

**STATEMENT OF
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AND
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UNITED STATES DEPARTMENT OF THE INTERIOR
BEFORE THE
COMMITTEE ON APPROPRIATIONS
SUBCOMMITTEE ON INTERIOR AND RELATED AGENCIES
UNITED STATES SENATE**

FEBRUARY 26, 2008

Madame Chairman and Members of the Committee, we appreciate the opportunity to testify today. This Committee has been instrumental in shaping our domestic energy program, particularly with regard to the sound development of our domestic oil and gas resources on the Outer Continental Shelf (OCS) and the management of mineral revenues from the OCS and from onshore Federal and Indian lands.

Today's testimony will focus on three areas:

1. The OCS leases that were issued in 1998 and 1999 without price thresholds.
2. The recent District Court decision in the Kerr-McGee litigation.
3. The recently issued report from the Subcommittee on Royalty Management and our subsequent implementation efforts.

The Department of the Interior and its agencies serve the public through careful stewardship of our Nation's natural resources. The Department also plays a vital role in domestic energy development: Approximately one third of all energy produced in the United States comes from resources managed by the Interior Department. The Department, through MMS, is also responsible for managing and providing the American people with an accurate and transparent accounting of the revenue this production generates. For example, since 1982 MMS has distributed approximately \$176.6 billion to Federal, State, and Indian accounts and special funds, including the following:

- \$107.8 billion to the U.S. Treasury and other Federal agencies;
- \$22.6 billion to the Land and Water Conservation Fund;
- \$22.3 billion to States;
- \$14.7 billion to the Reclamation Fund;
- \$5.7 billion for American Indian Tribes and allottees; and
- \$3.5 billion for the Natural Historic Preservation Fund.

1998-1999 OCS Leases without Price Thresholds for Royalty Relief

The Deep Water Royalty Relief Act of 1995 (DWRRA) required deep water leases issued from 1996 – 2000 to include a royalty incentive that allowed companies to produce a set volume of oil and gas before they began paying royalties. Price thresholds, which limit royalty relief when oil and gas prices are high, were included in leases issued in 1996, 1997 and 2000. However, they were not included in leases issued in 1998 and 1999.

A recent Federal District Court decision has called into question MMS's authority to establish price thresholds under the authority of the DWRRA. In the *Kerr-McGee* case, the District Court for the Western District of Louisiana ruled that MMS did not have the authority to apply price thresholds to the royalty relief provided in the deepwater leases issued in 1996 – 2000. On December 21, 2007, the Department of Justice filed a timely notice of appeal with the 5th Circuit Court of Appeals to protect the interests of the United States in the *Kerr-McGee* litigation. The 1998-1999 lease issue and the question of price thresholds is a sub-issue of the larger *Kerr-McGee* case.

The question of whether the Department has the authority to include price thresholds in royalty relief provisions for leases issues after 2000 is not at issue in the *Kerr-McGee* litigation. All leases issued after 2000 that include royalty relief also include price thresholds, and there is no dispute that MMS has the authority to condition this relief on the prices of oil and gas.

In an attempt to address the missing price thresholds in the OCS oil and gas leases issued during 1998 and 1999, early in my tenure as Assistant Secretary, I met with several oil companies. As a result of those meetings, voluntary agreements were reached with six companies, each of which has been paying royalties consistent with the terms of the agreement. We remain open and willing to discuss agreements with the remaining companies that hold leases issued without price thresholds.

If the District Court's decision in *Kerr-McGee* is not reversed, whether the leases issued in 1998-1999 contain price thresholds becomes moot. While we have had at least preliminary discussions with all companies holding leases issued in 1998 – 1999, I do not believe that any additional lessees will agree to price thresholds until they see the outcome of the *Kerr-McGee* case.

Royalty Policy Committee Report

As you know, we recently received a report that contains recommendations developed by the Royalty Policy Committee's Subcommittee on Royalty Management. I would like to discuss how the Subcommittee came to be established, its composition, and areas of responsibility. Director Luthi will address the current status of our efforts to implement the recommendations contained in the report.

On March 22, 2007, upon my recommendation, Secretary Kempthorne appointed the Subcommittee on Royalty Management ("the Subcommittee") to conduct an independent examination of MMS's minerals revenue management program. As you are aware,

reports from the Department's Office of Inspector General and others questioned whether the Department's royalty programs were adequate to assure that the public received the royalties that Congress had intended. While I had concluded at the time that there were not major problems in the royalty program, I felt there were many opportunities to improve those operations. As a result, the Secretary determined that a fully independent examination of the program was warranted, both to restore credibility to this important revenue-generating program, and to focus on the improvements that were needed.

Specifically, we asked the Subcommittee to review:

- the extent to which existing procedures and processes for reporting and accounting for Federal and Indian mineral revenues are sufficient to ensure MMS receives the correct amount;
- MMS's audit, compliance and enforcement procedures and processes to determine if they are adequate to ensure mineral companies are complying with existing statutes, lease terms, and regulations as they pertain to payment of royalties; and
- the operations of the Royalty in Kind Program to ensure that adequate policies, procedures, and controls are in place to ensure the decisions to take Federal oil and gas royalties in kind result in net benefits to the Federal government.

Subsequently, the Subcommittee was also asked to review procedures promulgated by the Department in response to the lack of price thresholds in Gulf of Mexico leases from 1998 and 1999 sales to ensure that future leases include price thresholds.

The panel, which was organized as a Subcommittee of the Royalty Policy Committee (RPC), a Federal Advisory Committee Act (FACA) body that advises the Secretary on matters related to mineral revenues, was comprised of seven distinguished members:

- Former U.S. Senator and Nebraska Governor Bob Kerry and former U.S. Senator Jake Garn, of Utah;
- Cynthia Lummis, a former Wyoming official who served as State Treasurer, and as a member of the Wyoming House and Senate, concentrating on natural resource and taxation issues;
- Perry Shirley, Assistant Director of the Navajo Nation's Minerals Department, who serves as the Principal Investigator responsible for administering a Cooperative Agreement between the Navajo Nation and the Minerals Management Service;
- Robert Wenzel, the highest ranking career official in the Internal Revenue Service from 1998 to 2003, whose responsibilities included the day-to-day operation and strategic management of the United States tax administration system;
- Dr. Mario Reyes, Associate Dean for Administrative Affairs and Director of Business Economics Programs in the College of Business and Economics at the University of Idaho; and
- David Deal, who serves as the vice-chair of the full Royalty Policy Committee;

To ensure independence, the Subcommittee staff came primarily from the Department's Office of Policy Analysis, but also included Bureau of Land Management staff and an independent staff member, Loretta Beaumont, who was selected by the co-chairs. MMS played no role in the Subcommittee's work beyond responding to requests for information.

I want to express my deep appreciation to each member of the Subcommittee and staff for their hard work in the preparation and completion of this thorough report.

The Subcommittee issued its Report on December 17, 2007, as a public document and in a public meeting on January 17, 2008, the RPC voted to accept the Subcommittee's Report. By letter dated January 25, 2008, the RPC Chairman transmitted the Report to the Secretary.

The Subcommittee concluded that MMS is an effective steward of the Minerals Revenue Management Program, and that MMS employees are genuinely concerned with fostering continued program improvements. The Subcommittee members unanimously agreed that MMS is the Federal agency best suited to fulfill the stewardship responsibilities for Federal and Indian leases. However, as we expected, the report identified many areas that warranted management attention to ensure public confidence.

The Report contains 110 recommendations, including 35 recommendations related to Collections and Production Accountability; 30 regarding the Royalty in Kind (RIK) Program; 27 on Audits Compliance and Enforcement; 10 related to Coordination, Communication, and Information Sharing among MMS, the Bureau of Land Management (BLM) and the Bureau of Indian Affairs (BIA); and 5 on OCS Royalty Relief (See Attachment #1). At least three of the recommendations would require legislative action. Notably, the Report concluded, "the advantages of including an RIK approach among MMS asset management options are clear and MMS's process for evaluating the feasibility of RIK versus Royalty in Value (RIV) appears to be rigorous and effective. Nevertheless, in order to ensure the program's successful operation, a number of challenges must be addressed."

The Report's recommendations span the responsibilities of all three Departmental Bureaus involved in royalty management - MMS, BLM, and BIA (See Attachment #2). Of the 110 recommendations, MMS is solely responsible for 73 and BLM is solely responsible for 15. The remaining 22 recommendations require coordination among the Bureaus. We are in the process of establishing a Production Coordination Committee with representatives from the BLM, MMS, and BIA whose task will be not only to coordinate and implement the cross cutting recommendations contained in the Subcommittee's report, but to also provide on-going coordination of issues related to the management of Federal and Indian mineral leases as suggested by one of the recommendations contained in the Report.

Implementation of Subcommittee Recommendations

In a memorandum dated January 14, 2008, Secretary Kempthorne asked the Department to review the report, develop an action plan, and begin implementing the Subcommittee's recommendations. I am pleased to report that as of February 11, 2008, 16 of the 110 recommendations are already complete (See Attachment #3). Of the remaining 94 recommendations, 29 are underway. We have developed a Joint Action Plan to address all of the Report's recommendations.

The plan identifies by recommendation the responsible Bureau, estimated timeframes for completion, and status. Points of contact are designated within each Bureau to monitor implementation and report on progress on a monthly basis. Many of the recommendations require further evaluation, and to that end, teams are being formed to determine appropriate actions and schedules. Likewise, many recommendations will need to be explored further through consultations with State and Tribal officials, and other organizations before they can be adequately implemented. We have developed a tracking system and have been and will continue to hold regular meetings to assess progress on the implementation of each action item.

Examples of the major focus areas contained in our Joint Action Plan include the following:

- Ensuring collection of sufficient data to make certain that royalties are being paid on the correct volume of oil and gas from Federal and Indian lands.
- Improving the coordination, collaboration, communication, and information sharing between BLM, MMS, and BIA.
- Requiring more reporting of data electronically and ensuring that bureaus have easy access to each other's systems.
- Implementing a risk-based compliance strategy and determining the extent to which a more flexible approach to audits, similar to that used by the IRS, is feasible.
- Ensuring the RIK program has the right personnel with the right skills to get the job done.
- Ensuring that all staff receive ethics training, including training focusing on public-private sector interactions.
- Ensuring that we have sufficient staff to support the Department's onshore and offshore royalty management activities.

Secretary Kempthorne and I are grateful to the Subcommittee for the time and energy it devoted in its review. The Department is committed to working with our stakeholders to implement the recommendations contained in the Report. We agree with the statement of the Subcommittee that implementing the recommendations in this report will greatly strengthen the management of the program, will restore public confidence, and will ensure maximum value for the U.S. taxpayer.

Conclusion

I am pleased with the results of our efforts thus far, but recognize that there is much more work to be done. MMS will continue to review and improve its royalty program. I have every confidence that MMS will successfully implement the Subcommittee on Royalty Management's recommendations which will assist MMS in ensuring that the American people receive a fair return from the important public resources the Department manages. I welcome your input on all of these initiatives, and we look forward to working with you.