

**STATEMENT OF
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UNITED STATES DEPARTMENT OF THE INTERIOR
BEFORE THE
COMMITTEE ON APPROPRIATIONS
SUBCOMMITTEE ON INTERIOR AND RELATED AGENCIES
UNITED STATES SENATE
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Chairman Feinstein, thank you for the opportunity to appear here today to discuss with you the Department of the Interior's role in managing energy production on the Outer Continental Shelf and revenue from all Federal and Indian mineral leases. This Committee has been instrumental in shaping our domestic energy program, particularly with regard to encouraging environmentally sound development of our domestic oil and gas resources on the Outer Continental Shelf.

The Department and its agencies, including the Minerals Management Service (MMS), serve the public through careful stewardship of our nation's natural resources. The Department also plays an important role in domestic energy development. One third of all energy produced in the United States comes from resources managed by the Interior Department.

As energy demand continues to increase, these resources are all the more important to our national security and to our economy. The Energy Information Administration estimates that, despite increased efficiencies and conservation, over the next 20 years energy consumption is expected to grow more than 25 percent. Even with more renewable energy production expected, oil and natural gas will continue to account for a majority of energy use through 2030. Interior's domestic energy programs, particularly offshore oil and gas production, will remain vital to our national energy portfolio for some time to come, as evidenced in Figure A attached at the end of my statement.

Since assuming the duties of Assistant Secretary of Land and Minerals Management four months ago, I have developed a deeper appreciation for the complexities involved in managing Federal energy production. I also am committed to ensuring we provide an accurate and transparent accounting of the revenue this production generates for the American people.

At the direction of Secretary Kempthorne, two important topics have been my major focus over the past four months – the deep water leases issued without price thresholds for royalty relief in 1998 and 1999, and the management of royalty revenues.

I would like to begin by providing some background on MMS's role in Federal energy production and revenue collection. I then will discuss in greater detail the two primary issues I am focusing on with MMS.

MMS Background

The MMS has two significant missions: managing access to offshore Federal energy resources and managing revenues generated by Federal and Indian mineral leases, on and offshore. Both of these functions are important to the nation's economic health and are key to meeting the nation's energy needs.

The Federal Outer Continental Shelf (OCS) covers 1.76 billion acres and is a major source of crude oil and natural gas for the domestic market. In fact, according to the Energy Information Administration, if the Federal OCS were treated as a separate country, it would rank among the top five nations in the world in terms of the amount of crude oil and second in natural gas it supplies for annual U.S. consumption.¹

Since 1982, MMS has overseen OCS production of almost 11 billion barrels of oil and 116 trillion cubic feet of natural gas.

According to MMS's calculations, within the next 5 years, offshore production will likely account for more than 40 percent of oil and 20 percent of U.S. natural gas production, primarily due to deep water discoveries in the Gulf of Mexico.

Attached Figure B shows the Energy Information Administration's 2007 forecast for total domestic oil and gas production and illustrates the significance of the OCS contribution to the Nation's energy security.

To support increased production offshore, MMS's Proposed 5-Year OCS Oil and Gas Leasing Program for 2007-2012 calls for a total of 21 lease sales.

Last month, the President modified a Presidential withdrawal in order to allow leasing in two areas previously closed - the North Aleutian Basin in Alaska and an area in the central Gulf of Mexico. The President modified the leasing status of these two areas in response to congressional action and the request of Alaska State leaders. The President's action allows the Secretary of the Interior the option of offering these areas during MMS's next five-year OCS oil and gas leasing program. In addition, this Administration has increased the royalty rate from 12.5 percent to 16.7 percent for any new deep water leases offered in the Gulf of Mexico.

In implementing the mandates of the Gulf of Mexico Energy Security Act, MMS will offer deep-water acreage in the "181 South" area and in a portion of the Sale 181 area remaining in the Eastern Gulf of Mexico.

Our analysis indicates that implementing the new 5-Year OCS Oil and Gas Leasing Program would result in a mean estimate of an additional 10 billion barrels of oil, 45 trillion cubic feet of gas, and \$170 billion in net benefits for the nation over a 40-year time span.

¹ EIA U.S. Imports by Country of Origin, 12-21-2006.

In addition to providing and managing access to the OCS, MMS administers and enforces the financial terms for all Federal mineral leases, both onshore and offshore and on Indian lands.

These activities have generated an average of more than \$9 billion in revenue per year over the past five years, representing one of the largest sources of non-tax revenue to the Federal Government. (In FY 2006, \$12.6 billion was collected and \$12.8 billion was disbursed, 60 percent of that was from offshore activities).

Since 1982, the MMS has distributed approximately \$164.9 billion to Federal, State, and Indian accounts and special funds, including approximately:

- \$101.1 billion to the General Fund of the U.S. Treasury;
- \$20.4 billion to 38 States;
- \$5.2 billion to the Department's Office of Trust Funds Management on behalf of 41 Indian tribes and 30,000 individual Indian mineral owners; and
- \$38.2 billion to the Land and Water Conservation Fund, the National Historic Preservation Fund, and the Reclamation Fund.

MMS carries out these responsibilities under statutory mandates and ongoing oversight by Congress, the Government Accountability Office (GAO) and the Department's Office of Inspector General.

I am happy to point out that for the past five years, as part of its annual CFO audit, MMS consistently has received clean audit opinions from the Office of the Inspector General and its delegated independent auditing firm.

1998-1999 OCS Leases without Price Thresholds for Royalty Relief

Last month, the Department's Office of Inspector General presented its findings on the 1998 -1999 deep water leases issued without price thresholds. The MMS requested this independent review last year. We appreciate the Inspector General's work and look forward to further reviewing the report.

The Department of the Interior shares Congress's frustration that during the previous Administration price thresholds were not included in the 1998 – 1999 deep water leases. This Administration has included price thresholds in **all** deep water leases it has issued with royalty relief. The American people own these resources and are entitled to receive a fair return.

The Deep Water Royalty Relief Act of 1995 required deep water leases issued from 1996 - 2000 to include a royalty incentive that allowed companies to produce a set volume of oil and gas before they began paying royalties. Since enactment, the deep waters of the Gulf of Mexico have become one of the Nation's most important sources of oil and natural gas. Price thresholds limit royalty relief when oil and gas prices are high. Price thresholds were included in leases before 1998 and after 1999. They were not included in the 1998 – 1999 leases.

This matter has been a focus of mine since I assumed this position last fall. In an attempt to address the missing price thresholds, we are now negotiating with companies to obtain agreements to apply price thresholds to the deep water leases issued in 1998 - 1999. We are focusing our negotiations on obtaining the much larger royalty amounts to be realized from future production, estimated to exceed \$9 billion.

To date our progress has included agreements reached in December 2006 with six companies. This is a significant but first step; there is still much more work to do in reaching agreements with additional companies.

I have adopted three basic principles to guide my actions in seeking to resolve this matter. First, our focus will be to negotiate price thresholds in leases prospectively; second, we will not give economic advantage to one company over another; and finally, we will strive to amend these agreements in a way that will minimize litigation risk.

To achieve these principles, the Administration and the Congress must work together. We cannot do this alone.

We know that Congress will consider addressing this issue legislatively. We appreciate Congress's efforts to encourage companies to come to the negotiating table. However, we must be mindful of potential unintended consequences. For example, potential new legislation could conceivably result in litigation. If legislation addressed future lease sales, and if a judge were to enjoin future lease issuance for a period of time, the resulting impacts would be significant. Litigation could take years to resolve. The MMS has attempted to project what the potential loss of production, revenue and royalties if lease sales were delayed for a three-year period could look like.

Attached Figure C shows for example, for a 3-year delay, production over 10 years would be reduced 1.6 billion barrels of oil equivalent (boe).

Attached Figure D shows for example, the expected cumulative revenue decline over a 10 year period of \$13 billion for a 3-year delay.

We all can agree this would not be in the Nation's best interest. The OCS is a significant supplier of oil and gas. We cannot afford major delays in offshore energy production due to unintended consequences.

We look forward to working with Congress on resolving this issue of national interest.

Management of Royalty Revenue

My second focus is the management of royalty revenue collected from Federal and Indian mineral leases. In FY 2006, about 2,600 companies reported and paid royalties totaling \$12.6 billion from approximately 27,800 producing Federal and Indian leases.

MMS's mineral revenue processes and procedures are complex and involve implementing myriad statutory authorities and regulations, as well as a complex set of case law from over 50 years of administrative and judicial decisions on Federal royalty matters.

The process begins when companies calculate their payments for royalties owed the Federal government. Royalties are calculated based upon four components: the volume of oil and gas produced from the lease, which is verified by BLM or MMS officials during regular on-site inspections; the royalty rate, which is specified in the lease document; the value of the oil and gas as determined by regulations; and any deductions for the costs of transporting and/or processing the oil and gas production, which are also determined by regulations. Companies are required to report this information and submit their royalty payments to MMS on a monthly basis.

MMS receives reports and payments from payors and accepts them into the accounting system, similar to filings with the Internal Revenue Service. Fundamental accounting processes identify revenue sources, and funds are distributed to recipients as prescribed by law. Interest is assessed on late and/or under payments.

MMS's audit and compliance program assesses whether royalty payments are correct. The types of questions that arise during compliance activities include whether the company reported and paid its royalty on the right volume, royalty rate, and value and whether the company correctly calculated allowable transportation and processing costs. Findings of underpayments are followed by collection of the payment plus interest. Enforcement proceedings range from alternative dispute resolution to orders to pay and penalty actions.

The current compliance strategy uses a combination of targeted and random audits, compliance reviews, and royalty-in-kind property reconciliations. The strategy calls for completion of the compliance cycle within 3 years of the royalty due date. In fiscal year 2006, this strategy resulted in compliance activities on \$5.8 billion in Federal and Indian mineral lease revenues, which represents 72.5 percent of total mineral revenues paid for calendar year 2003. As a result of the December 6, 2006 Office of the Inspector General report, MMS will be developing a new risk strategy and performance targets that reflect the number of companies and/or leases covered, not total royalties. In addition, as RIK gas volumes expand, MMS expects offshore compliance workloads to decrease, freeing up resources to be redirected toward highest risk, but smaller-dollar onshore Federal properties.

In recent years, MMS has completed an increased number of audits, doubling the number of audits in the most recent four-year period over the previous four years. From 1998 –

2001, MMS, State, and Tribal auditors completed 784 audits compared to the 1,572 audits completed from 2002-2005. This increase is partially the result of the effort in 2005 on the part of MMS to close a significant number of old audits as a result of a recommendation from an external peer review of our audit activities. Collections based on audit work fluctuate from year to year. The apparent reductions in collections resulting from compliance efforts from 2001 through 2004 stand in contrast with very large collections in the 1998-2001 period. This anomaly is due to resolution during the 1998-2001 period of numerous lawsuits on undervaluation of crude oil and natural gas in previous years. The result of the resolution of these issues was large payments of additional royalties. Because these issues were resolved, no additional large payments were owed in 2002-2005.

The MMS compliance and enforcement program has generated an annual average of more than \$125 million for each of the last 24 years. In other words, MMS has collected a total of more than \$3 billion dollars in additional mineral revenues since program inception in 1982.

From FY 2003 through FY 2005, for every dollar spent on compliance reviews, MMS has collected \$3.27. For every dollar spent on audits, MMS has collected \$2.06.

MMS aggressively pursues interest owed on late payments as required by law. In Fiscal Year 2006, MMS issued over 3,800 late payment interest bills and collected a net amount of \$7 million.

MMS has authority to use civil penalties in situations where routine compliance efforts have been unsuccessful. During the last 5 years MMS has collected over \$23 million in civil penalties resulting from MRM enforcement actions. So far in FY 2007 MMS has issued over \$2 million in civil penalty notices that are now in the administrative process. When combined with other MMS enforcement actions during the same time frame, MMS collected a total of \$52.4 million.

Last year, the MMS while performing reconciliation of volume imbalances, promptly identified that the Kerr McGee Oil and Gas Corporation had under-delivered royalty gas volumes to MMS's Royalty-In-Kind (RIK) program – at a time of very high gas prices. MMS pursued the issue and collected \$8.1 million – based on these high price periods - to resolve the issue.

In December, MMS announced that a bill for over \$32 million had been issued to BP America Production Company for additional royalties and interest due identified through audit work of BP's coalbed methane production that occurred in the State of New Mexico.

These day-to-day efforts are just part of MMS's normal course of business. These efforts are not only effective at ensuring compliance, but also beneficial in bringing the appropriate revenues to the States, Indians, and the American public.

I would like to emphasize, however, that although this work is important, our focus is not on numbers of audits or amounts obtained in collections. The real goal is to increase upfront voluntary compliance. We measure success in having higher levels of upfront compliance so that companies make correct payments the first time. Audits act as a deterrent, but we hope that audits will reveal fewer problems as companies become more proficient in calculating and paying the royalties they owe accurately.

MMS has taken steps to improve compliance rates in order to achieve this goal. They include the following:

- Clearer regulations - MMS has made significant progress in developing and implementing clearer regulations, eliminating much uncertainty and ambiguity that previously resulted in major findings.
- Royalty-In-Kind (RIK) - MMS is receiving an increasing percentage of revenues through its RIK program and has eliminated many valuation issues for the RIK volumes. During FY 2006, for example, MMS received about one-third of its revenues through RIK.
- More effective compliance strategies - Compliance reviews have allowed MMS to cover more properties than were possible using audits alone, thereby increasing the deterrent effect. This increased presence encourages companies to be more vigilant about proper reporting and payment.

We appreciate the recent report of the Office of Inspector General concerning the audit and compliance program. The results are similar in substance to audits I have reviewed in State government or in the private sector. My experience is that in any organization with such large and complex operations, I would expect any performance audit to find opportunities for improvement. MMS has embraced virtually all of the findings, and has an action plan to address them.

We note the Inspector General's major conclusion that compliance reviews are a useful tool in our program, and we look forward to implementing recommendations to further improve our application of compliance reviews. We submit for the Committee's attention our "Action Plan to Strengthen Minerals Management Service's Compliance Program Operations" which documents improvement actions taken and planned in this area.

MMS does not work alone in its efforts to ensure the proper collection of royalties; MMS collaborates with the States and tribes on our compliance and audit activities. In addition, every three years, the Federal audit function of MMS is peer-reviewed by an outside independent certified public accounting firm. Most recently, in 2005, the MMS audit program was found to meet all applicable government auditing standards. As noted earlier, for the past five years, as part of its annual Chief Financial Officer audit, MMS consistently has received clean audit opinions from the Office of the Inspector General and its delegated independent auditing firm.

Having said that, it is also true that MMS continues to look for ways to improve its programs, practices and performance. We welcome input from this Committee, the full Congress, the Office of the Inspector General, GAO and the public.

In response to the recent interest regarding the accuracy and effectiveness of the MMS's royalty management program, Secretary Kempthorne and I determined that an independent panel should be convened to review the procedures and processes surrounding MMS's management of mineral revenue. We are committed to ensuring our processes are effective and transparent, and we welcome advice and counsel.

The new panel will operate as a Subcommittee under the auspices of the Royalty Policy Committee, an independent advisory board appointed by the Interior Secretary to advise on royalty management issues and other mineral-related policies.

The Subcommittee on Royalty Management has been asked to review prospectively:

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

The Subcommittee will conduct its review over a six-month period and then provide its final findings and recommendations to the full Royalty Policy Committee and the Secretary of the Interior. We will be happy to share the recommendations with you when they are available.

Members of the Subcommittee will be announced in the near future.

Strategic Petroleum Reserve

During the State of the Union Address, President Bush announced plans to double our nation's Strategic Petroleum Reserve (SPR) to 1.5 billion barrels of oil. Also announced was a directive to fill the SPR to its current capacity of 727 million barrels. MMS will provide royalty in kind oil starting in July 2007 to accomplish this mandate. This policy decision will provide an additional layer of protection for our nation's energy security.

FY 2008 President's Budget Request

For FY 2008, MMS has submitted a budget request of \$297 million in current appropriations and offsetting receipts which is an overall increase of \$5 million from the

FY 2007 President's Budget (an additional \$16 million relative to the 2007 Continuing Resolution that is currently in place). The additional funds requested in the President's Budget will improve MMS' ability to: implement the 5-Year Oil & Gas Leasing Program (2007-2012); provide oversight of increasing ultra-deepwater offshore development; hire specialized staff to address well abandonment and pollution prevention issues in the Gulf of Mexico region; and fully fund projected fixed cost increases for personnel-related costs and rent.

In addition to the items listed above, the President's Budget also includes additional funding for two systems changes that are designed to enhance compliance and enforcement efforts in the management of mineral revenues. The budget includes \$940,000 for an adjustment line monitoring initiative for MRM Support System modifications to ensure that company reporting adjustments are made only within allowable timeframes. The budget also includes \$1.45 million for the first year of a two-year interactive payment reconciliation and billing initiative, which will allow MMS to automate the interface with its customer base on numerous activities. Both of these proposals provide a strong return on investment and will provide MMS with the resources necessary to continue to improve its robust audit and compliance program.

Conclusion

In the four months since I was confirmed to this position, I have been working closely with the MMS to understand the complex processes associated with accounting for the revenues generated from oil and gas development on Federal lands, including the Outer Continental Shelf. In an effort to gain a greater understanding of this work, in early January I traveled to MMS's Denver Office where I reviewed the procedures and controls used to ensure that minerals revenues are properly reported and accounted for. I also visited offices and reviewed operations in the Gulf of Mexico Regional Office.

This work is very important and must be undertaken carefully. Equally important, and very important to Secretary Kempthorne and me, is that we conduct business with the highest standards of ethics possible. Making sure we can live up to that standard has been a high priority of mine. I have stressed, and will continue to stress, our obligation to conduct ourselves in accordance with the highest ethical standards and to be accountable for our actions. Moreover, our conduct must be ethical both in fact as well as in perception.

To summarize my remarks today, I want to reiterate I will continue to focus on several key areas as I provide oversight to the Minerals Management Service.

We will issue our 5-year proposed OCS leasing program on time. This is an important plan that addresses national energy security and facilitates the development of critical energy resources now and in the future.

I will continue to seek prospective royalty agreements with the companies that entered into leases issued in 1998 and 1999 that lack price thresholds in order to capture the majority of the revenues the government would have received.

I am pleased at the results of our efforts thus far, but recognize that there is much more work to be done. I look forward to continuing to work with you, the members of Congress, to address this important issue.

In addition, I will continue to work with MMS to review and improve our royalty management programs. I have every confidence that MMS will successfully implement appropriate Inspector General's recommendations and that the review by the soon-to-be finalized Royalty Policy Subcommittee will provide a fresh perspective on royalty management issues and challenges.

I welcome your input on all of these initiatives, and I look forward to working with you.

Chairman Feinstein, this concludes my remarks. I would be happy to answer any questions you have.