MINERALS MANAGEMENT ADVISORY BOARD
ROYALTY POLICY COMMITTEE
SUMMARY OF MEETING
OCTOBER 22, 2002
SHERATON DENVER WEST HOTEL
LAKEWOOD, COLORADO

The Royalty Policy Committee (RPC) of the Minerals Management Advisory Board convened its fifteenth meeting at the Sheraton Denver West Hotel, 360 Union Boulevard, Lakewood, Colorado, on October 22, 2002. In accordance with Public Law 92-463, the meeting was open to the public.

Members/Alternates Present:

Pary Shofner, Western States Land Commissioners Association; Tammy Naron, Council of Petroleum Accountants Societies; Tom Shipps, Ute Mountain Ute Tribe; Brad Simpson, Western Governors' Association; Gary Paulson, Natural Gas Supply Association; R.M. Johnnie Burton, MMS Director; Hugh Schaefer, Independent Petroleum Association of Mountain States; Perry Shirley, Navajo Nation; Harold Kemp, Wyoming; Ronald Cattany, Western Governors' Association; David Darouse, Louisiana (alternate); Karen Anderson, Southern Ute Tribe; Spencer Reid, Western States Land Commissioners Association; Bill Hartzler, National Mining Association; Roger Good, Independent Petroleum Association of America; Daniel Riemer, American Petroleum Institute (alternate); Alby Modiano, US Oil and Gas Association; Alan Marcum, Oklahoma Independent Petroleum Association; Bill Barger, National Mining Association; Orme Lewis, Public Representative, Hank Banta, Public Representative, (alternate); Charles Mankin, Public Representative.

Other Attendees:

Assistant Secretary for Land and Minerals Management, Rebecca Watson; MMS Deputy Director, Walter Cruickshank; Associate Director for Policy and Management Improvement, George Triebsch; David Izon, John Price, Nancy Messer, Mary Robyn, Ellwood Soderlind, Akhtar Zaman, Brian McGee, T.E Schellinger, Theresa Bayani, Connie Bartram, Charles Roybal, Milt Dial, Pat Kent, Greg Smith, Tim Musil, Todd McCutheon, John Hovanec, Ken Vogel, William Radden-Lesage, Phil Sykora, Paula Neuroth, Kathy Martinez, Merrill Anderson, Dave Hubbard, Scott Ellis, Debbie Gibbs Tschudy, Gary Fields,

Welcome and Opening Remarks:

The Meeting convened at 8:36 a.m. Mr. Perry Shirley welcomed Committee members, presented opening remarks and confirmed the presence of a quorum with 21of 24 voting members present.

Assistant Secretary's Remarks:

Ms. Watson discussed the President's Healthy Forest and Fire Policy initiatives and the President's Energy Plan. She indicated, one of the reasons she wanted to serve in this Administration was to try and make a difference with small rural communities in the west where economic sustainability and stability is directly linked to the natural resources. She discussed the Secretary's philosophy of communication, collaboration, cooperation and service of conservation. She also discussed the criticality of natural gas to the energy plan, the availability of long and short-term supply of natural gas; prospects in the Gulf of Mexico; and highlighted the importance of addressing environmental concerns. She emphasized that the Administration and Secretary Norton are committed to the wise development of natural resources by looking at it in a sustainable way. Interior is trying to find a new way to talk about contentious issues instead of litigation and unproductive dialogue. Questions and answers followed.

Mr. Shipps: My question relates to supply. And in my experience in dealing with the National Petroleum Council, and also with the Department of Energy projections as to supply, there have not been breakouts of gas or oil potential on Indian reservation lands. I notice just in your comments about Montana and the Powder River basin, it's very rare that you are able to obtain a distinction about how much of those resources are available on public lands versus Indian lands. In our discussions with either people on the Hill it would be very helpful to get those statistics. If you could obtain some assistance from the National Petroleum Council to maybe work with the energy and minerals division of Interior to break that out, it would be extremely helpful in our discussions about potential modifications to the Indian Mineral Development Act. Our experience also has indicated that at least in the Rocky Mountain region many Indian tribes are quite interested in exploring the option of development of their minerals. I think with the proper legislative format and a proper regulatory format it would be very beneficial to the Indian country and to the country in terms of its supplies.

Ms. Watson: I'll check into that and see about those statistics. NPC doesn't generate its own statistics. It gets those from other places and then massages them to contractors.

Mr. Shipps: In discussions in the House with the energy bill, we talked about the potential for extending tax credits in Indian country, but there was nobody with any statistics that we could turn to in terms of the Administration to easily build that into the discussions.

Ms. Watson: I'll check with BLM and see what they did as far as reservation minerals.

Director's Remarks:

Ms. Burton began by expressing appreciation to the RPC for its advisory role to MMS regarding mineral production activities. She briefed the Committee on the President's Energy Policy and the new 5-year leasing plan for offshore. She explained that MMS is looking at giving incentives for deepwater (15k to 18k) exploration efforts and working on a rule to help existing shallow shelf leases. Discussions next moved to the progress made in Financial Management and Royalty-In-Kind (RIK). She mentioned that MMS would like to stay with the RIK program and possibly expand it but will first have an outside firm review the function to help make an informed decision.

She next discussed valuation issues and informed the Committee that MMS is reviewing its current rules to reduce the cases involving litigation. She next clarified MMS guidance regarding the statute of limitations making it MMS policy to stand by the seven-year statute. A policy memo was included in handouts. She also discussed the past Committee recommendations on appeals and assured the Committee that MMS will take another look at the recommendations. Questions and answers followed.

Ms. Naron: I would like to offer the offshore committee of IPAA as a resource for your staff as they develop that proposed rule for deep drilling on the shelf incentive. The Revenue Committee of COPAS focuses primarily on Federal valuation issues. As a producer involved in the RIK program, I could tell you that I applaud your staff in the changes that have been made in the last six to twelve months regarding the program. I'm glad to hear you have a policy memo on the statute of limitations, and I look forward to reading it.

Ms. Burton: Thank you very much for your comments and your help offer, we'll probably take you up on it.

Charter/Bylaw Discussion:

Mr. Hugh Schaefer highlighted the changes made to the Minerals Management Advisory Board charter and the RPC charter. The change to the RPC charter was on page 2, under description of discretionary members. "May possess knowledge of the mineral and the energy industry" has been added to last sentence. Based on these minor revisions I recommend we adopt the bylaws that we've used the past two years as our bylaws for the next two years. Mr. Cattany seconded the motion.

Vote: 21 in favor. 0 opposing. 0 abstaining. Motion carried.

Approval of Minutes:

Mr. Shirley asked for a motion to accept the minutes. Mr. Cattany moved to adopt the minutes as written. Mr. Simpson seconded the motion.

Vote: 20 in favor. 0 opposing. 1 abstaining. Motion carried.

Election of Parliamentarian:

Mr. Shirley discussed the Parliamentarian election process conducted at the March 12, 2002, Las Vegas meeting. Hugh Schaefer was unanimously elected for another two-year term but was not present to accept or decline the offer. Mr. Schaefer informed the Committee that he is retiring at the end of the year from his law practice. Mr. Schaefer offered to serve as acting parliamentarian if the committee had no objection. A parliamentarian election can be scheduled for the next RPC meeting. Mr. Cattany recommended the Committee accept Mr. Schaefer's proposal. Mr. Shirley agreed with the recommendation.

Financial Management Update:

Mr. Phil Sykora summarized the events that led to the Internet shutdown. He emphasized that reconnection to States and Tribes is awaiting site visits by the special master. He discussed impacts of the shutdown, systems problems and backlogs that delayed the development, testing and implementation of other modules including our exception processing and production reporting modules. He explained the distribution and disbursement procedures used during the shutdown and discussed system development plans and priorities to help MMS get back to normal processing.

Ms. Paula Neuroth and Kathy Martinez briefed the Committee on financial management recovery efforts and provided detailed handouts. They discussed functionality successes since the system came back online in November and discussed the remaining areas that required further work. All system issues have been identified and are on a priority list to work. The current error rate is 3.5 to 4 percent down significantly from 34 percent in November. They emphasized to the Committee that much progress has been realized in reducing royalty error rates and were optimistic the problems would be corrected in the short term. Question and answers followed.

Ms. Narron: I assume that interest will be due only from the date from which the original report was submitted.

Ms. Neuroth: Correct. Basically, we have no royalty backlogs. We're up to date. Everything that is received each day is processed. Most system issues on reference data and royalty have been identified, documented, and will be worked.

Mr. Shipps: At our last meeting, there was some discussion about the practice of MMS to send out courtesy notices when delay rentals were going to be paid. And as a result of the system closing down, those courtesy notices were not sent. Independents that might have relied upon those notices may have missed their delay rental payments. There may have been some issues about the continuing validity of leases. Has that issue been resolved? And if so, how?

Ms. Neuroth: Notices did not go out for the time period we were down. They were for rental payments due in the month of February, March and April. Many companies went ahead and made their rental payments. I have not received phone calls from industry saying I know I didn't make my rental payment. What do I need to do. So, I guess I'm not convinced that it's a major issue at this point.

Ms. Burton: We will apprise BLM of the issue because they have to decide what to do with those leases. The notices that industry receives are courtesy notices. They are supposed to pay their rentals when due. BLM will have to make a policy decision. We will work on the issue.

Mr. Modiano: Is it possible when you go back and ask BLM about the lease status it could be put into the minutes of this group?

Ms. Burton: I've talked to BLM. I don't know how they will resolve the issue. But if I have a firm response from them we wouldn't have any problem sending you some information.

Mr. Sykora: One of the exception processing modules that we have just implemented, Financial Terms Module, will help us identify these situations. Currently, payments are being matched with reports by the system and also manually by staff.

Mr. Simpson: You said all monies have been distributed. Does that mean that everything is out of the error files, out of suspense and distributed to the states and the tribes correctly?

Ms. Martinez: At any point in time, regardless of what day of the month it is, I will always have some working inventory. As of September 30th, my working inventory was at least a billion dollars. If you recall, Paula mentioned an issue where we are not able to load the system with new leases. If I don't have a lease, I don't have lease terms, I don't have reference data that tells me who owns the lease, how to share those monies. Almost 800 million of that billion is due to OCS lease sales that occurred last year. The money is collected, deposited, and sitting at Treasury. If we move the money then we stand the likelihood of the auditors accusing us of circumventing our internal controls. Because the bulk of that money is OCS lease revenue we're letting it sit until we get that issue addressed.

Mr. Simpson: Can the system now bill interest on audit deficiencies?

Ms. Neuroth: The automated system does have an interest calculation module in it but it is not implemented. What Kathy is distributing every month is cash in hand. If someone pays late and we should have billed interest on that late payment, we have not done that. That module probably will not be up until early 2003.

Mr. Simpson: What's the time frame on getting county level EOP reports? Most of our county levels close out their books at the end of December. They can't carry on to the next year. I was hoping it would be very soon

Ms. Martinez: It is the number one priority in the accounts payable list.

Ms. Naron: I assume that overpayment credits is not working? Last time we met, we talked about that payments were sent to Harbinger, your electronic receiver, but they were not transferred to the MMS on that same date.

Ms. Martinez: The entire interest calculation program is still in test. It will be moved to production early next year. All of the bills will be reviewed. And one of the key points there is that the payment should have been made on time. If the payment is made on time, there is no interest due. By and large companies were making payments on time. We wouldn't have been able to disburse revenues without the companies making payments on time. They know the rules.

Mr. Shirley: Who is performing the CFO audit, and what is their scope of work?

Ms. Martinez: The CFO audit is being done under contract by KPMG. They will be reviewing our financial statements, our internal controls and testing transactions. They have already selected a sample of transactions that they will walk through the system, everything from the lease terms to the final distribution and disbursement. Last week they finalized their sample. It includes leases from BLM, BIA and offshore.

Mr. Shirley: Are they looking at periods that extend into your previous system, or are they just concentrating on your new system?

Ms.Martinez: They are looking at fiscal year 2002. So they have to look at both systems. They are looking at how we transferred data from one sytem to the other and the account balances we started with in the new system.

Mr. Shirley: Do you know if they have plans to seek input from industry, states and tribes or other constituents?

Ms. Martinez: I have not been made aware that they will be seeking input from the revenue recipients. But, if they're taking a sample basis of all of our transactions and walking them through the entire system, then they may get confirmation from the BIA or the tribes, did you receive this money from OTFM, did you receive an explanation of payment in support of this money. Production reports are used for many purposes. BLM and BIA want the data for I&E activity and other forecasting information. We are trying to get the backlog in as soon as we can. BLM was shut down at the same time we were, so they are behind on processing their sundry notices and well completion reports. Most BLM offices are reporting they are caught up. We've had some system issues. We have many issues we have identified through systems investigation requests for our contractor to work.

Mr. Shirley: Can MMS keep us apprised of how they resolve the backlog? We depend on those production reports for our compliance system. It's very important that we be kept informed of what the final resolution of this is going to be, especially when we get into these periods here under the new system.

Ms. Neuroth: Sure. Our goal is to try to load as much as we can as quickly as we can to get the backlog free. It's going to be a combination of BLM getting caught up in their well information, MRM getting some system changes made and industry reporting a little bit cleaner data to us so we don't have quite as high a rejection rate. All those things have to come together to really make an impact on this backlog. That's why I'm saying I think it's not going to be a one or two month problem. It's going to be longer term.

Ms. Naron: Do you have a specific list of things that are being rejected on our reports that we could publish for industry?

Ms. Neuroth: We can certainly do that on a company by company basis. I have considered trying to send out a "Dear Reporter" letter identifying some of those major reporting errors. I've been a little bit hesitant waiting to see what the impact was of BLM getting caught up. When the document initially rejects it's really difficult to tell whether it's a company reporting error or a database error. A company may be reporting a well that is an accurate API well with the correct status, but BLM doesn't have their information in. I can't go back to the company and say you reported an error, because I'm really not sure yet. But I am considering trying to get something like that out.

The Indian over recoupment module makes sure that companies that are trying to recoup overpayments do it in accordance with the provisions we have established. The provisions are that if it's a recoupment against an allotted lease, you cannot reduce current revenue more than 50 percent. If it's a tribal lease, you cannot reduce it more than 100 percent in any particular month. The module was just implemented in September 2002. It ran in production the first time on 9/26 for the August 2001 time period. We have a year's worth of catch-up to do in this module. The module will be run twice a month to catch up the backlog period. The interest exception module calculates interest owed to MMS, or interest owed back to a company for overpayment. We are still in the process of testing this module. We have additional funding for our contractor to work on this issue

Ms. Naron: What does this do to the MMS audit cycles? We heard here that you were accelerating your audits to a three-year period and the CAM groups were being much more aggressive in attempting to get things reconciled within 18 to 24 months. What does this do to their plans? Am I going to have to submit information twice, once to financial management and second to an auditor or a CAM group?

Ms. Gibbs Tschudy: Clearly we are impacted by the backlog and we are also dedicating resources to help Financial get caught up. The production information is so important to us. But, we're not going to do things that cause additional burden on you, so it may result in some delay in our three-year compliance strategy.

Ms. Naron: Are you going to come out with a new audit plan?

Ms. Gibbs Tschudy: We haven't determined yet whether it's necessary to do that. We are still looking at targeting the largest properties that bring in the greatest revenue. But, we do that in partnership with our states and tribes to do audits and at this point they are doing those through their traditional audit methods. We've still got some old time periods to get caught up.

Mr. Shirley: Actually, your interest module not being in place does impact some of the work that we do because in the scope of our audits to determine if interest has been assessed and if it's been assessed properly. I can foresee that without much coordination and without some of these system bugs being corrected soon it's going to be somewhat painful on both sides.

Marginal Properties Subcommittee Report:

Ms. Pat Kent discussed the prepayment provisions applying only to federal leases or agreements that produce less than 15 barrels of oil per day or 90,000 cubic feet of gas per day or any combination thereof.

We first addressed the alternative accounting and auditing requirements and presented a proposal at the March 2001 RPC meeting. That proposal was forwarded on to the Director. The second part of our team was the prepayment of royalties. Back in '96 and '97 after RSFA came out, MMS held some outreach meetings. They got a lot of feedback from industry and states and came back with a proposed rule. However, it only applied to accounting and auditing relief, not prepayment of royalties. Our Subcommittee did take on the task of looking at prepayment of royalties.

MMS had a rough draft of a rule from its 1996 and 1997 outreach groups that we used as a starting point. We used that draft as our basis for deliberations. We agreed early that the states needed to be able to decide whether they wanted to participate or not participate. So, we gave them the ability to opt out. They can choose to accept prepayments or they can choose not to accept prepayments. We also had to look at the fact that leases do have minimum royalty requirements. So, we had to look at the prepayment of royalties and compare it to the minimum royalties under the leases. That was a very complex idea but we worked on it. We tried to make it easy for MMS to administer and for lessees to make prepayments. We provided the discount rate, time period, prices and formulas to calculate the prepayment. At the same time we had to consider the impact on some of these marginal properties? We decided that this prepayment notification would only apply if the lease or the agreement produced less than 1,000 barrels a year. We thought that was

the appropriate level of risk on both sides. The MMS risks the possibility that we might not have calculated something right and they may be losing out on a revenue stream. The lessees have a risk that they may have overpaid. But, that's an appropriate level of risk for us. What are the items that go into this calculation? We looked at was reserves and decline rate. We decided to look at a two-year decline curve

The prepayment period was a little harder. Once you've taken your reserves and applied that decline curve, it's possible that you might have a property that has a short remaining life. We could not find prices beyond seven years. So, we determined that the minimum prepayment would be two years and the maximum would be whatever the published prices were available. MMS is going to take the lead on determine what the ending date is.

The subcommittee determined that the discount rate had to be the Government's cost of money and we would have to realize that that's lower than what we would use as our internal hurdle. It will be a published rate so we can verify it very easily. The 24-month reporting period would be July through June of the year prior to prepayment. Written request for another kind of prepayment would be due by June 30th. And, that would also apply if you wanted to prepay a property that was in excess of 1,000 barrels a year.

Prepayment is to be accomplished by paying on 100 percent of the reserves from the property, regardless of the number of interest owners. We want it to be done in one calculation and with the interest owners allocating shares. All interest owners have to agree to participate or not participate.

When would we ever owe additional royalties if you prepaid royalties? What we decided was that in calculating a prepayment volume there is some risk. We built in a 10 percent tolerance. That was the number that both sides could come to agreement on. If we produce 90 percent of what we've prepaid, we're out 10 percent. If we produce 109 percent of what we prepaid, you've taken the risk that you're not going to get that 9 percent. But, if we produce 111 percent of what we said we were going to produce or what we've prepaid, then we pay the royalties on the additional 1 percent. The production reporting through all this time period continues. I recommend the RPC approve this report and send it to the Secretary. Questions and answers followed.

Mr. Darouse: I like the idea of the plus or minus 10 percent. I think that's real reasonable on the volume end of it. Are there any provisions to correct for price fluctuations?

Ms. Kent: No.

Mr. Paulson: With respect to multiple owners in the property, this presupposes that all agree or there's no submission, at all? And there's no process for one owner to make a submission and allow other owners to participate?

Ms. Kent: No. We determined that the administrative burden of trying to keep up was just too much.

Mr. Paulson: With respect to properties that produce more than 1,000 barrels, is there an upper limit?

Ms. Kent: It's a request basis. Now, the upper limit, of course, is that they have to be a marginal property. At the lease or agreement level, they have to have produced less than 15 barrels per day per well. There's a finite population and the MMS will be publishing what that population is each year. An owner could elect to use the same calculation for a property that's above 1,000 barrels. They have to send it in as a request. The MMS will evaluate that request and determine with the state whether they want to accept it or not. A large percentage of their properties are marginal properties and they weren't sure that they wanted to allow wholesale prepayments, but they also wanted to allow some flexibility.

Mr. Shirley: If no further discussion is there a motion to accept the report? Roger Good motions to accept the report. Ron Cattany seconds. Vote: 20 in favor. 0 opposing. 1 abstaining. Motion carries. Marginal Properties subcommittee report to be forwarded to the Department. What time frame are we looking at?

Ms. Burton: The Committee is sending it to the Secretary through the MMS and we will look at it at that point and see whether the Secretary wants to go ahead and start a rule. I can't give you a time line.

Mr. Cattany: I would suggest you give us a progress report.

Ms. Burton: I want to make the point that we are working on several rules and some of them rather urgent for OCS production and they're going to keep our attention. We may not have enough resources to jump on something new immediately, but we will keep you informed. I think it would be fair in between meetings to provide an update.

Director Burton presented certificates of appreciation to subcommittee members who were present.

Coal Subcommittee Update:

Mr. Ron Cattany briefed the Committee on the Wyoming Study Project to evaluate the merits of a simplified royalty rate structure. It does not include Indian coal leases. Committee members are in the process of providing production royalty information for 2001 and the legacy contracts in Wyoming. At the last RPC meeting, we identified about five issues we were concerned about as a result of the Solicitor's Opinion. The result of that has been the characterization of the coal waste pile issue that Bill Radden-Lesage from BLM is going to be doing for you next on the agenda.

We looked at Director Burton's guidance today on statute of limitations to determine affects on coal waste piles. There appear to be none. In terms of advance royalties, we will be working with BLM and MMS as they look at reevaluating the MOU process for advance royalty determinations. In June, we hosted a meeting on the MMS record retention policy. We also have been continuing to look at the issue of audit closure letters and letters that would go to royalty payors once their audits are completed. It appears that the guidance on statute of limitations may ostensibly be the audit closure letter implicitly in all of that. So, it appears that that issue may be addressed also by your guidelines that you issued today.

Impacts of Coal Waste Piles on the States:

Mr. Bill Radden-Lesage summarized the Solicitors Opinion and also presented data on the size of the problem, location, origination, proximity to market centers, accessibility, product characteristics, BTU content and the original separation technology. Coal waste piles have a prospective value when technology or market provides an economic advantage. He concluded that on a tonnage basis, approximately 30 percent of the waste originated from Federal leases that are already relinquished and have no royalty-bearing benefits. The remaining 70 percent of the waste is from active leases. Nothing indicates this value will ever actually be realized. This means that it goes on a case-by-case basis. Every coal waste pile is different. It needs to be analyzed on its own merits. In summary it adds up to $4.3 million dollars. Colorado's portion is about $1.5 million and Utah about one million. Questions and answers followed.

Mr. Cruickshank: I was just curious about the location of the piles as to whether they're on Federal, state, or private land and whether that makes a difference in how you view the potential?

Mr. Radden-Lesage: According to the Solicitor's Opinion it makes no difference where the pile is located.
Mr. Simpson: When you was coming up with a value did you ask any of the Utah coal company's what they had sold the waste piles for?

Mr. Radden-Lesage: The number came out of the Colorado State Office.

Mr. Simpson: Utah brought this issue up in 1997 through this Committee. At that point we had run across someone that was selling for $7 a ton. Is that royalty bearing?

Mr. Radden-Lesage: If we run under the assumption that so long as the Federal lease is still out there, yes, it could be royalty-bearing.

Mr. Simpson: I would assume since we ran across this back in 1997 we should be billing? I thought when they sold the coal pile the statute of limitations would start running.

Mr. Cruickshank: One of the things attached to the limitation is when you know or reasonably should have known, it's seven years from that point.

Mr. Cattany: Part of the issue that we're looking at coal that may sell for a $1 a ton given the quality of the coal. Our goal is reclamation. You don't want to do things that hamper the waste piles from being reclaimed. Historically, even on the hard rock side, we've looked at re-mining as a way to provide an economic incentive to clean up historic and abandoned hard rock mine sites in the state. Revenue is one issue, but reclamation is another issue. And, certainly, from a state perspective, we always try to balance those two out because there's a net gain to the public either way.

Mr. Schaefer: This whole thing is reclamation driven, but when revenue comes, we have to look at it. Some other questions that we asked the Solicitor from this Committee involved ownership. It did not get answered. Is the Department willing at this point to get us the answers back. I don't know what the Subcommittee at this point is doing.

Mr. Cattany: That's why the Subcommittee doesn't have a recommendation today. We want to really figure out whether or not there's enough of an issue here to run MMS through the drill again with the Solicitor's Office. We got a Solicitor's Opinion answering the question we didn't ask. There are a number of the questions out there that we asked that didn't get answered.

Sodium/Potassium Subcommittee Update:

Mr. Harold Kemp explained that the subcommittee was put together to come up with a set of regulations related to product valuation and reporting for Federal leaseable solid minerals. MMS put together a set of draft regulations for these commodities. The draft set of rules is attached to my report. Two issues came back to the RPC. The first involved primary product and was related to sodium bicarbonate and the process a company in Colorado used. The second issue is whether allowances should be given for transporting unfinished products that were not considered to be in a marketable condition. The Committee was gracious enough to allow us the time to continue to look at this. I want to submit a final report to the RPC.

I think the first issue involving a Colorado company has gone away due to changes in management and/or process. Since I have received no responses from members of the subcommittee I recommendation that we dissolve this Committee. I would also recommend the RPC ask the MMS to go forward with publishing these draft rules in the Federal Register and get them to the public for comment. The rule is very detailed and I want to highlight some of the guiding principles.

First, the price arrived at in the open marketplace between unrelated parties without reciprocity in dealing should be the basis in forming royalty value. All processes before the product reaches marketable condition should be considered production processes and the cost of such processes should be borne by the lessee without deductions. Royalties should be assessed on value at the point the product is in marketable condition. The basis of these principles is that royalty is due on the first marketable product while not owing on value-added processes or components, to include but not limited to transportation, packaging, the use of reagents and raw materials added to the product to yield a derivative commodity.

The subcommittee also accepted the premise that ore bodies were different in mineral composition, depth, and purity. The techniques the lessee used to mine and process the ore to finished product should be considered in valuing lease production. We accepted sodium/potassium minerals do require extensive beneficiation prior to shipping. The majority of these materials can be processed directly into a finished product. Some of these minerals are used as feedstock to make manufactured products. When feedstock is used the point of shipment is the point where the mineral is consumed to make a derivative product. Such feedstock was accepted as valued on a weighted average basis as if it were processed into a finished primary product at the normal point of shipment.

The subcommittee accepted as primary product the first material processed into a marketable condition after the ore mining process. Further beneficiation to improve the quality or grade did not change the primary product designation unless dissolution, followed by purification and re-crystallization, occurs with these products. Also, when the process normally used to produce a primary product was interrupted and the in-process product was consumed to make derivative product, the in-process product was considered an intermediate product for which there is also detail in the draft regulations. When the primary product is dissolved and re-crystallized or the chemical composition of the primary product was altered, the after products were termed as derivative products.

Under the accepted guidelines, if an affiliate sells lease production as a primary product, then the affiliates' resale price would be the basis for royalty value. If the affiliate sells lease production as a derivative product, then the value of lease production is based on arms-length sales prices of the primary product. The subcommittee felt deductions should be allowable for the actual cost of finished product transported, product packaging, and reagent additives.

Transportation from the mine to the processing facility and between the processing facilities is considered a part of processing and would not be allowed as a deduction under this draft. Product packaging deductions would be allowed for actual cost incurred in packaging finished products. The lessee is given the option to base package product royalties on the average sales price of the products sold in bulk form. The reagent deductions are allowed for products containing reagents. The calculation of value is based on the weight of the product sold less the weight of the reagent contained therein. No deduction is allowed for the lessee's reagent. However, it replaces a component that would have naturally occurred in the ore.

The draft provides definitions for the statutory term "gross value" and defines the types of compensation included or excluded from value. In an effort to be consistent with other MMS product valuation regulations, the term "bona fide" was replaced in these draft rules with "arms-length". Royalties can be paid under two options at the time the product is shipped or at the time the product is sold, but the chosen methodology may not be changed without MMS approval. Lessees must submit all sales contracts when solicited to do so by the MMS to include affiliate contracts where the lessee transfers or sells to an affiliate. These regulations are intended as comprehensive and specific for the mining, processing and marketing of sodium and potassium products. Questions and answers followed.

Mr. Cattany: Do we penalize people through the royalty rate structure for processing the product before it's marketed? Has that issue been addressed in the draft rules?

Mr. Kemp: The issue came down to whether sodium bicarbonate was a primary product or not. I think it's addressed as well as can be addressed in these rules. If these rules get out for public comment that's an issue that can be looked at further.

Ms. Robyn: We came up with the majority and minority report. I'm not so sure that Colorado is still not on a minority position. One of my objections is actually the detail. They draft rules are so detailed and based on the process of how they are making the product. As soon as we had a new producer come on line, the detail blew up because they had a new process. These rules inhibit a new process because if you don't go by this process you could get penalized. We have encouraged in the State of Colorado a new producer to be a less efficient producer based on these draft regulations. They are in compliance because they think these may become the rules. They changed their process to save royalty, and I don't think that's how it should be. So I urge the committee not to send these forward.

Mr. Kemp: Mary is right, the decision was that if there was not a consensus on these rules that we would not bring them forward. After contacting members of the MMS, discussing the issue with them, their idea was to get together with these companies. I think there was some commitment on the part of those company individuals at that time in Las Vegas to get together and resolve this issue. I leave it open to the Committee.

Ms. Robyn: Without the subcommittee actually considering this as a final-report I don't think we were ready to go forward.

Mr. Kemp: Mr. Chairman, you ought to dissolve this subcommittee and let MMS move forward. I don't think we'll have anything else to bring forward.

Mr. Barger: I can see that the regulations would preclude certain types of advanced mining that could be coming on line. But due to definitions in here it would preclude that type of mining. The draft rules could discourage new technologies. The coal waste pile can have implications on other industries. For example, phosphate, you have the exact same scenario and there are numerous other industries that have the exact same situation.

Mr. Simpson: There are no rules in existence right now for these products. I'm a little bit nervous about starting all over because I think MMS needs some direction real quick to do something for this industry.

Mr. Schaefer: I move that we set it on the agenda at the next meeting to give everybody on this committee an opportunity to review the language

Seconded by Mr. Rudden-Lesage.

Mr. Lewis: Would you entertain an amendment to that to dissolve the subcommittee?

Mr. Schaefer: I move that we defer acting on this proposal today and put it on the agenda for our next meeting, but accept the recommendation of Mr. Kemp that the subcommittee be dissolved.

Vote: 16 in favor. 2 opposed. 0 abstaining. Motion carried.

Status Update Royalty-In-Kind and Strategic Petroleum Reserve Initiative:

Ms. Stacy Leyshon briefed the Committee on the SPR fill deliveries initiative and Mr. Greg Smith discussed planning initiatives for the implementation management systems to support the RIK program. Mr. Smith also provided statistics that indicate almost 60 percent of our Gulf of Mexico royalty position is being taken in-kind. He discussed the joint project with the State of Wyoming that represents about 40 percent of the Federal position for oil in the State of Wyoming. Today, RIK is a permanent part of MMS' asset management strategy. MMS plans to evolve from pilot programs to operational practice over a three-year period ending December 2003. To do so, efforts are ongoing to focus on refining the business processes and implementing systems and management systems to manage the RIK portfolio. He emphasized that deliverables to support this structure are going to include separate oil and gas management systems with risk management components. RIK staff hopes to have the gas system implemented in early 2003 and the oil management system implemented by October 2003.

FERC Offshore Gulf of Mexico Discussion:

Ms. Tammy Naron briefed the Committee on the offshore transportation systems issue. Williams has decided to spin off some of they're gathering systems and remove them from the jurisdiction of the FERC. They are spinning off different pipeline systems and in some cases transportation rates have been increased by 500 percent. Industry is depended on FERC to determine if the rates are reasonable and to insure that all producers on the platforms can get into those lines. This will create monopolies and creates an adverse standard for establishing transportation lines on "offshore gathering systems". What I'm asking for today is the Federal Government as the royalty owner in all of these systems that may have the potential of being spun off act as a partner with the producers who are on these systems. If we can't get the product to shore we cannot pay royalty. What we're asking is for MMS to write a letter to FERC.

Mr. Schaefer: I move that we forward Tammy's report to MMS with a request that they give consideration to bringing the issues before the FERC.

Mr. Cattany: I amend that and suggest that it also go to the Anti-Trust Division in the Department of Justice.

Mr. Schaefer: I'll accept that amendment.

Mr. Shirley: Motion has been made and seconded by Ron Cattany.

Vote: 18 in favor. 0 Opposing. 0 abstaining. Motion Carried.

Ms. Naron: I'll be glad to have our folks draft a letter for you and attach the documents for your review.

Appeals Process:

Mr. Hugh Schaefer explained that the last time that the RPC visited this issue was at our meeting in April 2001. The majority of us voted in favor of asking Secretary Norton to review the prior actions of the department. On May 23rd, in implementation of that action, Perry wrote a letter to Secretary Norton requesting review of Secretary Babbitt's action. After the rulemaking was at the proposed stage and public comment came back, the Department decided not to go forward with implementing all of the recommendations of the RPC. Johnnie contacted me a few months ago to advise me that Secretary Norton has asked her to look into the matter and make a recommendation on our proposal. From a record standpoint our request is still pending before the Secretary.

Johnnie asked me to provide a history at this meeting. So I'm going to try to boil this down to its essence so that Johnnie can be fully briefed and go back to the Secretary at the time she deems appropriate to advise her what she thinks the Department ought to do.
The Appeals and ADR Subcommittee of the RPC was created in September 1995 to make recommendations to the RPC on ways to improve the processes involving appeals and alternative dispute resolution. The goal was to have an expeditious and independent review of cases involving disputed facts, legal issues or policy when requested by an adversely affected party. At the present time when a royalty payor receives an order to pay that triggers the running of an administrative appellate process. If the royalty payor is aggrieved by the order to pay then the payor has a right to appeal to the Director of the MMS. When that appeal arrives in the Director's Office, it's handed over to the Appeals Division of MMS to review and make a recommendation to the Director. If the Director denies the appeal then the payor has the right to appeal to the IBLA.

The IBLA is a quasi-independent tribunal within the Department that was established some years ago in connection with the enactment of the Federal Land Policy and Management Act. If you were aggrieved by a decision of the Department your only alternative was to appeal to the Secretary, or to bring an action in Federal District Court to seek judicial review of that agency decision. The parties who were aggrieved were filing lawsuits very regularly and it was straining the resources of the DOI and the Justice Department.

The IBLA was set up to put a step in between the agency and the courthouse to see if some of these matters could not be resolved prior to litigation. And, to save time, money and resources for all sides--the appellant as well as the Department. The Appeals Subcommittee met on frequent occasions. The committee was well represented with industry and state members. What the committee found and recommended to the RPC was that we looked first at trying to identify what the problems were with the current system. The concerns with the current appeals process involved a lack of timely resolution. The decisions were not coming out as rapidly as the appellants would like. Sometimes it took three and four years to get a decision. Another thing we identified was the lack of clarity in some orders. The orders were drafted in a way that was ambiguous. There was also a perception among appellants that there really wasn't any independence in the decision making process. It would put the Director in a difficult spot to be looking at the decision of an officer that reported to him or her and having to overrule that decision.

And there was the perception of unfairness. The unfairness arose primarily from the fact that prior to the promulgation of the decision on a royalty appeal the draft of the decision is circulated throughout the entire Department. In other words, it gets sur-named. The appellant does not have the benefit of those sur-naming comments. They never make it into the record of the case. I was perceived by payor appellants that there were possible ex parte communications between the state and tribes. Again, there was nothing in the record to substantiate that. Many times orders were issued to pay at a time when the Department's policy with respect to the issue in those cases had not been clearly defined and promulgated to royalty payors. After the passage of FOGRMA, things were coming hot and heavy to the department. Policies were in formation. But, nonetheless, the decisions were being made and at times there were some conflicts regarding departmental policy.

Another issue that the committee identified was the inability of an appellant to know or ascertain exactly what was contained in the administrative record. Early on in the process, if I had an appeal before the BLM I could come out to the Federal Center and sit down with the Solicitor and have the administrative record there before me on a BLM appeal. Early on with MMS it was not possible to get that because there really wasn't records done in the manner as formally as it is done before the BLM. The other perceived weakness in the system was the conflicting role of the Solicitor's Office in first satisfying the institutional needs, that is assisting the Department in setting royalty policy as well as overall litigation strategy, and then also acting as a legal advocate for the MMS. That meant that sometimes decisions got put to the side because the solicitor had been asked in another context to give the Department some guidance on the legal issues and what policies should we adopt. Finally, the other concern the Subcommittee and RPC had with the appeals process was the duplication of effort within the MMS Director review and the IBLA review. In other words, there is a two-step appeal process here with royalty appeals when contrasted with the BLM, there's only a one-step appeal. So, those were what the Subcommittee found to be the concerns with the appeals process. The Subcommittee and the RPC recommended that the current appeals process be altered in fundamental ways. It recommended that all fundamental policy questions be resolved before MMS or the delegated states and Indian tribes initiates an action. Secondly, the subcommittee recommends that the resolution of disputes without completing the formal administrative appeals process should be encouraged at ever step of the process. In other words, trying to bring some ADR to the table early on in the process to work on settling an appeal without having to exhaust the resources of the Government, and also of the royalty payor.
The RPC recommended that the standing of Indian lessors with respect to the administrative appeals process should be clarified. What we ended up in the proposed regulation was that in the appeal process the Indian tribes and the states would have a regulatory right to be heard and provide input in the decision-making process, and even participate in trying to resolve the case.

We also recommend that the structure of the administrative appeals process be altered so that appeals of MMS, state or tribal orders are taken directly to the IBLA under a new set of rules with respect to royalty appeals. But what we recommended to the Secretary was to allow a royalty payor to file a notice of appeal with the IBLA. That would be referred back to the Director of the MMS for input on whether or not the MMS wants to go forward to defend the appeal. Or, do they want to try to modify the order that was originally entered, or drop it altogether. In other words, we've looked at this and we think the appellant is right, or, the decision was partially right and partially wrong. We'll throw out the wrong part and we'll defend on the right part.

Because of the requirement in the RSFA, the provision in that Act required that there be a settlement conference to sit down between the government and an Indian tribe, or the state if they wanted to be involved, and try to settle the case. We identified what the administrative record should be in this case. Under that law you simply try the case on the record. In other words, the administrative officer who makes the decision even before the IBLA and even a Federal court must confine its decision to what has been developed in the record. This is not a jury trial, this procedure; there is no live testimony taken. There's no right to cross-examine witnesses. It's an administrative appeal, it is not a trial. If there is a dispute as to fact, then the IBLA has a procedure whereby, the Board can refer that dispute to an Administrative Law Judge within the DOI. He will conduct a hearing on the record, take live testimony, permit cross-examination and then make a recommendation to the IBLA with respect to how that factual dispute should be resolved. At that point the record is usually closed.

Once the IBLA makes its decision, and the appellant elects to seek judicial review, it goes to a Federal District Court Judge who can only rule on what's in that record. That is the record that was developed before the agency. It is a de novo review, but he does not conduct any trial, does not conduct any hearing. And, it's very difficult to seek to reopen the administrative record at that level once it's in Federal Court. The RPC recommended changes to the appeals process on March 27, 1997. In September 1997, Secretary Babbitt accepted the RPC report with some minor modifications. On January 12, 1999, the Department went forward with proposed rulemaking, proposing everything that had been recommended by the Committee, plus some things that the Department itself wanted to put in the rule. The rulemaking generated a lot of comment. As a result, the final rule was adopted in May of 1999, however, a substantial number of the RPC recommendations were not accepted. Basically what the Secretary did was finalize those rules that were necessary because of the statutory requirements of RSFA.

The RPC came back together and in July 1999 wrote a letter to the Secretary expressing our disappointment with his action. We heard from the Department. After hearing some amplification on the Secretary's reason for not accepting all the changes the RPC expressed its disappointment again. When Secretary Norton took office, we wrote her and asked her to review the matter and that's how Johnnie got involved.

We had some discussion about things going on in Washington and nobody on this committee was invited to come forward and assist with the work. Walter Rosenbush at that time was Director of MMS, and he said that the appeals subcommittee would be offered an opportunity to sit in and contribute to the effort to finalize the appeals process. I think the record will show that, in spite of the Secretary's initial action, MMS at least was still interested in going forward and trying to implement some of these things that we recommended. When the last administration left office the offer was still on the table that anybody on the Appeals Subcommittee who wanted to come forward and assist trying to write the rule again and get it published again were welcome. Questions and answers followed.

Mr. Hartzler: The 33-month time period outlined in RSFA only applies to oil and gas. I believe that the rule that was adopted excludes solid minerals. I know when the current rule was proposed that the solid mineral industry asked the rule to include the 33-month time period. For solid mineral and Indian leases, the agency has said they are going to work within the 33-month time period. If there's a backlog we have no assurance that our decisions will be made within 33 months.

Mr. Shipps : I have settled hundreds of millions of dollars worth of royalty issues before they ever get to the IBLA. I think there is some value that has been understated by the report with respect to having a two-tiered appellate system. The first one being in front of the Minerals Appeals Division. I think it gives the agency an opportunity to really measure the development of its policies before it goes to IBLA. I think with respect to possible consultation with state auditors and tribal auditors that may have been participating under the cloak of the MMS with respect to development of, or response to that appeal. I think that's appropriate as well, and while it may be viewed as unfair, I don't think it is unfair, given the way this system is set up, that they are actually contributing parties to the development of the issues and the orders themselves. The May 23 letter does reflect that there were some Committee members who did not support the recommendations. I do think it's important that the Director be informed that there are those of us who question the aspects of this report, and I am particularly opposed to the recommendation of eliminating the MMS division as being an intermediate step before you get to IBLA approval, or review.

Mr. Banta: The report generally moves in the direction of making the process more legalistic, more formalistic. It doesn't represent a streamlining. Policies tend to be formulated in the context of specific cases, and to preclude that or even attempt to preclude it is a mistake and could have some very dire consequences. I think the limitation of the state and tribal participation and appeal process is a mistake.

Mr. Modiano: I had my signature on many of these appeals. One of the real values of the appeal to the Director's office is that you do get to challenge the work ongoing out in the field. And you do challenge it in a way that facilitates self-examination of your policies. And you do challenge it in the way an administrator might that gives you probably the greatest opportunities and conflict resolution at the smallest possible point of where it becomes a big problem. I always thought it was one of the most valuable things the Director's Office actually does. And many times, people felt that their hands were tied by a policy that may have been incorrect. And this might have been the only way to shed light on the policy being wrongful. I also thought it was an incredibly interesting process because it gave you the opportunity to then disagree and still look to the IBLA.

Mr. Shipps: There are aspects of this report that we do support, and I think the clarification, formalization of the official role of tribes and states in the appellate process was one of the improvements reflected in these rules. I have the largest disagreement with the elimination of the intermediate step of the MMS appeal process prior to going to IBLA. I think there are other steps that could be taken to speed up the process. I think it is important to have a formal step in which the MMS appeal staff can review what's coming down with respect to a demand on an appealed order. MMS should have the opportunity internally to measure the facts of that case against formulated policies and see whether or not there's some mechanism for resolution before you have to take the formal steps of going to IBLA.

Mr. Schaefer: John Price, how many appeals are pending before the Director? Do you know offhand?

Mr. Price: I think there's about 280 appeals pending before the Director. At one point in time the number that were pending could have been 800 to 1000. I know between 1995 and 2001, 1600 of the 2100 to 2200 appeals, were resolved through ADR efforts.

Mr. Schaefer: I think in the discussions in the committee we felt was the best way to cure the problem of delay before the Director was to have the appeal lodged before the IBLA as a time line. In this way we could get action out of the MMS on a faster basis, knowing that there's that appeal pending before the IBLA. Whereas prior to that, the appeal got filed and there was nothing happening. Lodging the appeal with IBLA got everybody focused. That was the whole intent. We thought that that would be a way to make MMS and the Appeals Division work on the case.

Ms. Burton: I am worried about the independence of appealing to the Director when the staff who actually briefs me is also the staff that sent the order to begin with. I was very sensitive to the fact that the administrative record may not be very good and people did not know what was in the administrative record. And I'm familiar with where I was before. We had to build a record and that's what they rendered their judgment on. So, I know how important a good record is. I also was sensitive to the duplication of efforts. When you have to file briefs and essentially defend your position in front of the Director and then start all over again in front of the IBLA. So all of those things made me pay some attention to the report, understanding that there were also points of view that could be different. I also think that clarifying the role of the tribes and the role of the states was important. I may not agree with everything the original rule proposed but the general direction of that report has merit. I have taken the first step to meet with Assistant Secretary and brief her on what is the process today and where I'd like to go with the process.

What I plan on doing is to go to the Solicitor's Office and see how we can modify this process. I'll get back to you hopefully at the next committee meeting with more details. We'll start the regular process of the public hearings and all of the procedure to get comments from people. We have paid attention to this issue and we're going in the direction that the report suggests, although maybe not in all areas. We don't have a finished product, but we are working hard on that issue. If I may add one more comment. I had understood that this report was submitted to MMS and to the Secretary with a unanimous or majority vote. I also had understood that industry was in favor of that.

Mr. Shirley: I believe that the original recommendation of the RPC was unanimous. When Secretary Norton took office and we wrote a letter asking her to review the prior actions of the Department the vote was 14 in favor, 3 opposed, and 1 abstaining.

Mr. Shipps: I don't think it's insignificant to note that in between those periods of time we did have comment from the Secretary of the Interior as well as representatives from the Department that are still here indicating why it was not felt that eliminating the second step was important. I think it was helpful to get that kind of statement as to justification for retaining both stages of the appellant process for consideration. I think that's why the vote changed from being unanimous to being not unanimous but still majority.

Ms. Burton: I understand and that's why although I am partial right now to doing away with the two-step process, I'm also mindful of having enough built in the front end that takes care of some of the issues without going to a formal appeal.

Mr. Schaefer: I hope the invitation with whatever reform the Department elects to adopt to invite the Appeals Subcommittee to give input still stands.

Ms. Burton: The offer is still on the table and we plan on acting that way.

Mr. Shipps: With regards to Indian leases have you considered treating or administering the appeals concerning Indian leases separately than you would otherwise for Federal leases?

Ms. Burton: I don't think we have talked about handling Indian leases differently. The tribes have a different position and we are taking that into consideration when we build the system. One thing is certain. When we start putting this together, the BIA and the Commissioner for Indian Affairs will be apprised of what we're doing, and we'll discuss it at that point.

Legislative Update:

Mr. Walter Cruickshank briefed the Committee on current legislative issues and pointed out that at this time there is no energy bill. He emphasized it's been hung up on a lot of items such as, electricity deregulation, ANWR, ethanol and climate change. At this point the conferees are spending a lot of time talking about the RIK provisions, royalty relief from marginal wells, funding, setting up a research fund for ultra deep water and unconventional natural gas technologies and funding that out of OCS receipts. They are also discussing legislation that would provide MMS authority over energy-related activities on the OCS that aren't currently covered by other statutes. The provision also would presumably have language that more or less codifies what we've already done administratively with regard to deepwater royalty relief and consideration of lease extensions for sub-salt exploration. He also discussed the continuing resolution.

Ms. Burton: I want to report to the Committee that earlier this year Secretary Norton established a new award called the Joan Kilgore Award. Joan Kilgore was an MMS employee that devoted most of her career to Indian issues. She is retired and afflicted with a terminal disease, and we wanted to recognize both her work and what she stood for. She tried very hard during her time at MMS to help individuals on the tribe become more involved in mineral affairs. So this award was meant to recognize those folks that have done the most outstanding work to help their tribes. For the first time last spring three individuals were recognized as outstanding in the work they have done to help their tribes. Two of these people sit on this committee, Perry Shirley and Karen Anderson. They came to Washington and the Secretary herself handed out the awards. I think it was a tremendous honor and I want you to know that we really appreciate your work.

Schedule Next Meeting/Adjourn:

Mr. Shirley: We are tentatively planning the next meeting for early March 2003. The possible locations are New Orleans, San Antonio or Las Vegas. When final arrangements are confirmed Committee members will be notified.