WRITTEN TESTIMONY OF DENNIS ROLLER, AUDIT MANAGER FOR THE NORTH DAKOTA STATE AUDITOR'S OFFICE – ROYALTY AUDIT SECTION FOR THE MINERALS MANAGEMENT SERVICE BEFORE THE NATURAL RESOURCES SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES UNITED STATES HOUSE OF REPRESENTATIVES MARCH 11, 2008

Mr. Chairman and members of the committee, I want to thank you for the opportunity for me to comment and share my views concerning the wide array of challenges faced by the Minerals Management Service and State and Tribal compliance delegations.

The North Dakota State Auditor's Office Royalty Audit Section (ND delegation) was created in 1982 under the authority of section 205 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA). For the past 25 years the ND delegation has performed compliance work on federal mineral royalties paid in North Dakota.

The ND delegation from 1982 through 2001 collected over $26.6 million. During that same period, the costs of the ND delegation were less than $4.2 million. That's over $6 of revenue for every $1 spent. For all States that had a 205 delegation for 1982 through 2001 the total collections were over $296.5 million, while costs were under $58.5 million.

Given the delegations success in the past, I would like to discuss some of the challenges the MMS and the delegations are currently facing.

Before I go into those challenges however, I would like to express that my testimony is not being given without some trepidation. I'm testifying in the hopes and beliefs that the royalty compliance program will be improved for the benefit of all U. S. citizens. However, my testimony about the challenges and ineffectiveness of the program may be viewed differently by the Department of Interior, who is in control of ND's delegation contract funding.

In fact, in October 2006, a now former high ranking MMS official advised several STRAC delegation managers (including myself) to not testify at the upcoming House and Natural Resources Subcommittee hearing that eventually took place on March 28, 2007. This official expressed to us that Congress only requests that you testify so you aren't obligated to testify and that it is best to keep any problems in house. I'm of the view that as a government employee we are to serve the people and accountability to the people is a priority.

That said the first major challenge is the state of misreporting for the MMS 2014s, payment reporting document, and the Oil and Gas Operations Report (OGOR), production reporting document. Many State and Tribal delegations have expressed their concerns to me and others over the lack of correct reporting and the additional compliance hours used because of the incorrect reporting.

With the re-engineered system that went into place on November 1, 2001, the MMS changed the property numbering system used by company's to report the 2014s. The MMS also stopped doing any automated comparison of the OGOR and the 2014. Without any automated check, company reporting accuracy has drastically deteriorated.

This issue goes to the core of having an effective royalty management program and an effective compliance program. Having correct and current OGOR data is one of the first steps in having an efficient and effective compliance system. Without complete and current OGOR reporting, the MMS does not know what they should be being paid royalties on. The ND delegation recently sent 48 different properties to MMS for which OGOR reporting was at least six months behind and in some cases OGORs had not been filed for over two, three or more years. In one case, the property started production in February 2002 and no OGORs had ever been filed. The ND delegation is aware there are even more properties in ND for which the OGOR filings are late or never been done, but has not had the time to complete this reporting project (the known unreported OGORs in ND are for CY05 or later – a period for which the ND Delegation has not done our automated comparison for – so when we do that period these unreported OGOR issues will be addressed). Having complete and current OGOR data is one of the first steps in having an efficient and effective compliance system and the next step is having correct and complete 2014 data.

Because of the lack of correct and complete 2014 reporting, our audits now entail a reconciliation of every single 2014 payment made by a company for the review period in order to determine what the company intended to report and pay.

Here's an example of a recently worked ND delegation case depicting this (with the well name, lease numbers and company name changed). Federal well #1 is a lease well on lease A (meaning that 100% of the wells production is attributable/payable to that lease). For January 2003 through July 2003, Company XYZ paid (2014 reporting) well #1's sales incorrectly to communitization agreement #410, and allocated 75% to lease A and 25% to lease B. For July 2003, Company XYZ paid 100% of the sales to lease B. For August 2003 through June 2004, Company XYZ again paid well #1's sales to communitazation agreement #410, and allocated 75% to the lease A and 25% to lease B. For July 2004, Company XYZ paid 100% of well #1's sales to lease C. Finally, for August 2004 through December 2004, Company XYZ paid well #1's sales to unit #160, and allocated 58% to lease A, 2% to lease C, 16% to lease D and 24% to lease E. Net effect being that Company XYZ paid royalties on 100% of the production from well #1, so no additional royalties are due, but it was never once paid to the correct property on the 2014.

In this instance, the land types for all leases were the same (acquired lands) and thus there was not a land type issue. If the incorrect reporting crosses land types then the incorrect entity receives the royalties, public domain lease is distributed 48% to the State and 52% Federal Government, versus an acquired lease distribution of 75% Federal Government and 25% to the county from which the mineral was produced.

An IRS comparable scenario of this would be if I filed my tax return using friend A's social security number, and friend A filed his taxes under friend B, and so on. If you tried to file your taxes with the wrong social security number electronically the IRS would not even accept them, because the social security number did not match the name.

This "reconciliation" process (determining where the payments made by the company actually belong) has added a tremendous amount of hours and inefficiency to our audits. In order to combat this, the ND delegation requested the authority to perform volume and royalty rate automated verifications on October 1, 2005, as allowed for under the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 (FOGRSFA). The ND delegation was denied that request on January 20, 2006. However, the ND delegation later was granted by MMS the ability to perform limited scope compliance reviews using our comparison tool. The ND delegation has been performing limited scope oil volume and royalty rate compliance reviews (an automated comparison of the OGOR to the 2014 for oil) since October 1, 2006 and have discovered countless reporting issues, non payment issues, missing reporting documents issues and two company's that just quit paying their federal royalty obligation in ND. The ND delegation has taken on this comparison process at a time when ND's delegation funding has went from 6 FTE to 4 FTE and the audits we perform have become complicated by the misreporting, as already discussed.

The ND delegation efforts in this area for royalties paid for CY01 through CY02 resulted in identification of nearly $200,000 of incorrectly paid royalties at a cost less than $30,000. The automated comparison process that MMS used to perform was as successful too. Per the 2001 Minerals Management Service budget justification document, the last year such collection data was reported by the MMS, the AFS/PAAS automated comparison process collected $56.2 million in additional FY98 paid royalties and per the 2000 budget justification document the AFS/PAAS comparison collected $32.7 million for FY97 paid royalties.

Comparing the OGOR data (what volume we expect to receive royalties on) to what was actually received (2014 payments) is a must in order to have an effective and efficient compliance program.

This OGOR-2014 automated comparison process was a recommendation of the Fiscal Accountability of the Nation's Energy Resources of January 1982, commonly referred to as the Linowes Commission, which was the driving force for the creation of the MMS. Recommendation #5 of the internal controls section (Chapter 3) of the Linowes Commission report states "That the Federal royalty managers incorporate production data into the royalty management system in order to cross check the data with sales and royalty data for **all** leases each payment period." (emphasis added) The MMS did this automated comparison for years, commonly referred to as the AFS/PAAS comparison. However, since the implementation (11/1/01) of the re-engineered system this is no longer done.

Another area of concern that has been expressed to me by several delegations is interest. The MMS re-engineered system (implementated 11/1/01) did not have an interest module to bill late payment/collection interest until May 2003. In a recent IG report the MMS stated that interest will be caught up by the end of Federal Fiscal Year 2007 (9/30/07). However, based on the interest data the MMS provided the ND delegation through September 30, 2007 (the MMS has not yet provided any interest data information beyond September 30, 2007) there are many compliance royalty collections and late paid royalties for which interest has not been billed as of September 30, 2007.

In addition and more importantly, the ND delegation has determined that in many instances when a company pays their royalties late the system doesn't bill late paid interest and doesn't recoup the interest that was paid to the company on their estimate. An estimate is like a security deposit. It stays with the MMS until the company is no longer the payor and it allows the company to pay the royalties for the lease one month later than originally due.

For example, Company A has a $10,000 estimate for lease 55555. Company A pays $10,500 for January royalties on April 1, one day late since the January royalties are due the last day of February but because of the estimate they are due the last day of March. Because no royalties were paid by the due date (March 31) the system assumes no royalties are due and automatically calculates and pays interest to Company A for the entire month of March on the company's $10,000 estimate. On April 1st, the system should determine that the January royalties of $10,500 was paid late and bill Company A interest for 1 day on $10,500 and also bill Company A interest on $10,000 for the Month of March (recoup the interest paid on the estimate because the system assumed no royalties were due when in fact there were royalties due that were just paid late). The ND delegation has discovered that the calculation and billing of this interest often doesn't occur. In essence, Company A was paid interest to pay their royalties late. Specific examples of this can be provided by me upon request.

Another area of concern expressed by several delegations is MMS' unwillingness to accept STRAC input or make a STRAC suggested change. A good example of this is MMS' Government Performance Results Act (GPRA) goals. MMS set the goals based on dollars voluntarily paid by the company (2014 payments). The delegations for years argued that is not a good way to set goals (what about the property for which nothing is paid on but there should be royalties paid – one that compliance work should be done on – but you accomplish $0 toward the GPRA goals because $0 was paid on the property – it moves the compliance efforts away from severely under paid properties because less of the goal is accomplished). MMS refused to change the goals until a recent Inspector General report stated the goals should be revised.

An even better example of this is STRAC's written request to then-Director R.M. "Johnnie" Burton to immediately withdraw the "Guidelines Regarding Statute of Limiations for Demand, Orders and Appeals Decisions for Federal Leases", which was approved on October 15, 2002. Under these Guidelines, MMS required: (1) that the prospective only statute of limitations, enacted under the Royalty Simplification and Fairness Act (RSFA), be applied retroactively to oil and gas production, and (2) that the RFSA statute of limitations apply to solid mineral royalties, although not covered under RSFA.

The result of the Guidelines was that appeals were deemed lost and royalties uncollected, although MMS could claim a reduction in the number of outstanding appeals. Also, demands for payments were not issued and audits were closed. The dollars lost is unknown because MMS never evaluated the impact of the Guidelines before issuing them and making them binding on the State delegations.

On January 15, 2003, STRAC warned MMS that the Guidelines were of doubtful legality and that they would most likely result in an unnecessary litigation, but STRAC's concerns were dismissed. In 2007, the U.S District Court for the District of Columbia, in a suit brought by the California State Controller, invalidated the Guidelines as arbitrary and capricious, noting as grounds many of the arguments STRAC made to MMS in 2003.

On November 17, 2007, MMS Director Randall Luthi issued a memorandum rescinding the Guidelines. Yet, MMS has done nothing to date towards collection of royalties impacted by the Guidelines.

A final example of MMS not willing to accept input from STRAC is in the development of the recent Compliance Program Tool (CPT). CPT is a new MMS tool (STRAC delegations were provided training on the tool in mid CY07) used by MMS to perform their compliance reviews. In this instance, the MMS didn't even ask STRAC for input, even though they profess STRAC to be their partner. They developed the tool and they want all the delegations to use it, but unfortunately the tool is ineffective because the tool was built backwards. Instead of starting with production data (OGOR) and then comparing that to 2014 data, MMS used their GPRA philosophy of starting with dollars voluntarily paid (2104 payments) and then compared those to the OGOR. What this means, is that for all the OGORs that no payments were received (the ones that compliance should be looking at), the CPT tool doesn't show a difference (because there was no 2014 and thus there is no starting point). I refer you back to the earlier example of lease well #1's royalties being attributed 100% to lease A – but no payment was made as a lease well to lease A so the CPT would not show a difference. If MMS would have asked STRAC for input, this fatal tool error could have been avoided.

An IRS comparable scenario of this would be me not filing my taxes and the IRS never catching that I didn't file any taxes because there were no taxes filed by me in the universe that they looked at (taxes paid), even though the State of ND files with the IRS a w-2 showing that they paid me a salary.

Another area of concern as expressed by several delegations (States as it does not affect Tribes) is the net receipts sharing or the administrative provision which reduces by 2% the States share of the royalties from public domain lands as established under the Minerals Leasing Act. This was passed as part of the Federal Fiscal Year 2008 Interior Appropriation Bill (HR2764) and is again included in the Presidents Budget for Federal Fiscal Year 2009. The 2% results in approximately a $40 million decrease in Mineral Leasing Act royalty revenue to the States from which the minerals are produced. However, every U.S. citizen benefits from the royalty revenue program because of the revenue generation of the program. If every State benefits from the program, then why is the cost of administering the program (2% reduction of States share) being unfairly applied to only the States that produce the Federal Mineral? Plus, it's applied by the States with the most production shouldering the most administrative costs. Why should the States that produce the Federal Mineral, for the benefit of every U.S. citizen, solely bore the costs of administering that program?

Should the State of Montana bore most of the Core of Engineers costs associated with administering the dams on the Missouri River just because the majority of the water was originally produced from the mountains of Montana? No, the whole country benefits from those dams through electricity generation, barge traffic, water supply for cities, etc., so the cost should be bore by the country as a whole (Federal Government), not mostly by the State of Montana.

Should the State of Florida or Arizona pay more of the administration cost of the Social Security Benefit Program because they have more retirees in those states?

Secondly, the 50% State share as provided for originally under the Minerals Leasing Act was provided to the States because the States and Counties within the States were incurring large infrastructure and maintenance costs (road building, maintenance of roads costs, etc.) from development of the minerals on Federal Lands. However, the States and Counties did not receive any revenues from those lands (through taxation, royalties, agricultural use, etc.). So the Mineral Leasing Act provided the States 50% of the royalties to compensate for the loss of revenues from the Federal Lands (Bankhead Jones Act provided 25% to the Counties for acquired lands). Today the lack of revenue generation (other that the sharing of the royalties as provided for by the Mineral Leasing Act and the Bankhead Jones Act) from those Federal Lands is still the case, so why should the State's share to compensate for the lack of revenue be reduced by 2%?

The final area that I was asked to discuss is the Royalty Policy Committee (RPC) report on MMS. I was asked as STRACs chair to discuss STRAC's opinion and views of the report. Unfortunately, do to the timing of this hearing and the report, STRAC has not had an opportunity to meet as a whole and discuss the report. However, several STRAC delegations have provided comments to me upon learning that Congress wanted STRAC's views of the report. See attachment 2 for a summary of those comments about the recommendations. Note that these are not STRAC views as a whole, just a summation of views as presented by several STRAC delegations to myself.

I would sum up the comments on the RPC report to be that the report highlights many important areas of concern, but STRAC delegations should have a voice in how those concerns are corrected and addressed.

In closing, the STRAC delegations have been very successful in the past at collecting additional royalties owed from Federal Lands. However, the MMS has consistently shown over the last several years that they are not interested in accepting STRAC's opinion or more recently even willing to ask for STRAC's opinion, despite the fact that they profess STRAC to be their partner. With the increase in oil and gas prices over the last two years bringing on a flurry of activity that hasn't been seen for over twenty years, now is not the time to be reducing audits and compliance activities and resisting improving a system that has many problem areas.

This concludes my formal testimony. Thank you for the opportunity to appear before the Committee today. I will be happy to answer any questions you may have and to go into more detail surrounding these issues.