

## **Appendix G**

GAO Response to  
Questions for the Record from  
House Subcommittee on Energy and Mineral Resources  
March 11, 2008

## Questions for Dr. Rusco

### From the 03.11.08 House Subcommittee on Energy and Mineral Resources hearing

#### Majority Question Responses

1. Mr. Rusco, do you believe it is appropriate for MMS to be in charge of analyzing the success of the Royalty in Kind program? It seems that they have a strong incentive to show how well it is working, so would it be better to have someone outside of MMS be doing this review? And if so, who might you suggest?

A: Our review of the royalty-in-kind program raised significant concerns about the assumptions and methods that MMS uses to compare the revenues it collects in kind with what it would have collected in cash payments. However, we believe that if MMS addresses these concerns, MMS could produce reliable information on this key aspect of program performance.

2. Mr. Rusco, did GAO identify any specific instances of a breakdown in internal controls related to reporting?

A: We identified several instances where internal controls were either absent or not working effectively. One instance of a missing internal control we identified was the inability of MMS's information technology (IT) system to effectively identify missing royalty reports, a critical piece of data used by MMS to determine whether royalties were paid. We also identified several instances where internal controls were ineffective. For example, while MMS's IT system now has the ability to identify missing production reports, it now has a significant backlog of production data that staff are spending considerable time and resources attempting to reconcile. Finally, MMS's interest IT module, which is used to calculate and charge interest payments to

payors for late payments, never fully worked and is in the process of being re-designed, subject to funding.

We also identified several weaknesses in MMS's system for measuring and reporting the performance of the RIK program. Specifically, we determined that MMS does not appropriately measure or report: (1) the uncertainty of the benefits of taking royalties in kind or (2) the interest accrued from receiving royalty-in-kind payments earlier than cash payments. Further, we found that MMS's annual reports to Congress have not fully reported all the costs of administering the RIK program. These weaknesses make it unclear whether the benefits of taking royalties in kind have exceeded what MMS would have received had it taken royalties in cash instead.

3. Mr. Rusco, what is needed for MMS to better ensure the accurate collection of royalties?

A: We plan on issuing a product related to the ongoing work from which our testimony was drawn that will include recommendations on how MMS can better ensure accurate collections of royalties. Those recommendations will deal with improvements to help ensure the completeness and accuracy of royalty data and the related collections. Furthermore, we have additional ongoing work examining royalty collections and will include recommendations in our reporting as appropriate.

4. Mr. Rusco, it seems that MMS relies heavily on the audit and compliance group to find errors in royalty and production reporting. Is that more efficient than having the financial management system be better controlled?

A: We did not directly address the issue of whether MMS's financial management system with better controls would be more efficient than relying on audits and compliance reviews. Our work did identify that MMS currently

uses both up-front edit checks to prevent erroneous data from being initially entered into the financial system—preventive controls—as well as after-the-fact audits and compliance reviews to detect incorrect royalty payments—detection controls. An effective internal control environment consists of both strong preventive controls in addition to detection controls. An appropriate balance between the two is also important in achieving effectiveness and efficiency of internal controls. For example, where there is a high volume of transactions, the lack of preventive controls significantly increases the risk of errors and accordingly increases the need for particularly sensitive detection controls. In the absence of preventive controls, a high number of errors can render detection controls not only inefficient but also ineffective in detecting and correcting errors in a timely manner.

5. Mr. Rusco, in your testimony, you discuss what appear to be significant lapses in key internal controls. Would GAO agree that when controls are weak, particularly when surrounding a “checkbook” of billions of dollars, the risk of fraud goes up dramatically?

A: While we did not perform specific tests that might have uncovered potential fraud, it is true that the risk of fraud increases in the absence of strong internal controls. However, internal controls, even when operating optimally, will not provide a 100 percent guarantee that someone cannot commit fraud. Because fraud is usually concealed, material misstatements due to fraud are difficult to detect. Nevertheless, certain events or conditions that indicate incentives or pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes and rationalizations to justify a fraudulent action may be present at MMS. Such events or conditions are referred to as “fraud risk factors.” Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists. During the course of our work, we found that at least two of the three key indicators of fraud—an incentive for someone to misappropriate assets (for example

cash or gas and oil in this case), and the opportunity to do so (that is, a relatively low risk of being caught)—may exist in MMS's environment of collecting the federal government's fair share of royalties from oil and gas produced on federal properties. However, we have not uncovered any fraud during the course of our work so far.

6. Mr. Rusco, in response to a question at the hearing, Mr. Finfer stated that one of the crucial elements to a risk-based compliance strategy is good data. Do you believe that MMS currently has data of sufficient quality to properly implement an effective risk-based compliance strategy?

A: We agree that a crucial element of a risk-based compliance strategy is good data upon which to base management's risk assessments and judgments. We have previously reported on data accuracy problems in limited sets of royalty data extracted from MMS's financial management system. At this time, however, we are unable to comment on the full extent of the reliability of the underlying data used to assign risk as we did not assess many of the data elements that MMS has proposed to use in ranking both properties and payors. We are in the process of doing additional work in this area and will report out when that work is completed.

7. Mr. Rusco, we constantly hear from MMS that the Royalty in Kind program is performing well. Your testimony indicates the benefits are less certain. Do you think MMS's reports are giving us the full story, and could you provide an example of this?

A: MMS's annual reports are not providing the Congress with the full picture regarding the performance of the royalty-in-kind program. By presenting oil sales data aggregated by major sales category, the reports do not reflect the fact that, in many individual sales, MMS has sold the oil it collected in kind for less than it estimates it would have collected in cash. For example, MMS

estimates that, in fiscal year 2006, it sold 64 percent of all the oil it collected in kind, for less than it would have collected in cash.

8. Mr. Rusco, could you discuss your views of the usefulness of the State and Tribal Royalty Audit Committee, or "STRAC"? And do you see any way to improve the relationship between STRAC and MMS?

A: The State and Tribal Royalty Audit Committee (STRAC) works under authority granted in the Federal Oil and Gas Royalty Management Act. It performs compliance work through agreements with MMS and brings jurisdictional expertise and staff to MMS's compliance activities. We are aware that there are many written communications between STRAC and MMS. However, we have not examined whether or how the relationship between STRAC and MMS could be improved.

9. Mr. Rusco, in your testimony, you seem to say that if a company gets a compliance review or an audit, it can make an adjustment afterwards that MMS will never check? Is that true? Does the MMS "Adjustment Line Monitoring Initiative" help with that?

A: A company can make adjustments to data after MMS has completed either an audit or a compliance review, and MMS does not have controls in place to assess the justification for each of those adjustments. In commenting on our draft testimony, MMS stated that staff are currently developing requirements for an IT initiative to be completed in fiscal year 2008 that will assist in monitoring adjustments. As of March 2008, MMS has not finalized the IT specifications for this module, so we are unable to determine the extent to which this would address our concerns. As planned, the new IT system module would monitor adjustments made after the module went on-line and would not address prior adjustments. Accordingly, unless MMS goes back and

reviews past data, we will not be confident that all past adjustments have been warranted.

10. Mr. Rusco, in their testimony, Senators Kerrey and Garn discuss the difference in the so-called "front-end" and "back-end" of BLM's operations, saying that increased funding has been focused on additional leasing and processing of applications for permits to drill, but "there has not been sufficient attention" to collections, production accountability, and auditing requirements. Has GAO seen evidence of this in recent years?

A: BLM field office staff tell us that many resources are dedicated to processing drilling permits. These staff and the official BLM inspection strategy guidance, indicates that resources are prioritized for "front-end" activities, such as drilling inspections rather than "back-end" activities, such as production verification. Furthermore, we reported in *Oil and Gas Development: Increased Permitting Activity Has Lessened BLM's Ability to Meet Its Environmental Protection Responsibilities* (GAO-05-418) that BLM's ability to meet its environmental mitigation responsibilities for oil and gas development has been lessened by a dramatic increase in oil and gas operations on federal lands between 1999 and 2005. Since that time, permitting activity has continued to increase.

11. Mr. Rusco, I understand that GAO is now looking at some of the issues with the Accenture computing system that the Inspector General brought up in September. Could you discuss your work on this issue?

A: We agreed with the Department of the Interior's Inspector General (IG) that we would examine key functionalities of the IT system, whereas the IG would examine the contract Accenture had with MMS to develop the IT system and determine whether the end product was what the contract specified. Accordingly, we spoke with MMS staff and STRAC users of the IT

system and are doing further work to evaluate the quality of the data managed in that system. We will report on the results of this work when it is completed.

12. Mr. Rusco, the Subcommittee on Royalty Management's report says that "MMS's processes for evaluating the feasibility of RIK vs. RIV appears to be rigorous and effective." Do you agree with that statement?

A: Before MMS decides to take royalties from a particular property or pipeline in kind, MMS compares the revenues it expects to receive by taking the royalties in kind to what it currently receives in cash. We did not evaluate the effectiveness of this prospective analysis. Rather, we evaluated the methods that MMS uses to retrospectively determine whether the benefits from taking royalties in kind were, in fact, better than taking royalties in value. Our review raised significant concerns about this retrospective analysis. MMS can use its retrospective analysis to help inform prospective decisions about which properties or portfolios to keep in the in-kind program. For example, MMS placed one portfolio of natural gas leases back into the in-value program after noticing that sales from these leases had performed poorly. Our concerns about the retrospective analyses also raise significant concerns about whether these analyses provide reliable information regarding which leases to keep in the in-kind program over time.

13. Mr. Rusco, a footnote in your testimony says that certain BLM state officials believed the data in BLM's Automated Fluid Minerals Support System (AFMSS) were unreliable. Have you assessed the AFMSS and the reliability of its data?

A: We identified a number of discrepancies in the production inspection data stored in BLM's Automated Fluid Minerals Support System (AFMSS) and determined that it was not sufficiently reliable for our reporting purposes. During the course of our work, we took a number of steps to assess the

reliability of the production inspection data. These steps included requesting the fiscal year 2007 production inspection data from AFMSS from BLM's AFMSS database manager for those field offices that we included in our review. We then asked field staff to validate the numbers we received from AFMSS. In several cases, field office staff stated that the numbers were not correct and subsequently revised the numbers in AFMSS. However, in two instances, BLM staff were unable to validate the AFMSS production inspection numbers because they lacked confidence in the data. Consequently, we were uncomfortable reporting the actual production inspection numbers in our testimony. In assessing the reliability of the data, we did not perform electronic testing, nor did we compare records kept in BLM's paper files with data in AFMSS.

14. Mr. Rusco, in your testimony you say that MMS lacks an automated process to reconcile payor production data with production data filed by operators. However, MMS reports that they have an automated Compliance Process Tool (CPT) which makes those reconciliations. How do these two statements square up, and how does the CPT compare to MMS's old automated process?

A: MMS's prior IT system automatically compared all production reports and royalty reports within 6 months without human intervention. However, during the course of our work MMS officials told us that the that the new system only compared a portion of the production reports with the royalty reports through the compliance review process, which generally is done 3 years after royalties are reported. Furthermore, while this comparison is done via the Compliance Program Tool, it requires an analyst to manipulate the menus and query tools to complete the actual comparison. The need for staff to perform this comparison, rather than its being done automatically, takes time away from other compliance efforts. MMS recently told us that it is in the process of changing its policies on comparing production and royalty reports. However, we have not yet assessed this process.

15. Mr. Rusco, on page 8 of your testimony, you describe one instance of a bypass built around a gas meter and one instance of a company maintaining two sets of conflicting production data. What action was taken by BLM in these instances, and did the companies face any financial penalties?

A: In the instance of the bypass, BLM staff told us that they issued the company an Incident of Non-Compliance. The company subsequently removed the bypass. Because the company removed the bypass within the allotted timeframe, the company was not issued a financial fine.

In the other instance, according to BLM Petroleum Engineer Technicians, the company kept two sets of books—the internal raw data and the data reported to MMS on the Oil and Gas Operations Report (OGOR). Although, the total volumes of oil and gas on those books were the same, the company altered production amounts at the well level that they reported to MMS on the OGOR. BLM subsequently asked the company to correct and resubmit the OGORs and did not issue the company a financial fine.

16. Mr. Rusco, please describe whether the findings and recommendations of the Royalty Policy Committee report dated December 17, 2007 are consistent with findings reported by GAO in its testimony to the subcommittee on March 11, 2008, and point out any major differences that exist between the two reports.

A: The findings reported by GAO in its testimony to the subcommittee on March 11, 2008 are generally consistent with the findings and recommendations of the Royalty Policy Committee (RPC) report dated December 17, 2007. This similarity is due to the fact that both GAO's and RPC's objectives focused on two common objectives – (1) to determine whether MMS collects the correct amount of federal and Indian mineral royalties, and (2) to assess whether the federal government is benefited by

taking royalties in kind. To address these objectives, both GAO and RPC reviewed management's oversight activities, policies, procedures, systems and internal controls.

While RPC concluded that MMS is an effective steward for federal and Indian mineral interests, it also found a number of management activities requiring prompt, and in some cases, significant management attention, to ensure public confidence. Over 100 detailed recommendations to management were reported by RPC. For example, several of these recommendations were directed at MMS and BLM to improve production accountability and production measurement. GAO shares this concern and believes that without improvement in verification procedures, MMS can not be assured that it is receiving full compensation for oil and gas produced on federal and Indian properties.

GAO and RPC also evaluated the RIK program and concluded that improvements are needed to increase transparency of reporting and clarity of management decision-making when determining whether to take royalties in kind or in value. For example, RPC recommended, and GAO suggested in its testimony, that MMS should report on the uncertainties surrounding the benefits of taking royalties in kind. However, there are a number of differences between the two reports with respect to the RIK program. For example, RPC concluded that MMS should explore the feasibility of establishing a trust fund, the interest from which could be used to fund royalty management activities. The RPC also concluded that MMS should study the use of various governance arrangements for the RIK program. GAO has not explored these issues. Moreover, GAO was not requested to examine outer continental shelf (OCS) royalty relief as part of this testimony, whereas RPC was charged with reviewing the Department's procedures established in response to the lack of price thresholds for certain deep water leases in the Gulf of Mexico. This

additional examination by RPC resulted in six recommendations to improve management in offshore leases.

17. Mr. Rusco, please describe to what extent GAO considered the results of (1) audit reports issued by the Department of the Interior's independent public accountants, KPMG, and (2) an agreed upon procedures report issued by TCB&A, an independent accounting firm engaged by Interior, to examine its RIK cost methodology, in assessing and reporting on whether MMS's oversight provides adequate assurance that full compensation is being received from oil and gas produced on federal properties.

A: GAO reviewed and assessed these and other relevant accountants' and auditors' reports (e.g. reports of Interior's OIG) in planning the scope of our work. We also considered other auditors' results during the course of developing our findings and conclusions in reporting our work to the subcommittee. However, key differences existed between our work and the scope of the work done by both KPMG and TCB&A. In addition, key limitations in the scope of work done by KPMG and TCB&A required us to perform additional test work to assess MMS's oversight and controls over its royalty collections.

Specifically, with respect to KPMG's audit of Interior's financial statements for 2007 and preceding years (a separate audit was not completed for MMS's financial statements in 2007), KPMG's report specifically stated that the audit of the financial statements was not designed to provide an opinion on internal controls over financial reporting or over reported performance information. Accordingly, GAO performed additional procedures to assess these internal controls.

Similarly, GAO found that TCB&A's agreed-upon procedures report, dated June 30, 2005, was limited to reviewing the RIK/RIV cost comparison

methodology and certain underlying fiscal 2004 data. While the independent accountants reported MMS's methodology to be reasonable, they also found that many underlying data were based on undocumented estimates or were otherwise in error. Accordingly, GAO further analyzed the underlying data, including expenses through fiscal 2006, and found that key expense elements—principally information systems specifically used for the RIK program—had not been previously assessed and had not been included in MMS's cost comparison. Therefore, this earlier work supported GAO's conclusion that the RIK/RIV methodology may be improved and reported results may be made more transparent by including full and accurate costs.

18. Mr. Rusco, please describe the resources employed by GAO in its audits of MMS that led to the findings in its testimony. How many staff days and other resources were allocated and what were the qualifications of GAO staff who worked on these audits?

A: The findings included in our recent testimony on mineral revenues were developed over the course of a year by GAO staff with a wide range of qualifications, including staff with a juris doctorate, doctorates in economics and social science, and master's degrees in public administration, public affairs, environmental science, social science and research methods, business administration, and geology. Team members also hold certifications in public accounting, software engineering project management, government financial management, information system auditing, and management accounting.

19. Mr. Rusco, please describe and point out any major differences between GAO's and MMS's estimates of potential losses resulting from royalty relief in the Gulf of Mexico.

A: MMS's estimate for future losses from leases issued in the deep waters of the Gulf of Mexico in 1998 and 1999 compare favorably with scenarios that

GAO developed to show the effect of different production levels and prices. In February 2007, MMS estimated that potential losses could be between \$6.4 billion and \$9.8 billion. In April 2007, GAO developed and reported the results of scenarios that showed the losses from these leases could range between \$4.3 billion and \$10.5 billion. In June 2007, MMS revised its earlier estimate to between \$5.3 billion and \$7.8 billion, based on oil and gas prices of \$60.78 per barrel of oil and gas prices of \$7.52 per thousand cubic feet. We plan to update our scenarios in the near-future.

GAO has not developed scenarios that illustrate potential losses from leases issued in the deep waters of the Gulf of Mexico in 1996, 1997, and 2000. In October 2004, MMS estimated that forgone royalties on these leases could be as high as \$60 billion should price thresholds not apply to these leases. While we reported in April 2007 that this estimate was made in good faith, much had been learned since then and we believed that MMS may have been overly optimistic about the amount of oil and gas production that would occur over the lifetime of these leases. MMS concurred and revised this estimate in February 2008 to between \$15.7 billion and \$21.2 billion. We are currently reviewing this estimate and plan to develop scenarios that illustrate the effect of different production levels and prices.

### **Minority Question Response**

1. In our experience, when Congress requests the Government Accountability Office (GAO) to conduct a study or investigation, we find that GAO often comes back to negotiate the scope of the investigation. Oftentimes the reason underlying the negotiation is a lack of resources needed for the scope of the original request. In other words, GAO will try to prioritize the salient aspects of the study that they feel they can conduct within budgetary constraints. However, you appear to be criticizing the MMS for prioritizing hurricane recovery from the hurricanes that hit the Gulf in 2004 and 2005. Is that true?

Wouldn't you agree that cleaning up after several severe and unprecedented storms should have priority over meter inspections? What MMS, Coast Guard, and the oil & gas industry achieved during those storms and their aftermath was remarkable. The fact that: (1) there were no major spills even though many platforms were lost and (2) all oil field personnel were safely evacuated - seems to be the bigger success story rather than whether an internal best practices inspection goal (that exceeds legal requirements) was met. Do you agree or disagree?

A: One of the research objectives of our work was to determine whether MMS was completing the required meter inspections as required by agency policy and law. We did not consider or evaluate MMS's prioritization methodologies for hurricane safety, recovery, or cleanup activities. Therefore we cannot comment on the appropriateness of these decisions. However, MMS officials did explain to us that one reason they had not complied with their internal production inspection policy was that their limited resources were devoted to hurricane recovery and cleanup efforts, and we reported this in our testimony. An evaluation of what the Coast Guard, MMS, and the oil and gas industry achieved during and after Hurricanes Katrina and Rita was not within the scope of our work on the accuracy of royalties or the royalty-in-kind program.