

**OVERSIGHT OF THE OUTER CONTINENTAL SHELF
OIL AND NATURAL GAS ROYALTY MANAGEMENT**

HEARING
BEFORE A
SUBCOMMITTEE OF THE
COMMITTEE ON APPROPRIATIONS
UNITED STATES SENATE
ONE HUNDRED TENTH CONGRESS
FIRST SESSION

SPECIAL HEARING
FEBRUARY 13, 2007—WASHINGTON, DC

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OVERSIGHT OF THE OUTER CONTINENTAL SHELF OIL AND NATURAL GAS ROYALTY MANAGEMENT

TUESDAY, FEBRUARY 13, 2007

U.S. SENATE,
SUBCOMMITTEE ON DEPARTMENT OF THE INTERIOR,
ENVIRONMENT, AND RELATED AGENCIES,
COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 10:02 a.m., in room SD-124, Dirksen Senate Office Building, Hon. Dianne Feinstein (chairman) presiding.

Present: Senators Feinstein, Reed, Craig, Domenici, and Alexander.

OPENING STATEMENT OF SENATOR DIANNE FEINSTEIN

Senator FEINSTEIN. The meeting of the Interior Appropriations Subcommittee will come to order. Senator Craig is unavoidably delayed for a few minutes, but he will be along soon and has asked that we proceed ahead. I know there are meetings of other committees, so we might be short of members this morning, but I am delighted to see Senator Alexander here. Welcome, Senator. Great to have you here.

This morning the subcommittee will hear from Stephen Allred, the Interior Department's Assistant Secretary for Land and Minerals Management. As the administration's designated point man on the royalty relief issue, Mr. Allred is here this morning to shed light on what is being done to recoup the billions of dollars lost to the Treasury as a result of the flawed 1998-1999 offshore oil and gas leases.

Through bureaucratic oversight, the Department of the Interior issued offshore oil and gas leases in 1998 and 1999 that did not include the necessary royalty price threshold language. The companies holding the leases have taken advantage of the oversight to avoid paying royalties, while at the same time reaping record profits. These companies know the Government does not give away drilling rights for free, but most of them have decided to stick to their position. As a result, they have deprived the American taxpayer of \$1 billion thus far and may deprive the taxpayer of another \$9 billion before the 1998-1999 leases expire.

This should bother all of us on this subcommittee. No company should be allowed to earn enormous profits off the resources taken

from publicly owned land and water without paying back a fair return to the taxpayer.

Mr. Allred, I know you are not personally responsible for the fact that the Minerals Management Service signed leases with oil and gas companies that essentially gave away \$10 billion in royalty payments that were due the taxpayer. But you have nevertheless been delegated the unenviable task of resolving this problem. I want to assure you that I am ready to work with this administration to see that this enormous leak on the Nation's finances is plugged.

We are gratified that you have been able to reach agreement with six companies to renegotiate their leases and pay royalties on their oil and gas revenues. That is a very important first step. But more needs to be done and I believe it is up to Congress to provide an additional stimulus.

As you know, Mr. Allred, I proposed legislation that would require Secretary Kempthorne to enter into good faith negotiations over the 1998–1999 leases and deny a new lease to any company refusing to negotiate. I also look forward to exploring an additional idea with you that may in fact bring in the lion's share of what is still outstanding.

Finally, I want to note that recently President Bush decided to open new areas in the Gulf and Alaska to deep water exploration. I am concerned about the ecological safety of additional offshore oil drilling. According to your own agency data, 113 platforms were destroyed and another 52 were extensively damaged by Hurricanes Katrina and Rita. One oil pipeline was moved 5,000 feet by Hurricane Rita. I hope you will be able to shed some light on the extent of ecological damages from oil spills during these hurricanes.

I note that Senator Craig has not yet come, but what we will do when he comes, if it is agreeable, we will proceed with your presentation and perhaps interrupt you if necessary to hear from the ranking member.

We are also joined by Senator Reed. Delighted to have you here this morning.

The rule we will use will be the early bird rule modified by party. So we will do early bird, but go back and forth so that one side just cannot stack the deck, so to speak.

So we are delighted to have you here, Mr. Allred, and unless members have a statement that they like to make we will proceed with your statement.

**STATEMENT OF HON. C. STEPHEN ALLRED, ASSISTANT SECRETARY,
LAND AND MINERALS MANAGEMENT, DEPARTMENT OF THE IN-
TERIOR**

Mr. ALLRED. Thank you very much, Madam Chairman, Senator Alexander, Senator Reed. It is a pleasure to be here and I appreciate the opportunity to meet with you today to discuss our ongoing work as we address the absence of the price thresholds in the deep water leases that were issued in 1998 and 1999 in the Gulf of Mexico.

At the outset, let me state my belief that our Government employees have an obligation to protect the public interest of the United States and they must be perceived as doing so. If the public believes that we have somehow failed in this obligation, whether it

is in fact or perception, the damage operates to the detriment of all of us.

What I want to do in the next couple of minutes is just to allow you the maximum time for your questions, is to tell you what the Secretary and I are doing to deal with the issues that are the subject of this hearing. After the Senate confirmed me as Assistant Secretary some 4 months ago, Senator Kempthorne asked me, as you indicated, to review and manage the issues that were involved in the 1998 and 1999 leases and to deal with other royalty matters that were of concern.

As you know, he places great importance on the Department, its agencies, and its employees acting in a highly ethical manner, again both in fact and in perception. The Department has reviewed the Inspector General's report concerning the 1998 and 1999 leases and the collection of oil and gas revenues. In addition, I have traveled to the Minerals Management Service Denver operations office, which is responsible for collecting the revenues that are due the United States, the States, and Indian tribes, and I have been thoroughly briefed and reviewed their processes.

I have also traveled to the New Orleans Regional Office, which is the office in MMS that is responsible for both issuing the leases and managing those leases and in regulating the operations of the oil companies on the OCS.

We have also formed, as you probably are aware, a high-level review panel that will look at how we collect revenues to make sure that we have the input of an outside group as to how we can improve our operations. We hope to complete the selection of the panel members in the near future so that we can officially announce the membership of that panel.

I would like to say, though, that, in my opinion and after my review, I believe that we are collecting the revenues that are due the United States, the States and the Tribes. However, with any large organization with complex operations, there are many opportunities to improve our operations and we look forward to doing that as we go forward.

Now with regard to the absence of price thresholds in the 1998 and 1999 leases. We are reviewing the Inspector General's report, which we asked for, to review or to gain a more complete understanding of what happened in 1998 and 1999. When that review is fully complete, I have asked the Minerals Management Service to form a group, including a member of the Inspector General's staff, to conduct a lessons-learned review to apply these lessons to our ongoing leasing activities.

As you are aware, since 2001 the Department of the Interior has made certain that price thresholds have been included as part of any royalty relief granted under the Deep Water Royalty Relief Act that Congress has enacted. I have discussed this issue with most of the companies who hold these leases and in these discussions, I have had three guiding principles:

First, there is a valid contract between the United States and the companies.

Second, my goal in these discussions has been to focus on the greatest amount of royalties available, those which will be derived from future production.

Third, and this is one I will talk about a little bit further, I have sought to minimize to the extent possible the opportunities for legal challenges to this process, the processes that we will follow.

As you indicated, Madam Chairman, we have been successful in negotiating amendments with six of the companies that have those leases. We have continuing discussions with the rest of the companies. However, I believe that we will not make further progress until Congress has decided and defined the role that it chooses to play in this issue.

It is clear that our Nation's demand for oil and gas will continue to grow and that a significant portion of that supply will continue to come from the Gulf of Mexico. Madam Chairman, members of the committee, I have a chart up on the board and, while it is probably too far away to see—and you, incidentally, have a copy of these—I think what is important to look at is that top red line. That top red line indicates what the Energy Information Agency believes will continue to happen with the growth in the demand for energy in the United States. You will also, as you get a chance to look at that chart in more detail, see that that is in spite of a significant increase in renewables and alternative energy sources.

As you can see from that chart, the demand for oil has risen steadily and is projected to continue. The Gulf of Mexico is where a significant portion of that U.S. production occurs and will continue to occur. Given these trends, I am particularly concerned that as you and we go forward to address the missing price thresholds, that we do it in a way that will not result in unintended consequences that might otherwise disrupt the ability to supply the Nation's continuing energy needs.

Specifically, I am concerned as we decide what to do that we not provide an opportunity for a company that has entered into the leases with the Federal Government to be disadvantaged in such a way that they might convince a court to enjoin all future lease sales in the Gulf of Mexico until the matter is resolved. The impacts of such an action that the courts might take I think cannot be overstated.

I have two graphs here I would like to show you. The first indicates that if we were enjoined from issuing further leases, beginning with the sales that will occur this fall, what the effect would be on production in the gulf. The production delays over a 10-year period that could result in such a challenge and such an injunction for a period of 3 years would be some 1.6 billion barrels of oil, and that certainly would have a ripple effect through our economy.

Equally profound, I think to this committee particularly, would be the cumulative revenue impacts to the U.S. Treasury. Again, from a 3-year delay in leasing programs, which is what I think it might take to resolve it through the Supreme Court, the Treasury could lose some \$13 billion over a 10-year period.

PREPARED STATEMENT

These are difficult issues and are not going to be easily resolved. Nevertheless, I believe that we and Congress are making progress and we will continue to do so in concert with this committee and other committees.

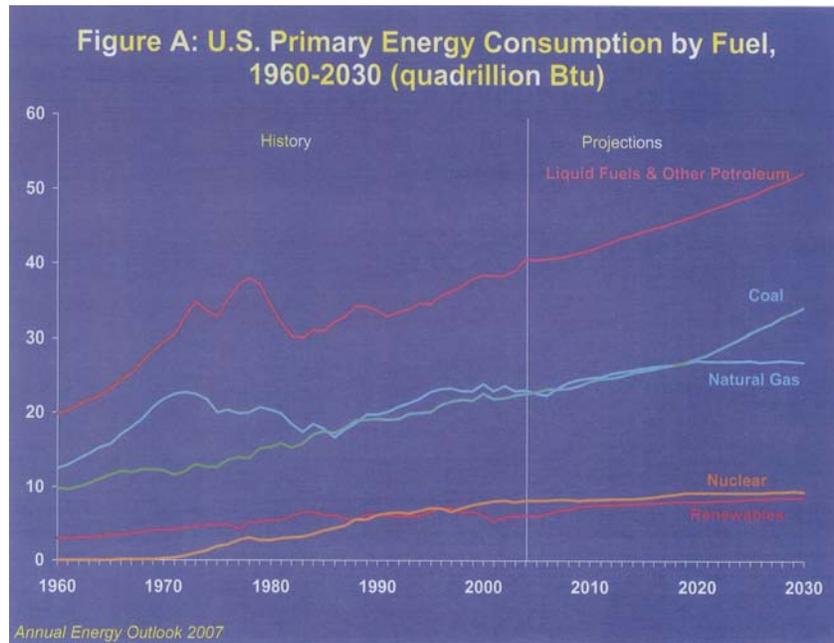
Madam Chairman, I stand ready to work with you to address these challenges as we move forward and I would be most happy to answer questions from yourself or from the committee.
[The statement follows:]

PREPARED STATEMENT OF HON. C. STEPHEN ALLRED

Chairman Feinstein, thank you for the opportunity to appear here today to discuss with you the Department of the Interior's role in managing energy production on the Outer Continental Shelf and revenue from all Federal and Indian mineral leases. This Committee has been instrumental in shaping our domestic energy program, particularly with regard to encouraging environmentally sound development of our domestic oil and gas resources on the Outer Continental Shelf.

The Department and its agencies, including the Minerals Management Service (MMS), serve the public through careful stewardship of our nation's natural resources. The Department also plays an important role in domestic energy development. One third of all energy produced in the United States comes from resources managed by the Interior Department.

As energy demand continues to increase, these resources are all the more important to our national security and to our economy. The Energy Information Administration estimates that, despite increased efficiencies and conservation, over the next 20 years energy consumption is expected to grow more than 25 percent. Even with more renewable energy production expected, oil and natural gas will continue to account for a majority of energy use through 2030. Interior's domestic energy programs, particularly offshore oil and gas production, will remain vital to our national energy portfolio for some time to come, as evidenced in Figure A attached at the end of my statement.



Since assuming the duties of Assistant Secretary of Land and Minerals Management four months ago, I have developed a deeper appreciation for the complexities involved in managing Federal energy production. I also am committed to ensuring we provide an accurate and transparent accounting of the revenue this production generates for the American people.

At the direction of Secretary Kempthorne, two important topics have been my major focus over the past 4 months—the deep water leases issued without price

thresholds for royalty relief in 1998 and 1999, and the management of royalty revenues.

I would like to begin by providing some background on MMS's role in Federal energy production and revenue collection. I then will discuss in greater detail the two primary issues I am focusing on with MMS.

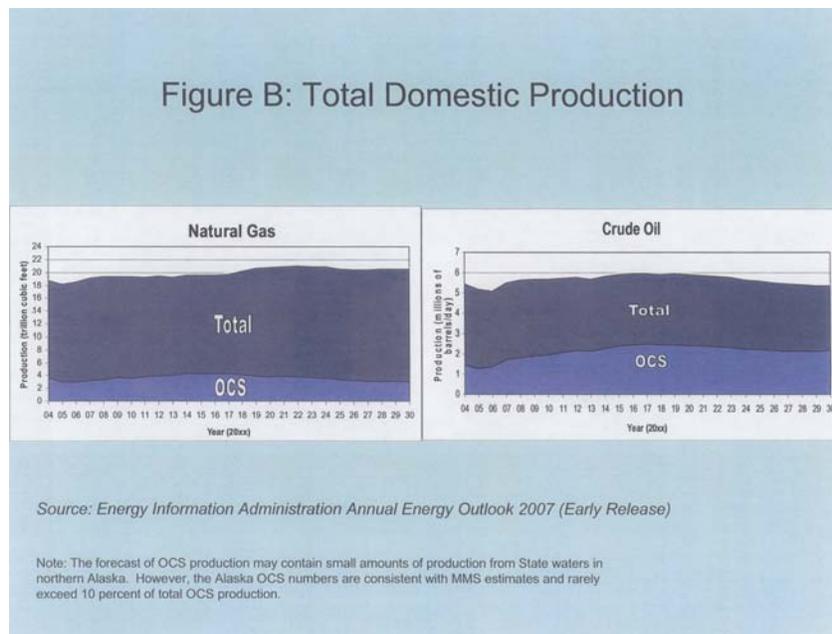
MMS BACKGROUND

The MMS has two significant missions: managing access to offshore Federal energy resources and managing revenues generated by Federal and Indian mineral leases, on and offshore. Both of these functions are important to the Nation's economic health and are key to meeting the Nation's energy needs.

The Federal Outer Continental Shelf (OCS) covers 1.76 billion acres and is a major source of crude oil and natural gas for the domestic market. In fact, according to the Energy Information Administration, if the Federal OCS were treated as a separate country, it would rank among the top five nations in the world in terms of the amount of crude oil and second in natural gas it supplies for annual U.S. consumption.¹

Since 1982, MMS has overseen OCS production of almost 11 billion barrels of oil and 116 trillion cubic feet of natural gas.

According to MMS's calculations, within the next 5 years, offshore production will likely account for more than 40 percent of oil and 20 percent of U.S. natural gas production, primarily due to deep water discoveries in the Gulf of Mexico.



Attached Figure B shows the Energy Information Administration's 2007 forecast for total domestic oil and gas production and illustrates the significance of the OCS contribution to the Nation's energy security.

To support increased production offshore, MMS's Proposed 5-Year OCS Oil and Gas Leasing Program for 2007–2012 calls for a total of 21 lease sales.

Last month, the President modified a Presidential withdrawal in order to allow leasing in two areas previously closed—the North Aleutian Basin in Alaska and an area in the central Gulf of Mexico. The President modified the leasing status of these two areas in response to congressional action and the request of Alaska State leaders. The President's action allows the Secretary of the Interior the option of offering these areas during MMS's next 5-year OCS oil and gas leasing program. In

¹ EIA U.S. Imports by Country of Origin, 12–21–2006.

addition, this administration has increased the royalty rate from 12.5 percent to 16.7 percent for any new deep water leases offered in the Gulf of Mexico.

In implementing the mandates of the Gulf of Mexico Energy Security Act, MMS will offer deep water acreage in the "181 South" area and in a portion of the Sale 181 area remaining in the Eastern Gulf of Mexico.

Our analysis indicates that implementing the new 5-Year OCS Oil and Gas Leasing Program would result in a mean estimate of an additional 10 billion barrels of oil, 45 trillion cubic feet of gas, and \$170 billion in net benefits for the nation over a 40-year time span.

In addition to providing and managing access to the OCS, MMS administers and enforces the financial terms for all Federal mineral leases, both onshore and offshore and on Indian lands.

These activities have generated an average of more than \$9 billion in revenue per year over the past 5 years, representing one of the largest sources of non-tax revenue to the Federal Government. (In fiscal year 2006, \$12.6 billion was collected and \$12.8 billion was disbursed, 60 percent of that was from offshore activities).

Since 1982, the MMS has distributed approximately \$164.9 billion to Federal, State, and Indian accounts and special funds, including approximately:

- \$101.1 billion to the General Fund of the U.S. Treasury;
- \$20.4 billion to 38 States;
- \$5.2 billion to the Department's Office of Trust Funds Management on behalf of 41 Indian tribes and 30,000 individual Indian mineral owners; and
- \$38.2 billion to the Land and Water Conservation Fund, the National Historic Preservation Fund, and the Reclamation Fund.

MMS carries out these responsibilities under statutory mandates and ongoing oversight by Congress, the Government Accountability Office (GAO) and the Department's Office of Inspector General.

I am happy to point out that for the past 5 years, as part of its annual CFO audit, MMS consistently has received clean audit opinions from the Office of the Inspector General and its delegated independent auditing firm.

1998–1999 OCS LEASES WITHOUT PRICE THRESHOLDS FOR ROYALTY RELIEF

Last month, the Department's Office of Inspector General presented its findings on the 1998–1999 deep water leases issued without price thresholds. The MMS requested this independent review last year. We appreciate the Inspector General's work and look forward to further reviewing the report.

The Department of the Interior shares Congress's frustration that during the previous Administration price thresholds were not included in the 1998–1999 deep water leases. This administration has included price thresholds in all deep water leases it has issued with royalty relief. The American people own these resources and are entitled to receive a fair return.

The Deep Water Royalty Relief Act of 1995 required deep water leases issued from 1996–2000 to include a royalty incentive that allowed companies to produce a set volume of oil and gas before they began paying royalties. Since enactment, the deep waters of the Gulf of Mexico have become one of the Nation's most important sources of oil and natural gas. Price thresholds limit royalty relief when oil and gas prices are high. Price thresholds were included in leases before 1998 and after 1999. They were not included in the 1998–1999 leases.

This matter has been a focus of mine since I assumed this position last fall. In an attempt to address the missing price thresholds, we are now negotiating with companies to obtain agreements to apply price thresholds to the deep water leases issued in 1998–1999. We are focusing our negotiations on obtaining the much larger royalty amounts to be realized from future production, estimated to exceed \$9 billion.

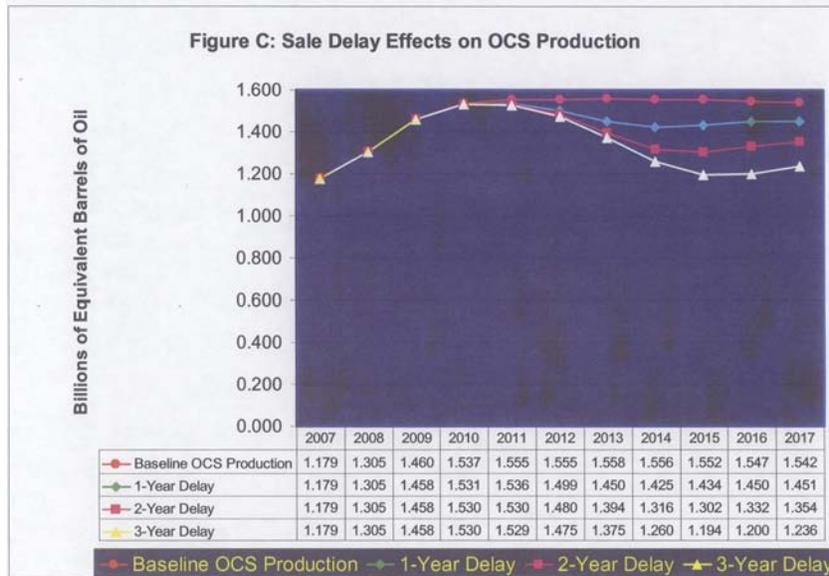
To date our progress has included agreements reached in December 2006 with six companies. This is a significant but first step; there is still much more work to do in reaching agreements with additional companies.

I have adopted three basic principles to guide my actions in seeking to resolve this matter. First, our focus will be to negotiate price thresholds in leases prospectively; second, we will not give economic advantage to one company over another; and finally, we will strive to amend these agreements in a way that will minimize litigation risk.

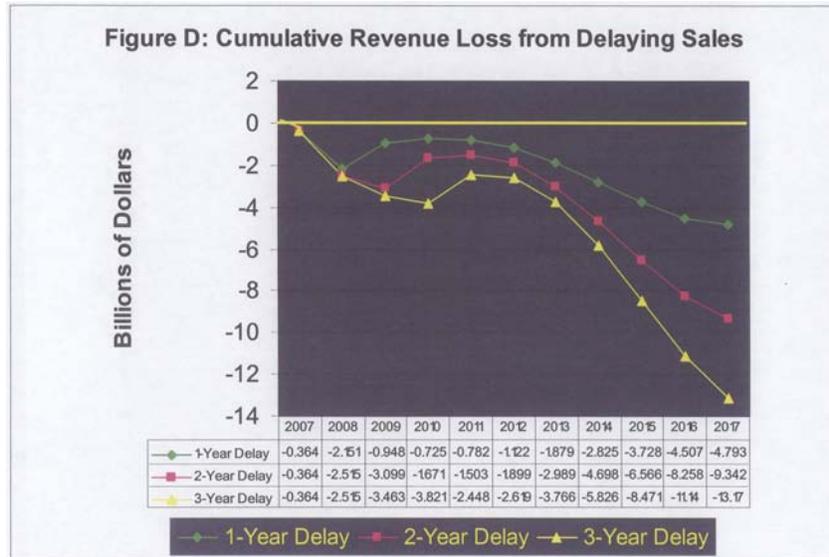
To achieve these principles, the administration and the Congress must work together. We cannot do this alone.

We know that Congress will consider addressing this issue legislatively. We appreciate Congress's efforts to encourage companies to come to the negotiating table. However, we must be mindful of potential unintended consequences. For example,

potential new legislation could conceivably result in litigation. If legislation addressed future lease sales, and if a judge were to enjoin future lease issuance for a period of time, the resulting impacts would be significant. Litigation could take years to resolve. The MMS has attempted to project what the potential loss of production, revenue and royalties if lease sales were delayed for a 3-year period could look like.



Attached Figure C shows for example, for a 3-year delay, production over 10 years would be reduced 1.6 billion barrels of oil equivalent (boe).



Attached Figure D shows for example, the expected cumulative revenue decline over a 10 year period of \$13 billion for a 3-year delay.

We all can agree this would not be in the Nation's best interest. The OCS is a significant supplier of oil and gas. We cannot afford major delays in offshore energy production due to unintended consequences.

We look forward to working with Congress on resolving this issue of national interest.

MANAGEMENT OF ROYALTY REVENUE

My second focus is the management of royalty revenue collected from Federal and Indian mineral leases. In fiscal year 2006, about 2,600 companies reported and paid royalties totaling \$12.6 billion from approximately 27,800 producing Federal and Indian leases.

MMS's mineral revenue processes and procedures are complex and involve implementing myriad statutory authorities and regulations, as well as a complex set of case law from over 50 years of administrative and judicial decisions on Federal royalty matters.

The process begins when companies calculate their payments for royalties owed the Federal Government. Royalties are calculated based upon four components: the volume of oil and gas produced from the lease, which is verified by BLM or MMS officials during regular on-site inspections; the royalty rate, which is specified in the lease document; the value of the oil and gas as determined by regulations; and any deductions for the costs of transporting and/or processing the oil and gas production, which are also determined by regulations. Companies are required to report this information and submit their royalty payments to MMS on a monthly basis.

MMS receives reports and payments from payors and accepts them into the accounting system, similar to filings with the Internal Revenue Service. Fundamental accounting processes identify revenue sources, and funds are distributed to recipients as prescribed by law. Interest is assessed on late and/or under payments.

MMS's audit and compliance program assesses whether royalty payments are correct. The types of questions that arise during compliance activities include whether the company reported and paid its royalty on the right volume, royalty rate, and value and whether the company correctly calculated allowable transportation and processing costs. Findings of underpayments are followed by collection of the payment plus interest. Enforcement proceedings range from alternative dispute resolution to orders to pay and penalty actions.

The current compliance strategy uses a combination of targeted and random audits, compliance reviews, and royalty-in-kind property reconciliations. The strategy calls for completion of the compliance cycle within 3 years of the royalty due date. In fiscal year 2006, this strategy resulted in compliance activities on \$5.8 billion in Federal and Indian mineral lease revenues, which represents 72.5 percent of total mineral revenues paid for calendar year 2003. As a result of the December 6, 2006 Office of the Inspector General report, MMS will be developing a new risk strategy and performance targets that reflect the number of companies and/or leases covered, not total royalties. In addition, as RIK gas volumes expand, MMS expects offshore compliance workloads to decrease, freeing up resources to be redirected toward highest risk, but smaller-dollar onshore Federal properties.

In recent years, MMS has completed an increased number of audits, doubling the number of audits in the most recent 4-year period over the previous 4 years. From 1998–2001, MMS, State, and Tribal auditors completed 784 audits compared to the 1,572 audits completed from 2002–2005. This increase is partially the result of the effort in 2005 on the part of MMS to close a significant number of old audits as a result of a recommendation from an external peer review of our audit activities. Collections based on audit work fluctuate from year to year. The apparent reductions in collections resulting from compliance efforts from 2001 through 2004 stand in contrast with very large collections in the 1998–2001 period. This anomaly is due to resolution during the 1998–2001 period of numerous lawsuits on undervaluation of crude oil and natural gas in previous years. The result of the resolution of these issues was large payments of additional royalties. Because these issues were resolved, no additional large payments were owed in 2002–2005.

The MMS compliance and enforcement program has generated an annual average of more than \$125 million for each of the last 24 years. In other words, MMS has collected a total of more than \$3 billion dollars in additional mineral revenues since program inception in 1982.

From fiscal year 2003 through fiscal year 2005, for every dollar spent on compliance reviews, MMS has collected \$3.27. For every dollar spent on audits, MMS has collected \$2.06.

MMS aggressively pursues interest owed on late payments as required by law. In fiscal year 2006, MMS issued over 3,800 late payment interest bills and collected a net amount of \$7 million.

MMS has authority to use civil penalties in situations where routine compliance efforts have been unsuccessful. During the last 5 years MMS has collected over \$23 million in civil penalties resulting from MRM enforcement actions. So far in fiscal year 2007 MMS has issued over \$2 million in civil penalty notices that are now in the administrative process. When combined with other MMS enforcement actions during the same time frame, MMS collected a total of \$52.4 million.

Last year, the MMS while performing reconciliation of volume imbalances, promptly identified that the Kerr McGee Oil and Gas Corporation had under-delivered royalty gas volumes to MMS's Royalty-In-Kind (RIK) program—at a time of very high gas prices. MMS pursued the issue and collected \$8.1 million—based on these high price periods—to resolve the issue.

In December, MMS announced that a bill for over \$32 million had been issued to BP America Production Company for additional royalties and interest due identified through audit work of BP's coalbed methane production that occurred in the State of New Mexico.

These day-to-day efforts are just part of MMS's normal course of business. These efforts are not only effective at ensuring compliance, but also beneficial in bringing the appropriate revenues to the States, Indians, and the American public.

I would like to emphasize, however, that although this work is important, our focus is not on numbers of audits or amounts obtained in collections. The real goal is to increase upfront voluntary compliance. We measure success in having higher levels of upfront compliance so that companies make correct payments the first time. Audits act as a deterrent, but we hope that audits will reveal fewer problems as companies become more proficient in calculating and paying the royalties they owe accurately.

MMS has taken steps to improve compliance rates in order to achieve this goal. They include the following:

—*Clearer Regulations.*—MMS has made significant progress in developing and implementing clearer regulations, eliminating much uncertainty and ambiguity that previously resulted in major findings.

—*Royalty-In-Kind (RIK).*—MMS is receiving an increasing percentage of revenues through its RIK program and has eliminated many valuation issues for the RIK volumes. During fiscal year 2006, for example, MMS received about one-third of its revenues through RIK.

—*More Effective Compliance Strategies.*—Compliance reviews have allowed MMS to cover more properties than were possible using audits alone, thereby increasing the deterrent effect. This increased presence encourages companies to be more vigilant about proper reporting and payment.

We appreciate the recent report of the Office of Inspector General concerning the audit and compliance program. The results are similar in substance to audits I have reviewed in State government or in the private sector. My experience is that in any organization with such large and complex operations, I would expect any performance audit to find opportunities for improvement. MMS has embraced virtually all of the findings, and has an action plan to address them.

We note the Inspector General's major conclusion that compliance reviews are a useful tool in our program, and we look forward to implementing recommendations to further improve our application of compliance reviews. We submit for the Committee's attention our "Action Plan to Strengthen Minerals Management Service's Compliance Program Operations" which documents improvement actions taken and planned in this area.

MMS does not work alone in its efforts to ensure the proper collection of royalties; MMS collaborates with the States and tribes on our compliance and audit activities. In addition, every three years, the Federal audit function of MMS is peer-reviewed by an outside independent certified public accounting firm. Most recently, in 2005, the MMS audit program was found to meet all applicable government auditing standards. As noted earlier, for the past five years, as part of its annual Chief Financial Officer audit, MMS consistently has received clean audit opinions from the Office of the Inspector General and its delegated independent auditing firm.

Having said that, it is also true that MMS continues to look for ways to improve its programs, practices and performance. We welcome input from this Committee, the full Congress, the Office of the Inspector General, GAO and the public.

In response to the recent interest regarding the accuracy and effectiveness of the MMS's royalty management program, Secretary Kempthorne and I determined that an independent panel should be convened to review the procedures and processes

surrounding MMS's management of mineral revenue. We are committed to ensuring our processes are effective and transparent, and we welcome advice and counsel.

The new panel will operate as a subcommittee under the auspices of the Royalty Policy Committee, an independent advisory board appointed by the Interior Secretary to advise on royalty management issues and other mineral-related policies.

The Subcommittee on Royalty Management has been asked to review prospectively:

- The extent to which existing procedures and processes for reporting and accounting for Federal and Indian mineral revenues are sufficient to ensure that the MMS receives the correct amount.

- The audit, compliance and enforcement procedures and processes of the MMS to determine if they are adequate to ensure that mineral companies are complying with existing statutes, lease terms, and regulations as they pertain to payment of royalties.

- The operations of the Royalty-in-Kind program to ensure that adequate policies, procedures and controls are in place to ensure that decisions to take Federal oil and gas royalties in kind result in net benefits to the American people.

The subcommittee will conduct its review over a 6-month period and then provide its final findings and recommendations to the full Royalty Policy Committee and the Secretary of the Interior. We will be happy to share the recommendations with you when they are available.

Members of the subcommittee will be announced in the near future.

STRATEGIC PETROLEUM RESERVE

During the State of the Union Address, President Bush announced plans to double our nation's Strategic Petroleum Reserve (SPR) to 1.5 billion barrels of oil. Also announced was a directive to fill the SPR to its current capacity of 727 million barrels. MMS will provide royalty in kind oil starting in July 2007 to accomplish this mandate. This policy decision will provide an additional layer of protection for our nation's energy security.

FISCAL YEAR 2008 PRESIDENT'S BUDGET REQUEST

For fiscal year 2008, MMS has submitted a budget request of \$297 million in current appropriations and offsetting receipts which is an overall increase of \$5 million from the fiscal year 2007 President's Budget (an additional \$16 million relative to the 2007 Continuing Resolution that is currently in place). The additional funds requested in the President's Budget will improve MMS' ability to: implement the 5-Year Oil & Gas Leasing Program (2007–2012); provide oversight of increasing ultra-deepwater offshore development; hire specialized staff to address well abandonment and pollution prevention issues in the Gulf of Mexico region; and fully fund projected fixed cost increases for personnel-related costs and rent.

In addition to the items listed above, the President's Budget also includes additional funding for two systems changes that are designed to enhance compliance and enforcement efforts in the management of mineral revenues. The budget includes \$940,000 for an adjustment line monitoring initiative for MRM Support System modifications to ensure that company reporting adjustments are made only within allowable timeframes. The budget also includes \$1.45 million for the first year of a two-year interactive payment reconciliation and billing initiative, which will allow MMS to automate the interface with its customer base on numerous activities. Both of these proposals provide a strong return on investment and will provide MMS with the resources necessary to continue to improve its robust audit and compliance program.

CONCLUSION

In the four months since I was confirmed to this position, I have been working closely with the MMS to understand the complex processes associated with accounting for the revenues generated from oil and gas development on Federal lands, including the Outer Continental Shelf. In an effort to gain a greater understanding of this work, in early January I traveled to MMS's Denver Office where I reviewed the procedures and controls used to ensure that minerals revenues are properly reported and accounted for. I also visited offices and reviewed operations in the Gulf of Mexico Regional Office.

This work is very important and must be undertaken carefully. Equally important, and very important to Secretary Kempthorne and me, is that we conduct business with the highest standards of ethics possible. Making sure we can live up to that standard has been a high priority of mine. I have stressed, and will continue to stress, our obligation to conduct ourselves in accordance with the highest ethical

standards and to be accountable for our actions. Moreover, our conduct must be ethical both in fact as well as in perception.

To summarize my remarks today, I want to reiterate I will continue to focus on several key areas as I provide oversight to the Minerals Management Service.

We will issue our 5-year proposed OCS leasing program on time. This is an important plan that addresses national energy security and facilitates the development of critical energy resources now and in the future.

I will continue to seek prospective royalty agreements with the companies that entered into leases issued in 1998 and 1999 that lack price thresholds in order to capture the majority of the revenues the government would have received.

I am pleased at the results of our efforts thus far, but recognize that there is much more work to be done. I look forward to continuing to work with you, the members of Congress, to address this important issue.

In addition, I will continue to work with MMS to review and improve our royalty management programs. I have every confidence that MMS will successfully implement appropriate Inspector General's recommendations and that the review by the soon-to-be finalized Royalty Policy Subcommittee will provide a fresh perspective on royalty management issues and challenges.

I welcome your input on all of these initiatives, and I look forward to working with you.

Chairman Feinstein, this concludes my remarks. I would be happy to answer any questions you have.

1998 AND 1999 LEASE SALES

Senator FEINSTEIN. Thank you very much, Mr. Allred.

We will have 5-minute rounds. If the staff could begin the clock running that would be appreciated.

I am going to go rapidly through a series of questions just to establish a record if I might, and if you could answer them briefly I would appreciate it.

First, how much revenue was lost from 1998 to 2006 as a result of the failure of MMS to specify price thresholds in the 1998 and 1999 lease sale contracts?

Mr. ALLRED. Madam Chairman, we believe that that is approximately \$900 million.

Senator FEINSTEIN. Thank you very much, Mr. Allred.

How much more does the Government stand to lose from these leases?

Mr. ALLRED. Madam Chairman, we have to make a lot of assumptions in doing this, but in making the assumptions based upon what we believe will be producing leases, we believe that is about \$9 billion.

Senator FEINSTEIN. For a total then of \$10 billion?

Mr. ALLRED. Approximately \$10 billion, yes.

Senator FEINSTEIN. Thank you.

Some of the companies have agreed to begin paying royalties effective October 2006. Are they agreeing to pay royalties on sales prior to last October?

Mr. ALLRED. Madam Chairman, in the contract amendment that I negotiated we reserved that issue. We did not deal with it.

Senator FEINSTEIN. So the answer is no, is that correct?

Mr. ALLRED. In the current signed agreements, they do not require them to pay prior to October 1. But that is not a resolved issue.

Senator FEINSTEIN. Thank you.

Are the companies that voluntarily comply paying the same royalty rates as the other leaseholders who entered into leases since 1999?

Mr. ALLRED. Madam Chairman, yes, they are. Those threshold rates are the same adjusted for inflation forward.

Senator FEINSTEIN. Thank you.

For the record, which companies are participating and which are not?

Mr. ALLRED. Madam Chairman, I am going to have to do this from memory, but it is BP, Shell, Marathon—

Senator FEINSTEIN. ConocoPhillips?

Mr. ALLRED. ConocoPhillips, and two companies of the Walters Group, two separate companies.

Senator FEINSTEIN. The holdouts are?

Mr. ALLRED. There are a number of them. If I could put up another chart it probably would be easy to illustrate.

Senator FEINSTEIN. I would just like, if you could, a listing of the companies that are holdouts.

Mr. ALLRED. The major companies are ExxonMobil, which has a small amount, Chevron-UNOCAL, Devon, Anadarko-Kerr McGee, Dominion Exploration and Production, Marabeni, which is out of Italy, Total, which is Norwegian. Then there are 32 other companies that have each, have small amounts each, but they total 29 percent of the estimated production.

Senator FEINSTEIN. Thank you. Thank you. This is very helpful.

Are foreign companies responsible for about 20 percent of deep water oil and gas production?

Mr. ALLRED. Madam Chairman, the companies—one of the things that you have to do is to have a U.S. subsidiary in order to hold leases. But those companies which do not otherwise operate in the United States comprise about 20 percent.

Senator FEINSTEIN. Thank you.

Would legislation to extend the duration of the 1998–1999 leases be an incentive to the holdouts to start paying royalties?

Mr. ALLRED. Madam Chairman, I believe that it would. In my discussions—and this has not been with all of them, but just speaking about the issue generally—I believe that that would favorably move us forward on changing the agreements. Without specific language, as you are aware, it is hard to get a commitment. But I believe that that would be viewed favorably.

Senator FEINSTEIN. Well, we are working on specific language and we would look forward to going over that with you if we might. That would be an extent of the leases in exchange for a payment of the back royalties.

Mr. ALLRED. We look forward to working with you on it.

Senator FEINSTEIN. Thank you very much.

My time has just about expired. I have got 6 seconds to spare. In order of arrival, the Senators are Senator Alexander, Senator Reed, and then Senator Domenici. Senator Alexander.

STATEMENT OF SENATOR LAMAR ALEXANDER

Senator ALEXANDER. Thank you, Madam Chairman.

I am glad to see Senator Domenici here because I want to talk about him. I would like to talk about a little different subject, but it has the outer continental shelf leasing in mind. It is something we have begun to call the Domenici one-eighth, and I wanted to ask about the Land and Water Conservation Fund as it relates to

the legislation Congress passed at the end of the last session, which allows for additional drilling in what we call lease 181. Within that there is a provision that \$1 out of \$8 that come in—that is the Domenici one-eighth—would go to fund the State side of the Land and Water Conservation Fund.

I want to talk about that and ask you a couple questions about it. The history on this is the following. In 1965 Congress created the Land and Water Conservation Fund and authorized funding of \$450 million for the State side and \$450 million for the Federal side. This was very helpful to States and cities. The chairman is a former mayor. I am a former Governor. We use this money for city parks, State parks, recreation areas, usually matching it with private funds and other funds.

The original funding for this was to come from sales of surplus Federal real property, motorboat fuel taxes, and fees for recreation use, but that did not amount to much, and so Congress added a different source. In 1968 an additional source of funding for the Land and Water Conservation Fund was to be revenues from the outer continental shelf development. It was to be a sort of conservation royalty. States get royalties when you drill onshore. It goes to the State. The idea would be if we do some drilling and we have an environmental burden maybe we will have an environmental benefit.

In 1985 a commission which I chaired and President Reagan appointed, called the President's Commission on Americans Outdoors, recommended that we fully fund the Land and Water Conservation Fund from receipts from the outer continental shelf. That has never really happened and in the last few years funding for the State side of the Land and Water Conservation Fund and the Federal side has been very low.

So in light of two developments, one of which the Senator from California was talking about and one is the Domenici one-eighth, I am looking to see if maybe we can—and perhaps through this subcommittee, Madam Chairman, would be a good place to begin a discussion—move toward full funding of the Federal side as well as the State side of the Land and Water Conservation Fund.

So my questions would be two. One would be, do you know yet how much money would be allocated to the State side of the Land and Water Conservation Fund as a result of the Domenici one-eighth, the conservation royalty that Congress enacted last year? Second, have you considered the possibility that as we negotiate, as you negotiate or Congress makes some decisions about this up to \$9 billion of money that should be owed to the taxpayers, have you considered whether some of that money could appropriately be used for the conservation royalty so that we could see full funding of the Land and Water Conservation Fund? Those are my two questions.

Mr. ALLRED. Senator, with regard to the first question, let me ask my staff if we have a forecast. I am not aware of one.

Senator ALEXANDER. If I do not today, could you supply the committee with an answer to that question?

Mr. ALLRED. Senator Alexander, I would be glad to do that. I think rather than giving you a number that I am not sure of, I would just rather get it to the committee.

[The information follows:]

GULF OF MEXICO ENERGY SECURITY ACT (GOMESA) OF 2006

GOMESA authorizes 12.5 percent of certain OCS receipts (subject to a cap in later years) to be deposited into the LWCF and made available in the following year for the National Park Service State LWCF grant program. Receipt projections are as follows:

[In millions of dollars]

	2007	2008	2009	2010	2011	2012
GOMESA receipts for LWCF	6.4	10.9	0.9	0.4	0.4
NPS LWCF Grants disbursements	6.4	10.9	0.9	0.4

Senator ALEXANDER. My understanding was that it would be a low number in the early years, but it might grow to be a number that could be as high as \$80 to \$100 million a year. As you consider your answer, will you also consider, I believe 181 had two parts to it. There was a Lease 181 and then there is some other area which we know less about, and that might be an even larger amount of funding that could come to the Land and Water Conservation Fund.

What about the possibility of using this up to \$9 billion, some of that money to appropriately fund the Land and Water Conservation Fund, as has been anticipated by Congress since 1968 and recommended by President Reagan's commission?

Mr. ALLRED. Senator, as you can imagine, that \$9 billion has attracted a lot of attention up here on the Hill, and we are prepared to put it wherever you choose to put it.

Senator ALEXANDER. Thank you, Madam Chairman.

Senator FEINSTEIN. Thank you.

Senator ALEXANDER. Madam Chairman, I would hope that—I know of your long interest in these issues and I would hope that we might have more discussions at some time about the Land and Water Conservation Fund.

Senator FEINSTEIN. I would look forward to that, Senator. Thank you very much.

Senator Reed.

1998 AND 1999 LEASE SALES

Senator REED. Thank you very much, Madam Chairman.

Thank you, Mr. Allred, for your testimony. The Secretary is in negotiations now with these leaseholders to correct the problem because of the contract. What leverage does he have in that negotiation and what leverage, additional leverage, might he use?

Mr. ALLRED. Senator Reed, up until this point in time I think the leverage we have is that of the goodwill of the companies themselves and the public pressure that they obviously are under with regard to this issue. That is why when asked in the Energy Committee hearing what other tools I would need that I suggested that it would be very helpful if we had the ability to offer these companies, based on due diligence upon a particular lease, an extension of 3 years. I believe in my discussions, again in very general terms, that that would attract many of the companies.

Senator REED. Has there been any consideration to barring these companies from further lease activity if they fail to negotiate?

Mr. ALLRED. Senator, we do not have the ability to do that.

Senator REED. That would require legislation?

Mr. ALLRED. That would require legislation. What I am concerned about, though, is the curves that I showed you previously, that that would have to be done I think very carefully so that we were not enjoined from issuing further leases. That is my concern as to how we do that.

KERR-MC GEE LITIGATION

Senator REED. Kerr-McGee is involved in litigation which could result, according to some reports, for up to a \$60 billion loss to the Treasury over 25 years. What is the administration doing to respond to the litigation, both in terms of trying to prevail, I presume, but also if that happens what is the fallback position?

Mr. ALLRED. Senator, that issue has to do with whether or not the act passed by Congress authorized us to put price thresholds on. It covers a period from 1995 to 2000. So it would have a big effect. GAO has estimated that that is like \$60 billion if they were to prevail.

We feel—our Solicitor's Office tells me and the Department of Justice they are confident in our position. However, you and I know judges do sometimes surprising things. We have been in mediation in an attempt to find a way to solve it. Of course, Kerr-McGee has been bought by Anadarko. I believe Anadarko would like to find a way to solve this issue. At this point in time we have not been able to do so. If we are unable to reach any agreement, my understanding is that on March 1 the court will then have to decide how to go forward and schedule the court proceedings.

It is a concern to us because, again, while we feel good about our position, courts can find however they find on these issues dealing with authorities under legislation.

ROYALTY RATES ON DEEP WATER GULF OF MEXICO LEASES

Senator REED. Mr. Allred, the President's budget proposes to increase royalty rates on deep water Gulf of Mexico leases starting in 2007 and to repeal certain provisions on deep water gas and oil drilling. Has the Department taken a comprehensive evaluation to determine whether the existing or proposed royalty provisions reflect changing market conditions? Specifically, how do they compare with rates charges by States on State land and private land-owners who are similarly selling the same thing? Are they getting the same return on their property?

Mr. ALLRED. Senator Reed, one of the reasons we changed it was that we felt that the activities on the shelf had matured to the point that we did not need as much incentive to get people out there. When you looked at the early days of drilling on the OCS, outer continental shelf, there was a high degree of risk. No one had done it before. Fifty years ago, it was very difficult to drill in 10 feet of water. Now we are drilling in 10,000 feet of water.

But we think there has been enough experience and enough technology development that the lower rates are no longer necessary. Now, as we have looked at comparing our processes with those on

State lands, State lands are—sometimes they mimic what we do and sometimes they are more or less. But there is a significant difference, particularly with regard to the OCS, in that when you can drive a rig up on dry land and drill a hole, you still have the risk of whether the resource is there or not, but you do not have all the other risks that are involved. That is one of the reasons why, for example, we did not increase it in Alaska, because there still is too much technology and too much risk there, we think, to raise that royalty rate in those areas.

So we look at this. We try to make judgments based on market conditions and then make a decision as to how to go forward.

Senator REED. Thank you, sir.

Thank you.

Senator FEINSTEIN. Senator Craig, the ranking member, has arrived. Senator, if you would like to make a brief statement, then we will go to Senator Domenici if that is agreeable.

Senator CRAIG. Thank you very much, Madam Chairman, for that courtesy. I wanted to get here to ask Mr. Allred a couple of questions, but at least for the time now let me congratulate you on becoming the chairman of this very important subcommittee, a tremendously important subcommittee for California, for the State of Idaho when we look at our land masses.

But now we are off, obviously, on an area that remains extremely important to both of us and that is energy production, done appropriately, in the outer reaches of our country and the difficulties involved and the complications that we know are there, both in contract and in the environmental realities.

Again, thank you and congratulations, and I look forward to working with you.

Senator FEINSTEIN. Thank you very much. I do as well.

Senator Domenici.

STATEMENT OF SENATOR PETE V. DOMENICI

Senator DOMENICI. Thank you very much, Madam Chairman. I am delighted to serve on your committee. I have been active heretofore and hope to continue.

We have a hearing now in the Energy Committee with three eminent scholars talking about climate change. So there are three hearings in the Congress today. I figure when those hearings are finished we will have solved the problem. Maybe tonight or tomorrow morning we will have it all solved.

Senator CRAIG. The ice storm will be over and it will be warm again.

Senator DOMENICI. In the meantime, let me just make sure that I state for the record what I know about this situation. Frankly, the Clinton administration and bidders set about to procure some leases in 1998 and 1999 and they were signed without any royalties. Neither side, neither the administration or the bidders, claim that anything was amiss. They just did not think royalties had to be in the leases or forgot or made a mistake, but just did not put them in.

Now, some run around saying that we are being cheated out of all this money. The truth of the matter is that it is a very legal

situation. It was done in a legal manner. But it is probably a mistake.

I think, Madam Chairperson, we have to try to resolve this issue in a way that will bring these oil companies to the table and talk good sense and suggest that indeed they ought to pay it as if it was in their leases and then actually change the leases to reflect that.

I want to ask you, have you asked the Solicitor whether there is any doctrine, any legal doctrine, which would permit the two parties to make a change here? Is there a mistake doctrine that would permit two contracting parties who made a mistake to come back and amicably adjust the mistake, sir?

Mr. ALLRED. Senator Domenici, we have looked at that issue a number of times and, while we always maintain our options based upon a set of facts that are before us, I think the report of the Inspector General makes it very difficult to claim the mistake. What the Inspector General has laid out is that in the preparation of the 1998 leases, and consequently the 1999 leases, there was a definitive decision and the person who wrote them was instructed to remove the price thresholds from those leases.

What is not clear is why or who gave that instruction. But given that information from the Inspector General, I believe that, and I am so advised by our Solicitor, that it would probably be very difficult to win an argument of mistake.

Senator DOMENICI. Well, I want to suggest, Madam Chairperson, that we use this committee and your leadership to get the oil companies in and have a talk, serious talk about getting this resolved. There are people here who want to do all kinds of things as a result of this where they lay blame and say therefore we want to take away the future of these oil companies. They do not deserve to be denied any future drilling. They did nothing wrong.

But we look at it and say, why should you get away with none for that year when you really should be paying. It is not like we could enforce it. We cannot go to court and get the money. I hope everybody understands that. If they could they would go there.

So I think these oil companies ought to know that to stay on the good side of Congress as we proceed with further royalty situations—and we will have a lot of them; we did that one big bill which you are aware of, that is going to open up a lot of bidding. These people are going to have to be out there bidding because they want to make money. We ought to see if we cannot get them in and say, the best thing for you would be to pay up.

I thank you for letting me mouth off here. I was not able to do it, but I was not in the right position, and I would help you in anything you would like to do.

Senator FEINSTEIN. Thank you very much, and I am very heartened by your comments and we will all work together toward that end.

Senator CRAIG, would you like a first round and then we will go to a second round.

MODIFYING COMPANY CONTRACTS

Senator CRAIG. Let me pick up where Senator Domenici left off, because this is obviously an important issue. It is a big dollar issue. It is also a very complicated legal issue that I know you are

trying to sort yourself through, Mr. Assistant Secretary Allred. Can you discuss the potential impact to the marketplace if statutory language was passed that coerced companies into modifying their contracts? Have you thought about that?

Mr. ALLRED. Senator Craig, it is always a pleasure to be in a hearing with you.

I have thought about that and, as you are aware, much of my career was in private business, where as a senior executive officer I had to make decisions about investments. So that colors my thoughts a little bit about how we deal with this issue.

Companies are willing to invest a certain amount of money. In deciding how to invest that amount of money, in order to reach their fiscal objectives, they are going to look at a number of things. One of them is risk. That will be either technological risk or political risk. I think it is interesting to look at what happens elsewhere where the political risks become so great that they choose either not to invest or they choose to only invest in the most lucrative projects.

So, if our concern is to develop as much domestically controlled oil as we can, I think if we were to develop an atmosphere here that would raise those risks to a company seeking to invest, it would be detrimental to our efforts to develop that oil. So I think again, just as I have concerns about the unintended consequences of what we do, I think our decisions have to be well thought out from the standpoint of business going forward and encouraging people to use private resources to develop these oil sources that we need.

Senator CRAIG. Well, we all know that where we are today in deep water is, while there has been some successes, it still is on the margin, and there is a margin out there. You call it risk. It is also an oil company not becoming a partner or a direct participant anymore with foreign resources, but simply becoming a service company that ultimately develops them for a foreign country. I do not think oil companies want that either.

So I have always felt that in correcting this—and I am not objecting in any way to its being corrected. I tend to agree with Senator Domenici that this needs to get solved. But it is important we do it in the context of the broader picture and what it may or may not do.

For example, would oil companies potentially pay less in bonus bids for the right to lease offshore if this kind of uncertainty over the sanctity of contracts is introduced into the marketplace?

Mr. ALLRED. Senator, I believe that they would. When you look at what a company decides to bid on a lease, they will apportion that among a number of things. For example, one of them will be bonuses; one of them will be royalty payments and rental payments; the other one will be the risk I talked about. If that risk number goes up, obviously the bonus number will go down.

Senator CRAIG. Well, there are other questions for me to ask. I am bouncing back and forth between a couple of committees. I think it is important, Madam Chairman, that we solve this problem and work cooperatively with the agency to get it done in a way that maintains the sanctity of a government contract, a government relationship with the private sector. We have phenomenal re-

sources out there. We ourselves are not in the business of developing them. We are in the business of developing relationships with the private sector as they develop them. We have had a good reputation to date in doing so. As we sort through who did not do what, when, and the impact it has, I think the issue at hand is getting it over with, getting it done right, and maintaining a relationship between the private sector and the government that is a reputable one.

Senator FEINSTEIN. I agree with you, Senator. Thank you very much.

INSPECTOR GENERAL REPORT ON LEASE SALES

I would like if I might to begin a second round. Mr. Allred, I want to just clear up something that you just testified to by reading directly from the IG report on the subject: "We found that shortly after the inception of the Outer Continental Shelf Deep Water Royalty Act in 1995, MMS made the policy decision to include price thresholds in the leases between 1995 and 2000. Field personnel initially attached addenda to the leases containing price threshold language, but it stopped for 2 years and instead cited a regulation that they thought contained threshold language when in fact it did not. MMS' review process, which included the Solicitor, simply failed to identify this discrepancy."

Is that an accurate statement of the facts?

Mr. ALLRED. Madam Chairman, that is what the Inspector General believes to be the overall impact. In the detailed report you will find e-mails and other information from the person who actually prepared it, where he was told to exclude it. I have asked this question several times as to who told him that. The conclusion that the Inspector General came to, was that it was probably a lack of coordination where rules were being developed and leases were being written and the two were never reconciled. That is his conclusion based upon what he saw out there.

I have no reason to dispute that. There just is no information as to—and I have asked several times if he could get more information. He has told me that it is just not available. So I think that is probably as good a characterization that could be made.

I think it was a definitive decision to not put them in. Why that decision or whether anybody realized the impact of not putting them in I think are two different things.

Senator FEINSTEIN. Well, the report then goes on to say: "We found that the omission was first brought to the attention of the former associate director for offshore minerals management in 2000. She chose not to inform the former MMS director, preferring to work out a solution within OMM."

That it seems to me was a big mistake. I mean, to see that this happened and not bring it to the attention of the director is certainly a major error in judgment, to say the least.

Mr. ALLRED. Madam Chairman, in fact there is a letter that resulted I believe from the incident you are talking about—it is not in the report, but it is available. The associate director at that point in time wrote a letter to the oil companies saying that they should not misinterpret the lack of price thresholds being in the leases as the authority not to include them because the Secretary

had the prerogative at that point in time whether or not to include them. So there was a response to the oil companies. It is a little bit hard from that letter to understand exactly what they were saying about the lack of price thresholds in the companies——

Senator FEINSTEIN. May we receive a copy of the letter for the record, please?

Mr. ALLRED. Madam Chairman, I believe that your staff already has that.

Senator FEINSTEIN. We will check. Thank you. Thank you very much.

[The information follows:]

MARINER ENERGY, INC.,
WESTLAKE PARK BLVD.,
Houston, Texas, January 12, 2001.

U.S. Department of the Interior,
Minerals Management Service, Gulf of Mexico OCS Region, New Orleans, LA.

Attn: Mr. Chris C. Oynes, Regional Director

Re: Deep Water Royalty Relief Act Price Triggers

GENTLEMEN: The Deep Water Royalty Relief Act ("the Act") authorized, among other things, royalty suspension volumes for certain deep water leases in the Gulf of Mexico. When applicable, certain price triggers eliminate royalty suspension volumes for the year in which the price of oil or gas exceeds a specified threshold. The Act does not expressly authorize the Minerals Management Service (MMS) to apply the price triggers to "post-Act leases."

Mariner Energy, Inc., was recently informally notified by your office that the MMS intends to collect royalty on some post-Act leases by virtue of a price trigger provision included as an addendum to those leases. This letter is to outline Mariner's position objecting to collection of royalty on these leases and to request a meeting where these issues can be more completely discussed.

BACKGROUND

In 1995, Congress passed the Outer Continental Shelf Deep Water Royalty Relief Act, codified at 43 U.S.C.A. 1337. Among other things, the Act authorized royalty relief for certain deep water leases in the Gulf of Mexico. Specifically, Congress required the automatic suspension of royalties on all eligible leases purchased in the five years following the date of enactment, so-called "post-Act leases."

The Act also allows qualifying leases in existence on the date of the Act, so-called "pre-Act leases," to apply for royalty relief. If, however, oil or gas prices reach a certain ceiling in a given year, the Act requires the payment of royalties on pre-Act leases. Significantly, Congress did not include price triggers for post-Act leases. The MMS implementing regulations, 30 C.F.R. Part 260, also do not contain price triggers for new leases.

Although not authorized either by statute or agency regulation, the MMS lease form used for the first four post-Act offshore lease sales (Sale 157, Sale 161, Sale 166, and Sale 168) contained an addendum with price triggers. The MMS removed the price trigger language from lease forms and notices of sale for subsequent sales.

Mariner Energy, Inc., is lessee under several post-Act leases that contain price trigger language. Three of those leases, Garden Banks 179 and 367, and Ewing Banks 966 had natural gas sales in the year 2000.

DISCUSSION

When enacting the Deep Water Royalty Relief Act, Congress expressly conditioned royalty relief for pre-Act leases on oil and gas prices remaining below a certain threshold. Congress placed no such limitation, however, on the automatic minimum royalty suspension volumes given to post-Act leases.

We contend that Congress intentionally chose not to apply price triggers to post-Act leases. Post-Act leases were offered for sale with the promise of minimum royalty suspension volumes to increase leasing activity in the Gulf and, as a result, bonus bids at post-Act sales increased significantly. On the other hand, because pre-Act lessees had already purchased their leases without royalty relief incentives, it was reasonable to impose a suspension of relief thereafter granted by the Act when oil and gas prices are high.

Further, while the Act specifically instructs the Secretary to promulgate implementing regulations, he chose not to include price triggers in the regulations applicable to post-Act leases. The only price triggers are found in 30 C.F.R. §203.78 which applies to pre-Act leases. By comparison, MMS's recent proposal to extend royalty relief for future leases by administrative means contains express price trigger language.

Finally, the fact that MMS removed the price trigger language from the lease forms and notices of sale after the fourth post-Act sale indicates the agency's recognition that it was not authorized to include the price triggers in post-Act leases.

In summary, it is Mariner's position that price trigger provisions included in post-Act leases are without statutory or regulatory authority and are therefore unenforceable.

Mariner Energy wishes to thank you in advance for your consideration in this matter, and we will be pleased to meet, at your convenience, to more fully discuss the issues.

Regards,

MARINER ENERGY, INC.,
Tom E. Young, Vice President-Land.

U.S. DEPARTMENT OF THE INTERIOR,
MINERALS MANAGEMENT SERVICE,
Washington, DC, February 14, 2001.

Mr. TOM E. YOUNG,
Vice President-Land, Mariner Energy, Inc., Houston, Texas.

DEAR MR. YOUNG: This letter responds to your letter of January 12, 2001, to the Regional Director, Gulf of Mexico Region, on the subject of "Deepwater Royalty Relief Act Price Triggers." Therein, you objected to our intent to collect royalties on certain deepwater leases and requested to meet with us. We will comment on your specific points below. After reading our response, if you should still want to have a meeting, we will be happy to do so. Simply call my office, or that of the Regional Director so we can arrange a site and time.

As you know, the Deep Water Royalty Relief Act (DWRRA) of 1995 provided for suspension of royalties for specified volumes of production for both active deepwater leases issued before passage of the Act and for new leases. As accurately noted in your letter, the Act also specified certain price thresholds that can rescind the royalty suspension volumes for years in which oil or gas prices exceed the thresholds. This past year is the first time the price threshold provisions have been triggered. The average price for natural gas in 2000 is 13.5 percent higher than the threshold. As gas prices were rising dramatically throughout the year, we published on our web site the implications of rising prices on royalty suspension leases. We also spoke to representatives of your company on numerous occasions about this emerging energy situation and its potential effect on suspended royalties. This was to ensure that the effect of higher prices would not be a surprise to your company.

As you know, the Minerals Management Service alerts bidders in our proposed OCS lease sale notices about the terms of the deepwater leases offered for sale on which they bid. The Secretary under U.S.C. 1337 and 30 CFR 260 may set and vary the terms and conditions thereof for each OCS lease sale. For your leases in question, the price threshold requirement was noted in the proposed and final Notices of Sale, and more importantly, in the lease documents that you and any joint owner signed. Accordingly, we expect that bidders are aware of the price threshold condition on the royalty incentive before acquiring a deepwater lease and factor the chance of the royalty suspension being unavailable under higher prices when formulating their bonus bid amounts for deepwater leases. Thus, while lease terms may change upon mutual agreement in certain situations, we think that a change now would, among other things, provide a windfall to those who bid on the value of the tracts in the presence of a price threshold. Hence, we cannot re-consider this lease term as a result of the contractual condition now being triggered by rising gas prices.

Despite the price threshold terms in your leases, you now contend that MMS did not have the authority to impose this condition because Congress explicitly specified price threshold language under DWRRA only for pre-Act leases. However, when offering leases with royalty suspensions, the Secretary under the OCS Lands Act (OCSLA), acting through MMS, does have authority to propose various terms and conditions on OCS leases, and hence to apply price threshold conditions for this royalty relief to post-Act deepwater leases as well, as discussed below.

Section 302 of the DWRRA provides a rather elaborate framework for evaluating requests for royalty relief from lessees holding certain deepwater tracts acquired prior to passage of the Act. Within this framework is a provision in Sections 302(v–vii) for a specific type of price threshold to apply. It stipulated, *inter alia*, that in any calendar year in which actual oil or gas prices exceeded its associated threshold price (as adjusted for inflation), royalties would be due on the relevant production for that calendar year even if such production were subject to an otherwise-approved suspension in royalties. Moreover, the relevant production in that year would be counted against any remaining royalty suspension volumes.

In contrast, no such elaborate framework was provided in Section 304 of the DWRRA addressing suspension volumes for newly offered deepwater leases. Rather, Section 304 referred back to Section 302 and simply set suspension volumes for leases issued in the 1996–2000 period at levels equivalent to those specified for pre-Act leases. For designing the bidding system and specific terms of sale for these deepwater leases, Section 304 requires MMS to use section 8(a)(1)(H) of the OCSLA, as amended by Section 303 of the DWRRA. The amendment in Section 303 not only provides us the general authority to utilize royalty volume suspensions in future OCS sales, but also states that the “suspensions may vary based on the price of production from the lease.”

Thus, the DWRRA actually provided MMS with even broader authority to specify or tie the amount of royalty suspension volume to price conditions for new leases. In practice, MMS chose to use the same price threshold for new leases as Congress mandated for active ones. This was partly to ensure administrative efficiencies when leases are unitized. Congress did not mean to omit specific price trigger language for new leases because it didn’t want MMS to use them. Instead, Congress provided broader authority for MMS to use or not use price triggers in a form we determined would be appropriate and consistent with the objectives of the Act. This observation is also true for other terms and conditions of sales held during the 1996–2000 period.

You have also stated that certain actions by MMS in promulgating the implementing regulations and lease notices indicate that MMS recognizes that it lacks authority to include price triggers for post-Act leases, but this is not the case. For interim regulations immediately following passage of the Act, MMS addressed price thresholds for active leases because Congress had mandated the specific elements. In contrast, because Congress did not mandate the specific elements for terms of new leases, we did not address it in regulation. Rather, we determined that the specific form of certain elements such as price triggers, would be best determined at the time of sale to allow more flexibility on the application and form.

For Notices of Sales held in 1998 and 1999, the price trigger language was left out of the notices and lease documents. This was within the discretion of MMS and the Secretary. Moreover, the threshold was reintroduced in subsequent sales. Therefore, it is incorrect for you to conclude that the omission of price threshold language from an earlier version of MMS’s regulations or certain lease sale documents is germane to the question of MMS’s authority to include price triggers with royalty suspension for post-Act leases.

We can understand that lessees are not anxious to have royalties due when price thresholds are actually exceeded. However, the intent of DWRRA, and MMS policies implementing it, were understood similarly by all stakeholders from the outset—i.e., to provide sufficient financial incentives to promote deepwater activity under certain conditions, with oil and gas prices being an explicit consideration. We believe Congress included references to product prices and specific price thresholds in the Act to protect interests of the Treasury for those years when prices rise to levels where the royalty incentive is no longer needed or appropriate, and in instances where MMS’s authority to set terms and conditions unilaterally, i.e., for active leases, is less flexible than for new leases.

In general, when oil or gas prices rise significantly relative to historic trends or price expectations, the profit gains to the lessee far outweigh any royalties due the government as a result of the price threshold terms. It is reasonable that the nation, as owner of the mineral resources, should participate in the revenue benefits of the price gain, as it was willing to provide the financial incentive when needed to promote the development of the resource at lower prices.

We appreciate your interest in our program and your willingness to share your concerns with us. But, we see no reason at this time to change our position concerning the application of price threshold terms in post-Act deepwater leases.

Sincerely,

CAROLITA U. KALLAUR,
Associate Director for Offshore Minerals Management.

Senator FEINSTEIN. So then is there any information that the Secretary would have known that these were not included?

Mr. ALLRED. Madam Chairman, as I understand from the Inspector General, there are no records and he has been unable to determine whether anybody above that level at that point in time understood that they were not in there.

Senator FEINSTEIN. Thank you.

COMPLIANCE AND AUDITING

Let me proceed with my questions then. Now, the Inspector General reported that compliance reviews are an important part of the compliance and asset management program, but are no substitute for full audits. How do those reviews differ from royalty audits?

Mr. ALLRED. Madam Chairman, first a little bit about what is due the U.S. Government in order perhaps to explain what occurs. Oil or gas is produced. It is metered through a meter that the Mineral Management Service supervises. So we know through both the meters and then subsequent production reports from the companies how much is being produced out of a well.

Then that oil or gas has to be transported to a place of collection or a place of use and it generally has to be processed to remove water or to separate oil and gas or whatever the process might be. When we look at Federal revenues and Federal royalties, it is the amount of oil or gas produced at the well, which we know, with certain costs subtracted, and those costs that are subtracted are the allowable costs for that transportation and the allowable costs for that production.

That is where the problems develop. It is just like deductions on income tax. You get arguments about what is a proper deduction and what is not. That is where the questions arise when we talk about these audits. It is not generally about how much was produced. It is a question of how much was deducted from the value of that which was produced.

We do two processes. The first is a full audit, where we go in and look at the costs of those companies, which either sometimes they are owned by the producing company, sometimes they are vendors, but to look at those total costs and to determine whether those deductions are proper or not under our rules.

There are a lot of situations. For example, as I indicated, some of those pipelines may be owned by, in part by the producer, or they may be owned by someone else. We have to determine which case that is and to what extent it is.

When we do a compliance audit, rather than a full audit, what we do is we compare—

Senator FEINSTEIN. Is that different from a compliance review?

Mr. ALLRED. That is different from a compliance review. The full audits—

Senator FEINSTEIN. Yes, what are the criteria for an audit?

Mr. ALLRED. It would be—a good many times they are triggered either by a compliance review or a periodic audit of that particular—

Senator FEINSTEIN. But my understanding is there is no criteria for an audit in the MMS.

Mr. ALLRED. Madam Chairman, no, we have criteria. If we have any reason to believe, either through records or other sources of information, that we are not being paid the full amount, we can audit. Keep in mind that there are two other audit functions here in addition to the Federal Government. There are the States and there are the Indian tribes which also receive these revenues, and they are part of the audit program, too.

But we have a number of criteria, which obviously we keep rather quiet as to what triggers an audit. But those audits are also very expensive and require lots of manpower. As the work load is increased—and it has increased significantly as we have new production—we have also added a second tier, and those are the compliance reviews. Those compliance reviews include information that we have. Keep in mind that we know what is being produced from the meters we supervise and from the reports that are supplied by the producer and also by reports that are supplied by the buyer. We then look, based upon our own information as to what transportation costs are or what processing costs are, do a review of what we are being paid. That will trigger questions in our minds. Sometimes it is obvious we have been underpaid and we bill the companies. They can challenge it, but we bill the companies.

In those cases where we have big questions about whether they have paid, it will trigger a full audit. Now, what the Inspector General recommended that we do is that we better develop the risk criteria by which we do those compliance reviews, and we are in the process of doing that. We have them, but he felt they needed to be more formalized.

I would also indicate that, again going back to my experience as a corporate executive, if you look at the facts which are in the audit of our royalty management, I was not necessarily surprised by what is in there. Those are the kinds of things you normally would see in a review of operations. Anything, as I indicated in my testimony, anything that is as large and as complex as royalty management is, there an outside audit will find lots of opportunities to improve it. That is why we periodically do these. It is important to have that outside review, and MMS has accepted most of those recommendations, those that it is capable of accepting, and we will implement those improvements.

CLOSING REMARKS

Senator FEINSTEIN. Thank you very much, Mr. Allred.

I think you heard the questions from members of the committee and, as you probably know, we discussed this issue last year at an Appropriations Subcommittee—excuse me, at the full Appropriations Committee, and I moved some language which was included in the appropriations bill, which of course is now the product of the CR.

But I want you to know that it is my intention to work with Senators Domenici, Craig, and members on this side as well as the other side, to include specific legislation in this bill which will in fact recover the money due to the taxpayers. I feel it very, very strongly. These companies have reaped record profits. I think one of them has reaped quarterly the greatest profits ever reaped by

any American corporation. I believe they deserve to repay the taxpayers for the loss of this money.

So we look forward to working with you on the how-to part of it and I think there are a couple of good ideas that you have mentioned and we will explore those more fully.

CONCLUSION OF HEARING

Do you have any further comments you might like to make at this time? If not, I will recess the hearing.

Mr. ALLRED. Madam Chairman, we look forward to working with you and to help solve this problem.

Senator FEINSTEIN. Thank you very much.

[Whereupon, at 10:54 a.m., Tuesday, February 13, the hearing was concluded, and the subcommittee was recessed, to reconvene subject to the call of the Chair].

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