

Testimony of Senators Bob Kerrey and Jake Garn  
Co-Chairmen, Subcommittee on Royalty Management  
Before the  
Committee on Natural Resources  
Subcommittee on Energy and Mineral Resources  
U. S. House of Representatives  
March 11, 2008

The Subcommittee on Royalty Management was established by the Secretary of the Interior, Dirk Kempthorne, in March 2007. It was created as a consequence of concerns about lapses in ethical behavior and inadequacies in lease issuance, royalty collection, and auditing. These concerns have been expressed by the Congress and by the Department's Inspector General who has investigated allegations of ethical lapses of personnel in the royalty in kind (RIK) program.

As co-chairmen of this Subcommittee, we are pleased to provide this statement on the Subcommittee's report entitled "Mineral Revenue Collection from Federal and Indian Lands and the Outer Continental Shelf." The report was released on December 17, 2007, and is the result of nine months of data gathering and analysis by the Subcommittee. It presents a comprehensive analysis of the federal mineral resource management program in the Department of the Interior. The program is a major source of revenue to the U. S. Treasury, with revenues in excess of \$11 billion in 2007.

The Subcommittee members conducted an independent evaluation of the revenue collection and royalty management program within the Department of the Interior. In addition to ourselves, the Subcommittee includes an impressive group of professionals: David Deal, our vice chairman, an oil and gas expert, and a member of the Royalty Policy Committee to whom the Subcommittee reports; Cynthia Lummis, a former Treasurer of the State of Wyoming.; Mario Reyes, a professor of finance at the University of Idaho; Perry Shirley, the Assistant Director for the Minerals Department of the Navajo Nation; and Bob Wenzel, a former Deputy Commissioner for the Internal Revenue Service (IRS).

The companies who lease the right to explore for and develop minerals on federal lands and offshore waters pay royalties on the minerals extracted from those lands and waters. Those royalties are either paid in cash, which is known as royalty in value, or in product, which is known as royalty in kind. The royalty in kind program has been quite cost effective, especially for natural gas production, and the program is expected to continue to grow. The Minerals Management Service (MMS) does not stockpile product "paid" through the RIK program. Rather, it sells the product through a closed bid auction procedure. We believe the RIK program is an extremely important component of the royalty management program and the RIK recommendations in the report are geared toward ensuring the program's survival.

The Subcommittee's report makes over 100 recommendations for improvements in the mineral resource management program. Most of these recommendations can be

implemented administratively. Many can be done quickly. Some will require long term effort and continued vigilance. A few of the recommendations depend upon legislative action. The Federal employees who work in the mineral leasing and royalty collection program are conscientious, hard working, and concerned about the reputation of the program and of the Department of the Interior. We believe that implementing the recommendations in this report will greatly strengthen the management of the program, will restore public confidence, and will ensure maximum value for the U.S. taxpayer.

We support all the Subcommittee's recommendations. However, for the balance of this testimony, we focus on a limited number of recommendations in 10 key areas that we believe are critical to ensure continued improvements in the program. Most of the recommendations will require some additional resources from the House and Senate Committees on Appropriations. A relatively modest increase in appropriations should yield increased revenues that more than offset the additional funding.

1. Over the past few years, MMS has relied more heavily on compliance reviews rather than full audits of industry royalty payments for production on federal lands and offshore waters. It appears that the increased reliance on compliance reviews has been based on funding and personnel constraints rather than on documented data on benefits and risks. MMS needs to establish an auditing and compliance program that includes an appropriate balance of audits and compliance reviews, and the program needs to be based on reliable data.

Specifically, MMS should implement a risk-based strategy for identifying companies and properties for audits and compliance reviews. This effort will require developing, testing, and refining various strategies over the next several years. While this will be an evolving process, and MMS is instituting a pilot program in this area, MMS needs to take aggressive action to establish an initial program over the short term. MMS should work with the IRS to benefit from the lessons IRS has learned in this area over the years.

2. We believe that one recommendation, which requires legislative action, deserves very serious consideration by the Congress. We recommend that MMS explore the feasibility of establishing an interest-bearing trust fund within the Treasury. Interest from this fund could be used to fund Department of the Interior activities; primarily, but not necessarily limited to, royalty management activities.
3. The Department of the Interior should strengthen and emphasize ethics training for all staff involved in royalty management. Training should include guidance on appropriate interaction with the private sector, prohibitions on the use of public office for private gain, and the handling of official and proprietary information.
4. In addition to MMS, the Bureau of Land Management (BLM) and the Bureau of Indian Affairs (BIA) play significant roles in onshore royalty management. Program improvements in these bureaus are needed, as is better coordination among MMS, BLM, and BIA. In particular, improved communication and

5. BLM has difficulty recruiting and retaining Petroleum Engineering Technicians and Petroleum Accountability Technicians. The number of Mining Engineers is also inadequate. The salaries for these positions need to be reviewed and training programs need to be improved. Also, the total number of positions needed should be determined based on workload in individual BLM field offices. For example, production accountability reviews are critical for accurate revenue collection. However, in 2006, BLM had only 20 Petroleum Accountability Technicians (PATs) nationwide and nineteen of the thirty-one BLM field offices with oil and gas responsibilities employed no PATs.

Emphasis within BLM over the past several years has been on increased funding for the “front end” of the program: namely, additional leasing and processing of applications of permits to drill. As the program has expanded, there has not been sufficient attention to funding the workload associated with the “back end” of the process: namely, increased collections, production accountability, and auditing requirements.

6. The Indian oil valuation rule has been languishing within the Department of the Interior for more than 10 years. Indian Tribes are understandably frustrated by the delay. The Subcommittee believes that the Department should immediately finalize its “technical changes” to the Indian oil valuation rule and, by June 2008, MMS should propose a rule that values Indian oil based on a market index as is done for production from federal oil leases and from Indian gas leases.
7. Improved oversight of the mineral revenue collection program is essential to ensure the problems that generated so much concern in the past are not repeated and new problems in the future are avoided. Therefore, we recommend the establishment of an RIK Subcommittee to the Royalty Policy Committee. The RIK Subcommittee should address such issues as performance benchmarks, volume verification, and market positioning. We also recommend the establishment of a Coordinating Committee, comprised of senior management officials in MMS, BLM, and BIA, to ensure that recommended improvements are implemented in these bureaus.
8. The skills necessary to administer the RIK program are not typical for a government agency. RIK is basically an oil and gas marketing operation. The Subcommittee recommends that issues associated with hiring and maintaining staff with industry expertise and dedicated legal support should be addressed in the RIK program. Also, MMS should evaluate the benefits and costs of alternative auction types and should develop a pilot program to test alternatives

that could improve net returns.

9. We recommend eliminating programs that are no longer cost effective or large enough to support their continuation. These include the onshore RIK crude oil program and the small refiners' set-aside RIK program. Market conditions in the future may be conducive to reinstating these programs but such is not the case today.
10. The Subcommittee's charter did not include a review of the situation surrounding the offshore oil and gas leases in the Gulf of Mexico issued in 1998 and 1999 without price thresholds. However, towards the end of our review, we were asked by the Assistant Secretary for Land and Minerals Management, Steven Allred, to comment on offshore lease issuance procedures enumerated in a February 2007 memorandum to him from Secretary Kempthorne.

Our recommendations are that the Department continue its efforts to pursue voluntary royalty payment agreements with holders of the leases; that Congress and the Secretary continue to explore legislative options that would address the loss of royalties without violating legitimately signed contracts; and that MMS and the Office of the Solicitor develop procedures and guidelines to ensure effective implementation of the 8 enumerated items in the memorandum within 60 days of release of the Subcommittee's report.

Thank you for the opportunity to provide this testimony. We look forward to working with you to improve this important program.