

RECOMMENDATIONS TO IMPROVE ROYALTY AUDITS

**ROYALTY POLICY COMMITTEE REPORT TO THE
DIRECTOR, MINERALS MANAGEMENT SERVICE**

JUNE 1996

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ROYALTY POLICY COMMITTEE ROSTER

Federal Government Representatives

Robert E. Brown, Minerals Management Service
Kenneth Carfine, Department of the Treasury
Leonard L. Coburn, Department of Energy
William L. Collier, Jr., Bureau of Indian Affairs
Alternates: Dick Wilson
Daniel Deerinwater
Marilyn Rand, Federal Energy Regulatory Commission
W. Hord Tipton, Bureau of Land Management

State Representatives

Johnnie Burton, Wyoming
Alternate: Paul Kruse
Jack Caldwell, Louisiana
Ronald W. Cattany, Western Governors' Association
Don Hoffman, Western Governors' Association
Maurice Lierz, Western States Land Commissioners Association

Indian Tribes and Allottee Associations Representatives

Eddie Jacobs, Oklahoma Indian Minerals Owners Association
David Harrison, Council of Energy Resource Tribes
Thomas H. Shipps, Southern Ute Indian Tribe
Perry Shirley, Navajo Nation
Alan R. Taradash, The Jicarilla Apache Tribe and Shii Shi Keyah
Allottee Association

Industry Representatives

David Blackman, Meridian
Rocky Mountain Oil & Gas Association
Wendy F. Daboval, Texaco
Alternate: George W. Butler, III, Chevron USA
American Petroleum Institute
Darrell Gingerich, Conoco, Inc.
Alternate: Mary J. Stonecipher, Amoco Corporation
Council of Petroleum Accountant Societies
Toni Hennike, Mobil Exploration and Producing U.S.
Alternate: John Sharp, Natural Gas Supply Association

Natural Gas Supply Association
J. Larry Nichols, Devon Energy Corporation
Alternates: Darryl Smette, Devon Energy Corporation
Gary Mcgee, Devon Energy Corporation
Independent Petroleum Association of America
Hugh V. Schaefer, Welbom Sullivan Meek & Tooley, P.C.
Independent Petroleum Association of Mountain States
Edward L. Sullivan, Peabody Holding Co., Inc.
Alternate: Brian McGee
National Mining Association
Steven P. Williams, Enron Oil and Gas Co.
Alternate: Albert L. Modiano, Mid-Continent Oil & Gas
Association
Mid-Continent Oil & Gas Association

PUBLIC REPRESENTATIVES

Sandy Blackstone, Environmental Attorney/Consultant
Ernest E. Smith, University of Texas at Austin

AUDIT SUBCOMMITTEE MEMBERSHIP ROSTER

Indian Representatives

Chairman

Perry Shirley, The Navajo Nation
Kathy Shelhamer, Southern Ute Tribe

State Representatives

Randy Bolles, Wyoming
David Darouse, Louisiana
Ed Dean, New Mexico
David Loomis, Colorado

Industry Representatives

Vice Chairman

Darrell Gingerich, Conoco
Council of Petroleum Accountant Societies
John Clark, Conoco
Council of Petroleum Accountant Societies
Ada Ganze, Exxon
Georgianna Haines, Marathon
Rocky Mountain Oil and Gas Association
Alpheus Moss, Coastal Corporation
Mid-Continent Oil and Gas Association
Tammy Naron
Independent Petroleum Association of America
Sue O'Connell, Hawthorn Oil Company
Independent Petroleum Association of Mountain States
John Quisenberry, Meridian
Rocky Mountain Oil and Gas Association
Ron Spratt, Unocal
American Petroleum Institute
Mary Stonecipher, Amoco
Natural Gas Supply Association
Pam Williams, Shell
Carla Wilson
Rocky Mountain Oil and Gas Association

MMS Representative

Sam Wilson

EXECUTIVE SUMMARY

Background

The Department of the Interior established a Royalty Policy Committee (RPC) in 1995 under the Minerals Management Advisory Board. The RPC's purpose was to provide advice on the Department's management of Federal and Indian mineral leases, revenues, and other minerals-related policies. RPC members represent mineral-producing States, Indian Tribes, and allottee organizations, and minerals industry associations, the general public, and Federal departments.

At its first meeting in September 1995, the RPC established eight subcommittees, including the Audit Subcommittee. The Audit Subcommittee defined as its mission "To make recommendations to the Royalty Policy Committee to improve and streamline the oil and gas audit process." This report, adopted by the RPC at its June 1996, meeting, sets forth those recommendations for consideration by the Director, Minerals Management Service (MMS).

The subcommittee applauds the Director, MMS, and staff of the Royalty Management Program for the July 14, 1995, Director's Policy Memorandum, "Guidelines—Audit Timing and Resource Allocation." This policy memorandum addressed some of the more contentious issues the subcommittee recognized, such as establishment of more current audit periods and audit closure.

Organization

The Audit Subcommittee included 18 representatives from the States, Tribes, and industry, plus one nonvoting representative from the MMS. A quorum of subcommittee voting members was present at each of the three meetings held. Consensus was reached on all recommendations.

Scope of Work

The Audit Subcommittee identified the following four audit-related areas to study for possible improvement:

- Audit Planning and Coordination
- Audit Process
- Audit Closure
- Audit Resources

Subcommittee members addressed each area to determine what actions were necessary to improve and streamline oil and gas audits and what recommendations would be appropriate. This report discusses those recommendations.

The subcommittee extensively discussed such issues as Indian dual accounting, testing and sampling plans, and prior period reporting adjustments but did not make any recommendations. It also discussed and recognized that such unsettled issues as revised Federal and Indian gas valuation regulations, the Royalty Fairness Bill, and budget reductions and downsizing could potentially require reallocations of audit resources. However, since these issues are not finalized, no recommendations were made.

The subcommittee did not address solid mineral audit-related issues because the solid mineral industry did not participate on the subcommittee; therefore, lacking solid mineral representatives, the subcommittee decided that it might be more appropriate for the Coal Subcommittee to address solid mineral audit issues.

Recommendations

Each recommendation is stated below:

Audit Planning and Coordination

- States, Tribes, and MMS should schedule audit planning and coordination meetings, as necessary, until satisfactory implementation of an automated tracking system providing audit organizations with complete planning and tracking data.
- Audit Engagement Letters to companies should provide maximum advance notification of the pending audit. The Engagement Letters should identify each audit participant, the number of auditors, and the date and length of onsite visits.
- The audit Entrance Conference should include, if possible, all audit participants; it should facilitate the company's understanding of the audit process and the gathering of important audit data. At the Entrance Conference, audit organizations and the company should designate audit coordinators and specify their respective duties.

Audit Process

- Auditors should prioritize and customize data requests by using company identifiers and form numbers. They should prepare separate requests for each lease and product. Company responses to data requests should be timely and thorough.
- Auditor Issue Letters should include a cover sheet that highlights pertinent information, and company responses should be timely and thorough. Subsequent enforcement documents should recount results of the Issue Letter process.
- Auditors and auditees should consider work experience and training as important criteria when making personnel assignments in the audit process.
- MMS should initiate audit process training for companies and notify those companies scheduled for audit of the planned training.
- Extrapolation and interpolation techniques, when agreed to by both parties, should be accepted methods for quantifying royalty underpayments and overpayments.
- MMS should improve interpretation of regulations by expanded auditor and payor training and continued use of the MMS Royalty Policy Board as a means of clarifying valuation/audit issues and communicating results of their deliberations through “Dear Payor” letters.

Audit Closure

- MMS should communicate audit closure policy as detailed in the MMS Director’s July 14, 1995, memorandum “Guidelines—Audit Timing and Resource Allocation” to auditors and industry. MMS should enforce that policy.
- The audit coordinator should timely notify auditees upon completion of field work.
- Resident auditors should, at the company’s request, issue an annual Interim Status Letter which would specify the audit period covered, list outstanding data requests, disclose both resolved and unresolved audit findings by issue, and identify any closed issues.

RECOMMENDATIONS FOR IMPROVED AUDIT COORDINATION

Audit Planning and Coordination

Problem: How to improve initial planning and scheduling of audits by using the audit resources of the MMS, States, and Tribes more effectively, better utilize time spent at audit sites, and close audits in the shortest possible time, thereby minimizing the impact on industry's accounting personnel with respect to time and duplication of effort.

Recommendations: MMS, States, and Tribes should schedule planning and coordination meetings as necessary, until satisfactory implementation of an automated tracking system.

Continue to improve the computerized royalty audit tracking system to provide complete planning and tracking data to the audit organizations of MMS, States, and Tribes.

Problem: How to improve the process of notifying companies selected for audit.

Recommendations: MMS, States, and Tribes should send companies an Engagement Letter to ensure that they receive maximum advance notification of scheduled audits and have adequate time to furnish requested information. Include the following in the Engagement Letter:

- Proposed schedule of site visits.
- Participating audit organizations (MMS, States, Tribes).
- Number of auditors involved.
- Estimated length of onsite field work.

Notify companies at least 30 days before beginning onsite field work.

Problem: How to improve Entrance Conferences to enhance the effectiveness of the initial site visit, minimize the impact on accounting personnel of the company under audit, and clarify policies regarding confidentiality.

Recommendations: All audit participants should attend the Entrance Conference. Information disseminated at the Entrance Conference should facilitate the company's understanding of the audit process, what to expect at various stages of the audit, and expected response times for information requests, Issue Letters, and enforcement documents.

Entrance Conference participants should:

- Describe the duties of both the auditors' and the auditees' coordinators.
- Designate appropriate contact personnel for Issue Letters and enforcement documents.
- Discuss confidentiality, including the positions of MMS, States, Tribes, and the company.
- Ensure that the conference facilitates data gathering and provides audit information important to all; for example, include:
 - A review and walkthrough of the company accounting system.
 - Questionnaires.
 - A company profile.
 - Initial data gathering, to include contracts.
 - A property portfolio.

The Expanded Entrance Conference, as described above, is preferred—depending, of course, on the resources, needs, and desires of the audit participants and the company representatives.

Audit Process

Problem: How to encourage auditors and companies to be more responsive to audit data requests.

Recommendations: Auditors should:

- Customize data requests to use the company's identifiers and report form numbers whenever possible.
- Separate data requests by lease and product.
- Prioritize the data requests.
- Promptly confirm back to the company the appropriateness of the data provided.

Companies should:

- Respond thoroughly and timely to each data request.
- Contact the appropriate audit office for clarification and resolution of any questions or concerns.

Problem: How to improve communication in Issue Letters and Demand Letters to elicit more timely responses from companies.

Recommendations: Auditors should:

- Use an Issue Letter cover sheet (see the appendix for an example) that clearly identifies the key elements of the letter, including:
 - Lease(s) involved.
 - Issues.
 - Dollar impact.
 - Due date for response.
 - Name and telephone number of the auditor.
 - Name and telephone number of the auditor's supervisor.

- Acknowledge the company's response to an Issue Letter within 30 days, as the company is requested to respond to the auditor's Issue Letter within 30 days.
- Provide information in the Demand Letter concerning the auditor's position versus the company's response to the Issue Letter. If portions of the original issues were dropped or modified based on information or clarification provided by the company in response to the Issue Letter, clearly state that in the Demand Letter.

Companies should:

- Respond thoroughly and timely to each Issue Letter.
- Contact the appropriate audit office for clarification and resolution of any questions or concerns.

Problem: How to deal with certain levels of inexperience of both the auditors and auditees attributable to lack of training, employee turnover, reorganization, downsizing, reassignment of auditors, etc.

Recommendations: Auditors and auditees should consider work experience and training as important criteria when making audit personnel assignments.

Problem: How to meet the need for more industry training on the audit process.

Recommendations: MMS should initiate audit process training for industry in geographical locations convenient to all companies, including smaller companies.

Make specific notification to companies with scheduled audits.

Problem: How to use extrapolation and interpolation techniques in appropriate circumstances to improve compliance and result in fewer Orders to Perform, with reduced administrative costs.

Recommendations: Extrapolation and interpolation should be accepted methods for quantifying royalty underpayments and overpayments when:

- An error discovered through testing is repetitive.
- The error rate is relatively constant.

- The auditor and the company both agree that the method is reasonable and cost-effective.

Problem: How to reduce the inconsistent interpretation and application of valuation regulations among MMS, States, Tribes, and companies.

Recommendations: Improve interpretation of the regulations by:

- Expanding auditor and payor valuation training.
- Continuing to use the MMS Royalty Policy Board as a means of clarifying valuation/audit issues and communicating the results of the board's deliberations through "Dear Payor" letters.

Additional Audit Process Issues

The subcommittee also extensively discussed several issues for which no recommendations were forthcoming, including the following:

- **Dual accounting on Indian leases.** Indian lease terms, regulations, case law, and policy require that lessees perform dual accounting for certain Indian leases. However, lessees have valid concerns related to access to documents and information necessary to perform dual accounting. The subcommittee understands that MMS's Indian Gas Valuation Rulemaking Committee is thoroughly addressing the issues related to dual accounting.
- **Testing/sampling plans.** Would random sampling or some other form of sampling be better than the judgmental sampling basis now in use? Under MMS's procedures, the sampling basis currently used is the only method that would result in the expected audit coverage.
- **Prior period adjustments.** Could they be handled more efficiently? Could tolerances be added or adjusted? Could a single entry be used to adjust multiple periods? The Audit Subcommittee decided that these are reporting issues and should be addressed by the Reporting Committee or on a case-by-case basis. State representatives reported tolerances are currently used in the audit process.

Audit Closure

Problem: How to complete audits and close audit periods timely to benefit all parties.

Recommendations: MMS should communicate the policy detailed in the July 14, 1995, Director's Policy Memorandum, "Guidelines—Audit Timing and Resource Allocation" to auditors and industry, and enforce the policy.

The audit coordinator should notify the auditee of the field work completion date in a timely manner.

At the company's request, resident auditors should issue an annual Interim Status Letter that includes:

- The audit period covered.
- The outstanding document requests.
- Field work findings by issue.
- Unresolved issues.
- Closed issues.

Audit Resources

The subcommittee recognizes that the following issues could potentially require reallocations of audit resources:

- FedRegNeg—Gas valuation
- IndRegNeg—Gas valuation
- Royalty Fairness Bill
- Unexpected issues
- Property portfolio changes by companies
- Payor liability
- Royalty-in-kind
- Audit delegation to States and Tribes
- Forty percent of MMS auditors on Contract Settlement work
- Auditor early retirements—20- to 30-percent reduction in personnel
- Budget reductions/downsizing
- Systems integration
- Electronic data interchange opportunities

APPENDIX
EXAMPLE OF ISSUE LETTER COVER SHEET

December 1, 1995

The Best Oil Company
Attn: Bob Doe
777 Sunset
Midland, Texas 79701

ISSUE LETTER

RESPONSE DUE 30 DAYS FROM RECEIPT

Reference: Indian Lease: 615-111110-0
Audit Period: January 1, 1991 - December 31, 1994
Findings Control Number - 4-20000

Issue: Compliance with Indian Dual Accounting Requirements

Audit Contact: John Jones 303-681-4000
Audit Supervisor: Mike Smith 303-681-4123

Dollar Impact: \$100,000
or
Order to Perform: Amount Undetermined