

MMS Response to POGO letter to Energy Bill Conferees

In a letter dated July 24, 2002, the Project on Government Oversight (POGO) urged the Energy Bill conferees to oppose provisions in the bill related to royalty in kind (RIK). While we appreciate POGO's viewpoint, we do not agree with their conclusions. We disagree with most of the statements POGO provides in their letter to support their recommendation. We are providing the following information regarding our specific disagreements, and we are available to provide additional details regarding the Minerals Management Service's RIK program.

One of the premises of POGO's recommendation is that the oil industry "devised a strategy known as royalty in kind" to avoid paying royalties under the requirements of new Federal oil valuation rules that went into effect in 2000.

Response: In reality, Congress has for over 80 years now recognized the value of an RIK alternative by providing for its use in the Mineral Leasing Act and Outer Continental Shelf Leasing Act. Further, MMS and its predecessor agency (USGS) have, since the 1970's continuously operated a crude oil royalty in kind program of considerable scale. In 1995, MMS began exploring the feasibility of utilizing the royalty in kind approach for natural gas, patterned in part after successful RIK programs operated by the States and the Province of Alberta. Since that time, the MMS conducted a feasibility study and a series of oil and gas RIK pilots to determine the relative merit of the RIK approach and its utility in an ongoing royalty management program. The conclusion reached by MMS from these studies and pilots is that the RIK approach is a viable alternative to administer Federal oil and gas royalties. However, it is to be used only in specific circumstances.

- 2 POGO describes MMS's first pilot program as a natural gas program that lost \$4.7 million in Wyoming alone.

Response: In fact, there has not been a natural gas RIK pilot program conducted in Wyoming or anywhere else onshore. MMS's first natural gas pilot was conducted offshore in the Gulf of Mexico in 1995. This early pilot effort documented that taking royalty gas at or near the wellhead was feasible and had merit. Although the pilot resulted in a marginal loss in revenue, MMS gained valuable knowledge and experience in interacting with the natural gas markets that have served as a foundation for future pilot programs.

3. POGO also describes a second MMS pilot program involving crude oil as having lost \$3 million.

Response: We assume that POGO is referring to the MMS/State of Wyoming Oil Pilot. If so, the Pilot Assessment Report prepared by the MMS with assistance from the State of Wyoming found, to the contrary, that RIK revenues for the 18-month period of the assessment exceeded comparable in value royalties by approximately \$810,000. It's important to emphasize that the Wyoming Pilot is a cooperative effort between the MMS and the State of Wyoming and that it includes RIK oil from both Federal and State lands. The MMS and the State of Wyoming support the results and have continued this RIK program to the present.

- 4 POGO describes a third pilot program and asserts that the MMS concluded in its own report that Interior did not track its administrative costs and therefore did not know if it lost money.

Response: The MMS has issued in draft for public comment an assessment report for the MMS/Texas General Land Office 8(g) Gas Royalty in Kind Pilot. The draft assessment report concludes that, contrary to POGO's statements, RIK natural gas sales at market centers will generally receive the same price as any other gas sold at the same market centers. The draft report further states that significant RIK value uplifts can be received from favorable transportation contracts resulting from the large Federal production volume position. Furthermore the draft report references cash flow advantages realized from the RIK approach in which revenues are received on average 5 days earlier than under cash royalties. The draft report did not draw any conclusions regarding the comparative administrative costs of operating an RIK program versus an in-value program. However, inherent benefits of the RIK approach were recognized in the form of simplified reporting, and from reduction in audits and associated appeals and litigation related to calculation issues.

5. POGO mentions pending lawsuits related to alleged manipulation of gas volumes and that these allegations should be fully investigated before any decisions are made related to royalty in kind.

Response: While the MMS is concerned about the allegations, we do not share POGO's view that the disposition of these allegations in some way will affect royalty paid in kind versus in-value. If production volumes have been misstated, the lessor stands to be impacted regardless of whether royalty payments are made in kind or in value.

- 6 POGO cites a 1998 General Accounting Office report and infers that the report found that conditions would never exist on federal leases that would support the royalty in kind approach.

Response: To the contrary, the GAO identified the conditions that needed to be present to make the royalty in kind approach feasible. According to GAO, "These conditions include having relatively easy access to pipelines to transport oil and gas, leases that produced relatively large volumes of oil and gas, competitive arrangements for processing oil and gas, and expertise in marketing oil and gas." MMS's pilots conducted since the issuance of the GAO report not only further confirmed the validity of the stated conditions but these conditions also served to provide the focus for planning, development and execution of each pilot. MMS's current RIK program now directly meets and leverages all of the conditions identified in the GAO report.

- 7 POGO also notes from the same GAO report that requiring royalty in kind on all federal leases will cost the government \$140 million to \$367 million annually.

Response: MMS provided this impact estimate in comments on pending legislation in the 105th Congress. The legislation would have required all federal oil and gas royalties to be taken in kind. The MMS continues to oppose a mandatory royalty in kind requirement because it is not a viable option in every case and could impact revenue negatively. However, we are convinced from extensive experience gained since 1997 that the royalty in kind approach can be viable. Under the right conditions, the royalty in kind approach does yield benefits to the lessor that are at least equal to or an improvement over what is received from the in-value approach. In fact, beginning in April 2002, the royalty in kind approach was invoked to provide crude oil from federal leases in the Gulf of Mexico to fill the remaining capacity of the Nation's Strategic Petroleum Reserve. This MMS/Department of Energy initiative is one of the key elements of the President's National Energy Plan to further enhance the Nation's energy security position.

In conclusion, MMS believes that royalty in kind is a viable approach when used in tandem with the in-value approach to manage the Nation's mineral revenues. The legislative language now in conference establishes requirements that must be met to assure that the royalty in kind approach will be utilized only when the benefits to be realized are at least equal those received from the in value approach.