REPORT TO

THE CONGRESS OF THE UNITED STATES

NEED FOR PROCEDURES TO PRECLUDE MORE THAN JUST COMPENSATION IN ACQUIRING OIL INTERESTS

CORPS OF ENGINEERS (CIVIL FUNCTIONS)
DEPARTMENT OF THE ARMY

BY

THE COMPTROLLER GENERAL OF THE UNITED STATES

SEPTEMBER 1967

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-162106

SEP 29 1967

To the President of the Senate and the
Speaker of the House of Representatives

The General Accounting Office has reviewed the policies and procedures of the Corps of Engineers (Civil Functions), Department of the Army, concerning oil interests acquired in obtaining land for construction projects. Our audit covered two reservoir projects near Carlyle, Illinois, and Tulsa, Oklahoma. This report presents our finding and proposal thereon.

We found that the Corps of Engineers, in acquiring land for the two projects, made payments of about $28 million to the land and mineral owners. Of this amount, about $7.2 million represented the estimated cost to the Government for acquiring the mineral interests. Agreements entered into by the Corps provided for payment to the owners for the full amount of the estimated oil reserves. Subsequent to appraisal of the estimated oil reserves, the owners were permitted under the agreements to extract oil having a fair market in-ground value of about $1.6 million, without an appropriate adjustment in the cost to the Government for acquiring the mineral interests.

Therefore, we suggested to the Secretary of the Army that the Corps' policies and procedures be revised to prevent the owners of mineral interests from receiving more than just compensation. We were advised that the Corps would prepare and modify instructions which would be designed to preclude owners from receiving windfall benefits.

We are reporting this matter to advise the Congress of the savings that may accrue to the Government as a result of changes which are to be made in the Corps policies and procedures. We believe that this report may be of value to other Government agencies who may acquire mineral interests in future land acquisition programs.

Copies of this report are being sent to the Director, Bureau of the Budget; the Secretary of Defense; and the Secretary of the Army.

Comptroller General
of the United States

Contents

any expediting was dependent upon the lessee's desire and operational capability. To base an appraisal on expedited recovery or a given rate of depletion could penalize the lessee as well as the lessor if such production did not materialize.

3. The damage to the property value occurred as of the date the subordination agreement was purchased or condemnation was filed. Since only a subordination was being purchased and no title to the oil was being acquired, recovery by the operator was proper.

4. In condemnation cases involving the subordination of oil rights, the United States District Court refused to admit testimony as to the amount of depletion of the reserves between the dates of taking and the date the project became operational.

We believe that, if it were not possible for the Tulsa District to defer subordinating all of the oil interest underlying about 5,000 tracts, subordination should have been deferred on the major tracts. There were 184 tracts with an appraised value of $5,000 or more, which accounted for 73 percent or about $4.2 million of the $5.7 million of estimated costs of the mineral interests subordinated, and we believe that it would not have been unreasonable for the District to have deferred subordinating these tracts.

As to the second and third comments, we believe that, where mineral interests are anticipated to be fully recoverable, payment should be restricted to those damages anticipated to result from operation under the Government's right to intermittently inundate mineral interests and from rearrangement of the property necessary for continued operation under such conditions. To compensate mineral owners for the full value of the mineral reserves affords the owner a remuneration for that of which he has not been deprived.

Where mineral interests are to be permanently inundated, we believe that the value of oil recovered after the date of appraisal should act to reduce the extent of damage and should therefore be considered in the determination of just compensation. Our review of the subordination cases did not disclose any attempt by the Tulsa District to negotiate prices that included consideration for depletion of the oil reserves subsequent to the appraisals. Consequently, there is no basis for determining how many owners would have agreed to such arrangements.

As of June 30, 1965, 25 agencies of the Government owned about 53 million acres of acquired land. Three agencies, the Departments of Agriculture, of Defense, and of the Interior, own about 52 million of the 53 million acres of acquired land. Because the acquisition of these lands may have included the acquisition of the underlying mineral interests, we believe that this report may be of value to those agencies.

The principal officials of the Department of Defense and the Department of the Army responsible for the administration of the activities discussed in this report are listed in appendix I.

BACKGROUND

In connection with the construction of civil works projects, it is often necessary for the Corps to acquire an interest in land and minerals which will be affected by the project. The Corps' general policy relative to the acquisition of mineral interests provides that:

> "Mineral, oil and gas rights will not be acquired except where the development thereof would interfere with project purposes, but mineral rights not acquired will be subordinated to the Government's right to regulate their development in a manner that will not interfere with the primary purposes of the project, including public access."

This policy is contained in Corps' regulations with a general statement to the effect that, except for construction areas, mineral rights will be subordinated rather than acquired in fee. Exceptions to this policy must be discussed in the real estate design memorandum and must be approved by the Chief of Engineers.

At reservoirs where approval has been given to acquire the mineral interests in fee, Corps Districts secure full title to the mineral interests for the Government by compensating the owners for the estimated value of the minerals. Where fee title is not acquired, the Corps generally enters into a subordination agreement, whereby the owner waives and subordinates his rights to the property to the right of the Federal Government to overflow, flood, and submerge the property as may be required in connection with the operation and maintenance of the project. Under subordination, the title in the mineral interests and the right to continue exploitation and operation of the mineral interests in a manner that will not interfere with project purposes remains with the mineral owners.

The costs of subordinating the mineral properties are determined by appraisal and represent the difference between the estimated fair market value of the minerals in the ground before subordination and their estimated in-ground value after subordination. In essence, the payment for subordination represents the payment for such damages as are anticipated to result from operation under flood conditions and for rearrangement of the property necessary for continued operation under these conditions.

Landowners may not always be the same as the mineral owners. Therefore, Corps regulations provide for the separate acquisition of lands and of mineral interests where necessary. For use in establishing prices where marketable mineral deposits are known to exist, the Corps secures separate mineral appraisals from a person qualified in appraising minerals. For oil interests, such an appraisal involves a review of the production records of the various wells on the property and a determination of their economic life and production potential. Frequently, where there are no known mineral deposits, the Corps does not secure separate mineral appraisals but adds a nominal amount to the appraised value of the land to cover the rights to any possible mineral deposits.

It is the stated policy of the Corps that, in an effort to acquire the property at a price considered just and reasonable, its negotiators will engage in actual, practical, and realistic negotiations to the same extent as is the normal practice between willing buyers and willing sellers. In implementing this policy, Corps regulations state that no offer be made by the negotiator, which cannot be considered fair and reasonable in light of the approved appraisal, and that the Corps provide negotiators with guidelines to assure that the original offers leave room for true negotiations.

Corps regulations further provide that negotiations will not be discontinued without making an offer at least equal to the appraised value. In addition, the Corps has procedures whereby they may accept a reasonable counter offer if the total purchase price does not exceed 115 percent of the appraised value. Corps regulations state also that action will be taken by the Corps to acquire the property by condemnation proceedings (court action) when negotiations fail, the Corps is unable to contact the owners, title defects are found, or other reasons exist.

Keystone Reservoir

The Keystone Reservoir, constructed on the Arkansas River near Tulsa, Oklahoma, was authorized by the Flood Control Act of 1950 (33 U.S.C. 701) as a unit of a master plan for development of the water resources in the Arkansas River Basin. Work on the dam and reservoir began in 1956 and was sufficiently complete to commence water impoundment in September 1964.

With the exception of about 10 oil properties which were acquired in fee because the wells were located in the vicinity of the dam, the Tulsa District subordinated all oil interests, underlying approximately 5,000 tracts at Keystone. Many of these tracts had mineral interests of only a nominal value and subordination was achieved when the interests in the lands were acquired. Separate mineral appraisals were prepared for the oil-producing properties. The appraiser determined the value of the minerals as of the date of the appraisal, and the Corps negotiated with the owners on the basis of this value. In those cases where negotiations were unsuccessful, the Corps secured subordination through condemnation proceedings.

The estimated cost to the Government for the mineral interests subordinated is about $5.7 million of the estimated $19 million necessary to acquire the needed lands and mineral interests at the Keystone Reservoir.

Carlyle Reservoir

The Carlyle Reservoir constructed on the Kaskaskia River near Carlyle, Illinois, was authorized by the Flood Control Act of 1938 (33 U.S.C. 701-1), and the Flood Control Act of 1958 (33 U.S.C. 701b-8a), as a unit of the comprehensive plan for development of the Mississippi River and its tributaries. Construction of the dam and reservoir commenced in October 1958 and formal closure of the dam took place on April 1, 1967. Some impoundment of water in the reservoir began in August 1965, with maintenance of the normal pool level occurring after closure.

In June 1961, the St. Louis District received approval of the Chief of Engineers to acquire ownership in two oil-producing fields lying totally or partially within the limits of the Carlyle Reservoir. The District's proposal to acquire the oil-producing properties in fee was made on the basis that subordination costs were approximately the same as fee acquisition costs. The estimated cost to the Government for the mineral interests acquired in fee and subordinated is about $1.5 million of the estimated $9 million necessary to acquire the needed lands and mineral interests at the Carlyle Reservoir.

FINDING

NEED FOR PROCEDURES TO PRECLUDE MINERAL (OIL) OWNERS FROM RECEIVING MORE THAN JUST COMPENSATION

Although the Corps of Engineers has procedures for implementing its policy relative to the need for acquiring or subordinating mineral interests, additional procedures and implementation would seem appropriate, in our opinion, to preclude the owners of mineral interests from receiving amounts greater than those which would be considered reasonable to satisfy the Government's obligation to provide just compensation for the value of property or property rights acquired.

Corps regulations specify the criterion for just compensation as the fair market value of the property at time of taking and define fair market value as the amount of cash, or terms reasonably equivalent to cash, for which in all probability the property would be sold by an owner willing but not obliged to sell to a purchaser who desires but is not obliged to buy. The United States Supreme Court has held that:

> "*** the Fifth Amendment of the Constitution provides that private property shall not be taken for public use without just compensation. Such compensation means the full and perfect equivalent in money of the property taken. The owner is to be put in as good position pecuniarily as he would have occupied if his property had not been taken."

Our review of Corps policies and procedures, applicable to the acquisition of mineral interests, disclosed no specific instructions or guidelines relating to the consideration which should be given to the rights retained by the owners to remove oil reserves for which they had been compensated. It appears to us that, because current Corps procedures do not fully recognize or restrict the rights retained by the owners to remove oil reserves after acquisition or subordination of the mineral interests by the Corps, the owners oftentimes receive more than just compensation.

The Tulsa and St. Louis District Offices, in acquiring the right to inundate oil properties at the Keystone and Carlyle reservoirs, entered into agreements, which provided for full payment, based on the appraised value, to the owners for the estimated value of the oil reserves in the

ground. Subsequent to the appraisals, the owners extracted oil having an appraised value of about $1.6 million without an appropriate adjustment in the cost to the Government of acquiring the mineral interests.

On the basis of our review, we believe that the establishment and implementation of procedures by the Corps, which would preclude mineral owners from receiving more than just compensation, would result in a reduction in costs to the Government.

Details on our findings at the two reservoirs are discussed in succeeding sections of this report.

Keystone Reservoir

Construction of the Keystone Reservoir was begun in December 1956. In 1958, the Tulsa District, in obtaining the interests needed in about 2,650 oil properties, contracted with several appraisal firms to appraise the properties. These appraisals, which were used as the basis for negotiations with the mineral owners, showed the appraised value of the oil reserves before and after subordination with the difference representing the costs of subordinating the oil reserves.

For our review at the Keystone Reservoir, we selected 94 of a total of 184 subordinations which had an appraised value of $5,000 or more. For 20 of the 94 properties, the subordination costs were determined on the basis that the properties could be operated indefinitely by modification to operating structures at costs significantly less than the appraised value of the oil reserves. In these instances, the district limited payments to estimated damages and an estimated cost of the modifications.

However, for the other 74 subordinations, the appraisals showed that the mineral reserves would have no value after subordination, therefore, the Corps paid at least the full appraised value of the mineral reserves for the right to subordinate, and in some cases the amounts paid were greater than the appraised values. Payments for these 74 subordinations aggregated about $2.2 million, or about 40 percent, of the $5.7 million of estimated costs to the Government for mineral interests subordinated at the Keystone Reservoir.

The Corps' costs for the 74 subordinations were based upon the quantities and values of oil determined by independent appraisals, but the dates of the appraisals preceded the scheduled date for impoundment of water,

August 1, 1964, by periods generally ranging from 2 to 5 years. During these periods, owners of the oil properties removed 1.1 million barrels of oil with an appraised value of about $942,000, which previously had been considered in determining the amounts paid by the Corps to the owners.

We found that, during the year subsequent to the scheduled date for water impoundment, an additional 118,000 barrels of oil, with a value of about $79,000, were extracted. Moreover, some of the wells were still in production when we made our review. We found no evidence that the Corps had screened the oil properties for the purpose of deferring purchase of the subordination rights, at least on the larger producing properties. In our opinion, deferral of appraisal action, deferral of subordination action, or subsequent adjustment to the appraisal based on actual extraction could have resulted in substantial savings to the Government.

For example, the Tulsa District subordinated an oil property for $83,415 on the basis of an appraisal made in November 1961, which showed estimated reserves of 62,700 barrels of oil with an appraised value in ground of about $80,200. The appraisal report showed that the property included four producing oil wells, one salt water disposal well, and six nonproducing wells. Production records showed that, from Novemeber 14, 1961, the date of appraisal, through August 1, 1964, the scheduled date for water impoundment, the owner extracted 24,560 barrels of oil valued in the ground at about $31,400. During the 12-month period subsequent to the scheduled impoundment of water, an additional 6,150 barrels of oil valued in ground at about $7,900 were removed. Four of the wells were still in production when we made our review.

Comments of the Tulsa District Engineer

In response to our questions as to why the subordinations at the Keystone Reservoir were not negotiated in a manner that included consideration of the value of oil reserves that could be removed subsequent to the appraisals, the Tulsa District Engineer made the following comments:

1. The number of mineral tracts involved at the Keystone Reservoir and the time necessary to acquire subordinations did not permit a deferral action.

2. The taking of property for public works by condemnation could not force expedited recovery and

any expediting was dependent upon the lessee's desire and operational capability. To base an appraisal on expedited recovery or a given rate of depletion could penalize the lessee as well as the lessor if such production did not materialize.

3. The damage to the property value occurred as of the date the subordination agreement was purchased or condemnation was filed. Since only a subordination was being purchased and no title to the oil was being acquired, recovery by the operator was proper.

4. In condemnation cases involving the subordination of oil rights, the United States District Court refused to admit testimony as to the amount of depletion of the reserves between the dates of taking and the date the project became operational.

We believe that, if it were not possible for the Tulsa District to defer subordinating all of the oil interest underlying about 5,000 tracts, subordination should have been deferred on the major tracts. There were 184 tracts with an appraised value of $5,000 or more, which accounted for 73 percent or about $4.2 million of the $5.7 million of estimated costs of the mineral interests subordinated, and we believe that it would not have been unreasonable for the District to have deferred subordinating these tracts.

As to the second and third comments, we believe that, where mineral interests are anticipated to be fully recoverable, payment should be restricted to those damages anticipated to result from operation under the Government's right to intermittently inundate mineral interests and from rearrangement of the property necessary for continued operation under such conditions. To compensate mineral owners for the full value of the mineral reserves affords the owner a remuneration for that of which he has not been deprived.

Where mineral interests are to be permanently inundated, we believe that the value of oil recovered after the date of appraisal should act to reduce the extent of damage and should therefore be considered in the determination of just compensation. Our review of the subordination cases did not disclose any attempt by the Tulsa District to negotiate prices that included consideration for depletion of the oil reserves subsequent to the appraisals. Consequently, there is no basis for determining how many owners would have agreed to such arrangements.

The Corps' last comment relates to condemnation cases involving subordination. The Tulsa District has in only one instance introduced testimony to the Court relative to the value of the oil produced by the owners in the interim between the date of taking and the date the project became operational. The Board of Court Commissioners, who were appointed by a Judge of the United States District Court, heard the case and, in their recommendations to the Court, agreed with the Government's testimony in arriving at the just compensation to be paid the owners. However, the Judge ruled that oil produced during the interim could not be considered in arriving at the just compensation. The Assistant United States Attorney, Tulsa, on behalf of the Government, lodged an objection to the Court's ruling, so that, upon final judgment, the Corps will be able to appeal the case, if necessary.

While the reasons presented by the District Engineer indicate that the acquisition or subordination of oil rights can present difficult problems, the reasons do not appear to us to preclude the Corps from negotiating for the acquisition or subordination of such rights in a manner that minimizes opportunities for the owners to receive more than just compensation.

Carlyle Reservoir

Construction of the Carlyle Reservoir was begun in October 1958 and impoundment of water was commenced in August 1965. In June 1961, the Chief of Engineers gave his approval to acquire in fee certain producing oil properties at the reservoir. The St. Louis District engaged the services of an appraiser who, for selected oil properties, estimated the reserves at February 1, 1962, at about 1,537,000 barrels with an appraised fair market value in ground of approximately $1,740,000.

The St. Louis District purchased rights in oil-producing properties in April 1963, under agreements which permitted the owners to continue operation to October 1, 1964, when they would be required to stop production. The district negotiated with the owners and paid them about $1,139,000 for oil reserves of about 1,050,000 barrels, estimated to be remaining at October 1, 1964. The remaining oil reserves of 1,050,000 barrels were determined on the basis of then-current extraction rates, even though the Corps knew that the owners were considering a plan to accelerate extraction.

At a meeting on August 9, 1961, representatives of the operator (one that owns, leases, or manages oil property)

advised officials of the St. Louis District that, in view of the reservoir project, the operator was considering a plan for faster and more efficient oil recovery through combining the operation of certain properties as a unit and the forcing of water into the oil-producing sand. In January 1962, the St. Louis District obtained a copy of an agreement, dated August 24, 1961, between certain of the owners of the oil properties and the operator, which provided for the operator to institute and carry out accelerated operations and to operate the oil properties as an entity, with oil production pooled and shared in by the participants.

Prior to April 1963, the date of purchase by the Corps, the operator initiated an extensive exploratory, development, and recovery program. Between June 1962 and March 1963, the operator converted 10 oil wells to water injection wells and completed the drilling of three new wells for the production of oil. Subsequent to April 1963, in order to accelerate operations, the operator converted additional oil wells to water injection wells and drilled three additional oil-producing wells.

Our examination of monthly oil production reports showed that, during the period February 1, 1962 to October 1, 1964, about 1,006,000 barrels of oil were removed from the oil properties rather than the 486,000 barrels previously estimated. The additional 520,000 barrels of oil recovered by the operator represented about $562,000 of the Corps payment to the mineral owners.

During the initial planning of the acquisition of oil properties, the Lower Mississippi Valley Division (LMVD) of the Corps of Engineers apparently recognized the need to account for the amount of oil that would be extracted during the period of continued production. In September 1960, LMVD made a proposal for acquiring the oil properties, which we believe would have precluded payment by the Government for oil reserves which the owners were allowed to recover. The plans proposed by LMVD included accounting for the amount of oil removed during the period that production would continue.

According to the record of a conference held in December 1960, representatives of LMVD and of the St. Louis District discussed the possibility of keeping a record of the oil produced as proposed by LMVD, but this idea was abandoned on the basis that it would have entailed a prohibitive amount of additional administrative and audit work. We found, however, that information on oil extraction was readily available from monthly production

reports which could have been purchased for about $15 a month.

Comments of the St. Louis District Engineer

In commenting on our finding concerning the acquisition of oil rights at the Carlyle Reservoir, the St. Louis District Engineer acknowledged that district officials were aware of the possibility of accelerated production but stated that any upward limitation on production (for example an override percentage of production in excess of a stipulated number of barrels) should, in equity and justice, be matched by a provision which would have made the Government liable for an additional payment if a stipulated minimum production had not been attained. He stated that the District was unwilling to enter into such an arrangement. He stated also that such an arrangement would have placed the Government in partnership with the oil operator without having the opportunity, or possibly even the knowledge, to participate in managerial judgment on the method and extent of operations or the costs of accelerating production.

We believe that, in cases where the Corps finds it necessary to acquire fee title to a producing mineral interest in advance of the date that the operator will be required to stop production, negotiations should be conducted on the basis of the appraised quantities of oil reserves, less the actual quantity of oil subsequently extracted, rather than on the basis of appraised quantities, less the estimated quantity of oil to be extracted. This method of acquisition, in our opinion, would be equitable to all parties concerned.

Agency comments and planned corrective action

We brought our finding to the attention of the Department of Defense and the Department of the Army and proposed that the Secretary of the Army request the Chief of Engineers to revise procedures so as to preclude the owners of mineral rights from receiving more than just compensation when the acquisition or subordination of such mineral rights are necessitated by the construction of water resources projects by the Corps of Engineers.

In a letter dated May 24, 1967, commenting on our proposal, the Department of the Army stated that the Chief of Engineers had the matter under study and would prepare and modify instructions to preclude owners of mineral rights from receiving windfall benefits in connection with the acquisition or subordination of their rights.

APPENDIXES

PRINCIPAL OFFICIALS OF THE DEPARTMENT OF DEFENSE AND THE DEPARTMENT OF THE ARMY RESPONSIBLE FOR ADMINISTRATION OF ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
DEPARTMENT OF DEFENSE		
SECRETARY OF DEFENSE:		
Robert S. McNamara	Jan. 1961	Present
Thomas S. Gates, Jr.	Dec. 1959	Jan. 1961
Neil H. McElroy	Oct. 1957	Dec. 1959
DEPARTMENT OF THE ARMY		
SECRETARY OF THE ARMY:		
Stanley R. Resor	July 1965	Present
Stephen Ailes	Jan. 1964	July 1965
Cyrus R. Vance	July 1962	Jan. 1964
Elvis J. Stahr, Jr.	Jan. 1961	June 1962
Wilber M. Brucker	July 1955	Jan. 1961
CHIEF OF ENGINEERS:		
Lt. Gen. William F. Cassidy	July 1965	Present
Lt. Gen. W. K. Wilson, Jr.	May 1961	June 1965
Lt. Gen. E. C. Itschner	Oct. 1956	May 1961
DIVISION ENGINEER, SOUTHWESTERN DIVISION:		
Brig. Gen. William T. Bradley	June 1966	Present
Brig. Gen. Richard H. Free	July 1964	June 1966
Brig. Gen. Carroll H. Dunn	Feb. 1962	July 1964
Maj. Gen. Robert J. Fleming, Jr.	Nov. 1960	Feb. 1962
Col. Stanley G. Reiff	Aug. 1960	Nov. 1960
Brig. Gen. William Whipple	June 1958	July 1960
Brig. Gen. Lyle E. Seeman	Sept. 1954	May 1958
DISTRICT ENGINEER, TULSA DISTRICT:		
Col. George A. Rebh	Aug. 1965	Present
Lt. Col. Warren A. Guinan	June 1965	Aug. 1965
Col. John W. Morris	June 1962	June 1965

PRINCIPAL OFFICIALS OF THE DEPARTMENT OF DEFENSE

AND THE DEPARTMENT OF THE ARMY

RESPONSIBLE FOR ADMINISTRATION OF ACTIVITIES

DISCUSSED IN THIS REPORT (continued)

	Tenure of office	
	From	To
DEPARTMENT OF THE ARMY (continued)		
DISTRICT ENGINEER, TULSA DISTRICT (continued):		
Col. Howard W. Penney	July 1959	June 1962
Col. John D. Bristor	July 1956	July 1959
DIVISION ENGINEER, LOWER MISSISSIPPI VALLEY DIVISION:		
Maj. Gen. Robert G. MacDonnell	Dec. 1966	Present
Col Joe A. Clema (acting)	Oct. 1966	Dec. 1966
Maj. Gen. Ellsworth I. Davis	July 1962	Sept. 1966
Maj. Gen. Thomas A. Lane	June 1960	June 1962
Maj. Gen. William A. Carter	Aug. 1957	June 1960
DISTRICT ENGINEER, ST. LOUIS DISTRICT:		
Col. Edwin R. Decker	Aug. 1966	Present
Col. James B. Meanor, Jr.	July 1963	Aug. 1966
Lt. Col. Harry B. Barke (acting)	Apr. 1963	July 1963
Col. Alfred J. D'Arezzo	Aug. 1960	Apr. 1963
Col. Charles B. Schweizer	Sept. 1957	July 1960

DEPARTMENT OF THE ARMY
WASHINGTON, D.C. 20310

24 MAY 1967

Mr. J. T. Hall, Jr.
Associate Director, Civil Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Hall:

This responds to the GAO letter of March 10, 1967, to the Secretary of Defense, which transmitted copies of a proposed GAO report to the Congress entitled "Review of procedures used in the acquisition of mineral (oil) interests, Corps of Engineers (Civil Functions), Department of the Army" (OSD Case #2574).

The report concludes that the Corps policies and procedures are not adequate to guide the district offices in the outright acquisition or subordination of mineral, oil, and gas rights when necessitated by the construction of water resources projects and recommends that the Corps' procedures be revised so as to preclude the owners of such rights from receiving more than just compensation.

In the two projects studied by the GAO, some oil producing properties were purchased in fee, others were subordinated and the non-producing properties were subordinated to the project requirements.

The subordination of mineral interests to a project is the payment for the imposition of the project over the subsurface estate. It amounts to buying a waiver for future damages which could result from the project, or a release from all future damages. In this sense an estate is not being acquired nor is there an acquisition of any tangible asset such as a tract of land or an identifiable interest in land.

The measure of damages to a subsurface interest has a relation to what is underground. In relation to a producing or proven mineral property an estimate of the reserves can be made. These estimates

will vary depending on the information available and the opinion of the estimator. The in place value of the reserve will be a guide in negotiating for a release from damages or subordination, and for the acquisition of the subsurface estate if required for construction.

The report assumes that the values developed by the appraisers were the fair market values. Actually the appraised value is used as the basis upon which the negotiations by the government are conducted. Various other factors influence the transaction and the records indicate that few acquisitions are closed for the appraised figure. The fee purchase of minerals also requires the owner to plug the wells, abandon the property and clear the site of debris and other materials which would pollute the water. It is usually much easier to deal for a subordination than for the fee, and if the fee has to be condemned, the awards have been substantially higher than the government's estimate of value.

It is Corps policy to permit the owners to recover natural resources, crops, timber and removable improvements not required for project purposes and efforts are made to permit this at no cost to the United States. Owners are permitted to remain in possession to accomplish this whenever and whereever possible. A substantial cost in producing oil from a filled reservoir is the cost of modifying production equipment to operate under project conditions. The payment for the subordination agreement includes this type of costs. Further, the conversion of production methods, drilling of new wells and the institution of water flooding operations also requires the investment of considerable capital. Thus, continued production under subordination agreements is not accomplished without cost by the operator.

Differences of considerable magnitude exist between mineral properties; some can be produced profitably under project conditions while others cannot. Some producing properties have continued to produce well beyond the estimate of reserves while others have not. Each has to be approached individually.

The Chief of Engineers has this matter under study and will prepare and modify instructions designed to preclude windfall benefits in connection with the acquisition and subordination of mineral rights at water resources projects.

This opportunity to comment on the draft report is appreciated.

Sincerely yours,

Alfred B. Fitt

Alfred B. Fitt
Special Assistant (Civil Functions)