U.S. Department of the Interior
Minerals Management Service

Performance and Accountability Report FY 2006

MMS

Securing Ocean Energy & Economic Value for America

Ship in Ice

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Message from the Director

It is my pleasure to provide the Fiscal Year (FY) 2006 Management Discussion and Analysis and Annual Financial Report of the Minerals Management Service (MMS).[1] The financial and performance data it presents are complete and reliable as outlined in Office of Management and Budget guidance. This report also presents the status of the bureau's compliance with certain legal and regulatory requirements. The annual assurance statement required by the Federal Managers' Financial Integrity Act (FMFIA) concludes that MMS can provide reasonable assurance that its systems of management, accounting, and administrative controls, taken as a whole, meet the objectives specified in Section 2 of the FMFIA. These objectives ensure that:

(1) Programs achieve their intended results;

(2) Resources are used consistent with Agency mission;

(3) Programs and resources are protected from waste, fraud, and mismanagement;

(4) Laws and regulations are followed; and

(5) Reliable and timely information is obtained, maintained, reported and used for decisionmaking.

The MMS prepares annual financial statements to help fulfill its responsibility to be publicly accountable, and to manage its programs efficiently and effectively. The aforementioned FMFIA objectives, which are addressed within the Discussion and Analysis of the Financial Statements section, document MMS's efforts to fulfill these responsibilities. Additionally, to provide greater assurance on the integrity of financial operations and the accuracy of financial data, MMS undergoes annual financial statement audits. The MMS obtained an unqualified opinion on its financial statements in FY 2006. Additional information regarding MMS's financial statements is located within the Discussion and Analysis of the Financial Statements section of this document.

For nearly 25 years, MMS has been a leader in asset management for the Federal Government. Our mission includes managing the energy and mineral resources on the Outer Continental Shelf (OCS), as well as Federal and Indian mineral revenues, to enhance both public and trust benefits, promote responsible use, and realize fair value. In pursuing this mission, MMS also supports the broader goals of the Department of the Interior (DOI or the Department), particularly:

- Resource Use for managing resources to enhance public benefit, promoting responsible use, and ensuring optimal value in energy and non-energy areas; and

- Serving Communities by fulfilling Indian trust responsibilities.

The MMS plays a key role in America's energy supply by managing the mineral resources on 1.76 billion acres of the OCS. The approximately 43 million leased OCS acres generally account for about 20 percent of America's domestic natural gas production and approximately 30 percent of America's domestic oil production. The MMS's oversight and regulatory frameworks ensure production and drilling are done in an environmentally responsible manner, and done safely. The MMS also ensures the country receives fair value for its mineral resources and collects, accounts for, substantiates, and

[1] Please see Appendix A for a list of MMS acronyms.

on average disburses more than $8 billion annually. Revenue collected from Federal and Indian gas and oil production is distributed to recipients such as the U.S. Treasury, states, special purpose trust funds such as the Land and Water Conservation Fund, and the Office of the Special Trustee for American Indians (OST), for disbursement to tribes and individual Indian mineral owners.

The MMS continues to help America meet its energy needs as we fulfill our responsibilities under the Energy Policy Act of 2005 (EPAct), signed by President Bush on August 8, 2005. The MMS, in consultation with other Federal agencies, states and affected parties, is implementing provisions that authorize MMS to permit and manage alternative energy projects on the OCS and to adopt regulatory measures that will increase energy production from traditional OCS oil and gas operations. We will strive to protect the environment, protect the lives and property of industry workers and our communities, and bring new sources of energy to our Nation while ensuring fair value for America's renewable resources as we work to achieve the Act's goals.

The MMS is committed to serving our country in the best, most efficient manner possible. As a small Bureau with a vast impact, we never stop looking for the most efficient means to ensure that the Nation receives the best value for its precious resources now and in the future.

R. M. "Johnnie" Burton
Minerals Management Service Director
October 6, 2006

Operations in Ice

MMS Mission Statement:
Manage the ocean energy and mineral resources on the Outer Continental Shelf and Federal and Indian mineral revenues to enhance public and trust benefit, promote responsible use, and realize fair value.

The MMS, a Federal Bureau within DOI, manages the Nation's natural gas, oil, and other energy and mineral resources on the OCS. The Bureau also collects, accounts for, and disburses, on average, more than $8 billion per year in revenues from Federal offshore mineral leases and from onshore mineral leases on Federal and Indian lands. The MMS's activities provide major economic and energy benefits to the American public, states, and the American Indian community.

The MMS has approximately 1,700 employees across the United States. The MMS Headquarters is located in Washington, D.C., with offices in Herndon, Virginia; New Orleans, Louisiana; Houma, Louisiana; Lafayette, Louisiana; Lake Charles, Louisiana; Camarillo, California; Anchorage, Alaska; Lakewood, Colorado; Clute, Houston, and Dallas, Texas; Tulsa and Oklahoma City, Oklahoma; and Farmington, New Mexico. The Agency has two primary operating programs: *Offshore Minerals Management* (OMM) and *Minerals Revenue Management* (MRM), supported by the Directorates of Policy and Management Improvement and Administration and Budget, as well as the Offices of Public and Congressional Affairs.

Every American benefits because of MMS's efforts, from the gasoline that powers our cars and the natural gas that heats our homes, to the benefits obtained through the disbursement of collected mineral revenues.

Mandated Duties Serving the American Public

The MMS has the responsibility of managing energy and mineral resources on the OCS, and for the fiscal accountability and management of the public's mineral revenues. The Outer Continental Shelf Lands Act (OCSLA) of 1953 called for the Federal Government to manage the oil, gas, and other mineral resources of the OCS to ensure national security, reduce dependence on foreign sources, protect the Nation's environmental health, and conserve the precious resources of the OCS. Secretarial Order 3071 created MMS in January 1982, based on a recommendation by the Independent Commission on Fiscal Accountability, that stated proper fiscal accountability and a Bureau devoted to minerals management would best serve management of the public's mineral resources. The Federal Oil and Gas Royalty Management Act of 1982 (as amended) mandates the manner in which MMS manages revenues from leasable minerals.

"The MMS is helping secure America's energy future and quality of life, while protecting the environment and providing fair equity for the use of Federal lands."

R. M. "Johnnie" Burton
MMS Director

The MMS Asset Management Process

The MMS is one of America's leading mineral asset managers. The Agency manages assets that typically generate about 30 percent of America's domestic oil production and approximately 20 percent of domestic natural gas[2], and provides more than $8 billion in annual revenues, on average, to States, American Indians, and the U.S. Treasury. Through the MMS asset management process, MMS ensures optimal value for America's mineral resources in the Gulf of Mexico (GOM) and on Federal and Indian lands. The OMM and the MRM programs carry out the mandated mission.

The *OMM* program manages pre-lease through post-lease activities ranging from the initial geological and geophysical analysis of OCS resource potential and the leasing process, to monitoring the safety of offshore facilities and protecting our coastal and marine environments. In addition to oil and gas resources, MMS provides access to State and local governments for the recovery of sand and gravel used to protect the Nation's coastal shores and wetlands. New responsibilities under the EPAct include offshore renewable energy and coastal impact assistance grant programs.

> *"Reliable and affordable energy is critical to our economic security."*
>
> President George W. Bush

The *MRM* program collects, accounts for, substantiates and disburses revenues from mineral production on leased Federal and Indian lands. Revenues collected by MMS are one of the largest sources of non-tax revenue to the Federal Government. The revenues are collected by taking Royalty-in-Value (RIV) (cash) or Royalty-in-Kind (RIK) (product). The RIK operations build on industry-proven approaches to marketing oil and gas production while ensuring fair market value is received for the Nation's oil and gas resources. Where the use of RIK provides increased revenues, creates greater administrative efficiency, or meets a security need of the Nation, MMS will collect royalties in-kind, sell the product in the marketplace, and disburse resulting revenues as prescribed by law. Through its compliance activities, MMS ensures the American people receive fair value for their domestic resources.

The MMS is committed to serving our country in the best, most efficient manner possible throughout all of our business activities. The graphic on the following page depicts how MMS secures ocean energy and economic value for America through its asset management process.

Sea Otters

[2]Note: Hurricanes and severe storms during 2004 and 2005 curtailed significant volumes of oil and gas production in the GOM which temporarily reduced the normal percentage of national production from the OCS. Recent declines in OCS natural gas production from the shallow waters of the GOM also will reduce the current estimates of the percent of U.S. production from the OCS, but production from new deepwater projects projected to come on line in 2007 is expected to offset some of this decline in the long-term

MMS: SECURING OCEAN ENERGY AND ECONOMIC VALUE FOR AMERICA

MMS Asset Management Process

mineral asset analysis

Offshore mineral resources management

- perform environmental & engineering analysis
- assess resources and assure fair value
- issue and manage leases

pre-leasing

post-leasing, pre-production

production & post-production

Federal and Indian mineral revenues management

- analyze marketing, transportation & economics
- select in-value/in-kind
- account for revenues

revenue collection

fund disbursement

compliance assurance

develop and enforce regulations
consult with stakeholders
forge partnerships

Benefits for the American People

Energy

Energy for consumers
Strategic Petroleum Reserve
Environmental protection
Worker safety

Revenue

Dollars to states and American Indians
Dollars to Treasury and environmental and cultural funds
American Indian Trust protection

Helping Meet the Energy Needs of the Nation

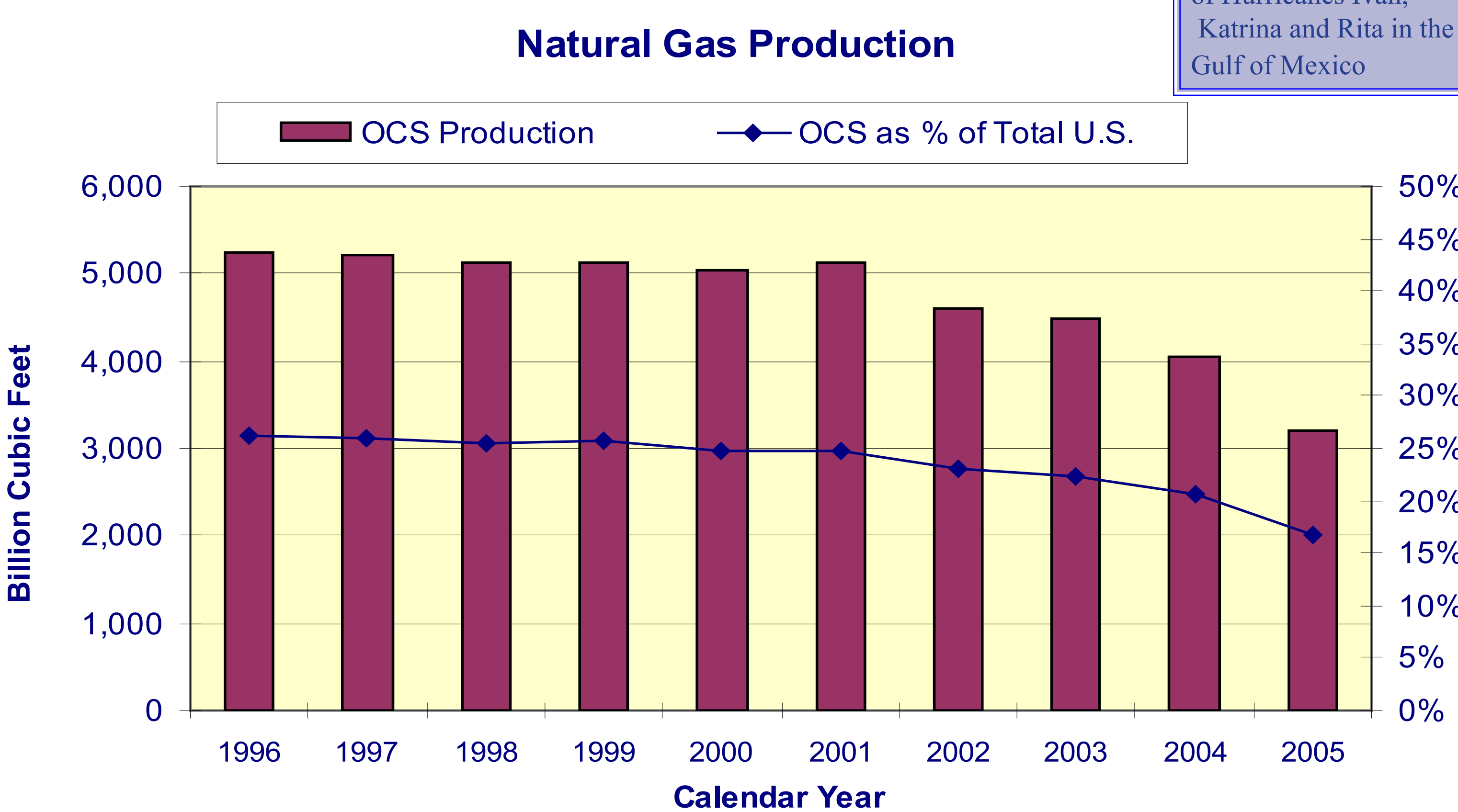
One of the cornerstones of President Bush's National Energy Policy is the role MMS plays in securing ocean energy for the Nation. From the start of the OCSLA, the OCS has contributed almost 16 billion barrels of oil and 166 trillion cubic feet of natural gas for U.S. consumption. The MMS now administers about 8,100 offshore leases, and about 4,000 offshore facilities. This is a 200 percent increase in leases since 1982. The trend will likely continue with the growing interest in deepwater and ultra-deepwater production in the GOM.

The offshore areas that MMS has designated for leasing consideration under the current 5-year Oil and Gas Leasing Program could yield as much as 22 billion barrels of oil and 61 trillion cubic feet of natural gas. It also may hold a potential future supply of natural gas from methane hydrates that could supply America's needs for natural gas for hundreds of years. The MMS plays a vital role in providing safe and environmentally sound access to these domestic energy resources.

The MMS is developing the new 5-Year Oil and Gas Leasing Program (2007 – 2012), as required by the OCSLA. The MMS received just under 39,500 comments on the Draft Proposed Program, with 39,200 from the public. Of those, just under 27,000 were in favor of expanded access and 12,200 opposed. The MMS published the Proposed Program and Draft Environmental Impact Statement (EIS) in August 2006 and expects to issue the Proposed Final Program (with a 60-day waiting period) in March 2007.

The graphic below depicts natural gas production for the calendar years of 1996 through 2005, including OCS production and the OCS production as a percentage of domestic production.

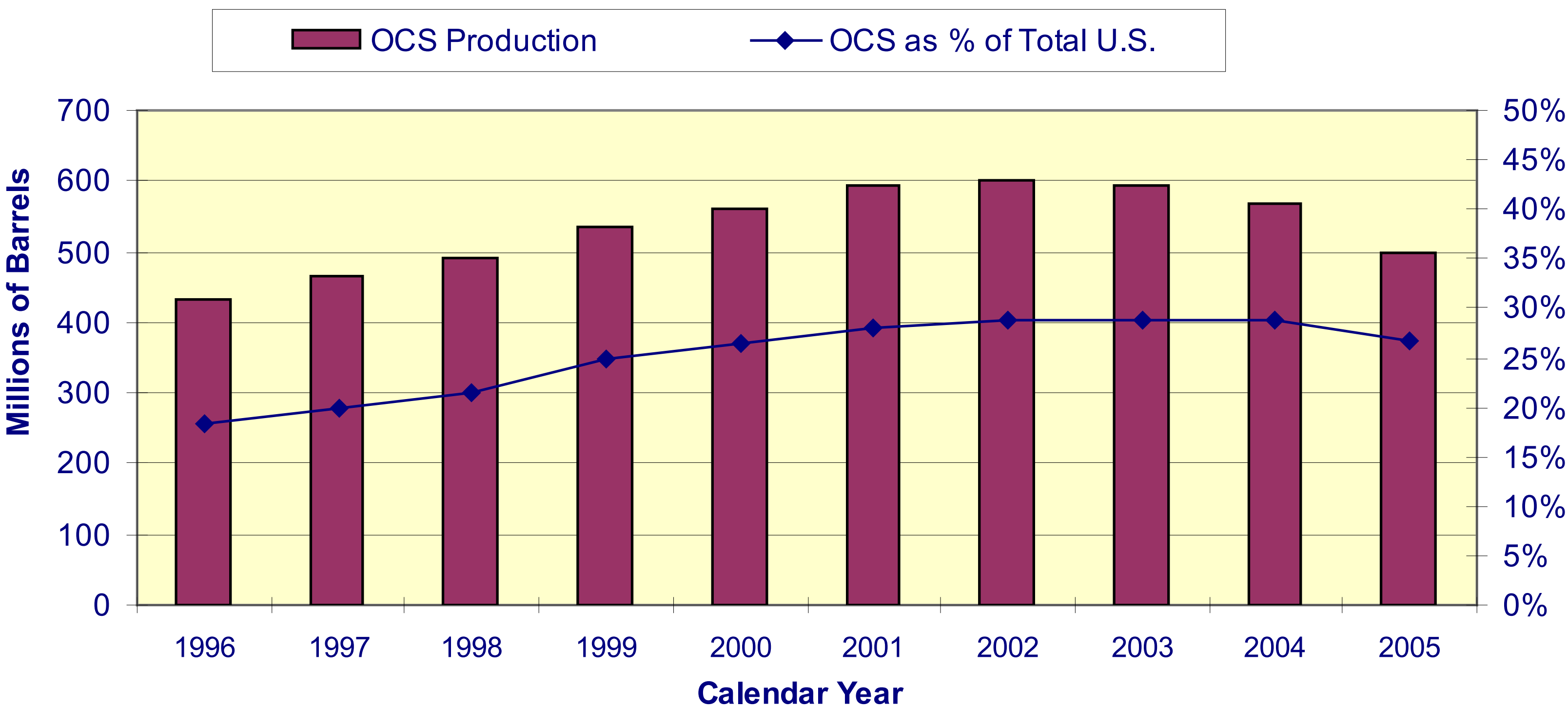
Production declines since 2004 due in part to effects of Hurricanes Ivan, Katrina and Rita in the Gulf of Mexico



The graphic below depicts crude oil and condensate production for the calendar years of 1996 through 2005, including OCS production and the OCS production as a percentage of domestic production.

Production declines since 2004 due in part to effects of Hurricanes Ivan, Katrina and Rita in the Gulf of Mexico

Crude Oil and Condensate Production

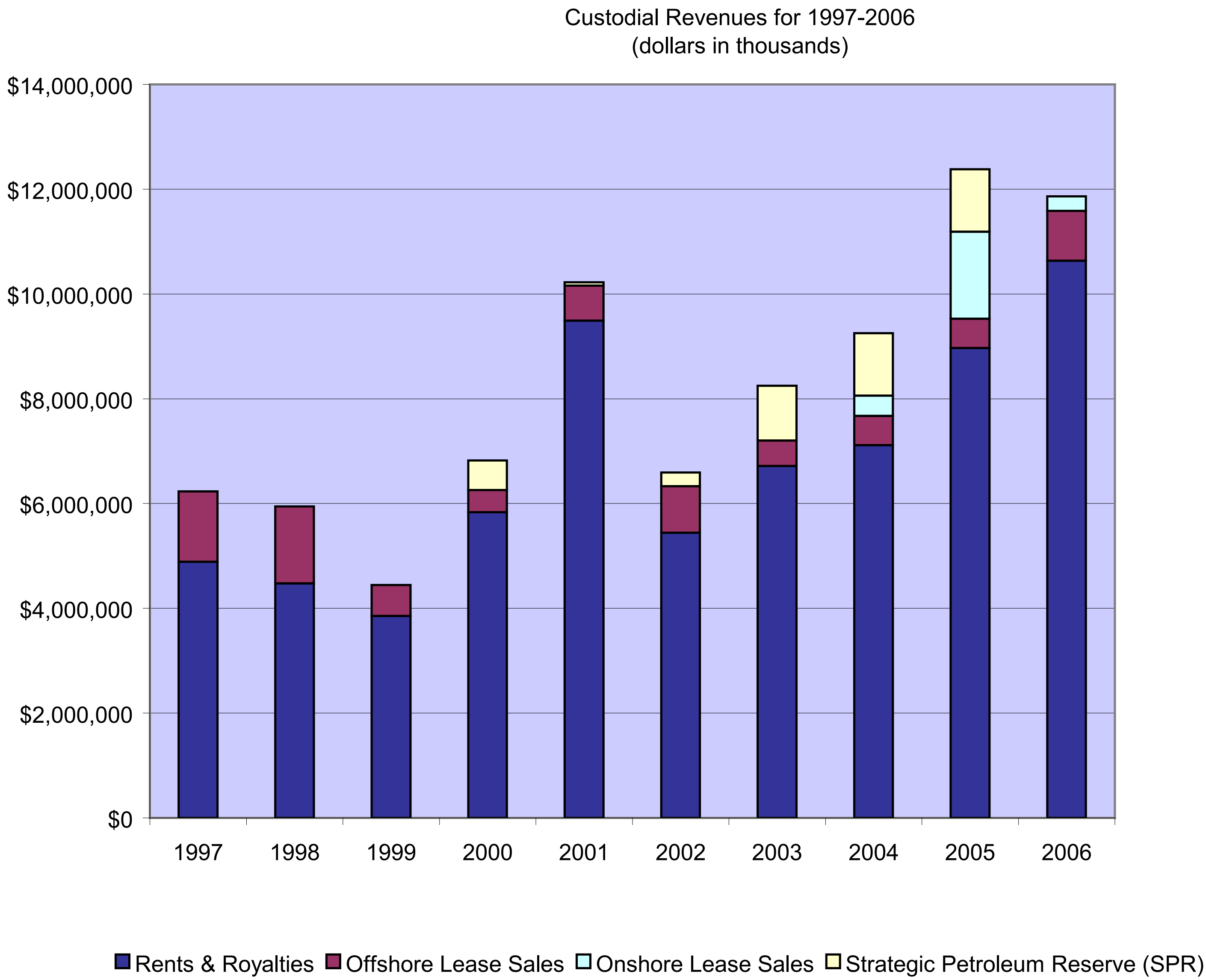


Providing Economic Value

Every American benefits from mineral resource development on Federal lands, whether the benefits are derived by energy produced from the lands or revenues generated from those natural resources.

The strategic use of both RIK and RIV options defines the royalty asset management strategy employed by MMS. The RIK program not only creates opportunities to realize additional royalty revenues relative to RIV, but the program also has established that RIK is a more cost-effective business process than RIV. In addition, taking royalties "in-kind" simplifies audits and reduces conflict associated with valuation of mineral royalties. Market conditions and MMS's competitive position at specific locations have resulted in greater revenues for the American public than from the RIV calculated revenues. As such, the option to utilize either RIK or RIV allows for a systematic analysis of the Federal royalty portfolio to selectively apply each method to optimize returns and efficiencies for the American public.

Mineral revenues over the last 10 years are shown in the revenue stack chart below. In its FY 2006 audited financial statements, MMS reports mineral revenues of about $11.9 billion.



Note: Historical SPR revenues represent value of oil taken in-kind for delivery to SPR rather than actual dollars. Beginning in FY 2005 the Statement of Custodial Activity was revised to present an additional revenue category for onshore lease sale activity; FY 2004 was also revised to include this category. This chart reflects those revisions.

PERFORMANCE GOALS AND RESULTS

The Government Performance and Results Act (GPRA) requires Federal agencies to formulate Strategic Plans, identify major strategic goals, and report performance related to those goals. In FY 2003, the DOI published an integrated Strategic Plan (2003-2008), which replaced the previous separate Bureau plans. In August, 2006, the Department published a revised draft Strategic Plan (FY 2007- FY 2012), to which MMS will align its strategic performance measures. The MMS reports on actual performance results below and in the Department's Performance and Accountability Report (PAR) published in November.

In FY 2006, MMS published a Data Verification and Validation (Data V&V) procedures guide, to ensure all GPRA, Program Assessment Rating Tool, and strategic plan measures are reliable. Responsibility for performance reporting is included in senior managers' annual performance plans and cascaded down through the organization.

MMS incurred the below costs related to the DOI Strategic Goals.

Goal	FY 2006	FY 2005
Resource Use-Energy	2,120,171	2,403,761
Resource Use-Non_Energy	1,204	1,745
Serving Communities	17,440	21,463
Reimbursable Activity and Other	(1,140)	(1,178)
Total[1]	2,137,675	2,425,791

[1] Dollars in thousands

The following is a discussion of MMS's key goals, measures, and performance as they pertain to DOI strategic goals.

OCS Leasing Activities

DOI End Outcome Goal	Measure	FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006 Planned	FY 2006 Actual
Resource Use: Manage or influence resource use to enhance public benefit, promote responsible use and ensure optimal value (energy)	Number of lease sales held consistent with the Secretary's Five Year Program.	3	4	4	2	2

To facilitate mineral production on the OCS, the MMS prepares a 5-year schedule of proposed oil and gas lease sales. The schedule includes lease sales in the available areas of the OCS (i.e., those areas not under congressional moratorium or executive withdrawal) that have the highest resource value and expected interest to industry, while recognizing environmental values, economic conditions, and competing uses. There are 20 lease sales planned for the current 5-year program (2002–2007); two sales for FY 2006.

During FY 2006, MMS conducted the following sales:

- **Central Gulf of Mexico Sale 198** was held on March 15, 2006. The sale attracted $588,309,791 in high bids from 82 companies. The total of all bids was $978,310,887. A total of 392 tracts were leased for a total of high bids of $581,820,861.
- **Western Gulf of Mexico Sale 200** was held on August 16, 2006. The sale attracted $340,935,514 in high bids from 62 companies. The total of all bids was $462,760,912. Bid analysis is ongoing to determine if Sale 200 bids meet DOI's fair market value determinations.

The MMS evaluated the **Cook Inlet lease sale, Lease Sale 199** as a "special sale." Special sales are held only if interest is expressed by industry. Cook Inlet did not receive interest; therefore, MMS did not perform pre-lease work or plan a sale.

The MMS is seeking comments through November 2006 on the Proposed OCS Oil and Gas Leasing Program for 2007-2012 and its associated Draft EIS, released for public comment on August 25, 2006. In addition to traditional sale areas in the GOM and Alaska, the Proposed Program includes sales in the North Aleutian Basin, Alaska, and in the Mid-Atlantic off the coast of Virginia. Both areas are subject to Presidential withdrawal and the entire Atlantic has been subject to congressional moratoria. These areas were included as both States expressed an interest in gathering more information and pursuing a dialogue about the energy potential in these areas. Lease sales would only be held if the President chooses to modify the withdrawal in both areas and Congress discontinues the annual statutory moratorium off the coast of Virginia. The MMS anticipates publishing the Proposed Final Program in late March of 2007.

Ensuring Safe and Clean Operations

DOI End Outcome Goal	Measure	FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006 Planned	FY 2006 Actual
Serving Communities: Protect lives, resources and property Note: target reported in DOI PAR was 6. The MMS adjusted target to 5 as a result of MMS/OMB FY 2005 PART negotiation.	Number of fatalities among workers in DOI permitted activities	11	3	6	5	9
Serving Communities: Protect lives, resources and property Note: target reported in DOI PAR was 25. The MMS adjusted target to 23 as a result of MMS/OMB FY 2005 PART negotiation.	Number of serious injuries among workers in DOI permitted activities	23	29	23	23	29
Resource Use: Manage or influence resource use to enhance public benefit, promote responsible use and ensure optimal value (energy)	Achieve oil spill rate of no more than x barrels spilled per million produced	4.2[1,2]	7.9[1,2]	31.2[2,3]	5	0.9[4]

[1]Former measure: Achieve an oil spill rate for offshore development of no more than .00001 barrel spilled per barrel produced.
[2]Production numbers are updated as MMS audits and reviews companies OCS properties to verify federal OCS production and royalty payments. These audits and reviews are normally conducted up to three years after the oil was produced. The result for this measure will continue to be revised in future years as "trapped" oil is recovered, previous unknown spills are found and OCS production is verified. Therefore, the following changes have been made to reflect the most recent information: FY03 - One spill was added (increasing the number of spills from 33 to 34) for 18.8 bbl. This increased the oil spill ratio from 4.1 to 4.2 per million produced. FY04 - Crude oil and condensate production revisions increased 20 million barrels and reduced oil spill ratio from 8.2 to 7.9 per million produced. FY05 - Crude oil and condensate production revisions increased 20 million barrels. Additional oil was also recovered through ongoing recovery efforts. Changes in both the numerator and denominator reduced the oil spill ratio from 33.0 to 31.2 per million produced. Future revisions are expected.[3]An estimated value is provided; the FY 2006 results are expected Spring 2007.
[3] Result may change as additional information becomes available, the spill rate *excluding* hurricanes is 0.2.
[4] Estimated value; FY 2006 results are expected Spring 2007.

Over the last 50 years, the safety and environmental record of the offshore industry has dramatically improved. The Nation has much to gain from excellent offshore safety and environmental performance because the production and consumption of energy are fundamental components of economic development, National security, and societal well-being. The MMS's ongoing commitment to safe and clean operations is a prerequisite for all activity on the OCS.

The MMS conducts thousands of inspections each year to ensure the safety of the oil and gas workforce and the protection of marine, coastal, and human environments. Prevention is our most important safety strategy. Annual inspections examine safety equipment designed to prevent blowouts, fires, spills, and other major accidents. The MMS inspectors have authority to shut down an operation immediately if it is being conducted improperly or without proper equipment.

The MMS closely monitors and analyzes incident-related data to understand the cause and occurrence of offshore accidents and spills and to identify actions that can be taken to prevent occurrence of similar incidents in the future. The annual average over the previous 3-year period was approximately 7 fatalities and 25 serious injuries. Though the true target for these outcomes is always zero, MMS had established an expected value performance goal of reducing fatalities and serious injuries to a level not to exceed 5 and 23, respectively, for the year.

While no single cause for the increase in fatalities in FY 2006 from FY 2005 can be identified, the unusual offshore activity level during FY 2006 is most likely a significant contributing factor. During FY 2006, the offshore industry in the Gulf of Mexico has been engaged in recovering from the record damage caused by Hurricanes Katrina and Rita in August and September, 2005. The number of repair operations and man-hours operating on the OCS has been well above that of recent years. The hurricanes also dramatically affected the availability of equipment and qualified people to conduct the recovery and repair operations. The increased activity and lack of equipment and experienced people were likely the most significant contributing factors to the greater number of fatalities. The MMS notes that four of the nine fatalities involve operations that are regulated by the United States Coast Guard. Three of these incidents involved diving operations at OCS facilities and one incident involved a person transferring from a motor vessel to a platform boat landing by using a swing rope. The MMS includes these incidents in our statistics because they occurred at OCS facilities even though MMS is not the primary agency responsible for the specific activities associated with the fatalities.

The estimated FY 2006 results for oil spills are significantly lower than recent years because there were no major hurricanes in the Gulf of Mexico or major spills during FY 2006. Additionally, FY 2004 and FY 2005 have been adjusted because of updated production results and additional oil recovered through cleanup exercises.

The FY 2005 hurricanes resulted in 31.2 barrels spilled per million barrels produced when including the 17,322 barrels of petroleum spilled during Hurricanes Katrina and Rita. The rate would be reduced to 23.6 barrels if only crude oil and condensate spilled (13,182 barrels) were included in the calculation which also includes refined petroleum. The FY 2005 result was impacted by the hurricanes with both an increase in numerator (spillage) and reduced denominator (production). For comparison, FY 2004 results excluding Hurricane Ivan spills are 0.2 barrels per million barrels produced. The FY 2005 results excluding Hurricanes Katrina and Rita spills are also 0.2 barrels per million barrels produced. Oil spill results are subject to revisions as hurricane damage assessments are completed and additional oil is recovered. The MMS remains committed to safety and environmental protection as top priorities.

Financial Management and Fulfilling Indian Trust Responsibilities

DOI End Outcome Goal	Measure	FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006 Planned	FY 2006 Actual
Resource Use: Manage or influence resource use to enhance public benefit, promote responsible use and ensure optimal value (energy)	Percent of revenues disbursed on a timely basis per statute	92.6%	95.5%	98.0%	96.5%[1]	94.5%[1]
Serving Communities: Fulfill Indian fiduciary trust responsibilities: Improve Indian Trust ownership and other information	Transfer X% of revenue to OST within 24 hours of receipt	99.3%	100%	100%	99.5%	100%
Serving Communities: Fulfill Indian fiduciary trust responsibilities: Improve Indian Trust ownership and other information	Provide lease distribution data to BIA for X% of royalties by first semi-monthly distribution	N/A New Measure	84%	92%	90%	94.7%[2]

[1]In FY 2006, MRM focused on reducing Accounts Receivable and unapplied payments. This resulted in the processing of several older payments, which lowered our timely disbursements result to 94.5%, compared to 98% in FY 2005. MRM has completed this work, so timely disbursements should increase during FY 2007.

[2]As the target for FY 2006 was being set, MRM anticipated some changes in the business process that would result in stricter enforcement of industry reporting requirements. These changes would have delayed distribution of some of the data to BIA. However, MRM

The MMS collects and processes reports and payments from bonuses, rents, and royalties from about 3,700 reporters for about 26,000 producing leases each month. The MMS distributes and disburses these revenues directly to States, the OST, other Federal agencies, and U.S. Treasury accounts. With the enactment of the EPAct, MMS has begun disbursement of geothermal royalty revenues to counties in a limited number of states. With this small exception, MMS is only required to disburse royalty revenues to States. The States may disburse royalty revenues to their counties at their discretion. The distribution and disbursement function ensures that revenues are properly disbursed to the appropriate recipients. The MMS achieved 94.5 percent timely disbursements in FY 2006.

The MMS contributes to DOI's ability to provide accurate and timely information and revenues to Trust beneficiaries. As an example, MMS transfers American Indian mineral revenues to OST on a daily basis. The OST in turn, deposits funds into interest-bearing accounts. The MMS has established a measure to document the percentage of all Indian revenue received on a daily basis transferred to OST within one business day of identification, and in FY 2006, the MMS achieved 100 percent timely transfer.

The Bureau of Indian Affairs (BIA) requires Financial Distribution Report information in order to distribute funds to individual Indian mineral owners. The MMS provides this lease distribution data to BIA twice each month. The MMS is improving the timeliness of sending lease distribution data to BIA, thus enhancing BIA's ability to provide revenues more quickly to the ultimate Trust beneficiaries. The MMS exceeded its FY 2006 goal of 90 percent, providing 94.7 percent of American Indian lease distribution data to BIA by the first semi-monthly distribution.

Mineral Revenue Compliance Activities

DOI End Outcome Goal	Measure	FY 2003 Actual	FY 2004 Actual	FY 2005 Actual	FY 2006 Plan	FY 2006 Actual
Resource Use: Manage or influence resource use to enhance public benefit, promote responsible use and ensure optimal value (energy)	Royalties received for mineral leases are X% of predicted revenues, based on market indicators in the production year	N/A New Measure	96.1% of predicted revenues (75% of CY 2001 royalty universe)	98% of predicted revenues (75% of CY 2002 royalty universe)	98% predicted revenues (75% of CY 2003 royalty universe)	98.5% predicted revenues (75% of CY 2003 royalty universe)
Resource Use: Manage or influence resource use to enhance public benefit, promote responsible use and ensure optimal value *(energy)*	Compliance work is completed within the 3-year compliance cycle for X% of roy-alties for production year X	46% of CY 2000 royalties	69.4% of CY 2001 royalties	71% of CY 2002 royalties	72% of CY 2003 royalties	72.5% of CY 2003 royalties

Mineral revenue compliance activities represent a large and critical part of MMS's operational strategy, to ensure timely and correct payment for minerals produced on Federal and Indian leased lands. The MMS predicts expected revenues, analyzes variances, performs targeted and random audits, resolves valuation discrepancies, and negotiates settlements to ensure that the American public and Indian recipients receive optimal value. During the time period from FY 1982 to FY 2005, additional collections of royalties and interest attributed to its compliance activities totaled over $3.1 billion. Compliance assurance is performed on all types of royalties due, whether received as RIV or RIK.

One compliance measure is a ratio comparing actual payments to predicted revenues. This measure provides an indication of not only how well industry is complying with MMS regulations and reporting guidelines, but also the effectiveness of MMS regulations and oversight at driving compliance. Utilizing the results from this measure, MMS coordinates with select companies to resolve issues and improve timeliness and accuracy of future reporting. In FY 2006, the MMS measured calendar year (CY) 2003 royalty payments and determined that company payments were 98.5 percent of predicted revenues (for properties representing about 75 percent of all CY 2003 royalties).

The MMS has recently implemented new aggressive compliance goals aimed at shortening the compliance cycle and increasing the percentage of revenues being reviewed and/or audited within three years. The MMS is continuing to expand compliance coverage within the shortened compliance cycle to ensure that the Government is realizing fair market value, and that companies comply with applicable laws, regulations and lease terms. In FY 2006, the MMS achieved its highest-ever level of contemporaneous (within 3 years) compliance coverage by confirming reasonable compliance on 72.5 percent of all CY 2003 royalties. In addition, in October 2005, the MMS's audit program received an unqualified peer review opinion from an independent certified public accounting firm stating that the system of quality control for the MMS audit function has been designed to meet the quality control standards established by the Comptroller General and to provide MMS with reasonable assurance of conforming with applicable auditing standards, policies, and procedures. The opinion was issued with no material weaknesses and no reportable conditions.

SIGNIFICANT ACCOMPLISHMENTS

Gulf of Mexico Regional Office Returns to New Orleans

The MMS Gulf of Mexico Regional Office (GOMR), located in New Orleans, Louisiana, sustained extensive damage during Hurricane Katrina, resulting in a temporary loss of offices housing more than 600 employees. The MMS quickly responded to the challenge by establishing a temporary office in Houston, operated by contingent MMS employees.

After operating for two months with a reduced staff in Houston, TX, MMS reopened GOMR offices with employees in both Houston and New Orleans. By April, 2006, all employees were located back in New Orleans. Approximately 100 district employees, who work in offices along the Gulf Coast, continued to work in their offices despite Hurricanes Katrina and Rita. Although forced to temporarily close as a result of Hurricane Rita, the Lake Charles district office resumed full operations on October 24, 2005. Throughout the severe disruptions to operations, MMS remained committed to New Orleans and its revival.

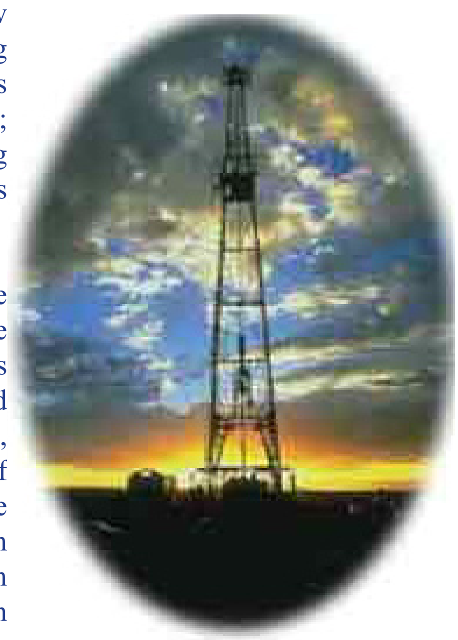
> *"The MMS is committed to stay in the New Orleans area and contribute to the economic revival of the area."*
>
> R.M. "Johnnie" Burton
> MMS Director

The safety of MMS employees was a primary concern for the Bureau throughout the hurricanes. According to GOMR Director Chris Oynes, "Most of the Gulf Regional employees who work in New Orleans live in the areas that were hardest hit by Hurricane Katrina. Although all of our employees escaped the powerful storm without serious injury, many of them lost their homes completely or their homes suffered major damage."

Implementation of the Energy Policy Act of 2005

Enacted August 8, 2005, the EPAct amended the OCSLA, the Mineral Leasing Act, the Geothermal Steam Act of 1970 and other statutes as well as creating new statutory requirements designed to increase the Nation's energy supplies. The Act establishes a number of new responsibilities and mandates for DOI which have been delegated to MMS.

Among its major provisions, MMS is now authorized to serve as the lead agency for the permitting of renewable energy and alternate uses of America's offshore public lands. The MMS has been charged by Congress to develop a comprehensive program and regulations to implement the new authority. Objectives of the new regulatory program are to provide access to the OCS in a way that: balances competing and complementary uses of offshore acreage; ensures consultation with affected states and local governments; takes into account the evolving nature of the energy industry; transfers responsibility for projects already under federal review (Cape Wind, Long Island Offshore Wind Park); and provides a fair return to the United States for access to the OCS.



Also, the Act directs the Secretary, as delegated to MMS, to establish and administer the Coastal Impact Assistance Program (CIAP). Under the program MMS is to disburse $250 million each fiscal year from FY 2007 through FY 2010 to the six coastal States (Alabama, Alaska, California, Louisiana, Mississippi, and Texas) where OCS oil and gas production occurs. A Notice of Availability was published in the September 29, 2006 *Federal Register* (FR) informing the States and the public of availability of guidelines for the Program. State Plans may be submitted to MMS following the Notice of Availability in the FR. The MMS will accept grant applications, from States with approved Plans in Spring 2007 and will award the CIAP funds to approved projects with objectives for the conservation, protection or restoration of coastal areas; mitigation of damage to fish, wildlife or natural resources; implementation of comprehensive conservation management plans; or the mitigation of the impact of OCS activities.

The MMS continues to make a major resource commitment to the timely and effective implementation of all the provisions of the Act for which we have responsibility. Since passage of the Act in August 2005, the MMS accomplished a great deal:

- Included Royalty Relief for Deep Water Production, as called for in the Act, in all GOM lease sales held after August 8, 2005.

- Published a comprehensive inventory of OCS oil and natural gas resources.

- Issued CIAP guidelines to assist eligible States in applying for the grants and complying with Federal grant program accounting and reporting requirements.

- Published, in partnership with the Bureau of Land Management (BLM), two Advanced Notice of Proposed Rulemakings (ANPR) seeking public comment on the use of royalty incentives to promote the future production of gas from hydrate deposits on the OCS and Federal lands in Alaska and to promote enhanced oil recovery on Federal leases through the injection of carbon dioxide (CO_2) and other appropriate substances. After a thorough review of the comments received in response to the ANPRs and an assessment of the emerging nature of these technologies, the Department determined, as provided for in the Act, that publication of royalty incentive rules for CO_2 and gas hydrates are not appropriate at this time. A separate report was submitted to Congress on opportunities to enhance natural gas production for gas hydrates on the OCS and Federal lands.

- Published, in conjunction with BLM, proposed rules to implement provisions and procedures for geothermal leasing, exploration, and development designed to streamline the geothermal valuation and payment process and encourage the development of new geothermal energy resources. The MMS has worked closely with the geothermal industry, affected States, and others in developing the regulations.

- Completed MRM Support System modifications for automated county-level geothermal royalty disbursements and disbursements to special accounts including Naval Petroleum Reserve, Ultra Deep Water Research, and CIAP. Initiated design and development of system changes needed to implement three credit provisions in the EPAct. The Act authorizes limited or partial credits against royalties for (1) geothermal lessees for the value of electricity delivered in-kind to a state or county government; (2) reimbursement of lessees for costs to reclaim orphaned, abandoned, or idled wells on leased or unleased Federal land; (3) payments made by a lessee directly to a state under section 6004(c) of the Oil Pollution Act (primarily involving one lessee and old drainage issues with the State of Louisiana).

- Established numerous new Treasury accounts to fund programs specified by the Act, including the Naval Petroleum Reserve, the BLM Permit Processing Pilot Office, and BLM Geothermal activities, and funded $35.8 million to date through mineral revenues.

- Submitted a report to Congress on actions taken to develop business processes and automated systems to fully support the RIK program and on future RIK business operation plans and objectives.

- Issued Notice of Intent to Prepare an EIS for Offshore Renewable Energy and Alternative Use of OCS Facilities.

- Published an ANPR for Alternative Energy-Related Uses on the OCS.

Although MMS has accomplished much during the first year of the Act, work still remains to be done. The MMS continues to work diligently to fully implement the provisions that have not been completed, while continuing to contribute toward helping meet the Nation's domestic energy needs.

The MMS Published Revised Incident Reporting Requirements

The MMS published the final rule titled "Oil and Gas and Sulphur Operations in the Outer Continental Shelf—Incident Reporting Requirements," which revises regulations at 30 CFR Part 250. The revisions pertain to requirements for reporting incidents associated with natural gas, oil, and other mineral operations on the OCS, and attempt to clarify the requirements by providing more precise reporting definitions, timeframes, and thresholds. The revisions are expected to result in more comprehensive and consistent operator reporting, which will enhance MMS's capability to identify incidents and evaluate the safety and environmental performance of OCS operations. The regulations will continue to require the reporting of all serious accidents, any death or serious injury, and all blowouts, explosions, and fires, by lessees, operators, easement holders, and other permit holders. The rule became effective July 17, 2006.

> *"The MMS has a strong regulatory program focused on safe and clean operations and the offshore industry has worked hard to achieve their excellent safety record. The MMS is committed to promoting further improvements by conducting improved analyses of incident information, sharing this information with the offshore industry, and working cooperatively with the industry to address safety and environmental concerns."*
>
> *R. M. "Johnnie" Burton*
> *MMS Director*

Gulf of Mexico Lower Tertiary Play

Results from a critical production test (announced September 5, 2006) on a GOM ultra-deepwater discovery, coupled with preliminary well data from the same geological trend have elevated the U.S. GOM's emerging Lower Tertiary play to significant national importance. This unfolding play is expansive—stretching several hundred miles across the Gulf, i.e., from Walker Ridge westward through Keathley and Alaminos canyons, at distances from about 150 to 200 miles offshore Texas and Louisiana—and is believed to hold potentially billions of barrels of recoverable oil in dozens of individual prospects.

The MMS is optimistic that industry will continue their interest and investment in this geologic trend. However, the Lower Tertiary is filled with risks, including vast salt sheets covering much of the trend that can make imaging targets below the salt difficult. Because of the challenging environment associated with the ultra-deepwater and drilling depths exceeding 6 miles, it will require new technology and billions of dollars in investment for the infrastructure to support the drilling, production and transportation of the oil to the U.S. markets. The MMS will continue to work with industry to explore and develop this national resource in a safe and environmentally-sound manner.

The MMS Offers Suspensions of Operations for Ultra-Deep Wells

The MMS issued a final rule that will allow, in certain situations, Suspensions of Operations (SOO) to oil and gas lessees or operators who drill ultra-deep wells. Ultra-deep wells are wells that are deeper than 25,000 feet true vertical depth below the ocean surface.

While technology indicates hydrocarbon accumulations may be present at ultra-deep levels, companies may be reluctant to drill without additional analysis, which can be not only time-consuming, but also costly. Normally, lessees must be producing or conducting other lease holding operations to extend leases beyond the primary term. The MMS recognizes that the added complexity and cost associated with planning and drilling an ultra-deep well may require more time for exploration and development. In such cases, the lease term may be extended through a SOO. By allowing companies to initiate a SOO, the 'clock' on the lease term is temporarily halted to prevent the lease from expiring. Although some leases with 10-year primary terms are issued in deep water, they are not covered by the final rule, because MMS believes that 10 years is sufficient to explore and develop such deep prospects. The MMS anticipates allowing SOOs will generate increased domestic production using ultra-deep wells.

Proposed New Indian Oil Valuation Rule

In February 2006, the MMS proposed a new Indian Oil Valuation Rule, which MMS developed following several public workshops and consultations with American Indian Tribes. The proposed rule focuses on adding more certainty to the valuation of oil produced from Indian lands and addressing the unique terms of Indian (Tribal and allotted) leases. Specifically addressed is the "major portion" provision, which is calculated based on the highest price paid or offered at the time of production for the major portion of oil produced from the same field. The MMS is contemplating not issuing the February 2006 proposed Indian Oil Valuation Rule as proposed, and instead taking separate actions by publishing a final rule containing technical corrections to the current 1988 Indian Oil Valuation Rule and establishing a negotiated rulemaking committee to address issues regarding oil major portion for Indian leases. The goal of the negotiated rulemaking committee will be to address alternatives for calculating oil major portion.

Implementation of National-scale Mineral Revenue Compliance Strategy

In FY 2006, the MMS continued to implement a national-scale mineral revenue compliance strategy as follows: closed 139 audits, conducted compliance reviews on approximately 4,000 producing properties, and achieved compliance on $5.8 billion in mineral revenues, and reviewed and/or audited 72.5 percent of all Federal and Indian royalty payments within three years from the date of receipt of payment, using a system that targets the largest royalty properties.

Audit Program Receives Unqualified Opinion

In October 2005, the MMS's audit program received an unqualified peer review opinion from an independent certified public accounting firm stating that the system of quality control for the MMS audit function has been designed to meet the quality control standards established by the Comptroller General and to provide MMS with reasonable assurance of conforming with applicable auditing standards, policies, and procedures. The opinion was issued with no material weaknesses and no reportable conditions. In its opinion, the accounting firm stated: "In our opinion, the system of quality control for the Federal Audit Function of MMS in effect for the 2-year period ending December 31, 2004, has been designed to meet the requirements of the quality control standards established by the Comptroller General of the United States for a Federal Government audit organization and was complied with during the 2-year period ending December 31, 2004, to provide MMS with reasonable assurance of conforming with applicable auditing standards, policies, and procedures."

Implemented a Comprehensive Business Recovery Plan

In FY 2006, the MMS's Minerals Revenue Management program successfully developed, implemented, and tested a comprehensive business recovery plan to ensure an alternate site for operation of the MMS mineral revenue financial and accounting systems in case of a national emergency or disaster.

Completed MRM Strategic Business Plan

The MRM Strategic Business Planning Initiative was completed in December 2005. This Initiative charts the course and direction of the future MRM business through the year 2012. The new Initiative focused on identifying and implementing best value services with high quality and integrity. Key outcomes include an MRM program-wide strategic plan and business plans that emphasize market-based regulatory guidance, valuation certainty, and improved business processes and systems with effective performance measures and strong internal controls. The MRM is currently developing the following five business plans over the course of the next 2 years: Financial Management, Compliance, Indian Trust, Asset Management, and Resource and Information Management. Importantly, the Initiative will be supportive of, and fully integrated with, Department and MMS strategic planning guidelines and responsive to the Administration's management improvement goals and objectives.

Implementing OMB Circular A-123

In FY 2006, the MMS conducted an evaluation of the internal controls over program operations and financial reporting in effect as of September 30, 2006. The evaluations were conducted in accordance with OMB Circular A-123, Management's Responsibility for Internal Control, and the CFO Council's Implementation Guide. Based on the results of the evaluation, MMS provides reasonable assurance that the internal controls over program operations and financial reporting for the line items identified as material to the Department of Interior were suitably designed and operating effectively as of September 30, 2006. No material weaknesses were found in the design or operation of the internal controls over program operations or financial reporting.

Wyoming Royalty-in-Kind Gas Pilot Initiated
The MMS successfully conducted its first pilot sale of RIK gas from Federal leases in Wyoming. The sale produced strong bids and resulted in two companies receiving contracts for the total sale of 10.95 billion cubic feet of Federal RIK gas produced in Wyoming. Delivery of the gas began on April 1, 2006; deliveries will take place over a period of 12 months. The MMS plans to conduct additional RIK gas sales in the future.

Royalty-in-Kind Generates Solid, Measurable Results
In March 2006, the MMS completed an analysis that examined the performance of the RIK program during FY 2005, the second full year the program was in an operational status following six years of pilot testing. Among the highlights of the report:

- RIK sales of oil and gas generated a revenue gain of $32.3 million over what would have been received if MMS had taken the royalties in-value, or as cash payments.
- Moreover actual, measured administrative costs were from 42 percent to 52 percent less than the costs that would have been incurred under a universal royalty in-value approach, an efficiency gain that translates to $3.7 million in cost avoidance.

New Pipeline may Provide Greater Return to the American Public
In 2006, the MMS signed a precedent agreement to transport natural gas through the Rockies Express Pipeline. The agreement becomes effective on the completion of the pipeline, which is dependent on meeting specific conditions outlined in the agreement. If all of the conditions are met, the pipeline will begin in Wyoming and become fully operational in 2009. If the agreement becomes effective, it commits MMS to transport more than 18 billion cubic feet (Bcf) of gas per year, or 50,000 thousand cubic feet per day, through the 1,323 mile Rockies Express Pipeline. The pipeline will transport gas from Wyoming and Colorado to markets in eastern Ohio, which connect with other pipelines serving markets in the eastern United States. The pipeline will allow MMS to expand its RIK program in Wyoming by transporting the increasing natural gas production from the Rocky Mountain Region to other regions and thus enabling expansion to other markets. The MMS signed the commitment following economic analysis, which demonstrated the potential to provide the American public greater returns by taking more gas in-kind and transporting that gas to higher priced markets. The pipeline project requires final approval from the Federal Energy Regulatory Commission, and the agreement becomes effective when the pipeline becomes fully operational in 2009.

Record Royalty-in-Kind Gas Sale
The MMS conducted a RIK gas sale in mid-March, selling a record volume of RIK gas produced from Federal leases in the GOM. Twenty-one companies submitted 127 offers for the 14 sales packages during this sale, setting a record for the total number of bidding companies and total number of bids for a sale. The sale provides for delivery of approximately 118 billion cubic feet of RIK gas over seven-month or twelve-month terms. The gas will be delivered to 14 offshore pipeline systems originating in the GOM, equating to 509,800 Million British Thermal Units (MMBtu) per day- enough to supply the heating needs of approximately 1.6 million Midwest homes for one year. The gas is destined for consumer and industry use in the continental United States. The MMS began deliveries on the sale in April 2006, and is billing on a monthly basis for those deliveries.

Presidential Management Agenda (PMA) Scorecards

The PMA Scorecards are one method used to track how bureaus are using the American public's money in the most efficient and effective manner. In 2006, the MMS continued to improve upon its performance within the PMA areas under its purview, including: Human Capital, Competitive Sourcing, Improved Financial Performance, E-Government, Budget and Performance Integration, Environmental Stewardship, and Transportation Management. In FY 2006, the MMS submitted its internal PMA Scorecards and Scorecard ratings to DOI once—in August 2006—which are listed below.

PMA Scorecard	Rating - August 2006[1,2]
Human Capital	**(green)**
Competitive Sourcing	**(green)**
Improved Financial Performance	**(yellow)**
E-Government	**(green)**
Budget and Performance Integration	**(yellow)**
Environmental Stewardship	**(green)**
Transportation Management	**(yellow)**

[1] Note: Ratings reflect MMS's self-assessment score. The ratings are pending Departmental assessment, and may be adjusted at a later time. For instance, the Department revised MMS's self-assessment for the Budget and Performance Integration scorecard, and changed the rating from green to yellow.

[2] The PMA Scorecard, which employs a stoplight scoring system, utilizes the following rating system: green (success), yellow (mixed results), red (unsatisfactory).

LOOKING AHEAD – MANAGEMENT CHALLENGES

"Although a number of different variables have to be taken into consideration in crafting a regime for other ocean uses, the scope and comprehensiveness of the OCS oil and gas program can be a model for the management of a wide variety of offshore activities."

Pg. 290 An Ocean Blueprint for the 21st Century, Final Report of the U.S. Commission on Ocean Policy, July 22, 2004.

The oil and gas industry is a globally competitive business. With an eye on the future, MMS is actively involved in providing access to energy resources for the American people, from traditional sources such as oil and natural gas, as well as renewable sources of energy on the OCS. The MMS ensures the American public receives the maximum benefit from these resources through the collection, accounting, and disbursement of revenues from mineral leases on OCS, Federal and American Indian lands.

Improving Preparations for Hurricanes

Several hurricanes affected MMS operations in the GOM last year, with Hurricanes Katrina and Rita causing the greatest overall destruction. The effects of these two hurricanes caused unprecedented and prolonged evacuations and shut-in offshore facilities, subsequently affecting the Nation's domestic oil and gas supply. While these storms were the worst in the history of GOM oil and gas production, the offshore industry was able to maintain a record of no loss of life and no significant environmental damage from wells on the OCS during both storms.

The MMS continues to research hurricane damage in an attempt to document lessons learned from the 2005 hurricane season. The MMS is sponsoring research on a variety of topics related to the hurricanes and the damage to offshore oil and gas facilities and effects on impacted communities. The research includes the following activities:

(1) Assess and evaluate pipeline movement or damage;

(2) Assess and evaluate fixed offshore platform damage;

(3) Develop a database of wind, sea state and currents resulting from Hurricanes Katrina and Rita meteorological data to assess the damages and the reason for the damages in those storms. The damage assessments will be used to determine if regulatory or design changes need to be made to prepare for future storms;

(4) Post-hurricane assessments of sensitive habitats, OCS-related infrastructures and communities; and fiscal and employment effects on impacted communities;

(5) Assess methods to eliminate hydrates in pipelines and risers during startups after a hurricane; and

(6) Assess the response of waves and currents throughout the water column in the northern GOM slope and shelf.

In addition, MMS is working closely with other Federal agencies and the oil and gas industry in the development of stronger safety standards for operations within the GOM for the 2006 hurricane season, in an attempt to apply lessons learned from the previous hurricanes. In preparation for hurricane season 2006, the MMS implemented several improvements to their oversight system. They include:

(1) Extensive pre-season planning with the Department of Energy and the U.S. Coast Guard (USCG) to facilitate communications during storms;

(2) Coordination with the industry to improve safety, specifically through Mobile Offshore Drilling Unit improvements, jack-up site assessment guidelines, risk assessment tools, and platform upgrades;

(3) Inviting a representative of the USCG to join the MMS Continuity of Operations Plan team to improve and enhance communication regarding damage to facilities and subsequent warnings to mariners by the USCG; and

(4) A new electronic hurricane reporting system, part of the eWell system, to better improve communications between industry and MMS.

Increasing Demands on the OCS

Managing access to the OCS is becoming more complicated for MMS and our sister agencies. Challenges include ultra-deepwater exploration, aquaculture, salt and sulphur, wind and wave power, hazard areas, artificial reefs, sand borrow sites, shipping, fishing, liquefied natural gas (LNG) ports and fiber optic cables competing for limited space. These projects present MMS with increasingly complicated multiple-use and primacy issues. The MMS may need to reevaluate environmental impact analyses and develop new lease stipulations and operating conditions, as alternative uses on the OCS continue to expand. The MMS expects to increase its coordination and consultation efforts to ensure that mineral resource domains remain accessible, that MMS-granted energy and non-energy rights are protected, and that OCS related activities continue to be conducted in a safe and environmentally sound manner.

RIK Gas Expansion

The RIK program is anticipated to add significant gas volumes by FY 2009 to roughly double the levels taken in-kind today to a total 1.2 Bcf per day. This expansion will also double the number of gas properties taken in-kind and increase the overall properties in RIK by 33 percent considering the existing oil portfolio. Growth of RIK gas volumes is projected at an optimal level consistent with expectations of being equal or exceeding appropriate fair market value benchmarks. Currently, the natural gas RIK business unit comprises more than 40 percent of GOM natural gas royalties; MMS expects this percentage to rise to 80 percent in the foreseeable future. In order to accomplish this, the RIK Five-Year Plan targets enhancement of specific marketing, analytical and supporting functions to allow the RIK program to evaluate various marketing alternatives, continuously monitoring historical and forward-looking market intelligence pertaining to the alternatives, and assess the risks and rewards associated with each marketing strategy and its potential impact on the portfolio.

RIK Risk Metrics

In FY 2007, the MMS plans to implement effective risk metrics to quantitatively identify exposures and inform commercial decisionmaking within the RIK Program. The metrics will be based on MMS's RIK Risk Management Policy and associated Risk Procedures Manual, which were published in FY 2005 and FY 2006. The MMS has adopted a conservative business model, based on sound and widely-used commercial practices, in itself a risk mitigation mechanism. All RIK decisions, including expansion of RIK volumes, will be made in accordance with this policy.

Managing Compliance Risk

The MMS uses a risk-based approach to select properties for review or audit and to allocate resources to achieve performance measures. The MMS's operational strategy is to address risk and capture process and cost efficiencies through full integration of Federal and Indian operations. In December 2005, the MRM published its program-wide Strategic Business Plan for FY 2007-2012. Over the 5-year Plan horizon, MMS will strategically direct compliance resources toward the highest risk areas (whether Indian or Federal) while still achieving ambitious royalty coverage targets. The MMS is currently reevaluating MRM Compliance strategies and measures as a part of the Compliance Business Planning process, and has engaged Lukens Energy Group to assist in identifying major areas of risk within MRM's compliance program, and to provide collaborative consultation regarding strategies and performance measures for fulfilling compliance responsibilities.

Increasing Indian Outreach

Working in partnership with our sister agencies, BLM, BIA, OST, and the U.S. Geological Survey, the MMS is leading an effort to expand the number of Indian outreach sessions provided by developing Indian oil and gas training that covers all aspects of trust management including land ownership, leasing, drilling, production verification, lease inspection, royalty reporting, compliance, royalty disbursement, and financial trust accounts. The new training will be tailored for tribes and Individual Indian Mineral Owners in the various regions where outreach is conducted, as well as for DOI employees who are involved in Indian oil and gas activities. The additional outreach sessions and the joint agency training program will provide Indian communities and DOI employees opportunities to gain more knowledge of the full spectrum of Indian mineral resources.

Implementing the Energy Policy Act of 2005 to Meet Increasing Energy Demand

The MMS has made great progress over the past year in implementing the provisions of the EPAct. Many of the items in the Act for which MMS is responsible have been completed, but much still remains to be done. Some of the tasks MMS will be working on in the upcoming year include:

- Develop and issue final rules providing royalty incentives to encourage the production of energy from geothermal resources, marginal properties, and from deep gas fields on the OCS.

- Establish a program for alternative energy-related uses on the OCS and provide for a 27 percent sharing of any royalties, bonuses, and rentals for these projects within three nautical miles seaward of State waters. Proposed rule to be published in Spring 2007.

- Continue the implementation of the new CIAP:
  - Receive grant applications as soon as October 2, 2006.
  - Dispense $250 million per year for FY 2007 through FY 2010 to Louisiana, Texas, Mississippi, Alabama, Alaska and California in a formula based upon each State's proximity to production, population and length of coastline.

- Implementation of Minerals Revenue Management Support System modifications to implement provisions of the EPAct that allow royalty credits.

New Frontiers for the OCS Oil and gas Program

With the increasing pressure on domestic and global energy markets, high oil and gas prices and growing dependence on foreign oil supplies, the United States is facing new challenges in meeting our energy demand. But these challenges also present new opportunities to expand the sources of our domestic oil and gas production. The offshore petroleum industry, under MMS oversight, has already moved into deeper OCS waters. This trend will continue, with exploration and production occurring in even deeper waters and from depths below the earth's surface not thought possible just a few years ago. As oil and gas companies have moved into deeper water in their search for essential energy supplies, MMS has had to develop the technical and environmental information and expertise necessary to support industry's progress and perform its regulatory responsibilities.

In addition to dealing with the challenges associated with these technological frontiers in existing areas of production, MMS is looking into the possibility of development in new geographic areas. The Proposed OCS Program for 2007 – 2012 considers leasing in areas that have not been available for many years. Should these areas remain in the Final Program, MMS will need to establish research initiatives to gather the information necessary to support decisions on whether or not to offer leases in these areas and, if so, when and under what conditions. Just as with industry's advance into deep water, we will not allow leasing and development in these frontier areas until we have sufficient environmental, geological and operational information to conclude that all proposed activities can take place cleanly, safely and in a manner compatible with other coastal and marine resources.

DISCUSSION AND ANALYSIS OF THE FINANCIAL STATEMENTS

The MMS prepares annual Financial Statements to help fulfill its responsibility to be publicly accountable, and to manage its programs efficiently and effectively. The MMS's principal Financial Statements include the consolidated balance sheet, consolidated statements of net cost, consolidated statement of changes in net position, consolidated statement of financing, combined statement of budgetary resources, and statement of custodial activity.

To provide greater assurance on the integrity of financial operations and the accuracy of financial data, MMS undergoes annual Financial Statement audits. The MMS's goals are to obtain an unqualified audit opinion on its Financial Statements, eliminate findings related to the internal control environment, and ensure the Bureau does not have instances of non-compliance with provisions of laws and regulations that have a direct and material impact on the Financial Statements. The MMS obtained an unqualified opinion on its Financial Statements in FY 2006 and FY 2005. While MMS has made significant progress in enhancing its overall control environment we have not been able to eliminate all instances of reportable conditions or non-compliance with applicable laws and regulations.

Limitation of Financial Statements

Responsibility for the integrity and objectivity of the Financial Statements lies with MMS management. The Financial Statements and supplementary schedules included in the report reflect the financial position and results of operations of MMS pursuant to the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. While the statements are prepared from the books and records of the Bureau in accordance with generally accepted accounting principles for Federal entities and the formats prescribed by OMB, the statements differ from financial reports used to monitor and control budgetary resources prepared from the same books and records. The Financial Statements should be read with the realization that MMS is a Bureau of the Department of the Interior, an Agency of the executive branch of the United States Government, a sovereign entity. Accordingly, unfunded liabilities reported in the statements cannot be liquidated without the enactment of an appropriation, and ongoing operations are subject to the enactment of appropriations.

General

Statement of Net Cost and the Strategic Plan

In accordance with OMB Circular A-136*,* MMS aligned its Statement of Net Cost directly to the goals and outcomes identified in the Department of the Interior Strategic Plan. As required by the Government Performance Results Act (GPRA), the Department updated its departmentwide strategic plan in FY 2004. Under the updated Strategic Plan, the mission goals and categories for MMS are as follows:

1. Resource Use
2. Serving Communities
3. Reimbursable Activity, and Other

Interior Franchise Fund

Realignment

Effective October 1, 2005, the Department of the Interior transferred the Interior Franchise Fund from the Minerals Management Service to Departmental Offices. In accordance with OMB Circular A-136, the Minerals Management Service has restated its FY 2005 financial statements to remove the Interior Franchise Fund financial amounts and therefore present the FY 2005 financial statements comparative to the FY 2006 financial statements. Note 24 of the financial statements summarizes the changes to the FY 2005 financial statements as a result of this change in reporting entity.

Operating Challenges

Fiscal year 2006 presented a number of important challenges that affected MMS's financial position and results of operations. The most significant of these were the realignment of the Interior Franchise Fund, increased royalty and related collections and distributions caused by higher oil and gas prices and production volume, and the development of alternative processes to accurately report on oil and gas production for those companies affected by Hurricanes Katrina and Rita.

Assets

The MMS's Consolidated Balance Sheet shows FY 2006 assets totaling $3,827 million, a decrease of $229 million from FY 2005. The decrease is primarily attributable to a decrease in Administrative Accounts Receivable due on deferred bonuses for on-shore solid mineral leases.

Liabilities and Net Position

The MMS's Consolidated Balance Sheet shows FY 2006 liabilities totaling $3,238 million, a decrease of $254. The decrease is primarily a result of a decrease State Liabilities.

Federal agencies, by law, cannot make payments unless Congress appropriated funds. The MMS's unfunded liabilities excluding the accrued liability to the States, deferred credits for lease bonus money on oil and gas leases that have not yet been finalized, and custodial liabilities for royalties payable is approximately $574 million. The $574 million consists of accrued contingent liabilities as described below, annual leave, unfunded workers compensation claims under the Federal Employees Compensation Act, which are considered an expense and liability in the current year, but which will be paid out of funds made available to the Agency in future years, and capital lease liabilities.

The Net Position of the Bureau consists of Unexpended Appropriations - Other Funds, Cumulative Results of Operations - Earmarked Funds, Cumulative Results of Operations - Other Funds. The MMS's Net Position as of September 30, 2006, is $590 million, which consists of $24.7 million of Unexpended Appropriations, a deficit of $502 million in Cumulative Results of Operations – Other Funds, and $1,067 million in Cumulative Results of Operations – Earmarked Funds.

The Unexpended Appropriations represent spending authority appropriated by Congress that has not yet been used. Cumulative Results of Operations is the net results of the Bureau's operations over time, and is a deficit at September 30, 2005, due to a legal contingent liability that has been accrued for. It is legal counsel's opinion that ultimately any liability associated with this case will be funded by the Department of Justice's Judgment Fund, at which time MMS will recognize a financing source, and the deficit will be eliminated. The Cumulative Results - Earmarked Funds related to the EIRF, results from a June 29, 2000 U.S. Supreme Court decree, settling a long-standing dispute between the State of Alaska and the Federal Government, over the State/Federal boundary of areas leased for oil and gas in the Beaufort Sea. The law requires that the corpus of the Fund be invested. Twenty percent of the interest earned each year is permanently appropriated to the Department of Commerce with the remaining interest staying with the fund to be appropriated by Congress to other agencies as specifically provided by the law.

Costs of Operations

As reflected on the Consolidated Statement of Net Cost, the total FY 2006 cost of MMS operations was $2.14 billion, a decrease of approximately $288 million from the FY 2005 cost of $2.42 billion. While there was a net overall decrease of $288 million there was a significant increase of approximately $494 million of royalty collections paid to the States. This increase was off-set by a decrease in lease bonus collections paid to the states.

Revenues

In general, MMS's strategic goals are intended to be funded by general government funds derived from tax receipts and other sources. However, other fees and collections support a number of MMS activities. As authorized by Congress, MMS collected approximately $168 million in revenues during FY 2006, from the public as royalties, rents, and bonus receipts.

Budgetary Resources

The MMS's major sources of budgetary resources consist of direct appropriations and offsetting collections. In FY 2006 total budgetary resources increased from $1,976 million to $2,510 million. The increase is primarily the result of a $494 million increase in appropriations received for royalties that will ultimately be distributed to the states.

The MMS's FY 2006 budgetary resources of $2,510 million consisted of approximately $173 million or 7% of offsetting collections, $2,320 million or 92% of appropriations received, and $17 million or 1% of Unobligated Balances brought forward from prior years, Recoveries of prior year unpaid obligations, nonexpenditure transfers, and other amounts either temporarily or permanently unavailable. Of the total budgetary resources, $2,469 million were obligated in FY 2006.

The MMS's mission critical operations are funded from three sources: the Royalty and Offshore Minerals Management (ROMM) appropriation, Oil Spill Research, and offsetting collections received primarily from rental receipts from offshore leases. For FY 2006, the MMS had total annual appropriated resources of $357.2 million, of which $171.2 million was from offsetting collections.

Custodial Accounts

The MMS's custodial revenues are from Outer Continental Shelf and onshore oil, gas, and mineral lease sales and royalties. These revenues are presented on MMS's Statement of Custodial Activity, and not its Statement of Net Cost or Statement of Changes in Net Position, because they are considered to be revenue of the Government as a whole rather than to MMS or the Department. Revenues are collected on behalf of the U.S. Treasury, other Federal agencies, States, Indian Tribes, and Individual Indian Allottees.

In FY 2006 MMS had custodial revenues of approximately $11,863 million, a decrease of approximately $519 million from FY 2005. Despite the overall decrease there was an increase of $1,688 million of rents and royalties collected due to a combination of higher oil and gas prices and increased volume by producers, and an increase of $389 million received for offshore lease sales. These increases were offset by decreases in onshore lease sales of $1,384 million, and a decrease of $1,213 million of receipts related to the Strategic Petroleum Reserve.

COMPLIANCE WITH LAWS, SYSTEMS, CONTROLS, AND FINANCIAL PERFORMANCE

Compliance With Laws

MMS is required to comply with several key legal and regulatory financial requirements, including the Prompt Payment Act, the Debt Collection Improvement Act, the Improper Payments Information Act, the Inspector General Act Amendments (Audit Follow-Up), the Federal Oil and Gas Royalty Management Act, the Federal Financial Management Improvement Act (FFMIA), and the Federal Financial Management Improvement Act (FFMIA).

Federal Financial Management Improvement Act (FFMIA)

As of September 30, 2006 MMS financial management systems complied substantially with the U.S. Standard General Ledger (USSGL) at the Transaction Level, financial management systems requirements, and accounting standards applicable to Federal entities.

Federal Managers' Financial Integrity Act (FMFIA)

The MMS centrally manages the Federal Managers Financial Integrity Act program, with oversight responsibilities assigned to the bureau CFO and deputy CFO. Each of the four MMS Associate Directors maintains responsibility for effective controls to provide reasonable assurance that Government resources are protected against fraud, waste, abuse, mismanagement, or misappropriation.

Audit Follow-Up

During fiscal year 2006 MMS made significant progress in implementing processes and procedures to correct findings identified during previous audits. While considerable effort and resources have been expended, and most findings from previous audits have been corrected, MMS has not yet completed its efforts to eliminate previous findings or non-compliances related to system and application controls and accounts receivable.

Improper Payments Information Act

The Improper Payments Information Act (IPIA) of 2002 (P.L. 107-300) requires Federal agencies to carry out a cost-effective program for identifying payment errors and recovering any amounts overpaid. An improper (or erroneous) payment includes any payment that should not have been made, or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirement. Incorrect amounts include: overpayments; underpayments (including inappropriate denials of payment or service); any payment made to an ineligible recipient or for an ineligible service; duplicate payments; payments for services not received; and payments that do not account for credit for applicable discounts.

To implement IPIA, the Office of Management and Budget (OMB) required agencies to review all programs (meeting OMB's definition of "program") to determine the risk susceptibility of making improper payments and to perform more in depth assessments for those programs meeting OMB's criteria for "significant erroneous payments", defined as annual erroneous payments in the program exceeding both 2.5% of program payments and $10 million.

Based on management analysis and a series of internal control review techniques, MMS determined that none of its programs are risk-susceptible for making significant improper payments at or above the threshold levels set by OMB. It should be noted that these reviews were conducted in addition to audits under the Chief Financial Officers Act of 1990, GAO reviews, and reviews by Interior's Inspector General. Three different techniques were used to arrive at this determination: (1) risk assessments of internal controls related to payments for all programs using the thresholds set out above; (2) Departmental Functional Reviews (DFRs) focusing on the general control environment for making payments and the controls related to specific payment types; and (3) post-payment recovery audits. Each of the three techniques is summarized below:

1. Risk Assessments. Under Departmental Management Control Guidance for FY 2006 MMS conducted risk assessments of all programs to determine if any were risk-susceptible for making significant improper payments. The assessments were used to establish risk profiles for all bureau programs. As a result of these reviews MMS came to the conclusion that none of its programs pose a high-risk of making significant improper payments based on OMB's criteria.

2. Department-Wide Functional Reviews (DFRs). Under Departmental guidance MMS conducted DFRs in FY 2006 for the following payment processes: vendor, travel, and purchase card. The results of the DFRs indicated that internal controls were adequate and working as intended in the vendor, travel, and purchase card processes.

3. *Recovery Audits* - In response to Section 831 of the Defense Authorization Act for FY 2002 (U.S. Code 31 USC 3561-3567), Interior contracted with a recovery audit firm that began work in FY 2004. Since 2004 the recovery audit firm has identified less than $75 thousand in erroneous payments.

MMS Plans for FY 2007 – FY 2008. Annual goals are to maintain adequate controls over payment processes to ensure that erroneous payments are minimized. The MMS will continue using contractor assistance to perform post-payment recovery audits initiated in FY 2004.

Financial Systems

Currently MMS relies on a set of financial management systems to collectively support program and financial managers. Systems are managed at various levels within MMS ranging from bureau level centrally managed systems, locally managed systems, and externally managed systems upon which MMS relies. Collectively these systems represent MMS's financial management systems architecture.

In alignment with the views of the government-wide CFO council, MMS believes that the key to improved program and financial management is improved financial management systems. To meet the need for improved systems MMS has fully aligned with a department wide initiative to implement the Financial and Business Management System (FBMS) and will convert to the FBMS system in the first quarter of FY2007.

Management Controls

MMS's management control program is designed to ensure compliance with the goals, objectives, and requirements of the FMFIA and Office of Management and Budget (OMB) Circular A-123, "*Management Accountability and Control,"* Circular A-127, *"Financial Systems,"* and OMB Circular A-130, "*Management of Federal Information Resources*."

MMS believes that in addition to reoccurring controls within each of its significant business processes, the key to sound internal control is cognizance of the overall control environment by all levels of management, and the communication of management's emphasis on the importance of a sound control environment. As part of its overall control program MMS has implemented a comprehensive management review program to include Administrative Management Assistance Reviews, Department-Wide Functional Reviews, and Risk Assessments of its major programs.

Financial Performance

The MMS monitors financial management performance through periodic collection and reporting of data for the Prompt Payment, Electronic Funds Transfers, and the Debt Collection Act. These reports are prepared and submitted to the Department of the Interior's Office of Financial Management for review by Departmental senior managers.

Performance Measure: To have the percentage of payments without interest penalties meet or exceed the government wide goal of 98 percent.

2006 Results: The MMS paid 99.7 percent of all payments without interest penalty in FY 2006.

Performance Measure: To use Electronic Funds Transfer (EFT) to the maximum extent possible when making payments, in-order to exceed the government wide goal of 90%.

2006 Results: The MMS achieved its goal by continuing to require new vendors and employees to enroll for EFT payments. During FY 2006, 99.9 percent of all payments were made via EFT.

Performance Measure: To identify and refer 95 percent of delinquent debt to Treasury when 180 days past due.

2006 Results: The MMS met this goal by identifying and referring 99.9 percent of eligible delinquent debt to Treasury when 180 days past due.

Performance Measure: To reduce the delinquency rate of employee individually billed travel charge card accounts past due 61+ days to one percent or less.

2006 Results: The MMS met this goal. In 2006 there were no delinquencies of employee individually billed travel charges.

Independent Auditors' Report

United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, DC 20240

Memorandum FEB - 5 2007

To: Director, Minerals Management Service

From: Anne L. Richards Anne L. Richards
Assistant Inspector General for Audits

Subject: Independent Auditors' Report on the Minerals Management Service Financial Statements for Fiscal Years 2006 and 2005 (Report No. X-IN-MMS-0019-2006)

INTRODUCTION

This memorandum transmits the KPMG LLP (KPMG) auditors' report of the Minerals Management Service (MMS) financial statements for fiscal years 2006 and 2005 (Attachment 1). The Chief Financial Officers Act of 1990 (Public Law 101-576), as amended, requires the Inspector General or an independent auditor, as determined by the Inspector General, to audit the Department of the Interior (DOI) financial statements. Under a contract issued by DOI and monitored by the Office of Inspector General (OIG), the independent public accounting firm KPMG performed an audit of the MMS fiscal years 2006 and 2005 financial statements. The contract required that the audit be performed in accordance with the "Government Auditing Standards" issued by the Comptroller General of the United States and with Office of Management and Budget Bulletin No. 06-03, "Audit Requirements for Federal Financial Statements."

RESULTS OF INDEPENDENT AUDIT

In its audit report dated November 13, 2006, KPMG issued an unqualified opinion on the MMS financial statements. However, KPMG identified two reportable conditions in internal controls over financial reporting, neither of which were considered to be material weaknesses. In addition, KPMG identified two instances where MMS did not comply with laws and regulations. The report contains four recommendations that, if implemented, should resolve the findings.

STATUS OF RECOMMENDATIONS

In its December 19, 2006 response (Attachment 2) to the draft report, MMS agreed with three of the four findings and disagreed with the non-compliance with laws and regulations. However, MMS agreed with each recommendation, stating that it was in the process of implementing all four of the recommendations (see Attachment 3, "Status of Audit Report Recommendations").

Two of the four recommendations are repeat recommendations that were made in last year's Report No. X-IN-MMS-0010-2005. One of the two repeat recommendations was closed after the Assistant Secretary for Policy, Management and Budget received documentation that the recommendation had been implemented; however, the action taken by MMS did not fix the condition. Therefore, KPMG found the same condition and made the same recommendation this year. We will refer this repeat recommendation to the Assistant Secretary for tracking of implementation. The remaining repeat recommendation is being tracked based on the prior report. We will refer the two new unimplemented recommendations to the Assistant Secretary for tracking of implementation.

EVALUATION OF KPMG AUDIT PERFORMANCE

To fulfill our monitoring responsibilities, the OIG:

- assessed KPMG's approach and planning of the audit;
- evaluated the qualifications and independence of the auditors;
- monitored the progress of the audit at key points;
- participated in periodic meetings with MMS management to discuss audit progress, findings, and recommendations;
- reviewed and accepted KPMG's audit report; and
- performed other procedures we deemed necessary.

KPMG is responsible for the attached auditors' report and for the conclusions expressed in the report. We do not express an opinion on MMS financial statements or KPMG conclusions on the effectiveness of internal controls or compliance with laws, regulations, and the Federal Financial Management Improvement Act of 1996.

REPORT DISTRIBUTION

The legislation, as amended, creating the OIG (5 U.S.C.A. app. 3) requires semiannual reporting to the Congress on all audit reports issued, actions taken to implement audit recommendations, and recommendations that have not been implemented. Therefore, we will include this report in our next semiannual report. The distribution of the report is not restricted, and copies are available for public inspection.

We appreciate the courtesies and cooperation extended to KPMG and OIG staff during the audit. If you have any questions regarding the report, please contact me at 202–208–5512.

Attachments (3)

cc: Assistant Secretary, Land and Minerals Management
Audit Liaison Officer, Land and Minerals Management
Chief Financial Officer, Minerals Management Service

Audit Liaison Officer, Minerals Management Service
Focus Group Leader, Management Control and Audit Follow-up, Office of Financial Management
Focus Leader, Financial Reporting, Office of Financial Management

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

Director of the Minerals Management Service and the Inspector General
U.S. Department of the Interior:

We have audited the accompanying consolidated balance sheets of the Minerals Management Service (MMS) as of September 30, 2006 and 2005, and the related consolidated statements of net cost, changes in net position, financing, and custodial activity, and the combined statements of budgetary resources (hereinafter referred to as "consolidated financial statements") for the years then ended. The objective of our audits was to express an opinion on the fair presentation of these consolidated financial statements. In connection with our fiscal year 2006 audit, we also considered MMS's internal control over financial reporting, Required Supplementary Stewardship Information, and performance measures and tested MMS's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on these consolidated financial statements.

SUMMARY

As stated in our opinion on the consolidated financial statements, we concluded that MMS's consolidated financial statements as of and for the years ended September 30, 2006 and 2005, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.

As discussed in our opinion, in fiscal year 2006, MMS changed its method of reporting for heritage assets, accounting for and reporting of earmarked funds, and restated its fiscal year 2005 financial statements to remove the Interior Franchise Fund transactions and balances.

Our consideration of internal control over financial reporting, Required Supplementary Stewardship Information, and performance measures resulted in the following conditions being identified as reportable conditions:

A. General and Application Controls over Financial Management Systems

B. Internal Controls over Offshore Lease Bonus Revenue

However, the reportable conditions are not believed to be material weaknesses.

The results of our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements disclosed the following instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*.

C. ***Debt Collection Improvement Act of 1996***

D. ***Outer Continental Shelf Lands Act (OCSLA) of 1953***

The following sections discuss our opinion on MMS's consolidated financial statements; our consideration of MMS's internal control over financial reporting, Required Supplementary Stewardship Information, and performance measures; our tests of MMS's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements; and management's and our responsibilities.

OPINION ON THE FINANCIAL STATEMENTS

We have audited the accompanying consolidated balance sheets of the Minerals Management Service as of September 30, 2006 and 2005, and the related consolidated statements of net cost, changes in net position, financing, and custodial activity, and the combined statements of budgetary resources for the years then ended.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Minerals Management Service as of September 30, 2006 and 2005, and its net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activity for the years then ended, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1.1 to the consolidated financial statements, MMS changed its method of reporting for heritage assets in fiscal year 2006 to adopt the applicable provisions of Statement of Federal Financial Accounting Standard (SFFAS) No. 29, *Heritage Assets and Stewardship Land.* Also, as discussed in Note 20 to the consolidated financial statements, MMS changed its method of accounting for and reporting earmarked funds in fiscal year 2006 to adopt the provisions of SFFAS No. 27, *Identifying and Reporting Earmarked Funds*. Also, as discussed in note 24 to the financial statements, MMS restated its fiscal year 2005 financial statements to remove the Interior Franchise Fund transactions and balances because the Interior Franchise Fund was transferred to the U.S. Department of the Interior's Departmental Offices effective October 1, 2005.

The information in the Management's Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information sections is not a required part of the consolidated financial statements, but is supplementary information required by U.S. generally accepted accounting principles and OMB Circular No. A-136, *Financial Reporting Requirements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

The information in Appendix A is presented for purposes of additional analysis and is not required as part of the consolidated financial statements. This information has not been subjected to auditing procedures and, accordingly, we express no opinion on it.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect MMS's ability to record, process, summarize, and report financial data consistent with the assertions by management in the consolidated financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud, in amounts that would be material in relation to the consolidated financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal control, misstatements due to error or fraud may nevertheless occur and not be detected.

In our fiscal year 2006 audit, we noted certain matters, described below, involving internal control over financial reporting and its operation that we consider to be reportable conditions. However, these reportable conditions are not believed to be material weaknesses. Exhibit I presents the status of prior year reportable conditions.

A. General and Application Controls over Financial Management Systems

MMS did not have adequate information technology controls to protect its financial information systems as required by OMB Circular No. A-130, *Management of Federal Information Resources*. These conditions could affect MMS's ability to prevent and detect unauthorized changes to financial information, control electronic access to sensitive information, and protect its information resources. Although MMS has improved its application and general controls, MMS needs to continue improving the security and general controls over its financial information systems, as discussed below.

1. *Entity-wide Security Program and Planning*

   MMS did not have policies in place to require entity-wide segregation of duties within key information system functions. In addition, MMS needs to improve its certification and accreditation documentation to ensure it includes all required information and considers changes made to systems and processes. Additionally, MMS did not perform all needed steps in the risk assessment process for one of its systems.

2. *Access Controls*

   MMS did not consistently maintain user access forms for system access. Although terminated employees' access was disabled or scheduled to be removed from the system or application, MMS did not consistently remove access of terminated employees in a timely manner. Additionally, MMS represented that it performs periodic reviews over systems and applications; however, MMS did not maintain evidence that MMS consistently performed these reviews to ensure that all users are authorized and the level of access rights are commensurate with each user's responsibilities. Although MMS has processes to grant and approve physical and logical access to contractors, MMS needs to improve its processes to verify that contractors completed security training and non-disclosure agreements, and verify that separated contractors' access is revoked in a timely manner.

MMS had not developed or implemented a policy that requires management to monitor security violations and inactive accounts. In addition, MMS did not consistently generate security and activity logs for its systems and applications. Furthermore, MMS did not consistently remove inactive accounts with access to systems and applications in a timely manner. Finally, the financial applications were not configured to prepare logs for security profile changes; therefore, MMS did not effectively review and approve security profile changes.

3. *System Software Controls*

   MMS had not formally documented policies and procedures for restricting access to system software. Although MMS documented a change management methodology to control changes to the operating system software, the policies do not include detailed testing procedures or separate procedures for addressing emergency changes. Additionally, MMS did not test changes to the operating system software. Furthermore, MMS did not have controls in place to prevent system software from being installed without management approval.

4. *Software Development and Change Controls*

   MMS had not formally developed, documented, or implemented data processing procedures to control and standardize the maintenance of one financial application. Although MMS documented program changes to financial applications, the documentation is not consistent and standardized for program changes and emergency changes to financial applications. In addition, MMS did not use library management software to control changes to the accounting system. Furthermore, MMS's system configurations did not adequately segregate duties as the configurations provided individuals, who are involved with programming, testing and migrating changes to production, access to the source code, test, and production libraries.

5. *Service Continuity*

   MMS had not developed and documented a comprehensive contingency and disaster recovery plan for two of its applications. MMS had not updated its continuity of operations plan for its current information technology environment. In addition, MMS did not have a comprehensive plan to train all essential employees on emergency responsibilities outlined within critical system and application contingency plans. Furthermore, MMS did not consistently test the backup files for certain financial applications.

Recommendation

We recommend that MMS develop and implement a formal action plan to improve the security and general controls over its financial information systems. This plan should address each of the areas discussed above, as well as other areas that might impact the information technology control environment, to ensure adequate security and protection of MMS's information systems.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendation.

B. Internal Controls over Offshore Lease Bonus Revenue

MMS did not record bonus revenue for offshore lease sales in the proper period because MMS did not fully establish controls to identify and record bonus revenue from offshore lease sales in the proper period. MMS recorded bonus revenue for all bids received for the Gulf of Mexico lease sale that occurred near year end; however, MMS had not completed the bid analysis, acceptance, and adjudication procedures for certain lease sales until fiscal year 2007. As a result, Interior incorrectly recorded $13 million in custodial revenue for 36 of the 129 lease sales.

Recommendation
We recommend that MMS enhance controls to ensure offshore bonus revenue is recorded in the proper period.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendation.

INTERNAL CONTROLS OVER REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION AND PERFORMANCE MEASURES

Under OMB Bulletin No. 06-03, the definition of material weaknesses is extended to other controls as follows. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud, in amounts that would be material in relation to the Required Supplementary Stewardship Information or material to a performance measure or aggregation of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal control, misstatements due to error or fraud may nevertheless occur and not be detected.

Our consideration of the internal control over the Required Supplementary Stewardship Information and the design and operation of internal control over the existence and completeness assertions related to performance measures reported in the Management's Discussion and Analysis section would not necessarily disclose all matters involving the internal control and its operation related to Required Supplementary Stewardship Information or the design and operation of the internal control over the existence and completeness assertions related to key performance measures that might be reportable conditions.

In our fiscal year 2006 audit, we noted no matters involving the internal control and its operation related to Required Supplementary Stewardship Information that we considered to be material weaknesses as defined above.

In our fiscal year 2006 audit, we noted no matters involving the design and operation of the internal control over the existence and completeness assertions related to key performance measures that we considered to be material weaknesses as defined above.

COMPLIANCE AND OTHER MATTERS

Our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, as described in the Responsibilities section of this report, exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed two instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 06-03, and are described below.

C. *Debt Collection Improvement Act of 1996*

In accordance with the *Debt Collection Improvement Act of 1996*, MMS is required to refer eligible receivables that are delinquent to the U.S. Department of the Treasury (Treasury) for collection or offset. Eligible receivables include those that are over 180 days delinquent and not the subject of litigation, related to foreclosure proceedings, or from organizations in bankruptcy. MMS did not properly identify delinquent receivables for referral to the Treasury for collection or offset in a timely manner. MMS implemented a process during the fiscal year to investigate all current and aged accounts receivable balances, which included sending every debtor a "Statement of Account" report to assist in matching and liquidating open receivables with unmatched payments or to receive payments for delinquent debt owed. Through this process, MMS resolved a significant portion of the aged receivable balances not under appeal; however, MMS did not refer 596 receivables totaling approximately $1.4 million to the Treasury within 180 days.

In addition, MMS was not able to complete the referral process for all open receivables over 180 days old by year end. As a result, MMS had 303 receivables totaling approximately $2 million of receivables as of September 30, 2006 that were over 180 days past due and had not been referred to Treasury for collection.

Recommendation
We recommend that in fiscal year 2007, MMS establish a process to ensure eligible receivables are referred to the Treasury in a timely manner.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings but indicated that the amounts are inconsequential.

Auditors' Response to Management's Response
In prior years, we recommended that MMS establish a process to identify and refer receivables; however, MMS did not fully establish a process until the middle of fiscal year 2006 to evaluate over $79 million of past due receivables and had not finished the process as of September 30, 2006. In addition, MMS did not refer 899 receivables totaling approximately $3.4 million to the Treasury within 180 days. Furthermore, MMS incorrectly included all custodial revenue and receivables in its evaluation because most of the receivables held at September 30, 2006 are not subject to referral as they are not past due 180 days. Therefore, MMS did not comply with the *Debt Collection Improvement Act of 1996*.

D. *Outer Continental Shelf Lands Act (OCSLA) of 1953*

In accordance with the Outer Continental Shelf Lands Act (OCSLA) of 1953 (section 8.g.2 of 43 USC 1337), MMS is required to disburse amounts to coastal states for a portion (27%) of custodial receipts from leasing mineral resources for all lease acreage within a 3-mile zone adjacent to the state coast line for leases adjudicated after September 18, 1978. The OCSLA also provides that the remaining custodial receipts be distributed to the U.S. Department of the Treasury. MMS did not consistently ensure that they disbursed the proper amounts in accordance with the OCSLA as we noted two lease exceptions out of the 269 OCSLA custodial disbursements tested from October 1, 2005 through September 30, 2006. As a result of our observations, MMS analyzed the custodial disbursements and determined that MMS had incorrectly disbursed amounts on six other leases. In total, MMS incorrectly disbursed approximately $15.8 million related to the eight leases.

Recommendation
We recommend that in fiscal year 2007, MMS require a second individual to compare the lease document, distributee code, and lease acreage and location in the royalty accounting system to the lease agreement and OCSLA and document approval on the distributee code change forms to ensure that custodial disbursements are in accordance with the OCSLA.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management disagreed with our findings.

Auditors' Response to Management's Response
MMS did not consistently ensure that they disbursed the proper amounts in accordance with the OCSLA because MMS incorrectly disbursed $15.8 million to the incorrect recipients related to eight leases. MMS indicated that it has a process to identify such incorrect disbursements; however, such process had not identified these incorrect disbursements. Therefore, MMS did not comply with OCSLA.

The results of our tests of compliance with certain provisions of other laws and regulations, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 06-03.

The results of our tests of FFMIA disclosed no instances in which MMS's financial management systems did not substantially comply with the three requirements discussed in the Responsibilities section of this report.

* * * * *

RESPONSIBILITIES

Management's Responsibilities. The United States Code Title 31 Section 3515 and 9106 require agencies to report annually to Congress on their financial status and any other information needed to fairly present their financial position and results of operations. To help the U.S. Department of the Interior meet these reporting requirements, the MMS prepares financial statements in accordance with OMB Circular No. A-136.

Management is responsible for the consolidated financial statements, including:

- Preparing the consolidated financial statements in conformity with U.S. generally accepted accounting principles;

- Preparing the Management's Discussion and Analysis (including the performance measures), Required Supplementary Information, and Required Supplementary Stewardship Information;

- Establishing and maintaining effective internal controls; and

- Complying with laws, regulations, contracts, and grant agreements applicable to MMS, including FFMIA.

In fulfilling this responsibility, management is required to make estimates and judgments to assess the expected benefits and related costs of internal control policies.

Auditors' Responsibilities. Our responsibility is to express an opinion on the fiscal year 2006 and 2005 consolidated financial statements of MMS based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 06-03. Those standards and OMB Bulletin No. 06-03 require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of MMS's internal control over financial reporting. Accordingly, we express no such opinion.

An audit also includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements;

- Assessing the accounting principles used and significant estimates made by management; and

- Evaluating the overall consolidated financial statement presentation.

We believe that our audits provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2006 audit, we considered MMS's internal control over financial reporting by obtaining an understanding of MMS's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards* and OMB Bulletin No. 06-03. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide an opinion on MMS's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin No. 06-03, in our fiscal year 2006 audit, we considered MMS's internal control over the Required Supplementary Stewardship Information by obtaining an understanding of MMS's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. We limited our testing to those controls necessary to test and report on the internal control over Required Supplementary Stewardship Information in accordance with OMB Bulletin No. 06-03. However, our procedures were not designed to provide an opinion on internal control over the Required Supplementary Stewardship Information and, accordingly, we do not provide an opinion thereon.

As further required by OMB Bulletin No. 06-03, in our fiscal year 2006 audit, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis section, we obtained an understanding of the design of internal controls relating to the existence and completeness assertions and determined whether these internal controls had been placed in operation. We limited our testing to those controls necessary to test and report on the internal control over key performance measures in accordance with OMB Bulletin No. 06-03. However, our procedures were not designed to provide an opinion on internal control over reported performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether MMS's fiscal year 2006 consolidated financial statements are free of material misstatement, we performed tests of MMS's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of the consolidated financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 06-03, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to MMS. However, providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 06-03 and FFMIA, auditors are required to report whether certain federal entities' financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To assist the auditors of the U.S. Department of the Interior meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

We noted certain additional matters that we have reported to management of MMS in a separate letter dated November 13, 2006.

RESTRICTED USE

This report is intended solely for the information and use of MMS's management, the U.S. Department of the Interior management, the U.S. Department of the Interior Office of Inspector General, OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 13, 2006

MINERALS MANAGEMENT SERVICE

Status of Prior Year Findings

September 30, 2006

Ref	Condition	Status
A	General and Application Controls over Financial Management Systems	This condition has been partially corrected in fiscal year 2006. See finding A.
B	Controls over Accounts and Interest Receivable	This condition was corrected in fiscal year 2006.
C	Debt Collection Improvement Act of 1996	This condition was not corrected in fiscal year 2006. See finding C.

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Washington, DC 20240

DEC 1 9 2006

Ms. Anne L. Richards
Assistant Inspector General for Audits
U.S. Department of Interior
Office of Inspector General
1849 C Street, NW., MS-5341
Washington, D.C. 20240

Mr. Jeff Norris
c/o KPMG LLP
2001 M Street, NW.
Washington, D.C. 20036

Dear Ms. Richards and Mr. Norris:

Thank you for the opportunity to respond to the independent auditors', KPMG, report on the Minerals Management Service (MMS) financial statements for Fiscal Years 2005 and 2006. We concur with the independent auditors' findings of two reportable conditions related to internal controls and financial operations and one instance of noncompliance with laws and regulations applicable to MMS. Enclosed are our specific comments on the identified recommendations.

Please contact Scott L. Mabry at 703-787-1243 if you have any further questions.

Sincerely,

Johnnie Burton

R. M. "Johnnie" Burton
Director

Enclosure

A. General and Application Controls over Financial Management Systems

The MMS concurs that there are certain risks and vulnerabilities associated with its financial information systems. The Office of Management and Budget (OMB) through Circular A-130, Appendix III, *Security of Federal Automated Information Resources,* (A)(2)(a), defines "adequate security" as ensuring security commensurate with the risk and magnitude of the harm resulting from the loss, misuse, or unauthorized access to or modification of information. This includes assuring that systems and applications used by the Agency operate effectively and provide appropriate confidentiality, integrity, and availability, through the use of cost-effective management, personnel, and operational and technical controls.

In order to have adequate security, the OMB Circular A-130, Appendix III, requires agencies to:

1. Plan for security.
2. Ensure that appropriate officials are assigned security responsibility.
3. Review the security controls in their information systems.
4. Authorize system processing prior to operations and periodically thereafter.

For each major application and general support system, the MMS has:

1. Developed a security plan.
2. Assigned security responsibility to an individual.
3. Conducted annual security reviews using the NIST Special Publication 800-26.
4. Authorized the system for operation using the *Department of the Interior Information Technology Certification and Accreditation (C&A) Guide.* The process includes the following:
    a. Privacy Impact Assessment
    b. Asset Valuation
    c. System Security Plan
    d. Risk Assessment
    e. System Testing and Evaluation
    f. Plan of Actions and Milestones

Certification is a comprehensive evaluation of the technical and nontechnical security features and other safeguards of an IT system and establishes the extent to which a particular design and implementation meets documented security requirements. *Accreditation* is the formal declaration by an approving authority that an IT system is compliant with established security requirements and is approved to operate using a prescribed set of safeguards.

The NIST SP 800-37, *Guide for Security Certification and Accreditation (C&A) of Federal Information System,* states: "The successful completion of the security C&A process provides Agency officials with the necessary confidence that the information system has adequate security controls, and that vulnerabilities in the system have been considered in the risk-based decision to authorize processing."

The MMS has completed the formal C&A process, with associated documentation, to provide evidence of a risk-based methodology that complies with the OMB Circular A-130, Department of the Interior, National Institute of Standards and Technology (NIST) Special Publication (SP) guidance and Federal regulations. This process assures adequate IT system security controls are implemented and tested, risks are assessed, and security plans are maintained. Specifically:

1. *Entitywide Security Program and Planning*

   The MMS concurs that it does not have an entitywide segregation of duties policy in place. Additionally, the MMS agrees that not all system changes were noted in its C&A documentation, and that not all steps were performed during the risk assessment of one of its externally owned systems.

   To correct this finding, the MMS will develop and implement an entity-wide segregation of duties policy. Additionally, the MMS will work closely with the National Business Center (NBC), the external system owner, to ensure that they conduct the C&A and risk assessment processes in the future.

2. *Access Controls*

   The MMS concurs that its access control policies and procedures should be fortified. The MMS has fortified its exit clearance process to ensure all system security managers are notified when a system user terminates employment and continues to examine the process to look for further improvements.

   The MMS will strengthen procedures for granting system access to ensure that user request forms for Network Administrator system access are maintained.

   The MMS will develop and implement a process to ensure that user profile reviews are thoroughly documented and maintained.

   The MMS concurs that it does not have a centralized database of contractors, but believes that it has processes in place to accurately monitor contractors while in the employ of the MMS. The MMS is following the Department's lead concerning the implementation of a secure and reliable form of identification for all employees and contractors. We have established a process and are in conformance with guidance outlined in Homeland Security Presidential Directive-12 and

Federal Information Processing Standards-201 for the registration and issuance of Personal Identity Verification-1 credentials. Unsupervised physical and logical access to MMS facilities and information systems is granted contingent upon a favorable FBI fingerprint check or National Agency Check. Background investigation data on MMS employees and contractors is maintained in the Personnel Security System (PSS), an electronic database maintained by the MMS Security Office. Information on all Office of Personnel Management background investigations initiated on MMS employees and contractors is contained in the PSS. The PSS has the capability of generating records and other audit features. The MMS is in the process of updating the PSS database to a new, more robust system. This new system will have additional features and reporting capabilities.

The MMS is currently in the process of implementing a new log management product enterprisewide. This product will assist in the collection, management, and correlation of security, application, and system logs from across the MMS enterprise.

3. *System Software Controls*

The MMS concurs with this finding and will document and implement a process for restricting access to operating system software including procedures for testing system software changes.

4. *Software Development and Change Controls*

The MMS agrees that it has not fully developed, documented, or implemented a change management process for the maintenance of all of its systems. Change control procedures have been enhanced to the best of the system's capabilities. The MMS will review the current process to determine if further process improvements are available.

The application in question is a Department-controlled application and all change requests are initiated on a Departmental level. The application was retired by the Department in 2004 and was to be replaced by PRISM/FBMS in 2005. This is now scheduled for FY 2007 or FY 2008. The MMS is currently in the process of negotiating a reimbursable service agreement with the NBC for ongoing support of this application.

The MMS also agrees that programmers have access to the source code, test, and production libraries for the purpose of moving changes through each step of the process from coding to production. However, those involved in testing do not have access to source code, and those involved in production do not have access to source code or testing.

As stated, the MMS does not use Library Management Software to manage changes to the ABACIS application. The MMS has migrated to the FBMS application. As a result, we felt that it would not have been cost beneficial to purchase Library Management Software during FY 2006. To mitigate the risk associated with not using this software, we limited those with change privileges to two individuals. We also implemented a third level of password for the two individuals involved in making changes to allow the production of a report that shows all changes made by individual. This report of changes was reviewed monthly by the change management group as described in the configuration management plan.

5. *Service Continuity*

The MMS concurs with this finding and will:

- Ensure the contingency plan for the MMS General Support System is updated during the upcoming C&A recertification.
- Conduct emergency response training annually ensuring all essential personnel are adequately trained.
- Document its entire backup process including procedures for testing the viability of backup media.

The corrective actions outlined above are the responsibility of the Chief Information Officer, and will be completed prior to June 30, 2007.

B. Internal Controls over Offshore Lease Bonus Revenue

The MMS agrees that it did not record bonus revenue for offshore lease sales in the proper period and has implemented reconciliation and senior management reviews to ensure recordings are timely and accurate. This action is the responsibility of the Chief, Office of Financial Management, and will be completed prior to June 30, 2007.

C. Debt Collection Improvement Act of 1996

The MMS concurs that not all amounts greater than 180 days delinquent were appropriately referred to Treasury for collection or offset. While MMS concurs with the finding, it should be noted that the dollar value of amounts not yet referred is inconsequential in comparison to the total value of accounts receivable and custodial revenue overall. Of the $2.6 billion in MMS's total accounts and interest receivable as of September 30, 2006, the $2 million in remaining unreferred receivables constitutes less than .07 percent, and it is less than .01 percent of the $11.9 billion in total custodial revenues.

During FY 2006, the MMS implemented additional controls to ensure that it referred delinquent debt to Treasury in a timely manner, but did not have enough resources in the first year of implementation to fully accomplish referral of every item. A stratified approach was implemented to focus on liquidating or referring the largest dollar value items first, and significant results were achieved during the year. The remaining small amounts are continuing to be aggressively pursued and either liquidated or referred as quickly as possible. The MMS has established a process, and will continue to follow that process to ensure eligible receivables are referred to the U.S. Department of the Treasury in a timely manner.

The above actions are the responsibility of the Chief, Office of Financial Management, and will be completed prior to June 30, 2007.

D. Outer Continental Shelf Lands Act (OCSLA) of 1953

The MMS concurs that there were two instances of disbursement error as identified in the report and has implemented a secondary review process to help ensure that disbursements are accurate. Further, we will review all consolidated offshore leases to ensure the lease coding for non-8(g) or 8(g) leases is accurate by reviewing the lease document, and lease acreage location. These procedures will be implemented prior to March 31, 2007, and are the responsibility of the Chief, Office of Financial Management.

The MMS does not, however, agree that these disbursements constitute a non-compliance with the OCSLA of 1953. The OCSLA does not state that there is a zero tolerance for erroneous payments, and the MMS has processes to identify erroneous payments, if made, and processes to recoup the payments. Additionally, the compliance audit is MMS's ultimate mechanism for catching and resolving errors, as has been supported in a previously issued solicitor's memo. Consequently, to the extent that the finding of "noncompliance with laws and regulations" implies, or creates any impression of, either continuing or wider noncompliance, or any pattern of noncompliance, beyond the two individual exceptions noted, it is without basis and incorrect.

STATUS OF AUDIT REPORT RECOMMENDATIONS

Recommendation	Status	Action Required
B and D	Resolved; not implemented	Recommendations will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation.
A	Repeat, resolved; not implemented	Continue tracking this repeat recommendation that was previously referred as Recommendation A in Report No. X-IN-MMS-0010-2005.
C	Repeat, resolved; not implemented	Repeat recommendation that was previously referred as Recommendation C in Report No. X-IN-MMS-0010-2005 and closed. We will refer this repeat recommendation to the Assistant Secretary for Policy, Management and Budget for tracking of implementation.

Principal Financial Statements

Launch of Remotely Operated Vehicle

U.S. Department of the Interior
Minerals Management Service
Consolidated Balance Sheet
As of September 30, 2006
(dollars in thousands)

		FY 2006
ASSETS		
Intragovernmental Assets:		
Administrative Fund Balance		148,541
Fund Balance with Treasury (Note 2)		148,541
Restricted Treasury Securities		1,062,796
Custodial Treasury Securities		58,392
Investments, Net (Note 3)		1,121,188
Custodial Accounts Receivable		267,707
Administrative Accounts Receivable		478
Accounts and Interest Receivable (Note 4)		268,185
Other:		
Advances and Prepayments		18
Total Intragovernmental Assets		1,537,932
Custodial Accounts and Interest Receivable		1,452,390
Administrative Accounts Receivable		812,654
Accounts and Interest Receivable, Net (Note 4)		2,265,044
General Property, Plant and Equipment, Net (Note 5)		24,452
TOTAL ASSETS (Note 6)	$	3,827,428
Stewardship Assets (Note 1)		

U.S. Department of the Interior
Minerals Management Service
Consolidated Balance Sheet
As of September 30, 2006
(dollars in thousands)

		FY 2006
LIABILITIES		
Intragovernmental Liabilities:		
Accounts Payable	$	3,838
Other:		
Custodial Liability		1,701,399
Accrued Employee Benefits		3,702
Total Intragovernmental Liabilities		1,708,939
Accounts Payable		18,222
Federal Employee Benefits - FECA Actuarial Liability (Note 7)		9,038
Other:		
State Liabilities		812,588
Contingent Liabilities (Note 8)		550,000
Royalty Credit Liability (Note 9)		44,322
Advances, Deferred Revenue, and Deposit Funds		55,112
Custodial Liability		22,080
Unfunded Annual Leave		12,138
Accrued Payroll and Benefits		5,057
Capital Lease Liability (Note 10)		24
TOTAL LIABILITIES (Note 11)		3,237,520
Commitments and Contingencies (Note 8 and 9)		
Net Position		
Unexpended Appropriations - Other Funds		24,768
Cumulative Results of Operations - Earmarked Funds (Note 20)		1,067,265
Cumulative Results of Operations - Other Funds		(502,125)
Total Net Position		589,908
TOTAL LIABILITIES AND NET POSITION	$	3,827,428

The accompanying notes are an integral part of these financial statements.

U.S. Department of the Interior
Minerals Management Service
Consolidated Balance Sheet
As of September 30, 2005
(dollars in thousands)

		FY 2005 (Restated - Note 24)
ASSETS		
Intragovernmental Assets:		
Administrative Fund Balance	$	111,724
Custodial Fund Balance		1
Fund Balance with Treasury (Note 2)		111,725
Restricted Treasury Securities		1,030,926
Custodial Treasury Securities		57,320
Investments, Net (Note 3)		1,088,246
Custodial Accounts Receivable		400,068
Administrative Accounts Receivable		1,471
Accounts and Interest Receivable (Note 4)		401,539
Other:		
Advances and Prepayments		107
Total Intragovernmental Assets		1,601,617
Custodial Accounts and Interest Receivable		1,416,540
Administrative Accounts Receivable		1,009,512
Accounts and Interest Receivable, Net (Note 4)		2,426,052
General Property, Plant and Equipment, Net (Note 5)		28,543
Other:		
Advances and Prepayments		2
TOTAL ASSETS (Note 6)	$	4,056,214

Stewardship Assets (Note 1)

U.S. Department of the Interior
Minerals Management Service
Consolidated Balance Sheet
As of September 30, 2005
(dollars in thousands)

		FY 2005 (Restated - Note 24)
LIABILITIES		
Intragovernmental Liabilities:		
Accounts Payable	$	2,827
Other:		
Custodial Liability		1,799,017
Accrued Employee Benefits		3,759
Advances and Deferred Revenue		536
Total Intragovernmental Liabilities		1,806,139
Accounts Payable		21,511
Federal Employee Benefits - FECA Actuarial Liability (Note 7)		9,837
Other:		
State Liabilities		1,009,419
Contingent Liabilities (Note 8)		550,690
Advances, Deferred Revenue, and Deposit Funds		52,502
Custodial Liability		23,238
Accrued Payroll and Benefits		17,495
Capital Lease Liability (Note 10)		51
TOTAL LIABILITIES (Note 11)		3,490,882
Commitments and Contingencies (Note 8)		
Net Position		
Unexpended Appropriations		8,573
Cumulative Results of Operations:		
Administrative Cumulative Results of Operations		(474,167)
EIRF Cumulative Results of Operations		1,030,926
Total Cumulative Results of Operations		556,759
Total Net Position		565,332
TOTAL LIABILITIES AND NET POSITION	$	4,056,214

The accompanying notes are an integral part of these financial statements.

U.S. Department of the Interior
Minerals Management Service
Consolidated Statement of Net Cost
For the years ended September 30, 2006 and 2005
(dollars in thousands)

	FY 2006	FY 2005
Resource Use Energy		
Manage and Provide Incentives for Access and Development		
Costs	$ 90,082	$ 80,566
Less: Earned Revenue	28,037	30,114
Net Cost	62,045	50,452
Enhance Responsible Use Management Practices		
Costs	70,704	69,117
Less: Earned Revenue	21,689	33,880
Net Cost	49,015	35,237
Effective Lease and Permit Management		
Costs	2,110,784	2,373,898
Less: Earned Revenue	104,665	58,278
Net Cost	2,006,119	2,315,620
Improve Information Base, Resource Management and Technical Assistance		
Costs	6,649	4,711
Less: Earned Revenue	3,657	2,259
Net Cost	2,992	2,452
Total Resource Use Energy		
Costs	2,278,219	2,528,292
Less: Earned Revenue	158,048	124,531
Net Cost	2,120,171	2,403,761
Resource Use Non-Energy		
Costs	3,536	3,872
Less: Earned Revenue	2,332	2,127
Net Cost	1,204	1,745
Serving Communities		
Costs	28,267	31,163
Less: Earned Revenue	10,827	9,700
Net Cost	17,440	21,463
Reimbursable Activity and Other (Restated - Note 24)		
Costs	14,595	13,271
Less: Earned Revenue	15,735	14,449
Net Cost	(1,140)	(1,178)
Total (Restated - Note 24)		
Costs	2,324,617	2,576,598
Less: Earned Revenue (Note 13)	186,942	150,807
Net Cost of Operations (Note 12)	$ 2,137,675	$ 2,425,791

The accompanying notes are an integral part of these financial statements.

U.S.Department of the Interior
Minerals Management Service
Consolidated Statement of Changes in Net Position
For the years ended September 30, 2006 and 2005
(dollars in thousands)

	Earmarked (Note 20)	All Other	**FY 2006 Consolidated**	FY 2005 Consolidated (Restated - Note 24)
UNEXPENDED APPROPRIATIONS				
Beginning Balance	$ -	$ 8,573	**$ 8,573**	$ 7,450
Budgetary Financing Sources				
Appropriations Received, General Funds	-	184,651	**184,651**	169,175
Appropriations Transferred In/(Out)	-	(3,343)	**(3,343)**	3,343
Appropriations-Used	-	(162,523)	**(162,523)**	(168,927)
Other Adjustments	-	(2,590)	**(2,590)**	(2,468)
Net Change	-	16,195	**16,195**	1,123
Ending Balance - Unexpended Appropriations	$ -	$ 24,768	**$ 24,768**	$ 8,573
CUMULATIVE RESULTS OF OPERATIONS				
Beginning Balance	$ 1,036,226	$ (479,467)	**$ 556,759**	$ 534,884
Budgetary Financing Sources				
Appropriations-Used	-	162,523	**162,523**	168,927
Other Budgetary Financing Sources - MRM Exchange Revenue (Note 14)	1,931,073	-	**1,931,073**	2,229,171
Non-Exchange Revenue	31,869	-	**31,869**	29,272
Transfers In/(Out) without Reimbursement	6,903	-	**6,903**	7,006
Other Financing Sources				
Transfers In/(Out) without Reimbursement	-	(1,253)	**(1,253)**	(838)
Imputed Financing from Costs Absorbed by Others	-	14,941	**14,941**	14,128
Total Financing Sources	1,969,845	176,211	**2,146,056**	2,447,666
Net Cost of Operations	(1,938,806)	(198,869)	**(2,137,675)**	(2,425,791)
Net Change	31,039	(22,658)	**8,381**	21,875
Ending Balance - Cumulative Results of Operations	$ 1,067,265	$ (502,125)	**$ 565,140**	$ 556,759

The accompanying notes are an integral part of these financial statements.

U.S. Department of the Interior
Minerals Management Service
Combined Statement of Budgetary Resources
For the years ended September 30, 2006 and 2005
(dollars in thousands)

	FY 2006	FY 2005 (Restated - Note 24)
Budgetay Resources:		
Unobligated balance, beginning of Fiscal Year:	$ 16,563	$ 13,572
Recoveries of prior year unpaid obligations	6,949	6,195
Budget Authority		
Appropriation	2,319,561	1,808,910
Spending authority from offsetting collections		
Earned		
Collected	187,050	150,266
Change in receivables from Federal sources	(993)	(136)
Change in unfilled customer orders		
Advance received	(1,302)	(6,605)
Without advance from Federal sources	(12,034)	2,568
Total Budgetary Authority	2,492,282	1,955,003
Nonexpenditure transfers, net, anticipated and actual	(3,344)	3,344
Temporarily not available pursuant to Public Law	(102)	(99)
Permanently not available	(2,590)	(2,467)
Total Budgetary Resources	$ 2,509,758	$ 1,975,548
Status of Budgetary Resources:		
Obligations incurred:		
Direct	$ 2,299,974	$ 1,810,450
Reimbursable	169,076	148,535
Total Obligations incurred (Note 15)	2,469,050	1,958,985
Unobligated balance available:		
Apportioned	38,607	15,105
Unobligated balance not available (Note 17)	2,101	1,458
Total Status of Budgetary Resources	$ 2,509,758	$ 1,975,548
Change in Obligated Balance:		
Obligated balance, net		
Unpaid obligations, brought forward, beginning of Fiscal Year	$ 109,927	$ 106,077
Less: Uncollected customer payments from Federal sources, brought forward, beginning of Fiscal Year	(14,767)	(12,336)
Total unpaid obligated balance, net, beginning of Fiscal Year	95,160	93,741
Obligations incurred, net	2,469,050	1,958,985
Less: Gross outlays	(2,462,493)	(1,948,939)
Less: Recoveries of prior year unpaid obligations, actual	(6,949)	(6,195)
Change in uncollected customer payments from Federal sources	13,027	(2,432)
Total, unpaid obligated balance, net, end of period	$ 107,795	$ 95,160
Obligated balance, net, end of period - by component:		
Unpaid obligations	$ 109,534	$ 109,927
Less: Uncollected customer payments from Federal sources	(1,739)	(14,767)
Total, unpaid obligated balance, net, end of period	$ 107,795	$ 95,160
Net Outlays:		
Net Outlays		
Gross outlays	$ 2,462,493	$ 1,948,939
Less: Offsetting collections	(185,749)	(143,661)
Less: Distributed Offsetting receipts	(2,640,078)	(2,070,117)
Net Outlays (Receipts)	$ (363,334)	$ (264,839)

The accompanying notes are an integral part of these financial statements.

Department of the Interior
Minerals Management Service
Consolidated Statement of Financing
For the years ended September 30, 2006 and 2005
(dollars in thousands)

	FY 2006	FY 2005 (Restated - Note 24)
Resources Used to Finance Activities:		
Budgetary Resources Obligated:		
Obligations Incurred	$ 2,469,050	$ 1,958,985
Less: Spending Authority From Offsetting Collections/Recoveries	(179,670)	(152,288)
Obligations Net of Offsetting Collections and Adjustments	2,289,380	1,806,697
Less: Offsetting Receipts	(2,640,078)	(2,070,117)
Net Obligations	(350,698)	(263,420)
Other Resources:		
Transfers In/Out Without Reimbursement	(1,253)	(838)
Imputed Financing From Costs Absorbed by Others	14,941	14,128
Net Other Resources Used to Finance Activities	13,688	13,290
Total Resources Used to Finance Activities	(337,010)	(250,130)
Resources Used to Finance Items Not Part of the Net Cost of Operations:		
Change in Budgetary Resources Obligated for Goods, Services, and Benefits Ordered but Not Yet Provided	(2,032)	6,898
Change in Unfilled Customer Orders	(13,335)	(4,038)
Resources That Fund Expenses Recognized in Prior Periods	(198,408)	(9)
Budgetary Offsetting Collections and Receipts That Do Not Affect Net Cost of Operations:		
Offsetting Receipts Not Part of the Net Cost of Operations	2,640,078	2,070,117
Resources That Finance the Acquisition of Assets	(1,214)	(2,218)
Other Resources or Adjustments to Net Obligated Resources That Do Not Affect Net Cost of Operations	235	529
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	2,425,324	2,071,279
Total Resources Used to Finance the Net Cost of Operations	2,088,314	1,821,149
Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future Periods:		
Increase in Annual Leave Liability (Note 21)	-	616
Other (Note 21)	44,322	599,060
Total Components of Net Cost of Operations That Will Require or Generate Resources in Future Periods	44,322	599,676
Components Not Requiring or Generating Resources:		
Depreciation and Amortization	4,800	4,898
Revaluation of Assets or Liabilities	242	283
Other	(3)	(215)
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	5,039	4,966
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	49,361	604,642
Net Cost of Operations	$ 2,137,675	$ 2,425,791

The accompanying notes are an integral part of these financial statements.

U.S. Department of the Interior
Minerals Management Service
Statement of Custodial Activity
For the years ended September 30, 2006 and 2005
(dollars in thousands)

	FY 2006	FY 2005
Revenues on Behalf of the Federal Government		
Mineral Lease Revenue		
Rents and Royalties	$ 10,656,292	$ 8,968,062
Onshore Lease Sales	275,031	1,658,786
Offshore Lease Sales	949,875	560,622
Strategic Petroleum Reserve (Note 22)	(18,466)	1,194,618
Total Revenue	$ 11,862,732	$ 12,382,088
Disposition of Revenue		
Distribution to Department of the Interior		
Minerals Management Service (Note 23)	2,295,815	1,762,091
Bureau of Reclamation	1,649,066	1,287,972
National Park Service Conservation Funds	898,304	1,048,870
Bureau of Land Management	71,821	81,408
Fish and Wildlife Service	1,608	1,036
Distribution to Other Federal Agencies		
Department of the Treasury	6,869,771	5,502,192
Department of Agriculture	73,531	50,860
Department of the Commerce	25	1
Department of Energy (Note 22)	(18,466)	1,194,618
Distribution to Indian Tribes and Agencies	158,155	114,025
Distribution to States and Others	82,355	72,323
Change in Untransferred Revenue	(219,253)	1,266,692
Total Disposition of Revenue	11,862,732	12,382,088
Net Custodial Activity	$ -	$ -

The accompanying notes are an integral part of these financial statements.

Note 1.1 Significant Accounting Policies

A. Basis of Presentation

These financial statements have been prepared to report the financial position, net cost of operations, changes in net position, budgetary resources, reconciliation of net cost to budgetary obligations, and custodial activities of the Minerals Management Service (MMS), as required by the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994.

The financial statements have been prepared from the accounting records of MMS in accordance with accounting principles generally accepted in the United States of America (GAAP) using guidance issued by the Federal Accounting Standards Advisory Board (FASAB). Significant MMS accounting policies are summarized in this note.

The financial statements should be read with the realization that they are for a component of the United States Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources and legal authority to do so.

Certain MMS financial activities interact with and depend on the financial activities of the centralized management function of the Federal Government. These activities are performed for the benefit of the whole Federal Government, and include public debt and employee retirement, life insurance, and health benefit programs. Employee retirement, life insurance and health benefit costs, along with an assigned (imputed) financing source for these costs, are included in the MMS financial statements. Public debt activities that are performed for the benefit of the Federal Government as a whole are not included in these financial statements.

B. Reporting Entity

The Minerals Management Service was created on January 19, 1982, by Secretarial Order No. 3071, under authority of Section 2 of Reorganization Plan No. 3 of 1950 (64 Stat. 1262). On May 10, 1982, by Secretarial Order No. 3071, Amendment No. 1, all Outer Continental Shelf (OCS) leasing responsibilities of the Department of the Interior were consolidated within MMS under Section 2 of Reorganization Plan No. 3 of 1950. Amendment No. 2, dated May 26, 1982, set forth the basic organizational structure for MMS and provided for the transfer of administrative functions. Secretarial Order No. 3087, dated December 3, 1982, and Amendment No. 1, dated February 7, 1983, provided for the transfer of royalty and mineral revenue management functions, including collection and distribution performed by the Bureau of Land Management, to MMS.

The accompanying financial statements include all components of Minerals Management Service, including, Royalty and Offshore Minerals Management, Mineral Leasing, and Oil Spill Research.

MMS has principal responsibility for the offshore leasing program, leasing management, and resource evaluation and classification functions, the environmental review of leasing activities, regulation of operations and lease management, inspection and enforcement programs, and leasing and related public liaison and planning functions on OCS lands. In addition, MMS is responsible for the prevention of fraud and theft and the prompt, full, and complete collection of monies and certain other forms of royalty due the Federal Government, States, and Indian lessors under contractual agreements with lessees.

The Minerals Revenue Management (MRM) Program, within MMS, performs primarily custodial activities that include the collection, distribution, and accounting for revenues as regulated by law. Some operational accounting activities also performed by MRM Program personnel include but are not limited to providing data for reporting requirements, investing revenues for both federal and non-federal funds, expending appropriations, establishing accounting procedures, and reconciling balances with other entities and Treasury.

In accordance with OMB Circular A-136, Financial Reporting Requirements, comparative statements are presented.

C. Transactions within MMS

Transactions and balances among the MMS components have been eliminated from the Consolidated Balance Sheet and the Consolidated Statement of Net Cost. The Consolidated Statement of Changes in Net Position does not have transactions or balances among the MMS components to be eliminated. In order to present all custodial activity, the distributions to MMS have not been eliminated on the Statement of Custodial Activity. However, the amounts are reported separately on the statement.

As provided for by OMB Circular A-136, Financial Reporting Requirements, the Statement of Budgetary Resources is presented on a combined basis. Therefore, intra-MMS transactions and balances have not been eliminated from this statement.

In accordance with OMB Circular A-136, intra-MMS transactions and balances have been eliminated from all the amounts on the Consolidated Statement of Financing, except for obligations incurred and spending authority from offsetting collections and adjustments, which are presented on a combined basis.

D. Basis of Accounting

MMS maintains its accounting records on both an accrual accounting basis and a budgetary accounting basis. Under the accrual method, revenues are recognized when earned and expenses are recognized when incurred, without regard to the receipt or payment of cash.

Under budgetary accounting, MMS records budgetary authority when it's legally received and records obligations of authority when legally incurred. Budgetary accounting facilitates compliance with constraints and controls over the use of Federal funds.

E. Fund Balance With Treasury

MMS's receipts and disbursements are processed through the Federal Reserve System and the U.S. Treasury. The "Fund Balance with Treasury" balance as shown on the Consolidated Balance Sheet includes the unexpended balances of appropriations from which MMS is authorized to incur expenses and pay liabilities. The unobligated appropriation fund balances in expired accounts are unavailable for new obligations.

F. Accounts and Interest Receivable

Accounts receivable consist of amounts owed to MMS by other federal agencies and the public. No allowance is established for receivables due from federal agencies, as they are considered fully collectible.

G. General Property, Plant, and Equipment, Net

Property and equipment are valued at historical costs. Property and equipment are capitalized if the initial acquisition cost is $15,000 or more and the estimated useful life is two years or greater (excluding internal use software). Internal use software with a purchase price or development cost of more than $100,000 and the estimated useful life is greater than two years is capitalized. Depreciation is recorded using the straight-line method based on useful lives ranging from 3 to 6 years for equipment and 10 years for internal use software.

H. Liabilities

Operating liabilities of MMS represent amounts likely to be paid by MMS as a result of transactions or events that have already occurred. However, no liabilities relating to MMS operations can be paid absent an appropriation. Liabilities for which an appropriation has not been enacted are classified as liabilities not covered by budgetary resources, without any certainty that an appropriation will be enacted.

I. Federal Employees Compensation Act

The Department of Labor (DOL) administers the Federal Employees Compensation Act (FECA), which provides workers' compensation benefits to Federal employees. There are two types of liabilities related to workers' compensation.

The first type is unfunded accrued FECA liability, which represents MMS Workers Compensation claims paid by the DOL for Workers' Compensation that have not yet been reimbursed by MMS. There is generally a two to three year time period between payment by DOL and reimbursement by MMS.

The second type is the unfunded actuarial FECA liability, which represents the estimated liability for future benefit payments as a result of past events. This liability includes death, disability, medical, and miscellaneous costs.

DOL determines the actuarial FECA liability annually, as of September 30, using a method that considers historical benefit payment patterns, wage inflation factors, medical inflation factors, and other variables. DOL discounts the projected annual benefit payments to present value using the Office of Management and Budget's economic assumptions for 10-year Treasury notes and bonds.

To provide for the effects of inflation on the actuarial FECA liability, DOL applies wage inflation factors (i.e., cost of living adjustments) and medical inflation factors (i.e., consumer price index medical adjustments) to the calculation of projected future benefit payments. These factors are also used to adjust historical benefit payments to current-year constant dollars. DOL applies a discounting formula to recognize the timing of benefit payments as 13 payments per year instead of one lump sum payment per year.

DOL evaluates the estimated projections to ensure that the estimated future benefit payments are appropriate. The analysis includes three tests: (1) a comparison of the current-year projections to the prior year projections; (2) a comparison of the prior-year projected payments to the current-year actual payments, excluding any new case payments that had arisen during the current year; and (3) a comparison of the current-year actual payment data to the prior-year actual payment data. Based on the outcome of this analysis, adjustments may be made to the estimated future benefit payments.

J. Federal Employees Group Life Insurance (FEGLI) Program

Most MMS employees are entitled to participate in the FEGLI Program. Participating employees can obtain "basic life" term life insurance, with the employee paying two-thirds of the cost and MMS paying one-third. Additional coverage is optional, to be paid fully by the employee. The basic life coverage may be continued into retirement if certain requirements are met.

The Office of Personnel Management (OPM) administers this program and is responsible for the reporting of liabilities. For each fiscal year, OPM calculates the U.S. Government's service cost for the post-retirement portion of the basic life coverage. Because MMS's contributions to the basic life coverage are fully allocated by OPM to the pre-retirement portion of coverage, MMS has recognized the entire service cost of the post-retirement portion of basic life coverage as an imputed cost and imputed financing source.

K. Advances and Deferred Revenue

Intra-governmental advances and deferred revenue represent liabilities to perform services or deliver goods to customers that have remitted payment in advance of receiving the goods and services. These amounts will be earned upon furnishing goods and services to customers typically within the next 12 months.

Public advances represent liabilities to perform services or deliver goods to customers that have remitted payment in advance of receiving the goods and services. These amounts will be earned upon furnishing goods and services to customers typically within the next 12 months. In FY 2005, deferred revenue consisted of receipts retained from royalty collections for the Strategic Petroleum Reserve (SPR). MMS was also authorized to retain collections for the transportation costs of the royalty oil taken in kind from Federal leases in the Gulf of Mexico, which was transferred to the Department of Energy. SPR receipts were recorded as deferred revenue when collected and the revenue was recognized when the costs were incurred for transportation costs. Since the SPR fill initiative was completed in July of 2005, the closing out of the fund took place in FY 2006 and there are no deferred revenues related to the SPR as of September 2006.

L. Accrued Unfunded Annual Leave

Amounts associated with the payment of annual leave are accrued while employees are earning leave. This accrual is reduced as leave is taken. Each year the balance in the accrued annual leave account is adjusted to reflect current pay rates. To the extent current or prior year appropriations are not available to finance annual leave, future financing sources will be used.

Sick leave and other types of leave are expensed as taken because they are non-vesting in nature.

M. Contingent Liabilities

Contingent liabilities are recorded when an event potentially leading to the recognition of a liability is probable, and the scope of the potential liability may be estimated.

Contingent liabilities are disclosed in the footnotes when the conditions for financial statement recognition are not met and when the outcome of a liability is more than remote and may be estimated.

N. Retirement Plans

MMS employees participate in one of two retirement systems, the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). Employees hired prior to January 1, 1984 could elect to join FERS or continue to participate in CSRS. Employees hired after December 31, 1983 are automatically covered by FERS and Social Security.

CSRS employees may contribute up to ten percent of basic pay and receive no matching contributions from MMS. For FERS employees, MMS automatically contributes one percent of pay and matches any employee contribution up to an additional four percent of pay. FERS employees may contribute up to 15 percent of gross earnings. For employees in FERS, MMS also contributes the employer's matching share for Social Security.

The OPM is responsible for reporting assets, accumulated plan benefits and unfunded liabilities, if any, applicable to CSRS participants and FERS employees government-wide, including MMS employees. MMS has recognized an imputed cost and imputed financing source for the difference between the estimated service cost and the contributions made by the MMS and covered CSRS employees.

O. Exchange Revenues

The prices charged by Minerals Management Service are set by law or regulation. Prices set for products and services offered through reimbursable agreements under the Economy Act are intended to recover the full costs incurred by these activities.

MMS reports, as exchange revenues, the amount of royalties, rents and bonuses that Congress authorizes MMS to use for operations, as these revenues off-set the costs incurred to generate the revenues.

P. Other Financing Sources and Revenues

The primary financing sources for Minerals Management Service operations come from its annual Congressional appropriation and its authority to retain certain receipts resulting from its activities. MMS is authorized to retain a portion of the rental income collected as a part of the custodial activity provided by the Minerals Revenue Management Program to fund its operating costs. These funds are used for operating and capital expenses of MMS. Additional amounts are obtained through reimbursements for services performed for other Federal agencies under the Economy Act.

In addition, MMS receives appropriations for specific purposes such as computer acquisitions; to carry out title I, section 1016, title IV, section 4202 and 4303, title VII, and title VIII, section 8201 of the Oil Pollution Act of 1990; to carry out provisions of the Minerals Leasing Act; to provide National Forest Fund payments to States, and to provide payments to States from lands acquired for flood control, navigation, and allied purposes.

Provisions in the FY 2006 Department of the Interior Appropriation's Bill enable MMS to recover Royalty-in-Kind (RIK) sales revenue previously transferred to Treasury to offset the expenses associated with transportation, processing and administrative costs for the RIK sales. Similar legislative provisions enable MMS to recover RIK sales revenue previously transferred to Treasury to offset the necessary expenses incurred to deliver oil of sufficient quality and quantity to the Department of Energy for deposit into the Strategic Petroleum Reserve.

Appropriations: Appropriations are recognized as financing sources on the Statement of Changes in Net Position when goods and services are received or benefits are provided. This is true whether the goods, services, and benefits are payable or paid as of fiscal year end and whether the appropriations are used for items that are expensed or capitalized. In addition, appropriations are recorded as budgetary authority on the Statement of Budgetary Resources when realized.

Imputed Financing Sources: In certain instances, operating costs of MMS are paid out of funds appropriated to other federal agencies. For example, the Office of Personnel Management, by law, pays certain costs of retirement programs and the Judgment Fund maintained by Treasury pays certain legal judgments against MMS. MMS also recognized imputed financing sources and costs for costs paid by other Interior components in accordance with the Federal Accounting Standards Advisory Board's Interpretation Number 6, *Accounting for Imputed Intra-departmental Costs: An Interpretation of SFFAS Number 4*. As a result, MMS recognized approximately $785 thousand and $1.7 million of imputed financing sources and costs in FY 2006 and FY 2005, respectively. For certain costs that are identifiable to MMS and directly attributable to MMS operations are paid by other agencies, MMS recognizes these amounts as operating expenses. In addition, MMS recognizes an imputed financing source on the Consolidated Statement of Changes in Net Position to indicate the funding of operations by other federal agencies.

Q. Net Position

Net position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations include available and unavailable unobligated balances as well as undelivered orders. Cumulative results of operations include the difference between revenues and expenses, the net amount of transfers of assets in and out without reimbursement, and donations (all of these include balances since the inception of the fund). The Environmental Improvement and Restoration Fund is not available until appropriated by Congress. As of September 30, 2006 and 2005, there are no estimated obligations related to canceled appropriations.

R. Income Taxes

As an entity of the U.S. Government, MMS is exempt from all income taxes imposed by any governing body, whether it is a federal, state, local, commonwealth, or foreign government.

S. Use of Estimates

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

T. Comparative Data

MMS has reclassified data on the fiscal year 2005 financial statements and footnotes to conform with fiscal year 2006 presentation requirements.

U. Stewardship Assets

Effective October 1, 2005, MMS adopted SFFAS No. 29, *Heritage Assets and Stewardship Land*. This standard requires federal agencies to reclassify all heritage asset information to the note disclosures (basic information) except for condition information. This change in reporting is phased in over a four year period beginning fiscal year 2006. The following is required disclosure information for fiscal year 2006.

The mission of MMS is to manage the mineral resources on the Outer Continental Shelf and Federal and Indian mineral revenues to enhance public and trust benefit, promote responsible use, and realize fair value. The museum property collection, although not directly related to this mission, provides information about processes, events, and interactions amount cultures, individuals, and the environment. Objects in the museum property collection provide baseline data, serving as scientific and historical documentation of MMS's resources and the purposes for which MMS was established.

The MMS policy on managing the collection follows the 411 DM 3.3 "Standards to Preserve and Protect Museum Property in Administrative Office Space" to ensure all our museum objects/displays meet the Departmental requirements.

V. Future Accounting Standards

SFFAS No. 30 - In August 2005, the FASAB issued SFFAS No. 30, *Inter-Entity Cost Implementation*. SFFAS No. 30 requires that the full inter-entity cost should incorporate the full cost of goods or services that an entity receives from other entities, and that recognition of inter-entity costs that are not fully reimbursed is limited to material items. SFFAS No. 30, *Inter-Entity Cost Implementation,* is effective for reporting periods beginning after September 30, 2008. MMS has not completed the process of evaluating the impact that will result from adopting SFFAS No. 30, *Inter-Entity Cost Implementation.*

SFFAS No. 31 – In October 2006, the FASAB issued SFFAS No. 31, Accounting for Fiduciary Activities. SFFAS 31 requires Federal entities to distinguish the information relating to fiduciary activities of the Federal entity from all other activities of the Federal entity. Further the Federal entity is required to provide a note disclosure that; explains the nature of the fiduciary relationship, provide a schedule of fiduciary net assets, and provide a schedule of fiduciary activity. SFFAS No. 31, Accounting for Fiduciary Activities is effective for periods beginning after September 30, 2008. MMS has not completed the process of evaluating the impact that will result from adopting the standard.

Note 1.2 Significant Accounting Policies Relating to the Minerals Revenue Management (MRM) Program

A. Financing Sources and Revenues

MMS collects and accrues for lease sales, rents, royalties and other receipts from Federal Government and Indian leases and distributes all proceeds to the Treasury, other Federal agencies, states, counties, Indian tribes, and Indian allottees in accordance with legislated allocation formulas. MMS reports these revenues on the Statement of Custodial Activity. MMS recognizes lease sales as bids are accepted and executed, rents when earned, and royalties and other receipts when MMS has legal claim.

In addition, MMS reports certain state amounts as revenues on the Statement of Changes in Net Position because the revenues are derived from the sale of federally owned mineral rights for which MMS incurred minimal costs in earning the revenue. When distributed to the states, MMS reports the distributions as costs in the Effective Lease and Permit Management program on the FY 2006 and FY 2005 Statements of Net Cost, respectively, because the distributions reduce the net position of the Federal Government as a whole and MMS received budgetary authority to make the distributions.

Royalty-in-Kind Program

MMS, under the provisions of the Mineral Lands Leasing Act of 1920 and the Outer Continental Shelf Lands Act (OCSLA) of 1953, may take part or all of its oil and gas royalties in-kind (a volume of the commodity) as opposed to in value (cash). MMS may either transfer the volume of oil or gas commodity taken in kind to Federal agencies for internal use or sell the commodity on the open market at fair market value and transfer the cash received. MMS determines the value of the RIK commodity using the fair market value on the date of the sale. MMS reflects royalty-in-kind as mineral lease revenue and as distributions to Federal agencies on the Statement of Custodial Activity.

In prior years, MMS assisted with the administration's initiative to fill the Strategic Petroleum Reserve, which was completed in July 2005. MMS transferred to the Department of Energy royalty oil taken in kind from Federal leases in the Gulf of Mexico. During fiscal year 2005, MMS transferred approximately 25.6 million barrels to the Department of Energy for use in adding to the reserve. MMS determined the value of the commodity transferred using the fair market value on the date of the transfer. MMS reports these transfers as mineral lease revenue and distribution to the Department of Energy on the Statement of Custodial Activity. The fiscal year 2006 Strategic Petroleum Reserve revenue and distribution to the Department of Energy represents changes to prior year estimates based on revised pipeline statements.

Environmental Improvement and Restoration Fund (EIRF)

The Environmental Improvement and Restoration Fund was established pursuant to Title 4 of the Department of the Interior and Related Agencies Appropriations Act for FY 1998. Half of the principal and interest from the distribution of the Alaska Escrow Fund was deposited into EIRF during FY 2000. During FY 2006 and 2005, MMS deposited to the EIRF interest earned from investments of the EIRF principal. Congress has permanently appropriated 20 percent of the prior fiscal year interest earned by the EIRF to the Department of Commerce. The remaining 80 percent of interest earned remains in the fund and is recorded as other non-exchange revenue on the Statement of Changes in Net Position. The remaining interest earned may be appropriated by Congress to certain other agencies, as provided by law. No assets of the fund are available to the Department of the Interior unless appropriated by Congress.

B. Distributions of Revenues

Federal Revenues: Distributions to other Federal entities are based on the Mineral Lands Leasing Act of 1920, 30 USC 191 as amended, the Federal Oil and Gas Royalty Management Act of 1982 (PL 97-451, 96 Stat. 2447, 30 USC 1701), the 1986 OCS Lands Act amendments of 1985 (PL 99-272), and subsequent legislation and lease terms.

Based on legislation, Federal revenues distributed to MMS are subsequently appropriated and/or made available for program expenses and disbursements approved by Congress. Monies collected in MMS administrative appropriated funds are recorded as exchange revenues and subsequently used for operational purposes.

Non-Federal Revenues: Distributions are based on the Mineral Lands Leasing Act of 1920, as amended, subsequent legislation and lease terms.

Revenues generated from mineral production on Indian Lands go directly to Interior's Office of Trust Fund Management for subsequent distribution to tribes and allottees, meeting a wide variety of needs as outlined in the Indian Mineral Development Act of 1982 and other applicable laws and guidance.

C. Fund Balance With Treasury

MMS receipts and disbursements are processed through the Federal Reserve System and the U.S. Treasury. Receipts are processed through electronic transfers, fedwires, Treasury's Government On-Line Accounting Link System, and checks. The "Custodial Fund Balance with Treasury" as shown on the Consolidated Balance Sheet includes deposit and clearing account balances that are not available for obligation.

At the end of each fiscal year, MMS distributes the undisbursed custodial clearing account fund balance to the General Fund of the Treasury and reports the portion due to non-Treasury entities as a custodial accounts receivable. At the beginning of the following year, the balance is returned from Treasury and is available for distribution to the beneficiaries.

D. Accounts and Interest Receivable

The custodial and administrative receivables represent amounts due for royalty revenue, deferred bonuses, accumulated interest, audit bills, and royalty in kind.

The royalty accrual for custodial receivables and distributions payable represents the current period activity anticipated to be received in the subsequent period. The balance is estimated based on an analysis of the last twelve months of royalty activity, and recent events, such as significant settlements due in September.

Receivables due from the public are reported net of allowances for uncollectible amounts. An allowance for estimated uncollectible custodial receivables is recognized to reduce the gross amount of receivables to its realizable value. The allowance is estimated based on historical experience of collections in relation to revenues. The allowance is calculated as the historical collection percentage multiplied by the year end accounts receivable balance.

E. Investments

Investments represent non-marketable market based Treasury securities issued by the Bureau of the Public Debt. These securities are not traded on any securities exchange, but mirror the prices of similar Treasury Securities trading in the Government securities market. Investments are expected to be held to maturity.

Investments are reported at cost, net of amortized premiums or discounts. Premiums and discounts for T-Bills, short term T-Notes and long-term T-Notes are amortized using effective interest method. Interest on investments is accrued as it is earned and is recorded as other non-exchange revenue on the Statement of Changes in Net Position.

The market value of investments is calculated using the market price of securities as shown on Treasury's FedInvest Price File on September 30. Market values for overnight investments are the same as, or equivalent to par value.

MMS has limited investment authority based on two categories: (1) restricted and (2) custodial.

Restricted Investments

The Environmental Improvement and Restoration Fund is available for investment under the DOI and Related Agencies Appropriations Act of 1998. Congress has permanently appropriated 20 percent of the prior fiscal year interest earned by the EIRF to the Department of Commerce. The remaining 80 percent of interest earned remains in the fund and may be appropriated by Congress to certain other agencies, as provided by law. This investment was initially funded in FY 2000 by the settlement of the boundary dispute with the State of Alaska.

Custodial Investments

MMS is also required by regulation to invest the 1/5 OCS bid amounts from the high bidders for all OCS lease sales. Should any of the high bids later be rejected, the 1/5 bid and actual interest earned are returned to the bidder. Should the bidder forfeit their bid, the 1/5 bonus and accrued interest reverts to Treasury. The interest earned on accepted bids reverts to the Treasury when the bids are accepted.

F. Liabilities

MMS liabilities include custodial liabilities, deposit funds, and royalty credit liability. Custodial liabilities represent amounts owed to royalty recipients (the public or Federal agencies) and offset custodial assets. Deposit funds include receipts for bonuses that are pending award or refund and non-Federal revenues collected on behalf of the states.

Liabilities for which an appropriation has not been enacted are classified as liabilities not covered by budgetary resources. MMS does not record a payable for potential overpayments by payors as MMS is not obligated, according to the Federal Oil and Gas Royalty Management Act of 1982 (PL 97-451, 96 Stat. 2447, 30 USC 1701), to repay such amounts until requested by the payor or until MMS completes a compliance audit and determines the amount that is refundable.

G. State Liabilities

MMS makes payments to states according to the Mineral Lands Leasing Act of 1920, 30 USC 191 as amended, the Federal Oil and Gas Royalty Management Act of 1982 (PL 97-451, 96 Stat. 2447, 30 USC 1701), and PL 99-272 from the 1986 OCS Lands Act amendments of 1985. The liabilities to states for accrued minerals revenue are shown as unfunded because budgetary resources, which are authorized by the Act as permanent indefinite appropriations, are based on actual collections (appropriated revenues). The accrued unfunded liabilities associated with expenses for the payments to the States are reported on the Consolidated Balance Sheet as "State Liabilities".

Note 2. Fund Balance with Treasury

A summary of the Fund Balance with Treasury (FBWT) by fund type is listed in the first table below. The general funds consist of the appropriated funds for the operation of MMS, such as salaries and expenses, and computer acquisition. The trust funds consist of funds for oil spill research and development. The other fund types consist of the proceeds from the sale of equipment. The proceeds received from the sale of equipment can be retained for two years to purchase new vehicles.

Fund Balance with Treasury by Fund Type
As of September 30
(dollars in thousands)

	FY 2006	FY 2005 Restated
General Funds	$142,928	$104,851
Trust Funds	5,575	6,872
Other Fund Types	38	2
Total Fund Balance with Treasury by Fund Type	**$148,541**	**$111,725**

The table below displays the status of FBWT amounts obligated and unobligated as presented in the Statement of Budgetary Resources.

Status of Fund Balance with Treasury
As of September 30
(dollars in thousands)

	FY 2006	FY 2005 Restated
Unobligated:		
Available	$38,607	$15,105
Unavailable	2,101	1,458
Obligated Net Yet Disbursed	107,795	95,160
Subtotal	**148,503**	**111,723**
FBWT not Covered by Budgetary Resources:		
Clearing and Deposit Accounts	38	2
Total Status of Fund Balance with Treasury	**$148,541**	**$111,725**

Note 3. Investments, Net

Investments consist of non-marketable, market-based Treasury securities that are not traded on any securities exchange but mirror the prices of marketable securities with similar terms. MMS has limited investment authority based on two categories: restricted and custodial. The restricted (EIRF) investments are further discussed in Note 1.2A and 1.2E, and the custodial investments are discussed in Note 1.2E.

As of September 30, 2006
(dollars in thousands)

	Investment Type	Cost	Net Amortized (Premium) / Discount	Investments, Net	Market Value Disclosure
U.S. Treasury Securities					
Restricted	Non-Marketable, market-based	$1,067,414	$(10,371)	$1,057,043	$1,039,783
Custodial	Non-Marketable, market-based	58,324	68	58,392	58,411
Total U.S. Treasury Securities		1,125,738	(10,303)	1,115,435	1,098,194
Accrued Interest		5,753	-	5,753	-
Total Non-Public Investments		1,131,491	(10,303)	1,121,188	1,098,194
Total Investments		**$1,131,491**	**$(10,303)**	**$1,121,188**	**$1,098,194**

As of September 30, 2005
(dollars in thousands)

	Investment Type	Cost	Net Amortized (Premium) / Discount	Investments, Net	Market Value Disclosure
U.S. Treasury Securities					
Restricted	Non-Marketable, market-based	$1,032,450	$(6,803)	$1,025,647	$1,014,909
Custodial	Non-Marketable, market-based	57,214	106	57,320	57,261
Total U.S. Treasury Securities		1,089,664	(6,697)	1,082,967	1,072,170
Accrued Interest		5,279	-	5,279	-
Total Non-Public Investments		1,094,943	(6,697)	1,088,246	1,072,170
Total Investments		**$1,094,943**	**$(6,697)**	**$1,088,246**	**$1,072,170**

Note 4. Accounts and Interest Receivable, Net

Accounts receivable relating to general operations of the bureau consist primarily of amounts due to MMS from other agencies in connection with various interagency agreements, and refunds due from MMS vendors and/or employees. MMS has custodial accounts receivable from intra-governmental agencies totaling approximately $268 and $400 million, of which, $268 and $344 million is due from Department of the Treasury and approximately $115 thousand and $56 million is due from Bureau of Land Management in FY 2006 and FY 2005 respectively. Interest receivables are included as part of the custodial receivables in the amount of approximately $79 million and $65 million as of FY 2006 and FY 2005, respectively. Refer to Note 1.2C for information on custodial receivables from Federal agencies.

Accounts and Interest Receivable, Net
As of September 30
(dollars in thousands)

	FY 2006	FY 2005 Restated
Accounts and Interest Receivable from Federal Agencies		
Billed	$115	$56,124
Unbilled	268,070	345,415
Total Accounts and Interest Receivable - Federal	**$268,185**	**$401,539**

	FY 2006	FY 2005 Restated
Accounts and Interest Receivable from Public		
Current	$348,040	$60,330
1 – 180 Days Past Due	184,215	112,759
181 – 365 Days Past Due	4,086	9,217
1 to 2 Years Past Due	3,015	21,427
Over 2 Years Past Due	68,469	76,688
Total Billed Accounts and Interest Receivable – Public	**607,825**	**280,421**
Unbilled Accounts and Interest Receivable	1,811,768	2,299,814
Total Accounts and Interest Receivable – Public	**2,419,593**	**2,580,235**
Allowance for Doubtful Accounts - Public	(154,549)	(154,183)
Total Accounts and Interest Receivable – Public, Net of Allowance	**$2,265,044**	**$2,426,052**

Note 5. General Property, Plant and Equipment, Net

MMS property and equipment categories, with corresponding accumulated depreciation, are shown in the table below. Depreciation expense amounted to approximately $4.8 million and $4.9 million as of September 30, 2006 and 2005, respectively.

General Property, Plant and Equipment, Net
As of September 30, 2006
(dollars in thousands)

	Acquisition Cost	Accumulated Depreciation	Net Book Value FY 2006
Equipment and Vehicles	$13,067	($10,015)	$3,052
Assets under Capital Lease	155	(118)	37
Internal Use Software, In Use	37,149	(15,786)	21,363
Total General Property, Plant and Equipment	**$50,371**	**($25,919)**	**$24,452**

General Property, Plant and Equipment, Net
As of September 30, 2005
(dollars in thousands)

	Acquisition Cost	Accumulated Depreciation	Net Book Value FY 2005
Equipment and Vehicles	$15,405	($12,004)	$3,401
Assets under Capital Lease	179	(114)	65
Internal Use Software, In Use	37,149	(12,072)	25,077
Total General Property, Plant and Equipment	**$52,733**	**($24,190)**	**$28,543**

Note 6. Assets Analysis

Assets of MMS include entity unrestricted, entity restricted and non-entity assets. Entity assets are those currently available for use by MMS. Restricted entity assets consist of the Environmental Improvement and Restoration Fund. Restricted entity assets cannot be used until appropriated by Congress, except for twenty percent of the interest earned on the EIRF investments that are transferred once a year to the Department of the Commerce. Non-entity assets are currently held by MMS but will be forwarded to Treasury, other agencies, or states at a future date. These assets are not available for use by MMS.

Asset Analysis
As of September 30, 2006
(dollars in thousands)

	Entity Unrestricted	Entity Restricted	Non Entity Restricted	FY 2006
Intragovernmental Assets:				
Fund Balance with Treasury	$148,541	$ -	$ -	$148,541
Investments, Net	-	1,062,796	58,392	1,121,188
Accounts and Interest Receivable	478	-	267,707	268,185
Other:				
Advances and Prepayments	18	-	-	18
Total Intragovernmental Assets	**149,037**	**1,062,796**	**326,099**	**1,537,932**
Accounts and Interest Receivable, Net	66	-	2,264,978	2,265,044
General Property, Plant and Equipment, Net	24,452	-	-	24,452
Total Assets	**$173,555**	**$1,062,796**	**$2,591,077**	**$3,827,428**

Asset Analysis
As of September 30, 2005
(dollars in thousands)

	Entity Unrestricted	Entity Restricted	Non Entity Restricted	FY 2005 Restated
Intragovernmental Assets:				
Fund Balance with Treasury	$111,724	$ -	$ 1	$ 111,725
Investments, Net	-	1,030,926	57,320	1,088,246
Accounts and Interest Receivable	1,471	-	400,068	401,539
Other:				
Advances and Prepayments	107	-	-	107
Total Intragovernmental Assets	**113,302**	**1,030,926**	**457,389**	**1,601,617**
Accounts and Interest Receivable, Net	94	-	2,425,958	2,426,052
General Property, Plant and Equipment, Net	28,543	-	-	28,543
Other:				
Advances and Prepayments	2	-	-	2
Total Assets	**$141,941**	**$1,030,926**	**$2,883,347**	**$4,056,214**

Note 7. Federal Employee Benefits – FECA Actuarial Liability

MMS has recorded an estimated, unfunded actuarial liability for the expected future cost for death, disability, and medical claims under the Federal Employees Compensation Act (FECA) of approximately $9.0 million and $9.8 million as of FY 2006 and FY 2005, respectively. This liability is determined using a method that utilizes historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period. Projected annual benefit payments are discounted to present value using the OMB's economic assumptions for 10-year Treasury notes and bonds. The resulting liability is then distributed by DOL to each benefiting agency.

Note 8. Contingent Liabilities

The MMS is party to various administrative proceedings, legal actions, environmental suits, and claims that may eventually result in the payment of substantial monetary claims to third parties. The cases primarily relate to oil and gas leases and employee claims. MMS accrued approximately $550 million and $551 million as of FY 2006 and FY 2005, respectively, for claims deemed probable of loss and where the amount of potential liability can be estimated. It is management's opinion that any amounts due will be paid from the Department of the Justice Judgment Fund. Management believes that the ultimate resolution of other proceedings, actions and claims will not materially affect the financial position or net cost of operations of MMS. The potential liability claims deemed to be probable and reasonably possible of loss are estimated in the chart below:

Estimated Range of Loss
As of September 30, 2006
(dollars in thousands)

		Estimated Range of Loss	
	Accrued Liabilities	Lower End of Range	Upper End of Range
Contingent Liabilities	$550,000		
Probable		$550,000	$2,000,000
Reasonably Possible		150	300

Estimated Range of Loss
As of September 30, 2005
(dollars in thousands)

		Estimated Range of Loss	
	Accrued Liabilities	Lower End of Range	Upper End of Range
Contingent Liabilities	$550,690		
Probable		$550,690	$1,200,690
Reasonably Possible		50	100

Note 9. Royalty Credit Liability

MMS has recognized a liability in the amount of $44.3 million, in accordance with Section 383 of the Energy Policy Act and provisions in Statement of Federal Financial Accounting Standards (SFFAS) 5, *Accounting for Liabilities of the Federal Government.* The liability is for compensation due to a lessee for the competitive oil and gas drainage of the West Delta field in Louisiana that occurred in the late 1980's. The liability will be reduced incrementally, beginning in fiscal year 2007, as royalty credits authorized by the Act are taken. Because no cash will be received or distributed to liquidate the lessee's royalty obligation, the royalty credits will reduce the distributions to the Department of the Treasury's General Funds as the credits are taken. Accordingly, the liquidation of the liability will not affect the financial position or net cost of MMS.

Note 10. Leases

Capital Leases:

MMS has six capital leases for copiers, which transfer ownership of the property to MMS at the end of the lease term. The gross cost and net book value of these leases is $155 thousand and $37 thousand as of FY 2006, and $179 thousand and $65 thousand as of FY 2005, respectively. The accumulated amortization is $118 and $114 as of FY 2006 and FY 2005, respectively. The table below shows the future minimum lease payments expected for these lease agreements.

Future Capital Lease Payments
As of September 30, 2006
(dollars in thousands)

Fiscal Year	Personal Property
2007	$16
2008	16
2009	-
2010	-
2011	-
Thereafter	-
Total Future Capital Lease Payments	**32**
Less: Imputed Interest	8
FY 2006 Net Capital Lease Liability	**$24**
FY 2005 Net Capital Lease Liability	**$51**

Note 10. Leases (Continued)

Operating Leases:

MMS has several General Services Administration (GSA) operating lease agreements for office space and vehicles. The terms of the space lease agreements vary according to whether the underlying assets are owned by GSA (or another Federal agency) or rented by GSA from the private sector. The GSA lease vehicle agreements are typically on a year-by-year basis or are cancelable at any time. Future minimum lease payments are subject to appropriations becoming available.

For GSA-owned property, MMS generally does not execute an agreement with GSA nor is there a formal lease expiration date. Although MMS may normally vacate these properties after giving 120 to 180 days notice of intent to vacate, in actuality, MMS normally occupies these properties for an extended period of time, with little variation from year to year.

For real and personal property, future operating lease payments are calculated based on the terms of the lease or if the lease is silent, an annual inflationary factor of 2.4 percent for years 2007 and beyond. The inflationary factors are applied against the actual 2006 rental expense. For operating leases that have an indefinite period of performance, future lease payments are only calculated for six years.

MMS also has equipment operating leases for copiers that are not disclosed in the schedule below as the amounts are insignificant. The Federal Real Property category consists of the office space leases, and the Federal Personal Property consists of the vehicles leases.

Future Operating Lease Payments
As of September 30, 2006
(dollars in thousands)

Fiscal Year	Real Property Federal	Personal Property Federal	Total
2007	$12,692	$40	$12,732
2008	13,902	41	13,943
2009	12,831	42	12,873
2010	9,936	43	9,979
2011	9,822	44	9,866
Thereafter	73,137	-	73,137
Total Future Operating Lease Payments	**$132,320**	**$210**	**$132,530**

Note 11. Liability Analysis

Liabilities shown below include all liabilities, both funded and unfunded, that are due to the public and other Federal entities. Funded liabilities are liabilities covered by budgetary resources; likewise, unfunded liabilities are liabilities not covered by budgetary resources. The Custodial Liability and Liabilities to States, which are current liabilities, not covered by budgetary resources, are further discussed in Note 1.2F.

Liability Analysis
As of September 30, 2006
(dollars in thousands)

	Covered by Budgetary Resources	Not Covered by Budgetary Resources		
	Current	**Current**	**Non-Current**	**FY 2006**
Intragovernmental Liabilities:				
Accounts Payable	$ 3,838	$ -	$ -	$3,838
Other:				
Custodial Liability	-	1,386,651	314,748	1,701,399
Accrued Employee Benefits	1,050	832	1,820	3,702
Total Other Liabilities	1,050	1,387,483	316,568	1,705,101
Total Intragovernmental Liabilities	**4,888**	**1,387,483**	**316,568**	**1,708,939**
Public Liabilities				
Accounts Payable	18,222	-	-	18,222
Federal Employee Benefits – FECA	-	-	9,038	9,038
Other:				
State Liabilities	-	497,842	314,746	812,588
Contingent Liabilities	-	-	550,000	550,000
Royalty Credit Liability	-	5,441	38,881	44,322
Advances, Deferred Revenue, and Deposit Funds	101	55,011	-	55,112
Custodial Liability	-	22,080	-	22,080
Unfunded Annual Leave	-	-	12,138	12,138
Accrued Payroll and Benefits	5,057	-	-	5,057
Capital Lease Liability	-	12	12	24
Total Other Liabilities	5,158	580,386	915,777	1,501,321
Total Public Liabilities	**23,380**	**580,386**	**924,815**	**1,528,581**
Total Liabilities	**$28,268**	**$1,967,869**	**$1,241,383**	**$3,237,520**

Note 11. Liability Analysis (Continued)

Liability Analysis
As of September 30, 2005
(dollars in thousands)

	Covered by Budgetary Resources	Not Covered by Budgetary Resources		FY 2005 Restated
	Current	Current	Non-Current	
Intragovernmental Liabilities:				
Accounts Payable	$2,827	$ -	$ -	$2,827
Other:				
Custodial Liability	-	1,799,017	-	1,799,017
Accrued Employee Benefits	1,082	845	1,832	3,759
Advances and Deferred Revenue	536	-	-	536
Total Other Liabilities	1,618	1,799,862	1,832	1,803,312
Total Intragovernmental Liabilities	**4,445**	**1,799,862**	**1,832**	**1,806,139**
Public Liabilities:				
Accounts Payable	21,511	-	-	21,511
Federal Employee Benefits – FECA	-	-	9,837	9,837
Other:				
State Liabilities	-	1,009,419	-	1,009,419
Contingent Liabilities	-	690	550,000	550,690
Advances, Deferred Revenue, and Deposits Funds	828	51,674	-	52,502
Custodial Liability	-	23,238	-	23,238
Accrued Payroll and Benefits	5,266	-	12,229	17,495
Capital Lease Liability	-	51	-	51
Total Other Liabilities	6,094	1,085,072	562,229	1,653,395
Total Public Liabilities	**27,605**	**1,085,072**	**572,066**	**1,684,743**
Total Liabilities	**$32,050**	**$2,884,934**	**$573,898**	**$3,490,882**

Note 12. Net Cost by Responsibility Segment

The Government Performance Results Act (GPRA) requires that Federal agencies formulate Strategic Plans, identify major strategic goals, and report performance and costs related to these goals. Under GPRA, Strategic Plans are to be revised and updated every three years. Accordingly, the Department of the Interior (Department) updated the Department-wide Strategic Plan in FY 2004. OMB Circular A-136, *Financial Reporting Requirements,* requires that the presentation of the Statement of Net Cost align directly with the goals and outcomes identified in the Strategic Plan. Accordingly, MMS has presented the earned revenues and gross costs in FY 2006 and FY 2005 by the applicable mission goals and categories in the Department's FY 2004 Strategic Plan as follows.

1. Resource Use
    a. Resource Use Energy
        i. Manage and Provide Incentives for Access and Development
        ii. Enhance Responsible Use Management Practices
        iii. Effective Lease and Permit Management
        iv. Improve Information Base, Resource Management and Technical Assistance
    b. Resource Use Non-Energy
2. Serving Communities
    a. Indian Trust Fulfillment
3. Reimbursable Activity and Other

OMB Circular A-136, requires that the presentation of the Statement of Net Cost align with the goals and outcomes identified in the Strategic Plan. Accordingly, MMS presented the earned revenue and gross costs in FY 2006 and FY 2005 by the Intermediate Strategy rolled up to the Mission Goals of the FY 2004 Strategic Plan.The tables on the following pages present MMS's earned revenues, gross cost and net cost of operations by program and by responsibility segment.

Note 12. Net Cost by Responsibility Segment (Continued)

Schedule of Net Cost by Program and Responsibility Segment
For the year ended September 30, 2006
(dollars in thousands)

	Offshore Minerals Management	Mineral Revenue Management	Other	Elimination of Intra Bureau Activity	FY 2006
Resource Use Energy					
Manage and Provide Incentives for Access and Development					
Intragovernmental Costs	$ 16,256	$ -	$ -	$ -	**$ 16,256**
Public Costs	73,826	-	-	-	**73,826**
Total Costs	90,082	-	-	-	**90,082**
Total Public Earned Revenue	28,037	-	-	-	**28,037**
Net Cost	62,045	-	-	-	**62,045**
Enhance Responsible Use Management Practices					
Intragovernmental Costs	25,649	37	-	-	**25,686**
Public Costs	45,022	(4)	-	-	**45,018**
Total Costs	70,671	33	-	-	**70,704**
Total Public Earned Revenue	21,526	163	-	-	**21,689**
Net Cost	49,145	(130)	-	-	**49,015**
Effective Lease and Permit Management					
Intragovernmental Costs	11,603	18,021	-	-	**29,624**
Public Costs	50,658	2,030,502	-	-	**2,081,160**
Total Costs	62,261	2,048,523	-	-	**2,110,784**
Total Public Earned Revenue	24,963	79,702	-	-	**104,665**
Net Cost	37,298	1,968,821	-	-	**2,006,119**
Improve Information Base, Resource Management and Technical Assistance					
Intragovernmental Costs	1,342	-	-	-	**1,342**
Public Costs	5,307	-	-	-	**5,307**
Total Costs	6,649	-	-	-	**6,649**
Total Public Earned Revenue	3,657	-	-	-	**3,657**
Net Cost	2,992	-	-	-	**2,992**
Total Resource Use Energy					
Intragovernmental Costs	54,850	18,058	-	-	**72,908**
Public Costs	174,813	2,030,498	-	-	**2,205,311**
Total Costs	229,663	2,048,556	-	-	**2,278,219**
Total Public Earned Revenue	78,183	79,865	-	-	**158,048**
Net Cost	151,480	1,968,691	-	-	**2,120,171**
Resource Use Non-Energy					
Intragovernmental Costs	360	-	-	-	**360**
Public Costs	3,176	-	-	-	**3,176**
Total Costs	3,536	-	-	-	**3,536**
Total Public Earned Revenue	2,332	-	-	-	**2,332**
Net Cost	1,204	-	-	-	**1,204**
Serving Communities					
Intragovernmental Costs	-	5,529	-	-	**5,529**
Public Costs	-	22,738	-	-	**22,738**
Total Costs	-	28,267	-	-	**28,267**
Total Public Earned Revenue	-	10,827	-	-	**10,827**
Net Cost	-	17,440	-	-	**17,440**
Reimbursable Activity and Other					
Intragovernmental Costs	-	-	3,400	(134)	**3,266**
Public Costs	-	-	11,329	-	**11,329**
Total Costs	-	-	14,729	(134)	**14,595**
Intragovernmental Earned Revenue	-	-	14,423	(134)	**14,289**
Public Earned Revenue	-	-	1,446	-	**1,446**
Total Earned Revenue	-	-	15,869	(134)	**15,735**
Net Cost	-	-	(1,140)	-	**(1,140)**
Total					
Intragovernmental Costs	55,210	23,587	3,400	(134)	**82,063**
Public Costs	177,989	2,053,236	11,329	-	**2,242,554**
Total Costs	233,199	2,076,823	14,729	(134)	**2,324,617**
Intragovernmental Earned Revenue	-	-	14,423	(134)	**14,289**
Public Earned Revenue	80,515	90,692	1,446	-	**172,653**
Total Earned Revenue	80,515	90,692	15,869	(134)	**186,942**
Net Cost of Operations	$ 152,684	$ 1,986,131	$ (1,140)	$ -	**$ 2,137,675**

Note 12. Net Cost by Responsibility Segment (Continued)

Schedule of Net Cost by Program and Responsibility Segment (Restated)
For the year ended September 30, 2005
(dollars in thousands)

	Offshore Minerals Management	Mineral Revenue Management	Other	Elimination of Intra Bureau Activity	**FY 2005**
Resource Use Energy					
Manage and Provide Incentives for Access and Development					
Intragovernmental Costs	$ 13,487	$ -	$ -	$ -	**$ 13,487**
Public Costs	67,079	-	-	-	**67,079**
Total Costs	80,566	-	-	-	**80,566**
Total Public Earned Revenue	30,114	-	-	-	**30,114**
Net Cost	50,452	-	-	-	**50,452**
Enhance Responsible Use Management Practices					
Intragovernmental Costs	20,675	220	-	-	**20,895**
Public Costs	34,673	13,549	-	-	**48,222**
Total Costs	55,348	13,769	-	-	**69,117**
Total Public Earned Revenue	20,111	13,769	-	-	**33,880**
Net Cost	35,237	-	-	-	**35,237**
Effective Lease and Permit Management					
Intragovernmental Costs	9,129	27,243	-	-	**36,372**
Public Costs	43,261	2,294,265	-	-	**2,337,526**
Total Costs	52,390	2,321,508	-	-	**2,373,898**
Total Public Earned Revenue	17,163	41,115	-	-	**58,278**
Net Cost	35,227	2,280,393	-	-	**2,315,620**
Improve Information Base, Resource Management and Technical Assistance					
Intragovernmental Costs	456	-	-	-	**456**
Public Costs	4,255	-	-	-	**4,255**
Total Costs	4,711	-	-	-	**4,711**
Total Public Earned Revenue	2,259	-	-	-	**2,259**
Net Cost	2,452	-	-	-	**2,452**
Total Resource Use Energy					
Intragovernmental Costs	43,747	27,463	-	-	**71,210**
Public Costs	149,268	2,307,814	-	-	**2,457,082**
Total Costs	193,015	2,335,277	-	-	**2,528,292**
Total Public Earned Revenue	69,647	54,884	-	-	**124,531**
Net Cost	123,368	2,280,393	-	-	**2,403,761**
Resource Use Non-Energy					
Intragovernmental Costs	324	-	-	-	**324**
Public Costs	3,548	-	-	-	**3,548**
Total Costs	3,872	-	-	-	**3,872**
Total Public Earned Revenue	2,127	-	-	-	**2,127**
Net Cost	1,745	-	-	-	**1,745**
Serving Communities					
Intragovernmental Costs	-	9,822	-	-	**9,822**
Public Costs	-	21,341	-	-	**21,341**
Total Costs	-	31,163	-	-	**31,163**
Total Public Earned Revenue	-	9,700	-	-	**9,700**
Net Cost	-	21,463	-	-	**21,463**
Reimbursable Activity and Other (Restated)					
Intragovernmental Costs	-	-	5,471	151	**5,622**
Public Costs	-	-	7,649	-	**7,649**
Total Costs	-	-	13,120	151	**13,271**
Intragovernmental Earned Revenue	-	-	13,630	151	**13,781**
Public Earned Revenue	-	-	668	-	**668**
Total Earned Revenue	-	-	14,298	151	**14,449**
Net Cost	-	-	(1,178)	-	**(1,178)**
Total					
Intragovernmental Costs	44,071	37,285	5,471	151	**86,978**
Public Costs	152,816	2,329,155	7,649	-	**2,489,620**
Total Costs	196,887	2,366,440	13,120	151	**2,576,598**
Intragovernmental Earned Revenue	-	-	13,630	151	**13,781**
Public Earned Revenue	71,774	64,584	668	-	**137,026**
Total Earned Revenue	71,774	64,584	14,298	151	**150,807**
Net Cost of Operations	$ 125,113	$ 2,301,856	$ (1,178)	$ -	**$ 2,425,791**

Note 13. Earned Revenue

The Sales of Goods and Services in the table below represent reimbursable revenues from customers recognized for services provided. Other revenues represent MRM federal revenues distributed to MMS for operational purposes.

Fiscal Years 2006 and 2005
(dollars in thousands)

	2006	2005 Restated
Sales of Goods and Services:		
To the Public	$428	$359
To Other Federal Agencies	14,289	13,781
Other Revenues:		
Other Revenues from the Public	1,022	304
As Appropriated by Congress	171,203	136,363
Total Earned Revenue	**$186,942**	**$150,807**

Note 14. MRM Exchange Revenues

The royalty exchange revenues distributed to Federal agencies are reported by the receiving entity on the Statement of Changes in Net Position as an exchange revenue in accordance with the federal accounting standards. In fiscal year 2006 and 2005, MMS received approximately $1,931 million and $2,229 million of revenues, respectively, of permanent indefinite appropriations that MMS subsequently provided to the states.

Note 15. Apportionment Categories of Obligations Incurred

The amounts of direct and reimbursable obligations incurred at MMS presented below, are apportioned under Category B and were subject to annual apportionment by OMB. The obligation amounts agree to the Statement of Budgetary Resources, but do not agree to MMS's FACTSII Report (SF-133) in FY 2006 and FY 2005 by $2 million and $1 million, respectively. This difference is attributable to the fact that MMS reports a portion of 14X5003 on FACTSII (SF-133) for Bureau of Land Management (BLM). BLM reports their portion of 14X5003 on it's Statement of Budgetary Resources.

The following table reflects direct and reimbursable obligations.

Fiscal Years 2006 and 2005
(dollars in thousands)

	2006	2005 Restated
Direct Obligations	$2,299,974	$1,810,450
Reimbursable Obligations	169,076	148,535
Total Obligations Incurred	**$2,469,050**	**$1,958,985**

Note 16. Permanent Indefinite Appropriations

MMS has four permanent, indefinite appropriations that relate to the State and County Programs:

1. The Mineral Leasing Act (MLA), 30 U.S.C. 181 et seq., provides that all States be paid 50 percent of the revenues resulting from the leasing of mineral resources on Federal public domain lands within their borders (except Alaska which receives 90 percent).

2. Under 16 U.S.C. 499, at the end of each fiscal year States receive a Forest Fund payment equal to 25 percent of all revenue obtained during that year as a result of activities occurring in each of the national forests situated in that State. The law requires a State's payment be based on national forest acreage, and where a national forest occurs in several States, an individual State's payment is proportionate to its area within that particular national forest.

3. Flood control payments to states are shared according to the Flood Control Act of 1936 (22U.S.C.701 et seq.) which provides that 75 percent of custodial revenue collected be shared with the state in which it was collected. These funds are to be expended as the state legislature may prescribe for the benefit of the public schools and roads in the county which the revenue was collected or for defraying of the expenses of county government. These types of expenses include public obligations of levee and drainage districts for flood control and draining improvements.

4. The Energy Policy Act of 2005 (P.L. 109-58) amended section twenty of the Geothermal Steam Act of 1970 (30 U.S.C. 1019 et seq.). The amendment provides that for the revenues collected from geothermal leasing, twenty-five percent are to be paid to the County in which the leased lands or geothermal resources are located.

Note 17. Legal Arrangements Affecting Use of Unobligated Balances

MMS's unobligated unavailable balances for FY 2006 and FY 2005 are approximately $2.1 million and $1.5 million, respectively, and consist of expired authority. Unobligated balances, whose period of availability has expired are not available to fund new obligations but is available to pay for adjustments to obligations incurred prior to expiration. For a fixed appropriation account, the balance can be carried forward for five fiscal years after the period of availability ends. At the end of the fifth year, the account is closed and any remaining balance is canceled.

Note 18. Undelivered Orders at the End of the Period

MMS's undelivered order balances at the end of FY 2006 and FY 2005 are approximately $81.4 million and $79.4 million, respectively.

Note 19. Differences Between the Statement of Budgetary Resources and the Budget of the United States Government

The FY 2008 Budget of the United States Government with the FY 2006 'actuals' was not available at the time the annual report was prepared. The document is expected to be available in February 2007 and may be found at the Office of Management and Budget website, www.whitehouse.gov/omb.

The differences between the FY 2005 Statement of Budgetary Resources (SBR) and actual amounts for FY 2005 as reported in the FY 2007 Budget of the United States Government are greatly attributed to the unique reporting requirements for each report. The specific differences exist as presented on the table following a - f explanations:

a. The unobligated balances, start of year line, and offsetting collections line reflect a difference between the SBR and the Budget of the United States Government because the SBR includes the expired appropriations, but the Budget of the United States Government does not.

b. For the resources available from recoveries of prior year obligations, the Budget of the United States Government does not include the Oil Spill Trust fund and annual year appropriations, where as the SBR does include them.

c. A difference resulted on the Total Budgetary Resources and Total Status of Budgetary Resources lines because the President's Budget did not include a "total budgetary resources available for obligation" line for funds 14X5003 – Mineral Leasing, 14X5243 – National Forest Fund, 14X5248 – Leases of Lands Acquired for Flood Control, Navigation, and Allied Purposes, and 14X8370 – Oil Spill Research; however, the MMS Combined Statement of Budgetary Resources includes these funds in the total budgetary resources and total status of budgetary resources. There is not a difference in the individual budgetary resource line items as both the President's Budget and the MMS Combined Statement of Budgetary Resources include the amount for funds 14X5003, 14X5243, 14X5248, and 14X8370

d. Appropriation 14X5003 is a shared appropriation between MMS and Bureau of Land Management. For reporting purposes, MMS reports the BLM annual amount for appropriation 14X5003 on the Budget of the United States Government, but does not report the BLM amount on the MMS SBR. However, it is reported on BLM's SBR. In FY 2005, the BLM amount that was included in the Budget of the US Government was approximately $1 million.

e. Due to the reclassification of Reimbursement and Other Income Earned – Collected to Delivered Orders – Paid in FY 2006 for the transfer out of the Interior Franchise Fund to the National Business Center.

f. Due to rounding, other small differences have resulted between the SBR and the Budget of the United States Government. The SBR is presented in "thousands of dollars", the Budget of the US Government is presented in "millions of dollars".

Note 19. Differences Between the Statement of Budgetary Resources and the Budget of the United States Government (Continued)

(dollars in millions)	Total President's Budget	Total Statement of Budgetary Resources	Difference	Explanation
Budgetary Resources:				
Unobligated balance, Beginning of Fiscal Year	$12	$13	($1)	a
Recoveries of Prior Year Unpaid Obligations	5	6	(1)	b
Budget Authority:				
Appropriations Received	1,810	1,809	1	f
Spending Authority from Offsetting Collections	183	146	37	e
Total Budgetary Resources	370	1,977	(1,607)	c,e
Status of Budgetary Resources:				
Obligations Incurred	1,995	1,959	36	d,e,f
Unobligated Balances – Available/Not Available	15	16	(1)	f
Total Status of Budgetary Resources	370	1,977	(1,607)	c,e
Change In Obligated Balance:				
Obligations Incurred	1,995	1,959	36	d,e,f
Less: Gross Outlays	(1,989)	(1,949)	(40)	d,e,f
Less: Recoveries of Prior Year Unpaid Obligations	(5)	(6)	(1)	b
Change in Uncollected Customer Payments from Federal Sources	0	(2)	(2)	f
Total Unpaid Obligated Balance, Net, End of Fiscal Year	(95)	(96)	(1)	f
Net Outlays:				
Gross Outlays	1,989	1,949	40	d,e,f
Less: Offsetting Collections	(183)	(144)	(39)	a,f

Note 20. Earmarked Funds

MMS adopted the provisions of Statement of Federal Financial Accounting Standard No. 27, *Identifying and Reporting Earmarked Funds,* effective October 1, 2005. In accordance with SFFAS No. 27, MMS reported earmarked non-exchange revenue, transfer in/(out) without reimbursement, and net cost of operations separately on the fiscal year 2006 Statement of Changes in Net Position. Cumulative results of operations attributable to earmarked funds on the Balance Sheet and Statement of Changes in Net Position were also reported separately for fiscal year 2006. In accordance with the federal accounting and reporting standards, MMS did not apply the provisions of SFFAS No. 27 to the fiscal year 2005 statements and note disclosures, thus making the balance sheets, statement of changes in net positions, and the earmarked fund note disclosure not comparable.

The Federal Government does not set aside assets to pay future benefits or other expenditures associated with earmarked funds. The cash receipts collected from the public for an earmarked fund are deposited in the U.S. Treasury, which uses the cash for general Government purposes. Treasury securities are issued to MMS as evidence of its receipts. Treasury securities are an asset to MMS and a liability to the Department of the Treasury. Because the MMS and the Department of the Treasury are both parts of the Government, these assets and liabilities offset each other from the standpoint of the Government as a whole. For this reason, they do not represent an asset or a liability in the U.S. Government-wide financial statements. Treasury securities provide MMS with authority to draw upon the Department of the Treasury to make expenditures. When MMS requires redemption of these securities to make expenditures, the Government finances those expenditures out of accumulated cash balances, by raising taxes or other receipts, by borrowing from the public or repaying less debt, or by curtailing other expenditures. This is the same way that the Government finances all other expenditures.

MMS's earmarked funds include Environmental Improvement and Restoration Fund, Oil Spill Research (OSR), and Payments to States and Counties.

Half of the Alaska Escrow Fund, an inflow to the government, was distributed to MMS to initially fund EIRF. MMS invests the EIRF in Treasury securities, in which Treasury uses the cash for general Government purposes. Since MMS and Treasury are both parts of the government, MMS assets and Treasury liabilities offset each other from the standpoint of the Government as a whole. For this reason, they do not represent an asset or a liability in the U.S. Government-wide financial statements. The purpose of EIRF is to invest money and earn interest, an intra-governmental flow, until there is further Congressional action. Congress has permanently appropriated and MRM transfers twenty percent of the prior fiscal year interest earned by the EIRF to the Department of Commerce each year for their marine research activities. The amounts transferred to the Department of Commerce were approximately $7.8 million and $6.8 million in FY 2006 and FY 2005, respectively. The remaining eighty percent will remain in the fund to earn interest and may be appropriated by Congress to certain other agencies, as provided by law. No assets of the fund are available to the Department of the Interior unless appropriated by Congress.

The funding for OSR is appropriated from the Department of the Treasury managed Oil Spill Liability Trust fund (OSLTF) each year. The OSLTF is funded from oil taxes, interest on fund principal, cost recovery from responsible parties, and penalties, which represent inflows to the government. The OSR appropriation funds oil spill research, oil spill prevention, response planning activities, and regulation of oil spill financial responsibility. MMS is the principal federal agency funding offshore oil spill response research. The Oil Spill Response Research (OSRR) program supports research to improve the capabilities for detecting and responding to an oil spill in the marine environment. MMS is responsible for the planning, preparedness, and response-related activities related to oil and gas exploration, development, and productions seaward of the coastline. The MMS also implements the financial responsibility provisions for Outer Continental Shelf Land Act (OCSLA) and Oil Pollution Act (OPA), which require companies responsible for certain offshore oil and gas facilities, in both Federal and State waters, to demonstrate their ability to pay the costs of facility oil spill discharge removal and damages. The amount transferred to MMS's OSR from the Department of the Treasury's OSLTF was approximately $7 million in FY 2006 and FY 2005, respectively.

MMS collects and accrues for lease sales, rents, royalties and other receipts from Federal Government leases as inflows to the federal government and distributes such proceeds to the states and counties in accordance with legislated allocation formulas. MMS reports these state and county amounts as revenues on the Statement of Changes in Net Position because the revenues are derived from the sale of federally owned mineral rights for which MMS incurred minimal costs in earning the revenue. When distributed to the states and counties, MMS reports the distributions as costs in the Effective Lease and Permit Management program on the FY 2006 and FY 2005 Statements of Net Cost, respectively, because the distributions reduce the net position of the Federal Government as a whole and MMS received budgetary authority to make the distributions. MMS makes payments to states and counties, which represent outflows to the federal government, according to the Mineral Lands Leasing Act of 1920, 30 USC 191 as amended, the Federal Oil and Gas Royalty Management Act of 1982 (PL 97-451, 96 Stat. 2447, 30 USC 1701), and PL 99-272 from the 1986 OCS Lands Act amendments of 1985. The liabilities to states for accrued minerals revenue are shown as unfunded because budgetary resources, which are authorized by the Act as permanent indefinite appropriations, are based on actual collections (appropriated revenues). The accrued unfunded liabilities associated with expenses for the payments to the States are reported on the Consolidated Balance Sheet as “State Liabilities”.

Note 20. Earmarked Funds (Continued)

Earmarked Funds
As of and for the year ended September 30, 2006
(dollars in thousands)

	Environmental Improvement and Restoration Fund	Oil Spill Research Fund	Mineral Leasing and Associated Payments to States and Counties	FY 2006
Assets				
Fund Balance with Treasury	$ -	$5,573	$ -	$5,573
Investments, Net	1,062,796	-	-	1,062,796
Accounts Receivable, Net	-	14	812,588	812,602
Total Assets	**$1,062,796**	**$5,587**	**$812,588**	**$1,880,971**
Liabilities				
Accounts Payable	$ -	$1,040	$ -	$1,040
Other Liabilities	-	78	812,588	812,666
Total Liabilities	**-**	**1,118**	**812,588**	**813,706**
Net Position				
Cumulative Results of Operations	1,062,796	4,469	-	1,067,265
Total Net Position	**1,062,796**	**4,469**	**-**	**1,067,265**
Total Liabilities and Net Position	**$1,062,796**	**$5,587**	**$812,588**	**$1,880,971**
Cost/Revenue				
Gross Costs	-	8,027	1,931,073	1,939,100
Earned Revenue	-	(294)	-	(294)
Net Cost of Operations	**-**	**7,733**	**1,931,073**	**1,938,806**
Net Position				
Net Position, Beginning Balance	1,030,927	5,299	-	1,036,226
Other Budgetary Financing Sources - MRM Exchange Revenue	-	-	1,931,073	1,931,073
Non-Exchange Revenue	31,869	-	-	31,869
Other Financing Sources:				
Transfers In/(Out) without Reimbursement	-	6,903	-	6,903
Net Cost of Operations	-	(7,733)	(1,931,073)	(1,938,806)
Change in Net Position	**31,869**	**(830)**	**-**	**31,039**
Net Position, Ending Balance	**$1,062,796**	**$4,469**	**$ -**	**$1,067,265**

Note 21. Explanation of the Relationship Between Liabilities Not Covered by Budgetary Resources on the Balance Sheet and the Change in Components Requiring or Generating Resources in Future Periods

Increases in unfunded liabilities that are not covered by budgetary resources are reported in the Components of Net Cost of Operations that will not Require or Generate Resources in the Current Period section of the Statement of Financing. In FY 2006, the royalty credit liability had an increase of $44.3 million. FY 2005 increases included unfunded annual leave and related taxes - $668 thousand, unfunded accrued and actuarial FECA - $1.8 million, contingent liabilities - $690 thousand, and liabilities to the states of $597 million. Unfunded liabilities that are not covered by budgetary resources with a decrease are reported in the Resources Used to Finance Items not part of the Net Cost of Operations section of the Statement of Financing. In FY 2006 decreases included, unfunded annual leave and related taxes- ($83) thousand, unfunded and actuarial FECA – ($832) thousand, contingent liabilities – ($690) thousand, and liabilities to the states – ($197) million.

Note 22. Strategic Petroleum Reserve

During FY 2005, MMS transferred to the Department of Energy approximately 25.6 million barrels of oil, drawn from Federal leases within the Gulf of Mexico. The purpose of these transfers was to refill selected Strategic Petroleum Reserve locations in accordance with no-cost transfer arrangements of Royalty-in-Kind crude oil to DOE. The transferred oil was reflected as mineral lease revenue and a distribution of revenue on the Statement of Custodial Activity. The SPR fill initiative was completed in July 2005.

The value of the oil transferred in FY 2005 was approximately $1,195 million. The value of the oil was based on actual volumes reported on pipeline statements applied to commodity prices at on-shore market centers less actual monthly value differences between offshore and onshore market centers that were bid by the successful bidders on the RIK volumes. The volume of oil transferred in September 2005 was estimated based on nominations (projected production) from the suppliers as the actuals were not available. In addition, the value of the September oil was estimated based on August pricing. Subsequent revisions to pipeline statements and final revisions to estimates were made during FY 2006 in a decrease amount of ($18) million.

Note 23. Custodial Distributions to MMS

MRM distributes custodial funds to MMS when amounts are collected from producers. These amounts fund payments to states and counties, RIK transportation and administrative costs, and MMS operations. The amount used to fund operations is legislated by Congress as part of MMS's Annual Appropriation.

Fiscal Years 2006 and 2005
(dollars in thousands)

	2006	2005
Payments to States	$2,123,991	$1,632,632
Payments to Counties	3,912	-
RIK and SPR Costs	44,882	21,751
Revenues to Fund Operations	123,030	107,708
Total Distribution	**$2,295,815**	**$1,762,091**

Note 24. Transfer out of Interior Franchise Fund Operations

Effective October 1, 2005, the Department of the Interior merged the Interior Franchise Fund (IFF) into the National Business Center (NBC), a component of Interior Departmental Offices. This action enabled the Department of the Interior to consolidate acquisition services in support of the delivery of effective and efficient services that are competitive and responsive to customer needs. In accordance with OMB Circular A-136, MMS has restated its FY 2005 financial statements to remove the IFF financial amounts and therefore present the FY 2005 financial statements comparative to the FY 2006 financial statements. The following summarizes the changes to the FY 2005 financial statements as a result of this change in reporting entity. The FY 2005 balances for the Statement of Budgetary Resources and Statement of Financing in the column "As Originally Reported Year Ended 2005", have been reclassified to conform with the FY 2006 presentation. The following schedules only include the Financial Statement line items that have been restated, therefore the totals do not represent the sum of lines above the total.

Description *(dollars in thousands)*	**As Originally Reported Year Ended 2005**	**Transfer Out of Interior Franchise Fund**	**Adjustment of Intra-Bureau Eliminations**	**As Restated Year Ended 2005**
Balance Sheet – restated line items only				
ASSETS				
Intragovernmental Assets:				
Fund Balance with Treasury	$1,444,637	($1,332,912)	$ -	$111,725
Account and Interest Receivable	404,789	(3,961)	711	401,539
Advances and Prepayments	194	(153)	66	107
Total Intragovernmental Assets	2,937,866	(1,337,026)	777	1,601,617
Accounts and Interest Receivable, Net	2,426,301	(249)	-	2,426,052
Total Assets	5,392,712	(1,337,275)	777	4,056,214
LIABILITIES				
Intragovernmental Liabilities				
Accounts Payable	3,464	(1,348)	711	2,827
Advances and Deferred Revenue	1,079,418	(1,078,948)	66	536
Accrued Employee Benefits	3,781	(22)	-	3,759
Total Intragovernmental Liabilities	2,885,680	(1,080,318)	777	1,806,139
Accounts Payable	249,353	(227,842)	-	21,511
Advances, Deferred Revenue, and Deposit Funds	52,504	(2)	-	52,502
Accrued Payroll and Benefits	17,966	(471)	-	17,495
Total Liabilities	4,798,738	(1,308,633)	777	3,490,882
Net Position				
Administrative Cumulative Results of Operations	(445,525)	(28,642)	-	(474,167)
Total Cumulative Results of Operations	585,401	(28,642)	-	556,759
Total Net Position	593,974	(28,642)	-	565,332
Total Liabilities and Net Position	5,392,712	(1,337,275)	777	4,056,214

Note 24. Transfer out of Interior Franchise Fund Operations (Continued)

Description *(dollars in thousands)*	As Originally Reported Year Ended 2005	Transfer Out of Interior Franchise Fund	Adjustment of Intra-Bureau Eliminations	As Restated Year Ended 2005
Statement of Net Cost – restated line items only				
Total Reimbursable Activity and Other				
Costs	1,520,404	(1,543,709)	36,576	13,271
Less: Earned Revenue	1,532,965	(1,555,092)	36,576	14,449
Net Cost	(12,561)	11,383	-	(1,178)
Total				
Costs	4,083,731	(1,543,709)	36,576	2,576,598
Less: Earned Revenue	1,669,323	(1,555,092)	36,576	150,807
Net Cost of Operations	2,414,408	11,383	-	2,425,791
Statement of Changes in Net Position – restated line items only				
Cumulative Results of Operations				
Beginning Balance	562,153	(27,269)	-	534,884
Budgetary Financing Sources				
Transfers In/(Out) without Reimbursement	(3,994)	11,000	-	7,006
Other Financing Sources				
Imputed Financing from Costs Absorbed by Others	15,117	(989)	-	14,128
Total Financing Sources	2,437,656	10,010	-	2,447,666
Net Cost of Operations	(2,414,408)	(11,383)	-	(2,425,791)
Net Change	23,248	(1,373)	-	21,875
Ending Balance – Cumulative Results of Operations	$585,401	($28,642)	$-	$556,759
Statement of Budgetary Resources – restated line items only				
Budgetary Resources:				
Unobligated Balance, beginning of Fiscal Year	$748,532	($734,960)	$-	$13,572
Budget Authority:				
Spending authority from offsetting collections				
Earned				
Collected	1,715,892	(1,565,626)	-	150,266
Change in receivables from Federal Sources	(1,474)	1,338	-	(136)
Change in unfilled customer orders				
Advance received	(64,641)	58,036	-	(6,605)
Without advance from Federal sources	(10,365)	12,933	-	2,568
Total Budgetary Resources	4,203,827	(2,228,279)	-	1,975,548

Note 24. Transfer out of Interior Franchise Fund Operations (Continued)

Description *(dollars in thousands)*	As Originally Reported Year Ended 2005	Transfer Out of Interior Franchise Fund	Adjustment of Intra-Bureau Eliminations	As Restated Year Ended 2005
Status of Budgetary Resources:				
Obligations Incurred:				
Reimbursable	1,588,204	(1,439,670)	-	148,535
Total Obligations incurred	3,398,654	(1,439,670)	-	1,958,985
Unobligated balance available:				
Apportioned	803,715	(788,610)	-	15,105
Total Status of Budgetary Resources	4,203,827	(2,228,279)	-	1,975,548
Change in Obligated Balance:				
Obligated balance, net				
Unpaid obligations, brought forward, beginning of Fiscal Year	938,552	(832,475)	-	106,077
Less: Uncollected customer payments from Federal Sources, brought forward, beginning of Fiscal Year	(185,548)	173,212	-	(12,336)
Total unpaid obligated balance, net, beginning of Fiscal Year	753,004	(659,263)	-	93,741
Obligations incurred, net	3,398,654	(1,439,670)	-	1,958,985
Less: Gross Outlays	(3,517,840)	1,568,901	-	(1,948,939)
Change in uncollected customer payments from Federal Sources	11,838	(14,270)	-	(2,432)
Total, unpaid obligated balance, net, end of period	639,462	(544,302)	-	95,160
Obligated balance, net, end of period – by component:				
Unpaid obligations	813,171	(703,244)	-	109,927
Less: Uncollected customer payments from Federal Sources	(173,710)	158,943	-	(14,767)
Total, unpaid obligated balance, net, end of period	639,462	(544,302)	-	95,160
Net Outlays:				
Net Outlays				
Gross outlays	3,517,840	(1,568,901)	-	1,948,939
Less: Offsetting collections	(1,651,249)	1,507,588	-	(143,661)
Net Outlays (Receipts)	(203,526)	(61,313)	-	(264,839)

Note 24. Transfer out of Interior Franchise Fund Operations(Continued)

Description *(dollars in thousands)*	As Originally Reported Year Ended 2005	Transfer Out of Interior Franchise Fund	Adjustment of Intra-Bureau Eliminations	As Restated Year Ended 2005
Statement of Financing – restated line items only				
Resources Used to Finance Activities:				
Budgetary Resources Obligated:				
Obligations Incurred	$3,398,654	($1,439,669)	-	1,958,985
Less: Spending Authority from Offsetting Collections/Recoveries	(1,645,607)	1,493,319	-	(152,288)
Obligations Net of Offsetting Collections and Adjustments	1,753,047	53,650	-	1,806,697
Net Obligations	(317,070)	53,650	-	(263,420)
Other Resources:				
Imputed Financing from Costs Absorbed by Others	15,117	(989)	-	14,128
Net Other Resources Used to Finance Activities	14,279	(989)	-	13,290
Total Resources Used to Finance Activities	(302,791)	52,661	-	(250,130)
Resources Used to Finance Items Not Part of the Net Cost of Operations				
Change in Budgetary Resources Obligated for Goods, Services, and Benefits Ordered but Not Yet Provided	130,103	(123,205)	-	6,898
Change in Unfilled Customer Orders	(75,006)	70,968	-	(4,038)
Resources that Fund Expenses Recognized in Prior Periods	32	(41)	-	(9)
Other Resources or Adjustments to Net Obligated Resources that do not affect Net Cost of Operations	(10,471)	11,000	-	529
Total Resources used to Finance Items not Part of Net Cost of Operations	2,112,556	(41,277)	-	2,071,279
Total Resources Used to Finance the Net Cost of Operations	1,809,766	11,383	-	1,821,149
Components of Net Cost of Operations that will not Require or Generate Resources in the Current Period:				
Net Cost of Operations	2,414,408	11,383	-	2,425,791

Required Supplementary Information
(Unaudited, see accompanying auditors' report)

U.S. Department of the Interior
Minerals Management Service
Combining Statement of Budgetary Resources
For the year ended September 30, 2006
(dollars in thousands)

	Royalty and Offshore Mineral Management	Mineral Leasing	Oil Spill Research	Other	Total Budgetary Accounts
Budgetay Resources:					
Unobligated balance, beginning of Fiscal Year:	$ 16,220	$ -	$ 343	$ -	$ 16,563
Recoveries of prior year unpaid obligations	6,744	-	205	-	6,949
Budget Authority:					
Appropriation	184,652	2,110,432	7,006	17,471	2,319,561
Spending authority from offsetting collections					
Earned					
Collected	186,607	-	443	-	187,050
Change in receivables from Federal sources	(845)	-	(148)	-	(993)
Change in unfilled customer orders					
Advance received	(1,294)	-	(8)	-	(1,302)
Without advance from Federal sources	(12,056)	-	22	-	(12,034)
Total Budgetary Authority	357,064	2,110,432	7,315	17,471	2,492,282
Nonexpenditure transfers, net, anticipated and actual	(3,344)	-	-	-	(3,344)
Temporarily not available pursuant to Public Law	-	-	(102)	-	(102)
Permanently not available	(2,590)	-	-	-	(2,590)
Total Budgetary Resources	$ 374,094	$ 2,110,432	$ 7,761	$ 17,471	$ 2,509,758
Status of Budgetary Resources:					
Obligations incurred:					
Direct	$ 164,882	$ 2,110,432	$ 7,189	$ 17,471	$ 2,299,974
Reimbursable	168,776	-	300	-	169,076
Total Obligations incurred	333,658	2,110,432	7,489	17,471	2,469,050
Unobligated balance available:					
Apportioned	38,335	-	272	-	38,607
Unobligated balance not available	2,101	-	-	-	2,101
Total Status of Budgetary Resources	$ 374,094	$ 2,110,432	$ 7,761	$ 17,471	$ 2,509,758
Change in Obligated Balance:					
Obligated balance, net					
Unpaid obligations, brought forward, beginning of Fiscal Year	$ 103,195	$ -	$ 6,732	$ -	$ 109,927
Less: Uncollected customer payments from Federal sources, brought forward, beginning of Fiscal Year	(14,564)	-	(203)	-	(14,767)
Total unpaid obligated balance, net, beginning of Fiscal Year	88,631	-	6,529	-	95,160
Obligations incurred, net	333,658	2,110,432	7,489	17,471	2,469,050
Less: Gross outlays	(325,954)	(2,110,432)	(8,636)	(17,471)	(2,462,493)
Less: Recoveries of prior year unpaid obligations, actual	(6,744)	-	(205)	-	(6,949)
Change in uncollected customer payments from Federal sources	12,901	-	126	-	13,027
Total, unpaid obligated balance, net, end of period	$ 102,492	$ -	$ 5,303	$ -	$ 107,795
Obligated balance, net, end of period - by component:					
Unpaid obligations	$ 104,154	$ -	$ 5,380	$ -	$ 109,534
Less: Uncollected customer payments from Federal sources	(1,662)	-	(77)	-	(1,739)
Total, unpaid obligated balance, net, end of period	$ 102,492	$ -	$ 5,303	$ -	$ 107,795
Net Outlays:					
Net Outlays					
Gross outlays	$ 325,954	$ 2,110,432	$ 8,636	$ 17,471	$ 2,462,493
Less: Offsetting collections	(185,314)	-	(435)	-	(185,749)
Less: Distributed Offsetting receipts	-	(2,110,432)	-	(529,646)	(2,640,078)
Net Outlays (Receipts)	$ 140,640	$ -	$ 8,201	$ (512,175)	$ (363,334)

U.S. Department of the Interior
Minerals Management Service
Combining Statement of Budgetary Resources
For the year ended September 30, 2005
(dollars in thousands)

	Royalty and Offshore Mineral Management	Mineral Leasing	Oil Spill Research	Other	Total Budgetary Accounts
					Restated - Note 24
Budgetay Resources:					
Unobligated balance, beginning of Fiscal Year:	$ 13,433	$ -	$ 139	$ -	$ 13,572
Recoveries of prior year unpaid obligations	5,923	-	272	-	6,195
Budget Authority:					
Appropriation	169,175	1,620,107	7,103	12,525	1,808,910
Spending authority from offsetting collections					
Earned					
Collected	149,910	-	356	-	150,266
Change in receivables from Federal sources	(274)	-	138	-	(136)
Change in unfilled customer orders					
Advance received	(6,492)	-	(113)	-	(6,605)
Without advance from Federal sources	2,607	-	(39)	-	2,568
Total Budgetary Authority	314,926	1,620,107	7,445	12,525	1,955,003
Nonexpenditure transfers, net, anticipated and actual	3,344	-	-	-	3,344
Temporarily not available pursuant to Public Law	-	-	(99)	-	(99)
Permanently not available	(2,467)	-	-	-	(2,467)
Total Budgetary Resources	$ 335,159	$ 1,620,107	$ 7,757	$ 12,525	$ 1,975,548
Status of Budgetary Resources:					
Obligations incurred:					
Direct	$ 170,748	$ 1,620,107	$ 7,070	$ 12,525	$ 1,810,450
Reimbursable	148,191	-	344	-	148,535
Total Obligations incurred	318,939	1,620,107	7,414	12,525	1,958,985
Unobligated balance available:					
Apportioned	14,762	-	343	-	15,105
Unobligated balance not available	1,458	-	-	-	1,458
Total Status of Budgetary Resources	$ 335,159	$ 1,620,107	$ 7,757	$ 12,525	$ 1,975,548
Change in Obligated Balance:					
Obligated balance, net					
Unpaid obligations, brought forward, beginning of Fiscal Year	$ 99,244	$ -	$ 6,833	$ -	$ 106,077
Less: Uncollected customer payments from Federal sources, brought forward, beginning of Fiscal Year	(12,231)	-	(105)	-	(12,336)
Total unpaid obligated balance, net, beginning of Fiscal Year	87,013	-	6,728	-	93,741
Obligations incurred, net	318,939	1,620,107	7,414	12,525	1,958,985
Less: Gross outlays	(309,064)	(1,620,107)	(7,243)	(12,525)	(1,948,939)
Less: Recoveries of prior year unpaid obligations, actual	(5,923)	-	(272)	-	(6,195)
Change in uncollected customer payments from Federal sources	(2,333)	-	(99)	-	(2,432)
Total, unpaid obligated balance, net, end of period	$ 88,632	$ -	$ 6,528	$ -	$ 95,160
Obligated balance, net, end of period - by component:					
Unpaid obligations	$ 103,195	$ -	$ 6,732	$ -	$ 109,927
Less: Uncollected customer payments from Federal sources	(14,563)	-	(204)	-	(14,767)
Total, unpaid obligated balance, net, end of period	$ 88,632	$ -	$ 6,528	$ -	$ 95,160
Net Outlays:					
Net Outlays					
Gross outlays	$ 309,064	$ 1,620,107	$ 7,243	$ 12,525	$ 1,948,939
Less: Offsetting collections	(143,418)	-	(243)	-	(143,661)
Less: Distributed Offsetting receipts	-	(1,620,107)	-	(450,010)	(2,070,117)
Net Outlays (Receipts)	$ 165,646	$ -	$ 7,000	$ (437,485)	$ (264,839)

Museum Collections:

The Mineral Management Service maintains a cultural museum collection that consists of Art, Ethnography, History, Documents, and Geology items. There were no accessions or deaccessions during the year. The assets within the collection are fully documented and are in good condition, as they are properly preserved and presentable to the public. The standards achieved by facilities that house collections are good indicators of the status of collections for which item-level condition data are not available. Facilities that meet at least 70% of the Department's standards for managing museum collections (411 DM 3) are judged to be in "good" condition.

FY 2006 Collectible Heritage Assets – Location Housing Assets							
MMS Museum Collections	Beginning Balance	Increases	Decreases	Ending Balance	Condition of Facility Housing Collection		
					Good	Fair	Poor
Held at MMS Facilities	1	-	-	1	100%		

Required Supplementary Stewardship Information

(Unaudited, see accompanying auditors' report)

Investment in Research and Development:

The MMS manages the mineral resources on 1.76 billion acres of the Outer Continental Shelf (OCS) to ensure that exploration, development, and production activities are conducted in a manner that conserves natural resources, provides for the safety of offshore workers, provides a fair return to the public for the mineral rights conveyed, and assures protection of the environment. Numerous laws, particularly the National Environmental Policy Act (NEPA), provide the basis for environmental assessment and study of impacts associated with OCS related activities. The OCS Lands Act (OCSLA) mandates the conduct of environmental studies needed for the assessment and management of potential environmental impacts on the human, marine, and coastal environments affected by oil, natural gas, or other mineral development. The Oil Pollution Act (OPA) of 1990 sets down specific areas of research to improve not only the technologies for preventing oil pollution, but also the response to accidental spills. Inherent in this effort is improvement of our understanding of the fate, transport, and effects of oil when spilled. MMS research supports the prediction of potential environmental impacts and aids in the development of mitigating measures to ensure safe, pollution-free operations. The Environmental Studies Program (ESP) provides environmental and socioeconomic information to support decision-making for all phases of the OCS minerals management program. The Technology Assessment and Research (TA&R) program pursues engineering studies focusing on operational safety, pollution prevention, and effective spill response.

Significant Outcomes/Accomplishments in the MMS studies programs include:

Field observations, data analysis and modeling of deepwater ocean currents on the Gulf of Mexico continental slope provide information which improves MMS's estimates of oil-spill transport, fate, and impacts to the environment. Observations and surveys of deepwater currents have been conducted in recent years using current meters, drifting buoys, satellite images, and shipboard surveys. Research efforts have improved our understanding of the depth of penetration of the Gulf of Mexico Loop Current which can have speeds up to four knots, the equivalent of a 60 mph gale-force wind, at depths down to 500 meters. Intense cold water jet currents, moving at speeds of up to 1.5 knots, have been detected at depths below 2,000 meters. Results are used by MMS for oil spill trajectory analyses, discharge models, and studies of larval dispersal. Findings directly support MMS management decisions and are useful in the review of development and production plans and oil spill contingency plans. As an outcome of the physical oceanography research, MMS established an information requirement for offshore drilling and production sites to collect and archive the surface and deepwater current observations made by the oil and gas industry. The information is shared among the operators in the Gulf of Mexico to enhance safe operations and improve the design of OCS structures to withstand the strong currents and current forces on offshore operations. In addition, as a pilot program under the U.S. Integrated Ocean Observing System, the data from nineteen companies are being transferred to the NOAA National Oceanographic Data Center and are publicly available on the internet.

In another example of adaptive management practices, MMS utilized a three-phased approach to understand the fates and effects of deepwater drilling and discharges. Because of the great water depths, effects may be much different from those found on the comparatively well studied continental shelf. In addition, new technological approaches to deepwater drilling and production, such as the greatly increased reliance on synthetic-based drilling fluids (SBF's), may result in volumes and characteristics of discharged material quite different from those used for decades in shallower water. The three-phased approach involved modeling the fate of chemical discharges, establishing reliable indicators of impacts, and undertaking field studies. To meet the information needs, field studies were undertaken to characterize the geological, physical, chemical, and biological characteristics and the physical and chemical impacts to each of the ecosystem components at exploration and post-development continental slope sites in the Central and Western Gulf of Mexico OCS. The study design addressed basic questions in the form of null hypotheses and utilized a closely integrated series of multi-disciplinary assessments for the impacts of oil and gas activities on deepwater ecosystems. The assessment used a statistically valid sampling design and incorporated numerous reference sites for comparison. Environmental indicators of contaminant stress were also examined to assess changes in the benthic environment. This study provided the information necessary for managing oil and gas development in the deepwaters of the Gulf of Mexico well beyond the continental shelf break. As an outcome, MMS was able to review existing mitigative measures and develop refinements for future deepwater exploration and development which continue to protect the deep ocean ecosystem.

OHMSETT – Oil and Hazardous Materials Simulated Environmental Test Tank:

As part of its mandate to ensure that the best and safest technologies are used in offshore oil and gas operations, MMS operates a 2.6-million gallon test tank for two essential functions related to oil spill response planning: responder training and full-scale equipment and chemical testing. Providing training at OHMSETT ensures responders can be trained under realistic conditions with releasing oil into the sea. Most of the quantitative performance data on mechanical equipment used by industry, the U.S. Coast Guard, and the U.S. Navy to contain and cleanup spilled oil was obtained through OHMSETT testing and evaluation. To increase testing value, MMS is upgrading the OHMSETT facility to provide greater reproducibility for testing and training. Additionally, OHMSETT is able to simulate realistic broken ice conditions. Recent activities include cold water dispersant effectiveness tests with Alaska crude oils, evaluations of oil booms, oil herding surfactants and ocean imaging sensors, basic research on the weathering of oil in ice and snow conditions, and annual Texas A&M University and Coast Guard oil spill response training.

MMS research activities are pursued in partnership with universities; private sector companies and associations; and Federal, State, and Foreign Government agencies – pursuing common goals in safety, environmental protection, and natural resource conservation.

Investment in Research and Development
(in millions)

Category	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	Total
Applied Research	$ 28.5	$ 29.4	$ 29.3	$ 30.2	$ 28.6	$ 146.0

Appendix A

List of MMS Acronyms

ANPR- Advanced Notice of Proposed Rulemaking
Bcf- billion cubic feet [of gas]
BIA- Bureau of Indian Affairs
BLM- Bureau of Land Management
CIAP- Coastal Impact Assistance Program
CO_2- carbon dioxide
CY- calendar year
Data V&V- Data Verification and Validation
DOI- Department of the Interior
EIS- Environmental Impact Statement
EPAct- Energy Policy Act of 2005
FR- *Federal Register*
FFMIA- Federal Financial Management Improvement Act
FMFIA- Federal Managers' Financial Integrity Act
FY- fiscal year
GOM- Gulf of Mexico
GOMR- Gulf of Mexico Regional Office
GPRA- Government Performance and Results Act
LNG- liquefied natural gas
MD&A- Management Discussion and Analysis
MMS- Minerals Management Service
MRM- Minerals Revenue Management
OCS- Outer Continental Shelf
OCSLA- Outer Continental Shelf Lands Act
OMM- Offshore Minerals Management
OST- Office of Special Trustee for American Indians
PAR- Performance and Accountability Report
RIK- Royalty-in-Kind
RIV- Royalty-in-Value
SOO- Suspensions of Operations
SPR- Strategic Petroleum Reserve
USCG- U.S. Coast Guard

The Department of the Interior Mission

As the Nation's principal conservation agency, the Department of the Interior has responsibility for most of our nationally owned public lands and natural resources. This includes fostering sound use of our land and water resources; protecting our fish, wildlife, and biological diversity; preserving the environmental and cultural values of our national parks and historical places; and providing for the enjoyment of life through outdoor recreation. The Department assesses our energy and mineral resources and works to ensure that their development is in the best interests of all our people by encouraging stewardship and citizen participation in their care. The Department also has a major responsibility for American Indian reservation communities and for people who live in island territories under U.S. administration.

The Minerals Management Service Mission

As a bureau of the Department of the Interior, the Minerals Management Service's (MMS) primary responsibilities are to manage the mineral resources located on the Nation's Outer Continental Shelf (OCS), collect revenue from the Federal OCS and onshore Federal and Indian lands, and distribute those revenues.

Moreover, in working to meet its responsibilities, the **Offshore Minerals Management Program** administers the OCS competitive leasing program and oversees the safe and environmentally sound exploration and production of our Nation's offshore natural gas, oil and other mineral resources. The MMS **Minerals Revenue Management** meets its responsibilities by ensuring the efficient, timely and accurate collection and disbursement of revenue from mineral leasing and production due to Indian tribes and allottees, States and the U.S. Treasury.

The MMS strives to fulfill its responsibilities through the general guiding principles of: (1) being responsive to the public's concerns and interests by maintaining a dialogue with all potentially affected parties and (2) carrying out its programs with an emphasis on working to enhance the quality of life for all Americans by lending MMS assistance and expertise to economic development and environmental protection.