MINUTES OF THE ROYALTY POLICY COMMITTEE

April 26, 2006

HOUSTON, TEXAS

Proceedings

Welcome and Opening Remarks

The Royalty Policy Committee (RPC) Meeting held in Houston, Texas, on April 26, 2006, was called to order at 8:30 a.m. by Chairperson Mr. Ronald Cattany. The meeting was held in accordance with the Federal Register Notice published on March 3, 2006. The agenda for the meeting is attached. Mr. Cattany welcomed everyone to the meeting and began by having all present introduce themselves. He thanked the RPC subcommittees for all their hard work since the last RPC meeting. He welcomed Johnnie Burton and said that she was doing a fine job as the Acting Assistant Secretary for Land and Minerals Management and her work was appreciated.

Chairman's Remarks

Mr. Cattany discussed his involvement with the RPC over the years and described Colorado's approach to royalties. Colorado has built water projects and helped local governments with these revenues, and both are long-term needs. As a result, Colorado policy has been to support the companies that pay those revenues for the long haul, knowing that in many cases, their role in local economies is irreplaceable. As a result, over the last 15 years, Colorado lowered its severance taxes and supported over $20 million in hardship royalty rate reductions, to allow their producers to maintain their competitive edge. State government cannot fix geology, engineering, or transportation issues, but it can support complex situations through flexibility in the tax structure.

He described the work of MMS and the RPC as vital over the last 20 years; federal, state, and tribal governments, along with industry, have made extraordinary progress in refining the royalty process. That is, in no small part, due to the hard work of the MMS staff and the RPC subcommittees. Questions have been asked, processes reviewed, and economies achieved; in most cases, they have been done in a way that is revenue neutral. He described it as an honor for the State of Colorado to participate as the Western Governors' Association representative to the RPC, and stated that they will continue to be involved through the subcommittee process. He thanked Johnnie Burton, and on behalf of Russell George, his Executive Director, and himself, and presented a book to Ms. Burton entitled "Reclaiming the American West." He also thanked Deborah Gibbs Tschudy by presenting her a copy of the same book. He said that Debbie's leadership through the years has been extraordinary as she attended the subcommittee meetings, worked through the issues, was very responsive, and fostered a dialogue for change. Mr. Cattany provided copies to RPC members and MMS staff of the book, "Messages in Stone," which was produced by the Colorado Geological Survey two years ago. He then introduced Johnnie Burton.

Director's Remarks

Ms. Burton thanked Mr. Cattany and expressed appreciation for the kind words toward MMS and its staff. She continued that the agency has worked very hard to accomplish its goals and vision, and the partnership, collaboration, and cooperation MMS has with the states and industry has been extremely beneficial and has helped all of us to manage a process that is complicated. Ms. Burton was complimentary of the good performers in industry who participated in the Industry Awards the day before (April 25, 2006). She said that as regulators, MMS must make sure that industry follows certain standards, rules, and regulations and applies them properly. But no matter how tough regulations are—to be applied and be successful—the people being regulated must be willing to work with us. She was pleased to say that, through MMS' diligent work with industry, some have really grasped that and done a marvelous job. The hurricanes that hit the coast last fall were the ultimate proof of how well prepared we are or are not. Although disastrous, the hurricanes could have been worse—which tells us that industry was very much attuned to safety. Out of the 4,000 platform or facilities offshore, over 3,000 were in the direct path of either or both Hurricanes Katrina and Rita. Hurricane Wilma did not come across like Katrina and Rita's bull's eye. She discussed that even though there was destruction, there was no significant pollution and no loss of life. She expressed her pride in how well the industry that MMS regulates performed.

Ms. Burton then discussed the *New York Times* articles and the workload impact on the MMS staff. She explained that the reporter asked an intriguing question: "Why has the price of natural gas increased so much without a one-to-one relationship to the increase in royalty we collected?" MMS found and proved—although not to the satisfaction of everyone—that collection of royalty or the amount of royalty we collect is definitely resting on the market price; however it is also a function of volume produced and the production of natural gas has dropped precipitously.

She also discussed incentives given to industry in the Gulf of Mexico to encourage them to find replacements for declining production off the shelf. In 1995, Congress—not the Administration—gave incentives to industry when the price of oil and gas was way down. The incentive was structured in such a way that anybody who drilled in a certain depth of water would receive a certain volume, royalty-free, from any new discoveries. At the time the leases were given out, a ceiling or threshold was put in on the price. MMS realized that industry would not need any incentives if the price of oil went above a certain level—around $38-$39/barrel of oil. Following an in-depth analysis, we discovered that for two years—1998 and 1999—no thresholds were worked into the leases, which means those companies that are now producing from leases that were let in those two years are still getting their incentives. The next question is why there was not a threshold then. She stated that MMS forgot to include the thresholds for those two years and Congress thought it was intentional -- but it was just a mistake. The mistake is somewhat explainable by the fact that the division of MMS that produces leases and the division that does rules are two separate divisions; and there was not enough of the right type of communication between them. They each thought the other would include it in the lease or rule, but it got included nowhere.

Ms. Burton stated that a lawsuit was filed in March 2006 by one of the companies contesting our ability to establish thresholds from 1995 to 2000. Should we lose that lawsuit, it will cost the government an enormous amount of money that we will probably have to refund. Most of the companies did pay when the threshold was exceeded, and a very few did not. This would be very damaging—not just to the Treasury of the United States—but also to industry. They may get a lot of money back, but they will have lost the good will of some of us in government and will earn a bad—maybe worse—reputation.

She discussed the successful lease sale in the Gulf in March. We had $588 million in bonuses in high bids on the central Gulf sales; very active bidding—about 707 bids for about 400 tracks—which was a very good, active auction. We had not awarded all the leases yet, because we need to perform an analysis to make sure that fair market value was obtained where there wasn't a lot of competition.

Ms Burton informed the RPC that in 2005, MMS distributed $10 billion to states, Indian tribes, Federal Treasury, and various other accounts within the Federal Treasury. We continue to do some rulemaking, amending certain rules, and hopefully making them more transparent. We are also trying to get more consistency between the different types of leases. She stated that the Royalty in Kind (RIK) program had a good year. Not only have we sold and received more than we would have for royalty-in-value for the same production, but we also have saved quite a bit of money in the administration of the program in comparison to royalty-in-value. She completed her presentation and asked if there were any questions.

Questions and Answers:
Orme Lewis asked about the thresholds. Have they fluctuated? Have they been at a main level? Ms. Burton explained that MMS economists perform an analysis of the market and projections in production to determine what incentives are needed. The rule of thumb is that whatever incentives were given at the time they were put into the lease or the rule, would allow them to recoup probably about 2/3 of their investment on one well. Aside

from that, the threshold is calculated to get that ceiling, but has a proviso that every year, it is adjusted for the inflation index.

Mr. Zaman asked about last month's lease sale and whether there was a problem related to lost bids. Ms. Burton stated that there were still incentives in last month's sale and there were thresholds in the lease terms. He asked a follow-on question about whether industry will challenge these thresholds. Ms. Burton explained that industry is not challenging the price thresholds after 2000, because the law was amended at some point where it made it clear that the Secretary of the Interior had the authority to do it.

Mr. Shipps questioned whether, as frustrating as the scrutiny from the press has been for the Agency, this was a mistake that would have otherwise been discovered by the Agency, had it not been for that scrutiny. Ms. Burton replied that the Agency would have definitely seen it, and probably some folks in the Agency, like the auditors, knew it because when they audit those years, they would see that there was no threshold and that the incentives were being taken. The problem is that there is nothing we can do about it now because the contracts were signed that way. Mr. Shipps also asked if there was an estimate of the amount of money that is at issue in the lawsuit challenging the authority of the Department to have imposed thresholds prior to the amendment statutorily? Ms. Burton stated that she can safely say it will be in the billions, but that she cannot really give a number because 1998 and 1999 leases are just beginning to come on-line.

Mr. Cattany stated that the issue of revenues from mineral and energy production, as prices and production are booming right now, is not limited to the federal government. Our legislature has actually directed the State Auditor's Office to do three audits on severance taxes. A reason for it is that this is about the only revenue source that is growing significantly these days.

Approval of November 2005 Minutes

The Chairperson made a Motion to Approve the Minutes from the previous RPC Meeting held in Denver Colorado on November 8, 2005. Pary Shofner made a motion to accept the minutes as presented. The Motion was seconded by Orme Lewis. The Motion carried unanimously (0 opposing; 0 abstaining).

Associate Director's Remarks

Ms. Denett began by describing personnel changes in MRM. John Price was named as the Chief of the Office of Enforcement replacing Ken Vogel, who retired. Phil Sykora the Compliance Program Director's retirement was also announced. Bob Davidoff, the Director of Solids and Geothermal, took a new position with the National Business Center; and Roman Geissel will step-in in the interim until the position is filled.

She then discussed the assumptions behind the *New York Times* article that indicated that MMS had not collected the right amount of royalties for FY 2005. We have responded to that assertion and the *New York Times*; and we have clearly—I think in a very substantive way—shown that the article is not accurate. Bottom line: there was no $700 million shortfall. We then documented it, as Johnnie mentioned, to Congress. She explained that oversight is good for government and that we have it on a daily basis from the Department's Inspector General (IG), the General Accountability Office (GAO), and the Office of the Special Trustee (OST), as well as Congress. She described the recent oversight activities as extensive and resulted in many staff hours consumed as a result.

Ms. Denett promised to provide the RPC with the price threshold chart used by MMS auditors for each fiscal year. Generally, we have received money on all of those leases from companies that have exceeded the price threshold. There's only one company that is litigating us, Kerr-McGee.

Ms.Denett described improvements we are making to statistical reporting to ensure that the information provided to anyone who asks is consistent and understandable.

She also discussed a recent letter from the State and Tribal Royalty Audit Committee (STRAC) following the *New York Times* article. She explained that we have a good working relationship, but periodically we do not agree on certain things—whether it is policy, funding, etc.—but those things arise, and we work through them. Ms. Denett stated that she was extremely disappointed when STRAC chose to involve the media and congressional committees in our debates, especially when it was done in reference to the *New York Times* article. STRAC sent several letters critical of MMS to the MMS Director, to her, and to the congressional committees. The concerns revolve around three issues—funding, compliance processes, and the automated system. When we look at what a state's funding was—what they were receiving from us from a contract perspective—the number of leases they need to cover and the amount of revenues that is being generated from those leases, we found that there were some huge discrepancies. The other issue is compliance. Ms. Denett described how MMS has moved aggressively to use compliance reviews. We have been successful with compliance reviews. In 2005 we were able –with our partners—to complete work on 71 percent of the revenues within our 3-year goal; compared to 11 percent in 2002. She agreed that as far as systems access, STRAC's concerns are legitimate; and MMS is working to resolve the problems.

She discussed the MRM Strategic Planning efforts including identifying the executive sponsors and leads for each of the areas and the approach of looking at the "as is" process to get to the "to be" process. She continued discussing audits. MMS did complete 632 audits and 1,445 compliance reviews that resulted in an additional $77.4 million in FY 2005. We looked at 3,400 properties which was 71 percent of work reviewed. Part of what helped us also was the Royalty In Kind program. We are taking more and more production in the Gulf in-kind, and our review is much more streamlined. A peer review of our audit program was completed, and we received an unqualified opinion with no material weaknesses and no reportable conditions; and she is extremely proud of the program for that.

Ms. Denett quickly discussed the status of the implementation of the Energy Policy Act. She stated that the RPC had a lot to do with the Geothermal Rule moving forward. We are working collaboratively with BLM on it. The Energy Policy Act allowed for the ability to provide credits, but our system has to be modified with some changes so we can account for credits.

She talked about the upcoming Peoplesoft upgrade and the impact on MMS of the re-compete of the operation and support contract. She concluded by discussing regulations that MMS was working on including Reporting Amendments, Service of Official Correspondence, the Geothermal Valuation Rule scheduled for July 2006, and the proposed Indian Oil Valuation Rule that was published in February 2006. Questions and answers followed.

Questions and Answers:
Mr. Kemp stated that the overview was very informative. He noticed in *The New York Times* article a reference to deductions that may be removed in the process of calculating the royalties. He asked whether MMS looked at whether there were changes in the dollar amounts being deducted from the royalties for those particular periods. He also asked about how compliance reviews were done. He said that in his state, he looks in terms of volume, value, and royalties, and a moving average with a tolerance to see where those kinds of things are cut off; and he assumes that MMS is doing that.

Ms. Denett said yes to both questions**.** We do look at the deductions that are applied to a payment. As far as compliance reviews; when she talks about the royalty equation, she is talking about volume times price times royalty rate, minus allowable deductions. Ms. Burton added that the reporter had been asking that question before he wrote his article about deductions. The problem is he disagrees totally with giving any deductions. This is another thing that entered in the way he wrote his article; it was not simply a disagreement on how much we collected, and whether we collected what was owed. It was a disagreement on the policy that has been in place since the beginning of production of fossil fuels, basically. Mr. Kemp thanked Ms. Burton and stated that his point was to compliment her for all the things that she is doing that she may not have mentioned here. He said that he thinks the bases are covered and that he really appreciates what MMS is doing.

Mr. Shipps echoed Mr. Kemp's compliments and stated that both Ms. Burton and Ms. Denett have done a great job for the public and for the government. He stated that there are also, however, some very dedicated people in the STRAC organization; and that the chairman of that organization right now is a representative from the Southern Ute Indian Tribe—who signed off on the letter that went to the Hill. The funding question is always a difficult issue, whether it is allocation between states and tribes, or allocations between non-delegated programs and delegated programs. He said that there seems to be a serious disagreement about whether the compliance review system developed by the agency is providing adequate coverage in comparison to the audit, what previously had been traditional audits. He asked whether it is just a funding concern with regard to compliance reviews and audits, or is there a legitimate substantive question about what you give up and what you gain back with regard to compliance reviews versus audits?" He also asked whether there has been any indication yet that Kerr-McGee's position is going to be joined by other industry, other companies in industry, or other trade associations with industry? Is Kerr-McGee just a rogue with regard to that, or are they going to be bringing industry along with them with regard to a joiner in that case, if you have had any indication?"

Ms. Burton stated that with regard to Kerr-McGee, it is hard for us to tell. Right now, Kerr-McGee seems to be alone. Ms. Denett added that some attorneys representing other companies have asked if we would issue them orders to pay under the Assistant Secretary's signature, so that they may go to Court like Kerr McGee. Lucy told them no. Ms. Burton explained that if the order is issued under Lucy's signature, the appeal has to go to IBLA. The only reason Kerr-McGee went to court is because they indicated to us that they thought the issue was serious enough, and they felt they had enough of a good argument that they really wanted the court to decide. And in order to get there faster, she signed that order.

Ms. Denett then responded to Mr. Shipps' first question regarding compliance reviews and stated that she apologized if she made it sound like every member of STRAC, or any member of STRAC, is not reasonable. That was not her intent. She said that the concerns about compliance reviews are a combination of things. When you do an audit, you go to source documents; you do very, very detailed reviews; it takes a much longer period of time. In the past, we did just do volume differences or quality differences. We had these different, individual pieces that we would look at, and we were approaching companies at various times, and they would make an adjustment because of a volume difference; and then we would come back in so many months later, and they had to make this other change. That was one of the inefficiencies of how we were operating before. What the compliance review is attempting to do is put all of those pieces together, and pick out where some of those things have differences. Based on us working the compliance review process for a number of years, we collected over $200 million from them.

From a management perspective—if we are trying to look at the universe of what we have 24,000 to 26,000 producing leases -- we have to be realistic in how we approach this. How much coverage can we get and that is not to say we are not doing audits, because we are. But if everybody is doing just audits, we are not going to be able to have as much coverage as we want to have. That is the real issue for us. She stated that she thinks compliance reviews are a productive tool for us. But again, if we only have so much funding, each of those STRAC members or offices has to say, okay, what is the best way for us to cover these properties. We also have Government Performance and Results Act (GPRA) goals and a responsibility to the taxpayer, so we are going to look at all of these things. And because the States and Tribes are our partners, they have to work with us, and are working with us, to help us reach those GPRA goals.

Ms. Tschudy stated that we have been having this debate since the late '90s when we started reengineering. At that time, we looked at ways we could be more efficient in our organization. We benchmarked with a number of states, federal agencies, other companies, other countries—even Norway and Alberta—and found this approach. Some of it is terminology. Wyoming calls its risk assessments; different organizations call it systemic reviews. It is a way to augment your audit program, to help you use your audit resources more effectively to target your audit resources to areas that you do need to expend the resources to do a full blown audit. We have had to find smarter ways to do our business with less money, and we are asking the STRAC to do the same thing; to tighten their belts and to be more efficient.

Ms. Williams added that with 19,000 producing leases, meeting escalating GPRA goals is just too difficult for the federal resources we have. The goals that we need to meet are not being met in the timeframes that we need them to be met. So, we are now asking that the State and Tribal contracts include the GPRA goals, and compliance reviews as an option if they cannot cover all the dollars and meet the goals that we require within the timeframes that we have.

Ms. Bayani added that we have had a lot of success in MMS with compliance reviews for Indian leases, and we have engaged in discussion with a couple of tribes regarding compliance reviews. But, as Mary mentioned, our goals—particularly some of the goals for the Indian leases—that we need to meet are contemporaneous, so we are working with the tribes so that we can have the combination of compliance reviews and audits to meet these goals.

Mr. Darouse stated that he wanted to go on record and comment on a few things that have been discussed so far. First, he echoed Harold's compliments on the work that MMS has done. He said that it is work that would not have been needed had the reporter correctly done his homework before he printed the article. Second, it was mentioned that some of the states did not support everything in the STRAC letter that went out to the Committee. Louisiana is one of those states. Both the content of the letter and the timing of the letter are the things that just did not suit us. We are moderately supportive of compliance reviews. We are not going to be able to send a letter about that, but we are currently working on seven compliance reviews right now in preliminary stages, and we are working to adapt the audit manual that has been developed to be the Louisiana version of the manual. We will be sending that to Phil Sykora shortly.

Mr. Zaman asked Ms. Denett, on compliance reviews, do you think it is not going to be recovered by auditors at a later stage? Ms. Denett responded that the auditors are not going to get to all of those things. They have not in the past, and they will not in the future. She also explained that there is a seven year statute of limitation on Federal leases. Personally, if we just did straight audits—unless we had a lot more auditors and a lot more funding—we are not going to get to everything. Reasonable people can disagree, but from what I have seen from being the manager over MRM, no, I do not think we can.

Mr. Zaman stated that he is on the Coal Subcommittee and he hears from the industry that there are two audits done on them instead of one. Ms.Denett said that she was surprised that we are doing two audits. The compliance reviews are going to be more across the board, and an audit is a bit different, because the auditor is going to come in and ask for very detailed information. One can lead to the other. Ms. Burton supported that statement and added that if the compliance review shows a weakness in some area, then there could be a follow up audit. That is the purpose. But, if the compliance review checks out pretty well, then you can move on to the next one. If we had unlimited staff and unlimited money, you ideally would audit everything. But, we cannot. So, we have to be wise in how we audit, and it makes sense to look at a broad scope and see where you can pinpoint a problem. Then, you focus on that and you audit. She then asked Ms. Denett how many full-blown audits are started per year since we have done compliance reviews and how many were done before compliance reviews. Ms. Denett committed to contacting Phil Sykora during the lunch break and providing that information to the RPC.

Mr. Anderson asked about what percent the IRS audits. Ms. Denett explained that IRS has not been willing to share that information in the past. Ms. Tschudy stated that IRS does have some general numbers on their website about coverage. Their coverage of smaller taxpayers was less than 10 percent. The large taxpayers were in the 20 to 30-percent range.

Mr. Hartzler said that he has some statistics from the Coal Subcommittee in his report for this afternoon, because we have been looking at the compliance review effort and the audits for Solid Minerals.

Mr. Barger stated that compliance review may be a real success story. He asked whether we had looked at the ratio of cost versus return. In other words, how much is it costing you to do the compliance reviews, and how much income do you get from it? Ms. Williams responded that on audit, it is 3:1 or 4:1, as far as dollar recovery to resources spent. I think it will be greater on the compliance reviews.

Mr. Cattany said that he thinks there is a disconnect between STRAC and this group. He suggested that in the future, STRAC give a report at the RPC meeting so that this group knows what is going on. He said that the two should be in communication with each other.

Tom Readinger's Remarks

Mr. Readinger informed the RPC that he announced his retirement. He complimented Ms. Denett for her hard work, integrity and interest in doing the right thing. His presentation focused on the future of the Offshore Program. He described the Offshore Program as booming due to the high prices. Mr. Readinger gave a brief summary of the key initiatives of the Offshore Program.

He discussed the five year plan process and the requirement under the OCS Lands Act, to do leasing through a very rigorous process. He discussed the potential of expanding the areas currently available for leasing especially in light of the nation's dire need for energy. He went on to talk about the Pacific Region. We are seeing with the high prices, believe it or not, companies interested in expanding the development of some of the existing leases that are out there. That area is covered by a moratorium. We are not issuing new leases, but those leases which we thought were end-of-life, now companies are trying to drill deeper, farther, horizontally, to get everything they can—which is good from a conservation standpoint. We are trying to work with them there, and we have a strategy aimed at doing just that.

Mr. Readinger discussed the Alaska program including the need to streamline the permitting process. MMS is making sure that we are doing everything we can to not put a lot of unnecessary hurdles in the way of that. It is moving along pretty well; but it is just a challenge for us as we try to open up some of that area.

He described the Energy Policy Act new authorities for MMS to lease the renewables and provide for the use of our current existing platforms for things that were not previously authorized. He also described the Cape Wind Project off Massachusetts and the LICO project off New York. He briefly described royalty relief as a result of the Energy Policy Act including marginal property relief and provided some detail on ultra deep water and its challenges.

The next item involved post-hurricane recovery and the need to study the hurricane impacts and the lessons learned. He talked about the Coastal Impact Assistance Program as a result of the Energy Policy Act and the draft guidelines that were issued. He briefly touched on standards and maintenance schedules for facilities, the pipeline program, Coast Guard inspections, operator safety, and individuals within MMS dislocated by the hurricanes. He detailed the e-government program including electronic document management. He went on to discuss the President's Ocean Action Plan. Cost recovery and the need to charge a recovery fee for services that benefit companies was also discussed.

Mr. Readinger described the direction required by the Energy Policy Act to do a complete inventory of what is out there, and report to Congress in terms of resource potential of all areas, whether they are under moratorium or not. The report is available at the mms.gov website. He discussed the potential associated with hydrates and the need to study and document what is out there. About 98 percent of the U.S.'s hydrate resource is thought to be contained offshore, so we want to be up front, so if it ever is economical, we are ready to move out and have that gas for the U.S. markets. He concluded by describing the initiative to evaluate royalty relief and its impacts.

Questions and Answers:
Mr. Lewis asked to what extent we concern ourselves with the security issues related to production of these fuel resources. Mr. Readinger replied that we actually do work very closely with TSA and other government agencies, the Coast Guard and Homeland Security. We are part of programs where there are considerable assets in other public lands as well. We are aware of such risks, and we have initiatives and things underway to ensure those are guarded. Mr. Cattany added that in addition to the work that government is doing in terms of government continuities of operation, the private sector also has an organization to deal with a lot of the security issues of critical and essential functions in the private sector.

Mr. Zaman asked whether MMS gets seismic data from offshore. Mr. Readinger said, yes, in fact, under the conditions of our permits, when any company goes out to shoot seismic data offshore, we have access to that.

Oil and Gas Valuation Subcommittee
Mr. Cattany introduced Dan Riemer and Mary Williams who briefed the Committee on work performed by the Oil and Gas Valuation Subcommittee. Mr. Riemer read the following quote from Johnnie Burton which was the basis for the work that the Committee was tasked to perform: "We have not relaxed our valuation rules, although we have clarified some requirements. Indeed, oil sales between affiliated companies, i.e., non-arm's length transactions, for the first time are valued using the NYMEX index price. This is a more transparent and objective way to value the product and avoid extensive conflicts over previous complex evaluation approaches. We have asked our Royalty Policy Committee to study a similar approach for natural gas." Mr. Riemer presented an update and said that the subcommittee's goal is to give a final report at the next RPC meeting.

Mr. Riemer stated that the first thing needed was to establish a baseline taking into consideration existing rules. The next thing needed is to get a better understanding of gas markets. He explained that the subcommittee also needed to define the expectations of the different stakeholders, primarily the lessees and the lessor including the Federal Government, states, tribes, and industry. Mr. Riemer discussed a meeting about the fundamentals of markets held in Denver March 30, 2006.

Mr. Riemer then summarized the subcommittee session held April 25, 2006. He stated that in every rule that MMS proposes, there is usually three fundamentals which are to provide simplicity, certainty, and preserve revenue neutrality. With this in mind, the subcommittee held a brainstorming session. Mr. Reimer then presented some of the key points that resulted from the session:

- System costs associated with changes to reporting, type of data captured, and how MMS uses the data must be considered;
- Clarity must be provided about allowances and options should be specific and limited;
- Minimize or eliminate prior period adjustments; and
- Recognize regional market impacts on revenue neutrality.

Mr. Riemer identified subcommittee action items. These included: developing spread or differential examples for the Rockies and San Juan Basin; determining how to handle premium and discounts to prices within an index price methodology; utilizing a single index versus multiple locations and publications; monthly pricing versus daily spot pricing; processed gas versus unprocessed gas; and review the benchmarks included in the regulation. Mr. Riemer concluded his presentation and asked for questions or comments.

Mr. Hodsoll said that he thought the group has done a great job, and he recognized that this is a difficult thing, because companies are worried about the impact of this high volatility environment. He asked whether the group was to use as a screen for potential options on how to do this, making sure the Federal Government does not influence in any way the economic path a company might take. Are you trying to make sure that the government stays out of influencing the economic decisions that a company would make? Mr. Riemer said that they are taking that into consideration. They have heard that some companies are voluntarily performing a net back methodology, even though that was not necessarily required under the statutes or the lease terms. Rather than change their systems, they are voluntarily reporting on a net-back basis, even though it was not required. Companies have found a way to comply with the rules and the future valuation agreements have helped that effort. After an additional question and response, Mr. Cattany thanked Mr. Riemer and the subcommittee for their efforts.

Oil and Gas Royalty Reporting Subcommittee
Mr. Cattany introduced Todd Druse and Deborah Gibbs Tschudy to brief the Committee on the efforts of the Oil and Gas Reporting Subcommittee. Mr. Druse began by reminding the Committee that, at the last RPC meeting held in Lakewood on November 8, 2005, the subcommittee was asked to try one more time to reach a consensus on streamlining royalty reporting. Mr. Druse informed the Committee that they were not successful. The first project for the subcommittee was to streamline the non-arm's length transportation and processing reporting. The subcommittee had representation from several of the industry associations, states, tribes, and MMS. They held several meetings via teleconference and met in person on April 25, 2006, in Houston. Mr. Druse explained that the current method and the four options considered by the subcommittee.

Mr. Druse told the Committee that industry supported Option 3, which was the use of the prior-year's rate on current-year production. Their second choice would have been to use the Option 1, which was just rolling forward the adjustment into the current-year's estimate. They viewed both of these options as ways to reduce their administrative efforts and could see no benefit in Options 2 and 4. States and tribes opposed Options 1 and 3 due to the uncertainty of the effects on revenues to either the state or tribe. The states and tribes viewed some advantage to Option 4, as it would preserve the audit trail. Industry did not see any advantage to this method because their systems are already set up for a two-line adjustment. Mr. Druse stated that the subcommittee was charged to go out and try to take another run at this, and they were unsuccessful and asked for approval of the report by the full Committee.

Mr. Cattany asked whether the report has a majority and minority component to it. Mr. Druse explained that the report discusses, tribal and state views, along with the industry's position. Mr. Cattany asked for a motion to adopt and accept the report of the Oil and Gas Reporting Subcommittee. A motion to accept was made by Mr. Watson and seconded by Mr. Shofner. The motion carried.

Mr. Druse briefly updated the Committee on a project that the subcommittee began working on regarding communitization agreements. He informed the Committee that the next scheduled meeting of the subcommittee is a teleconference on May 24, 2006.

Recognition Ceremony
Acting Assistant Secretary Johnnie Burton recognized five RPC members for their long time service to the Committee. Mr. Cattany, the Committee Chairperson, was provided a plaque and letter thanking him for his service and many contributions to the Committee. Pary Shofner, Thomas Shipps, William Hartzler, and Eddie Jacobs (in absentia) were also provided thank you letters.

Next Meeting
A decision was made to hold the next meeting of the RPC in Denver on November 14, 2006.

RPC Charter and Nomination Process
Ms. Denett explained that a new RPC Charter had been signed by the Secretary. She briefly explained the changes contained in the new Charter. These included format changes to provide consistency with other Department of the Interior Advisory Committee Charters, changes to the ethics clause, and removal of the grandfathering language from the membership section. Ms. Denett also informed the Committee members that the Department will be soliciting nominations for Committee membership as the terms of the current members were going to expire in September 2006.

Lunch Break

Afternoon Session

Indian Oil Valuation Subcommittee
Mr. Cattany introduced Theresa Bayani. Ms. Bayani presented a status report of the proposed Indian Oil Valuation Rule. She explained that in February of last year, MMS withdrew the 1998 and 2000 proposed Indian Oil Valuation rulemaking due to changes in the market and because of the time that had passed between the rulemakings. MMS held three public meetings regarding the new rulemaking in Billings, Oklahoma City, and Albuquerque. MMS also conducted five consultations with Indian tribes and individual Indian mineral owners to gather information regarding the new rulemaking process. MMS issued the proposed rulemaking in February of this year. The intent of the proposed rulemaking is to eliminate the reliance of posted prices, address the unique Indian lease provisions, and also to provide more certainty for the valuation of oil from Indian lands. Ms. Bayani provided a summary of the February 2006 proposed rule and explained that it would apply to tribal and allotted leases for oil production from Indian lands. The comment period closed on April 14, 2006. MMS is currently reviewing the comments which are available for public review on MMS's website.

Mr. Shirley then gave an update on the RPC Indian Oil Valuation Subcommittee. He said that the Indian Subcommittee had met once since the rule was published, on March the 8, 2006. There was limited participation—three industry members and one tribal member. Perry summarized the main issues of concern by industry and the tribes including transportation allowances, major portion, and the collection of data to support the major portion calculation. He said that the Navajo has been taking their crude oil in kind since August 1995 because of the market situation on their reservation – there were a lot of oil exchange agreements and their royalty was based upon posted prices. The Navajo Nation believes that there are existing conditions on Indian lands which still raise concerns with the posted price methodology.

Mr. Shirley asked that the Indian Oil Subcommittee be allowed to continue to do their work pending the final resolution of the Indian Oil Valuation rule. Ron Cattany asked if the RPC members agreed with continuation of the subcommittee during the rulemaking process. There was no disagreement, so Ron stated that the Indian Oil Subcommittee will continue.

Coal Subcommittee
Mr. Cattany introduced Bill Hartzler to brief the Committee on the activities of the Coal Subcommittee. Mr. Hartzler discussed the three Instruction Memorandums that have been issued by the Bureau of Land Management (BLM) to implement provisions of the Energy Policy Act of 2005 pending issuance of regulations. These memorandums involved lease modifications from 160 acres to 960, bonding with respect to bonus bids, and advanced payment of royalties.

Mr. Hartzler discussed presentations made to the Coal Subcommittee by: 1) Hill and Associates to on spot market prices for coal; 2) BLM on cost recovery regulations for the solid minerals program; 3) John Hovanec on the MMS document imaging system which, during its first phase, will allow BLM and the STRAC to access the MMS documents to assist them in compliance and audit efforts; and 4) Mr. Hovanec on the history of timely payments which impacts the ability of a company to self bond on deferred bonus payments under the Energy Policy Act of 2005. Mr. Hartzler said that the subcommittee revisited non-arm's length coal valuation as in certain audits this has become a big issue.

Mr. Hartzler relayed that a major issue that the subcommittee discussed at both of the meetings held since the last RPC meeting was the coordination between the coal compliance reviews and the audit process. This is a big issue since coal companies are required to submit all of their contracts and amendments every six months to the MMS, and monthly they also have to submit detailed sales information by customer, by tons shipped, the invoiced dollars, and quality. Industry has requests from the states to provide a lot of the duplicate information that was already submitted to MMS. He reported that MMS has been working with STRAC partners to address this issue. Mr. Hartzler stressed that with the limited audit resources and MMS budgetary constraints, the subcommittee believes that the coordination of the coal compliance review and the audit processes between MMS and STRAC toward more targeted issues can result in significant audit efficiencies and assurances of lessee compliance while continuing a selected program of random detailed audits. Mr. Hartzler also discussed the need to educate MMS as to what is happening with their agreements, so that MMS can have a better understanding of how changes in the market condition impact these agreements. One of the market conditions that Mr. Hartzler discussed related to the inability of the railroad companies to ship all the coal that is produced in the Powder River Basin.

Mr. Hartzler concluded his presentation and asked for questions.

Questions and Answers:
Mr. Cattany asked if the Union Pacific (UP) line is through Wyoming. Mr. Hartzler said that it is both lines out of Wyoming; the east/west line and the south line. Mr. Cattany said that the reason he asked that is that there is an interest on the part of some private parties in Colorado to build a rail line from Steamboat up to the UP line in Wyoming as a way to avoid the bottleneck through the Moffat tunnel in Colorado. It is very interesting if the east/west line is already at capacity, and whether or not building a rail line will benefit Colorado. Mr. Hartzler said that he did know what the issues are with congestion up there—maintenance is one; the other is finding qualified people for crews.

A discussion ensued between Michael Walden Newman and Ms. Denett regarding audit and compliance review statistics. Ms. Denett agreed to provide an informational package to RPC members. Ms. Burton said that it is important to view the total amount of revenue that is being looked at, either in compliance or in audit. If we have very few dollars that those audits bring back and we have looked at so much of the revenue, then it means we are doing a good job of giving guidance to industry on how to pay and how to report. On the other side, if we were to collect an enormous amount of money through audits, it means we are not doing too good a job. Because, really, the mission is to make sure people have what they need in order to comply. And, then, we look at whether they do or do not.

Ms. Denett distributed a chart that provided information on states that MMS has a 205 agreement it includes producing federal leases within their boundaries, royalties collected from those leases, MMS compliance funding by fiscal year, a three-year listing of the audits and the collections, and the compliance reviews and the collections. A discussion followed.

Royalty in Kind
Mr. Cattany introduced Greg Smith to provide an update on the Royalty in Kind (RIK) Program.
Mr. Smith discussed RIK Program performance for FY 2005, both administrative costs and revenues, new developments, and for 2006 he focused on gas, both onshore and offshore. He made the following points. The RIK program scope is 82 million barrels of oil equivalent, a little bit down from the year before, all on the oil side, and mostly reflecting the affects of Hurricane Katrina. Seventy-five percent of the Gulf of Mexico oil and 30 percent of gas was taken in-kind as of the end of 2005. In 2005, MMS completed the fill of the SPR with in-kind oil. The last cargo went in the morning of Katrina filling it up to 700 million, and then it went down after that with some loans and with some sales. Right now, it is at about 688 million barrels.

The number and diversity of RIK purchasers is increasing which increases the competition and helps achieve fair market value. FY 2005 was the second full year that RIK measured both administrative costs and revenues. RIK is either 42 percent less costly than the cash royalty system, or 52 percent, depending on if you measure it by barrels of oil equivalent (BOE) or the number of properties. If MMS had been receiving royalties in value in FY 2005 for all offshore RIK BOE, costs would have increased by $3.74 million. In 2005, there was no uncollectible debt and no appeals or litigation. The incremental revenues over fair market value benchmarks were $30.8 million and additional interest from earlier receipt of revenues was $1.5 million for a grand total of $32.3 million. If you add the cost avoidance number of $3.74 million, there is up to $36 million net benefit to the Federal Government.

Mr. Smith then focused on the RIK natural gas highlights. RIK volumes increased nearly 8 percent. Increase in percentage gain (1 to 1.5 percent) widened with increasing absolute gas price. These gains increased with volatile comparative economics of gas and liquids. The number of purchasers increased to 19 as industry continues to recognize the reliability of MMS as a seller and the benefits of purchasing RIK gas.

Mr. Smith described crude oil highlights. RIK volumes increased nearly 66 percent with addition of SPR volumes, more Wyoming-awarded volumes, and two new substantial sales packages. The average RIK Price/Barrel was $48.41 vs. average NYMEX WTI price of $53.80. The number of participants increased to 19 and two significant crude oil properties reverted to RIV. Mr. Smith stated that the combined FY 2004/2005 incremental revenues exceeded the five-year RIK business plan goal of $50 million. New RIK developments described by Mr. Smith included the Wyoming gas project.

Mr. Cattany asked what Wyoming views as the net increase as opposed to taking the cash? Do you think you will make 20 percent more in terms of revenue by doing royalty-in-kind? Mr. Kemp replied that they do not have their state gas committed at this particular point in time. They are in an RIK oil program with MMS, but they have put that program on hold for the last year, based on the kinds of bids they got this past October. The uplift has probably been from 1 to 3 percent. Our goal is to create a situation where we have fewer audits and more assurance of a certainty for industry. Mr. Kemp stated that it is not labor intensive and that he has one other person involved in this besides himself.

Mr. Smith concluded his presentation by describing the challenges ahead as building the organization and staffing of the gas/oil front offices in Houston, expanding the business model, continuing to work on controls, and managing the issues associated with price volatility, basis, and credit issues.

Mr. Hodsoll stated that Greg tends to be play down too much the success for RIK. Greg and Lucy deserve a huge amount of credit. They have built an organization within the Federal Government, in an environment that is not conducive to building organizations, and certainly not conducive to building this type of an organization, and they have successfully built it to a point where it represents $3.7 billion in royalties. They have reduced costs for Lucy's organization. Everybody needs to recognize what a huge success this is, and what a model this is for all of us. For anybody who is in the public sector--whether it is federal public sector or the state public sector-- if you are trying to develop an organization, you should look at RIK and see what are the lessons learned.

Public Remarks:
Mr. Cattany asked if there were any remarks from the public.

Mr. Lewis said that as a public representative, he commends and saluted the leadership of MMS and the staff. Obviously, we are very, very proud of you and fortunate to have the opportunity to work with you. A discussion was held between Ms. Denett and Mr. Lewis on the status of the geothermal rulemaking process.

Mr. Walden-Newman discussed his new job with the State of Wyoming. He stated that it was a pleasure to serve on the Committee and discussed the excellent customer service experience that he had with MMS.

Committee Roundtable
Mr. Cattany added to Mr. Walden-Newman's comments and said that he remembered when Lucy moved into this job, and in every organization, there is someone who can connect the dots, and not only connect the dots, but to explain why they are connected. Lucy's passion for her job came through this morning, but what's most important is her dedication to the job. Folks here are really attesting to that effort. So, congratulations!

Based on a question from Dan Riemer a discussion ensued regarding the status of the nominations of a member and alternate to represent the Natural Gas Supply Association. Ms. Denett relayed that the package was in the Office of the Secretary of the Interior for approval. The meeting was adjourned at 4:00 p.m.

RPC ATTENDEES: Ron Cattany, Western Governors' Association, Harold Kemp, State of Wyoming, David Darouse, State of Louisiana, Todd Druse, Ute Mountain Ute Tribe, Thomas Shipps, Southern Ute Indian Tribe, Akhtar Zaman, The Navajo Nation, Perry Shirley, The Navajo Nation, Marvin Stewart, The Crow Nation, Lisa Crothers, Independent Petroleum Association of America, Carla Wilson, Independent Petroleum Association Mountain States, Dan Riemer, U.S. Oil and Gas, William Hartzler, National Mining Association, Fred Watson, Council of Petroleum Accountants Society, Michael Coney, American Petroleum Institute, Pary Shofner, Western States Land Commissioners Association, Orme Lewis, Public Representative, William Barger, Public Representative Michael Walden-Newman, Public Representative, Lucy Querques Denett, MMS, Johnnie Burton, MMS, Francis Hodsoll, MMS, Bob Anderson, BLM, Darryl Francois, BIA, Tom Readinger, MMS, Deborah Gibbs-Tschudy, MMS, Greg Smith, MMS, John Hovanec, MMS, Glenn Kepler, MMS, Mary Williams, MMS, Cathy Hamilton, MMS, Theresa Walsh Bayani, MMS, Lonnie Kimball, MMS, Robert Prael, MMS, Anita Gonzales Evans, MMS, Cheri Hunter, MMS, Patrick Etchart, MMS, Nancy Messer, MMS, Rich Adamski, MMS, Shirley Conway, MMS, Gina Dan, MMS, Mary Ann O'Malley, BP, Mark Gress, Devon Energy, Ken Vogel, Lexon, Brenda Emmons, BHP Billiton, Ken Ramos, Millennium.

Attachment

Royalty Policy Committee
Agenda
Houston, Texas
April 26, 2006

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Welcome and Opening Remarks	**8:30 – 8:35**	**Ron Cattany**
Approval of November Minutes	**8:35 – 8:45**	**Ron Cattany**
Director's Remarks	**8:45 – 9:15**	**Johnnie Burton**
MRM Associate Director's Remarks	**9:15 – 9:45**	**Lucy Querques Denett**
Morning Break	**9:45 – 10:00**	
Offshore Minerals Management Initiatives	**10:00 – 10:30**	**Tom Readinger**
Oil & Gas Valuation Subcommittee Update	**10:30 –11:15**	**Dan Riemer** **Mary Williams**
Oil & Gas Royalty Reporting Subcommittee Update	**11:15 – 12:00**	**Todd Druse** **Debbie Gibbs Tschudy**
MMS Hosted Luncheon	**12:00 – 1:00**	
Indian Oil Valuation Subcommittee Update	**1:00 – 1:45**	**Perry Shirley** **Theresa Walsh Bayani**
Coal Subcommittee Update	**1:45 – 2:15**	**Bill Hartzler** **John Hovanec** **Glenn Kepler**
RIK Update	**2:15 – 3:00**	**Greg Smith**
Afternoon Break	**3:00 – 3:15**	
Public Remarks	**3:15 - 3:30**	
RPC Charter/Membership Discussion	**3:30 – 3:45**	**Lucy Querques Denett**
Committee Roundtable	**3:45 – 4:15**	**Committee**
Schedule Next Meeting/Adjourn	**4:15- 4:30**	**Chairperson**