CHAPTER SIX

STATES AND INDIAN TRIBES

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INTRODUCTION

Many States and Indian tribes have a tangible and immediate interest in the adequacy of the Federal government's royalty management system. Until recently, few have taken an active interest in Federal royalty management. For the most part, they have been passive recipients of the periodic Federal royalty checks. Now, attitudes of the States and Indian tribes are rapidly changing.

States receive 50 percent of the royalty income for minerals removed from Federal lands within their borders (Alaska receives approximately 90 percent). Royalties from Federal lands generate significant income for several States. In 1980, Wyoming and New Mexico received more than $100 million, while Utah, Colorado, and California, received from $17 million to $24 million. According to Interior Department projections, the 23 States sharing royalties from Fed*eral onshore leases could be collecting over $600* million by 1985, and $1.3 billion by 1990. States use these funds to provide essential government services. In addition, Federal royalty revenues deposited to the Land and Water Conservation Fund are made available to the States in the form of matching grants for the purchase and development of land and water areas for recreation purposes.

The Indian tribes and individual Indian landowners receive 100 percent of the royalties collected on

minerals removed from their lands. The Federal government collects these funds as trustee and turns them over to the Indian landowners. In fiscal year 1979, nineteen Indian reservations each received over $1 million in royalty income.

Of 300 federally recognized tribes, 240 have energy resources, most of which are not developed. Today, 27 tribes are producing oil and gas, two produce coal and uranium, and two produce non-energy minerals. For several tribes, royalties from minerals are an overwhelmingly important source of income. Total mineral royalties from Indian lands increased by 38 percent between fiscal year 1979 and 1980, rising from $143 million to $197 million.

Royalty income helps Indian tribes support basic government services such as police and fire protection, natural resources management, road maintenance, health care, and education. With less Federal funding for these services now available, mineral royalty income has become even more important. On some reservations, tribal leaders see mineral development as the key source of capital needed for economic development and the longterm economic security of the tribe.

THE STATES' EXPERIENCE

The States have several distinct interests in minerals management and royalty accounting. In addition to receiving royalties on minerals from Federal lands, many States receive income on mineral development from State owned lands. Moreover, several States impose severance or other taxes on mineral production within their borders. Consequently, for many States, minerals management is a substantial governmental activity. The Conservation Commissioner of Louisiana, R.T. Sutton, told the Commission that minerals are his State's most important resource, contributing

over 50 percent (directly and indirectly) to the State's operating budget.

As might be expected, the Commission found great variation in the States' depth of experience in the financial management aspects of mineral development. New Mexico, California, Texas, and Louisiana have long had active royalty management programs, and the quality of some aspects of their programs equals or exceeds that of the Federal program. (Two of these four States, New Mexico and California, have significant amounts of Federal and Indian land within their borders.) However, most of the other States that are rich in energy mineral resources have not yet developed sophisticated royalty management programs.

Utah State Tax Commission Chairman David Duncan described his State's response to published stories of oil thefts and of gross underpayment of royalties:

> When the news broke of these events a few months ago, we decided to investigate our own departmental practices and policies. We found that the accusing finger that pointed at the [U.S.] Department of the Interior also pointed equally at us.... We *found only* four or five States that had done anything more than just lease State lands and wait for the checks to come in and then be carried to the bank.

Duncan explained that most of the States with energy mineral resources have assigned various aspects of mineral revenue oversight to so many different agencies that little has been accomplished. In Utah, for example, the tasks of overseeing mineral revenues are included in the responsibilities of the State Lands and Forestry Department, the Oil, Gas and Mining Division of the Natural Resources Department, the Department of Finance, the State Treasurer, the

State Tax Commission's Assessed Property Office and its Audit Department, the State Auditor, and finally, the Legislative Auditor. While each of these departments had assumed responsibility for certain phases of the program, none of them had audited any oil and gas production or purchase records, and few site inspections were being made.

Duncan conceded that when it came to collecting royalties on minerals removed from State lands, Utah as yet had no means of verifying whether the royalties being paid were correct. "We pretty much go hat in hand to the companies, take the check they give us, and say 'Thank you very much,'" he said.

Recently, however, the Utah Tax Commission has been directed to coordinate the State's mineral revenue efforts. Duncan said that the State would be moving aggressively in the future to institute better controls over State revenues from mineral development of State and private lands. Colorado, Wyoming, and South Dakota officials also told the Commission that their States have recently begun to increase their attention to these same mineral revenue matters.

Indeed, in all the States with major energy mineral resources, interest in better management of revenues is now very high. Many of the States are actively working to improve the accountability of their own collection programs, and they are cooperating in unprecedented ways to make the best use of the talents and resources of each. In the past year, several important multistate organizations have greatly increased their attention to mineral revenue issues.

The organizations include the:

- Interstate Oil Compact Commission;
- Multistate Tax Commission;
- Western States Land Commissioners Association;

- Western Conference of the Council of State Governments; and
- Western Governors Conference.

W. Timothy Dowd, Executive Director of the Interstate Oil Compact Commission, testified that these States have gone about the business of coordination in a way he had never seen in 20 years of State government experience.

For instance, the Western State Land Commissioners Association and the Interstate Oil Compact Commission are preparing recommendations for common data elements to be used by all States in seeking tax and royalty information from the minerals industry. This should ease the reporting burden on the industry and increase the likelihood of data sharing among States.

For another example, the Multistate Tax Commission is preparing to undertake joint audits of companies which pay taxes on mineral production to several States. The effort is designed to reduce the auditing costs for individual States, to improve the quality of the audits, and to reduce the burden on the industry of multiple tax audits by individual States. In addition, States such as Colorado and Wyoming are hiring more accountants and inspectors in order to improve their minerals management efforts.

All of these States would like to see a concomitant effort by the Federal government to conduct the Federal royalty management program in a more accountable fashion. Many States expressed to the Commission their willingness to work cooperatively with the Department to help bring this improvement about. They believe they have important data to offer, such as purchasers' reports and production reports submitted by companies to the States for severance tax purposes. They also believe they have some valuable expertise in the area of revenue collection and enforcement. They recognize the value both to them-

selves and to the Federal government of an improved royalty management system.

THE INDIAN TRIBES' EXPERIENCE

The strong interest in improving royalty management evidenced by the States is shared by many Indian tribes. Like the States, the tribes have widely varying degrees of experience with the problems of minerals management and its financial aspects. Some have had considerable experience. Others have had virtually none, but appear interested in gaining it.

Several of the tribes have developed initial components of a royalty management and site inspection program. Tribal Vice Chairman Terry Knight of the Ute Mountain Ute Tribe told the Commission:

> [T]he Ute Mountain Ute Tribe has assembled its own oil and gas lease files which contain copies of each currently producing oil and gas lease for the Ute Mountain Ute Reservation. Card files with essential data have been established and are cross referenced by lease number and company.
>
> Each month, we review the USGS reports for each lease to determine the amount of production and royalty payment and compare these amounts with the previous month's totals. In this way, we can determine whether there have been unusual drops in production or royalty payments, and can request an explanation from both the USGS and the producer.

The Shoshone and Arapahoe Tribes of the Wind River Reservation have engaged an accounting firm, have conducted detailed lease analyses, and have successfully billed companies for underpayments. The Blackfeet and Fort Peck Tribes of Montana, the Uintah and Ouray Tribe of Utah and the Osage Tribe of Oklahoma now have inspection teams monitoring reservation leases. The BIA and the Osage Tribe collect the royalties for the Osage leases and have done so since 1906 under special statutory authority.

A mechanism for sharing expertise and information among a number of tribes is the Council of Energy Resource Tribes (CERT). As a coalition of 29 Indian tribes which possess substantial energy resources, CERT has a technical staff to assist member tribes in developing minerals management systems. In addition, in 1979, the BIA's Office of Trust Responsibilities established a Division of Energy and Mineral Resources based in Denver. That Office has provided training to over 150 tribal and BIA employees in oil and gas leasing procedures, including lease compliance. The program has the potential for making a major contribution to developing expertise in energy resource management among the tribes.

All of these efforts, however, are limited. For instance, the Osage Tribe's inspectors, made available through the Bureau of Indian Affairs, are only six in number and are charged with inspecting 11,000 wells. The new BIA Division of Energy and Minerals has only seven employees, and cannot respond to all of the requests it receives for assistance.

PROBLEM: NEED FOR AN EXPANDED POLICY OF COOPERATION

It seems clear that Indian tribes, like the States, are no longer content to be the passive recipients of mineral royalties. Both tribes and States have

demonstrated interest in playing a more active role in royalty management--both site security and royalty collection. They not only appreciate the significance of the revenues at stake, but they want to have greater assurance that they are receiving all royalties due them from Federal and Indian leases.

The potential for Federal, State and Indian cooperation is great. More effective mechanisms could be developed for sharing several functions--inspections, for example. Tribal government offices are often located closer to Indian lease sites than are USGS offices; it may be easier for tribal members than for Federal inspectors to perform inspections on reservations. Other benefits may come from having States perform audits or verify sales and production data.

The principal existing mechanism for State and tribal participation in the Federal royalty management program is a recently formed advisory committee within the USGS. Very recently, the USGS entered into cooperative agreements with two States; it plans agreements with five more States.

The Commission believes that greater State and Indian tribal involvement would be advantageous to all parties. The Federal government should encourage State and tribal participation, recognizing the current differences among the States and tribes in their royalty management experience and abilities.

The present Secretary of the Interior has already begun to open new lines of communication with States and Indian tribes, and the announcement of an expanded policy of cooperation in royalty management would provide more opportunities for such communication in the future. The Department should plan details of carrying out the expanded policy in concert with the States and tribes through a Secretarial level advisory committee.

It would not be appropriate, however, for the Department of the Interior to relinquish to the States or tribes the entire responsibility for the collection, accounting, and auditing of oil and gas royalties from the Federal leases in their domains. In the Commission's judgment, the Federal government must, at the very least, retain its oversight responsibility in those instances where States or Indian tribes take over certain royalty management functions through cooperative agreements with the Federal government. The Federal government must retain the ability to ensure that the mineral royalties due the United States Treasury and the Indians are paid in full. Such oversight, however, could take the form of periodic reviews of a State's or tribe's overall performance in those cases where the State or tribe has demonstrated its competence to perform the necessary functions.

Finally, the Commission's recommendations concern only management of royalties from Federal and Indian leases. The Commission makes no recommendations regarding the entirely separate subject of leasing of public lands, a matter not within the scope of the Commission's charter.

RECOMMENDATIONS

1. That the Secretary announce an expanded policy of cooperation with States and Indian tribes in the royalty management area--namely, that the Department will share information and royalty management functions (including inspections) with affected States and Indian tribes to the maximum extent possible, consistent with its responsibility to assure the proper account-

ability of the royalties paid on minerals removed from Federal and Indian lands.

2. That the Secretary appoint a formal advisory committee, reporting to the Secretary's Office, consisting of representatives of States and Indian tribes and related organizations and Departmental officials, to develop over a nine-month period a detailed plan for carrying out the expanded policy of Federal/ State/Indian cooperation on a comprehensive basis.

PROBLEM: IMPLEMENTING IMPROVED COOPERATION

The Department can begin immediately to put into effect an expanded policy of cooperation with States and Indian tribes. Indeed, cooperation has already begun at the initiative of the Secretary and the State of Wyoming. Since September 1981, the State Auditor of Wyoming and the USGS have cooperated in a program to review selected Federal leases in Wyoming. The success of this effort, which has collected more than $1 million thus far, has encouraged other States to volunteer to conduct similar joint programs.

The USGS has received other offers of immediate assistance. New Mexico and California have offered to enter into cooperative agreements with the USGS for the actual collection of royalties on Federal leases within their borders. A few Indian tribes have already expressed interest in assuming inspection responsibilities for leases on their reservations. To help verify royalty payments, a number of States have offered to share with the USGS information that is already in their files.

The Department should approach these offers of assistance on a case-by-case basis. It should take into account the special abilities of the various States and Indian tribes and coordinate the functions they undertake. In an area as complex as royalty management, close coordination of tasks undertaken by different entities is essential. In the beginning, it would be advisable for the Department to monitor closely the projects assigned to States and Indian tribes, or to enter into joint projects with them.

At this stage, immediate cost savings should not dictate which cooperative projects the Federal government pursues. Projects undertaken by States and Indians have the advantage that they can be on a small scale and be carefully controlled. They may be regarded as experiments, with results that can pay substantial dividends in the future.

Besides accepting appropriate offers of help from States and Indian tribes, the Department should assure, insofar as possible, that their particular needs are met. For example, since Osage Tribe activities are budgeted separately from those of other tribal and Federal leases, the Department should assure adequate inspection of Osage Tribe leases--at a minimum, an inspection of each lease at least once a year for royalty management purposes (site security and verification of production).

For the early cooperative projects, auditing, inspection, and training seem especially appropriate. With these activities, the States and Indian tribes can begin building institutions of their own, which will ultimately strengthen and support the Department's royalty management effort.

Under the Indian Self-Determination Act, the Department has legal authority to undertake cooperative projects with Indian tribes. The Department should seek legislation assuring that States and Indian

tribes cooperating in royalty management have adequate authority to enforce relevant Federal laws and regulations and to obtain information from private parties.

RECOMMENDATION

3. That the Secretary immediately take steps to assist States and tribes in carrying out certain royalty management functions, by:

   - Offering to enter into demonstration cooperative agreements with interested States and Indian tribes, especially for inspection of leases, audits, and training and to participate in the funding where appropriate.

   - Providing for increased technical support of Indian royalty management activities through the BIA's Division of Energy and Minerals in the Office of Trust Responsibilities and (since Osage Tribe activities are budgeted separately from those of other tribal and Federal leases) assuring that the Osage Tribe has inspectors adequate to conduct inspections for site security and production verification at each lease at least once a year.

   - Seeking legislation as necessary to enhance a State's or Indian tribe's ability to carry out royalty management and site security functions under cooperative agreements with the Department. Specifically, the program should authorize the enforcement of all applicable Federal laws and regulations by States and tribes (operating under a cooperative agreement with the Department) and their obtaining information from companies and others to the same extent as if they were employees of the Department. Any cooperative agreements should provide for the transfer of funds to the States and Indian tribes for an appropriate portion of the costs, based on the source of the funds and the respective responsibilities of the parties.

PROBLEM: SHARING INFORMATION

Some States gather a variety of data related in some way to Federal leases, either in connection with collecting severance taxes or with managing royalties for mineral resources on State lands. Some of the States have offered to share these data with the USGS to help cross check the production and sales data received by the USGS from lessees and other royalty payors. Because the present USGS royalty management system is so lacking in verification of the reports received from companies, this kind of information from States may prove especially valuable.

The Federal royalty managers should do an in-depth study of the data available from the States to determine whether the data should be incorporated into the

new royalty management system, either on a routine or a special case basis.

The States' effort to develop common data elements for reports submitted by mineral producing companies is worthy of Departmental support. In addition, the Department should examine its data needs carefully to assure that the Federal data collection effort is made as consistent as possible with the States' efforts.

One common theme of State and tribal witnesses before the Commission was that they did not receive adequate information from USGS, BLM and BIA. The complaint of Wyoming State Auditor Jim Griffith was typical:

> We have found that the USGS and the BLM are unable to provide the State Treasurer with sufficient support . . . for the semi-annual check we receive covering our half of Wyoming's Federal royalties. We are unable to document the source properties for these monies ($59 million in May 1981), and consequently, we cannot be assured of the reliability of the remitted amounts.

A New Mexico witness added that the "production detail we obtain almost never coincides with the payment received." The Council of Energy Resource Tribes detailed instances where Indian tribes also have received inadequate, inaccurate, and untimely data from the USGS and BIA.

Information sharing, like other cooperative projects, should be reciprocal. Unless States and tribes are to remain mere recipients of royalty payments, they must receive adequate and timely information from Federal royalty managers. Some States and tribes now have the ability to cross check USGS information with their own data, and it is in everyone's interest

that this capability be exercised. As other States and tribes improve their royalty management systems, they too should be able to check Federal data against their own.

The USGS has concurred with the suggestion that it share royalty management information with States and tribes on a routine basis, but has pointed out that it could cost as much as $1.2 million per year to operate an on-line data base management information system with that capability. Other less expensive ways of sharing data are now being explored. In fact, on-line capability would probably rarely be needed. Better information at the time the royalty check is transmitted to verify that the amount is correct, plus access to data in the lease files on a timely, but not necessarily immediate basis, appear feasible and not overly expensive.

The States and tribes have said that they would like to have projections of their royalty income for future years. At present, the USGS does these projections on a limited basis upon request. An expansion of this service once the new royalty management system is designed and implemented would assist States and tribes with their budget planning. Of course, Federal royalty managers cannot guarantee the States and tribes a specific income in future years, but it can aid them in making reasonable estimates.

In addition to sharing routine reports of sales, production, royalties, and projected revenues, Federal, State, and tribal auditors and inspectors could assist each other by sharing accumulated audit and inspection information through a central data bank. The Federal government, States and Indian tribes need to know which lease sites and which accounts require special attention. For example, companies which have repeatedly underpaid could be identified in such a central data bank. Similarly, lease sites which are especially vulnerable to theft could be identified and flagged for closer scrutiny by both Federal and

State or Indian inspectors. A joint data bank of auditing and inspection results would be beneficial to both the Federal government and the States and Indian tribes.

RECOMMENDATION

4. *That the Department substantially* increase the two-way flow of information between the Department and the States and tribes by:

   - Actively supporting the ongoing effort of States to develop common data elements for industry reporting, and by examining Federal data needs to make the Federal data collection effort as consistent as possible with the States' efforts.

   - Identifying those sources of information which States and tribes have which will assist the Federal royalty managers in *assuring that royalties* collected are correct and site security rules are observed; and entering into agreements with these States and tribes to obtain this information on a routine basis.

   - Designing and implementing a system of sharing with the individual States and Indian tribes on a timely basis all information which the Federal royalty program collects concerning leases within their respective boundaries, including information at the time the checks are distributed to verify the accuracy of the royalty payments and to audit the accounts if necessary.

   - Continuing and expanding upon the past USGS policy of making *forecasts of future royalty* revenues when requested to do so by a State or Indian tribe.

   - Creating a central data bank of Federal, State, and Indian audit and site inspection results so that Federal, State and Indian auditors and inspectors can have a comprehensive source for checking royalty payor and/or lease operator performance.

PROBLEM: SUPPORTING AUGMENTED AUDITS AND INSPECTIONS

The Commission has recommended that Federal royalty managers undertake, in cooperation with interested States and Indian tribes, an augmented program of the critical auditing and inspection functions. It is important to develop a solid, reliable basis for funding such inspections and auditing. Even now, when interest in improving royalty management is at a peak, it is difficult to find enough funds for basic auditing and inspection needs. A supplement to the fiscal 1982 budget will be required to pay for the minimum number of "look-back" audits. Likewise, even an augmented Federal force of 100 field inspectors for 17,500 onshore oil and gas leases (as now

planned by USGS) will still be nowhere near sufficient for adequate monitoring of site security and verification of production.

Federal resources for auditing and inspection have foreseeable limits. To ensure that State and tribal participation becomes a reality, it is necessary to identify and earmark funds for that purpose. The Commission recommends the establishment of a self-sustaining fund supported by a small deduction from oil and gas royalty income from all Federal and Indian leases.

In effect, the U.S. Treasury, the States and the Indians--all the beneficiaries of royalty income--would be making a contribution to better management of royalties. In the Commission's judgment, the modest share which each would contribute to the program would be repaid many times over, both in higher royalties, and in greater confidence that all royalties which should be paid are being paid.

It must be emphasized that the self-sustaining fund should not be used to pay for the basic, continuing royalty management program which is covered by the Federal budget. Nor should it be used as a device to avoid including a full complement of audits and inspections in the basic, continuing program. Rather, the fund must be devoted to the special augmented program of audits and inspections, much of it done under contract by States and Indians.

Money from the fund could also be used to pay for special "emergency" audits, conducted perhaps by private contractors under the Department's supervision. Occasionally, a situation is discovered that merits immediate auditing attention. Yet in Federal budget preparation, funds for new programs must usually be planned three years in advance. A new problem of undervaluation of oil or gas, for example, could drag on unresolved for years if audits directed

to the problem had to wait for funds from the regular budget.

The Commission contemplates an initial levy of one-half of one percent from all royalties. Based on 1981 net royalty revenues (after deduction of the Windfall Profit Tax) of about $3.1 billion, the fund would extract $15.5 million--enough to fund a good supplemental audit, inspection, and training program. States with royalty income in the $20 million range (e.g., Colorado, California and Utah in 1980) would contribute $100,000 each. Tribes with royalty incomes of $1 million would each contribute $5,000. More than three-quarters of the contributions to the fund will come from offshore Federal leases (which account for over three-quarters of all royalties).

Two objections have been raised to creating a self-sustaining fund. First, "earmarked" funds sometimes get out of budget control. If money in the fund builds up beyond reasonable levels, it may be spent too freely; or if it is retained in the fund, it denies those who paid into it the use of the money for other purposes. To assure that this does not happen, the Commission believes the fund should be closely controlled by the Secretary. After the first five years of the program, the Secretary should adjust the levy as needed, between zero and one percent of total royalties collected, so that excess funds are not allowed to build up.

The other objection came from some spokespersons for Indian tribes. They argued that part of the Federal government's trust responsibility is to perform all royalty collection services without charge to the Indians. The Commission does not agree with this view. The Congress has passed laws authorizing the collection of reasonable fees from Indian tribes to cover the cost of work performed by the Federal government on their behalf. These laws have been upheld in court.

If the fund levy taken from a tribe exceeded the government's cost of performing the joint activities for the tribe, then the tribe as trust beneficiary might have a justifiable complaint. However, the proposed rate of one-half of one percent is sufficiently low that the issue should not arise.

In the opinion of the Commission, the Indians and the States as well will benefit greatly from the use of the Fund, especially considering that all royalties collected for oil and gas taken from Federal and Indian lands--offshore as well as onshore--will be included.

RECOMMENDATIONS

5. That the Secretary of the Interior seek legislation to establish a self-sustaining fund which would:

   - Pay the costs of supplementary audits and lease production related inspections that are above those planned for and funded by the routine Federal royalty management budget. No environmental or site safety inspection functions would be financed by this fund and the fund would not be used as a substitute for a full audit and inspection program under the routine Federal royalty management budget.

   - Reimburse States, localities, and Indian tribes for costs they might incur for their part in any audits, inspections or enforcement done under cooperative or contractual arrangements with the Federal royalty managers with regard to mineral leases on Federal and Indian lands. Federal costs associated with the cooperative agreements would also be covered. These activities would include only those efforts done solely by the States, localities, or Indian tribes, those done jointly with the Federal royalty managers, and those done by contractors for any of these parties, under the terms of a cooperative agreement.

6. That the Secretary establish and maintain the fund by taking a percentage of the royalties collected from all existing and future Federal and Indian leases (both offshore and onshore) before any funds are distributed to the States, Indians, or the U.S. Treasury.

   That the legislation allow the Secretary, after the first five years, to adjust the level of the levy between zero and one percent of the total royalties collected. For the first five years, the levy should be set at one-half of one percent of such royalties. The yearly budget for the fund should be subject to Executive Branch and Congressional review and approval. After the first five years, the fund balance should not be allowed to exceed an amount equal to the

sum of the funds expended from the fund for the previous three years. In the event that the levy would result in excess monies accumulating in the fund, the Secretary would be required to adjust the fund by reducing the levy rate or by suspending the levy (reducing it to zero) for an appropriate period.

PROBLEM: ENSURING TIMELY PAYMENTS

With the increased costs of borrowing money, States and Indian tribes have become much more aware of delays in the Department's system of distributing royalties. The States are also conscious of the fact that they do not share in any interest paid to the USGS for underpayments and late payments by lessees.

Regular royalty distributions are required to be made to the States as soon as practicable after each six-month period of collection (ending March 31 and September 30 of each year). New Mexico representatives told the Commission that it takes 45 days after the close of the period before their State receives payments due. Assuming a 12 percent interest rate, the 45 day delay in receipt of money costs New Mexico $1.6 million each year in unearned interest.

In addition, testimony presented to the Commission indicates that it takes an inordinate length of time for the Indian royalty revenues to get to the tribes. Apparently, these checks travel a circuitous route through the offices of the Department before finally reaching the Indians. In addition, individual Indian landowners often must wait a considerable time before the funds due them are disbursed.

Consequently, State and tribal witnesses before the Commission urged that the Department improve the timeliness of its payments to the States and Indians and allow States to share in interest and penalties paid for late payments and underpayments. (The Indians already share in interest charges but not penalties for late payments.) The Commission agrees with these requests of the States and Indian tribes.

RECOMMENDATIONS

7. That the Federal government share with the States and Indian tribes both interest and penalties paid for late payments and underpayments.

8. That Indian tribal royalty payments be deposited immediately in interest bearing accounts and electronic transfer be actively encouraged; and that the Department seek ways to accelerate distribution of royalty payments to the individual Indian landowners.

9. That distribution of royalty funds to the States be made as quickly as possible after the close of the reporting period, and that the Secretary consider seeking legislation to allow payment of the States' share of royalties more frequently than once every six months.

CHAPTER SEVEN

ORGANIZATIONAL ISSUES

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INTRODUCTION

The Conservation Division of the U.S. Geological Survey has been responsible for royalty management since 1926. During the last 20 years it has been criticized by the General Accounting Office, the the Interior Department's own Office of Audit and Investigation and Inspector General, Congressional Committees, Indian tribes, and the States. These critics have recommended tightening the royalty management internal controls, enforcing the requirements on site security, reconciling out-of-balance accounts, and improving both the quality and quantity of personnel connected with royalty management.

That the USGS has failed, over a 20-year period, to correct the basic inadequacies cited repeatedly by critics raises the question of whether the USGS will ever effectively manage royalties.

Because the amounts of royalty payments are increasing rapidly, repairing the Federal government's royalty management system is more urgent than it was 20 years ago. In 1960, the USGS was responsible for collecting $123 million in royalties. In fiscal year 1981, royalties were $4.1 billion. In 1960, the Federal government distributed $35 million in royalties to the states. The amount distributed in 1980 was $315 million.

In short, royalty management today is a large-scale business enterprise. It is being run by a scientifically oriented agency far more attuned to geologic research than to financial management.

Reorganization of governmental functions is often recommended as a solution to complex problems. It is often the wrong solution. Reorganization may obscure the need for more fundamental changes; or it may disrupt ongoing activities and confuse reporting relationships, lines of communication, and definition of the organization's mission.

For these reasons, the Commission approached the possibility of organizational changes in the royalty management program with caution. The Commission focused first on needed changes in the program itself. Initially, the Commission took the view that any change in the organizational location of the royalty management program could be disruptive and probably was not necessary or desirable.

However, as the Commission inquired more deeply into the past performance of the USGS, considered the management skills USGS is applying to improvements in the royalty management system, and assessed the likelihood that USGS would carry out further improvements in a satisfactory manner, the Commission concluded that organizational change in royalty management is necessary. In fact, to assure that the problems of the past are not perpetuated, a change is essential. The Commission concluded, moreover, that an organizational move should cause little disruption.

In reaching these conclusions, the Commission was well aware that the USGS is making major changes in its royalty management program--changes initiated in 1979 when the General Accounting Office issued yet another report strongly critical of the Survey's longterm performance in royalty management. However, the Commission concluded that the management skills of USGS leadership are not those required for strong royalty management, and that efforts by the Survey's leaders will not be enough to overcome longstanding problems associated with the present location of the royalty management program.

The Commission gave serious consideration to three alternatives to the present situation: (1) creating a new Division for the royalty management program within USGS; (2) moving the royalty management program itself out of USGS; and (3) moving the entire Conservation Division, of which royalty management is a part, out of USGS, as a possible first step in the creation of a minerals management office.

THE PRESENT SITUATION

In order to understand the advantages and disadvantages of these three alternatives, the Commission reviewed the current structure of the USGS, the relationships of the royalty management program to other Departmental offices concerned with royalties, and the role of the royalty management program in the broader area of minerals management.

The U.S. Geological Survey is an esteemed scientific organization dedicated to the pursuit of the earth sciences. Its primary mission is to explore and map the geologic resources of the United States and to advance the scientific understanding of geological phenonemona as they relate to the beneficial use of the resources of this country.

The USGS has been referred to as the "rock" on which the geologic profession in this country stands. It is not common for a governmental agency to be looked upon as a leader in a scientific field. Yet, last year some 4500 scientific papers in geology and related subjects were published by the USGS, and the relationships between the USGS and academic and private research in geology are remarkably strong. Indicative of the scientific nature of the Survey is the fact that the Directors of the Survey have always been outstanding scientists in the field of geology.

New directors are usually chosen from a panel of candidates recommended by the National Academy of Sciences.

Within this scientific organization is the Conservation Division. Its staff consists primarily of engineers and others of related professions. Many of its functions are regulatory and operational rather than scientific. The primary mission of the Conservation Division is to ensure the efficient recovery of mineral resources from Federal and Indian lands. The functions of the Division include:

- Evaluation of resources, including classification of public lands to identify areas with valuable leasable minerals and water power or water storage potential.
- Evaluation of mineral resources on public lands that are exchanged, sold, or made available for development and production.
- Supervision of exploration, development, and minerals production operations on Indian lands and Federal onshore and offshore lands.

Last, and unfortunately least, of the Division's functions, is the collection and management of royalties from Federal and Indian lands, including inspections to ensure site security and to verify production and sales.

Of the 2300 people in the Conservation Division, 350 are directly involved in royalty management including approximately 28 staff-years devoted to inspections. Since the Division's activities are integrated to some extent, there is some overlap of activities. For instance, administrative and computer activities of the Survey support royalty management, as they

do other USGS activities. None of these latter resources are counted in the figures given above.

Until recently, the royalty management program was completely "integrated"--or perhaps submerged--in the rest of the Conservation Division. The Offshore and the Onshore sections of the Division both had royalty management functions which were dispersed in eleven area offices. There was no overall royalty management program in the Division.

A recent reorganization of the Division has created a separate section for royalty management under a Deputy Division Chief for Royalty Management. The Division's 138 field inspectors for oil and gas leases (75 offshore, 63 onshore) are still totally "integrated" and spend only about 20 percent of their time on activities related to royalty management (i.e., site security and production verification).

The Conservation Division has most but not all of the responsibility for royalty management. Two other Departmental Bureaus play important roles. The Bureau of Land Management (BLM) administers all leasing activity on public lands and maintains master lease files. The Conservation Division is dependent upon BLM for updating of lease ownership information which is helpful in tracing royalty payors. In addition, once royalty funds are collected by USGS, they are deposited in the U.S. Treasury and disbursed by the BLM to the States, as appropriate.

The Bureau of Indian Affairs (BIA) administers the leasing activity on tribal lands, in consultation with the tribes. It also administers leasing activity for individual Indians (allottees). BIA also receives royalty checks from USGS and distributes them to the tribes and individual Indian landowners. In addition, BIA has a somewhat ill-defined mission of assisting USGS in its interaction with the Indian tribes in the entire leasing area. BIA rather than USGS, has

the authority to recommend the cancellation of leases on Indian lands.

In the broader area of Federal minerals management, the Conservation Division is charged with only a portion of the program. The entire minerals management program includes:

- The identification of potential minerals development by geographical location;
- Evaluation of possible locations to estimate the quality and quantity of minerals;
- Environmental impact assessment;
- Initiation, issuing, and management of mineral leases;
- Royalty management; and
- Site inspection.

The Conservation Division is a major actor in this minerals management activity, but other divisions within the Geological Survey, and the Bureau of Mines, the Bureau of Land Management, the National Park Service, the Bureau of Indian Affairs, the Office of Surface Mining, and the Agriculture Department's Forest Service all play important roles. The consolidation of these minerals management functions into a single organization has sometimes been suggested.

Because of the nature of the Conservation Division, it is not surprising that the Division's top managers, including its Chief, come primarily from engineering and related professions, rather than from financial management and other management disciplines.

The recent recruitment program to find a new Chief of the Conservation Division was a case in point. Only persons with scientific or engineering backgrounds were eligible to apply. Persons with only financial management expertise or other general management experience were automatically excluded from consideration. While this policy may have met the engineering needs of the Division, it did not address the need for top level management attention to royalties.

Given the interests and background of top managers, both in the USGS and its Conservation Division, it is almost inevitable that the royalty management function has lacked the type of active high level management support that could help it to overcome the difficulties which have been so clearly identified by repeated GAO and internal Departmental reviews.

A rather passive management style, which is often appropriate in scientific organizations, has taken its toll on the royalty management program. This is true in the field offices as well as in headquarters. In the field, the inspection effort for royalty management purposes has usually been assigned low priority. It has received no coordinated direction even during the last year, when the poor performance of the Survey in site security has come to public attention.

Royalty management is no longer a small collection effort which can be managed while buried in a large engineering or scientific organization. Its performance has become a severe embarrassment to the Department. It is the Commission's judgment that the demands for quality improvements will not be met unless the organizational location of this program is changed. As the Commission considered the matter in depth, the issue became not whether the program should be moved, but where it should be moved and when.

ORGANIZATIONAL NEEDS

The Commission identified five major needs that can be met in part at least, by appropriate location of the royalty management program. The Commission assessed possible alternative reorganizations in terms of their ability to meet the identified needs without introducing serious new difficulties.

These five organizational needs are:

1) Creating a distinct, clearly visible mission for which the royalty management organization can be held accountable by higher management and by the public. Because the size and complexity of the royalty management task have grown so rapidly, some difficulties and failures in handling the task are understandable. What is most disturbing about the USGS performance is that failures were identified time and time again, and yet USGS management allowed the poor performance to continue. The Commission believes that the status quo was tolerable to top managers, in part at least, because the royalty management program was almost invisible and its mission unclear.

2) Obtaining an adequate budget and attracting high quality managers with the necessary specialized experience. It may have been possible in the distant past to operate a royalty management program with small funds and management by engineers and scientists who are capable in their own fields, but inexperienced in financial management and other broader administrative management skills. This is not the case today. The program is too important to the Treasury of the United States, the States, and the Indian tribes, and is too complex to be administered like other Geological Survey programs. Royalty management needs competent, active, problem-solving involvement within the program and at the highest level of the Department. A reorganization should offer the opportunity to improve the management

opportunity to improve the management of the royalty program by removing bureaucratic impediments and hiring new managers for new positions. The good intentions of the present managers of the royalty program cannot overcome their fundamental lack of financial management expertise commensurate with the complexity of the task.

3) Improving communication and coordination within the royalty management program, with other agencies and government entities, and with outside groups. Reorganizations break old lines of communication and create new ones. Reorganization of the royalty management program should be planned to improve those communications which are most important for efficient operations in the future. It is essential to strengthen communication between inspectors, accountants, and auditors in the royalty management program.

Improving communication with the States, Indian tribes, and Congressional committees is also essential. For example, many of the Commission's recommendations concern joint efforts with States and Indian tribes to monitor site security and verify production. Without coordination and communication, these efforts cannot succeed. For some of the Commission's recommendations, communication with industry is vital; for example, the requirement of a purchasers' statement or the requirement for documentation of oil.

Also highly important is communication between the royalty management program and the Bureau of Land Management, the Bureau of Indian Affairs, and related mineral management activities throughout the Department. At the same time, lower priority areas for communication should not be neglected. Functions should be assigned so as to avoid duplication as much as possible.

4) Avoiding disruption, insofar as possible, to the royalty management program. USGS has major changes to the royalty program under design. The Commission believes these changes, by and large, will take the program in the right direction (although some planned changes need to be modified, as indicated elsewhere in this report). It would be a mistake to disrupt this improvement process significantly.

Upon close examination of the ongoing activities in the USGS, the Commission concluded that a change in placement of royalty management would not interfere with these improvements in any major way. The recent reorganization within the Conservation Division has already separated out royalty management from other Division activities. A major geographical relocation of royalty management employees is already underway. Moreover, most of the design work for improved royalty management is being conducted by contractors.

Consequently even if the royalty management function alone were moved from its present location in the Survey's Conservation Division, its activities would experience only a minimal degree of additional disruption. In addition, the Commission concluded that if a choice must be made between speed of implementation of the improved system on the one hand, and improving the quality of the program through reorganization on the other, the preference must be given to quality.

5) Reducing interference from royalty management responsibilities with the Geological Survey's primary scientific mission. Although the Commission's charter concerned only royalty management rather than the overall mission of the USGS, the Commission could not ignore the fact that the royalty management program has interfered significantly with the primary scientific function of the USGS. This interference should be reduced if possible.

ORGANIZATIONAL OPTIONS

The Commission was convinced at the end of its inquiry that the present organizational location of the royalty management program is unacceptable.

The Commission seriously considered three major alternatives to the present placement:

1) Creation of a separate Division of Royalty Management (including inspection) WITHIN the USGS, with a review within two years to determine whether the program should be moved completely out of USGS.

2) Creation of a separate Office of Royalty Management (including inspection) OUTSIDE of the USGS, reporting to an Assistant Secretary or perhaps the Under Secretary.

3) Creation of a separate Office or Bureau of Conservation, by moving the Conservation Division out of USGS and forming a separate unit for Royalty Management (including inspection) within the new Bureau.

The Commission briefly considered moving the royalty management program to the Bureau of Land Management, but concluded this would be a mistake. It would offer little improvement in terms of the organizational needs identified by the Commission. BLM is already seriously overburdened with critical land management responsibilities. A transfer to BLM of the royalty management program would hamper the accomplishment of BLM's other missions and would not enhance the management of the royalty program.

The Commission also briefly considered recommending that the Internal Revenue Service (IRS) assume the royalty management function, but the IRS representatives who testified before the Commission were very firm in their position that the mission of IRS should continue to be restricted to tax collection and not

be expanded to the collection of other kinds of revenue. The Commission concurs.

In all three alternatives the inspection function would accompany the rest of the royalty management functions. The Commission believes that inspection must be an integral part of an improved royalty management system. Inspection is essential not only to assure the security of lease sites against theft, but also to provide an independent check of companies' production reports. As discussed in preceding chapters, inspectors can verify production by such means as monitoring of well tests, observation of wells in production and checking the accuracy of meters. At present, there are too few inspections for these purposes (see Chapter Five, Enforcement). If royalty management were severed from the inspection force, in all probability verification of production and site security would receive even less attention than they do now.

Firm integration of the inspection function with royalty management could make it necessary to hire additional inspectors for environmental and safety concerns. When royalty management is moved, some inspectors (those best trained for environment and safety standards) could remain behind in the Conservation Division. The USGS would then need to reprogram or request additional staff positions for the inspection functions remaining in the Conservation Division. Royalty management would also need additional field inspectors, to assure that every lease site receives at least one thorough inspection each year for site security and verification of production. The Commission rejected as inadequate the suggestion that the new royalty management "buy" its inspection services by contract from the Conservation Division.

The argument may be made that a "dual" inspection force is duplicative and inefficient. On the contrary, the Commission believes that field inspectors will

be better trained and more effective if their duties are not defined too broadly. The inspectors in the royalty management program will be specialists in seeing that site security rules are observed and in verifying production. They will be able to spend adequate time on these tasks and to apportion the time they spend at various sites according to the priority needs of royalty management. (For example, they may give high priority to checking site security on leases that are vulnerable to theft, or to verifying production on leases where company reports have been prone to error.)

Safety and environmental inspectors will have different specialized skills. They will select sites to visit on the basis of quite different criteria and needs and the enforcement strategy of the two inspection staffs will be different. With 18,762 lease sites (17,500 onshore), it would be a rare occurrence indeed that inspectors from the two different staffs would visit the same site anytime near the same date.

The Commission carefully weighed the advantages and defects of each alternative reorganization. The major arguments in favor of each of the three alternatives are presented below.

1) Creation of a separate Division of Royalty Management WITHIN USGS. This alternative involves the least disruption of present activities. It allows the maximum communication with those engineers and other personnel who would stay behind in USGS if the royalty management program were to be moved out of USGS entirely. This alternative minimizes the possibility of creating duplicate functions (such as engineering and computer expertise) in the new organization.

On the other hand, this alternative does little to improve communications with BLM and BIA and policy officials in the Department. More importantly, it does not satisfy very well other needs identified by the Commission--namely, defining a clear, separate

mission, obtaining sufficient budgetary resources and attracting high quality management, and reducing interference in the scientific mission of the USGS.

The separate division would give better visibility and accountability to the royalty management program, but not nearly so much as the other two alternatives considered. The Commission also doubts that the new division would have enough status to attract the high quality management needed to lead the program in the future. The new division would have to continue to compete against the scientific program for resources and the attention of the top management. Conversely USGS would still have the task of trying to manage this complex and functionally different program to the disadvantage of its scientific program.

2) Creation of a Separate Office of Royalty Management OUTSIDE of USGS. This alternative would create a freestanding office outside USGS devoted entirely to royalty management (including inspection). It would report to an Assistant Secretary or possibly to the Under Secretary.

The USGS has been the "mother" of organizations which began as operational programs within the Survey and which now have independent status, namely, the Bureau of Mines, and the Bureau of Reclamation. Separating the royalty management program out of the USGS is therefore consistent with previous Departmental reorganizations which sought to keep the USGS mission focused on scientific rather than on operational matters.

This alternative gives the royalty management office a single mission and makes it clearly accountable for its performance. Of the three alternatives considered, this one provides greatest visibility, clarity of mission, and accountability. As an independent office, it would no longer have to compete with

the other portions of USGS for resources. The creation of a separate office entirely devoted to royalty management should enhance the Department's ability to find highly qualified managers to lead the program in the future. With this alternative, communication with other Departmental offices such as BIA and BLM, and with outside groups such as States, Indian tribes, Congressional committees, and the industry should also be improved.

On the other hand the argument could be made that isolating the program from USGS would subject it to contradictory pressures from outside interest groups and Congress which it would not have the strength to withstand. Also, an independent royalty management office would not have any resources devoted to other functions and therefore could not quickly reprogram staff and funds to royalty management on an emergency basis, as, for instance, the USGS can do. The self-sustaining fund recommended by the Commission elsewhere in this report, however, would help to meet the new office's emergency resource needs.

With this alternative, there might be some difficulty in maintaining communications with engineers and other inspectors left behind in the USGS. Some duplication of functions could occur since some engineering, computer, and administrative expertise would have to be either moved or created anew. Disruption of ongoing activities would be greatest under this alternative, but would not be major in any case.

3) Creation of a Separate Bureau or Office Of Conservation, OUTSIDE of USGS This alternative would move the entire Conservation Division (except for certain minor water-related functions) out of the USGS. A separate Bureau or Office would be created reporting to an Assistant Secretary. Royalty management would be a separate division with its own inspectors within this new bureau.

This alternative represents a middle ground in terms of providing royalty management a separate, clearly visible mission. Although royalty management would be in a unit separate from the other functions in the new bureau, its position would be much the same in the bureau as it is now in the Conservation Division. On the other hand, the entire function of royalty management would be on a higher level in the Department's organizational structure. Because the other functions of the Conservation Division would continue to dominate in the new Bureau, it is likely that top management would remain more or less the same as it is now. The Commission is doubtful that the new bureau or office could attract the necessary high quality management talent for a royalty management unit located within the much larger bureau.

One feature of this alternative is that it provides the opportunity for the Secretary at some later date to consolidate the minerals management activities of the Department into the new organization. The Conservation Division is a core around which such a new comprehensive organization focused on minerals management could be formed. However, from the point of view of improving royalty management, this further reorganization has little advantage and raises the possibility that the royalty management program could be once again buried in a large organization which is charged with a very different mission.

THE COMMISSION'S RECOMMENDATIONS

The Commission strongly recommends that the Secretary not allow the present organizational placement of royalty management to continue. All the alternatives outlined above offer a better placement for this function of growing importance. Left where it is, the royalty management program cannot function effectively and it is likely to continue to be an

embarrassment to the Department. Both a new organizational location and new managers are needed. Among the available alternatives, the Commission favors moving royalty management out of the USGS to a location to be determined by the Secretary, but reporting to an Assistant Secretary, or perhaps to the Under Secretary. The Secretary may wish to consider assigning the program to the Assistant Secretary for Policy, Budget, and Administration, at least on a temporary basis.

In making its choice, the Commission placed the greatest weight on the following factors:

1) The need to create a distinct, clearly visible mission for which royalty managers will be held accountable by higher management and the public. Moving royalty management out of a Departmental bureau (USGS) and elevating it to the status of a small office within the Department will eliminate conflict with other USGS activities, thereby focusing high level attention directly on royalty management.

2) The need to obtain adequate budget and attract high quality managers. Although elevating the status of royalty management provides no guarantee of an adequate budget, at least the budget decisions will be made by top level Departmental officials, familiar with the past problems of the program. The higher status of the program will help attract top quality managers who will welcome the program's greater visibility and accountability and who will see service in this important program as a positive enhancement of their careers.

3) The need to improve communication and coordination within the royalty management program with other related offices, and with other governmental entities and outside groups. Removing the royalty management program from its present location as a branch of the Conservation Division and elevating it

to the status of a separate office will encourage other agencies, within the Department and outside, to pay attention to royalty management. Royalty management will not be considered an insignificant activity lacking top level attention. Furthermore, because the royalty management office will have top level support, it will be able to respond to the concerns of States and Indian tribes and cooperate successfully with them. It will also be in a better position to communicate and coordinate with industry on royalty management problems. Finally, during the next several years many Secretarial and Assistant Secretarial decisions will need to be made on royalty management policy. Among these are decisions on product valuation, enforcement strategy, and civil penalties. These decisions can be made more effectively if the program reports at the Assistant Secretarial level, or higher, within the Department.

4) The need to avoid disruption, insofar as possible, to the royalty management program. Although it is important to avoid major disruption, in this case any necessary disruption of the status quo will be minor. The Commission believes that the appointment of a project leader to take charge of implementing the new royalty management system will assure minimal disruption of this essential ongoing effort during the transition period.

5) The need to reduce interference from royalty management responsibilities with the Geological Survey's primary scientific mission. Removing royalty management from the USGS will reduce interference with the Survey's essential scientific mission. This need was not a primary concern to the Commission, since the Commission's charter was to investigate royalty management, not the other missions of the USGS. There is no doubt, however, that the scientific integrity of the Survey will be enhanced, not lessened, by the removal of an essentially financial function from an otherwise scientific mission.

Alternatives One and Three received serious consideration from the Commission. In the Commission's judgment, leaving royalty management within the USGS would leave it subject to the same pressures that submerged it for more than two decades. High level attention, funds, and personnel are sorely needed for royalty management. The Commission feared that, as a separate division within USGS, royalty management would continue to lose in the competition within USGS for these scarce resources.

A move at this time to place royalty management within another larger organization (a Bureau of Minerals Management) would subject it, once again, to the same kind of competition. Royalty management will continue to need special top level Departmental attention while the Commission's recommendations are being implemented.

At a later time, the Department may wish to consider a larger reorganization, perhaps leading to a Bureau of Minerals Management, once royalty management has a firmly established identity and mission which will not be submerged in the larger organization.

RECOMMENDATIONS

1. That the Secretary immediately move the royalty management program out of the USGS to a location to be determined by the Secretary, but reporting to an Assistant Secretary or perhaps the Under Secretary.

   In order to function as an organizational entity, royalty management must include the following post-lease functions from the USGS Conservation Division:

- Accounting
- Auditing
- Product valuation
- Data collection
- Regulation writing
- Enforcement (monitoring, inspection, sanctions)
- Engineering technical support

It must have its own inspection personnel. It must also have the authority to cooperate with the States and Indian tribes and to negotiate cooperative agreements for the Secretary's signature. Additionally, in order to ensure that the royalty management program functions smoothly, it must have at least the following support services: computer, procurement, budget, and personnel.

Finally, it should have the authority to deal at the policy level within the Department.

2. That the Secretary appoint a transition project director in order to assure that the reorganization is completed in an appropriate manner and that the Commission's recommendations are implemented expeditiously.

   The transition project director would report directly to the Secretary, the Under Secretary or an Assistant Secretary. This transition director would have the authority to assure that the royalty management program is correctly separated out from the USGS and that implementation of the Commission's recommendations as approved by the Secretary is expeditiously undertaken. He or she would

be responsible for the Secretary's advisory committee of State and Indian representatives and the preparation of the first annual report of the Secretary. This person would be in addition to the project leader for the new royalty management system recommended in Chapter Eight of this report.

3. That the Department initiate a study of what lines of communication should be established between the royalty management functions being moved from the USGS and other royalty management functions located in BIA and BLM. In addition, the Department should study which parts of the BIA and BLM royalty management functions might be combined with the USGS royalty management functions at a future time.

4. That the director of the new royalty management office be an experienced manager preferably with a background in financial management. His or her most important qualification should be strong management expertise, not program knowledge; however, if possible it would be desirable for the office director to be familiar with the minerals industry.

5. The Department should initiate a nationwide search for an office director. He or she must have the status of a bureau-level director within the Department, reporting at least to the level of an Assistant Secretary. The director must have

clearly delegated authority in order to respond expeditiously to changing needs.

High level placement within the Department and clearly delegated authority will make this position attractive to the financial community, encouraging high quality candidates to apply.

CHAPTER EIGHT

NEW APPROACHES TO ROYALTY MANAGEMENT

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NEW APPROACHES TO ROYALTY MANAGEMENT

INTRODUCTION

After twenty years of mounting problems with the old royalty management system, the Geological Survey is now developing a new one. Crucial parts of the system are not yet even designed, however, much less ready for adoption.

This chapter focuses on problems of completing the design of the new system and implementing it on schedule, while assuring that its elements have been adequately pretested for feasibility and usefulness.

The chapter also discusses the practical steps the Department must take to put in effect the whole range of those Commission recommendations which the Secretary decides to adopt.

To free staff for the major work of improving royalty management, the Commission recommends that royalty managers drop the task of calculating and verifying the Windfall Profit Tax for the royalties they collect.

The Commission also recommends that the basic royalty rate for oil and gas on Federal and Indian lands be raised from one-eighth (12-1/2 percent) to one-sixth (16-2/3 percent) for new and renegotiated leases.

PROBLEM: KEEPING PHASE ONE OF THE NEW SYSTEM ON SCHEDULE

Preparations for the first phase of the New Royalty Management System (the "Auditing and Financial System") are underway. Several private contractors are assisting the Geological Survey with design and implementation of this phase. The USGS plans to have Phase One in operation by January 1983. The Commission is concerned whether the work will be completed in an acceptable fashion by the target date.

One of the principal objectives of the first phase of the system is to improve recordkeeping. Phase One incorporates internal controls to identify and keep track of payors, that is, to assure that these payors, and the royalties they owe, are not misplaced or unaccounted for. Accounts in the new system should show reliably which payors have paid royalties and which ones still owe. The system will also flag delinquent accounts for investigation.

The Commission sees the difficulty of identifying missing payors as a possible major threat to adoption of the new payor based account system on time, that is, by January 1983. If Federal royalty managers attempt, as is presently planned, to assume the main responsibility for this formidable job, the adoption of payor based accounts could fall substantially behind schedule.

The Commission's recommendation for solving the "missing payor" problem is to assure that the industry takes major responsibility for the job, which rightly belongs to the lessee. The Department should immediately require all lessees or their agents (such as operators) to submit a payor plan, identifying all payors and the payment responsibilities of each. In addition, lessees should submit modified payor plans whenever there is a change in payors. (Details are provided in Chapter Three.)

The plans for Phase One of the new system call for checks on the validity--that is, the plausibility--of data that are entered into the system. For example, if an entry for an oil or gas royalty payment departs too far from royalties paid in the past, the computer will flag the exception for investigation. Another check on data validity will be a computer edit of payors' sales and royalty reports to assure that they have used the correct royalty rate.

A sophisticated data check planned for Phase One is the "Product Value Screen." The Geological Survey's Product Valuation Unit is preparing a computerized data base of current market values for oil and gas by geographical areas, taking into account characteristics of oil such as gravity, sulphur content, and impurities. The data base will be kept up to date. The plans call for prices and characteristics of products, as itemized in payors' sales reports, to be checked against the product value data base, with the computer flagging any discrepancies.

The Commission can see many pitfalls in the adoption of such complex features as those in Phase One of the new system by the target of date January 1983. First, there is some likelihood that the work simply will not be completed in time to meet the deadlines. Second, because the schedule is so constrained, there is danger that the Federal royalty managers will be inclined to automate the system without having first done tests and trial runs to assure that the concepts are workable.

The Commission believes that parts of the Auditing and Financial System should be tested manually, if necessary, before proceeding to automation.

RECOMMENDATION

1. That, where appropriate, those parts of the Auditing and Financial System

which are not already in place be implemented on an advance basis (manually or otherwise) before full automation is completed.

PROBLEM: COMPLETING AND ADOPTING PHASE TWO OF THE NEW SYSTEM

Neither the Geological Survey nor its contractors have decided yet what features to include in the second phase of the new system (the "Production Accounting and Auditing System.") Phase Two will include all of the system's checks on production. It is being planned to cross check company generated production reports with sales reports routinely. (Sales reports, in many instances, will have to be aggregated to be comparable with the operators' production reports, which are on a lease basis.)

The second phase of the new system may use several different kinds of reports from sources independent of the lessee or operator: purchasers' statements, data from States or commercial services, and decline curves of expected production from leases (based on well tests). It is Phase Two of the new system which will be mainly responsible for checking company-supplied production data against reports from independent sources.

None of the plans are firmly in place as yet. On the positive side, this means that enough time remains to incorporate the Commission's recommendations into the fundamental design of the new system. But the current state of planning also raises doubts whether the complex features contemplated for the system will be adequately tested before the target startup date of January 1984, and whether, in fact, the system will be in operation by this deadline.

A contractor for the USGS is now conducting some sample collections of data and reconciliation of company sales and production reports. The Commission believes that pretesting should be done on many of the planned features, on a manual basis if necessary. In this way, the Federal royalty managers should be able to meet the schedule, and at the same time have better assurance that the automated system will be sound.

To date, funds are available only for the design--not the implementation -- of the Production Accounting and Auditing System (Phase Two). The design is scheduled to be completed in April 1982, after which some parts of implementation (such as the writing of computer programs) could begin if funds are available. Funding for implementation of Phase Two is contained in the Department's 1982 supplemental budget request, but it is unlikely that Congress will have approved the request by April 1982.

Implementation of Phase Two of the system is crucial to effective royalty management, and should not be delayed pending receipt of the new funds. Instead, the Department should take any necessary steps (such as reprogramming) to assure that money and staff are available to begin implementing Phase Two of the system as soon as its design is complete.

The Commission believes the problems of design and testing of the new system can be solved, and solved on time. The momentum for correcting royalty management failures of 20 years' standing should not be lost. Attention at the Secretarial level will help to assure that the managers of the Federal royalty program adopt an effective, high quality, new system on schedule.

RECOMMENDATIONS

2. That appropriate portions of the Production Accounting and Auditing System be implemented on an advance basis (manually or otherwise) before full automation is completed.

3. That since the Production Accounting and Auditing System is so important to the proper functioning of the royalty management system, the Secretary take the necessary steps to assure that adequate financial and human resources are available through reprogramming or otherwise for prompt implementation after the design is completed in the spring of 1982.

PROBLEM: INCORPORATING THE COMMISSION RECOMMENDATIONS INTO AN IMPROVED ROYALTY MANAGEMENT SYSTEM

The managers of the Federal royalty program need a practical, step by step plan for incorporating the recommendations of this Commission (as adopted by the Secretary) into the new royalty management system. Without such a plan, the recommendations might be neglected, or at best, their adoption might be long postponed. Similarly, the conversion to the new system itself could be delayed, if Federal royalty managers do not properly organize the task of incorporating the Commission's recommendations.

The Commission has prepared a table of tasks and steps the Federal royalty managers and their contractors will need to take to implement the Commission's recommendations. The table is at the end of this chapter. The Commission is not suggesting that the royalty managers be held to every detail of this plan. Details may well need to be altered or improved. The Commission has provided this detailed plan to the Department for use as a model.

Several of the Commission's recommendations will require action by the Congress. Viewed individually, the proposals concern separate subjects (e.g., oil truck regulation, criminal law, Indian affairs) which are within the jurisdiction of different Congressional committees. All of the recommendations, however, concern improvements in royalty management. The Commission believes that its legislative proposals should be considered in a single omnibus bill. The accompanying table summarizes the Commission's proposals which require legislation.

A committee of Departmental staff most familiar with existing laws should draft an Omnibus Royalty Management Improvement Act to integrate the recommended changes into the existing laws. However, it is essential that the Secretary provide guidance to such a drafting committee, in the form of approval of those Commission recommendations with which he is in accord. The drafting process necessarily will involve the committee in policy matters, because many provisions of existing law differ markedly from the recommendations of this Commission. Thus, without guidance from the Secretary, the Committee would be confronted with important policy judgments which are rightly the province of the Secretary.

SUMMARY OF COMMISSION'S PROPOSALS
REQUIRING LEGISLATION

Area of Concern	Commission Recommendation Number	Provisions
Internal Controls	Recommendation 7	Authorizes Federal royalty managers to require purchasers' reports and imposes civil penalties for noncompliance.
	Recommendation 12	Amends Outer Continental Shelf Lands Act regarding refund of royalty overpayments.
Site Security	Recommendation 4	Requires truck haulers of oil to have run tickets.
	Recommendation 5	Empowers Federal inspectors to stop trucks and check run tickets.

Area of Concern	Commission Recommendation Number	Provisions
	Recommendation 7	Prohibits purchase of undocumented oil.
Enforcement	Recommendation 3	Authorizes civil penalties for site security violations. (See also Site Security Recommendation 2.)
	Recommendation 4	Authorizes civil penalties for nonpayments, late payments, underpayments, error ridden reports, and failure to submit required payor plan. (See also Internal Controls Recommendations 1, 2, 7 and Enforcement Recommendation 6.)
States and Indian Tribes	Recommendation 3	Authorizes States and tribes to carry out royalty management and site security functions under cooperative agreements.

Area of Concern	Commission Recommendation Number	Provisions
	Recommendation 5	Creates self-sustaining fund to finance supplemental audits, inspections and training. (See also States and Indian Tribes Recommendation 6.)
	Recommendation 7	Federal government shares with States interest and penalties paid for late payments and underpayments.
Royalty Management	Recommendation 8	Relieves Federal royalty program of Windfall Profit Tax responsibility (see discussion below).

Finally, to implement the new royalty management system, the Department should appoint a high level project manager with direct access to senior officials. The project manager's authority should be set forth in a written charter. It must be broad enough either to allow the manager himself to resolve with senior managers of the program any disputes over funding, staffing, or schedules, or to refer the matter to the appropriate officials for a prompt decision.

RECOMMENDATIONS

4. That the managers of the Federal royalty program proceed with the implementation of the improved royalty management system, as modified by the Commission's recommendations in this report, and that the Federal royalty managers immediately take steps to incorporate the recommendations of the Commission in the design and implementation of the new system.

5. That the Secretary appoint a Committee of Department officials to draft a proposed Omnibus Royalty Management Improvement Act and that the Secretary provide guidance to the Committee in the form of approval of those Commission recommendations with which he is in accord.

6. That a project manager be immediately appointed reporting to the transition director until appointment of a head of the Royalty

Management Office to oversee implementation of the new royalty management system. The authority of the project manager should be in writing and his authority should be broad enough to resolve disputes among senior program managers or to have them resolved by the director in a timely fashion.

PROBLEM: CONTINUED SUPPORT FOR IMPROVED ROYALTY MANAGEMENT

Without continued support, many of the policies and measures recommended in this report to improve royalty management may lose their effectiveness. A system must be established to ensure that the policies remain in effect, and that as needs change, the policies and mechanisms to implement them change accordingly.

The Secretary should demonstrate his firm commitment to the improvement of the royalty management system by preparing an annual report. The report would describe progress which the Department has made in implementing those recommendations of this Commission which the Secretary has approved, as well as progress made in the improvement of the royalty management system generally. An annual report is especially important in light of the long history of inadequate performance by the Department in royalty management. The report can be a key element in monitoring the Department's future performance in royalty management.

RECOMMENDATION

7. That the Secretary prepare an annual report on the implementation of those Commission recommendations adopted by the Secretary and the overall progress of the improved royalty management system. The report should be made available to appropriate committees of Congress and to the public. It should be issued on March 1 of each year, up to and including March 1, 1986. Prior to its transmittal, the Secretary should provide a copy of the draft report to mineral producing States and Indian tribes and should include their comments as part of the report when it is published.

PROBLEM: RELIEVING USGS OF WINDFALL PROFIT TAX RESPONSIBILITY

At present, the Geological Survey, rather than the industry, calculates and pays the Windfall Profit Tax on royalties for the oil produced on Federal leases.* (Oil from Indian leases is exempt from the tax.) This responsibility was placed on the USGS at its own request. Under earlier regulations of the Internal Revenue Service, confusion had arisen over whose responsibility it was to calculate and pay the

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*Technically, the USGS pays the tax on a volume of crude oil produced and sold on Federal leases which is equivalent to the government's royalty interest.

tax. The Commission believes that placing the burden on the Geological Survey is the wrong solution; it has added as much as 50 staff years to the workload of the royalty management program. The right solution is to place the responsibility with the industry.

The USGS requested the responsibility of calculating the Windfall Profit Tax on all the royalties it collects for oil produced from Federal leases because it was already doing the calculations for half of its royalties -- those that are taken "in-kind" (barrels of oil) in lieu of cash payment. About half the royalties received by the USGS are in-kind. IRS regulations classify the USGS as a "producer" of oil in cases where the oil royalty is paid in kind. Moreover, the USGS wanted to avoid the recalculation of royalties that would necessarily follow if the amount withheld for the Windfall Profit Tax was too high or too low.

The Commission believes that the USGS has undertaken a burdensome and unnecessary responsibility. The IRS regulations can be revised once more, so as not to require Federal royalty managers to calculate the taxes on oil for which the royalty program receives royalties in cash. In the case of taxes on oil taken in kind, the Department should seek a change of IRS definitions of "producer" so that government agencies are not included. The industry could then calculate and pay the Windfall Profit Tax on all oil produced from Federal leases.

For Windfall Profit Tax payments, as for other taxes, it is the Internal Revenue Service, not the managers of the Federal royalty program, which should be responsible for determining that the tax is paid in full. The Federal royalty managers should not attempt to act as an auditor of these taxes. The Commission believes that the resources of the royalty management program should be used more productively, on tasks directly related to improved royalty management rather than on tasks that are the responsibility of IRS and the industry.

RECOMMENDATION

8. That the Department request the assistance of IRS to revise its regulations or design a legislative change which would relieve the Federal royalty program of the responsibility of calculating and paying the Windfall Profit Tax on royalty in-kind transactions; and

   That the responsibility for calculating, withholding, and paying the Windfall Profit Tax on all crude oil sold on Federal leases be returned to the industry, with oversight by the IRS rather the Federal royalty management program.

PROBLEM: RAISING ROYALTIES TO APPROPRIATE LEVELS

The basic royalty rate for oil and gas produced from Federal offshore leases is one-sixth (16-2/3 percent). For onshore Federal and Indian leases, the standard rate is one-eighth (12-1/2 percent.) The Commission sees no reason for this disparity. In addition royalty rates in the private sector have been rising as the value of the oil and gas has risen. We therefore recommend a standard minimum royalty rate of 16-2/3 percent for new or renegotiatged onshore leases. There may be exceptional cases in which an Indian tribe or Indian landowner may wish to retain a lower royalty rate.

RECOMMENDATION

9. That the Secretary take the necessary steps to implement the use of a minimum royalty rate of 16-2/3 percent for new or renegotiated oil and gas leases, except where requested not to do so by an Indian tribe or Indian landowner.

A NOTE ON SOLID ENERGY MINERALS

The Commission directed its inquiry almost entirely to management of royalties for oil and gas produced from Federal and Indian lands. As production of other energy minerals--coal, uranium, possibly oil shale--increases, royalty management for these minerals also will take on added significance. In 1980, royalties for the solid energy minerals produced from Federal and Indian lands amounted to $49 million -- $40 million for coal, $9 million for uranium, and a negligible amount from oil shale. This compares with $2.6 billion in oil and gas royalties for the same year.

Depending on overall market demand and competition from non-Federal mines, coal production from Federal and Indian leases is expected to increase from 93 million tons in 1980 to 268 million tons by 1990. The anticipated rise in production could significantly increase Federal and Indian coal royalties. Coal production of 93 million tons on Federal and Indian leases yielded royalties of $40 million; 268 million tons is expected to produce royalties of at least $115 million (assuming no increase in coal prices.)

Because the Federal government owns 60 percent of the coal reserves in Western States, those States' share of Federal coal royalties could be a significant

source of income. Important Federally owned coal reserves are located in Colorado, Montana, New Mexico, North Dakota, Oklahoma, Utah and Wyoming. Just how significant coal may prove to be as a source of royalty income to the States and coal owning Indian tribes depends on the future significance of coal based synfuels and coal exports.

The Commission briefly reviewed some of the problems of royalty management for solid energy minerals. From this preliminary review, it appears that the general problems of verifying production, determining fair market value, and designing an effective audit program are common to all minerals. The Commission believes that many of the recommendations of this report, which were formulated primarily with oil and gas royalties in mind, may be applicable as well to managing royalties from the solid energy minerals.

The managers of the Federal royalty program should carefully study the solid energy minerals royalty area and assure itself that the changes being designed into the royalty management system are compatible with the solid energy minerals. The Commission saw no evidence that such an in-depth study has occurred. It should be done before the final system design is completed.

IMPLEMENTATION TASKS

INTERNAL CONTROLS

Recommendation	Required Actions*	Contract Implications (If any)
1. That the Department require an operator to notify it by telegram or equivalent means on the first business day after new production begins on a lease. Failure to comply would subject the operator to a penalty equal to the value of the total production between the start of production and the date of notification, except in those rare cases when extenuating circumstances require an exception.	-- Request legislation to assess civil penalties -- Issue implementing regulation -- Change permit to drill application by 2/15/82	-- Must provide for information in data base -- Must develop system so that start-up information can be matched against production data (to insure that production reports accurately reflect all production from startup)

*Actions to be accomplished by royalty management personnel unless otherwise noted.

INTERNAL CONTROLS

Recommendation	Required Actions	Contract Implications (If any)
2. That the Department immediately require all lessees of revenue producing leases or their agent (the operator or some other agent) to submit a payor plan signed by all payors indicating the payment responsibilities of each party. In the payor plan, the lessee should identify the payors for 100 percent of the royalty obligation. Modified payor plans must be submitted whenever any payor responsibilities change. Upon receiving such changes, the Federal royalty managers should consider them as being proper unless they are later disapproved. Non-compliance with these requirements would subject the lessees to substantial penalties.	-- Issue implementing regulation by 3/15/82 -- Design input Document -- Request legislation to assess civil penalties -- BLM change lease language for new leases by 3/15/82 -- Notify existing leaseholders by 4/15/82	-- Should assist in designing input document -- Must develop system to match payors with interests (for which they are paying) so all interests can be accounted for

INTERNAL CONTROLS Recommendation	Required Actions	Contract Implications (If any)
3. That the managers of the Federal royalty program complete in a timely fashion the installation of the new subaccount system in which each payor on a lease has an account, replacing the current system which features a statement of account by lease (but with multiple payors).	-- Already being done -- Keep on schedule	-- Already being done
4. That the Federal royalty managers work toward the implementation of the concept of an "operator of record" for each lease, and where possible, a single payor, the operator of record would be responsible for maintaining all records related to the payment of royalties from that lease.	-- Issue implementing regulations -- Office of the Solicitor resolve issues with DOJ and FTC	-- Must provide for "operators of record" for each lease, perhaps part of the AID number

INTERNAL CONTROLS Recommendation	Required Actions	Contract Implications (If any)
Each month after the payments are made, the operator of record would reconcile the payments with the production report, notify the Federal royalty managers of any discrepancies and the reasons for them, and provide the Federal royalty managers with the correct information. Where a single payor is possible, all payments for that lease would be made by one individual and all records kept by him.		-- Must have a file of operators of record
5. That the Federal royalty managers incorporate production data into its royalty management system in order to cross check the data with the sales and royalty data for all leases each payment period. This should begin immediately on a systematic sampling basis even though it will have to be done manually.	-- Implement manual checks immediately of production reports by 1/31/82	-- Assist in deciding what information should be included in the automated PAAS -- Develop PAAS system to use data for comparisons

INTERNAL CONTROLS Recommendation	Required Actions	Contract Implications (If any)
	-- Identify company generated and other production data which will be used as a check against payor submitted reports -- Work with contractor on development of checks in automated system	
6. That the Federal royalty managers periodically obtain well test data, run tickets, and LACT meter readings on a sample basis, or according to some	-- Decide upon initial manual process to be followed for	-- Assist in deciding the role of run tickets, LACT meter

INTERNAL CONTROLS Recommendation	Required Actions	Contract Implications (If any)
other systematic plan, and use them to cross check production reports. This comparison would be in addition to that done as part of an audit program focused on leases with suspected irregularities.	cross checks of production reports by 2/15/82 -- Decide if all or some portion of cross checks should be automated -- Develop process to have inspection data shared with accountants	readings, and well test data in the new system -- Build necessary changes into design of PAAS
7. That the Department seek legislation authorizing the Federal royalty managers to require that purchasers	-- Request and obtain necessary legislation	-- Design system to accept purchaser's report data for

INTERNAL CONTROLS

Recommendation	Required Actions	Contract Implications (If any)
submit copies of their reports directly to the Federal royalty managers in a format prescribed by the royalty managers, and to impose civil penalties in the event of noncompliance. This authority would be exercised at least in those cases where there is no other government-required report provided by a party different from the payor covering that particular oil, gas, or other mineral taken from the lease for the same reporting period; and	(Develop by 2/28/82) -- Issue implementing regulations -- Insure that contractor designs system to accept purchaser data	cross check against sales data
That the Federal royalty managers systematically check these purchaser reports against reports submitted by the payor, at least on a sample basis.		
8. That the Secretary request the Inspector General to lead a study of alternatives to purchasers' statements	-- Secretary ask I.G. to initiate study	-- If study results deem useful tracing minerals

INTERNAL CONTROLS

Recommendation	Required Actions	Contract Implications (If any)
for the purpose of cross checking oil and gas sales in cases where there may be collusion between purchasers and sellers. The study should include an evaluation of the usefulness and legal complexities of tracing minerals through channels of commerce to processors or major end users, not just to first purchasers, as an ultimate cross check on production, sales, and royalty reports.	-- Federal royalty managers take part in study -- If study results positive, request necessary legislation -- Issue implementing regulations	through channels of commerce, design system accordingly
9. That the Federal royalty managers incorporate in the new royalty management system data elements derived from field inspections, and that they establish criteria for irregularities identified by internal accounting and auditing procedures, which should trigger an onsite review.	-- Identify criteria which would trigger review by accountants and auditors	-- Assist in identifying criteria -- Design AFS and PAAS to accept required data and issue discrepancy reports

INTERNAL CONTROLS Recommendation	Required Actions	Contract Implications (If any)
	-- Identify criteria which would trigger review by inspectors	leading to reviews
10. That within five months after the filing of the Commission's report, Federal royalty managers decide what issues related to fair market value and other product value matters must be settled by the Department before more definitive guidance can be provided to the industry, and determine what issues can be settled by the royalty managers alone.	-- Identify all production value issues -- Identify issues which can be resolved without solicitor or other high-level decision makers	-- Make necessary provisions for relevant product valuation data in system
That by January 1, 1983, the Federal royalty managers provide preliminary guidance to the industry on the issues identified for resolution without significant Departmental participation; and	-- Resolve issues -- Identify issues requiring solicitor	

INTERNAL CONTROLS Recommendation	Required Actions	Contract Implications (If any)
That by July 1, 1983, the Federal royalty managers issued detailed guidance to industry covering both sets of issues.	and/or other high level decisions -- Request decisions -- Receive decisions -- Issue preliminary guidance by 1/1/83 -- Issue guidance for all issues by 7/1/83	
11. That the Federal royalty managers, as soon as possible, incorporate into the royalty management system the automatic identification of late payments and institute a policy of immediate follow-up.	-- Define late payments -- Design management system for late payments	-- Design report of late payments

INTERNAL CONTROLS

Recommendation	Required Actions	Contract Implications (If any)
	-- Implement management system for late payments	
12. That the Secretary urge the Congress to change the time-consuming process which the industry must go through to obtain refunds of royalty overpayments on offshore leases.	-- Draft legislative amendment by 2/28/82	
13. That the Federal royalty managers continue charging at least the "current value of funds rate" established quarterly by the U.S. Treasury for late payments or underpayments.	-- Issue regulations implementing late payment and underpayment charges	-- Design program to to calculate interest for late payments
14. That the Federal royalty managers allow 60 days for payment of royalties	-- Change regulations to allow	-- Design AFS late payment screen to

INTERNAL CONTROLS

Recommendation	Required USGS Action	Contract Implications (If any)
for natural gas after the end of the month in which the gas is used, sold, or removed from the lease. This policy would be consistent with present industry practice.	payment for natural gas royalties in 60 days	identify natural gas royalty payments
15. That the Department carry out the first 25 look-back audits on an accelerated schedule with completion no later than the end of calendar year 1983, and that audits of companies in addition to the first 25 be initiated as soon as possible, but no later than the end of calendar year 1983.	-- Request supplemental appropriation -- Modify conflict of interest provisions to allow more contract auditors to qualify -- Request funds in 1983 budget	

INTERNAL CONTROLS Recommendation	Required Actions	Contract Implications (If any)
	-- Expedite implementation	
16. That the Department develop a definitive plan for choosing which companies should be the subject of both the first 25 look-back audits and subsequent ones. This plan should include provision for assuring adequate coverage of small companies and onshore leases including Indian leases.	-- Work with IG or independently to develop criteria for sampling. Sampling criteria to include small companies, onshore and Indian leases -- Develop implementation plan by 5/1/82 -- Budget for audits	

INTERNAL CONTROLS Recommendation	Required Actions	Contract Implications (If any)
17. That the managers of the Federal royalty program develop a definitive plan for choosing lease accounts for reconciliation. This should be based on a reasonable method for determining which accounts on leases (or groups of leases, such as in units) it would be most beneficial to pursue in detail. Because account balances are unreliable indicators, they should not serve as the sole basis for this selection. The plan should be developed and initial analyses begun without delay. Look-back audits should not be considered an alternative to lease account reconciliations.	-- Develop plan for accomplishing selected lease account reconciliations by 2/15/82 -- Request necessary personnel and funds -- Implement lease account reconciliation by 10/1/82	

INTERNAL CONTROLS

Recommendation	Required Actions	Contract Implications (If any)
18. That the Federal royalty managers adopt a program of increased systematic audits. In addition, provision should be made for audits triggered by flagged discrepancies between production reports and sales or royalty reports or by discrepancies discovered by inspectors in the field.	-- Identify which kinds of discrepancies warrant audits -- Determine thresholds for audits by 2/15/82 -- Train audit staff -- Establish audit program	-- Program AFS and PAS to flag discrepancies
19. That the managers of the Federal royalty program institute a formal system by which the program's own audit findings and those of GAO and the Inspector General are systematically reviewed to identify weaknesses which can be corrected in the royalty management system.	-- Assign responsibility to independent staff within royalty management of identifying recurring problems	

INTERNAL CONTROLS

Recommendation	Required Actions	Contract Implications (If any)
	which could be corrected by issuing guidance or changing procedures or policies	
20. That the Secretary consult with the American Institute of Certified Public Accountants to arrange for professional services by the companies' certified public accountants with respect to the adequacy of the internal controls and accounting for royalty payments, either through an extension of the CPA's regular auditing procedures or through separate engagements; and	-- I. G. identify for the Office of the Secretary appropriate contacts wihin the AICPA -- Arrange meeting for the Office of the Secretary with contacts	
That the Secretary consider including a requirement for such professional services in future leases and regulations.	-- I. G. identify staff for follow-up with AICPA	

INTERNAL CONTROLS

Recommendation	Required Actions	Contract Implications (If any)
	-- Issue new regulations if required by 12/30/82	
21. That the Secretary provide additional staff to the royalty management program in the accounting, auditing, and product valuation programs as soon as possible and protect the royalty management program from across the board budget cuts and personnel freezes for several years; to accomplish this as early as possible, submit the 1982 budget supplemental as developed by the USGS with the full $5 million for look-back audits and with other increases as necessary to carry out these Commission recommendations approved by the Secretary.	-- Provide back-up as necessary for budget requests -- Review Commission report and revise supplemental request -- Send revised supplemental request ASAP -- Increase FY 83 base budget request	

INTERNAL CONTROLS

Recommendation	Required Actions	Contract Implications (If any)
22. That the Federal royalty managers immediately provide a comprehensive training program for their financial staff in oil and gas industry practices.	-- Identify training needs -- Provide funding -- Develop required training programs -- Assign staff for training	
23. That the Senior Executive Service and Merit Pay Standards for the royalty management system managers be revised to include specific standards with deadlines which will hold the managers and supervisors accountable for the success or failure of the implementation of the new royalty management system, and for	-- Review SES and Merit pay standards for all royalty management managers -- Assign specific managers tasks in	

INTERNAL CONTROLS

Recommendation	Required Actions	Contract Implications (If any)
the implementation of those recommendations of this Commission approved by the Secretary.	implementing recommendations and new royalty management system -- Renegotiate merit pay and SES standards to reflect above-mentioned tasks by 3/30/82 -- Evaluate managers quarterly -- The Secretary take remedial actions (including removal) where managers fail to perform adequately. Reward those who perform well	

IMPLEMENTATION TASKS

SITE SECURITY

Recommendation	Required Actions*
1. That the Secretary reaffirm by letter to all lessees and lease operators that the Department holds them responsible for security on Federal and Indian lease sites and that the Department will conduct an active enforcement program to assure that their site security responsibilities are carried out in a satisfactory manner.	-- Draft press release by 1/31/82 -- Draft letter for Secretary's signature to chief executive officers and directors of IPAA, API and AGA by 1/31/82
2. That all operators on Federal and Indian lands be required by regulation to develop lease site security plans detailing how that operator will carry out his responsibility to ensure security of the site. These plans would be required to be consistent with minimum government standards and would be submitted to the managers of the Federal royalty management program.	-- Designate a task force to determine the elements of a site security plan -- Draft regulations to implement the site security plan requirement

*Actions to be accomplished by royalty management personnel unless otherwise noted.

SITE SECURITY

Recommendation	Required Actions
3. That USGS regulatory requirements be revised to eliminate any detailed regulatory requirements for site security and require instead that operators take the necessary steps to provide for site security as well as to meet minimum standards. Both requirements must be incorporated by operators into all site security plans. Deviations from these minimum requirements would be permitted on a case-by-case basis by the Federal royalty managers. Noncompliance with the principal requirements of the plan proposed and agreed to by the operator would be prima facie evidence of noncompliance with the Federal regulations. Noncompliance with the minimum requirements would also be a violation. Both violations would be subject to substantial penalties. (See Chapter Five, Enforcement.) The requirements of the new regulations would be phased in during a transition period.	-- Designate a task force to determine the minimum standards -- Draft regulations to implement the general requirement and the minimum standards

SITE SECURITY

Recommendation	Required Actions
4. That the Department seek legislation or publish regulations, as necessary, to require truck haulers of oil to have run tickets in their possession at all times while transporting oil from Federal and Indian leases.	-- Request legislation if necessary -- Issue implementing regulations
5. That the Department seek legislation to empower Federal inspectors (within Constitutional limits) to stop trucks in order to check that the truck hauler possesses a run ticket.	-- Draft legislative proposal by 2/28/82.
6. That the Federal government establish cooperative relationships with State and local enforcement officials and encourage them to use their authority to inspect for run tickets in the possession of haulers of oil and to deter oil theft generally.	-- Consult with key mineral State officials and with officials of multistate organizations -- Include provisions for inspecting for run tickets in cooperative agreements

SITE SECURITY

Recommendation	Required Actions
7. That the Department seek Federal Legislation to prohibit the purchase of undocumented crude oil and require purchasers of crude oil up to and including refiners to keep documentation showing from whom they purchased the product and from what lease or unit.	-- Seek legislation -- Issue implementing regulations -- Establish program to review documents on sampling basis -- Investigate discrepancies between documents and reported production -- Bring charges for fraud when documentation is false

IMPLEMENTATION TASKS

ENFORCEMENT

Recommendation	Required Actions*
1. That the Federal royalty managers design and implement an inspection/enforcement strategy which will assure that the performance of the industry both in guarding site security and in reporting production volumes, is properly monitored. This strategy should include how often and how the field staff will inspect sites, how violations will be determined and penalties assessed, what other methods will be used to ensure site security and to verify production on site, and how the managers of the Federal royalty program will use the program's resources, both present and future, to implement this strategy. To implement this strategy the Department should:	-- Designate a task force to design an inspection/enforcement strategy (invite States and Indian tribes to contribute)
o increase the number of Federal inspectors so that at a minimum each Federal and Indian lease can be inspected once a year for site security and production verification purposes.	-- Proceed to hire and train new field inspectors to bring the total inspection staff to a minimum of 83

* Actions to be accomplished by royalty management personnel unless otherwise noted.

ENFORCEMENT

Recommendation	Required Actions
o in order to increase the frequency of inspection beyond the once a year minimum, enter into cooperative agreements with State and Indian tribes and use contractors as necessary to assist with the monitoring of the sites.	-- Negotiate cooperative agreements with interested States -- Negotiate contracts with qualified contractors if determined necessary and feasible.
2. That the Secretary direct employees of the Federal royalty program that he expects enforcement of the program's regulations fairly, but firmly, with penalties imposed when violations are found.	-- Draft memorandum for the Secretary's signature supporting firm but fair enforcement of the USGS regulations, including assessment of liquidated damages or civil penalties by 1/31/82
3. That the Department seek legal authority to assess civil penalties for site security violations. The civil penalty system should have fines up to $10,000	-- Draft legislative proposal by 2/28/82

ENFORCEMENT

Recommendation	Required Actions
and under certain circumstances, each day should be counted as a separate violation. After the legislation is enacted, appropriate criteria for levying fines should be developed and promulgated after publication in the Federal Register for review and comment. These criteria should include the operator's history of violations, the potential for theft, negligence of the operator, and good faith in compliance. Civil penalties should be imposed both for violations detected for the first time and for noncompliance, i.e., failure to obey an order.	-- Designate task force to issue implementing regulations -- Design civil penalty program -- Hire and train personnel
4. That the Department seek legal authority for a civil penalty system for nonpayments, late payments, underpayments, error ridden reports, and failure to submit or update the required payor plan.	-- Draft legislation by 2/28/82 -- Issue implementing regulations

ENFORCEMENT

Recommendation	Required Actions
The Internal Revenue Service's system of a sliding penalty scale based on the culpability of the payor and harm to the government could be used as a model. As applied to royalty collections this would provide that failure to report would result in a penalty of 5 percent per month of the royalty owed up to a maximum of 25 percent, unless the payor shows that his failure to report is due to reasonable cause and not willful neglect. Chronically error ridden reports would be treated as a failure to report. Also, there would be a penalty for failure to pay the royalty when due of one-half of one percent per month of the amount owed up to a maximum of 25 percent. Where underreporting represents 25 percent or more of the amount owed and is willful the USGS should impose a civil penalty of 50 percent of the total royalties due. Penalties would be applied in addition to interest levied on the delinquent royalties.	-- Design procedures for assessing civil penalties -- Hire and train employees

ENFORCEMENT

Recommendation	Required Actions
5. That the Federal royalty managers use shut-in authority in cases of noncompliance where there is serious potential for theft. Operators should be charged the value of the average daily royalty that otherwise would have been paid had the lease not been shut-in, as liquidated damages or penalty.	-- Determine criteria for shut-ins and publish regulations
6. That the Secretary of the Interior exercise his authority to use shut-ins and lease cancellations as sanctions for severe cases of underpayments. Operators should be charged the value of the average daily royalty that would otherwise have been paid during the shut-in, as liquidated damages or penalty.	-- Determine criteria for shut-ins and lease cancellations in cases of underpayment and publish regulations
7. That the Secretary pursue lease cancellation in cases of repeated theft or serious lease security problems.	-- Develop criteria for pursuing lease cancellation and publish criteria in Federal Register

IMPLEMENTATION TASKS

STATES AND INDIAN TRIBES

Recommendation	Required Actions*
1. That the Secretary announce an expanded policy of cooperation with States and Indian tribes in the royalty management area --namely, that the Department will share information and royalty management functions (including inspections) with affected States and Indian tribes to the maximum extent possible, consistent with its responsibility to assure the proper accountability of the royalties paid on minerals removed from Federal and Indian lands.	-- Draft a press release for the Secretary by 1/31/82 -- Draft a letter to governors and tribes by 1/31/81
2. That the Secretary appoint a formal advisory committee, reporting to the Secretary's Office, consisting of representatives of States and Indian	-- Identify to the Office of the Secretary possible representatives of States,

*Actions to be accomplished by royalty management personnel unless otherwise noted.

STATES AND INDIAN TRIBES

Recommendation	Required Actions
2. (continued)	
tribes and related organizations and Departmental officials, to develop a detailed plan over a nine-month period for carrying out the expanded policy of Federal/State/Indian cooperation on a comprehensive basis.	Indian tribes, concerned organizations, and DOI officials to form advisory group -- Implement plan developed by advisory group
3. That the Secretary immediately take steps to assist States and tribes in carrying out certain royalty management functions, by:	-- Draft activities to be covered by cooperative agreements, criteria for funding, and application procedures -- Issue specific invitations to States and tribes by 1/31/82

STATES AND INDIAN TRIBES

Recommendation	Required Actions
3. (continued)	
° Offering to enter into demonstration cooperative agreements with interested States and Indian tribes, especially for inspection of leases, audits and training and to participate in the funding where appropriate.	-- Execute first cooperative agreement by 3/15/82 -- Provide Departmental participation in and oversight of all agreements
° Providing for increased technical support of Indian royalty management activities through the BIA's Division of Energy and Minerals in the Office of Trust Responsibilities and (since Osage Tribe activities are budgeted separately from those of other tribal and Federal leases) assuring that the Osage Tribe has inspectors adequate to conduct inspections for site security and production verification at each lease at least once a year.	-- BIA design an expanded program for increased technical support of Indian royalty management activities -- BIA allocate funds and personnel by 7/1/82 -- BIA identify number of inspectors necessary for Osage to increase

STATES AND INDIAN TRIBES

Recommendation	Required Actions
3. (continued)	
	frequency of inspections to once a year for site security and production verification -- BIA provide personnel slots for inspectors for Osage
° Seeking legislation as necessary to enhance a State's or Indian tribe's ability to carry out royalty management and site security functions under cooperative agreements with the Department. Specifically, the program should authorize the the enforcement of all applicable Federal laws and regulations by States and tribes operating under a cooperative agreement with the Department and their obtaining	-- Department request legislation to enable States and Indian tribes to enforce all applicable Federal laws and regulations by 2/28/82 -- Department request legislation to enable States and Indian tribes to

STATES AND INDIAN TRIBES

Recommendation	Required Actions
3. (continued)	
information from companies and others to the same extent as if they were employees of the Department. Any cooperative agreements should provide for the transfer of appropriate funds to the States and Indian tribes for an appropriate portion of the costs, based on the source of the funds and the respective responsibilities of the parties.	obtain information from companies and others to same extent as if they were employees of the Department by 2/28/82
4. That the Department substantially increase the two way flow of information between the Department and the States and tribes by:	-- Assist States, multistate and tribal organizations in developing common data elements
° Actively supporting the on-going effort of States to develop common data elements for industry reporting, and by examining Federal data needs to make the	-- Review reporting formats for consistency with multistate efforts

STATES AND INDIAN TRIBES

Recommendation	Required Actions
4. (continued)	
Federal data collection effort as consistent as possible with the State efforts.	-- Change reporting formats where possible to be consistent with multistate data elements
° Identifying those sources of information which States and tribes have which will assist the Federal royalty managers in assuring that royalties collected are correct and site security rules are observed; and entering into agreements with these States and tribes to obtain this information on a routine basis.	-- Identify sources of State and tribal information useful to royalty management (to assure royalties collected are correct and site security rules are observed)
	-- Develop a plan and procedures for entering into agreements to get the information on a routine basis

STATES AND INDIAN TRIBES

Recommendation	Required Actions
4. (continued)	
	-- Implement agreements
° Designing and implementing a system of sharing with the individual States and Indian tribes on a timely basis all information which the Federal royalty program collects concerning leases within their respective boundaries, including information at the time the checks are distributed to verify the accuracy of the royalty payments and to audit the accounts if necessary.	-- In conjunction with the BLM identify information necessary to provide back-up to States and Indian tribes for their royalty checks
	-- Direct contractor to incorporate into the design of the system the capability to provide necessary back-up information
	-- Design procedures for coordinating information with BLM and BIA to ensure reporting time

STATES AND INDIAN TRIBES

Recommendation	Required Actions
4. (continued)	
	frames coincide with disbursements to States and tribes by 3/1/82
° *Continuing and expanding upon past USGS* policy of making forecasts of future royalty revenues when requested to do so by a State or Indian tribe.	-- Draft procedures for responding to requests of States and Indian tribes for forecasts of future royalty revenues by 3/1/82
° Creating a central data bank of Federal, State, and Indian audit and site inspection results so that Federal, State, and Indian auditors and inspectors can have a comprehensive source for checking royalty payor and/or lease operator performance.	-- In cooperation with States and Indian tribes design specifications for a central data bank of Federal, State, and Indian audit and site inspection results

STATES AND INDIAN TRIBES

Recommendation	Required Actions
4. (continued)	
	-- Draft scope of work for design
	-- Contract for design of central data bank by 10/15/82
5. That the Secretary of the Interior seek legislation to establish a self-sustaining fund which would:	-- Request necessary legislation to establish self-sustaining fund by 2/28/82
° Pay the costs of supplementary audits and lease production-related inspections that are deemed appropriate over and above those planned for and funded by the routine Federal Royalty Management budget. No	

STATES AND INDIAN TRIBES

Recommendation	Required Actions
5. (continued)	
environmental or site safety inspection functions would be financed by this fund and the fund would not be used as a substitute for a full audit and inspection program under the routine budget.	
° Reimburse States, localities, and Indian tribes for costs they might incur for their part in any audits, inspections or enforcement done under cooperative or contractual arrangements with the Federal royalty managers with regard to mineral leases on Federal and Indian lands. Federal costs associated with the cooperative agreements would also be covered. These activities would include only those efforts	-- Draft Federal Register notice outlining activities to be covered by cooperative agreements, criteria for funding, and application procedures

STATES AND INDIAN TRIBES

Recommendation	Required Actions
5. (continued)	
done solely by the States, localities, or Indian tribes, those done jointly with the Federal royalty managers, and those done by contractors for any of these parties, under terms of a cooperative agreement.	
6. That the Secretary establish and maintain the fund by taking a percentage of the royalties collected from all existing and future Federal and Indian leases (both offshore and onshore) before any funds are distributed to the States, Indians, or the Federal Treasury.	
That the legislation allow the Secretary, after the first five years, to adjust the level of the levy between zero and one percent of the total royalties collected. For the first five years, the levy should be set at one half of one	

STATES AND INDIAN TRIBES

Recommendation	Required Actions
6. (continued)	
percent of such royalties. The yearly budget for the fund should be subject to Executive Branch and Congressional review and approval. After the first five years, the fund balance should not be allowed to exceed an amount equal to the sum of the monies expended from the fund for the three previous years. In the event that the levy would result in excess monies accumulating in the fund, the Secretary would be required to adjust the fund by reducing the levy rate or by suspending levy (reducing it to zero) for an appropriate period.	
7. That the Federal government share with the States interest and penalities paid for late payments and underpayments.	-- After consultation with Treasury and OMB, Department request legislation

STATES AND INDIAN TRIBES

Recommendation	Required Actions
	allowing sharing of interest and penalties for late payments by 2/28/82
8. That Indian tribal royalty payments be deposited immediately in interest-bearing accounts and electronic transfer be actively encouraged; and that the Department seek ways to accelerate distribution of royalty payments to the individual Indian landowners.	-- BIA develop procedures to deposit immediately funds into an interest-bearing accounts (by 3/15/82) -- BIA draft letter to royalty payors (large companies) requesting deposit by electronic transfer into interest-bearing accounts

STATES AND INDIAN TRIBES

Recommendation	Required Actions
	-- BIA identify method of payment to individual Indian landowners which will result in payments being made faster by 3/15/82
9. That distribution of royalty funds to the States be made as quickly as possible after the close of the reporting period, and that the Secretary consider seeking legislation to allow payment of the States' share of royalties more often than once every six months.	-- BLM design procedures for more quickly distributing royalty payments -- After consultation with Treasury and OMB, Department draft for consideration by the Secretary a legislative proposal allowing States to receive payment of their share of royalties more often than once every six months by 2/28/82.

IMPLEMENTATION TASKS

ORGANIZATIONAL ISSUES

Recommendation	Required Actions*
1. That the Secretary immediately move the royalty management program out of the USGS to a location to be determined by the Secretary, but reporting to an Assistant Secretary or perhaps the Under Secretary.	-- Secretary determine organizational location of royalty management by 2/1/82

In order to function as an organizational entity, royalty management must include the following post-lease functions from the USGS Conservation Division:

- Accounting
- Auditing
- Product valuation
- Data collection
- Regulation writing
- Enforcement (monitoring, inspection, sanctions)
- Engineering technical support

*Actions to be accomplished by royalty management personnel unless otherwise noted.

ORGANIZATIONAL ISSUES

Recommendation	Required Actions
It must have its own inspection personnel. It must also have the authority to cooperate with the States and Indian tribes and to negotiate cooperative agreements for the Secretary's signature. Additionally, in order to insure that the royalty management program functions smoothly, it must have at least the following support services: computer, procurement, budget, and personnel. Finally, it should have the authority to deal at the policy level within the Department.	
2. That the Secretary appoint a transition project director in order to assure that the reorganization is completed in an appropriate manner and that the Commission's recommendations are implemented expeditiously.	-- Secretary appoint transition director for royalty management by 2/1/82
The transition project director would report directly to the Secretary, the Under Secretary or an Assistant Secretary. This transition director would have the authority to assure that the royalty management program is correctly separated out from the USGS and that imple-	-- Submit nominees to Secretary for State/tribal/Federal cooperative planning committee by 2/15/82

ORGANIZATIONAL ISSUES

Recommendation	Required Actions
mentation of the Commission's recommendations as approved by the Secretary are expeditiously undertaken. He or she would be responsible for the Secretary's advisory committee of State and Indian representatives and the preparation of the first annual report of the Secretary. This person would be in addition to the project leader for the new royalty management system recommended in Chapter Eight of this report.	-- Prepare royalty management reorganization plan by 2/28/82 -- Secretary approve or modify reorganization plan by 3/10/82 -- Prepare first annual report on implementation and circulate to energy producing States and tribes by 12/31/82
3. That the Department initiate a study of what lines of communication should be established between the royalty management functions being moved from the USGS and other royalty management functions located in BIA and BLM. In addition, the Department should study which	-- Initiate study of lines of communication between royalty management and BLM and BIA by 3/15/82

ORGANIZATIONAL ISSUES

Recommendation	Required Actions
parts of the BIA and BLM royalty management functions might be combined with the USGS royalty management functions at a future time.	
4. That the director of the new royalty management office be an experienced manager preferably with a background in financial management. His or her most important qualification should be strong management expertise, not program knowledge; however, if possible it would be desirable for the office director to be familiar with the minerals industry.	-- Initiate search for Director of Royalty Management by 2/15/82
5. The Department should initiate a nationwide search for an office director. He or she must have the status of a bureau-level director within the Department, reporting at least to the level of an Assistant Secretary. The director must have clearly delegated authority in order to respond expeditiously to changing needs.	

ORGANIZATIONAL ISSUES

Recommendation	Required Actions
High level placement within the Department and clearly delegated authority will make this position attractive to the financial community, encouraging high quality candidates to apply.	

IMPLEMENTATION TASKS

NEW APPROACHES TO ROYALTY MANAGEMENT

Recommendation	Required Actions*
1. That, where appropriate, those parts of the Auditing and Financial System which are not already in place be implemented on an advance basis (manually or otherwise) before full automation is completed.	-- Identify parts of the AFS which would be suitable for implementation on a trial basis -- Implement parts of AFS on a trial basis -- Analyze results of trials -- Modify design of AFS per results of trials
2. That appropriate portions of the Production Accounting and Auditing System be implemented on an advance basis (manually or otherwise) before full automation is completed.	-- Identify parts of the PAAS which would be suitable for testing on a trial basis

*Actions to be accomplished by royalty management personnel unless otherwise noted.

NEW APPROACHES TO ROYALTY MANAGEMENT

Recommendation	Required Actions
	-- Implement parts of PAAS on a trial basis -- Analyze results of trials -- Modify design of PAAS per results of trials
3. That since the Production Accounting and Auditing System is so important to the proper functioning of the royalty management system, the Secretary take the necessary steps to assure that adequate financial and human resources are available through reprogramming or otherwise for prompt implementation after the design is completed in the Spring of 1982.	-- Reprogram funds as necessary to avoid any lapse of funding for implementing the PAAS

NEW APPROACHES TO ROYALTY MANAGEMENT

Recommendation	Required Actions
4. That the managers of the Federal royalty program proceed with the implementation of the improved royalty management system, as modified by the Commission's recommendations in this report, and that the Federal royalty managers immediately take steps to incorporate recommendations of the Commission in the design and implementation of the new system.	-- See all the implementation tasks
5. That the Secretary appoint a committee of Department officials to draft a proposed Omnibus Royalty Management Improvement Act and that the Secretary provide guidance to the Committee in the form of approval of those Commission recommendation with which he is in accord.	-- Secretary appoint committee -- Secretary approve/disapprove recommendations
6. That a project manager, reporting to the director of the royalty management program, be immediately appointed to oversee implementation of the new royalty management system. The authority of the project manager should be	-- Identify for the Secretary possible candidates for the position of project manager

NEW APPROACHES TO ROYALTY MANAGEMENT

Recommendation	Required Actions
in writing and his authority should be broad enough to resolve disputes among senior program managers, or to have them resolved by the director in a timely fashion.	-- Draft charter for the project manager
7. That the Secretary prepare an annual report on the implementation of those Commission recommendations adopted by the Secretary and the overall progress of the royalty management system. The report should be made available to appropriate committees of Congress and to the public. It should be issued on March 1 of each year, up to and including March 1, 1986. Prior to its transmittal, the Secretary should provide a copy of the draft report to mineral producing States and Indian tribes and should include their comments as part of the report when it is published.	-- Draft annual report -- Circulate draft report to mineral producing States and Indian tribes -- Draft response to comments for inclusion in final report -- Include comments of Indian tribes and States

NEW APPROACHES TO ROYALTY MANAGEMENT

Recommendation	Required Actions
8. That the Department request the assistance of IRS to revise its regulations or design a legislative change which would relieve the the Federal royalty program of the responsibility of calculating and paying the Windfall Profit Tax on royalty in kind transactions; and	-- Contact IRS for assistance in drafting regulations or legislation -- Request legislation by 1/31/82
That the responsibility for calculating, withholding, and paying Windfall Profit Tax on all crude oil sold on Federal leases be returned to the industry, with oversight by the IRS rather than Federal royalty managers.	-- IRS issue implementing regulations
9. That the Secretary take the necessary steps to implement the use of a minimum royalty rate of 16-2/3 percent for new or renegotiated oil and gas leases, except where requested not to do so by an Indian tribe or Indian landowner.	-- Request legislation -- Renegotiate leases -- Change lease forms for new leases.

CHAPTER NINE

SUMMARY OF RECOMMENDATIONS

CHAPTER NINE

SUMMARY OF RECOMMENDATIONS

INTERNAL CONTROLS

Production Start-up Notification

1. That the Department require an operator to notify it by telegram or equivalent means on the first business day after new production begins on a lease. Failure to comply would subject the operator to a penalty equal to the value of the total production between the start of production and the date of notification, except in those rare cases when extenuating circumstances require an exception.(Page 48)

Payor Plan

2. That the Department immediately require all lessees of revenue producing leases or their agent (the operator or some other agent) to submit a payor plan signed by all payors indicating the payment responsibilities of each party. In the payor plan, the lessee should identify the payors for 100 percent of the royalty obligation. Modified payor plans must be submitted whenever any payor responsibilities change. Upon receiving such changes, the Federal royalty managers should

consider them as being proper unless they are later disapproved. Noncompliance with these requirements would subject the lessees to substantial penalties.(Page 51)

Lease Subaccounts

3. That the managers of the Federal royalty program complete in a timely fashion the installation of the new subaccount system in which each payor on a lease has an account, replacing the current system which features a statement of account by lease (but with multiple payors).(Page 54)

Operator of Record

4. That the Federal royalty managers work toward the implementation of the concept of an "operator of record" for each lease and, where possible, a single payor; the operator of record would be responsible for maintaining all records related to the payment of royalties from that lease.

   Each month after the payments are made, the operator of record would reconcile the payments with the production report, notify the Federal royalty managers of any discrepancies and the reasons for them, and provide the Federal royalty managers with the correct information. Where a single payor is possible, all payments for

that lease would be made by one individual and all records kept by him. (Page 54)

Use of Production Records

5. That the Federal royalty managers incorporate production data into the royalty management system in order to cross check the data with sales and royalty data for all leases each payment period. This should begin immediately on a systematic sampling basis even though it will have to be done manually. (Page 62)

Verification of Production and Sales

6. That the Federal royalty managers periodically obtain well test data, run tickets, and LACT meter readings on a sample basis, or according to some other systematic plan, and use them to cross check production reports. This comparison would be in addition to that done as part of an audit program focused on leases with suspected irregularities. (Page 62)

Purchasers' Reports

7. That the Department seek legislation authorizing the Federal royalty managers to require that purchasers submit copies of their reports directly to the Federal royalty managers in a format prescribed by the royalty managers,

and to impose civil penalties in the event of noncompliance. This authority would be exercised at least in those cases where there is no other government-required report provided by a party different from the payor covering that particular oil, gas, or other mineral taken from the lease for the same reporting period; and

That the Federal royalty managers systematically check these purchaser reports against reports submitted by the payor, at least on a sample basis. (Page 62)

Channels of Commerce Study

8. That the Secretary request the Inspector General to lead a study of alternatives to purchasers' statements for the purpose of cross checking oil and gas sales in cases where there may be collusion between purchasers and sellers. The study should include an evaluation of the usefulness and legal complexities of tracing minerals through channels of commerce to processors or major end users, not just to first purchasers, as an ultimate cross check on production, sales, and royalty reports.(Page 63)

Meshing Inspection and Financial Management

9. That the Federal royalty managers incorporate in the new royalty management system data elements derived from field inspections, and that they establish criteria for irregularities identified by internal accounting and auditing procedures which should trigger an onsite review. (Page 63)

Product Valuation Guidance

10. That within five months after the filing of the Commission's report, Federal royalty managers decide what issues related to fair market value and other product value matters must be settled by the Department before more definitive guidance can be provided to the industry, and determine what issues can be settled by the royalty managers alone;

That by January 1, 1983, the Federal royalty managers provide preliminary guidance to the industry on the issues identified for resolution without significant Departmental participation; and

That by July 1, 1983, the Federal royalty managers issue detailed guidance to industry covering both sets of issues. (Page 67)

Late Payment Identification

11. That the Federal royalty managers, as soon as possible, incorporate into the royalty management system the automatic identification of late payments and institute a policy of immediate follow-up. (Page 69)

Offshore Refunds

12. That the Secretary urge the Congress to change the time-consuming process which the industry must go through to obtain refunds of royalty overpayments on offshore leases.(Page 69)

Interest Rates

13. That the Federal royalty managers continue charging at least the "current value of funds rate" established quarterly by the U.S. Treasury for late payments or underpayments. (Page 69)

60 Day Payment for Gas

14. That the Federal royalty managers allow 60 days for payment of royalties for natural gas after the end of the month in which the gas is used, sold, or removed from the lease. This policy would be consistent with present industry practice.(Page 69)

Accelerated Look-Back Audits

15. That the Department carry out the first 25 look-back audits on an accelerated schedule with completion no later than the end of calendar year 1983, and that audits of companies in addition to the first 25 be initiated as soon as possible, but no later than the end of calendar year 1983. (Page 73)

Look-Back Audit Plan

16. That the Department develop a definitive plan for choosing which companies should be the subject of both the first 25 look-back audits and subsequent ones. This plan should include provision for assuring adequate coverage of small companies and onshore leases, including Indian leases.(Page 73)

Account Reconciliation

17. That the managers of the Federal royalty program develop a definitive plan for choosing lease accounts for reconciliation. This should be based on a reasonable method for determining which accounts on leases (or groups of leases, such as in units) it would be most beneficial to pursue in detail. Because account balances are unreliable indicators, they should not serve as the sole basis for this selection. The plan should be developed and initial analyses begun without delay. Look-back audits should not be considered

an alternative to lease account reconciliations. (Page 73)

Routine Audit Program

18. That the Federal royalty managers adopt a program of increased systematic audits. In addition, provision should be made for audits triggered by flagged discrepancies between production reports and sales or royalty reports or by discrepancies discovered by inspectors in the field. (Page 75)

System Corrections

19. That the managers of the Federal royalty program institute a formal system by which the program's own audit findings and those of GAO and the Inspector General are systematically reviewed to identify weaknesses which can be corrected in the royalty management system. (Page 75)

Certified Public Accountants

20. That the Secretary consult with the American Institute of Certified Public Accountants to arrange for professional services by the companies' certified public accountants with respect to the adequacy of the internal controls and accounting for royalty payments, either through an extension of the CPA's regular auditing procedures or through separate engagements; and

That the Secretary consider including a requirement for such professional services in future leases and regulations. (Page 77)

Additional Staff

21. That the Secretary provide additional staff to the royalty management program in the accounting, auditing, and product valuation programs as soon as possible and protect the royalty management program from across the board budget cuts and personnel freezes for several years; to accomplish this, as early as possible, submit the 1982 budget supplemental as developed by the USGS with the full $5 million for look-back audits, and with other increases as necessary to carry out those Commission recommendations approved by the Secretary. (Page 79)

Comprehensive Training

22. That the Federal royalty managers immediately provide a comprehensive training program for their financial staff in oil and gas industry practices. (Page 79)

Performance Standards for Managers

23. That the Senior Executive Service and Merit Pay Standards for the royalty management system managers be revised

to include specific standards with deadlines which will hold the managers and supervisors accountable for the success or failure of the implementation of the new royalty management system, and for the implementation of those recommendations of this Commission approved by the Secretary.(Page 79)

SITE SECURITY

Departmental Policy

1. That the Secretary reaffirm by a letter to all lessees and lease operators that the Department holds them responsible for security on Federal and Indian lease sites and that the Department will conduct an active enforcement program to assure that their site security responsibilities are carried out in a satisfactory manner. (Page 91)

Site Security Plans

2. That all operators on Federal and Indian lands be required by regulation to develop lease site security plans detailing how that operator will carry out his responsibility to ensure security of the site. These plans would be required to be consistent with minimum government standards and would be submitted to the managers of the Federal royalty program. (Page 91)

Revised Regulations

3. That USGS regulatory requirements be revised to eliminate any detailed regulatory requirements for site security and require instead that operators take the necessary steps

to provide for site security as well as to meet minimum standards. Both requirements must be incorporated by operators into all site security plans. Deviations from these minimum requirements would be permitted on a case-by-case basis by the Federal royalty managers. Noncompliance with the principal requirements of the plan proposed and agreed to by the operator would be prima facie evidence of noncompliance with the Federal regulations. Noncompliance with the minimum requirements would also be a violation. Both violations would be subject to substantial penalties. (See Chapter Five, Enforcement.) The requirements of the new regulations would be phased in during a transition period. (Page 92)

Run Tickets

4. That the Department seek legislation or publish regulations, as necessary, to require truck haulers of oil to have run tickets in their possession at all times while transporting oil from Federal and Indian leases.(Page 95)

Expand Inspectors' Authority

5. That the Department seek legislation to empower Federal inspectors (within constitutional limits) to stop trucks in order to check that the truck hauler possesses a run ticket. (Page 96)

State and Local Enforcement

6. That the Federal government establish cooperative relationships with State and local enforcement officials and encourage them to use their authority to inspect for run tickets in the possession of haulers of oil and to deter oil theft generally. (Page 96)

Undocumented Oil

7. That the Department seek Federal legislation to prohibit the purchase of undocumented crude oil and require purchasers of crude oil up to and including refiners to keep documentation showing from whom they purchased the product and from what lease or unit. (Page 96)

ENFORCEMENT

Inspection/Enforcement Strategy

1. That the Federal royalty managers design and implement an inspection/enforcement strategy which will assure that the performance of the industry, both in assuring site security and in reporting production volumes, is properly monitored. This strategy should include how often and in what manner the field staff will inspect sites, how violations will be determined and penalties assessed, what other methods will be used to ensure site security and to verify production on site, and how the managers of the Federal royalty program will use the program's resources, both present and future, to carry out this strategy. To implement the strategy the Department should:

   - o Increase the number of Federal inspectors so that at a minimum each Federal and Indian lease can be inspected once a year for site security and production verification purposes. (A minimum of 83 inspectors devoting 100 percent of their time to these two duties.)

   - o Increase the frequency of inspection beyond the once a year minimum, by entering into cooperative agreements with States and Indian

tribes and by using contractors as necessary to assist with the monitoring of the site. (See Chapter Six for further discussion of this recommendation.)(Page 103)

Fair But Firm Enforcement

2. That the Secretary direct employees of the Federal royalty program that he expects enforcement of the program's regulations to be conducted fairly, but firmly, with penalties imposed when violations are found. (Page 109)

Civil Penalties: Site Security

3. That the Department seek legal authority to assess civil penalties for site security violations. The civil penalty system should have fines up to $10,000 per violation, and under certain circumstances, each day should be counted as a separate violation.

   After the legislation is enacted, appropriate criteria for levying fines should be developed and promulgated after publication in the Federal Register for review and comment.

   These criteria should include the operator's history of violations, the potential for theft, negligence of the operator, and good faith in

compliance. Civil penalties should be imposed both for violations detected for the first time and for noncompliance, that is, failure to obey an order. (Page 109)

Civil Penalties: Payments

4. That the Department seek legal authority for a civil penalty system for nonpayments, late payments, underpayments, error ridden reports, and failure to submit or update the required payor plan.

The Internal Revenue Service's system of a sliding penalty scale based on the culpability of the payor and harm to the government could be used as a model. As applied to royalty collections, this would provide that failure to report would result in a penalty of 5 percent per month of the royalty owed up to a maximum of 25 percent, unless the payor shows that his failure to report is due to reasonable cause and not willful neglect. Chronically error ridden reports would be treated as a failure to report.

Also, there should be a penalty for failure to pay the royalty when due of one-half of one percent per month of the amount owed, up to a maximum of 25 percent.

Where underreporting represents 25 percent or more of the amount owed

and is willful, the USGS should impose a civil penalty of 50 percent of the total unpaid royalties due. Penalties would be applied in addition to interest levied on the delinquent royalties. (Page 110)

Shut-in: Site Security

5. That the Federal royalty managers use shut-in authority in cases of noncompliance where there is serious potential for theft. Operators should be charged the value of the average daily royalty that otherwise would have been paid had the lease not been shut-in, as liquidated damages or penalty. (Page 110)

Shut-in: Underpayments

6. That the Secretary of the Interior exercise his authority to use shut-ins and lease cancellations as sanctions for severe cases of underpayments. Operators should be charged the value of the average daily royalty that would otherwise have been paid had the lease not been shut-in, as liquidated damages or penalty. (Page 111)

Lease Cancellation

7. That the Secretary pursue lease cancellation in cases of repeated theft or serious lease security problems.(Page 111)

STATES AND INDIAN TRIBES

Expanded Policy

1. That the Secretary announce an expanded policy of cooperation with States and Indian tribes in the royalty management area--namely, that the Department will share information and royalty management functions (including inspections) with affected States and Indian tribes to the maximum extent possible, consistent with its responsibility to assure the proper accountability of the royalties paid on minerals removed from Federal and Indian lands. (Page 123)

Secretarial Advisory Committee

2. That the Secretary appoint a formal advisory committee, reporting to the Secretary's Office, consisting of representatives of States and Indian tribes and related organizations and Departmental officials, to develop over a nine-month period a detailed plan for carrying out the expanded policy of Federal/ State/Indian cooperation on a comprehensive basis. (Page 124)

Immediate Implementation

3. That the Secretary immediately take steps to assist States and tribes in carrying out certain royalty management functions, by:

   - Offering to enter into demonstration cooperative agreements with interested States and Indian tribes, especially for inspection of leases, audits, and training and to participate in the funding where appropriate.

   - Providing for increased technical support of Indian royalty management activities through the BIA's Division of Energy and Minerals in the Office of Trust Responsibilities and (since Osage Tribe activities are budgeted separately from those of other tribal and Federal leases) assuring that the Osage Tribe has inspectors adequate to conduct inspections for site security and production verification at each lease at least once a year.

   - Seeking legislation as necessary to enhance a State's or Indian tribe's ability to carry out royalty management and site security functions under cooperative agreements with the Department. Specifically, the program should authorize the enforcement of all applicable Federal laws and regulations

by States and tribes (operating under a cooperative agreement with the Department) and their obtaining information from companies and others to the same extent as if they were employees of the Department. Any cooperative agreements should provide for the transfer of funds to the States and Indian tribes for an appropriate portion of the costs, based on the source of the funds and the respective responsibilities of the parties. (Page 126)

Information Exchange

4. That the Department substantially increase the two-way flow of information between the Department and the States and tribes by:

   - Actively supporting the ongoing effort of States to develop common data elements for industry reporting, and by examining Federal data needs to make the Federal data collection effort as consistent as possible with the States' efforts.

   - Identifying those sources of information which States and tribes have which will assist the Federal royalty managers in assuring that royalties collected are correct and site security rules are observed; and entering into agreements with these States and tribes to obtain this information on a routine basis.

   - Designing and implementing a system of sharing with the individual States and Indian tribes on a timely basis all information which the Federal royalty program collects concerning leases within their respective boundaries, including information at the time the checks are distributed to verify the accuracy of the royalty payments and to audit the accounts if necessary.

   - Continuing and expanding upon the past USGS policy of making forecasts of future royalty revenues when requested to do so by a State or Indian tribe.

   - Creating a central data bank of Federal, State, and Indian audit and site inspection results so that Federal, State and Indian auditors and inspectors can have a comprehensive source for checking royalty payor and/or lease operator performance. (Page 130)

Self-Sustaining Fund: Purpose

5. That the Secretary of the Interior seek legislation to establish a self-sustaining fund which would:

- Pay the costs of supplementary audits and lease production related inspections that are above those planned for and funded by the routine Federal royalty management budget. No environmental or site safety inspection functions would be financed by this fund and the fund would not be used as a substitute for a full audit and inspection program under the routine Federal royalty management budget.

- Reimburse States, localities, and Indian tribes for costs they might incur for their part in any audits, inspections or enforcement done under cooperative or contractual arrangements with the Federal royalty managers with regard to mineral leases on Federal and Indian lands. Federal costs associated with the cooperative agreements would also be covered. These activities would include only those efforts done solely by the States, localities, or Indian tribes, those done jointly with the Federal royalty managers, and those done by contractors for any of these parties, under the terms of a cooperative agreement. (Page 134)

Self-sustaining Fund: Levy

6. That the Secretary establish and maintain the fund by taking a percentage of the royalties collected from all existing and future Federal and Indian leases (both offshore and onshore) before any funds are distributed to the States, Indians, or the U.S. Treasury.

   That the legislation allow the Secretary, after the first five years, to adjust the level of the levy between zero and one percent of the total royalties collected. For the first five years, the levy should be set at one-half of one percent of such royalties. The yearly budget for the fund should be subject to Executive Branch and Congressional review and approval. After the first five years, the fund balance should not be allowed to exceed an amount equal to the sum of the funds expended from the fund for the previous three years. In the event that the levy would result in excess monies accumulating in the fund, the Secretary would be required to adjust the fund by reducing the levy rate or by suspending the levy (reducing it to zero) for an appropriate period.(Page 135)

Sharing Penalties and Interest

7. That the Federal government share with the States and Indian tribes both interest and penalties paid for late payments and underpayments. (Page 137)

Accelerated Payments to Indians

8. That Indian tribal royalty payments be deposited immediately in interest bearing accounts and electronic transfer be actively encouraged; and that the Department seek ways to accelerate distribution of royalty payments to the individual Indian landowners. (Page 137)

Accelerated Payments to States

9. That distribution of royalty funds to the States be made as quickly as possible after the close of the reporting period, and that the Secretary consider seeking legislation to allow payment of the States' share of royalties more frequently than once every six months.(Page 137)

ORGANIZATIONAL ISSUES

Create New Office of Royalty Management

1. That the Secretary immediately move the royalty management program out of the USGS to a location to be determined by the Secretary, but reporting to an Assistant Secretary or perhaps the Under Secretary.

In order to function as an organizational entity, royalty management must include the following post-lease functions from the USGS Conservation Division:

- Accounting
- Auditing
- Product valuation
- Data collection
- Regulation writing
- Enforcement (monitoring, inspection, sanctions)
- Engineering technical support

It must have its own inspection personnel. It must also have the authority to cooperate with the States and Indian tribes and to negotiate cooperative agreements for the Secretary's signature. Additionally, in order to ensure that the royalty management program functions smoothly, it must have at least the following support services: computer, procurement, budget, and personnel.

Finally, it should have the authority to deal at the policy level within the Department. (Page 159)

Transition Project Director

2. That the Secretary appoint a transition project director in order to assure that the reorganization is completed in an appropriate manner and that the Commission's recommendations are implemented expeditiously.

The transition project director would report directly to the Secretary, the Under Secretary or an Assistant Secretary. This transition director would have the authority to assure that the royalty management program is correctly separated out from the USGS and that implementation of the Commission's recommendations as approved by the Secretary is expeditiously undertaken. He or she would be responsible for the Secretary's advisory committee of State and Indian representatives and the preparation of the first annual report of the Secretary. This person would be in addition to the project leader for the new royalty management system recommended in Chapter Eight of this report. (Page 160)

Study of BIA/BLM Royalty Management Functions

3. That the Department initiate a study of what lines of communication should be established between the royalty management functions being

moved from the USGS and other royalty management functions located in BIA and BLM. In addition, the Department should study which parts of the BIA and BLM royalty management functions might be combined with the USGS royalty management functions at a future time. (Page 161)

Qualifications of Director

4. That the director of the new royalty management office be an experienced manager preferably with a background in financial management. His or her most important qualification should be strong management expertise, not program knowledge; however, if possible it would be desirable for the office director to be familiar with the minerals industry. (Page 161)

Nationwide Search

5. The Department should initiate a nationwide search for an office director. He or she must have the status of a bureau-level director within the Department, reporting at least to the level of an Assistant Secretary. The director must have clearly delegated authority in order to respond expeditiously to changing needs.

High level placement within the Department and clearly delegated authority will make this position attractive to the financial community, encouraging high quality candidates to apply.(Page 161)

NEW APPROACHES TO ROYALTY MANAGEMENT

Advance Implementation of Financial System

1. That, where appropriate, those parts of the Auditing and Financial System which are not already in place be implemented on an advance basis (manually or otherwise) before full automation is completed. (Page 167)

Advance Implementation of Production System

2. That appropriate portions of the Production Accounting and Auditing System be implemented on an advance basis (manually or otherwise) before full automation is completed.(Page 170)

Immediate Implementation of Production System

3. That since the Production Accounting and Auditing System is so important to the proper functioning of the royalty management system, the Secretary take the necessary steps to assure that adequate financial and human resources are available through reprogramming or otherwise for prompt implementation after the design is completed in the spring of 1982. (Page 170)

Modification of Improved Royalty Management System

4. That the managers of the Federal royalty program proceed with the implementation of the improved royalty management system, as modified by the Commission's recommendations in this report, and that the Federal royalty managers immediately take steps to incorporate the recommendations of the Commission in the design and implementation of the new system. (Page 175)

Omnibus Royalty Management Improvement Act

5. That the Secretary appoint a Committee of Department officials to draft a proposed Omnibus Royalty Management Improvement Act and that the Secretary provide guidance to the Committee in the form of approval of those Commission recommendations with which he is in accord. (Page 175)

Project Manager

6. That a project manager be immediately appointed reporting to the transition director until appointment of a head of the Royalty Management Office to oversee implementation of the new royalty management system. The authority of the project manager should be in writing and his authority should be broad enough to resolve disputes among senior program managers or to have

them resolved by the director in a timely fashion. (Page 175)

Annual Report

7. That the Secretary prepare an annual report on the implementation of those Commission recommendations adopted by the Secretary and the overall progress of the improved royalty management system. The report should be made available to appropriate committees of Congress and to the public. It should be issued on March 1 of each year, up to and including March 1, 1986. Prior to its transmittal, the Secretary should provide a copy of the draft report to mineral producing States and Indian tribes and should include their comments as part of the report when it is published. (Page 177)

Windfall Profit Tax

8. That the Department request the assistance of IRS to revise its regulations or design a legislative change which would relieve the Federal royalty program of the responsibility of calculating and paying the Windfall Profit Tax on royalty in-kind transactions; and

That the responsibility for calculating, withholding, and paying the Windfall Profit Tax on all crude oil sold on Federal leases be returned to the industry, with oversight by the IRS rather the Federal royalty management program. (Page 179)

Increased Royalty Rate

9. That the Secretary take the necessary steps to implement the use of a minimum royalty rate of 16-2/3 percent for new or renegotiated oil and gas leases, except where requested not to do so by an Indian tribe or Indian landowner. (Page 180)