Federal Royalty Management on Federal Onshore and Indian Lands: Industry Concerns

R. Carol Harvey

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FEDERAL ROYALTY MANAGEMENT
ON FEDERAL ONSHORE AND
INDIAN LANDS: INDUSTRY CONCERNS

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PUBLIC LANDS MINERAL
LEASING: ISSUES AND
DIRECTIONS

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I. Historical Perspective on Royalty Management on Federal Onshore and Indian Tribal and Allotted Lands.

A. From 1942-1982, financial management for oil and gas royalty accounting for production from federal and Indian leases was handled by the Conservation Division of the United States Geological Survey, Department of the Interior. (The Minerals Management Service of the Department of the Interior is currently auditing federal onshore, offshore, and Indian leases retroactively six years (e.g., 1977-1983) so the period of control by the Conservation Division is critical to the audit.)

1. This authority for financial management was derived from the statutory authority vested in the Department of the Interior by Congress to oversee the management and development of mineral resources on federal and Indian lands.

   a. These statutory authorities included the following:


2. These authorities are applicable to Minerals Management Service as well.

B. Under the regulations implementing these statutes, the Conservation Division invoiced
for, collected, accounted and audited for, and
distributed royalties from oil and gas
production from federal and Indian lands.

1. States receive 50% of collected royalties
for production from federal lands within
their borders, with the exception of
Alaska which receives 90%.

2. Indian tribes and individual Indian
allottees receive all collected royalties
for production from their lands.

C. The cites to the federal regulations governing
royalty management on federal lands during the
tenure of the Conservation Division are set
forth in Appendix A hereto.

D. The cites to the federal regulations governing
royalty management on Indian tribal and
allotted lands during the jurisdiction of the
Conservation Division are listed in Appendix B
hereto.

E. Federal onshore royalty lease terms provide
for the following, in general:
1. The lessee is required to pay royalty in kind or in value. The Lessor has the option to take its share of production in kind; otherwise, the royalty is paid in value.

2. The Lessee is required to pay the Lessor a royalty which is a percentage of the amount, or the value, of the production removed or sold from the lease, computed in accordance with the royalty regulations, which are not inconsistent with any specific lease provisions.

3. The Secretary of the Interior may establish reasonable minimum values for purposes of computing royalty on production. In doing so, the Secretary will give due consideration to:
   
a. the highest price paid for a part or for a majority of production of like quality in the same field;

   b. the price received by the Lessee;

   c. to posted prices;
d. other relevant matters; and

e. whenever appropriate, notice and an opportunity to be heard shall be available to the Lessee.

(30 C.F.R. §221.47).

F. In general, Indian royalty lease terms provide as follows:

1. The Lessee will pay royalty in kind or value. The Lessor has the option to take its royalty share of production in kind; otherwise, the royalty is paid in value.

(25 C.F.R. §211.13).

2. The Lessor's royalty is a percentage of the value or amount of all oil, gas, natural gasoline, and hydrocarbon substances produced and saved from the lease. (25 C.F.R. §211.13).

3. During the period of supervision, value for royalty purposes may, in the Secretary's discretion, be calculated by considering:
a. the highest price paid or offered at the time of production for the major portion of the production of like quality produced and sold from the field; and

b. the actual volume of the marketable product, less the entrained foreign substances (25 C.F.R. §211.13).

4. In determining value, the Secretary, in his discretion, may deem the actual amount realized by the Lessee from the sale of production as either mere evidence of or conclusive evidence of the value of such production (25 C.F.R. §211.13).

5. When products, such as natural gasoline, are derived from the treatment of gas, a reasonable allowance for the cost of manufacture shall be made. Unless the Secretary makes a determination to the contrary, the manufacturing allowance shall be 2/3 of the value of the marketable product (25 C.F.R. §211.13).
6. The royalty on gas, casinghead gas, or the products thereof (i.e. residue gas, natural gasoline, propane, butane, etc.) will be computed on the greater of either (1) the value of the gas or casinghead gas, or (2) the value of the products thereof (25 C.F.R. §211.13).

G. The Conservation Division also promulgated several relevant Notice's to Lessees concerning royalty obligations:

1. Notice's to Lessees


b. NTL-1A NOTICE TO LESSEES AND OPERATORS OF INDIAN OIL AND GAS LEASES (NTL-1A) PROCEDURES FOR REPORTING AND ACCOUNTING FOR
c. NTL-4

NOTICE TO LESSEES AND OPERATORS OF ONSHORE FEDERAL AND INDIAN OIL AND GAS LEASES, ROYALTY PAYMENT ON OIL AND GAS LOST (Effective Dec. 1, 1974)

d. NTL-4A

NTL-4 WAS REVOKED AND SUPERCEDED BY NTL-4A, ROYALTY OR COMPENSATION FOR OIL AND GAS LOST; REVOCA TION OF CERTAIN PROVISIONS CONTAINED IN NOTICES TO LESSEES AND OPERATORS (NTL-4A), 44 Fed. Reg. 76600 (Dec. 27, 1979).

NTL-4 was revoked as a result of the decisions in Marathon Oil Co. v. Andrus, 452 F. Supp. 548 (D. Wyo. 1978) and Gulf Oil Corp. v. Andrus, 460 F. Supp. 15 (C.D. Cal. 1978). These
cases held that NTL-4 which required the payment of royalty on oil and gas which was unavoidably lost or used in lease or production operations was arbitrary, capricious, and an abuse of discretion by the Secretary.


H. The Conservation Division also published internal procedures in its Department of the Interior, Geological Survey, Conservation
Division Manual. This manual is a critical resource tool due to the current retroactive Minerals Management Service audit.

I. During the tenure of the Conservation Division, the primary disputed royalty issues on federal onshore and Indian leases concerned treating and marketing costs, and whether tax reimbursements constituted part of gross proceeds, as evidenced by cases litigated within the Department of the Interior's Board of Land Appeals and appealed to the federal courts. Costs for gathering, compression, and dehydration on federal onshore leases were held to be nondeductible costs from the lessor's royalty share. [See The Texas Co., 64 I.D. 76 (1957); Placid Oil Company, GS-28-O&G (May 4, 1962); Big Piney Oil and Gas Co., A-29895 (July 27, 1964).] The federal onshore lessee was obligated to place production in marketable condition at no cost to the lessor, with the exception where processing or manufacturing costs were incurred which were chargeable against the royalty share. [See California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961).] Tax reimbursements to the lessee by a purchaser, for services due the lessor, were considered part of gross


A. Commencing in 1959 and culminating in the early eighties, General Accounting Office and Department of the Interior audit reports criticized the ongoing U.S.G.S. Conservation Division's royalty management program. See Report by the Comptroller General of the United States, "Oil and Gas Royalty Collections - Serious Financial Management Problems Need Congressional Attention", April 13, 1979. See Report by the Comptroller General of the United States, "Oil and Gas Royalty
B. In 1978, the Chief of the Conservation Division appointed an Improved Royalty Management Task Force to study the problems concerning royalty management.

1. Their report recommended the following:

   a. The existing Royalty Accounting System ("RAS") be replaced by modern computerized accounting systems for both financial and production accounting;

   b. The existing organizational structure, placing royalty accounting and auditing functions in the Conservation Division field offices, be abolished, and the functions be centralized in a single location, preferably Denver, Colorado;

   c. A separate organizational structure be created within the Conservation
Division headed by a Deputy Division Chief for Royalty Management;

d. The royalty management program include a comprehensive audit capacity which would be available on a full-time basis for the audit of royalty payment compliance matters; and

e. Accounting be established on a payor basis rather than at the lease level so that each individual or company responsible for paying royalties would have its own account. [Staff of the Committee on Interior and Insular Affairs of the U.S. House of Representatives with the Assistance of the General Accounting Office, FEDERAL MINERALS ROYALTY MANAGEMENT, AN ANALYSIS OF PROBLEM AREAS RELATED TO THE MANAGEMENT OF THE FEDERAL MINERALS ROYALTY MANAGEMENT PROGRAM BY THE MINERALS MANAGEMENT SERVICE OF THE DEPARTMENT OF THE INTERIOR, WITH RECOMMENDED SOLUTIONS,
2. The Task Force Report was the basis for the following policy decisions:

a. All royalty management activities would be located in a single royalty accounting center—the Federal Center in Lakewood, Colorado was subsequently designated;

b. A contract would be let to design a new royalty accounting system utilizing sophisticated "state of the art" computerized accounting techniques with strong internal controls;

c. The system would be on a payor subaccount basis with each payor having its own reporting and paying responsibility; and

d. The system would be based on traditional revenue accounting system principles and would be on an
exception basis similar to that used by the Internal Revenue Service. All data would be considered valid and accepted unless rejected by a highly sophisticated series of system edits and tolerances. (Interior Committee Report, p. 8).

3. Based on the DOI Task Force policy decisions, the design and development of a new royalty system was undertaken.


C. In July 1981, the Secretary of the Interior also appointed the Commission on Fiscal Accountability of the Nation's Energy Resources (commonly referred to as the Linowes Commission for its Chairman, David F. Linowes) as a response to reports and media allegations
of theft of oil and under-reporting of royalties owed for production from federal and Indian lands.

1. The Commission's tasks were as follows:

a. To examine the allegations of massive irregularities in royalties on the Nation's energy resources which are owed to the Federal government, Indian tribes, and States;

b. To investigate the allegations of theft of oil from Federal and Indian lands; and


2. Their report, issued on January 21, 1982, based on interviews with representatives from Congress, the government, industry,
tribes, states and the public made some 60 recommendations for improving royalty management, which included the following:

a. Removal of the royalty management function from the United States Geological Survey to a separate office. USGS, according to the Commission, lacked the active, sophisticated management necessary to run a royalty management system.

b. Cooperation by the federal government, states, and Indian tribes, sharing both information and specific tasks, such as auditing and site inspection.

c. Performance of an oversight role by the federal government in cross-checks of payment of royalties and imposition of meaningful penalties for false statements or gross errors.

d. Placing the burden on lessees, not the federal government, to assure

A. The basis for the present Minerals Management Service royalty management program is the Federal Oil and Gas Royalty Management Act of 1982 ("FOGRMA") which in summary form provides as follows:


2. Applies to federal offshore and onshore and Indian leases. [30 U.S.C. §1701 (a)].

3. Secretary's duties:
a. Establish comprehensive royalty management system. [30 U.S.C. §1711 (a)].

b. Provide for annual inspection of lease sites with significant production or where operator has history of noncompliance. [30 U.S.C. §1711 (b)].

c. Audit and reconcile to extent practicable all current and past lease accounts. [30 U.S.C. §1711 (c)].

d. Charge interest on late payments or underpayments (30 U.S.C. §1721).

4. Lessee's duties:

a. Make royalty and other payments required under federal and Indian leases in time and manner specified by Secretary. [30 U.S.C. §1712 (a)].
b. Notify the Secretary of any assignment by the payor of the obligation to make royalty or other payments. [30 U.S.C. §1712 (a)].

c. Develop minimum site security measures to protect oil or gas from theft. [30 U.S.C. §1712 (b)].

d. Notify the Secretary within five business days that well has begun or resumed production. [30 U.S.C. §1712 (b) (3)].

e. Maintain records, make reports and provide any information the Secretary may by rule reasonably require. Such records, reports or information shall be made available for inspection and duplication by Secretary or his designee, and shall be maintained for six years (or longer if audit is underway). (30 U.S.C. §1713).
f. To pay royalty on oil or gas negligently lost or wasted from a lease site. (30 U.S.C. §1756).

5. Procedures:

a. Rulemaking: Secretary must use informal rulemaking procedures (notice and written comment), and may not waive same under the exemption of the Administrative Procedure Act. [30 U.S.C. §1751 (b)].

b. Investigations: Secretary may conduct any investigation or inquiry, and after notice, any hearing or audit (30 U.S.C. §1717):

i. May require submission of affidavits;

ii. Has subpoena power;

iii. May take depositions.

c. Inspections: Secretary may enter upon and inspect lease sites without
advance notice and may obtain immediate access from operator to secured facilities on lease sites. (30 U.S.C. §1718).


a. Secretary may enter into cooperative agreements with states or Indian tribes to carry out inspection, auditing, investigation or enforcement activities under FOGRMA.

b. States or Indian tribes which are party to a cooperative agreement shall have access to royalty accounting information.

7. Secretary may delegate inspection, audit and investigation duties to states. (30 U.S.C. §1735).


10. Contains no royalty valuation requirements.


A. On January 19, 1982, Secretary Watt abolished the Conservation Division and transferred royalty management functions to MMS. [United States Department of the Interior, Office of the Secretary, Order No. 3071 (Jan. 19, 1982)].

B. On December 8, 1982, Secretary Watt transferred all financial management activities associated with federal onshore and Indian mineral leasing to MMS. [United States Department of the Interior, Office of the Secretary, Order No. 3087, Organizational Restructuring of the Department of the Interior Minerals Management Functions (Dec. 3, 1982)].
C. MMS responsibilities include the accounting for, collection, distribution, and auditing oversight of:

1. Royalty payments;
2. Bonuses;
3. Rentals;
4. Royalties-in-kind;
5. Other revenues from the leasing and extraction of minerals from federal and Indian leases.

D. MMS came into being in the spotlight of media allegations of rampant theft and underpayments. To counteract these allegations, it has implemented a comprehensive and controversial royalty management program, not without substantial problems to lessees and producers.

E. This program is and will be impacted by the following factors:

1. Media publicity;
2. Pressure from states and tribes for royalty accountability;
3. Congressional oversight activities;
4. Industry lobbying for reasonable regulatory and audit activities;
5. Public sentiment;
6. Numerous administrative appeals; and
7. Ongoing litigation.

F. The extreme allegations of theft and under-payment of royalties contained in the Linowes Commission Report have not been substantiated to the extent thought to exist.

V. Minerals Management Service's Regulatory Activities.

A. Design and implementation of the Auditing and Financial System ("AFS").

1. To process, account for, collect, and distribute royalty payments.


B. Design and testing of the Production Accounting and Auditing System ("PAAS").

1. PAAS will track, based upon production reports submitted by lease and facility operators, all production from Federal and Indian lands from the source of production to the point of disposition, with emphasis on the point of royalty determination. Peter A. Rutledge, Production Accounting and Auditing System, Paper Presented at The Oil Daily Forum on Federal Royalty Management, April 24, 1984.

2. With the information required by operators regarding sales volumes and qualities, the PAAS will automatically determine whether the proper volumes and qualities have been reported to the Auditing and Financial System (AFS) by those parties responsible for the payment of royalties (Id.)

4. PAAS is currently in a pilot testing phase by 14 companies involving approximately 850 leases and agreements and 6,000 wells.

5. PAAS interfaces with AFS to determine if royalties are being properly paid.

6. The interface of AFS and PAAS has not been implemented or fully tested.

   a. Modifications to PAAS have been issued: PAAS Alerts I and II.

7. Audit exceptions will be generated when there are discrepancies between the AFS and PAAS data.
a. AFS is on a 30 day reporting cycle;
b. PAAS is on a 45 day cycle;
c. It is uncertain whether the comparison of AFS-PAAS data will be made on a 90 or 180 day basis or 6 months.

8. Audit exceptions will be reviewed by MMS's Royalty Compliance Division.

9. PAAS is an extremely complex system requiring a number of reports. (See Appendix D for a listing of PAAS Parts and reports.)

C. MMS issued NTL-7 to address site-security concerns in the removal of crude oil from federal and Indian leases. [NTL-7: Notice to Lessees and Operators of Onshore Federal and Indian Oil and Gas Leases (NTL) Removal of Crude Oil from Federal and Indian Oil and Gas Leases by Means Other Than An Approved Lease Automatic Custody Transfer System. 47 Fed. Reg. 20762 (May 4, 1982); for historical purposes see Interim NTL-7 at 46 Fed. Reg. 45695 (Sep. 14, 1981)].
D. MMS has considered implementing single payor and operator of record regulations.

1. On June 21, 1982, MMS issued notice of its intention to propose a rulemaking requiring an operator of record for each federal mineral lease and a single payor of royalties for each such lease. 47 Fed. Reg. 26856 (June 22, 1982). The "operator of record" would be responsible for "maintaining all lease production and sales records" and for maintaining site security. 47 Fed. Reg. at 26856. The payor of record would be responsible for all royalty and rental payments on a lease basis.


3. This issue was reborn on December 6, 1984 when MMS issued its notice of intent to require a single payor for each federal
and Indian lease. 49 Fed. Reg. 47624 (Dec. 6, 1984). Industry has again opposed this single payor requirement due to substantial administrative, accounting, economic and legal problems. No further notice has been issued on this matter.

E. MMS updated and redesignated the U.S.G.S. royalty regulations, segregating royalty matters from operational matters. 47 Fed. Reg. 47758 (Oct. 27, 1982). No substantive changes were made in the royalty regulations. See Appendix E for a listing of the redesignated regulations. FOGRMA did not contain royalty valuation requirements.

F. MMS has proposed guidelines for royalty valuation, not yet issued in proposed rule-making procedures, in response to recommendations of the Linowes Commission. The Commission urged that valuation guidelines be issued to aid royalty payors in determining how to value production for royalty purposes. The most difficult area is where the production is used internally without a sale.


G. The principle behind MMS's Valuation Guidelines has been expressed as follows:

1. "A key principle of the valuation process for natural gas under the guidelines now under final review within the Department is that gross proceeds determined under the terms of a freely negotiated arm's-length contract would be the determining value upon which royalties are calculated."

(Mr. David C. Russell, Acting Director, MMS, in his testimony before the House Committee on Energy and Commerce, Subcommittee on Fossil and Synthetic Fuels).

2. For gas sales for which there is not an arm's-length contract or a sale, such as an intracompany use of the oil, gas, or gas products, benchmarks will be established for comparison purposes in establishing a royalty value.

3. The benchmarks proposed by MMS for consideration in non-arm's length situations, to determine whether payments
represent fair market value, for royalty purposes, are the following (Draft Federal Gas Guidelines at pp. 27, 28):

a. The price received by the Lessee;

b. Prices being paid under contracts negotiated at a similar point in time, for a part, or for a majority, of similar-sized sales quantities of like-quality of Gases and/or Gas Products from the same Field or Area;

c. Other reasonable prices available to the Lessee from buyers capable of offering a stable and secure long-term (and, in the case of "spot" sales, an adequate short-term) market for a quantity of Gases and/or Gas Products as large as that being offered for sale by the Lessee;

d. Efforts made by the Lessee to obtain a higher price;
e. Published Natural Gas Policy Act (NGPA) ceiling prices;

f. The reasonable cost to the Lessee for transporting the royalty share of gas and/or Gas Products to a point of sale remote from the Lease;

g. The reasonable cost to the Lessee for processing Gas Products from the royalty share of gas produced from the Lease;

h. General market conditions, fluctuations in supply and demand, and the salability of certain types of gases and/or Gas Products;

i. Other relevant matters;

j. Gross proceeds accruing, or which could accrue, to the Lessee. . . ."

4. The draft proposed Indian gas valuation guidelines when issued were based on the concept of dual-accounting which is
currently in litigation. See Appendix F for a definition of dual accounting.

a. Jicarille Apache Tribe v. Supron Energy Corp., 687 F.2d 13294 (10th Cir. 1982), rehearing granted Mar. 30, 1984. The Tenth Circuit Court of Appeals ruled in Supron that dual-accounting is required for gas production when wet gas is processed and the lessee owns the processing plant or realizes direct income from the sale of the productions. The Court further ruled that the New Mexico Natural Gas Pricing Act is applicable to gas production on Indian lands. Dual accounting requires the lessee to pay royalty based on the highest of the following: the Btu value at the wellhead, the net realization value from residue gas and gas products less manufacturing costs, or gross proceeds received by the lessee. The plaintiffs in Supron have asked, and been granted, a rehearing en banc by the Tenth Circuit.
No. CIV-76-430-P (D.N.M.);


H. Proposed guidelines are planned for processing allowances and transportation allowances.

I. MMS promulgated regulations implementing FOGRMA [49 Fed. Reg. 37336 (Sep. 21, 1984)] which generally track the statutory requirements, with the following exceptions:

1. 30 C.F.R. §218.52(b) allows MMS to designate a single payor on any lease;

2. 30 C.F.R. §218.56 allows MMS to assess a $10.00 per day per line item penalty for late or incorrect reports. Considering a major royalty payor may report up to 6200 line items on a monthly basis this could be a significant penalty.
J. State audit delegation regulations (30 C.F.R. Part 229) have been issued allowing states to audit federal onshore leases within state borders following administrative hearings in those states requesting auditing authority. [Interim rule at 49 Fed. Reg. 40024 (Oct. 12, 1984); notice of hearings at 49 Fed. Reg. 40107 (Oct. 12, 1984); final rule at 50 Fed. Reg. 2663 (Jan. 18, 1985).]

K. MMS notified royalty payors by letter, dated October 24, 1984, that it intends to use its FOGRMA penalty authority.

L. MMS is considering a rulemaking requiring direct payment by lessees of rentals, royalties, and other monies payable to Indian allottees. 50 Fed. Reg. 6362 (Feb. 15, 1985).

M. As part of its ongoing audit activities the following Minerals Management Service Procedure Paper has been drafted, though not published for notice and comment under the Administrative Procedure Act:

Minerals Management Service Royalty Valuation and Standards Division Royalty Compliance
N. MMS is considering regulations which would prohibit a lessee from acquiring oil and gas leases if in noncompliance with royalty requirements.

VI. Industry's Regulatory Concerns.

A. Fair, reasonable, practical, and understandable reporting regulations are needed with uniform, consistent and equitable enforcement.

B. AFS and PAAS were designed prior to industry input and are difficult systems to change.

C. AFS and PAAS may be imposed despite industry concerns due to the substantial federal investment in these systems.

D. Piecemeal transition from RAS to AFS/PAAS has been extremely difficult. Any piecemeal approach in implementing AFS/PAAS should be
avoided. It is costly and fraught with accounting, auditing, and legal difficulties.

E. AFS is too complex and costly; interface with PAAS has not been fully tested; implemented without APA compliance.

F. PAAS is too complex, costly, impractical, and may yield misleading data.

G. Single payor requirement would be costly to industry and would involve questionable anti-trust issues.

H. Product Valuation Guidelines are needed so that payors know what is required for royalty compliance. The royalty basis should be gross proceeds received by lessee since that is the best market indicator of value.

I. Direct payment to Indian allottees would be burdensome and costly and should be handled by the Bureau of Indian Affairs which maintains title records and has title expertise.

J. Costs of compliance are too high.
K. Manpower requirements are excessive.

VII. Office of Inspector General ("OIG") Audit Activities.


B. The OIG is auditing major royalty payors on federal leases for royalty payments made for the past six years. (See Appendix G for one such example.)

C. OIG audit procedures:

1. No published OIG audit and enforcement procedures.

2. Records are requested of royalty payor.

3. Records are audited by OIG or contract auditors.

5. Draft audit report submitted to payor for review and comment.

6. Final audit report issued after receipt of payor's comments.

7. OIG decides to recommend to MMS to assess, not assess, or modify liability.

8. No appeal by royalty payor to final OIG audit report.

9. MMS conducts any further audit activities.

10. OIG final audit report may be released to public under Freedom of Information Act.

D. Potential for inconsistent audit royalty valuation interpretations between MMS and OIG exists.

1. The Assistant Inspector General for Auditing stated that:

"We do not disagree that the potential for inconsistent agency audit procedures exists. The risk of inconsistency is a disadvantage
which an organization accepts in return for the advantages achieved by segregating related duties organizationally and geographically. However, both the OIG and MMS follow procedures which are intended to minimize the risk of inconsistencies."


VIII. Minerals Management Service's Audit Activities.

A. MMS is conducting resident audits of a number of large royalty payors.

1. MMS auditors are assigned to a particular company.

2. MMS auditors are housed in company's offices.

B. MMS's audit procedures:

1. No published audit practices and procedures.
2. Review and reconcile OIG final audit report.

3. Initiate audits on its own.

4. Issue preliminary determination letter requesting review and comment by payor within 30 days of receipt.

5. Review any comments received and determine if assessment warranted.

6. Issue final determination letter if assessment is to be made.

7. Demand for payment is made in final determination letter notwithstanding any appeal taken.

8. Interest runs from date payment is due as set forth in final determination letter (Interest rates varied during retroactive audit period.)

9. May impose penalties.
10. Appeal must be filed within 30 days of receipt of final determination letter. See 30 C.F.R. Part 290.

11. Payor may request permission to post a bond, rather than pay amount demanded, if MMS' decision is to be appealed.

IX. Industry's Audit Concerns.

A. MMS' admission on royalty regulations highlights a major concern to companies under audit by the OIG and the MMS:

"An MMS review of the existing regulations and guidelines for valuing oil, gases, and gas products found many problem areas. Existing regulations were found to be outdated, misleading, and in some cases, incorrect. Many existing regulations are impossible to implement in a practical manner. Collectively, they are either too misleading, and/or too fraught with potential for misinterpretation to successfully serve the requirements of MMS's new AFS." ("HOW TO VALUE, FOR ROYALTY PURPOSES, GAS AND GAS PRODUCTS FORM FEDERAL LEASES, ONSHORE AND
B. Any clarification or interpretation of royalty requirements should not be retroactively applied in ongoing OIG/MMS audits.

1. Industry has relied on the consistent and longstanding policy and practice of U.S.G.S. in paying royalties on gross proceeds received by the lessee.

2. A retroactive change of U.S.G.S. requirements, interpretations, and applications would be arbitrary, capricious, unreasonable, and a violation of due process.

C. The OIG's and MMS's overlapping audit authority leads to uncertainty and excessive, possibly inconsistent, auditing.

D. The lack of published audit procedures places lessees in a vulnerable position with potential for abuse of auditing authority by OIG/MMS.
E. The lack of audit closure requirements leaves lessees open for reauditing indefinitely.

F. Re-audits are allowed at the discretion of the OIG and MMS.

G. Product Valuation Guidelines have not been published. Due to ongoing litigation, it may be difficult to rely on the Guidelines pending legal resolution of product valuation issues.


2. State and federal maximum lawful prices during price controls as value for royalty computation. See Supron supra.


H. Industry is concerned about the imposition of penalties since they must be paid up front upon demand by MMS. See Marathon supra.

I. MMS is imposing interest charges retroactively notwithstanding the lack of notice. On the
issue of notice, see Atlantic Richfield Co., 21 L.B.L.A. 98 (1975).

J. Wyoming, Montana, Oklahoma, Colorado, and North Dakota have auditing authority. Alaska, California, and Utah are also seeking the right to audit federal leases within their borders.

1. One state has publicly stated that it will not blindly accept MMS's product value determinations if the state believes they are incorrect. The state will initiate litigation on its own behalf to support its interpretation. (30 U.S.C. §1734).

2. If individual states decide to honor or disregard, at their election, various Secretarial determinations concerning royalty matters, lessees will bear the responsibility and cost for contesting such state action.

K. Audits by Indian governing bodies are expected. The Navajo Nation, Shoshone, and
Arapahoe Tribes, and the Jicarilla Apache Tribe have also requested auditing authority.

L. Industry faces excessive costs and manpower demands due to the ongoing MMS audits and expected state and tribal audits.

M. Underlying equity issues may be lost in this auditing process.

X. Minerals Management Service's Royalty Valuation Determinations.

A. MMS has authority to determine reasonable minimum value for royalty calculation purposes and is using such authority on a case-by-case basis where a payor requests such a determination.

1. This is invaluable to industry given current market conditions.

XI. Interior Committee Oversight Review of Minerals Management Service's Royalty Management Program.

A. Numerous complaints from states, Indian tribes, and industry led to the oversight
review of Minerals Management Service's Royalty Management Program by the House Interior Committee and the General Accounting Office. The Interior Committee review found that the royalty management problems highlighted in 1978 by USGS and by the Linowes Commission in 1981 not only persist but may have become worse.

1. The Interior Committee stated as follows: "There have been and still are therefore, numerous problems within the Royalty Management Program which have adversely affected the Department of the Interiors ability to manage efficiently Federal mineral royalties. Many of these problems could have been avoided if MMS's approach to and management of the Royalty Management System development had been carried out in an orderly, systematic manner."

(Interior Committee Report at p.2).

B. Problem Areas (Interior Committee Report at pp. 2 et seq.).
1. Failure to collect interest owed.

2. Inadequate reports to states and Indian tribes.

3. Failure to publish product valuation guidance.

4. No on-site production verification.

5. No exception processing (when financial and production data do not match).

6. More direct MMS involvement in State and Indian cooperative audits is needed.

7. Inordinate delay in implementation of sections 202 and 205 (allowing for state and tribal auditing).

8. Poor communication and coordination with states and Indian tribes.

9. Genuine reconciliation of U.S.G.S. royalty accounting system account balances not being accomplished. (States and Indian tribes are maintaining that the
reconciliation effort is limited to a mere search for negative and positive balances to match and subsequently adjust entries, which is primarily a paper exercise. The MMS method handling the account balances was to write off balances under a $100,000. The cost benefit analysis supporting $100,000 threshold was not available for the Committee's review. Writeoffs over $20,000 require DOJ approval).

10. Some royalty payments are not being accounted for by MMS.

11. Problems with the MMS royalty systems development.

12. Systems development effort was overly-ambitious. (MMS had expected to design, develop, and implement AFS and PAAS within three years. The Interior Committee recommends that future systems efforts establish realistic time frames).

13. PAAS design needs reassessment. (The Interior Committee recommends that this
issue be addressed with the advice and counsel of a Federal Advisory Committee prior to full scale implementation of PAAS).

14. Assessment of need and definition of AFS functional requirements missing.

15. Lack of a complete, accurate lease universe.

16. Inadequate planning for equipment requirements.

17. Project management and top-level departmental involvement needs to be improved.

18. Inefficient automatic data processing programs.


C. Conclusions and Recommendations (Interior Committee Report at pp. 28 et seq.).

1. Cancel or defer System X. (Which is the procurement of new computer hardware and
conversion of the AFS, PAAS and BRASS software until a post implementation review can be performed to determine how the AFS can be designed to satisfy the internal and external users needs and how the design can be simplified).

2. Clean-up the data base.

3. Perform a detailed post-implementation review. (Reassess the accounting and auditing needs of the MMS royalty programs and the design of the AFS with the advice and counsel of a Federal Advisory Committee consisting of industry, state, and tribal representatives, with the approval of any redesign work to be made by a Department of Interior systems review panel).

4. Establish a state/Indian liaison office.

5. Improve reports to states and Indian tribes so that they are useful as audit tools. (Information needed on units sold, unit values, sales, gross royalties, adjustments, net disbursements,
percentage of payor ownership and amount of money being held in suspense in addition to information they are now receiving in order to properly determine whether they are being paid correctly).

6. Enhance project management.

7. Establish a Federal Advisory Committee.

8. Increase Departmental management involvement.

9. Validate lease universe.

10. Continue Production Accounting and Auditing System (PAAS) pilot program but delay implementation of complete PAAS.

11. Initiate on-site production verification.

12. Implement good configuration management.

13. Obtain emergency back-up computer capacity.
14. Insure the use of the DOI systems review panel.

15. Retain multiple payor concept for existing leases.

16. Study the $100,000 threshold for PAAS account reconciliation write-offs.

XII. Potential Impact of the Interior Committee Report is Substantial for the Accounting and Legal Profession.

A. It will affect the future development of AFS and PAAS.

B. It may result in an increased emphasis by states and Indians to commence their own auditing efforts.

C. It may affect the $100,000 threshold, which MMS has used in its RAS account reconciliations.

D. It may affect MMS's organizational and managerial structure.
XIII. Continuing Industry Problems.

A. Legal controversy over valuation of production for royalty computation and payment purposes;

B. Production of records for auditing purposes;

C. Reconciliation of lease accounts;

D. Reconciliation of OIG/MMS audit findings;

E. Development and maintenance of computerized systems to interface with MMS systems;

F. Reporting and paying under AFS and PAAS;

G. Legally protecting rights under the regulatory and audit requirements of MMS; and

H. Lack of response by MMS to Interior Committee's concerns evidenced by MMS' issuance of PAAS proposed rulemaking. The Interior Committee recommended a reassessment of PAAS by MMS with the assistance of a Federal Advisory Committee composed of industry, state, and tribal representatives.
APPENDIX A
FEDERAL ONSHORE ROYALTY REGULATIONS

1. 30 C.F.R. §221.40 Royalty and rental payments. 7 Fed. Reg. 4132 (June 2, 1942).


5. 30 C.F.R. §221.46 Quantity basis for computing royalties on natural gasoline, butane, propane, and other liquid hydrocarbon substances extracted from gas. 7 Fed. Reg. 4132 (June 2, 1942).


7. 30 C.F.R. §221.48 Royalty rates on oil; flat-rate leases. 7 Fed. Reg. 4132 (June 2, 1942).


10. 30 C.F.R. §221.51 Royalty on casing-head or natural gasoline, butane, propane, or other liquid hydrocarbon substances extracted from gas. 7 Fed. Reg. 4132 (June 2, 1942).

11. 30 C.F.R. §221.52 Royalty on drip gasoline or other natural condensate. 7 Fed. Reg. 4132 (June 2, 1942).
APPENDIX B

INDIAN TRIBAL REGULATIONS


INDIAN ALLOTED REGULATIONS


APPENDIX C
KEY ROYALTY CASES


2. Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950).


APPENDIX D

PRODUCTION ACCOUNTING AND AUDITING SYSTEM

PAAS HANDBOOKS

. Part I--Handbook for Lease and Facility/Measurement Point Operators

. Part II--Handbook for Gas Plant and Fractionation Plant Operators

. Part III--Handbook for First Purchasers

. Part IV--Handbook for Mine and Secondary Processing Facility Operators

. Part V--PAAS Automated Entry and Editing Criteria for Reporting Firms

PAAS REPORTS

ANCR  API Well Number Change Report

FMIR    Facility and Measurement Information Form

FMIF-S  Facility and Measurement Information Form--Supplement

FPOR    Fractionation Plant Operations Report

FPR     First Purchaser Report

GAR     Gas Analysis Report

GPOR    Gas Plant Operations Report

OGOR    Oil and Gas Operations Report

PASR    Production Allocation Schedule Report

WIF     Well Information Form
APPENDIX E
REDESIGNATED FEDERAL ONSHORE ROYALTY REGULATIONS


1. 30 C.F.R. §221.40 redesignated as §221.105 now §218.100.
2. 30 C.F.R. §221.43 redesignated as §221.106 now §202.101.
3. 30 C.F.R. §221.44 redesignated as §221.107 now §202.102.
4. 30 C.F.R. §221.45 redesignated as §221.108 now §206.101.
5. 30 C.F.R. §221.46 redesignated as §221.109 now §206.102.
6. 30 C.F.R. §221.47 redesignated as §221.110 now §206.103.
7. 30 C.F.R. §221.48 redesignated as §221.111 now §202.103.
8. 30 C.F.R. §221.49 redesignated as §221.112 now §206.104.
9. 30 C.F.R. §221.50 redesignated as §221.113 now §206.105.
10. 30 C.F.R. §221.51 redesignated as §221.114 now §206.106.
11. 30 C.F.R. §221.52 redesignated as §221.115 now §206.107.
APPENDIX F
DUAL-ACCOUNTING DEFINITION

Payors will pay royalty on the method which yields the greatest royalty. (Royalty Payor Handbook, Appendix B.5.1, Feb. 1982).

**BTU Method (Unprocessed or Wet Gas)**--Royalty will be computed on the value of unprocessed gas. The value of unprocessed gas is obtained by multiplying the base contract price per MCF by the BTU content of the gas at the lease/wellhead.

**Net Realization (Processed Gas--Residue Plus Plant Products).**--Royalty will be computed on 100 percent of the value of all residue gas remaining after processing plus 100 percent of the value of the plant products allocable to the lease, minus a manufacturing allowance for plant products when approved by MMS.

**Gross Proceeds.**--The actual value of gas and plant products accruing to the lessee from the sale of the natural gas.

"The purpose of the audit was to determine if Conoco's settlement system adequately provides for the proper computation and payment of royalties in accordance with applicable Federal laws, regulations, and directives. Our examination was made, as applicable, in accordance with the 'Standards for Audit of Governmental Organizations, Programs, Activities, and Functions' issued by the Comptroller General of the United States. Accordingly, we have included such tests of Conoco's settlement system, accounting records, and other data and such other auditing procedures as we considered necessary in the circumstances. The audit covered the years 1978 through 1980, except where specifically noted in this report. Field work was performed at Conoco offices in Ponca City, Oklahoma; Casper, Wyoming; and New Orleans, Louisiana; and GS's Gulf of Mexico Outer Continental Shelf (OCS) Regional Office in Metairie, Louisiana. . . . We have determined that the settlement system Conoco employs for the payment of royalties to GS for natural gas removed from Federal leases does not contain any material weaknesses and adequately provides for the reasonable payment of royalties."

According to the Linowes Commission Report, TEN STAFF YEARS of auditing effort were expended to audit Conoco's federal leases and El Paso's federal onshore and Indian leases. (Commission Report at p. 26).
APPENDIX H
ARTICLES


