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# Federal Oil and Gas Royalties

Statement of
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House Committee on Interior and Insular Affairs

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the Department of the Interior's procedures for collecting and accounting for oil and gas royalties due the federal government, states, and Indian tribes and allottees.[1]

In the past 30 years, numerous GAO and Department of the Interior audit reports and a blue ribbon study commission, commonly referred to as the Linowes Commission, have addressed the need for Interior to correct the long-standing management problems that have plagued its oil and gas royalty management program. The Congress has also called for improvements during numerous oversight hearings and reports. For instance, a comprehensive report by the House Committee on Interior and Insular Affairs in December 1984 highlighted serious continuing royalty management problems facing the department and presented a series of recommendations to correct those problems.

The department has put forth major efforts over a number of years to improve its performance in this difficult and complex area. However, it continues to experience serious difficulties in the following critical areas:

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1An Indian allottee is an individual who receives a royalty payment.

--developing and publishing acceptable product valuation guidance,

-- implementing an effective accounting system for royalty collections and distributions,

-- verifying production through a viable lease inspection program, and

-- establishing an adequate auditing program to check on the accuracy and completeness of the industry's royalty payments.

Before proceeding further, I would like to point out that our current assessment is based primarily on a monitoring effort which we are performing at the request of the Chairman of the House Committee on Interior and Insular Affairs and work for the Chairman of the House Appropriations Interior and Related agencies. These efforts have not included any system or transaction testing or other in-depth work.

## OVERVIEW OF THE EXISTING SYSTEM

Following the issuance of the Linowes Commission report in 1982, Interior established the Minerals Management Service (MMS) to administer the royalty management program and to ensure that the proper amount of royalties is being collected. While MMS has the primary responsibility for royalty management, the Bureau of Land Management and the Bureau of Indian Affairs have certain responsibilities regarding leasing, site inspection, and disbursement of royalties to Indian tribes and allottees.

Royalty accounting is complex by nature. Royalties are not paid on the basis of production but on sales, typically after the product has been processed. The fact that a number of companies are often on one lease further complicates the process. At the time of sale, the industry establishes a value which takes into account processing and transportation allowances and the market price for the product. The royalty is then computed and paid by the company.

Tracking production and verifying the royalty calculation through this maze is difficult. Also, industry-calculated payments are accepted as correct unless MMS determines otherwise through its accounting system and audits.

As an illustration:

-- Oil or gas is pumped out of the ground at the wellhead and the leasing companies report production volume to the department.

-- The oil or gas is transported to a processing plant, creating a transportation cost allowance which is calculated by the industry and can vary from lease to lease.

-- After the oil or gas is processed, the industry calculates a processing cost allowance which can vary based on the plant involved and the quality of oil or gas.

-- The finished product is sold.

-- The industry calculates the value of the finished product, taking into account transportation and processing cost allowances as well as the market price for the product, and computes its royalty payment.

-- The industry reports the sale of its finished product and sends the royalty to MMS.

-- MMS accepts the payment and disburses royalties to the respective states or the Bureau of Indian Affairs.

-- MMS relies primarily on audits to identify underpayments.

## LACK OF ACCEPTABLE PRODUCT VALUATION REGULATION

A continuing problem is determining the proper value of oil and gas for purposes of calculating royalties. The Linowes Commission reported in 1982 that improper valuation was the primary factor for royalty underpayments. Also, valuation problems account for about $110 million of the $261 million in underpayments identified through MMS audits between October 1981 and August 1986.

Existing valuation regulations are complex and subject to varying interpretations. Most audit exceptions to royalty calculations by the industry are due to differing interpretations of the regulations, which can end up in litigation.

Proposed revisions to Interior's valuation regulations, including NTL-5, are unlikely to resolve the complexity of valuation issues. In addition, the revisions may not be agreeable to states and Indian tribes and allottees who will receive reduced royalty payments under the proposed industry cost allowances.

LONG-STANDING SYSTEM PROBLEMS
PRECLUDE ADEQUATE ROYALTY ACCOUNTING

The development of an adequate accounting system also continues to be a serious problem. We first reported in 1959 that Interior did not have an adequate royalty accounting system. Unverified data were used to compute royalties, and lease records contained numerous errors and omissions.

In 1979, faced with both growing criticism of its inability to adequately account for royalty payments as well as reports that millions of dollars of royalties were not being collected, the department began developing a new automated royalty accounting system, called the Auditing and Financial System. This system is the primary vehicle used by MMS today to collect, account for, and disburse oil and gas royalties received from the about 25,000 producing leases.

In January 1983, we issued a report[2] to the Secretary recommending that the system not be implemented on February 1, 1983, as planned, because of inadequate system documentation, unclear user requirements, inadequate testing, and other unresolved problems. However, the department went ahead with its

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[2] Interior Should Solve Its Royalty Accounting Problems Before Implementing New Accounting System (GAO/AFMD-83-43; January 27, 1983).

plan to implement the system, without first resolving these matters. Since then, the system has experienced numerous problems which, for the most part, can be traced to inadequate computer capacity. Because of its inadequate capacity, the system cannot process the accounting data or produce reports necessary to ensure that the proper amount of royalties has been paid.

In April 1985, MMS contracted for the conversion of the system to a larger computer. The conversion, originally slated for December 1985, has slipped to July of this year. After conversion, we believe MMS should further enhance the system so that it better satisfies information needs of the federal government, states, Indian tribes and allottees, and the industry.

## INSUFFICIENT VERIFICATION OF PRODUCTION

To assist in verifying royalty payments, the accounting system should compare industry reports of oil and gas production from leased fields with industry data on sales volume that are subsequently reported at the time the royalty is paid. However, the department is unable to effectively verify royalty payments for the about 23,000 onshore leases[3] because it does not have a

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[3]There are about 2,000 offshore leases.

system in place to make the necessary comparison between production and sales volume.

A principal problem has been the complexity of such a system and the accompanying costs and paperwork burden it would place on the oil and gas industry. The House Committee on Interior and Insular Affairs, in its 1984 report, advised MMS to reassess its requirements before proceeding with full-scale implementation of such a system. To date, MMS has not been able to resolve the concerns raised.

Another problem with verifying royalty payments is the insufficient number of Interior field inspectors who must monitor production in the leased fields. For example, the Bureau of Land Management has about 100 inspectors who monitor the about 23,000 producing leases and about 100,000 nonproducing leases. These inspectors also have collateral duties to protect the environment and to monitor security and safety.

## AUDIT RESOURCES ARE INADEQUATE

The Department of the Interior also does not have enough auditors to verify the accuracy and completeness of the industry's royalty payments.

Although auditing is the principal internal control, MMS only has about 175 auditors to review the 25,000 producing leases. The Director of MMS has mandated that each lease will be audited at least once every 6 years. Under the most optimistic circumstances, this work load will only allow each auditor about 2 weeks to review a lease, which requires examination of leasing agreements, contract provisions, accumulation and allocation of processing costs, product valuation, and royalty calculations.

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In conclusion, the department has worked hard to strengthen royalty management. While there has been progress, problems remain. This effort must continue to receive a high priority, including necessary funding for accounting systems development, inspection, and auditing.

In addition, the department must search for solutions to some of the fundamental accountability problems we have outlined today. New approaches to simplify the process should be explored since determining the proper royalty at the point of sale and the related accounting have been continuing problems. We stand ready to work with the Congress and the department in this endeavor.

Mr. Chairman, this concludes my remarks. We would be pleased to respond to any questions you or members of the Subcommittee may have at this time.