

Appendix A

POGO's Response to
"MMS Response to POGO Letter to Energy Bill Conferees"

Exposing Corruption Exploring Solutions

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POGO does not oppose Royalty In Kind (RIK) in principle – however, the Minerals Management Service (MMS) of the Department of Interior has failed to provide evidence of genuinely successful RIK pilot programs. In fact, a Trustee for the State of California testified before the House Resources Committee that, "Although RIK sales prices are consistently above posted prices, they are consistently below fair market values." In the rare circumstances when the government needs oil, for example to fill the Strategic Petroleum Reserve, it may make sense for the government take RIK.¹ There may also be specific cases where RIK would yield benefits to the taxpayer beyond royalty in value. MMS pilot programs have failed, however, to persuasively make this case.

As can be seen from this point-by-point analysis of MMS's August response, the pilot programs – performed presumably at the most favorable leases – have not proven to be a good deal for the public.

"1. 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.

[MMS] 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."

¹Currently President Bush's plan to fill the Strategic Petroleum Reserve has resulting in increasing the use of RIK exponentially – accounting for 40% of royalty revenues, according to the American Petroleum Institute.

POGO's Counter-Response to MMS: It is misleading for MMS to suggest that this legislative proposal is simply a natural outgrowth of longtime RIK programs. In fact, MMS's historic RIK programs were aimed at providing oil to small independent refiners. MMS did not act as a "market participant." The more recent pilot programs are an entirely different animal.

With regards to the question of whether this new push for RIK is an industry creation, the General Accounting Office (GAO) documented industries' efforts to turn MMS away from the new oil royalty rule in favor of RIK: "Although states that receive distributions of these royalties generally support the proposed regulations, oil industry representatives generally oppose them, believe that oil companies should not pay royalties on higher prices and that they would suffer increased administrative requirements. As an alternative, the oil industry has suggested that MMS instead be required to accept, as the federal government's royalties, a percentage of the actual oil and gas produced from federal leases (known as royalties in kind)."² The DOI Inspector General Report also reported that: "oil and gas industry officials are advocating that the Service take its royalties in-kind."³ In fact the websites of the two most active oil and gas industry associations that lobbied against the MMS oil valuation rule change, the American Petroleum Institute and the Independent Producers Association of America, identify expanding the use of RIK as one of their top legislative priorities.⁴ Let us not forget that the oil industry was forced to pay back \$438 million in underpaid royalties, due to their schemes to cheat the taxpayers.

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

[MMS]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."

POGO's Counter-Response to MMS: MMS is correct in pointing out that this natural gas pilot took place in the Gulf of Mexico rather than Wyoming. According to the GAO: "MMS estimated that this program lost about \$4.7 million (about 7 percent) when compared to the revenues the

² General Accounting Office; Federal Oil Valuation: Efforts to Revise Regulations and an Analysis of Royalties in Kind GAO/RCED-98-242; August, 1998.

³ Department of Interior Inspector General; Advisory Report: Royalty-in-Kind Demonstration Pilots, Minerals Management Service; Report# 99-I-371; March 1999.

⁴ <http://api-ep.api.org/issues/index.cfm?bitmask=002006011001000000>;
<http://www.ipaa.org/govrelations/viewpoint1.asp>

agency would have received if it had taken its gas royalties in cash.”⁵ Furthermore, according to the Interior Inspector General audit: “The Service concluded, in its September 1996 report ‘Minerals Management Service Royalty Gas Marketing Pilot,’ that the Pilot was an operational success but that the amount of royalties collected was 6.5 percent less than what would have been collected under the in-value system. When project to the Gulf of Mexico lease universe, the Service estimated that a royalty loss of \$82 million would have resulted for the year.”⁶

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

[MMS] 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.”

POGO’s Counter-Response to MMS: An independent economist who reviewed the RIK pilot program in Wyoming on behalf of the state of California found that “royalty and tax values were computed under the old royalty rule,”⁷ a discredited rule that relied on posted prices made up by oil companies that resulted in lost revenues to the taxpayer. The economist estimated that the RIK pilot in Wyoming actually lost \$3 million when compared to fair market value prices as codified under the existing oil royalty rule, rather than the posted prices that MMS knew shortchanged the government.

“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.

[MMS] 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

⁵ General Accounting Office; Federal Oil Valuation: Efforts to Revise Regulations and an Analysis of Royalties in Kind GAO/RCED-98-242; August, 1998.

⁶ Department of Interior Inspector General; Advisory Report: Royalty-in-Kind Demonstration Pilots, Minerals Management Service; Report# 99-I-371; March 1999.

⁷ Innovation and Information Consultants, Inc.; Memo on MMS Report in RIK Pilot Program in Wyoming to James N. McCabe, Deputy City Attorney, City of Long Beach, Trustee for State of California and M. Brian McMahon, Attorney, City of Long Beach and State of California; April 24, 2001.

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."

POGO's Counter-Response to MMS: As POGO stated earlier, and MMS now confirms, Interior did not track its administrative costs and therefore does not know if it lost money. Without accurate information about all of the associated costs of the RIK program it is simply impossible for Congress to know if RIK is a good deal for the taxpayers. MMS has expended considerable resources attempting to make itself an expert in oil and gas marketing, an exercise that has questionable futility given the enormous level of control that the oil and gas industries have over market prices. MMS has repeatedly failed to depict the true costs of the RIK program and, as a result, has failed to meet two of its four goals for the pilot programs:

- "To determine if the government (and industry) can save money by reducing the cost and burden of collecting royalties."
- "To determine if RIK can create value (revenue enhancement or neutrality) for the Taxpayer."

"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.

[MMS] 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."

POGO's Counter-Response to MMS: According to a pending False Claims Act lawsuit filed against 82 gas pipeline companies: "This lawsuit challenges Defendants' mismeasurement of the volume and wrongful analysis of the heating content of natural gas, causing substantial underpayments of royalties to the United States...for at least the last ten years, the United States has not been paid royalties on a very large portion, which the Relator presently calculates to be in excess of 20%, of the gas for which royalties were due." While it is correct that volume manipulation will certainly affect royalty payments in kind as well as in value, POGO does not believe that MMS should be conducting business with companies engaged in criminal or unethical activity. These companies expose our taxpayer dollars to fraud.

“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.

[MMS] 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.”

POGO’s Counter-Response to MMS: Also from the same GAO report: “However, these conditions do not exist for the federal government or for most federal leases. The federal government does not currently have relatively easy access to pipelines, has thousands of leases that produce relatively low volumes, has many gas leases for which competitive processing arrangements do not exist, and has limited experience in oil or gas marketing.” Since this GAO report, MMS has set out to demonstrate that the right conditions do exist on certain leases. The evaluation issued by MMS, “Texas General Land Office/Minerals Management Service Texas 8(g) Gas Royalty In-Kind Pilot: A Report,” demonstrates that the agency is clearly advancing in its expertise and ability to effectively determine which properties merit RIK programs. However, even with this demonstrated progress, MMS has not yet shown that royalty in kind makes more or the same amount of money for the taxpayer when all costs associated with the program are taken into consideration.

“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.

[MMS] 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.”

POGO’s Counter-Response to MMS: With regards to the RIK provision in HR 4, MMS would be able to compare the revenues likely to have been accrued through a “comparable” royalty-in-value program to royalty-in-kind revenues PLUS administrative cost savings and undefined “benefits” to the United States. Under these amorphous conditions, it would be difficult for MMS to find an RIK sale that could not appear to have saved money, no matter how much in fact was lost for the taxpayer. It is also notable that the language is vague about exactly which royalty-in-value program to compare with the RIK program – why does it not specify that RIK be compared to existing royalty valuation rules?