TESTIMONY OF

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Madam Chairman and Members of the Subcommittee, I appreciate the opportunity to appear today to present testimony on H.R. 3334, and on the Minerals Management Service's (MMS) implementation of programs to take oil and gas royalties "in kind." In testimony submitted for the July 31, 1997 and September 18, 1997 hearings on royalty in kind (RIK) before the Subcommittee, we provided background information, described the results of our 1997 Royalty in Kind Feasibility Study, and summarized our plans to implement three RIK pilot projects. My testimony today will briefly address RIK legislative initiatives before providing a progress report on our three pilot projects.

RIK Legislation. At the outset, I would like to make the Department's position on RIK legislation perfectly clear. Legislation is not needed to exercise our lease contract rights to take royalties in kind. The Mineral Leasing Act, the OCS Lands Act and the lease agreements with the producers all grant the Federal government the option to take our royalties in kind. The Department, therefore, strongly opposes any legislation mandating the United States to take its mineral royalties in kind and would recommend that H.R. 3334 be vetoed if it were presented to the President.

I would also like to clarify our position on RIK implementation. As I testified last year before this Subcommittee, we are excited by the potential of RIK programs to streamline and improve aspects of our royalty collection and verification processes. RIK programs might increase revenues to the Federal government, but only if implemented under favorable conditions. Accordingly, we are aggressively working on an ambitious schedule to implement three major RIK pilot projects. The results of these pilots will allow us to select areas where RIK can provide additional net revenues, and avoid those areas that will lose revenues.

There is no inconsistency in these two positions. We strongly believe that both the Federal government and industry need to conduct realistic tests of the RIK concept under actual conditions prior to any administrative or legislative decisions on broader implementation. RIK is unproven and risky for royalty collection in the U.S. As stewards of public assets, we must have assurance that the revenue and administrative effects of RIK are decidedly positive before moving to implementation. Anything less is a gambler's folly with the taxpayers money. We must identify and test those factors that would lead to RIK program success and then structure any broad programs around those factors. A legislatively-mandated RIK program would unnecessarily limit the flexibility of lessees and the lessor in the optimal design and implementation of RIK and destroy the value of being able to choose which collection method, "in-kind" or "in-value," works best in each location.

H.R. 3334. I will limit my discussion of the bill that is the subject of this hearing to only a few general reactions because we have not prepared a detailed analysis. First, we are frankly disappointed that this bill is weighted heavily in favor of the oil and gas industry. Simply put, the bill would force the United States to relinquish many of its long-established legal rights as lessor while relieving lessees of many of their equally long-established legal obligations. The collective result of the bill is to drastically reduce the options and legal rights of the Federal mineral lessor. We must seriously ask ourselves how it is to the advantage of the citizens of the United States to give up these rights, and as a result, give up a substantial part of the value they receive for the production of their non-renewable resources.

There are many specific components of this bill that would act to decrease the value of Federal mineral royalties. Although these details would have substantial revenue and legal implications, they are too numerous to discuss adequately in this testimony. We will provide a list and description of effects of these items under separate cover. For today's purposes, the most important point we wish to make is that, notwithstanding the details of the bill, there are several overarching reasons why this legislation is misguided and detrimental to the public.

- First, the Federal lessor would assume costs of marketing oil and gas in an RIK program where production under U.S. title is sold downstream of the lease. Under the historical "in value" royalty scheme currently in effect, the Federal government has not shared such costs. Thus, royalty revenues to the Federal Treasury will logically and unambiguously decline under RIK.

  A major purpose of our RIK pilot programs is to identify and test the circumstances under which Federal in kind production could be made more valuable in the marketplace. Our 1995 Gas Marketing Pilot demonstrated the potential for RIK to lose money. Our 1997 Feasibility Study suggested that revenue "uplift" is most likely for Gulf of Mexico gas, and unlikely for oil. No one, however, knows and actual tests are necessary for both oil and gas, to better understand the real potential for enhanced value.

- Second, our 1997 RIK Feasibility Study and subsequent analyses have identified several unfavorable conditions under which RIK programs would reduce revenues. These conditions include taking de minimis volumes in remote areas, taking production at less than marketable condition, and paying above market rates for transportation. H.R. 3334 would mandate RIK programs in areas where these unfavorable conditions exist, ensuring a loss of revenue from these areas.

    Our RIK pilot programs will be structured to isolate and test the effects of various factors affecting RIK program success, thus reducing the exposure of Federal revenues to loss and providing the information needed to intelligently choose where to implement RIK.

- Third, the Bill would statutorily adopt many of the positions taken by the oil and gas industry in historic valuation disputes with the Department -- disputes, I might add, that have been consistently won by the Department. This would be an unjustified major economic gift to the lessee. Specifically, the Bill would require the United States to begin paying for: (1) gathering of production before it reaches the royalty meter; (2) movement of unseparated, bulk production; (3) field treatment of production; and (4) would absolve the lessee from the duty to market. Further, the bill's prescribed methods for setting rates for upstream transportation would significantly increase these rates, which the Federal government would be forced to pay.

- Fourth, the bill's criteria under which government marketing agents could sell to themselves or affiliates are so broad and unenforceable that they would assure continuation of disputes between marketers and the U.S. over sales prices and substantial administrative costs for both the government and marketers.

- Finally, we believe the bill is riddled with other provisions that make it unacceptable.

We must be careful not to enact legislation that serve only the special interests of either lessee or lessor. For the reasons I have described, we can only conclude that this legislative initiative is primarily designed to enhance the interests of oil and gas producers, at the expense of the American taxpayer.

Model RIK Programs. In its support of mandatory RIK, the oil and gas industry has pointed to the RIK programs of Texas and Alberta as models of successful RIK program. Yet, many of the major elements of these programs are not included in this legislation. It is these key "missing" elements that are, in fact, directly responsible for the success of the Texas and Alberta programs. Specifically:

- <u>Alberta:</u> According to Alberta officials, the Province's agent has the authority to take imbalance shortages at times of high prices. Further, lessees are required to deliver Crown production to pipeline interconnects, at significant distances from the lease, at non-discriminatory rates. The marketing agents' 5 cents per barrel marketing fee is modest because much of the work to aggregate Crown production is performed by the lessee. Domestic producers have told us that U.S. marketing fees could be at least 15 cents per barrel. Without these and other advantages, Alberta's marginal 5 cents per barrel revenue gain from RIK would quickly become a big loss.

- <u>Texas:</u> We understand that the State's oil RIK program has in recent years gone from decidedly revenue positive to essentially revenue neutral, as producers began paying royalties for non-RIK State production at market value. In addition, the State's oil RIK program is not mandatory, and it does not include production from wells that produce less than 10 barrels per day or from any particular lease that the state chooses to exclude from the program. The inclusion of such tiny volumes would likely cause the State program to lose revenue.

  With respect to Texas' RIK program for natural gas, the State directs the producer to deliver royalty volumes to convenient sales points, <u>free of any charges</u>. Further, State law requires pipelines in the State to transport Texas royalty volumes if nominated, at non-discriminatory rates. These are big advantages that essentially assure success. If we truly want a successful RIK program for the U.S., why don't we see these key elements in this legislation?

<u>Relationship to Valuation Regulations.</u> We at MMS regard our program initiatives in valuation regulations and in-kind royalties as completely independent efforts. However, it has become apparent that the oil and gas industry views these efforts as directly related. Specifically, we are told by industry representatives that mandatory, across-the-board RIK is needed because MMS valuation policies and regulations are abandoning gross proceeds as a valuation basis. To such assertions, I respond as follows:

- Our recently-published supplemental proposed rule for crude oil valuation contains five valuation principles, including that royalty obligations for arm's-length contracts should be based on gross proceeds received under such contracts.

- Under our supplemental proposed rule, some 68% of Rocky Mountain crude oil production would be valued for royalty purposes based on gross proceeds received under arm's-length sales.

- In a close-out audit meeting, the General Accounting Office recently told us that it found MMS has been responsive to industry concerns expressed in public notice and comment on the crude oil rule, and that it did not advise statutorily-mandatory RIK programs.

- For the record, I wish to clarify the lease requirement that a lessee has the duty to market at no cost to the lessor, since it has so often been misrepresented. It does not mean that we will second guess a lessee's decision not to market at downstream locations. MMS has never done such second guessing and has no plans to do so in the future. MMS does not participate in the marketing decisions of the lessee, does not tell the lessee how to market its product, and accordingly does not participate in its cost.

Royalty in Kind Pilot Projects. As you are aware, last summer, our senior management team at MMS accepted the recommendations of the 1997 RIK Feasibility Study, namely to implement RIK pilot projects in Wyoming (crude oil in-kind), offshore Texas in 8(g) waters (natural gas in-kind), and the Gulf of Mexico (natural gas in-kind). I am pleased to report to you that we are currently making great progress in implementing these recommendations. We have formed an RIK team of some 16 staff dedicated to successfully implementing these projects.

> Wyoming Crude Oil Pilot: We are on course to begin this 2- to 3- year pilot program in October of this year. The objective of the Wyoming Pilot is to test the administrative and economic feasibility of a variety of methods and conditions of RIK programs for onshore crude oil - in a manner that at least preserves revenue neutrality. From the outset, we have been developing the pilot in close partnership with the State of Wyoming.
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> We will test the effects of such factors as sales methods, production volumes and qualities, transportation methods, and lease location. We recently held a well-attended public meeting in Casper where the RIK team obtained useful input on these and other factors, primarily from the industry and State governments. The pilot is currently on track for its October 1, 1998 start date.

We have been enjoying a close and cooperative working relationship with personnel from the State of Wyoming. I understand that the State is considering whether to commit State lease royalty volumes to the joint RIK Pilot. We understand it will decide after an early April briefing on the detailed final structure of the Pilot. Governor Geringer and I will receive the same decision briefing from the RIK implementation team. Our interests in the pilot are the same--to produce the best possible test of the RIK concept and the knowledge to confidently use it to assure full and fair market value for our resources.

Texas 8(g) Pilot Project. We are working with the State of Texas concerning implementation of a natural gas Pilot project for offshore 8(g) leases in the Gulf of Mexico. As you know, the State has an existing successful RIK program from State leases. While Texas enjoys significant advantages in its RIK program, that we will not have, the General Land Office has considerable experience and expertise that will help us design the best possible pilot. We are exploring the potential for a joint program that could potentially supply the State, other end users in Texas, and Federal facilities. By supplying the needs of Federal Facilities with RIK gas, we might not only increase royalty revenue but also reduce energy costs for the Federal government. We also expect this pilot to begin October 1, 1998.

Outer Continental Shelf RIK Project. This project is a logical follow-on to our 1995 gas RIK pilot, and will involve substantial volumes of OCS natural gas handled by one or several marketing agents. Similar to the Wyoming Pilot, the OCS project will test a variety of factors, including the method of marketing.

The size and complexity of this project dictate that it will take another year before we can begin with confidence. The start-up date is anticipated to be October, 1999. Currently, we are assessing lease data, pipeline infrastructures, procurement options, and marketing strategies. The project structure will be presented in the Fall of this year. We anticipate convening a series of public meetings to collect comments, have open discussions about our planning, and further refine our pilot. We invite the industry and all interested entities to work with us.

I wish to emphasize that the pilot projects described above form a logical, deliberate process designed to test the feasibility of RIK programs across a broad swath of Federal lease and production situations. We strongly believe that implementation of RIK across-the-board, without discovering its real impacts in actual programs, is unwise and risky. The royalty revenues from Federal leases are too important to the American taxpayer and mineral producing States to risk blindly jumping into mandatory RIK before we know how and if it will work.

Some have speculated that we oppose legislation mandating RIK because of a fear of losing jobs. We highly value the contributions of our employees, and will continue to do so under any type of royalty scheme that may evolve from the current one. We at MMS believe that we have a very effective royalty management program, which last year cost taxpayers only a penny for each dollar collected. Nevertheless, we are always striving to improve our royalty management systems to increase efficiency and effectiveness. Our current reengineering effort in the royalty management program promises to provide efficiencies to increase our productivity for the taxpayer. Even with mandatory RIK many of our functions and costs would remain. Our opposition to this legislation begins and ends with the fundamental principle of ensuring that the public receives fair market value for its assets.

In closing, let me state that we are enthusiastic about the prospects of implementing successful RIK programs for Federal mineral leases. Such programs may provide an innovative way to streamline the royalty management process. Effective implementation of the already existing RIK option, developed through the practical and prudent investigation of our pilot programs, spells success not only for royalty management but for the taxpayer as well.

We will need some time to fully assess the revenue implications of this bill. However, it clearly represents a dramatic transfer of costs and obligations from the oil and gas industry to the American taxpayer. Our preliminary analysis suggests that the revenue loss would be significant and on the order of hundreds of millions of dollars at a minimum. I believe we must seriously ask ourselves how the American taxpayer would benefit from H.R. 3334. Because of the disastrous effect this bill would have on the taxpayer and the budget, the Department is prepared to recommend a veto.

Thank you Madam Chairman and Members of the Subcommittee, this concludes my prepared remarks. I would be pleased to answer any questions you may have.