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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION

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SEPTEMBER 15, 1982

The Honorable Morris K. Udall
Chairman, Committee on Interior and Insular Affairs
House of Representatives

119498

Dear Mr. Chairman:

Subject: Overview of Department of the Interior's and Selected States' Royalty Accounting Systems (GAO/AFMD-82-107)

Your June 24, 1982, letter (see encl. 1) requested that we further assist your Committee in its ongoing work to improve the Department of the Interior's royalty management program. You asked us to assess the feasibility of the new royalty accounting system being developed by Interior and to determine the type of accounting systems used by the States of California, Colorado, New Mexico, and Wyoming for their State-owned oil and gas leases. You also asked that we obtain the views of some of those affected by Interior's new royalty accounting system.

OBJECTIVE, SCOPE, AND METHODOLOGY

As requested in the Chairman's June 24 letter and based on discussions with the Committee staff, the principal objectives of this review were to (1) assess the feasibility of Interior's new royalty accounting system presently under development, (2) obtain an overview of the royalty accounting systems in use in the States of California, Colorado, New Mexico, and Wyoming, (3) estimate the number of Federal and State oil and gas leases involved in each of those States, and (4) obtain views of the States, Indians, and oil and gas company representatives regarding Interior's new royalty accounting system. The review was performed in accordance with the General Accounting Office's Standards for Audit of Governmental Organizations, Programs, Activities, and Functions.

As specified in the request letter, we obtained a description of the States' royalty accounting systems, the type of reports received by the States from oil and gas companies, and how these reports are used to ensure the accuracy of the royalties received. We were asked to brief the Committee staff by July 15, which we did. Because of the tight time frame, the Chairman's office asked

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that we do not analyze the States' systems in depth, but, rather, obtain an overview of the systems and controls in place to account for and manage royalties.

We interviewed the officials of Interior's Mineral Management Service in Reston, Virginia, and Lakewood, Colorado, who are responsible for the planning, design, and implementation of the new royalty accounting system. We interviewed State officials responsible for their respective State's royalty accounting systems. To obtain views on Interior's new royalty accounting system, we also met with representatives of (1) the Independent Petroleum Association of Mountain States in Denver, Colorado, (2) the Shoshone and Arapahoe Indian tribes of the Wind River Reservation in Cheyenne, Wyoming, (3) the Bureau of Indian Affairs in Cheyenne, Wyoming, and (4) a major oil company in Dallas, Texas.

DEPARTMENT OF THE INTERIOR EFFORTS TO IMPROVE ITS ROYALTY ACCOUNTING SYSTEM

As discussed in our April 27, 1982, report "Oil and Gas Royalty Accounting--Improvements Have Been Initiated But Continued Emphasis Is Needed To Ensure Success" (AFMD-82-55), the Department of the Interior is making a concerted effort to correct its longstanding royalty accounting problems and is emphasizing the need for effective management of the program. The Department established the Mineral Management Service in January 1982, assigning it responsibility for royalty accounting. A new royalty accounting system is being developed to be implemented in two primary phases over several years--(1) the accounting phase, scheduled to be operational in January 1983 and (2) the production phase, to be implemented in fiscal 1984. The production phase will permit the matching of production and sales data.

As pointed out in our April report, in developing the preliminary design of the accounting phase, many of the longstanding problems were considered. Until this phase is operational, we will not know whether the effort is fully successful. If the detailed design is carried through and successfully implemented, the system should vastly improve the Department's ability to account for and control royalties received from Federal and Indian lands. But in designing and implementing an automated system, problems are often encountered. The Department must be given an opportunity to work out any initial problems with the new system.

Agencies are required to obtain the Comptroller General's approval of their accounting and internal control system designs. As part of that process, we are presently reviewing the detailed design of the accounting phase and will be working with the Mineral Management Service to resolve any concerns as they arise.

Also, the production phase, which is not yet designed, is extremely important because it must alleviate the present total reliance on information reported by the oil and gas companies. The Department has an overall concept for this phase but still must determine how it will interface with the accounting phase. The Department must also decide how to use such information as run tickets and meter readings to verify reported sales and production. The production phase will require careful planning because of the inherent complexities in verifying production and in interfacing all phases of the new system.

STATES' ROYALTY ACCOUNTING SYSTEMS

We found that the sophistication of the States' royalty accounting systems varied greatly. Their means of verifying royalty payments and their review and analysis of data reported by the oil and gas companies also varied. California, Colorado, and Wyoming officials would like to perform the royalty accounting and collecting functions for Federal leases within their boundaries. Of these three, only California now has a system that may be capable of doing so. The California system is staff intensive, however, and may be difficult to extend to Federal leases because of the large number of such leases. Colorado and Wyoming are presently developing automated royalty accounting systems and may be able to assume Federal royalty functions at a later date.

New Mexico also appears to have a good system. However, New Mexico offiCals do not believe the system could be readily adapted to Federal leases, and the State does not want to assume the royalty accounting and collection function for Federal leases. Details of each State's royalty accounting system follow.

California's system

California has 55 producing oil and gas leases, on State-owned lands for which it receives approximately $100 million in royalties annually. It receives another $390 million in royalties annually from a State-owned lease managed by the City of Long Beach. California also has 330 producing Federal leases, for which the State's share of royalties will approximate $36 million in 1982.

California uses a manual and automated system to verify the accuracy of royalty payments. An integral part of the verification process is an extensive site inspection program. State officials told us that 11 inspectors are used to visit each of the 55 leases daily. Before removing oil and gas, the company must notify California of its intention to do so and then a State inspector will generally witness the removal of the oil and gas from the lease site, thereby ensuring the accuracy of the reported production. State officials told us that well tests, 1/ which are essential in

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1/A well test is a procedure to measure the rate of production of a well and includes a determination of the amounts of water and oil being produced.

the verification of reported production, are performed about every 10 days. California holds the operator of a lease responsible for all activities involving that lease.

Royalty payments are based on the quantity produced, rather than the quantity sold, as with Federal leases. When the State receives the run tickets, which indicate the amount of oil and gas removed from a given lease site, it adjusts reported production for the beginning and ending inventory and arrives at total monthly production for that lease. It computes the royalties due from the oil and gas company by using the adjusted reported production and the highest posted price for the oil and gas. If the royalties paid by a company do not match the amount computed by the State, the difference is reconciled with the company.

From our limited analysis and discussions with State officials, California's system can apparently assure the accuracy of the royalties received from State-owned leases. Because of the short time frame allowed for our review, however, we were not able to ascertain if the State's system could adequately handle the Federal leases in the same diligent manner as for State-owned leases. An assessment of whether or not California could assume these functions would require consideration of a number of factors. For example, the workload will increase sixfold--from 55 leases to 385 leases (55 State-owned leases and 330 Federal leases). To maintain the same ratio of inspectors as with State leases, 70 more inspectors would have to be hired. In this regard, the question of who pays for the incurred cost--the Federal Government or the State--would have to be addressed.

California has expressed a willingness to perform the accounting and collection function for Federal leases and to adopt policies and procedures outlined by the Secretary of the Interior, provided the State is consulted during their development. State officials also said that if California assumed the responsibility and found that its system needed extensive modification, the incurred costs should be borne by the Federal Government. In this regard, California recently informed the Department of the Interior that it would perform, on a reimbursable basis, the auditing and inspection functions on all Federal leases within the State from July 1, 1982, through June 30, 1985, for about $5 million. California officials would rather be reimbursed by the Federal Government for costs incurred in auditing the leases, than enter into a cooperative agreement as is now being used in Colorado, New Mexico, and Wyoming. Under a cooperative agreement, the Federal Government and the State share the auditing costs.

Colorado's system

Colorado has about 450 producing oil and gas leases on State-owned lands. Royalties from these leases run between $16 million and $18 million annually. In comparison, about 1,000 Federal leases, exclusive of Indian leases, are producing in the State. Colorado's share of royalties due from Federal leases will be about $20 million in 1982.

At the present time, Colorado has a completely manual system for verifying royalties paid. One individual is responsible for processing monthly royalty checks. However, oil and gas companies have reported very little comparison of sales and production data. In essence, Colorado generally accepts as correct the reported royalty payments, and simply accounts for payments received.

Through the current manual system, Colorado is able to determine if a royalty payment has not been received. But the system cannot ascertain if the royalty payment is accurate or if all royalties due have been received. In addition, the current system cannot assess interest on late payments or for nonreporting. The State is in the process of revising lease agreements to provide for assessing interest.

Colorado officials indicated that the manual process is very time comsuming, and the review and recording of all the transactions each month is becoming increasingly difficult. As a result, the State is in the process of developing an automated system. Colorado officials and contractor personnel stated that the system is being developed in phases and that the royalty collection phase is scheduled to be implemented by mid-1983. Colorado officials said that the State is very interested in performing the royalty accounting and collection functions for Federal leases within the State, but they readily acknowledged that until Colorado's new automated system is in place, the State will not be able to do so.

New Mexico's system

New Mexico has 4,000 producing oil and gas leases on State-owned land. Royalties for these leases amount to about $200 million annually. Within New Mexico there are approximately 4,700 producing Federal leases, exclusive of Indian leases, and the State's share of annual Federal royalties will amount to about $158 million in 1982.

The New Mexico Oil and Gas Accounting Division is responsible for collecting State royalties and operates the State's automated system to verify reported sales and production and to ascertain the accuracy of royalty payments. Unlike the Department of the Interior's system and the other State systems we reviewed that maintain royalty data by lease, New Mexico uses a production unit number as a means of reporting oil and gas sales and accounting for royalty payments. A production unit is referred to as a "producing property." A producing property can be one well or a group of wells having common ownership.

As part of New Mexico's verification process, each operator and purchaser is required to submit two reports monthly. The operators' reports (1) detail the total volume and value of each product sold from the production unit and (2) summarize the royalty payments the operators are required to certify that data shown on the reports is accurate. The purchasers' reports are similar, except that the information reported relates to the amount purchased from a production unit during the month. Two-thirds of the detailed transactions that the accounting division receives from the purchaser oil and gas companies are on magnetic computer tape which can be entered directly into the State's automated system.

Information from the operator and purchaser reports, as well as the royalty payment, which is generally submitted by the operator, is entered into the accounting system for detailed analysis and comparison by production unit. Any differences between the reported sales and purchases are identified by the system, and when differences occur, the reports are returned to the preparers for correction. Until the reports are reconciled, the differences remain in a suspense file. The system also recomputes the amount of the royalty due to ensure that proper payment was received at the time the entries are being processed.

Operator and purchaser reports and accompanying remittances are due within 65 days following the end of the calendar month covered by the reports. There is no provision for an extension of time, and interest on past due amounts is computed at the rate of 1 percent per month, or fraction thereof. Although the operator or purchaser may actually remit the royalty to the State, ultimate responsibility for payment lies with the lessees.

The New Mexico Oil Conservation Division also plays an integral part in verifying reported sales and production. This division is responsible for auditing oil and gas production, oil run volumes, gas sales volumes, and inventories, and for performing field inspections. The division has three field offices, each employing nine field inspectors and three geologists. The information the accounting division receives is compared to conservation division records, and discrepancies are brought to the attention of the production unit operator who must explain the discrepancies or provide an amended report.

Based on our limited analysis and discussions with State officials, New Mexico appears to have a good system for accounting and collecting oil and gas royalties for State-owned leases. However, New Mexico officials said that their system could not be easily modified to meet reporting requirements for Federal leases primarily because New Mexico's system is production unit oriented, not lease oriented, and because State severance tax calculations are also involved. Furthermore, New Mexico officials said that the State was not interested in accounting and collecting royalties on Federal leases within New Mexico and was not willing to conform to policies and procedures that may be issued by the Secretary of the Interior pursuant to such an arrangement.

Wyoming's system

Wyoming has approximately 800 producing oil and gas leases on State-owned lands. Royalties from these leases amount to about $12 million annually. In comparison, about 7,000 Federal leases, exclusive of Indian leases, are within Wyoming, and the State's share of royalties due from these leases will be about $155 million in 1982.

Currently, Wyoming has a completely manual system for verifying royalties paid and for matching production and sales data. That system has been in place since October 1981. Before that, Wyoming verified little of the data it received, essentially accepting as correct the royalty payments received from the oil and gas companies.

To verify royalties and compare reported sales and production data, Wyoming officials manually compare the report of monthly sales--prepared by the lease operator--with the monthly statement of production--reported by the lessee of record or the lease operator. For its 800 producing State leases, Wyoming receives about 300 sales reports and between 500 and 600 production reports monthly.

Sales reports show the sales date, type of product, the quantity sold, and the total dollar value of the sale. The State requires that run tickets and purchaser reports be attached. Production reports indicate the quantity of oil, gas, and other products sold and the price, total value, and amount of royalty owed the State for each product sold.

If the sales and production reports do not agree, the production report is returned to the preparer for correction. We were told that if the data is not corrected within 10 days, the lease is subject to cancellation and a monthly penalty of $100 is assessed.

Wyoming officials indicated that the manual process is very time consuming, and it is becoming increasingly difficult to record all the transactions each month. As a result, Wyoming is in the process of developing an automated system. At the present time, State officials estimate that the royalty collection function for State-owned leases will be automated by mid-1983. Wyoming's first priority is to begin in July 1982 to develop an inventory of State-owned lands and to record this information within the system.

As with Colorado, Wyoming is very interested in assuming the accounting and collection functions for Federal oil and gas leases within their State but does not now have the capability to do so. Wyoming officials believe that once their automated system is in place, the State will be able to assume the function for Federal leases.

VIEWS ON DEPARTMENT OF THE INTERIOR'S NEW ROYALTY ACCOUNTING SYSTEM

Besides obtaining an overview of the States' royalty accounting systems, we also learned the States' views on the new royalty accounting system the Department of the Interior is designing. In addition, we obtained the views of representatives of Indian tribes and the oil and gas industry regarding the royalty accounting system. We met with representatives of the Shoshone and Arapahoe tribes, the Independent Petroleum Association of Mountain States, and a major oil company that has numerous Federal leases.

Without exception, State officials expressed concern that they have not been adequately informed as to how Interior's new royalty accounting system will operate or the type of data they will receive from the system to support the royalty payment. As a result, State officials were skeptical of the new system's ability to correct the longstanding royalty accounting problems.

This lack of communication was first brought to our attention when we visited New Mexico. We advised Interior's Mineral Management Service of that State's concerns, and the Mineral Management Service subsequently briefed New Mexico officials on the new system. After receiving the briefing, State officials informed us that they are more optimistic about Interior's efforts and believe the new system will improve royalty accounting. Based on their response, the other States involved, as well as other interested parties, would also likely benefit from briefings about the new system and how it will improve royalty accounting.

The views of the Indian representatives we met were similar to those of the States in that they did believe they had been adequately informed about the new royalty accounting system. Representatives for the Shoshone and Arapahoe tribes were concerned that since they have so few leases in comparison to the total number of Federal leases--only 99 of over 18,000--the new system may not provide the same degree of scrutiny to the Indian leases as to the others. So these tribes would like to receive data related to their leases that can be used to verify the royalty payments.

The Independent Petroleum Association of Mountain States is an organization of small independent companies and at the present time has about 1,800 members. Association officials said that they have not been contacted by Interior concerning the design and development of the new royalty accounting system and, therefore, were unable to provide comments concerning the possible impact the system may have on its members.

The major oil company we contacted generally supported Interior on its efforts to develop a new royalty accounting system and improve overall royalty financial management. Company representatives said they had little input into the development of the accounting phase but are in favor of centralizing accounting as Interior plans to do under the new system. The representatives also believe that the revised reporting format developed as part of the accounting phase will be a vast improvement. The company has been primarily involved with developing the production phase of the new system, providing five representatives to serve on an industry advisory panel that is providing comments on the preliminary design of the production phase. The company expressed a desire to maintain the current working relationship with Interior regarding the system development.

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As requested by your office, we did not obtain written comments from the Department of the Interior or from the States, Indian tribes, or the oil and gas industry representatives we contacted. Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its date. At that time, we will send the report to interested parties and make copies available to others who request them.

Sincerely yours,

W. D. Campbell
W. D. Campbell
Acting Director

Enclosure

COMMITTEE ON INTERIOR AND INSULAR AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C. 20515

June 24, 1982

The Honorable Charles Bowsher
Comptroller General of the United States
United States General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Bowsher:

The Accounting and Financial Management Division of the General Accounting Office (GAO) has been assisting our full committee staff in analyzing some of the problems and issues involved with improving the Department of the Interior's minerals royalty management system and in drafting amendments to pending royalty management legislation.

To further assist the committee in this effort I request that the GAO visit the royalty management offices of the States of California, Colorado and Wyoming to ascertain what types of mineral royalty or severance tax management systems these States are using and how their systems might be integrated into the new Mineral Management Service (MMS) system.

In addition, I would appreciate GAO discussing the new federal royalty management system with some of the concerned Indian tribes and with representatives of the oil and gas industry to identify problems with the new system from the standpoint of those groups.

I would appreciate their briefing the Committee staff by July 15, 1982, on the results of this work. Information to be developed should include (but not be limited to):

- O A determination of the feasibility of the new MMS sales and production accounting systems;
- O A description of the State royalty or severence tax accounting systems;
- O An analysis of the data submitted for each mineral lease and whether this information can be used to verify and compare production and sales data;
- O An estimate of the number of federal, state, Indian, acquired and onshore oil and gas leases involved in each state surveyed.

June 24, 1982

Since the Committee is working under a tight timeframe, I realize your analysis will not be an in-depth review. Also, because of the short deadline formal agency comments on the information developed should not be obtained.

The committee is aware that the staff of the GAO's Energy and Minerals Division has recently started a broader assessment of States mineral managment activities. In this regard, we are interested in the States' management of not only oil and gas but also of other minerals. I would hope that the study would identify ways in which the Federal and State governments could share minerals information and work together to the greatest extent practicable to aid the overall capability of government to account for resources taken from State, Federal, and Indian lands. I would appreciate a briefing on this work by July 20, 1982, with appropriate written briefing documents to follow.

Sincerely,

Morris Udall

MORRIS K. UDALL
Chairman