THE STATE *OF WYOMING*

DEPARTMENT OF REVENUE

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March 31, 1998

Mr. David Blackmon, Chairman
Royalty Policy Committee
Burlington Resources
801 Cherry, Suite 700
Fort Worth, TX 76102

Dear Mr. Blackmon:

Enclosed, please find the report prepared by the Net Receipts Sharing Subcommittee. This report has been sent directly to the members of the full Royalty Policy Committee for their information.

The subcommittee would be most appreciative if you would place this report on the agenda of the next RPC meeting. It is hoped that the RPC will accept the recommendations made by the subcommittee and will agree to forward such recommendations to the Secretary of Interior for consideration. It is also hoped that if approved by the RPC, a copy of the report would be forwarded to the Secretary of Agriculture for recommendations addressing the U S Forest Service.

Please, let me know if there is any other procedure I need to follow before our next meeting.

Sincerely,

R.M. Johnnie Burton, Chairman
Net Receipts Sharing Subcommittee
Royalty Policy Committee

cc. : RPC Members
Don Gilman, MMS
Mike Miller, MMS

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ROYALTY POLICY COMMITTEE

SUBCOMMITTEE ON

NET RECEIPTS SHARING

MARCH 1998

NET RECEIPTS SHARING SUBCOMMITTEE

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EXECUTIVE SUMMARY

INTRODUCTION

The Department of the Interior (DOI) created in 1995 a Royalty Policy Committee (RPC) to act as an advisory board. In creating the RPC, the Secretary sought advice on the Department's practices, procedures and policies in its administration of Federal and Indian mineral leases. The RPC is comprised of representatives of states, Indian tribes, allottee associations, mineral industry associations, federal agencies and the public. In September 1995, when it first met, the RPC organized itself in a series of subcommittees. Each subcommittee was charged with the study of specific programs. The Subcommittee on Net Receipts Sharing was charged with studying the distribution of mineral royalties, and more specifically the determination and allocation of costs incurred by the Federal government in its administration of federal mineral leases.

SUBCOMMITTEE ON NET RECEIPTS SHARING

The Omnibus Budget Reconciliation Act of 1993 amended the Mineral Lease Act to deduct a portion of onshore leasing program costs from royalties shared with states prior to distribution. Onshore leasing program costs currently being deducted from royalty payments to the states are derived from three sources: 1) the Minerals Management Service, 2) the Bureau of Land Management, and 3) the Forest Service (the Agencies).
The Subcommittee on Net Receipts Sharing (NRS) is made up of representatives from Western States which are most affected by the distribution of royalties collected by the Mineral Management Service (MMS).

CONCERNS WITH THE PRESENT SYSTEM

Although the states are responsible for only 25 percent of onshore leasing costs, the costs charged against the states are not insignificant. From inception through September 1997, **NRS has deducted from the states' share of royalty revenue more than $203 million.** In FY 97 alone, 50 percent of the total costs amounted to $56,752,124; the resulting states' responsibility was initially calculated at $28,376,062. This number was adjusted to $22,033.305 when the lower amounts of the two allocation methods for each state were tallied. Wyoming and New Mexico bear the brunt of this amount: $7,000,000 and $6,000,000 respectively in round numbers for FY 97. Statutorily, states are required to shoulder a portion of the expense to administer the programs; they want to be assured that the costs they do bear are legitimate and justifiable.

The current accounting systems in the Agencies do not provide sufficient documentation that would allow the states to make this determination. Where enough documentation is furnished, the states may not agree with the applicability of costs being passed on to them.

RECOMMENDATIONS

The NRS Subcommittee offers the following recommendations to improve the determination and allocation of costs incurred by the Agencies in their administration of the federal mineral onshore leasing program.

General - Applicable to All Agencies

Refund the overcharges of $8,790,296 quantified by the Inspector General's (IG) office for FY 94 through FY 96 and other, as yet unquantified, amounts once they are properly determined.

Investigate potential overcharges to the states for the periods prior to the IG's examination (i.e., 1992 and 1993), and refund appropriate amounts to the states.

Gather timely and accurate data on employee functions and direct cost expenditures to enable the correct allocation of costs between land categories and among states.

Document and clearly explain all overhead charges. This recommendation is targeting particularly the BLM and USFS.

Establish an additive method of accruing costs with each addition fully explained.

Minerals Management Service

Examine the cost drivers currently in use for allocating costs to the states, e.g. 205 contract amounts are not necessarily indicative of efforts expended by MMS in conjunction with the states.

Examine the cost drivers currently in use for allocating costs to the different land categories, i.e., onshore, offshore, and Indian lands. (MMS is currently addressing this issue.)

Continue to implement the recent change of using a single cost pool to allocate costs to the states under both the cost and revenue methods.

Assume responsibility for verifying the accuracy, appropriateness, and reasonableness of costs passed through by the BLM and FS.

Bureau of Land Management

Remove the costs associated with preleasing activities from net receipts calculations.

Identify and separately account for Indian leasing activities, including only the onshore federal leasing costs in NRS. Calculate and refund any overcharge to the

states for FYs 1992, 1993, 1997 and 1998 as a result of the underestimation of costs to Indian leasing activities.

Allocate support costs to the Indian lease management and the mineral material sales management divisions, in addition to the states. Calculate and refund any overcharge to the states for FYs 1992, 1993, 1997 and 1998 as a result of the misallocation of support costs.

Identify a more equitable cost driver for offices that administer multiple state areas than one dependent upon lease numbers.

Verify the appropriateness of the annual overhead rate.

U. S. Forest Service

Remove the costs associated with preleasing activities from net receipts calculations.

Document Regional Office and Washington Office costs, with only those costs associated with onshore leasing to be included in NRS.

Deduct FS cost allocations from revenue derived solely from Forest Service lands.

Forward a copy of this report and its recommendations concerning the Forest Service to the Secretary of the Department of Agriculture.

INTRODUCTION

GENERAL COMMENTS

The Subcommittee, conscious of budget restrictions, remained in contact mostly by telephone and written communication. The States of Montana and Utah are to be commended for the amount of work and research their representatives did for the benefit of the whole subcommittee.

The Subcommittee's objective was to examine Net Receipts Sharing as implemented by the Omnibus Budget Reconciliation Act of 1992, Title X, Subtitle C, Section 1021. The Act requires:

> 50 percent of the portion of the enacted appropriation of the Department of the Interior and any other agency during the preceding fiscal year allocable to the administration of all laws providing for the leasing of any onshore lands or interest in land owned by the United States for the production of the same types of minerals leasable under this Act or of geothermal steam, and to enforcement of such laws, shall be deducted from the receipts derived under those laws . . .

The Congressional Committee on Energy and Natural Resources' report contains the following language:

> . . . Subtitle C amends the Mineral Leasing Act to provide that 50 percent of the costs to administer the onshore leasing program be deducted from mineral receipts prior to the receipts being distributed to the states. States, therefore are responsible for 25 percent of the administrative costs of the program . . .

The Subcommittee's work was essentially stopped two or three months after work began on this project in 1995 due to some special circumstances. The subcommittee experienced difficulties in obtaining specific information from certain agencies. At that same time, it was learned that a congressional request had been sent to the Inspector General of the Interior Department (IG) and to the General Accounting Office (GAO) for studies that would require the same data the Subcommittee was attempting to obtain. Not wanting to duplicate efforts, the Subcommittee decided to delay its own study until the reports from both federal offices were available.

The report from the GAO was available by end of calendar year 1996. Its focus was the comparison of costs incurred by states in administration of their mineral leases versus costs incurred by federal agencies in administration of their mineral leases. The Subcommittee was disappointed to find that little specific information was included in the report. The Subcommittee found that GAO's conclusion, that the programs could not be compared because they were too dissimilar, was too broad and too general to be useful.

The IG's audit report, dated October 1997 (appendix A), was provided to the Subcommittee in late November. The report found that:

> . . . the cost sharing deductions were computed efficiently and deducted from the state's mineral leasing receipts on a timely basis. However, the methodologies used by the three agencies to determine the amount of cost deductions for fiscal years 1994 through 1996 did not result in an equitable distribution of mineral leasing program costs. Specifically, we found that the three agencies inaccurately identified and allocated certain mineral leasing program and related general administrative costs . . . As a result, the costs of $75.9 million that were deducted from the states' mineral leasing receipts during fiscal years 1994 through 1996 were overstated by $8.8 million, or 11.6 per cent.

The Subcommittee performed its own information gathering and examined the workpapers and conclusions of the IG. The Subcommittee has drawn its own conclusions as a result of that analysis. Its findings and recommendations are stated below.

AGENCY SPECIFICS

Minerals Management Service (MMS) - Department of the Interior

In addition to providing the services relating to mineral production, for which states share revenues and costs through the net receipts sharing process, MMS provides services in conjunction with offshore and Indian geothermal, gas, oil, coal and other solid mineral production. Royalties from offshore production are deposited into the Federal Treasury; only the revenues connected with offshore leases designated as "8G" (within a certain distance from the shore) are shared with coastal states. No costs are passed to the involved states for these "8G" leases. Nor are any costs passed to Indian tribes.

The MMS calculates the costs to be "shared" under two different methods: the *revenue* method and the *cost* method. After allocating costs to states using both methods, MMS deducts from royalty receipts the lesser of the two amounts; the revenue method is used for all states except Wyoming and New Mexico. The allocated costs are then recovered by reducing the affected state's share of monthly royalty revenue prior to distribution.

Revenue Method

The revenue method, in effect prior to 1996, was calculated by making minor adjustments to the previous year's MMS enacted budget. For example, the revenue method used in 1994 resulted in $56,842,000 of MMS costs to be allocated among offshore, onshore and Indian costs pools for FY 95 deductions. The MMS allocated this amount based solely upon the number of producing leases in each of the land categories. This method assumed costs accrue to each producing lease equally and did not correlate actual benefits to actual costs incurred. There are, however, significant differences between onshore and offshore leases. The average offshore lease covers 4,671 acres while the average onshore lease covers 544 acres. The average royalty rate for offshore leases is 16.667 percent

while the average royalty rate for onshore leases is less than 12.5 percent.[1] With a few exceptions,[2] 50 percent of the royalties generated from onshore leases are shared with the producing state while all of the royalty revenue from offshore leases is deposited into the federal treasury.

Allocation by number of producing leases also presupposed that each lease required the same level of attention from MMS in terms of processing production information, reporting and paying royalties, correcting errors, and performing audits. This is not the case. For example, costs were allocated to solid mineral and geothermal leases as if MMS performed the same system maintenance and exception processing procedures on them as were performed on oil and gas leases, when considerably fewer resources were expended in these areas.

Under the new revenue method effective beginning FY 97, MMS costs for indirect activities (divisions) are allocated to direct activities based on the budgeted dollars of each direct activity to the total budgeted dollars of all direct activities. Then, all direct activities are identified as either onshore, offshore or Indian based on the type of work the division performs and applicable workload factors (as explained under the description of the cost method below). In other words, beginning in FY 97, the number of producing leases is not the cost driver for the initial allocation of costs among land categories.

As the agency which deducts NRS costs from federal royalty distributions, after MMS determines its onshore costs under the revenue method, it adds in the mineral leasing costs reported by the Bureau of Land Management and the Forest Service. Under the revenue method, MMS then allocates 50 percent of chargeable costs to the states based upon the percentage of funds disbursed to each state in comparison to the total funds disbursed to all states. The disbursed funds include all types of revenue disbursed by MMS to the states regardless of origin (i.e. BLM or FS lands, oil, gas, solid or geothermal lease, etc.)

Cost Method

Under the cost method, MMS allocates its costs from each operating division among three cost pools based upon land category (i.e., offshore, onshore and Indian) in a variety of ways, depending on the source. of the costs, including number of producing leases and management's best estimate of time spent. After the total onshore cost pool has been determined, the costs are allocated to the states based upon each group's workload emphasis, e.g., the number of leases and number of production and/or correction lines of

[1] DOI has granted royalty rate reductions as low as ½% for stripper oil wells and heavy crude oil, resulting in reduced revenues for all states. In addition, DOI proposes regulations to reduce onshore royalty rates for stripper gas wells (see 61 F.R. 8537).

[2] On acquired lands leases, only 25% is shared and that goes directly to counties, not the states. The State of Alaska receives 90% of royalties collected. The "8G" leases contain the same offshore royalty rate of 16.667%, but only 27% of that amount is shared with the adjacent states of Alabama, California, Louisiana, Mississippi and Texas.

data processed through the system, etc. As discussed above, this presumes all leases benefit equally from all services.

It is to be noted that for implementation in 1997, MMS has changed its procedure so that a single cost pool is used in the revenue method and the cost method, injecting some measure of consistency in the process.

After MMS allocates its costs to each state, it then adds the costs reported by the BLM and FS. The BLM and FS perform their own accumulation of costs and allocation to the states.

Overhead

Overhead costs are an area of special concern, particularly the costs passed from the Washington, D.C. offices of the MMS and the Department of Interior. This concern extends to all three agencies contributing charges to be deducted from royalty revenue. While the Subcommittee understands the inclusion of certain overhead costs in the Agencies' interpretation of the statutory phrase "allocable charges," it contends that not all overhead presently charged would qualify for inclusion in the cost pool.

Bureau of Land Management (BLM) - Department of the Interior

The BLM is the single largest contributor to costs allocated to the states under the Net Receipts Sharing program. The BLM calculates an amount for each state based on the costs budgeted for each state. In particular, those local BLM offices and regional offices that serve multiple states need to be examined for correct allocation between states. This allocation is currently done on the relative number of producing leases for each involved state. This methodology suffers from the same deficiencies noted above for MMS' allocations using number of leases.

The expenditures that make up the costs reported to the MMS by BLM need to be scrutinized. The Subcommittee believes that BLM's methodology of starting with the overall budget and removing those amounts that it can identify as unrelated to state mineral leasing is problematic. Because the BLM does not accurately track some categories of costs, it must rely upon estimations and assumptions about what portion of a certain cost category is related to Indian activities. In fact, the lG's report stated that the BLM "did not accurately estimate its appropriation associated with Indian lease management on the net receipts computation work sheets (page 7)."

As mentioned above, the Subcommittee believes that, based on the data it obtained, there are problems with the overhead charged to the states. Overhead calculations seem arbitrary and in some instances overly high. BLM begins with district and state expenditures, then adds charges for the Washington offices, the Phoenix Training Center, Denver Service Center, Bureau-wide Change-of-Station and Reserve Accounts (support costs). The propriety of allocating such costs is questionable. The question becomes

even more pressing when the Subcommittee found that an additional 18%[3] of the total of all of the above categories, some of which are already considered to be overhead, was added as "overhead;" this appears to be overhead charged on overhead. In the 1998 NRS deductions using 1997 budget amounts, the calculations were as follows:

District & State Appropriations	$43,022,000	59.4%
Washington Office, etc.	18,317,000	25.3%
Additional Overhead (18% of above two)	11,041,000	15.3%
Total Charged to NRS	$72,380,000[4]	100.0%

As demonstrated above, over forty percent (Washington Office and support costs, 25.3% plus additional overhead, 15.3%) of the charges relate to costs incurred outside the states. The Subcommittee finds this unsubstantiated allocation to be an unusually high percentage for overhead costs.

The IG's report noted that the BLM "did not correctly allocate its support costs to the states (page 8)." The BLM allocated the Washington Office and other support costs disproportionately to the states when costs should have also been allocated to the Indian lease management and the mineral material sales management programs.

In summary, the IG determined that the BLM had overcharged the states in all three years audited. The amount of overcharge is included in the $8.8 million total.

Environmental Impact Studies (EIS). These studies, including both environmental impact statements and environmental assessments, serve multiple functions. The Subcommittee concurs that, at most, only costs involved with actual mineral leasing should be passed through. EIS costs are incurred prior to any leasing and often, the land studied does not qualify for mineral leasing. The IG questioned the propriety of including preleasing costs in the net receipts formula. The IG report states, EIS are completed before the land is leased; leasing may never occur in areas that the EIS consider unsuitable for mineral operations.

U.S. Forest Service (FS) - Department of Agriculture

While the FS adds the least amount to the Net Receipts Sharing pool, it is not an inconsequential amount. States were charged $15 million, $12 million and initially $10.5 million respectively for FY 94, FY 95 and FY 96. These amounts were all based upon appropriations and estimates. The total was allocated based on each state's respective percentage of national forest acreage less national less wilderness and recreation area

[3] The BLM used 19% prior to FY 97, but did change to the lower number in response to the IG's findings.

[4] The BLM also included a credit of $852,125 in filing fees in the NRS formula, which results in a net pass through of $71.5 million. However, the Subcommittee could not identify to which of the other elements this credit would attach and found that it would result in only a minor adjustment. For example, if the credit was taken against the District and State Appropriations, that percentage would be reduced from 59.4% to 59%.

acreages. This methodology is problematic because the total acreage of forest land within a state has no correlation to mineral leasing activity.

For FY 97, FY 98 and the recalculation of FY 96, the FS, when calculating its costs for NRS purposes, begin with individual state and regional office costs. The Subcommittee was unable to obtain specific information on what was included in the regional office costs. The FS then adds to these costs, a percentage of the regional office costs (50.77% for FY 97, 88.77% for FY 98) to represent the Washington Office's share of costs. This percentage does not vary between regions and seems akin to the 40 percent added by the BLM (Washington office and support costs plus additional overhead). No one the Subcommittee contacted at the FS could explain the rationale used to support the Washington Office percentages or explain their inconsistency.

At the Subcommittee's request, the Washington, D.C. FS Office compiled the actual expenditures for FY 96. The actual costs coded to "leasable minerals" by all national forests was only $9.78 million, or $750,000 less than the original costs ($10.53 million) charged to the states. At that time, the FS did report this overcharge to MMS and credit was given to the applicable states in the August and September 1996 deductions.

As with BLM, for the FS, Environmental Impact Studies (EIS) account for a significant portion of the costs charged to states. The Subcommittee has the same concern regarding the FS EIS as it does with the BLM EIS relating to the appropriateness of including these costs. The Regional Office for Region 1 of the Forest Service verified that the bulk of the charges for the region was to conduct such studies.

Congress increased the Forest Service's mineral budget to cover the costs of these EIS, and the Washington office developed a national schedule for their completion with the first priority going to those areas with the highest production potential. However, it is the Subcommittee's understanding that every National Forest must complete an EIS on all acreage under their jurisdiction, regardless of the possible production potential.

In its work, the Subcommittee obtained detailed information from only one National Forest. On that forest, the EIS covered approximately one million acres; of this total, 60 percent will probably be classified as leasable but with very high stipulations, such as "no surface occupancy" and requiring the cooperation of adjacent landowners before any drilling can occur; only 2.5% of the entire forest will be available under standard leasing terms. Because of these restrictions, the Resource Officer for the Forest estimated that less than 10 percent of the acreage would ever be leased and much of that for exploration or speculative purposes only. There is a very high possibility that actual production from this Forest may never occur.

However, the FS is to be congratulated for voluntarily changing its method of reporting costs for NRS. For FY 97, the FS based its pass-through costs on the actual FY 96 expenditures, not on budgeted appropriations, for the individual state and regional offices. The states were charged slightly more than $7.3 million, a substantial reduction from the previous three years.

RECOMMENDATIONS

The NRS Subcommittee offers the following recommendations to improve the determination and allocation of costs incurred by the Agencies in their administration of the federal mineral onshore leasing program.

General - Applicable to All Agencies

Refund the overcharges of $8,790,296 quantified by the Inspector General's office for FY 94 through FY 96 and other, as yet unquantified, amounts once they are properly determined.

The overcharges identified by the IG were the result of several errors and incorrect assumptions. The Subcommittee reviewed the workpapers prepared by the IG for its report and will address each agency's portion of the overcharges in this report.

For MMS, the major problem was the method used to determine the revenue cost pool and the subsequent allocation of this pool based on lease numbers. The workpapers documented that MMS was aware, at least as early as 1995, that its methodology of allocating costs based on the number of leases was faulty. In addition, the MMS peer review group conducted a study in 1995 and advocated changing from two costs pools[5] to a single cost calculation. Nevertheless, MMS chose to continue using two cost pools for both 1995 and 1996. If MMS had followed the recommendations for 1995 and 1996, approximately 90% of the overcharges quantified by the IG would have been avoided.

MMS also had a mathematical error that resulted in a $114,000 overcharge to the states. **The total amount of *MMS overcharges* quantified by the IG for 1994 through 1996 was $7,627,403.**

The IG found that the BLM had overcharged the states because of estimation errors, misallocation of expenses, and an incorrect overhead rate. **The total *BLM overcharge*, quantified by the IG, to the states due to these errors was $1,206.563.** The Subcommittee does not believe the states should be charged for errors for which they had no avenue of discovery or responsibility.

The IG found that after correcting 1996, the FS methodology resulted in an undercharge to the states of $43,670. The IG netted this amount against the MMS and BLM overcharges for a total quantified overcharge to the states of $8,790,296.

[5] The two costs pools resulted in widely varying results. For FY 95, the cost method resulted in costs of $67.2 million and the revenue method was $72.8 million; for FY 96 the cost method was $57.3 million and the revenue method was $70.7 million. From these numbers, it appears that the revenue method guaranteed overcharges to the states. The IG report states, "We determined that the costs pools for the revenue method were overstated and the cost pools for the cost method were generally accurate. . . In our opinion, only one cost pool should have been developed for the program regardless of whether the revenue or cost allocation method was used to determine the cost deductions." As previously stated. most states were charged using the revenue method.

The Subcommittee feels strongly that the amount identified and quantified by the IG should be refunded to the involved states as soon as possible. In addition, the Subcommittee recommends that interest be calculated from the date of overcharges and refunded to the states.

Investigate potential overcharges to the states for the periods prior to the IG's examination (i.e., 1992 and 1993), and refund appropriate amounts to the states.

The IG did not evaluate the years prior to 1994. However, because MMS had used the same methodology with two separate costs pools until 1997, overcharges could have occurred in 1992 and 1993 for the same reasons the IG report itemizes. The Subcommittee recommends that MMS recalculate the NRS deductions for 1992 and 1993 using only the expenses identified in the cost pool and allocating this amount under both the cost and revenue methods. The Subcommittee also recommends that MMS, request the BLM and FS reexamine their reported costs for 1992 and 1993 and refund the overcharged amounts.

Gather timely and accurate data on employee functions and direct cost expenditures to enable the correct allocation of costs between land categories and among states.

The Subcommittee strongly advocates that the costs charged against royalty revenue in the NRS formula should be real costs. BLM and MMS continue to use budgeted/appropriated amounts which may or may not bear any resemblance to actual expenditures. It appears from our own research and that of the GAO and IG that the federal agencies have difficulties in identifying actual costs.

The Subcommittee recommends that the Agencies establish a cost accounting system that gathers timely and accurate information regarding the costs expended for and the time spent by employees on specific functions. The Subcommittee recognizes that there are costs associated with a cost accounting system and further recommends that the cost of developing, implementing and maintaining a cost accounting system be weighed against the benefit gained. If the cost of a new accounting system exceeds the net increase to the states, the states simply should not be charged for the accounting system through Net Receipt Sharing, if the agencies still choose to implement such a system.

Document and clearly explain all overhead.

At this time, none of the three agencies has provided the methodology and documentation supporting their overhead calculations. MMS has provided substantially more information than either the BLM or the FS. However, the MMS information is still insufficient to determine reasonableness. As an example, the states must furnish detailed justification for the overhead included in their 205 contract budget requests; and the usual rate is less than 20%. The Subcommittee believes that the agencies should be held to the same standard of reporting.

Establish an additive method of accruing costs with each addition fully explained.

For BLM and MMS, it appears that each agency calculates the expenses of the mineral leasing program that will be included in the cost pool of the NRS by a netback method that is far from precise. Each agency starts with its bottom line total expense appropriation for the program and subtracts what it feels is not pertinent to the NRS formula. It would be easier for the states to understand what they are being charged, if the agencies started with 100 percent of the direct costs to NRS; and then added any additional costs that can be supported as being relevant. Each addition should be justified and the states should receive an explanation and accounting of what services they are receiving. Currently, the states receive a bottom line number for their monthly deduction and can see the bottom line from each agency but do not know what constitutes that particular number.

In those cases, where an Agency uses budget/appropriation or estimated costs, the Subcommittee recommends that a reconciliation with actually incurred costs be performed at the appropriate time after the close of the fiscal year. Where actual expenditures are lower than appropriations or estimations, the difference be credited to the states in the following year's NRS calculations.

Minerals Management Service

Examine the cost drivers currently in use for allocating costs to the states, e.g. 205 contract amounts are not necessarily indicative of efforts expended by MMS in conjunction with the states.

MMS has examined and changed many of its allocation cost drivers. Some cost drivers still being employed do not reflect the work performed. In particular, the costs of the State and Indian Compliance Division (SICD) are being allocated based upon the face value of the 202/205 contracts. The Subcommittee believes that MMS must find a cost driver that accurately portrays the amount of time that SICD employees actually expend with each state and tribe. The face amount of the contract could be evidence of the costs associated with work the state or tribe completes but is certainly not indicative of the efforts of MMS personnel on behalf of a particular state or tribe.

As stated in the general comments, a costs accounting system that tracks actual employee time and other direct expenses could be beneficial. The Subcommittee hastens to add that the costs and benefits of such a system should be carefully evaluated from a cost/benefit viewpoint before it is instituted (see discussion under general recommendations above).

Examine the cost drivers currently in use for allocating costs to the different land categories, i.e., onshore, offshore, and Indian lands. (MMS is currently addressing this issue.)

MMS is to be commended for the work it is doing on examining and adjusting this category of cost drivers. The Subcommittee would like to request that the states be kept informed of any future changes and the reasons for making them. The Subcommittee recommends that MMS continue to examine, refine and implement changes to the cost drivers to achieve an equitable distribution of costs.

Continue to implement the recent change of using a single cost pool to allocate costs to the states under both the cost and revenue methods.

The Subcommittee believes MMS' recent change is appropriate and should be continued. If MMS had made this change when recommended, a major portion of the past overcharges to the states would have been avoided.

Assume responsibility for verifying the accuracy, appropriateness and reasonableness of costs passed through by the BLM and FS.

Currently the BLM and the FS provide very little documentation of their costs for MMS' use in calculating state deductions. The Subcommittee feels that because MMS is the agency actually withholding funds from the states, it has a responsibility to gain reasonable assurance that the reported costs represent actual costs. For the recently completed FY 98 deductions, a state representative discovered that the BLM had made a $5 million math error; resulting in slightly more than $1 million in overcharges.[6] MMS could have discovered the same problem, had it verified the BLM's report. States should not be put in the position of having to audit the federal government to be sure they are not being overcharged for services.

<u>Bureau of Land Management</u>

Remove the costs associated with preleasing from net receipts calculations.

The IG's report states:

> . . . costs associated with preleasing activities were included in the cost pools of the Bureau of Land Management and the Forest Service for fiscal years for 1994 through 1996. . . Preleasing activities consisted primarily of preparing environmental impact statements and environmental assessments to determine the suitability of an area for mineral leasing operations. The two agencies conducted these evaluations to comply with the environmental protection mandates of the National Environmental Policy Act of 1969 [NEPA]. However, <u>these costs may</u>

[6] Since bringing this error to the attention of both BLM and MMS, the states have been assured that they will receive a reduction in current deductions to the correct amount for FY 98.

not be an allocable cost deduction. . . . Since environmental work is completed before the land is leased and leasing may not occur in areas considered unsuitable for mineral operations. (Emphasis added.)

The Subcommittee members concur that these costs should not be included in the net receipts formula when incurred. NEPA is not mineral leasing legislation. It is an environmental protection law, and as such the states should not have to bear the costs. In addition, the states often disagree with some of the Agencies' judgment calls and even with the data collected by these studies. Rather than promoting the utilization of resources, EIS can actually hinder exploration and production, even when the affected state feels that there are mitigating strategies that the controlling agency refuses to acknowledge. As a result states can lose potential lease revenues and still have to pay, through reduced royalties, for the cost of the EIS.

The Subcommittee recommends that BLM evaluate the multiple uses associated with EIS' (e.g., recreation, grazing, timber, etc.). If it is determined that EIS' attributable to multiple uses have been charged solely to the mineral leasing function, the Subcommittee recommends that BLM calculate and refund the proportion of EIS costs that have benefited other uses of BLM lands and have been charged to the states through NRS since 1992. The Subcommittee further recommends that EIS costs be removed from the NRS formula.

Identify and separately account for Indian leasing activities, including only the onshore federal leasing costs in NRS. Calculate and refund any overcharge to the states for fiscal years 1992, 1993, 1997 and 1998 as a result of the underestimation of costs to Indian leasing activities.

The IG report found that the BLM did not have adequate measures in place to account separately for costs associated with Indian leasing activities. Because of this, the BLM was required to estimate certain costs and its estimates were higher than the actual historical costs incurred, resulting in overcharges to the states (IG Report, page 7). The Subcommittee recommends that BLM immediately institute procedures to correct this deficiency in their accounting system.

The IG quantified the overcharges for 1994-1996. The Subcommittee recommends that BLM evaluate its reported costs for 1992 and 1993 for similar overestimations and issue appropriate refunds; and that BLM quantify the overcharge for 1997 and 1998 and accordingly reduce the current 1998 cost pass-through by this amount.

Allocate support costs to the Indian lease management and the mineral material sales management divisions, in addition to the states. Calculate and refund any overcharge to the states for fiscal years 1992, 1993, 1997 and 1998 as a result of the misallocation of support costs.

The IG report found:

> The [BLM] did not correctly allocate its support costs to the states. Specifically, costs associated with the following areas were allocated primarily to the states: personnel leave surcharge; Bureauwide permanent changes of station; and general administration and operation of the Bureau's National Training Center, National Business Center and Washington Office. Instead, an appropriate share of the these support costs should have been allocated to the program areas of Indian lease management and mineral material sales management. The effect of not allocating costs to the Bureau programs was an overcharge of the costs deductions to the states.

Again, the Subcommittee recommends that the BLM immediately institute procedures to correct this deficiency, quantify the overcharges for 1992, 1993, 1997 and 1998, and reduce the 1998 pass-through amount accordingly.

Identify a more equitable cost driver for offices that administer multiple state areas than one dependent upon lease numbers.

Several BLM state offices (i.e., New Mexico, Montana, Wyoming, and Oregon) administer the mineral leasing function for other states, in addition to their own. For these regional offices, the BLM merely allocates total expenses based upon relative number of producing leases within each state. As stated earlier, this presupposes that all leases require and receive equal attention. This is not the case because of the variety of leases that exist. This method of allocating costs could lead to inequities between the states. The Subcommittee recommends that the BLM determine a more accurate cost driver in these situations. A system based upon actual time spent and actual expenses incurred would be preferable.

Verify the appropriateness of the annual overhead rate.

The BLM did not provide any documentation for the calculation of its overhead rate. However, the IG determined that the 18% rate is correct for the 1994 through 1996 time period and its overcharge calculations were based upon the 18%. The Subcommittee commends BLM for changing to this rate in 1998, but also recommends that the BLM quantify the overcharge for 1992, 1993, 1997 and reduce the 1998 pass-through costs accordingly. The Subcommittee was able to estimate that the overcharge to the states for 1997 was approximately $120,000.

In the future, the Subcommittee recommends that the BLM provide documentation and support for its overhead charges along with its submission of pass-through costs to the MMS and that MMS provide this information to the states.

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Remove the costs associated with preleasing from net receipts calculations.

The Subcommittee found similarities between the preleasing costs incurred by the FS and BLM for environmental impact statements and environmental assessments. Please see the discussion under the BLM on this topic, regard to the Subcommittee's recommendations. The same recommendations apply to the FS.

Document and explain Regional Office and Washington Office costs with only those costs associated with onshore leasing to be included in NRS.

The Subcommittee could not obtain any documentation of the Regional and Washington Office costs. At a minimum, the Subcommittee believes that if the Forest Service is allowed to pass through costs to the states, it must be required to provide information on how the costs are calculated and provide supporting documentation. As noted earlier in this report, the Washington Office costs appear to be a single percentage applied to all regions across the board. It is not apparent to the Subcommittee how this method could possibly equate to actual benefits derived by the regions or states. In addition, the percentage is very high and changes from year to year for no apparent reason (see page 11).

In the future, the Subcommittee recommends that the FS provide documentation and support for its overhead charges along with its submission of pass-through costs to the MMS and that MMS provide this information to the states.

Deduct cost allocations from revenue derived solely from Forest Service lands.

In its investigations of the FS costs, the Subcommittee found that the level of costs bore no relationship to the benefits, if any, derived from mineral leasing on FS lands. From the records that we could obtain, the royalty revenues from FS lands is comparatively minimal.[7]

The Subcommittee recommends that FS costs should only be charged against FS revenue. FS is located in the Department of Agriculture, while BLM and MMS are within the Department of the Interior. This recommendation is in keeping with § 10201 (b)4 of the Omnibus Act governing net receipts sharing. This section basically said that states would not be charged more than they individually received in revenue. Therefore, the Subcommittee recommends that FS deductions be offset against FS royalty revenue separately from the DOI's deductions and revenues.

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[7] Examination of the 1997 figures are illustrative. Per MMS' record of state disbursements, the states received a total of $3,612.603 from Forest Service properties and were charged $1,858,605 through net receipts sharing - a return rate of 1.9. At the same time, the states received $585,794,353 from DOI lands and were charged a total of $19,283,237 by the BLM and MMS - a return rate of 30.4. (These figures do not include royalty revenue derived from acquired lands, which is paid directly to the counties where the lease is physically located.) In addition, some states received substantial net receipts charges without receiving <u>any</u> revenue from Forest Service lands.

Forward a copy of this report and its recommendations concerning the Forest Service to the Secretary of the Department of Agriculture.

The Subcommittee requests that the Secretary of Interior provide a copy of this report to the Secretary of Agriculture as it applies to Forest Service lands.

SUMMARY

The Subcommittee believes and recognizes that progress has been made by the Agencies in responding to the states' concerns regarding the high costs of NRS. However, the states should not be penalized for past errors or incorrect assumptions; nor should the states have to audit the federal government to avoid being overcharged.

As a final note, the Subcommittee wishes to acknowledge that it received good cooperation from the agencies and particularly from MMS. Where the Subcommittee could not obtain data, it believes that this stemmed, not from a lack of cooperation, but rather demonstrated the limitations of each agency's accounting systems and their ability to abstract meaningful data. This has been a concern of the states for many years. Recently passed legislation (FOGRSFA) allows states to assume greater responsibilities with regard to administering Federal royalties, if they are able to demonstrate they can perform such responsibilities at the same or a lesser cost. When virtually no cost accounting system exists at MMS, BLM, or FS, these agencies cannot produce a precise accounting of costs for comparison purposes.