

**STATEMENT OF  
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and  
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U.S. DEPARTMENT OF INTERIOR  
BEFORE THE  
HOUSE NATURAL RESOURCES  
SUBCOMMITTEE ON ENERGY AND MINERAL RESOURCES  
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Mr. 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 onshore Federal and Indian lands, and the management of mineral revenues from these lands. Our testimony will focus on the recently issued report from the Royalty Policy Committee's Subcommittee on Royalty Management and the Department of the Interior's (Department) subsequent implementation efforts, and the status of the Department's response to findings and implementation of the recommendations contained in the previous reports and audits from the Department's Office of Inspector General (OIG), the General Accountability Office (GAO), and internal reviews. As we are all aware, GAO is currently working on a similar analysis and report of the Department's royalty management program. I anticipate that GAO's findings will be similar to and support the findings and recommendations of the Royalty Policy Committee (RPC) Subcommittee.

**Background**

The Department 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 Department of the Interior.

The Bureau of Land Management (BLM) is charged with managing 700 million acres of our Nation's onshore subsurface mineral estate. The BLM issues onshore leases, establishes lease terms and conditions; and conducts on-the-ground inspections to ensure that unnecessary environmental impacts do not occur; that drilling operations are completed in accordance with an approved drilling plan; that measuring points for production of oil and gas are secure; and, that the onsite physical infrastructure for transporting oil and gas from a lease is secure so as to prevent theft of oil and gas. Furthermore, to supplement the on-the ground inspections, production reviews are performed to verify the production figures that operators have sent to the Minerals Management Service (MMS).

MMS is responsible for managing off-shore mineral resources and providing the American people with an accurate and transparent accounting of revenue that production from all Federally-owned minerals generates. In Fiscal Year 2007, MMS collected more than \$11.4 billion in revenues from Federal production, disbursing the revenue to states, American Indians, and the U.S. Treasury as directed by various statutes. Since its establishment in 1982, MMS has collected and disbursed more than \$176 billion in oil, natural gas and other mineral revenues. I am happy to point out that for the past five

years, as part of its annual CFO audit, MMS consistently has received clean audit opinions from the Office of the Inspector General's contracted independent auditing firm.

In addition to the BLM and MMS roles, the Bureau of Indian Affairs (BIA) maintains ownership information for Indian lands that determines the distribution of revenue to tribes and individual Indians. Given these shared responsibilities, the success of the royalty program requires close coordination and sharing of information between these three bureaus. The roles that BLM and BIA play in the process are equally important and significantly impact the ability of MMS to successfully achieve its mission.

As you know, the Secretary recently received a report that contains recommendations developed by the Subcommittee on Royalty Management. We would like to discuss how the Subcommittee came to be established, its composition, areas of responsibility, and the current status of our efforts to implement the recommendations contained in the report.

### **Establishment of the RPC Subcommittee**

On March 22, 2007, upon my recommendation, Secretary Kempthorne appointed the Subcommittee on Royalty Management ("the Subcommittee") to conduct an independent examination of the minerals revenue management program. As you are aware, reports from the Department's OIG 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 that there needed to be a comprehensive look at the royalty program and that there would be 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 (RIK) 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 deep water leases from 1998 and 1999 sales to ensure that future leases with royalty suspension provisions include price thresholds.

The panel 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, and 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, and served as the Royalty Policy Committee’s representative on the Subcommittee.

To ensure independence, the Subcommittee staff came primarily from the Department's Office of Policy Analysis, but also included BLM 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.

### **Royalty Policy Committee 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 (MRM) 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 account for and distribute royalties that are paid for the production of oil and gas from Federal and Indian leases.

As we expected, however, 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 from both onshore and OCS operations; 30 regarding the royalty in-kind (RIK) Program; 27 on audits compliance and enforcement; 10 related to coordination, communication, and information sharing among MMS, BLM, and BIA; and 5 on OCS royalty relief and ethics (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).

Examples of the roles of the three bureaus include:

- The results of Production Accountability Reviews performed by BLM and the MMS Offshore program are sent to the MRM program when there is a discrepancy of production reported to MRM and what is actually discovered by the accountability review. MRM then orders the operator to correct their production report and, if necessary, also orders the payor to pay additional royalties.

- BIA maintains ownership information for Indian lands that determines the distribution of revenue to tribes and individual Indians;
- Land title maintained by BLM for federal lands, i.e. classification of land, determines the distribution of revenue between the Treasury, States, and other funds;
- Lease terms and conditions established by BLM determine the royalty rate and provisions for royalty rate reductions for onshore leases;
- Authorizations and regulations control drilling of wells and construction of facilities, pipelines, and measurement equipment; and
- BLM inspections ensure the integrity of the facilities and the protection of the environment.

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 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

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, restore public confidence, and ensure maximum value for the U.S. taxpayer.

Randall Luthi, Director of the MMS, is here today to provide the Subcommittee with an update on the work being done to implement the findings and recommendations of the RPC Subcommittee and other previous reviews.

The MMS's royalty management program of today is not the same program of 25 years ago when it was in its infancy, or even 5 or 2 years ago. The MMS royalty management program of today is the culmination of 26 years of ideas, findings and recommendations for program enhancements from the best and the brightest, both internal and external, to the agency. Since FY 2003, the MRM has completed 59 internal control reviews, identified 713 recommendations for improvement, and successfully closed 612 of the recommendations. Since FY 2003, 24 external reviews by the GAO and OIG, and annual CFO audits and external peer reviews have resulted in 195 recommendations, of which MMS has successfully closed 124.

Notably, many significant changes were identified through the internal review process and were ultimately supported in the findings and recommendations reported by the various external reviews. For example, as part of the MRM program-wide Strategic Business Planning process, the MMS royalty management program identified in June

2006 the need for a risk-based compliance approach that expands compliance coverage to a greater number of companies and properties. In its December 2006 audit of MMS's compliance review process, the OIG also recommended a risk-based compliance approach. MMS recently completed the pilot project for this initiative. Additionally, in February 2006, MMS identified the need for an automated adjustment line monitoring tool to ensure that companies' royalty adjustments are made within the allowed timeframes and in compliance with applicable laws and regulations. Funding was appropriated for this initiative as part of the FY 2008 budget. The royalty management program continues to make improvements. For example, in June 2006, as part of its strategic planning initiative, MMS began pursuing the development of a risk-based strategy for compliance that expands compliance coverage to a greater number of companies and properties. This strategy will allow us to rank companies and properties according to particular risk identifiers, to provide the detail needed to identify properties or payors where audits or compliance reviews are warranted, and to identify when and where we need additional resources. Also, MRM proposed to improve the timeliness and efficiency of the interest assessment to companies by implementing computer system enhancements. The President's Fiscal Year 2009 Budget includes a request for an additional \$3.7 million for these two initiatives.

### **Implementation of Subcommittee Recommendations**

I would like to turn your attention to our progress to implement the RPC Subcommittee Report. 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:

- Completing Production Accountability Reviews at BLM and MMS for producing leases to make certain that royalties are being paid on the correct volume and quality 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 receives 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.

The BLM has already taken measures to strengthen its Production Accountability Reviews by increasing funding in FY 2008 and FY 2009, and, for FY 2009, BLM plans to hire an additional 15 Production Accountability Technicians (PATs) to increase the number of reviews in order to verify production reported to MMS by oil and gas operators. In addition, as part of the Joint Action Plan, the BLM is examining issues and recommendations to lower the thresholds for production of oil and gas for which annual reviews will be given; revise its policy and regulations on evaluating the quality of oil (API gravity) and gas (BTU factor) when doing production verification, as inaccurate reporting of these values will impact royalty collections; consolidate its policy on oil and gas measurement and when gas can be used on a lease without paying royalties on that gas; and update and consolidate policy across the program for more effective implementation of the oil and gas inspection program, including production accountability. The BLM is also examining further

increased staffing of Production Accountability Technicians, ensuring PATs are properly trained, and developing standardized position descriptions for PATs. Finally, BLM is working to develop better communications with MMS, including scheduling annual workshops on production accountability, and developing protocols for operators who have been identified as underreporting production.

Recently, Assistant Secretary Allred sent to Chairman Costa and Ranking Member Pearce, MMS's status update on the action MMS has taken to address the findings of the OIG in two of its most recent reports. I am pleased to report that as of February 29, 2008, MMS completed all of the 23 items in the action plan associated with the December 2006 audit report on MMS's compliance review process, and 12 of the 15 actions associated with the September 2007 OIG report on false claims allegations.

The OIG's December 2006 report on the compliance review process represents the culmination of an audit that the OIG performed of MMS's compliance review process. The objectives of the audit were to determine (1) whether compliance reviews are an effective part of the Compliance and Asset Management's (CAM) operation, and (2) whether MMS is effectively managing the compliance review process.

The OIG concluded in its audit that compliance reviews can serve a useful role as part of MMS's CAM program operations. The OIG further reported that compliance reviews are a legitimate tool for evaluating the reasonableness of company-reported royalties and allow a broader coverage of royalties, while requiring fewer resources than audits. While

the OIG report concluded that compliance reviews are an effective part of MMS's CAM program operations, it made recommendations to strengthen policies and procedures to improve automated tracking and verification systems and improve the compliance review process.

MMS administers a royalty Compliance and Asset Management operation charged with ensuring that fair market value is received for the mineral assets removed from Federal and Indian lands. MMS is committed to the administration of a Federal and Indian mineral revenue compliance program of the highest quality and integrity. Our efforts are to ensure that Federal and Indian mineral revenues are timely and correctly reported and paid by the minerals industry in compliance with applicable laws, regulations and lease terms.

Our compliance strategies and activities are carried out through a nation-wide MRM field audit structure and partnership through delegated and cooperative audit agreements with 11 States and 7 Indian tribes. This strategy effectively utilizes a combination of targeted and random audits, compliance reviews, and royalty in kind property reconciliations.

The strategy calls for completion of the compliance cycle within 3 years of the royalty due date. In Fiscal Year 2007, this strategy ensured reasonable compliance on \$5.8 billion in Federal and Indian mineral lease revenues, 64.7 percent of total mineral revenues paid for calendar year 2004 production. MMS's royalty compliance activities have yielded over \$3.4 billion in additional mineral revenues since program inception in 1982. The cost benefit analysis of compliance reviews and audits for Fiscal Years (FY)

2005 through 2007 shows that for every \$1 spent on compliance reviews, MMS collected \$5.49. In August of 2007, MMS reached a \$105.3 million settlement with Burlington Resources, resulting from complex, multi-year audit work. Without this anomaly being recorded in FY 2007, the cost benefit analysis for audits shows that for every \$1 spent on audits, MMS collected \$4.71 (See attachment #4). We agree with the OIG and the RPC Subcommittee that compliance reviews are a valuable management tool.

Through the implementation of MMS's compliance action plan we have taken steps to strengthen the compliance review process by establishing and implementing a pilot project to further develop and begin implementing risk-based compliance strategies, restoring MMS's access to BLM's Automated Fluid Minerals Support System that was interrupted by the Cobell litigation, amending production verification procedures, and ensuring state and tribal auditors have access to compliance tools.

The OIG's September 2007 report on the false claims allegations responded to Assistant Secretary Allred's request that they look into the qui tam lawsuits that were filed by some MMS employees (relators) against several energy companies alleging fraudulent activities. The OIG report indicates that 1) the relators did not follow MMS procedures, and 2) there was no evidence of retaliation by management against employees. The report also identified a number of areas for improvement that MMS embraced and moved aggressively to build upon.

As a result of this report, MMS analyzed its practices and, where applicable, identified opportunities to implement policy and procedural changes. These opportunities were outlined in the action plan containing 15 items, 12 of which have been completed.

Significant accomplishments include eliminating the backlog in interest billing; fully briefing decision makers on the interest calculation policy; updating manuals and other guidance on safeguarding proprietary and business confidential information and on procedures for reporting suspected fraud; and establishing policies to ensure mandatory training and performance management requirements are met. Of special note, in FY 2007, MMS billed more than \$66 million of interest on late royalty payments and is now regularly billing the lessees for any late payments on a monthly basis. The MMS will complete the remaining three action items this spring.

In addition, in October 2007, MMS met with the U.S. Attorney's Office (USAO) and the OIG to begin the process of strengthening our relationships regarding the referral and investigation of false claims cases. As a result of MMS's initiative, this group has begun meeting every month to discuss joint training on detecting and referring false claims and referral of potential royalty cases to the USAO.

## **Conclusion**

Each month, approximately 2,100 companies report and pay royalties associated with over 28,000 producing Federal and Indian leases. In FY 2007 alone, the 537 employees of the MRM program processed over 400,000 reports containing more than 7.7 million



lines of data. The magnitude and complexity of this program requires that the Federal government work with all its partners to ensure the use of best practices, the best technology, and the most efficient use of available resources. We will continue to identify and respond to opportunities to improve our efficiency and streamlining our processes, within the confines of available resources. The Department's goal is to ensure that companies are in compliance with applicable laws, regulations, and lease terms and the Government is receiving fair market value. We are pleased with the results of MMS's efforts thus far, but recognize that there is much more work to be done. We can assure you that MMS will successfully implement the remaining recommendations of the OIG and that the three Bureaus will continue to work together to implement the RPC Subcommittee's recommendations.

We welcome your input on all of these initiatives, and look forward to working with the Committee as we strengthen and improve the royalty management program.