result of an increase in the Administrative Fund Balance With Treasury of approximately $242 million related to an increased amount of advances received from others for activity within the IFF, and an increase in Accounts and Interest Receivable of $201 million related to Custodial Accounts and Interest Receivable, and Administrative Accounts Receivable for rents and royalties that will ultimately be paid to the states

Budgetary Resources

MMS's major sources of budgetary resources consist of direct appropriations and offsetting collections. MMS's Fiscal Year 2004 budgetary resources of $3,791 million consisted of approximately $1,715 million or 45% of offsetting collections, $1,341 million or 35% of appropriations received, and $732 million or 19% of Unobligated Balances brought forward from prior years. Of the total budgetary resources, $3,042 million were obligated in Fiscal Year 2004.

MMS's mission critical operations are funded from three sources: the Royalty and Offshore Minerals Management (ROMM) appropriation, Oil Spill Research, and offsetting collections received primarily from rental receipts from offshore leases. For Fiscal Year 2004, the MMS had total annual appropriated resources of $271.5 million, of which $100.2 million was from offsetting collections.

Although the MMS had a significant increase in Fiscal Year 2004 for both Appropriations Received and Unobligated Balance brought forward, total budgetary resources decreased from FY 2003 by approximately $79 million. The overall decrease is a result of a portion of activity related to the IFF being recorded in both 14X1917 – Royalties and Offshore Minerals Management (ROMM) and in 14X4529 – Interior Franchise Fund in Fiscal Year 2003. In accordance with the President's Budget and the reporting standards, MMS recorded and reported the Interior Franchise Fund activity in both accounts for FY 2003. The Interior Franchise Fund activity between account 14X1917 – Royalties and Offshore Minerals Management and account 14X4529 Interior Franchise Fund was eliminated on the consolidated balance sheet and consolidated statement of net cost, however, this activity is not eliminated on the standards. In the President's Budget for FY 2004, the Interior Franchise Fund activity was only included in account 14X4529 Interior Franchise Fund. As a result, MMS only recorded and reported Interior Franchise Fund activity in account 14X4529 Interior Franchise Fund and the FY 2004 combined statement of budgetary resources. This resulted in a decrease in budgetary resources and status of budgetary resources when comparing the FY 2004 and FY 2003 combined statement of budgetary resources.

Custodial Accounts

The MMS's custodial revenues are from Outer Continental Shelf and onshore oil, gas, and mineral lease sales and royalties. These revenues are presented on MMS's Statement of Custodial Activity, and not its Statement of Net Cost or Statement of Changes in Net Position because they are considered to be revenue of the government as a whole rather than to MMS or the Department. Revenues are collected on behalf of the U.S. Treasury, other Federal agencies, States, Indian Tribes, and Individual Indian Allottees.

In Fiscal Year 2004 MMS had custodial revenues of approximately $9,250 million, an increase of approximately $1,003 million from Fiscal Year 2003. The sharp increase is attributable to a combination of higher oil and gas prices and increased volume by producers. Additionally on-shore lease sales were up significantly related to a coal lease of $274 million in the state of Wyoming.

Liabilities and Net Position

Federal agencies, by law, cannot make payments unless Congress has appropriated funds. MMS's unfunded liabilities excluding the accrued liability to the states, deferred credits for lease bonus money on oil and gas leases that have not yet been finalized, and custodial liabilities for royalties payable is approximately $572 million. The $572 million consists of accrued contingent liabilities as described below, and annual leave and unfunded workers compensation claims under the Federal Employees Compensation Act which are considered an expense and liability in the current year, but which will be paid out of funds made available to the agency in future years.

The Net Position of the bureau consists of Unexpended Appropriations, Cumulative Results of Operations, and Restricted Equity for the Environmental Improvement Restoration Fund (EIRF). MMS's Net Position as of September 30, 2004 is $570 million which consists of $7 million of Unexpended Appropriations, a deficit of $439 million in Cumulative Results of Operations and $1,002 million in Restricted Equity for the EIRF.

The Unexpended Appropriations represent spending authority appropriated by Congress that has not yet been used. Cumulative Results of Operations is the net results of the bureau's operations over time, and is a deficit at September 30, 2004 due to a legal contingent liability that has been accrued for. It is legal counsel's opinion that ultimately any liability associated with this case will be funded by the Department of Justice's Judgment fund at which time MMS will recognize an imputed financing source and the deficit will be eliminated. The Restricted Equity for the EIRF results from a June 29, 2000 U.S. Supreme Court decree settling a long-standing dispute between the state of Alaska and the Federal Government over the State/Federal boundary of areas leased for oil and gas in the Beaufort Sea.

COMPLIANCE WITH LAWS, SYSTEMS, CONTROLS, AND FINANCIAL PERFORMANCE

Compliance With Laws

MMS is required to comply with several key legal and regulatory financial requirements, including the Prompt Payment Act, the Debt Collection Improvement Act, the Improper Payments Information Act, the Inspector General Act Amendments (Audit Follow-Up), the Federal Oil and Gas Royalty Management Act, and the Federal Financial Management Improvement Act (FFMIA).

Based on the results of the FY 2004 independent audit of the financial statements, MMS was determined to be non-compliant with certain legal and regulatory requirements that could have a direct and material impact on the financial statements. In addition to being non-compliant for two components of FFMIA as described below, MMS was also non-compliant with the Debt Collection Improvement Act and the Prompt Payment Act.

Federal Financial Management Improvement Act (FFMIA)

As of September 30, MMS financial management systems complied substantially with the U.S. Standard General Ledger (USSGL) at the Transaction Level.

MMS did not comply substantially with federal financial management systems requirements, or . accounting standards applicable to Federal entities. MMS has implemented steps to address and correct both of these non-compliances in Fiscal Year 2005.

Federal Managers' Financial Integrity Act (FMFIA)

The MMS centrally manages the Federal Managers Financial Integrity Act program, with oversight responsibilities assigned to the bureau CFO and deputy CFO. Each of the four MMS Associate Directors maintains responsibility for effective controls to provide reasonable assurance that Government resources are protected against fraud, waste, abuse, mismanagement, or misappropriation.

Audit Follow-Up

The objective of a 2003 Inspector General's audit was to determine if MMS had effective internal quality controls sufficient to ensure its audits follow Government Auditing Standards. The audit determined MMS's systems and safeguards were insufficient and that some of its audit work did not meet the standards.

During FY 2004, MMS has implemented all of the Inspector General's 2003 recommendations related to MRM audits, including completion of an external quality control peer review on MRM audit activities.

Most of the implemented corrective actions were designed to improve audits initiated after the period covered by the recent external peer review. Therefore, as expected, the peer review disclosed some of the same deficiencies previously identified by the Inspector General. In 2004, MMS prepared a comprehensive Audit Quality Improvement Action Plan, and has made substantial progress in implementing 25 of the 39 action items.

Improper Payments Information Act

The Improper Payments Information Act (IPIA) of 2002 (P.L. 107-300) requires Federal agencies to carry out a cost-effective program for identifying payment errors and recovering any amounts overpaid. An improper (or erroneous) payment includes any payment that should not have been made, or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirement. Incorrect amounts include: overpayments; underpayments (including inappropriate denials of payment or service); any payment made to an ineligible recipient or for an ineligible service; duplicate payments; payments for services not received; and payments that do not account for credit for applicable discounts.

To implement IPIA, the Office of Management and Budget (OMB) required agencies to review all programs (meeting OMB's definition of "program") to determine the risk susceptibility of making improper payments and to perform more in depth assessments for those programs meeting OMB's criteria for "significant erroneous payments", defined as annual erroneous payments in the program exceeding both 2.5% of program payments and $10 million. To assess the susceptibility MMS tested a census of all payments greater than $500,000 for Interior Franchise Fund Payments and $50,000 for all other programs. For payments not meeting these thresholds MMS performed monetary unit sampling using a 95% confidence interval and a 2.5% tolerable deviation.

Based on a series of internal control review techniques, MMS determined that none of its programs are risk-susceptible for making significant improper payments at or above the threshold levels set by OMB. It should be noted that these reviews were conducted in addition to audits under the Chief Financial Officers Act of 1990, GAO reviews, and reviews by Interior's Inspector General. Three different techniques were used to arrive at this determination: (1) risk assessments of internal controls related to payments for all programs using the thresholds set out above; (2) Departmental Functional Reviews (DFRs) focusing on the general control environment for making payments and the controls related to specific payment types; and (3) post-payment recovery audits. Each of the three techniques is summarized below:

1. Risk Assessments. Under Departmental Management Control Guidance for FY 2004 MMS conducted risk assessments of all programs to determine if any were risk-susceptible for making significant improper payments. The assessments were used to establish risk profiles for all bureau programs As a result of these reviews MMS came to the conclusion that none of its programs pose a high-risk of making significant improper payments based on OMB's criteria.

2. *Department-Wide Functional Reviews (DFRs).*
Under Departmental guidance MMS conducted DFRs in FY 2004 for the following payment processes: vendor, travel, and purchase card. The results of the DFRs indicated that internal controls were adequate and working as intended in the vendor, travel, and purchase card processes.

3. Recovery Audits - In response to Section 831 of the Defense Authorization Act for FY 2002 (U.S. Code 31 USC 3561-3567), Interior contracted with a recovery audit firm that began work in FY 2004.

MMS Plans for FY 2005 – FY 2007. Annual goals are to maintain adequate controls over payment processes to ensure that erroneous payments are minimized. The MMS will continue using contractor assistance to perform post-payment recovery audits initiated in FY 2004.

Financial Systems

Currently MMS relies on a set of financial management systems to collectively support program and financial managers. Systems are managed at various levels within MMS ranging from bureau level centrally managed systems, locally managed systems, and externally managed systems upon which MMS relies. Collectively these systems represent MMS's financial management systems architecture.

In alignment with the views of the government-wide CFO council, MMS believes that the key to improved program and financial management is improved financial management systems. To meet the need for improved systems MMS has fully aligned with a department wide initiative to implement the Financial and Business Management System (FBMS). MMS will be one of the first group of DOI bureaus to implement the FBMS system and is scheduled to implement all components of the system on October 1, 2005.

Management Controls

MMS's management control program is designed to ensure compliance with the goals, objectives, and requirements of the FMFIA and Office of Management and Budget (OMB) Circular A-123, "*Management Accountability and Control,*" Circular A-127, "*Financial Systems,*" and OMB Circular A-130, "Management of Federal Information Resources."

MMS believes that in addition to recurring controls within each of its significant business processes, the key to sound internal control is cognizance of the overall control environment by all levels of management, and the communication of management's emphasis on the importance of a sound control environment. As part of its overall control program MMS has implemented a comprehensive management review program to include Administrative Management Assistance Reviews, Department-Wide Functional Reviews, and Risk Assessments of its major programs.

While MMS has made significant progress in enhancing its overall control environment, based on the results of the FY 2004 independent audit of the financial statements, MMS was determined to have a material weakness related to its controls around the royalties year-end closing process. During the audit it was identified that MMS did not have adequate controls during its year-end closing process to ensure that funds received from oil and gas producers were properly matched to royalty documents. As a result an adjustment was required to fairly state its asset and liability position. In response to the finding MMS has developed procedures and controls to ensure that balances are correctly stated.

Financial Performance

The MMS monitors financial management performance through periodic collection and reporting of data for the Prompt Payment, Electronic Funds Transfers, and the Debt Collection Act. These reports are prepared and submitted to the Department of the Interior's Office of Financial Management for review by departmental senior managers.

Performance Measure: To have the percentage of payments without interest penalties meet or exceed the government-wide goal of 97 percent.

2004 Results: The MMS paid 96 percent of all payments without interest penalty in fiscal year 2004. While MMS did not achieve the 97 percent goal for the year, the bureau did exceed the goal in the third and fourth quarter by paying invoices on time 99 percent of the time. New operational procedures were implemented by the MMS during the fiscal year that allowed the MMS to adapt to the volume of payments made for activity within the Interior Franchise Fund and enabled the MMS to exceed the government-wide goal for the final quarter of the Fiscal Year.

Performance Measure: To use Electronic Funds Transfer (EFT) to the maximum extent possible, except for payments covered by waiver.

2004 Results: MMS achieved its goal by continuing to require new vendors and employees to enroll for EFT payments. During fiscal year 2004, 99 percent of all payments were made via EFT.

Performance Measure: To identify and refer 93 percent of delinquent debt to Treasury when 180 days past due.

2004 Results: MMS met this goal by identifying and referring 99 percent of eligible delinquent debt to Treasury when 180 days past due.

Principal Financial Statements

Department of the Interior
Minerals Management Service
Consolidated Balance Sheet
As of September 30, 2004 and 2003
(dollars in thousands)

	2004	2003
ASSETS		
Intragovernmental Assets:		
Administrative Fund Balance	$ **1,501,562**	$ 1,259,161
Restricted Fund Balance	**2**	1
Custodial Fund Balance	**1**	437
Fund Balance with Treasury (Note 2)	**1,501,565**	1,259,599
Restricted Treasury Securities	**1,001,652**	977,521
Custodial Treasury Securities	**27,767**	25,073
Investments, Net (Note 3)	**1,029,419**	1,002,594
Custodial Accounts Receivable	**289,150**	194,939
Administrative Accounts Receivable	**5,840**	21,842
Accounts and Interest Receivable, Net (Note 4)	**294,990**	216,781
Other:		
Advances and Prepayments	**1,283**	5
Total Intragovernmental Assets	**2,827,257**	2,478,979
Custodial Accounts and Interest Receivable	**734,781**	789,658
Administrative Accounts Receivable	**413,255**	234,507
Accounts and Interest Receivable, Net (Note 4)	**1,148,036**	1,024,165
Property & Equipment, Net of Accumulated Depreciation (Note 5)	**32,058**	36,360
Other:		
Travel Advances	**3**	8
Total Public Assets	**1,180,097**	1,060,533
TOTAL ASSETS (Note 6)	$ **4,007,354**	$ 3,539,512

(Continued)

Department of the Interior
Minerals Management Service
Consolidated Balance Sheet
As of September 30, 2004 and 2003
(dollars in thousands)

	2004	2003
LIABILITIES		
Intragovernmental Liabilities:		
Administrative Accounts Payable	**$ 4,865**	$ 4,739
Other:		
Advances and Deferred Revenue	**1,137,546**	872,973
Custodial Liability	**999,250**	948,605
Accrued Payroll and Benefits	**2,866**	2,504
Total Intragovernmental Liabilities	**2,144,527**	1,828,821
Public Liabilities:		
Administrative Accounts Payable	**245,192**	301,805
Federal Employees Compensation Act Liability (Note 7)	**8,711**	9,376
Accounts Payable	**253,903**	311,181
Other:		
Contingent Liabilities (Note 8)	**550,000**	550,000
Liabilities to States	**412,881**	234,416
Deferred Credits	**34,996**	25,738
Custodial Liability	**24,681**	35,992
Accrued Payroll and Benefits	**16,298**	13,791
Advances and Deferred Revenue	**391**	68
Capital Lease Liability (Note 9)	**74**	51
Total Public Liabilities	**1,293,224**	1,171,237
TOTAL LIABILITIES (Note 10)	**3,437,751**	3,000,058
Commitments and Contingencies (Note 8 and 9)		
Net Position		
Unexpended Appropriations	**7,450**	6,969
Cumulative Results of Operations:		
Administrative Cumulative Results of Operations	**(439,501)**	(445,037)
EIRF Cumulative Results of Operations	**1,001,654**	977,522
Total Cumulative Results of Operations	**562,153**	532,485
Total Net Position	**569,603**	539,454
TOTAL LIABILITIES AND NET POSITION	**$ 4,007,354**	$ 3,539,512

The accompanying notes are an integral part of these financial statements.

Department of the Interior
Minerals Management Service
Consolidated Statement of Net Cost
For the year ended September 30, 2004
(dollars in thousands)

	2004
Resource Use Energy	
Manage and Provide Incentives for Access and Development	
Cost -Services provided to the Public	$ 71,184
Revenue Earned from the Public	27,929
Net Cost (Revenue) of Operations	43,255
Enhance Responsible Use Management Practices	
Cost -Services provided to the Public	71,162
Revenue Earned from the Public	36,591
Net Cost (Revenue) of Operations	34,571
Effective Lease and Permit Management	
Cost -Services provided to the Public	1,474,791
Revenue Earned from the Public	46,955
Net Cost (Revenue) of Operations	1,427,836
Improve Information Base, Resource Management and Technical Assistance	
Cost -Services provided to the Public	5,279
Revenue Earned from the Public	2,131
Net Cost (Revenue) of Operations	3,148
Resource Use Non-Energy	
Cost -Services provided to the Public	2,225
Revenue Earned from the Public	2,063
Net Cost (Revenue) of Operations	162
Serving Communities	
Indian Trust Fulfillment	
Cost -Services provided to the Public	31,314
Revenue Earned from the Public	9,632
Net Cost (Revenue) of Operations	21,682
Reimbursable Activity and Other	
Interior Franchise Fund	
Cost -Services provided to the Public	8
Revenue Earned from the Public	8
Net Cost of Services to the Public	-
Cost - Services provided to Federal Agencies	1,332,599
Revenue Earned from Federal Agencies	1,350,748
Net Cost of Services provided to Federal Agencies	(18,149)
Net Cost (Revenue) of Operations	(18,149)
Other	
Cost -Services provided to the Public	121
Revenue Earned from the Public	440
Net Cost of Services to the Public	(319)
Cost - Services provided to Federal Agencies	3,556
Revenue Earned from Federal Agencies	3,556
Net Cost of Services provided to Federal Agencies	-
Net Cost (Revenue) of Operations	(319)
Total	
Cost -Services provided to the Public	1,656,084
Revenue Earned from the Public (Note 12)	125,749
Net Cost of Services to the Public	1,530,335
Cost - Services provided to Federal Agencies	1,336,155
Revenue Earned from Federal Agencies (Note 12)	1,354,304
Net Cost of Services provided to Federal Agencies	(18,149)
Net Cost (Revenue) of Operations (Note 11)	$ 1,512,186

The accompanying notes are an integral part of these financial statements.

Department of the Interior
Minerals Management Service
Consolidated Statement of Net Cost
For the year ended September 30, 2003
(dollars in thousands)

		2003
Safety		
Cost -Services provided to the Public	$	64,577
Revenue Earned from the Public		26,168
Net Cost (Revenue) of Operations		38,409
Environment		
Cost -Services provided to the Public		59,876
Revenue Earned from the Public		24,860
Net Cost (Revenue) of Operations		35,016
Fair Market Value		
Cost -Services provided to the Public		32,949
Revenue Earned from the Public		14,191
Net Cost (Revenue) of Operations		18,758
Access to Money		
Cost -Services provided to the Public		859,713
Revenue Earned from the Public		21,655
Net Cost (Revenue) of Operations		838,058
Royalty Compliance		
Cost -Services provided to the Public		74,606
Revenue Earned from the Public		30,876
Net Cost (Revenue) of Operations		43,730
Interior Franchise Fund		
Cost - Services provided to Federal Agencies		1,120,933
Revenue Earned from Federal Agencies		1,138,445
Net Cost (Revenue) of Operations		(17,512)
Other		
Cost -Services provided to the Public		99
Revenue Earned from the Public		99
Net Cost of Services to the Public		-
Cost - Services provided to Federal Agencies		7,431
Revenue Earned from Federal Agencies		7,431
Net Cost of Services provided to Federal Agencies		-
Net Cost (Revenue) of Operations		-
Total		
Cost -Services provided to the Public		1,091,820
Revenue Earned from the Public (Note 12)		117,849
Net Cost of Services to the Public		973,971
Cost - Services provided to Federal Agencies		1,128,364
Revenue Earned from Federal Agencies (Note 12)		1,145,876
Net Cost of Services provided to Federal Agencies		(17,512)
Net Cost (Revenue) of Operations (Note11)	$	956,459

The accompanying notes are an integral part of these financial statements.

Department of the Interior
Minerals Management Service
Consolidated Statement of Changes in Net Position
For the years ended September 30, 2004 and 2003
(dollars in thousands)

	2004	2003
UNEXPENDED APPROPRIATIONS		
Beginning Balances	**$ 6,969**	$ 6,316
Budgetary Financing Sources		
Appropriations Received, General Funds	**165,316**	165,321
Appropriations-Used	**(162,538)**	(162,550)
Other Adjustments	**(2,297)**	(2,118)
Total Budgetary Financing Sources	**481**	653
Ending Balance - Unexpended Appropriations	**$ 7,450**	$ 6,969
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	**$ 532,485**	$ 484,651
Transfer In of the Interior Franchise Fund Operations (Note 17)	**-**	1,410
Beginning Balances, as adjusted	**532,485**	486,061
Budgetary Financing Sources		
Appropriations-Used	**162,538**	162,550
MRM Exchange Revenue (Note 13)	**1,346,761**	812,765
Transfers In/Out without Reimbursement	**(3,983)**	6,065
Non-Exchange Revenue:		
Other Non-Exchange Revenue	**24,132**	10,248
Other Financing Sources		
Imputed Financing from Financing absorbed from others	**12,975**	11,525
Transfers In/Out without Reimbursement	**(569)**	(270)
Total Financing Sources	**1,541,854**	1,002,883
Net Cost of Operations	**(1,512,186)**	(956,459)
Ending Balance - Cumulative Results of Operations	**$ 562,153**	$ 532,485

The accompanying notes are an integral part of these financial statements.

Department of the Interior
Minerals Management Service
Combined Statement of Budgetary Resources
For the years ended September 30, 2004 and 2003
(dollars in thousands)

	2004	2003
Budgetary Resources:		
Budget Authority:		
Appropriations Received	**$ 1,340,716**	$ 1,124,694
Unobligated Balance:		
Beginning of Period	**731,785**	9,838
Transfer In of the Interior Franchise Fund Operations, Beginning of Period (Note 17)	**-**	378,443
Spending Authority From Offsetting Collections:		
Earned		
Collected	**1,525,212**	2,163,170
Receivable from Federal Sources	**(16,747)**	(119,020)
Change in Unfilled Customer Orders		
Advance Received	**271,914**	499,075
Without Advance from Federal Sources	**(65,953)**	(189,857)
Recoveries of Prior Year Obligations	**6,225**	7,130
Temporarily not Available Pursuant to Public Law	**(88)**	-
Permanently not Available	**(2,296)**	(2,158)
Total Budgetary Resources	**$ 3,790,768**	$ 3,871,315
Status of Budgetary Resources:		
Obligations Incurred:		
Direct (Category B)	**$ 1,340,054**	$ 1,124,291
Reimbursable (Category B)	**1,702,182**	2,015,239
Total Obligations Incurred (Note 14)	**3,042,236**	3,139,530
Unobligated Balances:		
Apportioned	**747,763**	730,542
Unobligated Balance not Available	**769**	1,243
Total Status of Budgetary Resources	**$ 3,790,768**	$ 3,871,315
Relationship of Obligations to Outlays:		
Obligations Incurred	**$ 3,042,236**	$ 3,139,530
Obligated Balance, Net, Beginning of Period	**527,364**	84,270
Transfer In of the IFF Operations, Obligated Balance, Net Beginning of Period (Note 17)	**-**	48,799
Obligated Balance, Net, End of Period:		
Accounts Receivable	**6,907**	23,653
Unfilled Customer Orders from Federal Sources	**178,641**	244,594
Undelivered Orders	**(681,852)**	(484,808)
Accounts Payable	**(256,700)**	(310,803)
Less: Spending Authority Adjustments	**76,475**	301,747
Outlays:		
Disbursements	**2,893,071**	3,046,982
Collections	**(1,797,126)**	(2,662,245)
Net Outlays before Offsetting Receipts	**1,095,945**	384,737
Less: Offsetting Receipts	**(1,427,168)**	(1,191,019)
Net Outlays	**$ (331,223)**	$ (806,282)

The accompanying notes are an integral part of these financial statements.

Department of the Interior
Minerals Management Service
Consolidated Statement of Financing
For the years ended September 30, 2004 and 2003
(dollars in thousands)

		2004		2003
Resources Used to Finance Activities:				
Budgetary Resources Obligated:				
Obligations Incurred	**$ 3,042,236**		$ 3,139,530	
Less: Spending Authority From Offsetting Collections/Adjustments	**(1,720,651)**		(2,360,498)	
Obligations Net of Offsetting Collections and Adjustments	**1,321,585**		779,032	
Less: Offsetting Receipts	**(1,427,168)**		(1,191,019)	
Net Obligations	**(105,583)**		(411,987)	
Other Resources:				
Transfers In/Out Without Reimbursement	**(569)**		(270)	
Imputed Financing From Costs Absorbed by Others	**12,975**		11,525	
Net Other Resources Used to Finance Activities	**12,406**		11,255	
Total Resources Used to Finance Activities		**(93,177)**		(400,732)
Resources Used to Finance Items Not Part of the Net Cost of Operations:				
Change in Budgetary Resources Obligated for Goods, Services, and Benefits Ordered but Not Yet Provided	**7,615**		308,818	
Resources That Fund Expenses Recognized in Prior Periods	**178,176**		(140,570)	
Budgetary Offsetting Collections and Receipts That Do Not Affect Net Cost of Operations:				
Offsetting Receipts Not Part of the Net Cost of Operations	**1,427,168**		1,191,019	
Resources That Finance the Acquisition of Assets	**(815)**		(7,775)	
Other Resources or Adjustments to Net Obligated Resources That Do Not Affect Net Cost of Operations	**(11,000)**		-	
Total Resources Used to Finance Items Not Part of the Net Cost of Operations		**1,601,144**		1,351,492
Total Resources Used to Finance the Net Cost of Operations		**1,507,967**		950,760
Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period:				
Components Requiring or Generating Resources in Future Periods:				
Increase (Decrease) in Annual Leave Liability (Note 19)	**1,216**		(247)	
Change in Unfunded Liabilities and Other (Note 19)	**(544)**		(355)	
Total Components of Net Cost of Operations That Will Require or Generate Resources in Future Periods	**672**		(602)	
Components Not Requiring or Generating Resources:				
Depreciation and Amortization	**5,117**		4,722	
Bad Debt Expense	**(1,570)**		1,579	
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	**3,547**		6,301	
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period		**4,219**		5,699
Net Cost of Operations		**$ 1,512,186**		$ 956,459

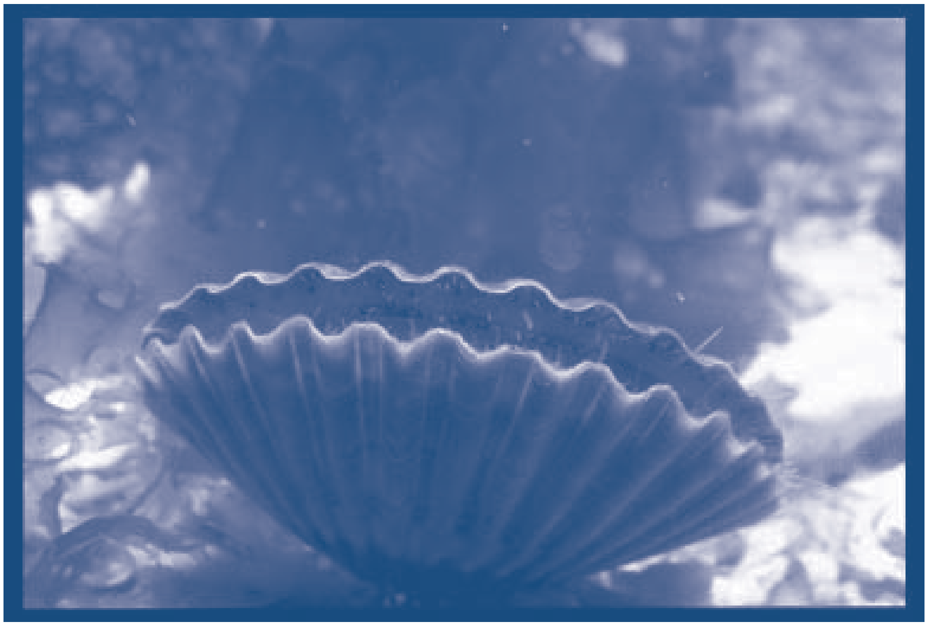
The accompanying notes are an integral part of these financial statements.

Department of the Interior
Minerals Management Service
Statement of Custodial Activity
For the years ended September 30, 2004 and 2003

(dollars in thousands)

		2004		2003
Revenues on Behalf of the Federal Government				
Mineral Lease Revenue				
Rents and Royalties	**$**	**7,498,235**	$	6,716,830
Offshore Lease Sales		**560,225**		485,841
Strategic Petroleum Reserve (Note 20)		**1,191,284**		1,044,350
Total Revenue	**$**	**9,249,744**	$	8,247,021
Disposition of Revenue				
Distribution to Department of the Interior				
Minerals Management Service (Note 21)	**$**	**1,300,525**	$	1,070,294
National Park Service Conservation Funds		**1,049,000**		1,049,000
Bureau of Reclamation		**924,486**		753,374
Bureau of Land Management		**16,216**		72,843
Fish and Wildlife Service		**737**		2,909
Distribution to Other Federal Agencies				
Department of the Treasury		**4,375,633**		4,208,092
Department of Energy (Note 20)		**1,191,284**		1,044,350
Department of Agriculture		**25,232**		22,920
Distribution to Indian Tribes and Agencies		**93,892**		79,544
Distribution to States and Others		**75,776**		65,488
Change in Untransferred Revenue		**196,963**		(121,793)
Total Disposition of Revenue	**$**	**9,249,744**	$	8,247,021

The accompanying notes are an integral part of these financial statements.



Notes to Financial Statements
September 30, 2004 and 2003

Note 1.1 Significant Accounting Policies

A. Basis of Presentation

These financial statements have been prepared to report the financial position, net cost of operations, changes in net position, budgetary resources, reconciliation of net cost to budgetary obligations, and custodial activities of the Minerals Management Service (MMS), as required by the Chief Financial Officers Act of 1990.

The financial statements have been prepared from the accounting records of MMS in accordance with accounting principles generally accepted in the United States of America (GAAP) using guidance issued by the Federal Accounting Standards Advisory Board (FASAB). Significant MMS accounting policies are summarized in this note.

The financial statements should be read with the realization that they are for a component of the United States Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources and legal authority to do so.

Certain MMS financial activities interact with and depend on the financial activities of the centralized management function of the Federal Government. These activities are performed for the benefit of the whole Federal Government, and include public debt and employee retirement, life insurance, and health benefit programs. Employee retirement, life insurance and health benefit costs, along with an assigned (imputed) financing source for these costs, are included in the MMS financial statements. Public debt activities that are performed for the benefit of the Federal Government as a whole are not included in these financial statements.

B. Reporting Entity

The Minerals Management Service was created on January 19, 1982, by Secretarial Order No. 3071, under authority of Section 2 of Reorganization Plan No. 3 of 1950 (64 Stat. 1262). On May 10, 1982, by Secretarial Order No. 3071, Amendment No. 1, all Outer Continental Shelf (OCS) leasing responsibilities of the Department of the Interior were consolidated within MMS under Section 2 of Reorganization Plan No. 3 of 1950. Amendment No. 2, dated May 26, 1982, set forth the basic organizational structure for MMS and provided for the transfer of administrative functions. Secretarial Order No. 3087, dated December 3, 1982, and Amendment No. 1, dated February 7, 1983, provided for the transfer of royalty and mineral revenue management functions, including collection and distribution performed by the Bureau of Land Management, to MMS.

The accompanying financial statements include all components of Minerals Management Service, including, Royalty and Offshore Minerals Management, Mineral Leasing, Oil Spill Research, and Interior Franchise Fund.

MMS has principal responsibility for the offshore leasing program, leasing management, and resource evaluation and classification functions, the environmental review of leasing activities, regulation of operations and lease management, inspection and enforcement programs, and leasing and related public liaison and planning functions on OCS lands. In addition, MMS is responsible for the prevention of fraud and theft and the prompt, full, and complete collection of monies and certain other forms of royalty due the Federal Government, States, and Indian lessors under contractual agreements with lessees.

The Minerals Revenue Management (MRM) Program performs primarily custodial activities that include the collection, distribution, and accounting for revenues and asset transfers as regulated by law. Some operational accounting activities also performed by MRM Program personnel include but are not limited to providing data for reporting requirements, investing revenues for both federal and non-federal funds, expending appropriations, establishing accounting procedures, and reconciling balances with other entities and Treasury.

The Interior Franchise Fund (IFF) was established in May 1996 as a result of the Government Management Reform Act (GMRA) of 1994. It operates as a revolving fund providing common administrative support service on a competitive fee-for-service basis for government agencies. A revolving fund is a budgetary structure set by statute that authorizes Executive Branch agencies to collect user fees or revenue to finance operational activities. The IFF is a component of MMS and represents 35 percent of assets and 40 percent of liabilities on the FY 2004 consolidated balance sheet, 90 percent of MMS total revenues on the FY 2004 consolidated statement of net cost, and 61 percent of the total budgetary resources on the FY 2004 combined statement of budgetary resources.

Section 632 of Title VI within the General Provisions of the President's 2005 budget, extends the Franchise Fund Pilot Program authorizing legislation to October 1, 2005. The IFF sunset date creates an uncertainty about MMS's ability to continue as a going concern because the operation of the IFF is dependent on the extension of its authorizing legislation.

Management's plan with respect to this uncertainty is to seek additional wording in the FY 2006 appropriation language that establishes franchising as a permanent program or provides franchise-like authority permanently. Should this plan be unsuccessful, MMS will no longer offer services under IFF and instead offer the same services under the authority of the Economy Act and adjust its pricing conventions to eliminate retained earnings. In addition, MMS will continue to operate its non-IFF funds and programs.

In accordance with OMB Bulletin No. 01-09, Form and Content of Agency Financial Statements, comparative statements will be presented, except for the Statement of Net Cost, as discussed in Note 11. Net Cost by Responsibility Segment.

C. Transactions within MMS

Transactions and balances among the MMS components have been eliminated from the Consolidated Balance Sheet, the Consolidated Statement of Net Cost, and the Consolidated Statement of Changes in Net Position.

As provided for by OMB Bulletin No. 01-09, Form and Content of Agency Financial Statements, the Statement of Budgetary Resources is presented on a combined basis. Therefore, intra-MMS transactions and balances have not been eliminated from this statement.

In accordance with OMB Bulletin No. 01-09, intra-MMS transactions and balances have been eliminated from all the amounts on the Consolidated Statement of Financing, except for obligations incurred and spending authority from offsetting collections and adjustments, which are presented on a combined basis.

In order to present all custodial activity, the distributions to MMS have not been eliminated on the Statement of Custodial Activity. However, the amounts are reported separately on the statement.

D. Basis of Accounting

MMS maintains its accounting records on both an accrual accounting basis and a budgetary accounting basis. Under the accrual method, revenues are recognized when earned and expenses are recognized when incurred, without regard to the receipt or payment of cash.

Under budgetary accounting, MMS records budgetary authority when it's legally received and records obligations of authority when legally incurred. Budgetary accounting facilitates compliance with constraints and controls over the use of Federal Funds.

E. Fund Balance With Treasury

MMS's receipts and disbursements are processed through the Federal Reserve System and the U.S. Treasury. The "Fund Balance with Treasury" balance as shown on the Consolidated Balance Sheet includes the unexpended balances of appropriations from which MMS is authorized to incur expenses and pay liabilities. The unobligated appropriation fund balances in expired accounts are unavailable for new obligations.

F. Accounts Receivable

Accounts receivable consist of amounts owed to MMS by other federal agencies and the public. No allowance is established for receivables due from federal agencies, as they are considered fully collectible.

G. Property and Equipment

Property and equipment are valued at historical costs. Property and equipment are capitalized if the initial acquisition cost is $15,000 or more and the estimated useful life is two years or greater (excluding internal use software). Internal use software with a purchase price or development cost of more than $100,000 is capitalized. Depreciation is recorded using the straight-line method based on useful lives ranging from 3 to 6 years for equipment and 10 years for internal use software.

H. Liabilities

Operating liabilities of MMS represent amounts likely to be paid by MMS as a result of transactions or events that have already occurred. However, no liabilities relating to MMS operations can be paid absent an appropriation. Liabilities for which an appropriation has not been enacted are classified as liabilities not covered by budgetary resources, without any certainty that an appropriation will be enacted.

I. Federal Employees Compensation Act

The Department of Labor (DOL) administers the Federal Employees Compensation Act (FECA), which provides workers' compensation benefits to Federal employees. There are two types of liabilities related to workers' compensation.

The first type is unfunded accrued FECA liability, which represents MMS Workers Compensation claims paid by the DOL for Workers' Compensation that have not yet been reimbursed by MMS. There is generally a two to three year time period between payment by DOL and reimbursement by MMS.

The second type is the unfunded actuarial FECA liability, which represents the estimated liability of future workers' compensation. This liability includes death, disability, medical, and miscellaneous costs.

DOL determines the actuarial FECA liability annually, as of September 30, using a method that considers historical benefit payment patterns, wage inflation factors, medical inflation factors, and other variables. DOL discounts the projected annual benefit payments to present value using the Office of Management and Budget's economic assumptions for 10-year Treasury notes and bonds.

To provide for the effects of inflation on the actuarial FECA liability, DOL applies wage inflation factors (i.e., cost of living adjustments) and medical inflation factors (i.e., consumer price index medical adjustments) to the calculation of projected future benefit payments. These factors are also used to adjust historical benefit payments to current-year constant dollars. DOL applies a discounting formula to recognize the timing of benefit payments as 13 payments per year instead of one lump sum payment per year.

DOL evaluates the estimated projections to ensure that the estimated future benefit payments are appropriate. The analysis includes three tests: (1) a comparison of the current-year projections to the prior year projections; (2) a comparison of the prior-year projected payments to the current-year actual payments, excluding any new case payments that had arisen during the current year; and (3) a comparison of the current-year actual payment data to the prior-year actual payment data. Based on the outcome of this analysis, adjustments may be made to the estimated future benefit payments.

J. Federal Employees Group Life Insurance (FEGLI) Program

Most MMS employees are entitled to participate in the FEGLI Program. Participating employees can obtain "basic life" term life insurance, with the employee paying two-thirds of the cost and MMS paying one-third. Additional coverage is optional, to be paid fully by the employee. The basic life coverage may be continued into retirement if certain requirements are met.

The Office of Personnel Management (OPM) administers this program and is responsible for the reporting of liabilities. For each fiscal year, OPM calculates the U.S. Government's service cost for the post-retirement portion of the basic life coverage. Because MMS's contributions to the basic life coverage are fully allocated by OPM to the pre-retirement portion of coverage, MMS has recognized the entire service cost of the post-retirement portion of basic life coverage as an imputed cost and imputed financing source.

K. Advances and Deferred Revenue

Federal advances and deferred revenue represent liabilities to perform services or deliver goods to customers that have remitted payment in advance of receiving the goods and services. These amounts will be earned upon furnishing goods and services to customers typically within the next 12 months.

Public advances and deferred revenue consists of bond forfeiture collections and receipts retained from royalty collections for the Strategic Petroleum Reserve (SPR). MMS is authorized to use bond collections of an Outer Continental Shelf lessee who did not fulfill the requirements of the lease. These forfeited bond collections are to be used to cover the cost of improvement, protection, or rehabilitation work arising from the forfeiture. MMS is also authorized to retain collections for the transportation costs of the royalty oil taken in kind from Federal leases in the Gulf of Mexico, which is transferred to the Department of Energy. Bond fortfeitures and SPR receipts are recorded as deferred revenue when collected and the revenue is recognized when costs are incurred for improvement, protection, or rehabilitation, and transportation costs.

L. Accrued Unfunded Annual Leave

Amounts associated with the payment of annual leave are accrued while employees are earning leave. This accrual is reduced as leave is taken. Each year the balance in the accrued annual leave account is adjusted to reflect current pay rates. To the extent current or prior year appropriations are not available to finance annual leave, future financing sources will be used.

Sick leave and other types of leave are expensed as taken because they are non-vesting in nature.

M. Contingent Liabilities

Contingent liabilities are recorded in the financial statements when an event potentially leading to the recognition of a liability is probable, and the scope of the potential liability may be estimated.

Contingent liabilities are disclosed in the footnotes to the financial statements when the conditions for financial statement recognition are not met and when the outcome of a liability is more than remote.

N. Retirement Plans

MMS employees participate in one of two retirement systems, the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). Employees hired prior to January 1, 1984 could elect to join FERS or continue to participate in CSRS. Employees hired after December 31, 1983 are automatically covered by FERS and Social Security.

CSRS employees may contribute up to nine percent of basic pay and receive no matching contributions from MMS. For FERS employees, MMS automatically contributes one percent of pay and matches any employee contribution up to an additional four percent of pay. FERS employees may contribute up to 14 percent of gross earnings. For employees in FERS, MMS also contributes the employer's matching share for Social Security.

The OPM is responsible for reporting assets, accumulated plan benefits and unfunded liabilities, if any, applicable to CSRS participants and FERS employees government-wide, including MMS employees. MMS has recognized an imputed cost and imputed financing source for the difference between the estimated service cost and the contributions made by the MMS and covered CSRS employees.

O. Exchange Revenues

The prices charged by Minerals Management Service are set by law or regulation. MMS bases the prices for products/services offered through the Interior Franchise Fund on the cost of products/services plus a fee of up to four percent of the cost of products/services. The Interior Franchise Fund is authorized to charge a fee of up to four percent in accordance with the GMRA. Prices set for products and services offered through reimbursable agreements under the Economy Act are intended to recover the full costs incurred by these activities.

MMS reports, as exchange revenues, the amount of royalties, rents and bonuses that Congress authorizes MMS to use for operations, as these revenues off-set the costs incurred to generate the revenues.

P. Other Financing Sources and Revenues

The primary financing sources for Minerals Management Service operations come from its annual Congressional appropriation and its authority to retain certain receipts resulting from its activities. MMS is authorized to retain a portion of the rental income collected as a part of the custodial activity provided by the Minerals Revenue Management Program to fund its operating costs. These funds are used for operating and capital expenses of MMS. Additional amounts are obtained through reimbursements for services performed for other Federal agencies under the GMRA or Economy Act.

In addition, MMS receives appropriations for specific purposes such as computer acquisitions; to carry out title I, section 1016, title IV, section 4202 and 4303, title VII, and title VIII, section 8201 of the Oil Pollution Act of 1990; to carry out provisions of the Minerals Leasing Act; to provide National Forest Fund payments to States, and to provide payments to States from lands acquired for flood control, navigation, and allied purposes.

Appropriations: Appropriations are recognized as financing sources on the Statement of Changes in Net Position when goods and services are received or benefits are provided. This is true whether the goods, services, and benefits are payable or paid as of fiscal year end and whether the appropriations are used for items that are expensed or capitalized. In addition, appropriations are recorded as budgetary authority on the Statement of Budgetary Resources when realized.

Imputed Financing Sources: In certain instances, operating costs of MMS are paid out of funds appropriated to other federal agencies. For example, the Office of Personnel Management, by law, pays certain costs of retirement programs and the Judgment Fund maintained by Treasury pays certain legal judgments against MMS. When costs that are identifiable to MMS and directly attributable to MMS operations are paid by other agencies, MMS recognizes these amounts as operating expenses of MMS. In addition, MMS recognizes an imputed financing source on the Consolidated Statement of Changes in Net Position to indicate the funding of Bureau operations by other federal agencies.

Q. Net Position

Net position consists of unexpended appropriations, cumulative results of operations, and restricted equity. Unexpended appropriations include available and unavailable unobligated balances as well as undelivered orders. Cumulative results of operations include the difference between revenues and expenses, the net amount of transfers of assets in and out without reimbursement, and donations (all of these include balances since the inception of the fund). The Environmental Improvement and Restoration Fund is classified as restricted equity on the Balance Sheet, as it does not belong to MMS until appropriated by Congress. As of September 30, 2004 and September 30, 2003, there are no estimated obligations related to canceled appropriations.

R. Income Taxes

As an entity of the U.S. Government, MMS is exempt from all income taxes imposed by any governing body, whether it is a federal, state, local, commonwealth, or foreign government.

S. Use of Estimates

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

Note 1.2 Significant Accounting Policies Relating to the Minerals Revenue Management (MRM) Program

A. Financing Sources and Revenues

MMS collects and accrues for bonuses, rents, royalties and other receipts from Federal Government and Indian leases and distributes all proceeds to the Treasury, other Federal agencies, states, Indian tribes, and Indian allottees, in accordance with legislated allocation formulas. MMS reports these revenues on the Statement of Custodial Activity.

In addition, MMS reports certain state amounts as revenues on the Statement of Changes in Net Position because the revenues are derived from the sale of federally owned mineral rights for which MMS incurred minimal costs in earning the revenue. When distributed to the states, MMS reports the distributions as costs in the Access to Money and Effective Lease and Permit Management programs on the FY 2003 and FY 2004 Statements of Net Cost, respectively, because the distributions reduce the net position of the Federal Government as a whole and MMS received budgetary authority to make the distributions.

Royalty-in-Kind (RIK) Program

MMS, under the provisions of the Mineral Lands Leasing Act of 1920 and the Outer Continental Shelf Lands Act (OCSLA) of 1953, may take part or all of its oil and gas royalties in-kind (a volume of the commodity) as opposed to in value (cash). MMS may either transfer the volume of oil or gas commodity taken in kind to Federal agencies for internal use or sell the commodity on the open market at fair market value and transfer the cash received. MMS determines the value of the RIK commodity using the fair market value on the date of the sale. MMS reflects royalty-in-kind as mineral lease revenue and as distributions to Federal agencies on the Statement of Custodial Activity.

MMS assists the administration's initiative to fill the Strategic Petroleum Reserve. MMS transfers to the Department of Energy royalty oil taken in kind from Federal leases in the Gulf of Mexico. During fiscal years 2004 and 2003, MMS transferred approximately 38.4 and 38.2 million barrels, respectively, to the Department of Energy for use in adding to the reserve. MMS determines the value of the commodity transferred using the fair market value on the date of the transfer. MMS reports these transfers as mineral lease revenue and distribution to the Department of Energy on the Statement of Custodial Activity.

Environmental Improvement and Restoration Fund (EIRF)

The Environmental Improvement and Restoration Fund was established pursuant to Title 4 of the Department of the Interior and Related Agencies Appropriations Act for FY 1998. Half of the principal and interest from the distribution of the Alaska Escrow Fund was deposited into EIRF during FY 2000. During FY 2004 and 2003, MMS deposited to the EIRF interest earned from investments of the EIRF principal. Congress has permanently appropriated 20% of the prior fiscal year interest earned by the EIRF to the Department of Commerce. The remaining 80% of interest earned remains in the fund and is recorded as other non-exchange revenue on the Statement of Changes in Net Position. The remaining interest earned may be appropriated by Congress to certain other agencies, as provided by law. No assets of the fund are available to the Department of the Interior unless appropriated by Congress.

B. Distributions of Revenues

Federal Revenues: Distributions are based on the Mineral Lands Leasing Act of 1920, 30 USC 191 as amended, the Federal Oil and Gas Royalty Management Act of 1982 (PL 97-451, 96 Stat. 2447, 30 USC 1701), the 1986 OCS Lands Act amendments of 1985 (PL 99-272), and subsequent legislation and lease terms.

Federal revenues distributed to MMS are subsequently appropriated and/or made available for program expenses and disbursements approved by Congress. Monies collected in MMS administrative appropriated funds are recorded as exchange revenues and subsequently used for operational purposes.

Non-Federal Revenues: Distributions are based on the Mineral Lands Leasing Act of 1920, as amended, subsequent legislation and lease terms.

Revenues generated from mineral production on Indian Lands go directly to Interior's Office of Trust Fund Management for subsequent distribution to tribes and allottees, meeting a wide variety of needs as outlined in the Indian Mineral Development Act of 1982 and other applicable laws and guidance. Indian nonstandard leases are negotiated directly between individual Indian tribes and industry.

C. Fund Balance With Treasury

MMS receipts and disbursements are processed through the Federal Reserve System and the U.S. Treasury. Receipts are processed through electronic transfers, fedwires, Treasury's Government On-Line Accounting Link System, and checks. The "Fund Balance with Treasury" as shown on the Consolidated Balance Sheet for custodial activity includes deposit and clearing account balances that are not available for obligation.

At the end of each fiscal year, MMS transfers the undistributed custodial clearing account fund balance to the General Fund of the Treasury and reports the portion due to non-Treasury entities as an accounts receivable. At the beginning of the following year, the balances are received from Treasury and distributed to the beneficiaries.

D. Accounts Receivable

The custodial and administrative receivables represent amounts due for royalty revenue, deferred bonuses, accumulated interest, audit bills, and royalty in kind.

Oil and gas companies provide MMS sureties to secure the majority of receivables under appeal. The current surety value is $303 million and $293 million of September 30, 2004 and September 30, 2003, respectively.

The royalty accrual for custodial receivables and distributions payable represents the current period activity anticipated to be received in the subsequent period. The balance is estimated based on an analysis of the last twelve months of royalty activity, and recent events, such as significant settlements due in September.

Receivables due from the public are reported net of allowances for un-collectable amounts. An allowance for estimated uncollectible custodial receivables is recognized to reduce the gross amount of receivables to its realizable value. The allowance is estimated based on historical experience of collections in relation to revenues. The allowance is calculated as the historical collection percentage multiplied by the year end accounts receivable balance.

E. Investments of Custodial Assets

Investments represent non-marketable market based Treasury securities issued by the Bureau of the Public Debt. These securities are not traded on any securities exchange, but mirror the prices of similar Treasury Securities trading in the Government securities market. Investments are expected to be held to maturity.

Investments are reported at cost, net of amortized premiums or discounts. Premiums and discounts for T-Bills, short term T-Notes and long-term T-Notes are amortized using effective interest method. Interest on investments is accrued as it is earned and is recorded as other non-exchange revenue on the Statement of Changes in Net Position. The market value of investments is calculated using the market price of securities as shown on Treasury's FedInvest Price File on September 30. Market values for overnight investments are the same as, or equivalent to par value.

MMS has limited investment authority based on two categories: (1) restricted and (2) custodial.

Restricted Investments

The Environmental Improvement and Restoration Fund is available for investment under the DOI and Related Agencies Appropriations Act, 1998. Congress has permanently appropriated 20% of the prior fiscal year interest earned by the EIRF to the Department of Commerce. The remaining 80% of interest earned remains in the fund and may be appropriated by Congress to certain other agencies, as provided by law. This investment was initially funded in FY 2000 by the settlement of the boundary dispute with the State of Alaska.

Custodial Investments

MMS is also required by regulation to invest the 1/5 OCS bid amounts from the apparent high bidders for all OCS lease sales. Should any of the apparent high bids later be rejected, the 1/5 bid and actual interest earned are returned to the bidder. Should the bidder forfeit their bid, the 1/5 bonus and accrued interest reverts to Treasury. The interest earned on accepted bids reverts to the Treasury when the bids are accepted.

F. Liabilities

MMS liabilities include custodial liabilities, deposit liabilities, and other accrued liabilities. Custodial liabilities represent amounts owed to royalty recipients (the public or Federal agencies) and offset custodial assets. Deposit liabilities include receipts for bonuses that are pending award or refund and non-Federal revenues collected on behalf of the states. Other Accrued Liabilities include payments due to the states for Federal revenues that will be funded from future revenues appropriated for this purpose.

Liabilities for which an appropriation has not been enacted are classified as liabilities not covered by budgetary resources.

MMS does not record a liability for potential overpayments by payors as MMS is not obligated, according to the Federal Oil and Gas Royalty Management Act of 1982 (PL 97-451, 96 Stat. 2447, 30 USC 1701), to repay such amounts until requested by the payor or until MMS completes a compliance audit and determines the amount that is refundable.

G. Other Accrued Liabilities

MMS makes payments to states according to the Mineral Lands Leasing Act of 1920, 30 USC 191 as amended, the Federal Oil and Gas Royalty Management Act of 1982 (PL 97-451, 96 Stat. 2447, 30 USC 1701), and PL 99-272 from the 1986 OCS Lands Act amendments of 1985. The liabilities to states for accrued minerals revenue are shown as unfunded because budgetary resources, which are authorized by the Act as permanent indefinite appropriations, are based on actual collections (appropriated revenues). The accrued unfunded liabilities associated with expenses for the payments to the States are reported on the Consolidated Balance Sheet.

Note 2. Fund Balance with Treasury

A summary of the Fund Balance with Treasury by fund type is listed in the first table below. The general funds consist of the appropriated funds for the operation of MMS, such as salaries and expenses, and computer acquisition. The trust funds consist of oil spill liability funds. The revolving funds represent collections from Interior Franchise Fund customers. The special fund represents EIRF. Refer to Footnote 1.2A for information on the EIRF. The other funds are custodial funds and proceeds from the sale of vehicles. The custodial funds represent royalty collections received by MMS, they are held as custodial, until disbursed to recipients. The proceeds received from the sale of vehicles can be retained for two years to purchase new vehicles. The second table shows the same information by status instead of fund type.

Fund Balance with Treasury by Fund Type
As of September 30
(dollars in thousands)

	2004	2003
General Funds	$100,446	$91,275
Trust Funds	6,866	5,961
Revolving Funds	1,394,224	1,161,913
Special Fund (EIRF)	2	1
Other Funds	27	449
Total Fund Balance with Treasury	$1,501,565	$1,259,599

The table below displays the status of Fund Balance with Treasury only. The Statement of Budgetary Resources includes Fund Balance with Treasury as well as additional obligated and unobligated balances of investments and allocation transfers. Thus, the obligated and unobligated balances in the Status of Fund Balance with Treasury table will not agree with the Statement of Budgetary Resources.

Status of Fund Balance
As of September 30,
(dollars in thousands)

	2004	2003
Unobligated Balance		
Available – Budget Authority	$747,762	$ 730,542
Unavailable	799	1,693
Obligated Balance not yet Disbursed	753,004	527,364
Total Fund Balance with Treasury	$1,501,565	$1,259,599

Note 3. Investments, Net

Investments consist of non-marketable, market-based Treasury securities that are not traded on any securities exchange but mirror the prices of marketable securities with similar terms. MMS has limited investment authority based on two categories: restricted and custodial. The restricted (EIRF) investments are further discussed in Footnote 1.2A and 1.2E, and the custodial investments are discussed in Footnote 1.2E.

As of September 30, 2004
(dollars in thousands)

Description	Cost	Amortized (Premium)/ Discount	Investments, Net	Market Value Disclosure
Non-Marketable market-based Treasury Securities				
Restricted	$1,003,202	($6,911)	$996,291	$1,007,471
Custodial	27,759	8	27,767	27,769
Total U.S. Treasury Securities	1,030,961	(6,903)	1,024,058	1,035,240
Restricted Accrued Interest	5,361	-	5,361	-
Total Treasury Securities	$1,036,322	($6,903)	$1,029,419	$1,035,240

As of September 30, 2003
(dollars in thousands)

Description	Cost	Amortized (Premium)/ Discount	Investments, Net	Market Value Disclosure
Non-Marketable market-based Treasury Securities				
Restricted	$977,236	$285	$977,521	$977,595
Custodial	25,070	3	25,073	25,074
Total Treasury Securities	$1,002,306	$288	$1,002,594	$1,002,669

Note 4. Accounts and Interest Receivable, Net

Accounts receivable relating to general operations of the bureau consist primarily of amounts due to MMS from other agencies in connection with various interagency agreements, and refunds due from MMS vendors and/or employees. MMS has custodial accounts receivable from intragovernmental agencies totaling $289 million, of which, $216 is due from Department of the Treasury and $73 million is due from Bureau of Land Management. Interest receivables are included as part of the custodial receivables in the amount of $175 million and $165 million as of September 30, 2004 and September 30, 2003, respectively. Refer to Footnote 1.2C for information on custodial receivables from Federal agencies.

Accounts and Interest Receivable, Net
As of September 30
(dollars in thousands)

	2004	2003
Accounts Receivable from Federal Agencies		
Billed - Current	$18,448	$4
Unbilled Accounts Receivable	276,542	218,354
Total Accounts Receivable – Federal	**$294,990**	**$218,358**
Allowance for Doubtful Accounts	-	(1,577)
Total Accounts Receivable – Federal Net of Allowance	**$294,990**	**$216,781**
Change in Allowance for Bad Debts - Federal		
Allowance for Doubtful Accounts, Beginning	$1,577	-
Deletions	(1,577)	$1,577
Allowance for Bad Debts - Federal	$-	$1,577

	2004	2003
Accounts and Interest Receivable from the Public		
Current	$57,522	$56,377
1 – 180 Days Past Due	8,930	79,669
181 – 365 Days Past Due	31,066	60,225
Over 1 Year Past Due	271,159	239,216
Total Billed Accounts and Interest Receivable – Public	**$368,677**	**$435,487**
Unbilled Accounts Receivable	1,057,392	882,145
Total Accounts and Interest Receivable – Public	**$1,426,069**	**$1,317,632**
Allowance for Doubtful Accounts	(278,033)	(293,467)
Total Accounts and Interest Receivable – Public Net of Allowance	**$1,148,036**	**$1,024,165**
Change in Allowance for Bad Debts - Public		
Allowance for Doubtful Accounts, Beginning	$293,467	$300,948
Deletions	(15,434)	(7,481)
Allowance for Bad Debts - Public	**$278,033**	**$293,467**

Note 5. Property and Equipment, Net

MMS property and equipment categories, with corresponding accumulated depreciation, are shown in the table below. Depreciation expense amounted to approximately $5.1 million as of September 30, 2004 and $4.7 million in fiscal year 2003.

Property and Equipment, Net
As of September 30, 2004
(dollars in thousands)

Description	Gross	Accumulated Depreciation	Net Book Value
Equipment and Vehicles	$16,053	($12,105)	$3,948
Internal Use Software, In Use	36,520	(8,410)	28,110
Total Property and Equipment	**$52,573**	**($20,515)**	**$32,058**

Property and Equipment, Net
As of September 30, 2003
(dollars in thousands)

Description	Gross	Accumulated Depreciation	Net Book Value
Equipment and Vehicles	$17,368	($12,770)	$4,598
Internal Use Software, In Use	36,519	(4,757)	31,762
Total Property and Equipment	**$53,887**	**($17,527)**	**$36,360**

Note 6. Assets Analysis

Assets of MMS include entity unrestricted, entity restricted and non-entity assets. Entity assets are those currently available for use by MMS. Restricted entity assets consist of the Environmental Improvement and Restoration Fund. Restricted entity assets cannot be used until appropriated by Congress, except for twenty percent of the interest earned on the EIRF investments that are transferred once a year to the Department of the Commerce. Non-entity assets are currently held by MMS but will be forwarded to Treasury, other agencies, or states at a future date. These assets are not available for use by MMS.

Assets Analysis
As of September 30, 2004
(dollars in thousands)

Description	Entity Unrestricted	Entity Restricted	Total Entity	Non-Entity	2004
Intragovernmental Assets:					
Fund Balance with Treasury	$1,501,562	$2	$1,501,564	$1	$1,501,565
Investments, Net - Treasury Securities	-	1,001,652	1,001,652	27,767	1,029,419
Accounts and Interest Receivable, Net	5,840	-	5,840	289,150	294,990
Advances and Prepayments	1,283	-	1,283	-	1,283
Total Intragovermental Assets	**$1,508,685**	**$1,001,654**	**$2,510,339**	**$316,918**	**$2,827,257**
Accounts and Interest Receivable, Net	374	-	374	1,147,662	1,148,036
Property & Equipment, Net	32,058	-	32,058	-	32,058
Travel Advances	3	-	3	-	3
Total Public Assets	**$32,435**	**$-**	**$32,435**	**$1,147,662**	**$1,180,097**
Total Assets	**$1,541,120**	**$1,001,654**	**$2,542,774**	**$1,464,580**	**$4,007,354**

Assets Analysis
As of September 30, 2003
(dollars in thousands)

Description	Entity Unrestricted	Entity Restricted	Total Entity	Non-Entity	2003
Intragovernmental Assets:					
Fund Balance with Treasury	$1,259,161	$1	$1,259,162	$437	$1,259,599
Investments, Net - Treasury Securities	-	977,521	977,521	25,073	1,002,594
Accounts and Interest Receivable, Net	21,842	-	21,842	194,939	216,781
Advances and Prepayments	5	-	5	-	5
Total Intragovermental Assets	**$1,281,008**	**$977,522**	**$2,258,530**	**$220,449**	**$2,478,979**
Accounts and Interest Receivable, Net	90	-	90	1,024,075	1,024,165
Property & Equipment, Net	36,360	-	36,360	-	36,360
Travel Advances	8	-	8	-	8
Total Public Assets	**$36,458**	**$-**	**$36,458**	**$1,024,075**	**$1,060,533**
Total Assets	**$1,317,466**	**$977,522**	**$2,294,988**	**$1,244,524**	**$3,539,512**

Note 7. Federal Employee Compensation Act Liability Due to the Public

MMS has recorded an estimated, unfunded actuarial liability for the expected future cost for death, disability, and medical claims under the Federal Employees Compensation Act (FECA) of approximately $8.7 million and $9.4 million as of September 30, 2004 and September 30, 2003, respectively. This liability is determined using a method that utilizes historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period. Projected annual benefit payments are discounted to present value using the OMB's economic assumptions for 10-year Treasury notes and bonds. The resulting liability is then distributed by DOL to each benefiting agency.

DOL calculates the estimated future benefit payments based on various assumptions. The interest rates used to discount the estimated future benefit payments to present values are 4.88 percent in year one and 5.24 percent in all subsequent years. The wage inflation factors and medical inflation factors used in the calculation are as follows:

FECA Wage Inflation Factors

	2004		2003	
Fiscal Year	Cost of Living Adjustment	Consumer Price Index Medical Adjustment	Cost of Living Adjustment	Consumer Price Index Medical Adjustment
2005	2.03%	4.14%	2.00%	3.54%
2006	2.73%	3.96%	1.83%	3.64%
2007	2.40%	3.98%	1.97%	3.80%
2008	2.40%	3.99%	2.17%	3.92%
2009+	2.40%	4.02%	2.17%	3.92%

Note 8. Contingent Liabilities

The MMS is party to various administrative proceedings, legal actions, environmental suits, and claims that may eventually result in the payment of substantial monetary claims to third parties. MMS accrued $550 million as of September 30, 2004 and September 30, 2003 respectively, for claims deemed probable of loss and where the amount of potential liability can be estimated. The potential liability claims deemed to be probable of loss have been estimated between $205 million and $1,231 million as of September 30, 2004 and September 30, 2003, respectively. It is management's opinion that any amounts due will be paid from the Department of the Justice Judgment Fund. Management believes that the ultimate resolution of other proceedings, actions and claims will not materially affect the financial position or net cost of operations of MMS.

Note 9. Leases

Capital Leases:

MMS has six capital leases with Oce USA, Inc., Xerox, and Canon for copiers, which transfer ownership of the property to MMS at the end of the lease term. The gross cost and net book value of these leases is $179 thousand and $95 thousand as of September 30, 2004, and $121 thousand and $67 thousand as of September 30, 2003, respectively. The table below shows the future payments expected for these lease agreements.

Future Payments Due
As of September 30, 2004
(dollars in thousands)

Capital Leases:	
Fiscal Year	**Copiers**
2005	$30
2006	26
2007	22
2008	18
2009	-
Total Future Lease Payments	96
Less: Imputed Interest	(22)
Net Capital Lease Liability	$74
Lease Liability Covered by Budgetary Resources	$74

Operating Leases:

MMS has several General Services Administration (GSA) lease agreements for office space. The terms of the lease agreements vary according to whether the underlying assets are owned by GSA (or another Federal agency) or rented by GSA from the private sector. Future lease payments are subject to appropriations becoming available.

For GSA-owned property, MMS generally does not execute an agreement with GSA nor is there a formal lease expiration date. Although MMS may normally vacate these properties after giving 120 to 180 days notice of intent to vacate, in actuality, MMS normally occupies these properties for an extended period of time, with little variation from year to year.

In the table below, MMS discloses future lease commitments in years 2005 through 2009 for GSA-owned property and future lease commitments for privately owned property based on the lease terms. The future lease payments for all leases are based on 2004 actual expenses plus an escalation in accordance with GSA budget estimates, normally 1.7 percent but ranging up to 10 percent for selected locations for 2004, with an escalation of 1.5 percent per year for all periods after 2005.

MMS also has some small equipment operating leases for copiers that are not disclosed in the schedule below as the amounts are insignificant.

Future Payments Due
As of September 30, 2004
(dollars in thousands)

Operating Leases:	
Fiscal Year	**Real Property (Federal)**
2005	$13,892
2006	14,101
2007	14,312
2008	14,527
2009	14,745
Thereafter	30,157
Total Future Lease Payments	$101,734

Note 10. Liabilities

Liabilities shown below include all liabilities, both funded and unfunded, that are due to the public and other Federal entities. Funded liabilities are liabilities covered by budgetary resources; likewise, unfunded liabilities are liabilities not covered by budgetary resources. The Custodial Liability and Liabilities to States, which are current liabilities, not covered by budgetary resources, are further discussed in Footnote 1.2F.

Liabilities
As of September 30, 2004
(dollars in thousands)

	Covered by Budgetary Resources	Not Covered by Budgetary Resources		
	Current	**Current**	**Non-Current**	**2004**
Intragovernmental Liabilities:				
Accounts Payable	$4,865	$-	$-	$4,865
Other:				
Advances and Deferred Revenue	1,137,546	-	-	1,137,546
Custodial Liability	-	999,250	-	999,250
Accrued Payroll and Benefits	895	584	1,387	2,866
Total Intragovernmental Liabilities	**1,143,306**	**999,834**	**1,387**	**2,144,527**
Public Liabilities:				
Accounts Payable	245,192	-	-	245,192
Federal Employees Compensation Act Liabilities	-	-	8,711	8,711
Other:				
Contingent Liabilities	-	-	550,000	550,000
Liabilities to States	-	412,881	-	412,881
Deferred Credits	7,203	27,793	-	34,996
Custodial Liability	-	24,681	-	24,681
Accrued Payroll and Benefits	4,685	-	11,613	16,298
Advances and Deferred Revenue	391	-	-	391
Capital Lease Liability	-	74	-	74
Total Public Liabilities	**$257,471**	**$465,429**	**$570,324**	**$1,293,224**
Total Liabilities	**$1,400,777**	**$1,465,263**	**$571,711**	**$3,437,751**

Note 10. Liabilities (Continued)

Liabilities
As of September 30, 2003
(dollars in thousands)

	Covered by Budgetary Resources	Not Covered by Budgetary Resources		
	Current	**Current**	**Non-Current**	**2003**
Intragovernmental Liabilities:				
Accounts Payable	$4,739	$-	$-	$4,739
Other:				
Advances and Deferred Revenue	872,973	-	-	872,973
Custodial Liability	-	948,605	-	948,605
Accrued Payroll and Benefits	630	573	1,301	2,504
Total Intragovernmental Liabilities	**878,342**	**949,178**	**1,301**	**1,828,821**
Public Liabilities:				
Accounts Payable	301,805	-	-	301,805
Federal Employees Compensation Act Liabilities	-	-	9,376	9,376
Other:				
Contingent Liabilities	-	-	550,000	550,000
Liabilities to States	-	234,416	-	234,416
Deferred Credits	216	25,522	-	25,738
Custodial Liability	-	35,992	-	35,992
Accrued Payroll and Benefits	3,395	-	10,396	13,791
Advances and Deferred Revenue	68	-	-	68
Capital Lease Liability	-	51	-	51
Total Public Liabilities	**$305,484**	**$295,981**	**$569,772**	**$1,171,237**
Total Liabilities	**$1,183,826**	**$1,245,159**	**$571,073**	**$3,000,058**

Note 11. Net Cost by Responsibility Segment

The Government Performance Results Act (GPRA) requires that Federal agencies formulate Strategic Plans, identify major strategic goals, and report performance and costs related to these goals. Under GPRA, Strategic Plans are to be revised and updated every three years. Accordingly, the Department of the Interior (Department) updated the Department-wide Strategic Plan in FY 2004 and replaced the mission goals applicable in fiscal years 2001 through 2003 with five new mission goals applicable in FY 2004 and thereafter. The FY 2004 mission goals and categories within each goal that are applicable to MMS are summarized as follows:

1. Resource Use
   a. Resource Use Energy
      i. Manage and Provide Incentives for Access and Development
      ii. Enhance Responsible Use Management Practices
      iii. Effective Lease and Permit Management
      iv. Improve Information Base, Resource Management and Technical Assistance
   b. Resource Use Non-Energy
2. Serving Communities
   a. Indian Trust Fulfillment
3. Reimbursable Activity, and Other
   a. Interior Franchise Fund
   b. Other

OMB Bulletin No. 01-09 *Form and Content of Agency Financial Statements* requires that the presentation of the Statement of Net Cost align directly with the goals and outcomes identified in the Strategic Plan. Accordingly, MMS has presented the earned revenues and gross costs in FY 2004 by the applicable mission goals and categories in the Department's FY 2004 Strategic Plan and the earned revenues and gross costs for fiscal year 2003 by the applicable mission goals and categories in the Department's FY 2001 Strategic Plan. As a result, the FY 2004 Consolidated Statement of Net Cost is not comparable to the FY 2003 Consolidated Statement of Net Cost. The more significant changes from FY 2003 to FY 2004 include the following:

1. Realigning the Offshore Minerals Management activity from Safety, Environment, and Fair Market Value in FY 2003 to four components under Resource Use Energy and Resource Use Non-Energy in FY 2004.

2. Realigning the Mineral Revenue Management activity from Access to Money and Royalty Compliance in FY 2003 to two components under Resource Use Energy and Indian Trust Fulfillment.

The tables on the following pages present MMS's earned revenues, gross cost and net cost of operations by program and by responsibility segment.

Note 11. Net Cost by Responsibility Segment (Continued)

Schedule of Net Cost by Program and Responsibility Segment
For the year ended September 30, 2004
(dollars in thousands)

	Offshore Minerals Management	Minerals Revenue Managment	Interior Franchise Fund	Other	Elimination of Intra Bureau Activity	2004
Resource Use Energy						
Manage and Provide Incentives for Access and Development						
Cost – Services provided to the Public	$71,184	$-	$-	$-	$-	$71,184
Revenue Earned from the Public	27,929	-	-	-	-	27,929
Net Cost (Revenue) of Operations	43,255	-	-	-	-	43,255
Enhance Responsible Use Management Practices						
Cost – Services provided to the Public	53,149	18,013	-	-	-	71,162
Revenue Earned from the Public	18,578	18,013	-	-	-	36,591
Net Cost (Revenue) of Operations	34,571	-	-	-	-	34,571
Effective Lease and Permit Management						
Cost – Services provided to the Public	44,719	1,430,072	-	-	-	1,474,791
Revenue Earned from the Public	15,705	31,250	-	-	-	46,955
Net Cost (Revenue) of Operations	29,014	1,398,822	-	-	-	1,427,836
Improve Information Base, Resource Management and Technical Assistance						
Cost – Services provided to the Public	5,279	-	-	-	-	5,279
Revenue Earned from the Public	2,131	-	-	-	-	2,131
Net Cost (Revenue) of Operations	3,148	-	-	-	-	3,148
Resource Use Non-Energy						
Cost – Services provided to the Public	2,225	-	-	-	-	2,225
Revenue Earned from the Public	2,063	-	-	-	-	2,063
Net Cost (Revenue) of Operations	162	-	-	-	-	162
Serving Communities						
Indian Trust Fulfillment						
Cost – Services provided to the Public	-	31,314	-	-	-	31,314
Revenue Earned from the Public	-	9,632	-	-	-	9,632
Net Cost (Revenue) of Operations	-	21,682	-	-	-	21,682
Reimbursable Activity and Other						
Interior Franchise Fund						
Cost – Services provided to the Public	-	-	8	-	-	8
Revenue Earned from the Public	-	-	8	-	-	8
Net Cost of Services to the Public	-	-	-	-	-	-
Cost – Services provided to Federal Agencies	-	-	1,361,459	-	(28,860)	1,332,599
Revenue Earned from Federal Agencies	-	-	1,379,608	-	(28,860)	1,350,748
Net Cost of Services provided to Federal Agencies	-	-	(18,149)	-	-	(18,149)
Net Cost (Revenue) of Operations	-	-	(18,149)	-	-	(18,149)
Other						
Cost – Services provided to the Public	-	-	-	121	-	121
Revenue Earned from the Public	-	-	-	440	-	440
Net Cost of Services to the Public	-	-	-	(319)	-	(319)
Cost – Services provided to Federal Agencies	-	-	-	3,556	-	3,556
Revenue Earned from Federal Agencies	-	-	-	3,556	-	3,556
Net Cost of Services provided to Federal Agencies	-	-	-	-	-	-
Net Cost (Revenue) of Operations	-	-	-	(319)	-	(319)
Total						
Cost – Services provided to the Public	176,556	1,479,399	8	121	-	1,656,084
Revenue Earned from the Public	66,406	58,895	8	440	-	125,749
Net Cost of Services to the Public	110,150	1,420,504	-	(319)	-	1,530,335
Cost – Services provided to Federal Agencies	-	-	1,361,459	3,556	(28,860)	1,336,155
Revenue Earned from Federal Agencies	-	-	1,379,608	3,556	(28,860)	1,354,304
Net Cost of Services provided to Federal Agencies	-	-	(18,149)	-	-	(18,149)
Net Cost (Revenue) of Operations	$110,150	$1,420,504	($18,149)	($319)	$-	$1,512,186

Note 11. Net Cost by Responsibility Segment (Continued)

Schedule of Net Cost by Program and Responsibility Segment
For the year ended September 30, 2003
(dollars in thousands)

	Offshore Minerals Management	Minerals Revenue Management	Interior Franchise Fund	Other	Elimination of Intra Bureau Activity	2003
Safety						
Cost – Services provided to the Public	$64,577	$-	$-	$-	$-	$64,577
Revenue Earned from the Public	26,168	-	-	-	-	26,168
Net Cost (Revenue) of Operations	38,409	-	-	-	-	38,409
Environment						
Cost – Services provided to the Public	59,876	-	-	-	-	59,876
Revenue Earned from the Public	24,860	-	-	-	-	24,860
Net Cost (Revenue) of Operations	35,016	-	-	-	-	35,016
Fair Market Value						
Cost – Services provided to the Public	32,949	-	-	-	-	32,949
Revenue Earned from the Public	14,191	-	-	-	-	14,191
Net Cost (Revenue) of Operations	18,758	-	-	-	-	18,758
Access to Money						
Cost – Services provided to the Public	-	859,713	-	-	-	859,713
Revenue Earned from the Public	-	21,655	-	-	-	21,655
Net Cost (Revenue) of Operations	-	838,058	-	-	-	838,058
Royalty Compliance						
Cost – Services provided to the Public	-	74,606	-	-	-	74,606
Revenue Earned from the Public	-	30,876	-	-	-	30,876
Net Cost (Revenue) of Operations	-	43,730	-	-	-	43,730
Interior Franchise Fund						
Cost – Services provided to Federal Agencies	-	-	1,901,591	-	(780,658)	1,120,933
Revenue Earned from Federal Agencies	-	-	1,919,103	-	(780,658)	1,138,445
Net Cost (Revenue) of Operations	-	-	(17,512)	-	-	(17,512)
Other						
Cost – Services provided to the Public	-	-	-	99	-	99
Revenue Earned from the Public	-	-	-	99	-	99
Net Cost of Services to the Public	-	-	-	-	-	-
Cost – Services provided to Federal Agencies	-	-	-	7,431	-	7,431
Revenue Earned from Federal Agencies	-	-	-	7,431	-	7,431
Net Cost of Services provided to Federal Agencies	-	-	-	-	-	-
Net Cost (Revenue) of Operations	-	-	-	-	-	-
Total						
Cost – Services provided to the Public	157,402	934,319	-	99	-	1,091,820
Revenue Earned from the Public	65,219	52,531	-	99	-	117,849
Net Cost of Services to the Public	92,183	881,788	-	-	-	973,971
Cost – Services provided to Federal Agencies	-	-	1,901,591	7,431	(780,658)	1,128,364
Revenue Earned from Federal Agencies	-	-	1,919,103	7,431	(780,658)	1,145,876
Net Cost of Services provided to Federal Agencies	-	-	(17,512)	-	-	(17,512)
Net Cost (Revenue) of Operations	$92,183	$881,788	$(17,512)	$-	$-	$956,459

Note 12. Earned Revenue

The Sales of Goods and Services in the table below represent reimbursable revenues from customers recognized for services provided. Other revenues represent MRM federal revenues distributed to MMS for operational purposes.

Fiscal Years 2004 and 2003
(dollars in thousands)

Description	2004	2003
Sales of Goods and Services:		
To the Public	$129	$99
To Other Federal Agencies - IFF	1,350,748	1,138,445
To Other Federal Agencies - Other	3,556	7,431
Other Revenues:		
Other Revenues from the Public	377	724
As appropriated by Congress	125,243	117,026
Total Earned Revenue	**$1,480,053**	**$1,263,725**

Note 13. MRM Exchange Revenues

The royalty exchange revenues distributed to Federal agencies are reported by the receiving entity on the Statement of Changes in Net Position as an exchange revenue in accordance with the federal accounting standards. In fiscal year 2004 and 2003, MMS received $1,347 million and $813 million of revenues, respectively, of permanent indefinite appropriations that MMS subsequently provided to the states.

Note 14. Apportionment Categories of Obligations Incurred

The amounts of direct and reimbursable obligations incurred at MMS, are apportioned under Category B and were subject to annual apportionment by OMB. The obligation amounts match the Statement of Budgetary Resources, but do not match MMS's FACTSII Report (SF-133) in FY 2004 and FY 2003 by $1 million. This difference is attributable to the fact that MMS reports a portion of 14X5003 on FACTSII (SF-133) for Bureau of Land Management (BLM). BLM reports their portion of 14X5003 on their Statement of Budgetary Resources.

The following table reflects direct and reimbursable obligations.

Fiscal Years 2004 and 2003
(dollars in thousands)

Description	2004	2003
Direct Obligations	$1,340,054	$1,124,291
Reimbursable Obligations	1,702,182	2,015,239
Total Obligations	**$3,042,236**	**$3,139,530**

Note 15. Permanent Indefinite Appropriations

MMS has three permanent, indefinite appropriations that relate to the State Program:

1. The Mineral Leasing Act (MLA), 30 U.S.C. 181 et seq., provides that all States be paid 50 percent of the revenues resulting from the leasing of mineral resources on Federal public domain lands within their borders (except Alaska which receives 90%).

2. Forest Fund payments to a state are determined by the total revenues collected from mineral leasing and production within its boundaries except for the Forest Fund payments. Law requires a state's payment be based on national forest acreage and where a national forest is situated in several states, an individual state's payment is proportionate to its area within that particular national forest.

3. Flood control payments to states are shared according to the Flood Control Act of 1936 (22U.S.C.701 et seq.) which provides that 75 percent of revenue collected be shared with the state in which it was collected. These funds are to be expended as the state legislature may prescribe for the benefit of the public schools and roads in the county which the revenue was collected or for defraying of the expenses of county government. These types of expenses include public obligations of levee and drainage districts for flood control and draining improvements.

Note 16. Differences Between the Statement of Budgetary Resources and the Budget of the United States Government

The differences between the FY 2003 Statement of Budgetary Resources (SBR), the SF-133, and Budget of the United States Government are greatly attributed to the unique reporting requirements for each report. The differences are summarized as follows:

a. Appropriation 14X5003 is a shared appropriation between MMS and Bureau of Land Management (BLM). For reporting purposes, MMS reports the BLM annual amount for appropriation 14X5003 on the MMS SF-133 and Budget of the United States Government, but does not report the BLM amount on the MMS SBR. However, it is reported on BLM's SBR. In FY 2003, the BLM amount that was included in the MMS SF-133 and Budget of the US Government was approximately $1 million. This difference occurs in the following lines, new obligations, budgetary resources available for obligation, appropriations, and outlays. Due to rounding on the Budget of the United States Government, this difference is not apparent when looking at the SBR, but is on the SF-133.

b. Unobligated balances, start of year, reflect a difference of $3 million between the SBR, SF-133 and the Budget of the United States Government because the SBR and SF-133 include expired appropriations but the Budget of the United States Government does not.

c. For the resources available from recoveries of prior year obligations, the Budget of the United States Government does not include $1 million of the Oil Spill Trust fund and annual year appropriations, where as the SBR and SF-133 do include them.

d. The budgetary resources available for obligation contains a difference of $963 million due to the fact that the SBR and SF-133 include expired appropriations and appropriations 14X5003, 14X5243, 14X5248, and 14X8370, yet in the Budget of the United States Government the budgetary resources available for obligations for these funds is zero.

e. Due to rounding, other small differences have resulted between the SBR, SF-133 and the Budget of the United States Government. The SBR is presented in "thousands of dollars", the Budget of the US Government is presented in "millions of dollars", and the SF-133 is not rounded.

The FY 2006 Budget of the United States Government with the FY 2004 'actuals' was not available at the time the annual report was prepared. The document is expected to be available in February 2005 and may be found at the Office of Management and Budget website, www.whitehouse.gov/omb.

Note 17. Transfer in of Interior Franchise Fund Operations

As a result of the significant growth of the Interior Franchise Fund and increase in operating costs, the Department of the Interior management determined that it could improve the efficiency of the Interior Franchise Fund by transferring the Interior Franchise Fund to MMS. Effective October 1, 2002, Interior's Departmental Offices transferred the Interior Franchise Fund to MMS. MMS will provide the products and services for the existing customer agreements and future customer agreements related to Government Works and U.S. Films and Video Productions.

MMS received and has reflected the transfer in of the Interior Franchise Fund operations. These transfers are shown on the fiscal year 2003 Statement of Changes in Net Position and Statement of Budgetary Resources. The following table reflects amounts MMS received from Departmental Offices.

Description	**Amounts** (dollars in thousands)
Assets	$468,870
Liabilities	467,460
Net Position	1,410
Unobligated Budgetary Resources	378,443
Obligated Budgetary Resources	48,799

Note 18. Dedicated Collections

Half of the Alaska Escrow Fund was distributed to MMS to initially fund the Environmental Improvement Restoration Fund. MMS invests the EIRF in Treasury securities. The purpose of EIRF is to invest money and earn interest until there is further Congressional action. Congress has permanently appropriated and MRM transfers twenty percent of the prior fiscal year interest earned by the EIRF to the Department of Commerce each year for their marine research activities. The amounts transferred to the Department of Commerce were $5.3 million and $3 million in FY 2004 and FY 2003, respectively. The remaining eighty percent will remain in the fund to earn interest and may be appropriated by Congress to certain other agencies, as provided by law. No assets of the fund are available to the Department of the Interior unless appropriated by Congress.

(dollars in thousands)	**2004**	**2003**
Assets		
Fund Balance with Treasury	$2	$1
Investments	1,001,652	977,521
Total Assets	**$1,001,654**	**$977,522**
Total Net Position	$1,001,654	$977,522
Total Liabilities and Net Position	**$1,001,654**	**$977,522**
Change in Net Position		
Net Position, Beginning of Fiscal Year	$977,522	$967,274
Change in Net Position:		
Investment Interest and Other	24,132	10,248
Net Position, End of Fiscal Year	**$1,001,654**	**$977,522**

Note 19. Explanation of the Relationship Between Liabilities Not Covered by Budgetary Resources on the Balance Sheet and the Change in Components Requiring or Generating Resources in Future Periods

Increases and decreases in unfunded liabilities that are not covered by budgetary resources, excluding custodial liabilities, liabilities to states, and deferred credits, (see Note 10) are displayed in this section of the statement of financing.

Liability	2004	2003	Increase/(Decrease) (dollars in thousands)
Annual Leave Liability	$11,612	$10,396	$1,216
Unfunded Liabilities and Other	560,757	561,301	(544)
Total	**$572,369**	**$571,697**	**$672**

Liability	2003	2002	Decrease (dollars in thousands)
Annual Leave Liability	$10,396	$10,643	($247)
Unfunded Liabilities and Other	561,301	561,656	(355)
Total	**$571,697**	**$572,299**	**($602)**

Note 20. Strategic Petroleum Reserve

During FY 2004 and FY 2003, MMS transferred to the Department of Energy (DOE) approximately 38.4 million and 38.2 million barrels of oil, respectively, drawn from Federal leases within the Gulf of Mexico. The purpose of these transfers was to refill selected Strategic Petroleum Reserve (SPR) locations in accordance with no-cost transfer arrangements of Royalty-in-Kind crude oil to DOE. The transferred oil is reflected as mineral lease revenue and a distribution of revenue on the Statement of Custodial Activity.

The value of the oil transferred in FY 2004 and FY 2003 was approximately $1,191 million and $1,044 million, respectively. The value of the oil is based on actual volumes reported on pipeline statements applied to commodity prices at on-shore market centers less actual monthly value differences between offshore and onshore market centers that were bid by the successful bidders on the RIK volumes. The volume of oil transferred in September is estimated based on nominations from the suppliers as the actuals were not available. In addition, the value of the September oil is estimated based on August pricing.

Note 21. Custodial Distributions to MMS

MRM distributes custodial funds to MMS, which includes payments to States, RIK and SPR transportation costs, and revenues to fund operations. The amount distributed as Revenues to Fund Operations is legislated by Congress as part of MMS's Annual Appropriation.

Fiscal Years 2004 and 2003
(dollars in thousands)

Distribution to MMS	2004	2003
Payments to States	$1,168,295	$953,268
RIK and SPR Transportation	32,000	17,250
Revenues to Fund Operations	100,230	99,776
Total Distribution	**$1,300,525**	**$1,070,294**

Required Supplementary Information

(Unaudited, see accompanying auditors' report)

Department of the Interior
Minerals Management Service
Combining Statement of Budgetary Resources
For the year ended September 30, 2004
(dollars in thousands)

	Royalty and Offshore Minerals Management	Mineral Leasing	Oil Spill Research	Interior Franchise Fund	Other	2004
Budgetary Resources:						
Budget Authority:						
Appropriations Received	$ 165,316	$ 1,162,955	$ 7,105	$ -	$ 5,340	**$ 1,340,716**
Unobligated Balance:						
Beginning of Period	11,119	-	122	720,544	-	**731,785**
Spending Authority From Offsetting Collections:						
Earned						
Collected	128,463	-	207	1,396,542	-	**1,525,212**
Receivable from Federal Sources	294	-	14	(17,055)	-	**(16,747)**
Change in Unfilled Customer Orders						
Advance Received	7,310	-	98	264,506	-	**271,914**
Without Advance from Federal Sources	(91)	-	10	(65,872)	-	**(65,953)**
Recoveries of Prior Year Obligations	6,172	-	53	-	-	**6,225**
Temporarily not Available Pursuant to Public Law	-	-	(88)	-	-	**(88)**
Permanently not Available	(2,296)	-	-	-	-	**(2,296)**
Total Budgetary Resources	$ 316,287	$ 1,162,955	$ 7,521	$ 2,298,665	$ 5,340	**$ 3,790,768**
Status of Budgetary Resources:						
Obligations Incurred:						
Direct (Category B)	$ 164,701	$ 1,162,955	$ 7,058	$ -	$ 5,340	**$ 1,340,054**
Reimbursable (Category B)	138,154	-	324	1,563,704	-	**1,702,182**
Total Obligations Incurred	302,855	1,162,955	7,382	1,563,704	5,340	**3,042,236**
Unobligated Balance:						
Apportioned	12,663	-	139	734,961	-	**747,763**
Unobligated Balance not Available	769	-	-	-	-	**769**
Total Status of Budgetary Resources	$ 316,287	$ 1,162,955	$ 7,521	$ 2,298,665	$ 5,340	**$ 3,790,768**
Relationship of Obligations to Outlays:						
Obligations Incurred	$ 302,855	$ 1,162,955	$ 7,382	$ 1,563,704	$ 5,340	**$ 3,042,236**
Obligated Balance, Net, Beginning of Period	79,518	-	5,838	442,008	-	**527,364**
Obligated Balance, Net, End of Period:						
Accounts Receivable	517	-	25	6,365	-	**6,907**
Unfilled Customer Orders from Federal Sources	1,125	-	80	177,436	-	**178,641**
Undelivered Orders	(70,737)	-	(6,006)	(605,109)	-	**(681,852)**
Accounts Payable	(18,510)	-	(827)	(237,363)	-	**(256,700)**
Less: Spending Authority Adjustments	(6,375)	-	(75)	82,925	-	**76,475**
Outlays						
Disbursements	288,393	1,162,955	6,417	1,429,966	5,340	**2,893,071**
Collections	(135,773)	-	(305)	(1,661,048)	-	**(1,797,126)**
Net Outlays before Offsetting Receipts	152,620	1,162,955	6,112	(231,082)	5,340	**1,095,945**
Less: Offsetting Receipts	-	(1,162,955)	-	-	(264,213)	**(1,427,168)**
Net Outlays	$ 152,620	$ -	$ 6,112	$ (231,082)	$ (258,873)	**$ (331,223)**

Department of the Interior
Minerals Management Service
Combining Statement of Budgetary Resources
For the year ended September 30, 2003
(dollars in thousands)

	Royalty and Offshore Minerals Management	Mineral Leasing	Oil Spill Research	Interior Franchise Fund	Other	2003
Budgetary Resources:						
Budget Authority:						
Appropriations Received	$ 165,321	$ 947,006	$ 6,105	$ -	$ 6,262	**$ 1,124,694**
Unobligated Balance:						
Beginning of Period	9,816	-	9	13	-	**9,838**
Transfer In of the Interior Franchise Fund Operations, Beginning of Period	-	-	-	378,443	-	**378,443**
Spending Authority From Offsetting Collections:						
Earned						
Collected	125,170	-	178	2,037,822	-	**2,163,170**
Receivable from Federal Sources	(319)	-	(19)	(118,682)	-	**(119,020)**
Change in Unfilled Customer Orders						
Advance Received	(575)	-	(30)	499,680	-	**499,075**
Without Advance from Federal Sources	(3,139)	-	71	(186,789)	-	**(189,857)**
Recoveries of Prior Year Obligations	7,124	-	6	-	-	**7,130**
Permanently not Available	(2,118)	-	(40)	-	-	**(2,158)**
Total Budgetary Resources	$ 301,280	$ 947,006	$ 6,280	$ 2,610,487	$ 6,262	**$ 3,871,315**
Status of Budgetary Resources:						
Obligations Incurred:						
Direct (Category B)	$ 165,065	$ 947,006	$ 5,958	$ -	$ 6,262	**$ 1,124,291**
Reimbursable (Category B)	125,096	-	200	1,889,943	-	**2,015,239**
Total Obligations Incurred	290,161	947,006	6,158	1,889,943	6,262	**3,139,530**
Unobligated Balance:						
Apportioned	9,876	-	122	720,544	-	**730,542**
Unobligated Balance not Available	1,243	-	-	-	-	**1,243**
Total Status of Budgetary Resources	$ 301,280	$ 947,006	$ 6,280	$ 2,610,487	$ 6,262	**$ 3,871,315**
Relationship of Obligations to Outlays:						
Obligations Incurred	$ 290,161	$ 947,006	$ 6,158	$ 1,889,943	$ 6,262	**$ 3,139,530**
Obligated Balance, Net, Beginning of Period	77,844	-	6,251	175	-	**84,270**
Transfer In of the IFF Operations, Obligated Balance, Net Beginning of Period	-	-	-	48,799		**48,799**
Obligated Balance, Net, End of Period:						
Accounts Receivable	222	-	11	23,420	-	**23,653**
Unfilled Customer Orders from Federal Sources	1,215	-	71	243,308	-	**244,594**
Undelivered Orders	(63,385)	-	(5,065)	(416,358)	-	**(484,808)**
Accounts Payable	(17,570)	-	(855)	(292,378)	-	**(310,803)**
Less: Spending Authority Adjustments	(3,666)	-	(58)	305,471	-	**301,747**
Outlays						
Disbursements	284,821	947,006	6,513	1,802,380	6,262	**3,046,982**
Collections	(124,595)	-	(148)	(2,537,502)	-	**(2,662,245)**
Net Outlays before Offsetting Receipts	160,226	947,006	6,365	(735,122)	6,262	**384,737**
Less: Offsetting Receipts	-	(947,006)	-	-	(244,013)	**(1,191,019)**
Net Outlays	$ 160,226	$ -	$ 6,365	$ (735,122)	$ (237,751)	**$ (806,282)**

Interior Franchise Fund

The Interior Franchise Fund (IFF) comprises two business entities – GovWorks and US Films. GovWorks (MMS Herndon, VA) provides full life cycle procurement services to DoD and the Civilian Agencies through a staff of Federal contracting officers and support staff. In FY 2004, DoD and the military service branches accounted for $917.2 million (56.8%) and $792.6 million (57.9%) in FY 2003, while the Civilian Agencies represented $697.5 million (43.2%) in FY 2004 and $576.2 million (42.1%) in FY 2003. The client base includes the Executive Office of the President totaling $157.9 million (9.8%) and the Department of Defense at $296.3 million (18.4%) in FY 2004 and $298.8 million (22%) and $555.9 million (40%) respectively in FY 2003.

US Films (MMS Denver, CO) offers video production, copywriting, creative development, and production management. Still photos, digital video, and graphics coupled with occasional editing and audio engineering complete the product offering. US Films also bundles video production and printing through a government owned contractor operation, producing integrated training packages for a broad range of clients – but primarily Civilian agencies. Total revenue for FY 2004 and FY 2003 was $1,700 thousand and $1,472 thousand, respectively. The major clients for FY 2004 include US Army at $842 thousand (50%) and Department of the Interior at $320 thousand (19%). Major clients for FY 2003 include the FDA at $350 thousand (18%), TSA at $100 thousand, and DOI's Office of Law Enforcement at $75 thousand.

Interior Franchise Fund (dollars in thousands)	**2004**	**2003**
Fund Balance with Treasury	$1,393,632	$1,162,551
Accounts and Interest Receivable, Net	6,662	21,849
Advances and Prepayments	1,285	-
Total Assets	$1,401,579	$1,184,400
Accounts Payable	236,881	292,065
Accrued Payroll and Benefits	487	316
Advances and Deferred Revenue	1,136,987	872,480
Net Position	27,224	19,539
Total Liabilities and Net Position	$1,401,579	$1,184,400

As authorized by the Government Management Reform Act (GMRA), which allows the use of retained funds for the improvement and implementation of Department financial management, the Interior Franchise Fund transferred $11 million to the Department to meet the implementation costs of the Financial and Business Management System and the Enterprise Services Network. This transfer resulted in an $11 million dollar decrease to IFF net position that is not reflected in the net costs of operations.

Summary of Interior Franchise Fund Business Lines
For the year ending September, 2004
(dollars in thousands)

	Full Cost of Goods and Services Provided	Related Exchange Revenue	Excess of Exchange Revenues Over Full Cost
U.S. Films and Video Productions	$1,700	($1,700)	$-
GovWorks Acquisition Services	1,330,907	(1,349,056)	(18,149)
Total	$1,332,607	($1,350,756)	($18,149)

Summary of Interior Franchise Fund Business Lines
For the year ending September 30, 2003
(dollars in thousands)

	Full Cost of Goods and Services Provided	Related Exchange Revenue	Excess of Exchange Revenues Over Full Cost
U.S. Films and Video Productions	$1,472	($1,472)	$-
GovWorks Acquisition Services	1,119,461	(1,136,973)	(17,512)
Total	$1,120,933	($1,138,445)	($17,512)

Required Supplementary Stewardship Information

(Unaudited, see accompanying auditors' report)

Museum Collections

The Minerals Management Service maintains a collection of 54 objects in its administrative offices at five bureau locations (table below). There were no accessions or deaccessions during the year. The current museum collection consists of 4 Art, 3 Ethnography, 5 History, 12 Documents, and 30 Geology items. The collection is fully documented and is in good condition.

FY 2004 Status of Cataloging and Condition of Cataloged Museum Collections								
Total Collection Size FY 2003	Additions Since Last Report	Withdrawals Since Last Report	Total Collection Size FY 2004	Total Number of Museum Items Cataloged	Number of Catalogued Items with Item-Level Condition Data	Number of Catalogued Items in Good, Fair, & Poor Condition		
						Good	Fair	Poor
54	-	-	54	54	54	100%		

MMS Identification and Cataloging of Collection					
	FY 2000	**FY 2001**	**FY 2002**	**FY 2003**	**FY 2004**
Total Museum Collection Size (estimates)	54	54	54	54	54
Number of items cataloged	54	54	54	54	54

Investment in Research and Development:

Environmental studies and operational requirements for the leasing and development of natural gas and oil are mandated by the OCS Lands Act (OCSLA). Research in support of these mandates has been pursued to allow prediction of potential impacts, aid in development of mitigating measures, and to ensure safe, pollution-free operations. In addition to research as required by the OCSLA, the Oil Pollution Act (OPA) of 1990 sets down specific areas of research for agencies, including MMS. The goal of the Act is to improve not only the technologies for preventing oil pollution, but also the response to accidental spills. Inherent in this effort is improvement of our understanding of the fate, transport, and effects of oil when spilled. The MMS research program, which implements the OCSLA and OPA requirements, is pursued with universities, private companies, and Government laboratories, US and foreign.

Significant accomplishments during Fiscal Year 2004 include:

Arctic Nearshore Impact Monitoring in the Development Area (ANIMIDA). This five-year program was undertaken to provide MMS managers with information needed for environmentally sound decision-making with the exploration, development, and production of offshore oil and gas in the Alaskan Beaufort Sea. Study results completed during FY 2004 provide data on: hydrocarbon chemistry of sediments and biota (clams and amphipods); the sources, concentrations, composition, and dispersion pathways for suspended sediment in the coastal Beaufort Sea; amount of daily and annual productivity of the Steffanson Sound "Boulder Patch" which supports the only known kelp bed on the Alaskan arctic coast; bioaccumulation of trace substances, including contaminants resulting from human activities in five species of fish; and an assessment of subsistence whaling at Cross Island. This monitoring information provides MMS with an adaptive management tool for continually improving offshore leasing and lease management policies and practices as offshore oil and gas activities proceed in the Beaufort Sea.

Environmental Justice Considerations in Lafourche Parish, Louisiana. Results of this study, completed during FY 2004, provide MMS with a characterization of environmental justice and the potential hazards and impacts of Outer Continental Shelf (OCS)-related oil and gas extraction, transport, and processing in Lafourche Parish, Louisiana, a principal land-based supply center for the majority of the offshore oil and gas activity occurring in the Gulf of Mexico. The MMS, like all other federal agencies, must identify any disproportionate impacts of its activities on minority and/or low-income populations. The information provided by this project is used by MMS in Environmental Impact Statements (EIS) that seek to identify adverse environmental impacts that must be assessed in response to Executive Order 12898 (59 FR 7629). Using GIS techniques to integrate OCS-related activities, census data, and digital transportation data, the potential geographic and demographic impacts of OCS-related hazards on minority and low-income populations have been identified. These data provide MMS with a more rigorous empirical analysis.

Investment in Research and Development (in millions)					
	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004
	MMS/OMM	MMS/OMM	MMS/OMM	MMS/OMM	MMS/OMM
Applied	$30.7	$31.0	$28.5	$29.4	$29.3
Total R&D Investment	$30.7	$31.0	$28.5	$29.4	$29.3

Other Supplementary Information

(See accompanying auditors' report)

Department of the Interior
Minerals Management Service
Consolidating Balance Sheet
As of September 30, 2004
(dollars in thousands)

	Minerals Revenue Management	Offshore Minerals Management	Interior Franchise Fund	Custodial	Environmental	Other	Elimination of Intra Bureau Activity	2004
ASSETS								
Intragovernmental Assets:								
Administrative Fund Balance	$ 38,788	$ 68,546	$ 1,393,632	$ -	$ -	$ 596	$ -	**$ 1,501,562**
Restricted Fund Balance	-	-	-	-	2	-	-	**2**
Custodial Fund Balance	-	-	-	1	-	-	-	**1**
Fund Balance with Treasury	38,788	68,546	1,393,632	1	2	596	-	**1,501,565**
Restricted Treasury Securities	-	-	-	-	1,001,652	-	-	**1,001,652**
Custodial Treasury Securities	-	-	-	27,767	-	-	-	**27,767**
Investments, Net	-	-	-	27,767	1,001,652	-	-	**1,029,419**
Custodial Accounts Receivable	-	-	-	289,150	-	-	-	**289,150**
Administrative Accounts Receivable	-	-	6,370	-	-	541	(1,071)	**5,840**
Accounts and Interest Receivable, Net	-	-	6,370	289,150	-	541	(1,071)	**294,990**
Other:								
Advances and Prepayments	12	19	1,283	-	-	-	(31)	**1,283**
Total Intragovernmental Assets	38,800	68,565	1,401,285	316,918	1,001,654	1,137	(1,102)	**2,827,257**
Custodial Accounts and Interest Receivable	-	-	-	734,781	-	-	-	**734,781**
Administrative Accounts Receivable	412,887	76	292	-	-	-	-	**413,255**
Accounts and Interest Receivable, Net	412,887	76	292	734,781	-	-	-	**1,148,036**
Property & Equipment, Net of Accumulated Depreciation	29,606	2,452	-	-	-	-	-	**32,058**
Other:								
Travel Advances	-	1	2	-	-	-	-	**3**
Total Public Assets	442,493	2,529	294	734,781	-	-	-	**1,180,097**
TOTAL ASSETS	$ 481,293	$ 71,094	$ 1,401,579	$ 1,051,699	$ 1,001,654	$ 1,137	$ (1,102)	**$ 4,007,354**

Department of the Interior
Minerals Management Service
Consolidating Balance Sheet
As of September 30, 2004
(dollars in thousands)

	Minerals Revenue Management	Offshore Minerals Management	Interior Franchise Fund	Custodial	Environmental	Other	Elimination of Intra Bureau Activity	2004
LIABILITIES								
Intragovernmental Liabilities:								
Administrative Accounts Payable	$ 153	$ 2,960	$ 2,821	$ -	$ -	$ 2	$ (1,071)	**$ 4,865**
Other:								
Advances and Deferred Revenue	-	-	1,136,985	-	-	592	(31)	**1,137,546**
Custodial Liability	-	-	-	999,250	-	-	-	**999,250**
Accrued Payroll and Benefits	1,068	1,733	54	-	-	11	-	**2,866**
Total Intragovernmental Liabilities	1,221	4,693	1,139,860	999,250	-	605	(1,102)	**2,144,527**
Public Liabilities:								
Administrative Accounts Payable	3,702	7,378	234,060	-	-	52	-	**245,192**
Federal Employees Compensation Act Liability	3,300	5,411	-	-	-	-	-	**8,711**
Accounts Payable	7,002	12,789	234,060	-	-	52	-	**253,903**
Other:								
Contingent Liabilities	208,340	341,660	-	-	-	-	-	**550,000**
Liabilities to States	412,881	-	-	-	-	-	-	**412,881**
Deferred Credits	6,985	216	-	27,768	-	27	-	**34,996**
Custodial Liability	-	-	-	24,681	-	-	-	**24,681**
Accrued Payroll and Benefits	5,997	9,804	433	-	-	64	-	**16,298**
Advances and Deferred Revenue	-	-	2	-	-	389	-	**391**
Captial Lease Liability	28	46	-	-	-	-	-	**74**
Total Public Liabilities	641,233	364,515	234,495	52,449	-	532	-	**1,293,224**
TOTAL LIABILITIES	642,454	369,208	1,374,355	1,051,699	-	1,137	(1,102)	**3,437,751**
Commitments and Contingencies								
Net Position								
Unexpended Appropriations	3,931	3,519	-	-	-	-	-	**7,450**
Cumulative Results of Operations:								
Administrative Cumulative Results of Operations	(165,092)	(301,633)	27,224	-	-	-	-	**(439,501)**
EIRF Cumulative Results of Operations	-	-	-	-	1,001,654	-	-	**1,001,654**
Total Cumulative Results of Operations	(165,092)	(301,633)	27,224	-	1,001,654	-	-	**562,153**
Total Net Position	(161,161)	(298,114)	27,224	-	1,001,654	-	-	**569,603**
TOTAL LIABILITIES AND NET POSITION	$ 481,293	$ 71,094	$ 1,401,579	$ 1,051,699	$ 1,001,654	$ 1,137	$ (1,102)	**$ 4,007,354**

Department of the Interior
Minerals Management Service
Consolidating Balance Sheet
As of September 30, 2003
(dollars in thousands)

	Minerals Revenue Management	Offshore Minerals Management	Interior Franchise Fund	Custodial	Environmental	Other	Elimination of Intra Bureau Activity	2003
ASSETS								
Intragovernmental Assets:								
Administrative Fund Balance	$ 36,478	$ 59,537	$ 1,162,551	$ -	$ -	$ 595	$ -	**$ 1,259,161**
Restricted Fund Balance	-	-	-	-	1	-	-	**1**
Custodial Fund Balance	-	-	-	437	-	-	-	**437**
Fund Balance with Treasury	36,478	59,537	1,162,551	437	1	595	-	**1,259,599**
Restricted Treasury Securities	-	-	-	-	977,521	-	-	**977,521**
Custodial Treasury Securities	-	-	-	25,073	-	-	-	**25,073**
Investments, Net	-	-	-	25,073	977,521	-	-	**1,002,594**
Custodial Accounts Receivable	-	-	-	194,939	-	-	-	**194,939**
Administrative Accounts Receivable	-	-	21,846	-	-	234	(238)	**21,842**
Accounts and Interest Receivable, Net	-	-	21,846	194,939	-	234	(238)	**216,781**
Other:								
Advances and Prepayments	2	3	-	-	-	-	-	**5**
Total Intragovernmental Assets	36,480	59,540	1,184,397	220,449	977,522	829	(238)	**2,478,979**
Custodial Accounts and Interest Receivable	-	-	-	789,658	-	-	-	**789,658**
Administrative Accounts Receivable	234,453	51	3	-	-	-	-	**234,507**
Accounts and Interest Receivable, Net	234,453	51	3	789,658	-	-	-	**1,024,165**
Property & Equipment, Net of Accumulated Depreciation	33,381	2,979	-	-	-	-	-	**36,360**
Other:								
Travel Advances	3	5	-	-	-	-	-	**8**
Total Public Assets	267,837	3,035	3	789,658	-	-	-	**1,060,533**
TOTAL ASSETS	$ 304,317	$ 62,575	$ 1,184,400	$ 1,010,107	$ 977,522	$ 829	$ (238)	**$ 3,539,512**

Department of the Interior
Minerals Management Service
Consolidating Balance Sheet
As of September 30, 2003
(dollars in thousands)

	Minerals Revenue Management	Offshore Minerals Management	Interior Franchise Fund	Custodial	Environmental	Other	Elimination of Intra Bureau Activity	2003
LIABILITIES								
Intragovernmental Liabilities:								
Administrative Accounts Payable	$ 858	$ 1,536	$ 2,581	$ -	$ -	$ 2	$ (238)	**$ 4,739**
Other:								
Advances and Deferred Revenue	-	-	872,480	-	-	493	-	**872,973**
Custodial Liability	-	-	-	948,605	-	-	-	**948,605**
Accrued Payroll and Benefits	911	1,556	31	-	-	6	-	**2,504**
Total Intragovernmental Liabilities	1,769	3,092	875,092	948,605	-	501	(238)	**1,828,821**
Public Liabilities:								
Administrative Accounts Payable	5,777	6,319	289,484	-	-	225	-	**301,805**
Federal Employees Compensation Act Liability	3,300	6,076	-	-	-	-	-	**9,376**
Accounts Payable	9,077	12,395	289,484	-	-	225	-	**311,181**
Other:								
Contingent Liabilities	193,600	356,400	-	-	-	-	-	**550,000**
Liabilities to States	234,416	-	-	-	-	-	-	**234,416**
Deferred Credits	4	224	-	25,510	-	-	-	**25,738**
Custodial Liability	-	-	-	35,992	-	-	-	**35,992**
Accrued Payroll and Benefits	4,963	8,508	285	-	-	35	-	**13,791**
Advances and Deferred Revenue	-	-	-	-	-	68	-	**68**
Capital Lease Liability	18	33	-	-	-	-	-	**51**
Total Public Liabilities	442,078	377,560	289,769	61,502	-	328	-	**1,171,237**
TOTAL LIABILITIES	443,847	380,652	1,164,861	1,010,107	-	829	(238)	**3,000,058**
Commitments and Contingencies								
Net Position								
Unexpended Appropriations	3,142	3,827	-	-	-	-	-	**6,969**
Cumulative Results of Operations:								
Administrative Cumulative Results of Operations	(142,672)	(321,904)	19,539	-	-	-	-	**(445,037)**
EIRF Cumulative Results of Operations	-	-	-	-	977,522	-	-	**977,522**
Total Cumulative Results of Operations	(142,672)	(321,904)	19,539	-	977,522	-	-	**532,485**
Total Net Position	(139,530)	(318,077)	19,539	-	977,522	-	-	**539,454**
TOTAL LIABILITIES AND NET POSITION	$ 304,317	$ 62,575	$ 1,184,400	$ 1,010,107	$ 977,522	$ 829	$ (238)	**$ 3,539,512**

Independent Auditors' Report

United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20240

February 3, 2005

Memorandum

To: Director, Minerals Management Service

From: Roger La Rouche Kimberly Elmore
for Assistant Inspector General for Audits

Subject: Independent Auditors' Report on the Minerals Management Service's Financial Statements for Fiscal Years 2004 and 2003 (Report No. E-IN-MMS-0055-2004)

We contracted with KPMG LLP (KPMG), an independent certified public accounting firm, to audit the Minerals Management Service's (MMS) financial statements for fiscal years 2004 and 2003. The contract required that KPMG conduct its audit in accordance with the Comptroller General of the United States of America's *Government Auditing Standards*; Office of Management and Budget Bulletin 01-02, as amended, *Audit Requirements for Federal Financial Statements*; and the Government Accountability Office/President's Council on Integrity and Efficiency *Financial Audit Manual.*

In its audit of MMS (Attachment 1), KPMG found that the financial statements were fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles. As discussed in KPMG's report and note 1.1.B to the financial statements the expiration of the Interior Franchise Fund's authorizing legislation on October 1, 2005, creates uncertainty about its ability to continue as a going concern. Also, as discussed in KPMG's report and note 11 to the financial statements, MMS's fiscal year 2004 consolidated statement of net cost is not comparable to its fiscal year 2003 consolidated statement of net cost. This occurred because in fiscal year 2004, MMS revised the presentation of costs and revenues to match the *Government Performance and Results* Act strategic plan applicable to fiscal year 2004, which is different from the plan applicable to fiscal year 2003.

KPMG identified three reportable conditions related to the internal controls over financial reporting and financial operations, the first of which KPMG considers to be a material weakness:

- Controls Over the Year-end Closing Process
- General and Application Controls over Financial Management Systems
- Accounts and Interest Receivable.

1

KPMG also found that MMS's financial management systems did not comply with the *Federal Financial Management Improvement Act of 1996* (FFMIA) because of substantial noncompliance with federal financial management systems requirements. Further, KPMG found instances of noncompliance with the *Prompt Payment Act* and the *Debt Collection Improvement Act of 1996*.

KPMG is responsible for the attached auditors' report and for the conclusions expressed therein. We do not express an opinion on the MMS's financial statements, conclusions on the effectiveness of internal controls, conclusions on whether MMS's financial management systems substantially complied with FFMIA, or conclusions on MMS's compliance with laws and regulations.

In its November 26, 2004 response (Attachment 2), MMS generally concurred with the report's findings and recommendations and indicated corrective actions would be taken. Based on MMS's response, we consider all the recommendations resolved but not implemented. The recommendations will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation.

The legislation, as amended, creating the Office of Inspector General, (5 U.S.C.A. App. 3) requires semiannual reporting to Congress on all audit reports issued, actions taken to implement audit recommendations, and recommendations that have not been implemented. Therefore, this report will be included in our next semiannual report. The distribution of the report is not restricted and copies are available for public inspection.

We appreciate the cooperation and assistance of MMS personnel during the audit. If you have any questions, please contact me at (202) 208-5512.

Attachments (2)

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

Director of the Minerals Management Service and Inspector General
U.S. Department of the Interior:

We have audited the accompanying consolidated balance sheets of Minerals Management Service (MMS) as of September 30, 2004 and 2003, and the related consolidated statements of net cost, consolidated statements of changes in net position, combined statements of budgetary resources, consolidated statements of financing, and statements of custodial activity for the years then ended (hereinafter referred to as the "financial statements"). The objective of our audits was to express an opinion on the fair presentation of these financial statements. In connection with our audits, we also considered MMS's internal control over financial reporting and tested MMS's compliance with certain provisions of applicable laws, regulations, and contracts that could have a direct and material effect on its financial statements.

Summary

As stated in our opinion on the financial statements, we concluded that the MMS's financial statements as of and for the years ended September 30, 2004 and 2003 are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

MMS prepared the accompanying financial statements assuming that the Interior Franchise Fund would continue as a going concern. As discussed in note 1.1.B to the financial statements, the expiration of the Interior Franchise Fund's authorizing legislation on October 1, 2005 creates an uncertainty about MMS's ability to continue as a going concern. Management plans regarding this matter are also described in note 1.1.B. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As discussed in note 11 to the financial statements, MMS's fiscal year 2004 consolidated statement of net cost is not comparable to the fiscal year 2003 consolidated statement of net cost because in fiscal year 2004, MMS revised the presentation of costs and revenues to match the *Government Performance and Results Act* strategic plan applicable to fiscal year 2004, which is different from the plan applicable to fiscal year 2003.

Our consideration of internal control over financial reporting identified the following reportable conditions:

Reportable Conditions that are Considered to be Material Weaknesses:

A. Controls over the Year-end Closing Process

Other Reportable Conditions:

B. General and Application Controls over Financial Management Systems

C. Accounts and Interest Receivable

The results of our tests of compliance with certain provisions of laws, regulations, and contracts disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*:

D. *Prompt Payment Act*

E. *Debt Collection Improvement Act of 1996*

F. *Federal Financial Management Improvement Act of 1996 (FFMIA)*

The following sections discuss our opinion on the financial statements; our consideration of MMS's internal control over financial reporting; our tests of MMS's compliance with certain provisions of applicable laws, regulations, and contracts; and management's and our responsibilities.

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Minerals Management Service as of September 30, 2004 and 2003, and the related consolidated statements of net cost, consolidated statements of changes in net position, combined statements of budgetary resources, consolidated statements of financing, and statements of custodial activity for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of MMS as of September 30, 2004 and 2003, and its net cost, changes in net position, budgetary resources, reconciliation of net cost to budgetary obligations, and custodial activities for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

MMS prepared the accompanying financial statements assuming that the Interior Franchise Fund would continue as a going concern. As discussed in note 1.1.B to the financial statements, the expiration of the Interior Franchise Fund's authorizing legislation on October 1, 2005 creates an uncertainty about MMS's ability to continue as a going concern. Management plans regarding this matter are also described in note 1.1.B. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As discussed in note 11 to the financial statements, MMS's fiscal year 2004 consolidated statement of net cost is not comparable to the fiscal year 2003 consolidated statement of net cost because in fiscal year 2004, MMS revised the presentation of costs and revenues to match the *Government Performance and Results Act* strategic plan applicable to fiscal year 2004, which is different from the plan applicable to fiscal year 2003.

The information in the Management's Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information sections is not a required part of the financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information in the Other Supplementary Information section is presented for purposes of additional analysis of the consolidated balance sheets rather than to present the financial position of MMS's components individually. The consolidating information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

Internal Control over Financial Reporting

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect MMS's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

In our fiscal year 2004 audit, we noted certain matters involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that reportable condition A is a material weakness.

A. Controls over the Year-end Closing Process

MMS needs to improve controls over the recording and reporting of year-end transactions to ensure that transactions are promptly and properly recorded for reliable financial reports, as follows:

1. *Year-end Cash Receipts* – Although MMS had matched approximately $368 million of cash received in September 2004 with the related accounts receivable, MMS incorrectly recorded these cash receipts as custodial revenue rather than as a decrease to accounts receivable. In addition, MMS did not effectively match approximately $22 million of cash received in September 2004 with the related billed accounts receivable, resulting in an overstatement of accounts receivable and custodial activity.

2. *Year-end Lease Sales* – The Bureau of Land Management (BLM), another component of the Department of the Interior, processes royalty lease sales on lands managed by BLM. In accordance with legislation, BLM is required to collect the rents and 20% of the bonuses in the first year of the lease and remit these collections and related lease documentation to MMS. MMS is responsible for collecting the rents, royalties, and 80% of the bonuses in the subsequent years. BLM completed several lease and bonus transactions in September 2004; however, BLM did not provide the royalties and bonuses collected and the related lease documentation to MMS until October 2004, and BLM did not properly record these transactions as a liability to MMS. As a result, MMS's accounts receivable, custodial liabilities, and related custodial activity was understated by approximately $293 million.

As a result of our observations, MMS expended a significant amount of time and resources analyzing and adjusting its fiscal year 2004 financial statements.

Recommendations
We recommend that MMS implement the following recommendations to ensure that year-end transactions are properly recorded in the financial statements:

1. *Year-end Cash Receipts*
   a. Record matched cash receipts as a decrease to the related accounts receivable.
   b. Enhance the cash matching process to verify that all cash receipts are properly matched with the related accounts receivable.
   c. Require supervisors to review and approve the cash receipts reconciliation process and the related general ledger entries. This should include comparing unmatched cash to unmatched receivables to ensure that the matching process was effective and complete.

2. *Year-end Lease Sales*
   a. Meet with BLM to establish controls that ensure BLM provides MMS the rents and bonuses collected and the related lease documentation in a timely manner.
   b. Review rents, bonuses, and the related lease documentation received from BLM after September 30th to identify transactions that should be recorded as of September 30th.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendations.

B. General and Application Controls over Financial Management Systems

MMS does not have adequate information technology controls to protect its financial information systems as required by OMB Circular A-130, *Management of Federal Information Resources*. These conditions could affect MMS's ability to prevent and detect unauthorized changes to financial information, control electronic access to sensitive information, and protect its information resources. Although MMS has improved its application and general controls, MMS needs to continue improving its security and general controls, as discussed below:

1. *Entity-wide Security Program and Planning*

   MMS has a security monitoring and reporting program; however, MMS's security monitoring and reporting process did not include all information systems, platforms, and components. In addition, MMS did not have evidence of recent background investigations readily available for all of the employees sampled. Furthermore, MMS has not finalized the service agreement, which outlines the security responsibilities of each organization, with the National Business Center.

2. *Access Controls*

   MMS does not consistently maintain user access requests forms and does not periodically review user access to ensure that system privileges are commensurate with users' responsibilities and that users do not have duplicate accounts. Additionally, MMS does not consistently remove access of terminated employees from the applications and general support systems timely.

   MMS has not configured the general support system and financial applications to prepare logs for security profile changes; therefore, MMS does not review security profile changes. In addition, MMS does not generate security and activity logs for the financial applications and therefore does not monitor and investigate security violations or inactive accounts. As a result of application limitations, one of MMS's financial applications is not configured to lockout users after a certain number of failed log-on attempts. MMS has documented its physical security program for its operations facility; however, MMS has not finalized and approved the plan.

3. *System Software Controls*

   Controls over the modification of system software change controls should provide reasonable assurance that operating system controls are not compromised. MMS needs to expand the system software policies to include restricting and monitoring access, configuration management, system software problem resolution, emergency system software change procedures, and the approval requirements for system software changes. In addition, MMS does not use an independent library control group to perform system software changes that are migrated to production.

4. *Software Development and Change Controls*

   MMS does not use library management software to control changes to the core financial application or maintain logs of changes that have been moved in and out of the library. In addition, existing system configurations provide individuals who—are involved with programming, testing, and migrating changes to production—access to the source code, test, and production libraries.

5. *Segregation of Duties*

   MMS has not fully segregated royalty transaction error processing responsibilities as individuals responsible for resolving errors may also enter and approve adjustments. Additionally, application programmers have access to the production library.

6. *Service Continuity*

   MMS has not fully documented its service continuity procedures or fully trained team members for emergency response. In addition, MMS does not consistently maintain maintenance agreements and the test results for the un-interrupted power supply. Although MMS recently used offsite tapes to successfully recover data for the core financial application, MMS does not conduct regular testing and does not consistently document the test procedures, expectations, and testing results.

Recommendation
We recommend that MMS develop and implement a formal action plan to improve the general and application controls over its financial management systems. This plan should address each of the areas discussed above, as well as other areas that might impact the information technology control environment, to ensure adequate security and protection of MMS's information systems.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendations.

C. Accounts and Interest Receivable

MMS needs to improve controls over accounts receivable to ensure that transactions are promptly and properly recorded for timely and reliable financial reports:

1. *Royalty Receivables*

   Although MMS has reserved all receivable balances over one-year old and reserved a portion of receivables over six-months old, MMS has aged receivable transactions related to custodial revenues, invoices, bonuses, rents, and other transactions dating back to 1986. During fiscal year 2004, MMS established a plan and allocated resources to analyze and resolve aged receivable transactions. Although MMS made progress in resolving some of the aged receivable transactions, MMS had not resolved approximately $196.6 million of the aged transactions that are substantially reserved.

2. *Debt Collection*

   MMS does not have adequate controls to ensure that they refer eligible receivables that are delinquent to the U.S. Department of the Treasury (Treasury) for collection or offset. MMS was not able to provide evidence indicating that two eligible receivables had been referred to Treasury. In addition, MMS does not consistently reconcile its records with Treasury's records to validate accounts have been referred, or consistently update the status of accounts in its accounting system to indicate that accounts have been referred to Treasury. We determined that 8 of the 32 items tested were listed as referred to U.S. Department of the Treasury; however, these items had not been referred, or had been referred and subsequently returned from the U.S. Department of the Treasury to MMS. Finally, MMS does not refer accounts to the U.S. Department of the Treasury in a timely manner, due to the research required to identify lessees.

3. *Interest*

   Organizations are required to submit royalty payments to MMS by the end of the reporting month and MMS is required to bill for interest on any late payments. As of September 30, 2004, MMS has only billed for interest on late payments through February 2003, except in certain circumstances. As a result, MMS has not billed for an estimated $22 million of interest. In addition, MMS did not consider imputed interest of approximately $21 million when recording lease bonus receivables that are due over the next four years.

Recommendations
We recommend that MMS implement the following procedures to improve controls over receivables:

1. *Royalty Receivables*

   a. Investigate and resolve the aged receivables related to custodial revenues, invoices, bonuses, rents, and other transactions.

   b. Enhance matching processes to minimize the growth of aged receivable transactions.

2. *Debt Collection*

   a. Refer eligible receivables within the established timelines and maintain the related referral documentation.

   b. Update the status of receivables in the accounting system for receivables referred to Treasury and receivables returned from Treasury.

   c. Require a second individual to reconcile MMS's records with Treasury's records to ensure accounts have been referred and to ensure the status of the accounts are properly updated in the accounting system.

d. Accelerate the research process to identify lessees to enable MMS to refer accounts to Treasury in a timely manner.

3. *Interest Billings*

Implement procedures to ensure that interest is calculated and recorded when the financial event occurs.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendations.

We have identified controls over the year-end closing process as a material weakness that MMS did not include in its *Federal Managers' Financial Integrity Act* assurance statement to the Department of the Interior.

A summary of the status of prior year reportable conditions is included as Exhibit I. We also noted other matters involving internal control over financial reporting and its operation that we have reported to the management of MMS in a separate letter dated November 15, 2004.

KPMG

Compliance and Other Matters

Our tests of compliance with certain provisions of laws, regulations, and contracts, as described in the Responsibilities section of this report, exclusive of those referred to in the *Federal Financial Management Improvement Act* (FFMIA), disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, and are described below.

D. ***Prompt Payment Act***

In accordance with the *Prompt Payment Act,* MMS is required to pay interest penalties when payments are late. MMS's accounting system is not properly configured to calculate prompt payment interest. As a result, MMS calculates and pays simple interest rather than the required compounded interest, and uses an incorrect interest rate to calculate and pay prompt payment interest for invoices greater than one month past due. In addition, MMS incorrectly included prompt payment interest on one of 32 disbursements that we tested.

Recommendations
We recommend that in fiscal year 2005, MMS perform the following:

1. Modify the accounting system to calculate prompt payment interest using the appropriate interest rate and using the compound method. If this modification is not cost beneficial, as MMS is in the process of implementing a new accounting system, MMS should consider implementing manual procedures to assess and adjust the prompt payment interest amounts to ensure compliance with the *Prompt Payment Act*.

2. Provide periodic training to personnel responsible for entering the prompt payment information into the accounting system to ensure that they understand the requirements and properly enter information into the accounting system.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendations.

E. ***Debt Collection Improvement Act of 1996***

In accordance with the *Debt Collection Improvement Act of 1996*, MMS is required to refer eligible receivables that are delinquent to the U.S. Department of the Treasury for collection or offset. Eligible receivables include those that are not the subject of litigation, related to foreclosure proceedings, or from organizations in bankruptcy. MMS did not consistently refer receivables that are over 180 days delinquent to the U.S. Department of the Treasury. Interior did not refer 2 of the 32 receivables tested and did not consistently update the referral status of receivables in its accounting system.

Recommendation
We recommend that in fiscal year 2005, MMS establish a process to ensure eligible receivables are referred to the U.S. Department of the Treasury in a timely manner.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendations.

The results of our tests of compliance with certain provisions of other laws and regulations, exclusive of those referred to in FFMIA, disclosed no other instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02.

The results of our tests of FFMIA disclosed instances, described below, where MMS's financial management systems did not substantially comply with Federal financial management systems requirements and the Federal accounting standards. The results of our tests of FFMIA disclosed no instances in which MMS's financial management systems did not substantially comply with the United States Standard General Ledger at the transaction level.

F. *Federal Financial Management Improvement Act of 1996* (FFMIA)

1. *Federal Financial Management System Requirements*

   As discussed in the section of our report entitled "Internal Control over Financial Reporting," MMS needs to improve its EDP security and general control environment. MMS needs to improve its entity-wide security program, increase access controls, strengthen system software controls, improve software change and development controls, fully segregate duties, and enhance its service continuity procedures. As a result, MMS does not substantially comply with the security and general control requirements of OMB Circular A-130, *Management of Federal Information Resources*.

2. *Federal Accounting Standards*

   MMS is required to prepare its financial statements in accordance with Federal accounting standards. As discussed in the section of our report entitled "Internal Control over Financial Reporting," we identified a material weakness that affected MMS's ability to prepare its financial statements in accordance with Federal accounting standards. Specifically, we determined that MMS needs to improve controls over the year-end closing process. As a result of these conditions, MMS did not substantially comply with Federal accounting standards.

Recommendation
We recommend that during fiscal year 2005, MMS perform the following:

1. *Federal Financial Management Systems Requirements*
   Improve the application and general controls over its financial management systems in accordance with requirements set forth in OMB Circular A-130.

2. *Federal Accounting Standards*

   Improve procedures and internal controls to ensure that the financial statements and related disclosures are prepared in accordance with the Federal accounting standards.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendations.

We also noted other matters involving compliance with laws, regulations, and contracts that, under *Government Auditing Standards* and OMB Bulletin No. 01-02, were not required to be included in this report, that we have reported to the management of MMS in a separate letter dated November 15, 2004.

Responsibilities

Management's Responsibilities

The *Government Management Reform Act of 1994* (GMRA) requires each Chief Financial Officer (CFO) Act agency to report annually to Congress on its financial status and any other information needed to fairly present its financial position and results of operations. To assist the Department of the Interior in meeting the GMRA reporting requirements, MMS prepares annual financial statements.

Management is responsible for the financial statements, including:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal controls over financial reporting and preparing the Management's Discussion and Analysis (including the performance measures), Required Supplementary Information, and Required Supplementary Stewardship Information; and
- Complying with laws, regulations, and contracts, including FFMIA.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements, due to error or fraud, may nevertheless occur and not be detected.

Auditors' Responsibilities

Our responsibility is to express an opinion on the fiscal year 2004 and 2003 financial statements of MMS based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall financial statement presentation.

We believe that our audits provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2004 audit, we considered the MMS's internal control over financial reporting by obtaining an understanding of the MMS's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards* and OMB Bulletin No. 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity*

Act of 1982. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. Also, projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate. In addition, our internal control testing may not be sufficient for other purposes. The objective of our audit was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin No. 01-02, we considered the MMS's internal control over Required Supplementary Stewardship Information by obtaining an understanding of the MMS's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. Our procedures were not designed to provide assurance on internal control over Required Supplementary Stewardship Information and, accordingly, we do not provide an opinion thereon.

As further required by OMB Bulletin No. 01-02, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis section, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal control over performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether the MMS's fiscal year 2004 financial statements are free of material misstatement, we performed tests of the MMS's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence and we did not test compliance with all laws, regulations, and contracts applicable to the MMS. Accordingly, noncompliance may occur and not be detected by these tests and such testing may not be sufficient for other purposes. Providing an opinion on compliance with laws, regulations, and contracts was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 01-02 and FFMIA, we are required to report whether MMS's financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

Distribution

This report is intended for the information and use of MMS and the Department of the Interior's management, the Department of the Interior's Office of Inspector General, the U.S. Government Accountability Office, OMB, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 15, 2004, except as to notes 1.1.B and 8, which are as of January 11, 2005

Exhibit I

Minerals Management Service
Summary of the Status of Prior Year Findings
September 30, 2004

Ref	Condition	Status
A	Application and General Controls over Financial Management Systems	This condition has not been corrected and is repeated in fiscal year 2004. See finding B.
B	Transactions and Balances with Trading Partners	This condition has been corrected.
C	Accounts Receivable	This condition has not been corrected and is repeated in fiscal year 2004. See finding C.
D	Customer Orders	This condition has been corrected.
E	*Federal Financial Management Improvement Act of 1996* (FFMIA)	This condition has not been corrected and is repeated in fiscal year 2004. See finding F.

ATTACHMENT 2

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Washington, DC 20240

NOV 2 6 2004

Memorandum

To: Assistant Inspector General for Audits

From: R. M. "Johnnie" Burton
Director

Walter D. Cruickshank
Deputy Director and Chief Financial Officer

Subject: Independent Auditors' Report on the Minerals Management Service's Financial Statements for Fiscal Years 2004 and 2003 (Assignment Number: E-IN-MMS-0055-2004)

Thank you for the opportunity to respond to the independent auditors' (KPMG) report on MMS's financial statements for Fiscal Years 2004 and 2003. We concur with the independent auditors' findings of three reportable conditions, one of which is considered a material weakness, related to internal controls and financial operations. Attached are our specific comments on the identified recommendations.

Please contact Scott L. Mabry at 703-787-1243 if you have any further questions.

Attachment

TAKE PRIDE IN AMERICA

Attachment: Response to Independent Auditor's Report

General Comments

MMS concurs with the independent auditors' findings involving internal control over financial reporting and its operations and provides the following specific comments:

INTERNAL CONTROL OVER FINANCIAL REPORTING

A. **Controls Over the Year-end Closing Process**

MMS concurs that it needs to improve controls over the recording and reporting of year-end transactions to ensure that transactions are promptly and properly recorded for reliable financial reports and will implement these procedures prior to September 30, 2005. MMS identified both of the conditions discussed below and provided detailed support and explanation to KPMG for the necessary adjusting entries. To ensure that transactions related to year-end cash receipts and lease sales are promptly and properly recorded in the future MMS will:

Year-end Cash Receipts

1. Develop a methodology to estimate and record cash receipts anticipated to be matched in the subsequent accounting period, but related to the current accounting period, as a decrease to the related accounts receivable.
2. Include in the above methodology, a process to help ensure that all potential unmatched cash receipts are included as an adjustment to decrease accounts receivable as appropriate.
3. Compare unmatched cash to unmatched receivables to help ensure that the methodology used to estimate subsequent matching events captures matching activity and records it to the correct accounting period.
4. Ensure supervisory review of the above procedures.

Year-end Lease Sales

1. Meet with BLM to establish controls that ensure BLM provides MMS the royalties and bonuses collected and the related lease documentation in a timely manner.
2. Review royalties, bonuses, and the related lease documentation received from BLM after September 30th to identify transactions that should be recorded as of September 30th.

B. **General and Application Controls over Financial Management Systems**

The Office of Management and Budget (OMB) through Circular A-130, Appendix III, *Security of Federal Automated Information Resources,* (A)(2)(a) defines "adequate security" as ensuring security is commensurate with the risk and magnitude of the harm resulting from the loss, misuse, or unauthorized access to or modification of information. This includes assuring that systems and applications used by the agency operate effectively and provide appropriate confidentiality, integrity, and availability, through the use of cost-effective management, personnel, operational, and technical controls.

In order to have adequate security, the OMB Circular A-130, Appendix III requires agencies to:

1. Plan for security;
2. Ensure that appropriate officials are assigned security responsibility;
3. Review the security controls in their information systems; and
4. Authorize system processing prior to operations and periodically thereafter.

For each major application and general support system, the MMS has:

1. Developed a security plan;
2. Assigned security responsibility to an individual;
3. Conducted annual security reviews using the NIST Special Publication 800-26.
4. Authorized the system for operation using the *Department of the Interior Information Technology Certification and Accreditation (C&A) Guide*. The process includes:
    a. Privacy Impact Assessment;
    b. Asset Valuation;
    c. System Security Plan;
    d. Risk Assessment;
    e. System Testing & Evaluation;
    f. Plan of Actions and Milestones.

Certification is a comprehensive evaluation of the technical and non-technical security features and other safeguards of an IT system and establishes the extent to which a particular design and implementation meets documented security requirements. *Accreditation* is the formal declaration by an approving authority that an IT system is compliant with established security requirements and is approved to operate using a prescribed set of safeguards.

NIST SP 800-37 *Guide for Security Certification and Accreditation of Federal Information System* states, "The successful completion of the security certification and accreditation process provides agency officials with the necessary confidence that the information system has adequate security controls, that any vulnerabilities in the system have been considered in the risk-based decision to authorize processing."

The MMS has recently completed the formal Certification and Accreditation process, with associated documentation, to provide evidence of a risk-based methodology that complies with the OMB Circular A-130, Department of the Interior, National Institute of Standards and Technology (NIST) Special Publication (SP) guidance and Federal regulations. This process assures adequate IT system security controls are implemented and tested, risks are assessed, and security plans are maintained.

MMS concurs that there are certain risks and vulnerabilities associated with financial information systems. Specifically:

1. *Entity-wide Security Program and Planning*

    MMS is evaluating its security monitoring and reporting process to ensure that all information systems, platforms and components are included prior to March 31, 2005. In addition, MMS has implemented procedures to ensure that evidence of background investigations is readily available as background investigations are completed. MMS has also finalized and executed a service level agreement outlining the security responsibilities of both MMS and the National Business Center.

2. *Access Controls*

The MMS currently has a process that requires that a system request form be initiated for all new users. Because this is a new process, initiated in 2004, there are instances where employees who have had system access for a number of years did not have request forms on file. MMS has begun a process to identify all users for which we do not have system access forms. After users without system access forms have been identified we will initiate access updates for each user. This process will be completed prior to March 31, 2005.

The MMS performed an analysis of the list of multiple users that KPMG provided and agree that there were certain duplicate active accounts. These have been disabled. Additionally MMS will develop procedures, prior to June 30, 2005, to ensure that user accounts are periodically reviewed, and that duplicate accounts are removed.

The MMS has initiated procedures to ensure the timely revocation of system access at the time of termination. These procedures include notification, at the time of termination, to all system security personnel that an employee has left the organization and should be terminated. MMS is also in the process of developing procedures to perform a complete scrub of user accounts.

To ensure MMS prepares logs of security profile changes, the implementation of NetRat software for collection of logging events is targeted for 12/15/04. MMS is also researching the use of Microsoft's Audit Collection System (ACS) in all program areas. ACS will be configured to consolidate security audit logs for all Windows 2000 and higher servers into a central repository. Additional tools may be needed for network components.

3. *System Software Controls*

MMS has expanded its system software change controls procedures to include all of its current systems. The procedures are being developed so as to include restricting and monitoring access, configuration management, system software problem resolution, emergency system software change procedures, and the approval requirements for system software changes. The target completion date for developing these procedures is June 30, 2005.

4. *Software Development and Change Controls*

As stated MMS does not use Library Management Software to manage changes to the ABACIS application. Because MMS is scheduled to migrate to the FBMS application on 1 October 2005, we feel that it would not be cost beneficial to purchase Library Management Software at this time. To mitigate the risk associated with not using this software we have limited those with change privileges to two individuals. We have also implemented a third level of password for the two individuals involved in making changes to allow the production of a report that shows all changes made by individual. This report of changes is being reviewed monthly by the change management group as described in the configuration management plan.

MMS agrees that programmers have access to the source code, test, and production libraries for the purpose of moving changes through each step of the process from coding to production. However, those involved in testing, do not have access to source code, and those involved in production do not have access to source code or testing. As noted above this condition will be corrected with the implementation of the FBMS application on 1 October, 2005.

5. *Segregation of Duties*

MMS agrees that royalty transaction error processing has not been fully segregated and that implementation of the recommendation would be helpful in enabling management to analyze the decisions made in the error processing process. However, when changes are made to a company's report as a result of an error, a confirmation is provided to the company, thus providing third party verification that the change is correct. Because confirmations are provided to all companies when changes to the companies' reports are made, MMS feels that a full analysis of the risks associated with not segregating the process and the cost benefit of fully segregating the process will need to be performed before changes are made. The analysis will be completed by March 30, 2005, with any requisite changes being made by September 30, 2005.

6. *Service Continuity*

MMS has implemented a training monitoring process to ensure that all team members responsible for service continuity and emergency response procedures are fully trained and that the training is properly documented. In addition, MMS has begun the process of periodically testing its un-interrupted power supply. MMS has also begun the process of testing the recovery, from its offsite data warehouse, of data for its core financial application.

MMS has included the above items on its Plan of Actions and Milestones (POAM) to ensure the improvement of the general and application controls over its financial management systems. The POAM addresses each of the areas discussed above, as well as other areas that might impact the information technology control environment, to ensure adequate security and protection of MMS's information systems.

C. **Accounts and Interest Receivable**

MMS concurs that it needs to improve controls over accounts receivable related to royalties to ensure that transactions are promptly and properly recorded for timely and reliable financial reports:

1. *Royalty Receivables*

As indicated in the Auditor's Report, MMS has made progress in resolving a portion of its aged receivable transactions, but has not resolved approximately $196.6 million of the aged transactions that are substantially reserved for. In 2005 MMS will continue efforts implemented during 2004, with a completion date of September 30, 2005. This will include:

- Dedicating resources to continue its focus on receivables and payments
- The continuation of extensive management oversight
- The implementation of system upgrades to enhance the cash application process
- Finalization of a write-off policy for royalty related receivables
- Management evaluation of compliance bills to identify items for write-off

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2. *Debt Collection*

MMS is developing and implementing controls to ensure that eligible receivables that are delinquent are referred to the U.S. Department of the Treasury (Treasury) for collection or offset. In developing the controls MMS will ensure that support documenting the referral of eligible receivables is maintained, that reconciliations with Treasury are performed to validate the consistency of information between the U.S Department of Treasury and MMS, and to ensure that referrals are performed timely.

3. *Interest*

In 2005 MMS will dedicate adequate resources to ensure that the interest billing process is brought current and all backlogs are eliminated by June 30, 2005. MMS will also analyze the financial statement impact of not imputing interest on its deferred bonus payments, and, if significant, will implement procedures for discounting to net present value long term deferred bonuses.

COMPLIANCE AND OTHER MATTERS

D. ***Prompt Payment Act***

MMS concurs with the finding from a strict compliance definition, although it should be noted that the dollar impact, based on 100% of its transactions, of $3,861 in overpayments and $1,094 of underpayments is inconsequential to MMS's approximately 23,000 payments valued at approximately $1.3 billion dollars. During FY 2004 MMS performed a complete management review of its payment procedures to identify process improvements which would reduce the overall instances of late payments. As a result of the review MMS:

- Implemented tracking procedures to monitor the invoice payment process from invoice receipt to cash disbursement.
- Implemented strict supervisory reviews of invoices received to ensure accurate assignment of payment due dates.
- In July, conducted twelve hours of prompt pay training for all individuals involved in the payment process

MMS will continue to assess its payment process to identify additional opportunities for improvement, but while MMS understands the recommendations provided we do not view them as either practical or cost beneficial in light of the inconsequential value of the errors, ABACIS system limitations, and the expected implementation of a new financial management system on October 1, 2005.

E. ***Debt Collection Improvement Act of 1996***

As noted above MMS is implementing controls with a target completion date of March 31, 2005 to ensure that eligible receivables that are delinquent are referred to the U.S. Department of the Treasury (Treasury) for collection or offset in a timely manner. These procedures will include the updating of data within the accounting system, supervisory review of the reconciliation between MMS's records and Treasury's, dedication of resources to ensure that referral eligible debt is identified timely, and maintenance of referral documentation.

F. ***Federal Financial Management Improvement Act of 1996* (FFMIA)**

1. *Federal Financial Management System Requirements*

MMS has noted the risks and vulnerabilities associated with its financial information systems and have included them in its Plan of Actions and Milestones (POAM). The corrective action plan for each item on the POAM will be developed to fortify entity-wide security, increase access controls, strengthen system software controls, improve software change and development controls, fully segregate duties, and enhance its service continuity procedures.

2. *Federal Accounting Standards*

As noted above MMS is developing procedures and controls over the recording and reporting of year-end transactions to ensure that transactions are promptly and properly recorded for reliable financial reports, and that material weaknesses are corrected. As the non-compliance with federal accounting standards is a direct result of the identification of the material weakness discussed above, MMS will comply with Federal accounting standards when the weakness is corrected.

The Department of the Interior Mission

As the Nation's principal conservation agency, the Department of the Interior has responsibility for most of our nationally owned public lands and natural resources. This includes fostering sound use of our land and water resources; protecting our fish, wildlife, and biological diversity; preserving the environmental and cultural values of our national parks and historical places; and providing for the enjoyment of life through outdoor recreation. The Department assesses our energy and mineral resources and works to ensure that their development is in the best interests of all our people by encouraging stewardship and citizen participation in their care. The Department also has a major responsibility for American Indian reservation communities and for people who live in island territories under U.S. administration.

The Minerals Management Service Mission

As a bureau of the Department of the Interior, the Minerals Management Service's (MMS) primary responsibilities are to manage the mineral resources located on the Nation's Outer Continental Shelf (OCS), collect revenue from the Federal OCS and onshore Federal and Indian lands, and distribute those revenues.

Moreover, in working to meet its responbilities, the **Offshore Minerals Management Program** administers the OCS competitive leasing program and oversees the safe and environmentally sound exploration and production of our Nation's offshore natural gas, oil and other mineral resources. The MMS **Minerals Revenue Management** meets its responsibilities by ensuring the efficient, timely and accurate collection and disbursement of revenue from mineral leasing and production due to Indian tribes and allottees, States and the U.S. Treasury.

The MMS strives to fulfill its responbilities through the general guiding principles of: (1) being responsive to the public's concerns and interests by maintaining a dialogue with all potentially affected parties and (2) carrying out its programs with an emphasis on working to enhance the development and environmental protection.