



# United States Department of the Interior

MINERALS MANAGEMENT SERVICE  
Washington, DC 20240



MAY 17 2006

The Honorable Carolyn B. Maloney  
House of Representatives  
Washington, D.C. 20515

Dear Ms. Maloney:

This letter responds to your April 3, 2006, letter (Enclosure 1) regarding questions from you and the State and Tribal Royalty Audit Committee (STRAC) about mineral royalty compliance issues. I am also including other pertinent correspondence as Enclosures 2, 3, and 4.

The MMS compliance program, supported by state and tribal partners, is very successful. I am proud of our collective achievements, as detailed in a recent summary from Lucy Querques Denett, Associate Director for Minerals Revenue Management (Enclosure 5). The compliance program provides assurance to the American public and to our Indian beneficiaries, that we are receiving the proper royalties from Federal and Indian mineral leases and that companies are paying and reporting in compliance with the laws, lease terms and regulations.

MMS strives to make optimum use of its compliance resources to ensure it provides compliance oversight of the maximum amount of mineral revenues possible. By using "compliance reviews" in addition to traditional audits, MMS has been able to expand its compliance coverage significantly. Many of STRAC's questions involve the use of such compliance reviews.

Compliance reviews apply a series of tests to the four elements of the "royalty equation" (volume, royalty rate, value, and allowances) to determine if royalty payments are within a prescribed range on a property basis. Full-scope traditional audits, which are much more resource intensive, are also an important part of our compliance strategy. With over 27,000 producing Federal and Indian mineral leases under our jurisdiction, there are simply too many properties to rely on the traditional audit approach alone.

Compliance reviews have helped MMS cover more revenue dollars and complete compliance work more contemporaneously. MMS has established goals under the Government Performance and Results Act (GPRA) to complete compliance work within 3 years of production. Since implementing compliance reviews, MMS has significantly increased the amount of compliance work completed within this timeframe. For example, by the end of fiscal year 2005, MMS completed compliance work on 71 percent of 2002 mineral revenues. This compares to a baseline of only 10% completed within 3 years when we started the process.

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Due in large part to compliance reviews, MMS is achieving far higher contemporaneous compliance coverage for offshore federal leases than for onshore. MMS is encouraging the state delegations to utilize compliance reviews to help increase onshore compliance coverage as well.

The MMS has not abandoned audits nor reduced the rigor of its overall compliance program. In fact, by including compliance reviews, strategically integrated with audits, we believe the overall compliance program is much stronger. The MMS encourages states and tribes to use a combination of approaches on a risk-sensitive basis to obtain the broadest possible coverage while providing more in-depth audit coverage for certain properties, companies, or issues, based on their judgment.

Your first comment involved the authority of states and tribes to perform compliance reviews. The law and existing regulations are clearly broad enough to include alternative approaches to compliance. The Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA) provides for the delegation of “inspections, audits, and investigations.” The Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 (FOGRSFA) went further by authorizing the delegation of “automated verifications.” The MMS implemented regulations following RSFA that referred to automated activities that were in effect at that time. Since then, those automated processes have been overtaken by new approaches as MMS consolidated multiple processes into what is known as “end-to-end compliance reviews.” The FOGRSFA regulations clearly cover all the essential elements of compliance reviews.

Some STRAC members have indeed been skeptical about compliance reviews and have periodically requested MMS to justify their use. Others have been quite supportive of compliance reviews. We have worked closely with states and tribes during the development and implementation of compliance reviews, consulting with them many times and including state and tribal representatives in our pilot teams that developed the new process.

Following are our responses to your specific queries:

Dollars Collected - Following are the collections since FY 2001 attributable to compliance reviews and those attributable to audits<sup>1</sup>:

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<sup>1</sup> MMS does not maintain the necessary data to provide requested breakouts for 8(g) and Tribal vs. Allottee leases.

DESCRIPTION	FY 2005 Collections	FY 2004 Collections	FY 2003 Collections	FY 2002 Collections	FY 2001 Collections	TOTAL
<b>AUDIT</b>						
MMS - Federal Onshore	\$49,472	\$40,846	\$36,847	\$105,654	\$114,908	\$407,527
MMS - Indian	\$1,892,978	\$870,777	\$260,958	\$108,805	\$2,213,849	\$5,147,367
MMS - Solids & Geothermal	\$3,202	\$0	\$0	\$0	\$142,879	\$148,181
MMS - Offshore	\$13,392,830	\$17,040,293	\$17,074,139	\$3,764,492	\$53,587,408	\$105,459,181
States and Tribes	\$1,265,559	\$1,571,385	\$7,500,065	\$33,077,203	\$8,838,915	\$52,251,727
Total	\$16,604,041	\$19,323,101	\$25,472,809	\$37,116,154	\$64,896,057	\$153,411,963
<b>COMPLIANCE REVIEW</b>						
MMS - Federal Onshore	\$3,726,181	\$0	\$0	(\$45,043)	\$302,135	\$3,982,673
MMS - Indian	\$3,750,712	\$2,063,732	\$1,796,709	\$1,948,967	\$14,727	\$9,574,847
MMS - Solids & Geothermal	\$1,929,935	\$7,551,349	\$0	\$0	\$0	\$9,481,284
MMS - Offshore	\$52,728,898	\$2,468,154	\$9,328,359	\$5,180,373	\$102,901,892	\$172,585,776
States and Tribes	\$198,068	\$510,812	\$207,865	\$404,127	\$28,649,598	\$29,970,068
Total	\$62,333,792	\$12,591,848	\$11,332,733	\$7,467,824	\$131,868,451	\$225,594,648
<b>GRAND TOTAL</b>	<b>\$78,937,833</b>	<b>\$31,914,950</b>	<b>\$36,805,542</b>	<b>\$44,583,978</b>	<b>\$198,764,509</b>	<b>\$369,006,611</b>

Cost Benefit of Compliance Reviews – The MMS conducted an analysis of compliance reviews for presentation at the May 5, 2006, STRAC meeting. These results show that for every dollar spent on compliance reviews over the past 3 years, MMS has collected \$3.27. For every dollar spent on audits, MMS has collected \$2.06. The MMS does not believe, however, that the amount of additional collections is the sole or even the primary benefit of compliance. Ideally, collections will actually decline over time as greater company compliance is achieved. The increased revenue coverage provided by using compliance reviews increases the likelihood that underpayments will be detected and increases the incentive for companies to report and pay correctly.

Random Audits - The term “random audit” is used to describe multiple types of audit activities:

- Random selection is frequently used by MMS and its state and tribal partners to select companies, properties, and sample months, (as provided for in standard audit procedures).
- The MMS has begun performing “random audits” to validate the results of compliance reviews and, if possible, improve the compliance tools or benchmarks used in reviewing the properties. These random audits are typically performed a year after the compliance review is complete. During FY 2002, MMS initiated 13 such random audits—1 Indian, 9 offshore, and 3 onshore. The MMS has 49 more such random audits underway or planned for FY 2006-2007, including 1 Indian, 15 onshore, and 33 offshore<sup>2</sup>.
- Additional random audits are performed periodically as resources are available. For example in FY 2003, 15 Federal onshore properties were selected for audit randomly from those states without delegated compliance and audit authority.

Audit Referrals – The MMS has always considered the opportunity for audit referrals to be one of the expected benefits of compliance reviews. During a compliance review, a

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<sup>2</sup> MMS does not maintain the necessary data to provide requested breakouts for 8(g) and Tribal vs. Allottee leases.

skilled analyst or auditor may determine that further investigation would be fruitful and will refer a matter for audit. To date, MMS has not made extensive use of this approach primarily due to the fact that compliance resources have been fully occupied with planned audits and compliance reviews.

Results of audit referrals and random audits – While we remain committed to the strategies, MMS has not yet made full use of random audits and referrals as means to improve our compliance process. As we continue to adapt and refine our processes, we expect to make greater use of these approaches in the future.

Numbers of orders issued – The MMS maintains data on audits and compliance reviews conducted and on collections but does not maintain statistics on the numbers or amounts of orders issued. The MMS successfully resolves many royalty payment issues identified during audits without the use of orders. Often when MMS identifies a problem, companies voluntarily make corrections to all properties and timeframes. An order is only utilized when a company is unwilling to correct the reporting and payment issues during the informal process. Frequently, during audits, we determine that no additional royalties are due. While it is important to collect additional revenues through enforcement actions, MMS believes it is as important, if not more important, to obtain compliance with the laws, regulations, and lease terms as soon as possible. Ideally, this occurs without prompting from MMS at the time the company initially reports and pays.

Compliance and Other Costs – Following are the total costs for compliance activities from FY 2001 through FY 2005:

	(\$Millions)				
	FY2001	FY2002	FY2003	FY2004	FY2005
MMS Audit and Compliance	23.9	24.8	25.7	24.5	25.5
State and Tribal Cooperative Audit	8.2	8.3	8.5	8.3	9.1
<b>Total Compliance Funding</b>	<b>32.1</b>	<b>33.1</b>	<b>34.2</b>	<b>32.8</b>	<b>34.6</b>

The MMS recently analyzed its FY 2000 and FY 2005 costs to determine the relative proportions of costs attributable to audits and to compliance reviews. The statistics below reflect how MMS has shifted part of its resources from audits to compliance reviews:

	FY 2000		FY 2005	
	Cost	Percent	Cost	Percent
Audit	\$21.5 million	62%	\$12.1 million	35%
Compliance Review	\$11.9 million	34%	\$21.7 million	63%
Other	\$ 1.3 million	4%	\$0.8 million	2%
<b>TOTAL</b>	<b>\$33.7 million</b>	<b>100%</b>	<b>\$34.6 million</b>	<b>100%</b>

The MMS does not record costs based on all of the categories requested. For example, costs related to “random or referral audits, quality reviews, training, preparation of congressional reports and strategic plans” would be part of our normal mission work and

would not be separately categorized and tracked. To the extent the data were available, we have provided the costs related to the categories you requested:

Contractor Costs – Obligations for MRM’s major contractors and consultants:

	<u>\$Millions</u>				
	<u>FY 2001</u>	<u>FY2002</u>	<u>FY 2003</u>	<u>FY 2004</u>	<u>FY 2005</u>
AMSOC*	9.3	2.9	0.0	0.0	0.0
Accenture*	16.0	20.4	18.5	17.5	18.0
INOVIS (electronic commerce)	0.4	0.2	0.3	0.4	0.3
Lukens (RIK assessment and consultation)			0.3	0.1	0.4
OMS (records management)	0.3	0.4	0.4	0.4	0.4

\*Costs include full outsourcing of MRM system activities for financial system, RIK system, compliance system, and data warehouse. Includes system design and development, operations/support, and data center operations.

SES Promotions and Bonuses – There is no cost associated with SES promotions *per se*, although the pay scale is typically modestly higher than a GS-15, depending on years of service and other factors. Following are the numbers of SES members on board with MMS as of the end of each year and the total bonuses paid:

Year	Senior Executives On Board at Year End	Total SES Bonuses
2001	10	\$26,369
2002	11	31,200
2003	13	42,800
2004	13	-0-
2005	15	77,115

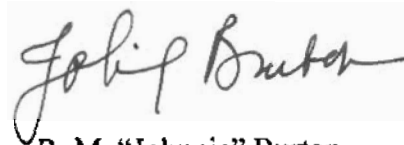
Labor hours to conduct compliance reviews – For FY 2005, MMS averaged 142 labor hours per review. This total includes detailed documentation, supervisory reviews, and other controls required by MMS’s Compliance Review Manual.

In summary, I would like to emphasize that MMS’s use of compliance reviews, in concert with audits, utilizes best practices and maximizes the compliance coverage per tax dollar. Relying on audits alone would severely restrict the number of properties that could be reviewed. During FY 2007, we plan to engage the states and tribes more directly in helping MRM achieve these goals by cascading similar goals into the delegation contracts. We plan to work cooperatively with each state and tribe to customize these goals and to collaborate on the appropriate use of compliance reviews in their compliance programs.

As requested, we are also providing our response to the states and tribes participating in the delegated and cooperative compliance program.

If I can be of further assistance, please do not hesitate to call me at (202) 208-3500 or call Ms. Lyn Herdt, Chief, MMS, Office of Congressional Affairs, at (202) 208-3502. An identical letter is being sent to each signer of your letter.

Sincerely,

A handwritten signature in black ink, appearing to read "Johnnie Burton", is centered on the page. The signature is written in a cursive, flowing style.

R. M. "Johnnie" Burton  
Director

cc: State and Tribe Managers and/or Revenue Departments  
Governors and Tribal Chairpersons

# Congress of the United States

Washington, DC 20515

April 3, 2006

The Honorable Johnnie Burton  
Director  
Minerals Management Service  
1849 C Street, NW  
Washington, D.C. 20240

Dear Director Burton,

We are writing to follow up on a February 2, 2006, letter sent by the State and Tribal Royalty Audit Committee (STRAC) to the Minerals Management Service (MMS) requesting information about MMS's compliance review program. We share STRAC's concerns about the auditing and compliance review processes for the states and Native American tribes.

According to the letter, at a recent State and Tribal Royalty Audit Committee (STRAC)/MMS meeting in Salt Lake City, STRAC was informed that as part of the individual jurisdictions' contracts with the Department of Interior, they must request authority to conduct compliance reviews. Under their current contracts, these jurisdictions have been delegated the authority to conduct audits, not compliance reviews, of leases within their respective borders. According to STRAC, no statute or regulation exists under which its jurisdictions can request the authority to conduct compliance reviews.

Although STRAC has requested that MMS provide it with data about the quality and efficiency of compliance reviews, it has been waiting for this information for more than two years. STRAC contends that this information is vital to its ability to advise its jurisdictions about the value of conducting compliance reviews. Therefore, we reiterate its request for the following information:

- The total dollars collected since 2001 as a direct result of the compliance review process, broken down in terms of offshore, 8(g), onshore, Tribal and Allottee leases. This should exclude collections since 2001 attributable to the previous audit program and, particularly, audits conducted by States and Tribes;
- The cost/benefit of conducting compliance reviews;
- The number of random audits conducted under the compliance review process, broken down in terms of offshore, 8(g), onshore, Tribal and Allottee leases;
- The number of audit referrals conducted under the compliance review process, broken down in terms of offshore, 8(g), onshore, Tribal and Allottee leases;
- The number of random or referral audits that revealed further underpayments of royalties, the type of violations involved and the effort made by MMS to compile the type of

violations into its compliance review process;

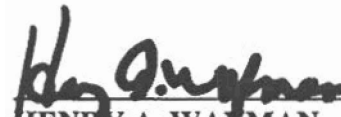
- The number of orders issued by MMS as a direct result of the compliance review process, broken down in terms of offshore, 8(g), onshore, Tribal and Allottee leases. This should exclude orders issued since 2001 attributable to the previous audit program and, particularly, orders issued as a result of audits conducted by States and Tribes;
- A breakdown of MMS's appropriated or offline dollars since 2001 allocated to compliance reviews, random or referral audits, Accenture, other private consultants or entities (such as Inovis); quality reviews, training preparation of congressional reports and strategic plans, SES promotions, and bonuses; and
- Average labor hours needed to perform a compliance review.

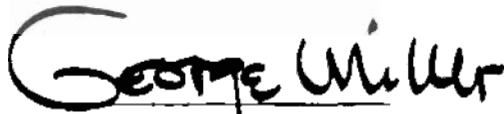
We respectfully request that you disseminate this information to us and to STRAC as soon as possible.

Thank you for your assistance in this matter.


Sincerely,

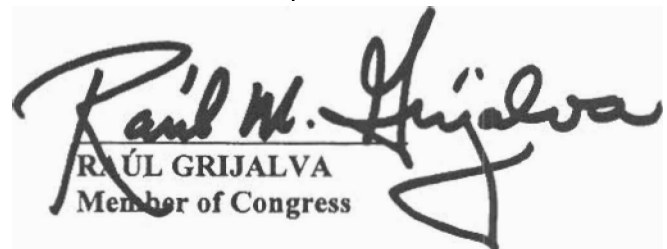
  
CAROLYN B. MALONEY  
Member of Congress

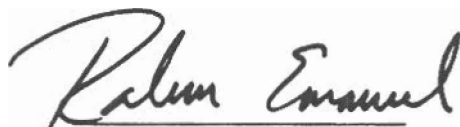
  
HENRY A. WAXMAN  
Member of Congress

  
GEORGE MILLER  
Member of Congress

  
EDWARD MARKEY  
Member of Congress

  
MAURICE HINCHEY  
Member of Congress

  
RAÚL GRIJALVA  
Member of Congress

  
RAHM EMANUEL  
Member of Congress

## STATE and TRIBAL ROYALTY AUDIT COMMITTEE

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State of Alaska • Blackfeet Nation • State of California • State of Colorado • Fort Peck Tribes  
Jicarilla Apache Tribe • State of Louisiana • State of Montana • Navajo Nation • State of New Mexico  
State of North Dakota • State of Oklahoma • Shoshone & Arapaho Tribes • Southern Ute Indian Tribe • State of Texas  
State of Utah • Ute Indian Tribe • Ute Mountain Ute Tribe • State of Wyoming

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Lisa Doekter, *Chair* (970) 563-5559  
Dennis R. Rolier, *1st Vice Chair* (701) 250-4682

*Former Chair, Ex Officio:*  
Joe Vintze

Lucy Querques Denett  
Associate Director  
Minerals Management Service  
Washington, DC 20240

Dear Ms. Denett:

On behalf of the State and Tribal Royalty Audit Committee (STRAC), we are writing to request information on the Minerals Management Service's (MMS's) "compliance review" program.

At the recent STRAC/MMS meeting in Salt Lake City, STRAC was told that its individual jurisdictions would be "required to request" authority to conduct compliance reviews as part of their contracts with Interior. Currently, our jurisdictions' contracts delegate authority to conduct "audits" of leases within their respective borders; a compliance review is not an audit.

There is no statute or regulation under which our jurisdictions can request the authority to conduct compliance reviews, despite the fact the MMS's program has been in place since 2001. MMS officials and staff at the meeting were in hopeless disagreement regarding the authority for delegation of the compliance review function. Mr. Sykora disagreed with the Contracting Office and MMS managers. States and Tribes cannot be paid for work that cannot be delegated under the law, which was also acknowledged by MMS.

For well over two years, STRAC has asked MMS to provide it with statistics and other data regarding the quality and efficiency of compliance reviews to no avail. STRAC needs this information so that it can advise its jurisdictions on whether conducting compliance reviews is worthwhile. As you know, MMS used to publish statistics on the revenue collections attributable to its separate approaches, e.g., exceptions processing. MMS ceased these publications in 2001, the year the compliance review process was initiated. At the Salt Lake meeting, MMS did make a presentation involving a few anecdotal compliance reviews, approximately four, but these raised more questions than they answered.

Ms. Lucy Querques Denett

2/2/2006

Accordingly, we must renew our request for the information that we have repeatedly told MMS is necessary. This includes:

- The total dollars collected since 2001 as a *direct result* of the compliance review process, broken down in terms of offshore, 8(g), onshore, Tribal and Allottee leases. This should exclude collections since 2001 attributable to the previous audit program and, particularly, audits conducted by States and Tribes;
- The cost/benefit of conducting compliance reviews;
- The number of random audits conducted under the compliance review process, broken down in terms of offshore, 8(g), onshore, Tribal and Allottee leases;
- The number of audit referrals conducted under the compliance review process, broken down in terms of offshore, 8(g), onshore, Tribal and Allottee leases;
- The number of random or referral audits that revealed further underpayments of royalties, the type of violations involved and the effort made by MMS to compile the type of violations into its compliance review process;
- The number of orders issued by MMS as a *direct result* of the compliance review process, broken down in terms of offshore, 8(g), onshore, Tribal and Allottee leases. This should exclude orders issued since 2001 attributable to the previous audit program and, particularly, orders issued as a result of audits conducted by States and Tribes; and
- A breakdown of MMS's appropriated or offline dollars since 2001 allocated to compliance reviews, random or referral audits, Accenture, other private consultants or entities (such as Inovis); quality reviews, training, preparation of congressional reports and strategic plans, SES promotions, and bonuses.
- Average labor hours needed to perform a compliance review.

As you know, many STRAC jurisdictions question the merit of compliance reviews. For example, some think that these reviews are little more than partial data entry verification efforts similar to exceptions processing. In fact, some delegations have found that without an effective exception verification process since the re-engineering efforts, there are many more reporting errors. Others think that the flaws in MMS's new automated compliance system, which you recently referred to as "over re-engineering", has lead to serious deficiencies in compliance reviews. Others think that compliance reviews are simply a means to squeeze States and Tribes out of the program. Similarly, some others

Ms. Lucy Querques Denett

2/2/2006


– with a substantial number of so-called “strategic” properties – fear that requiring them to conduct compliance reviews will risk their ability to create more dollars for their jurisdictions, which will threaten their program evaluations.

In MMS’s recent “Strategic Business Planning Initiative”, the agency pledged to improve its cooperation with States and Tribes. Yet, these jurisdictions remain without the data necessary to enhance cooperation between them and MMS. STRAC jurisdictions need the above information if MMS truly desires them to support the agency’s goals.

STRAC would appreciate receiving the information requested as soon as possible and no later than the next scheduled STRAC/MMS meeting in New Mexico.

Thank you, in advance, for your cooperation

Sincerely,



Lisa Dockter,  
STRAC Chair  
State and Tribal Royalty Audit Committee

## STATE and TRIBAL ROYALTY AUDIT COMMITTEE

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State of Alaska • Blackfeet Nation • State of California • State of Colorado • Fort Peck Tribes  
Jicarilla Apache Tribe • State of Louisiana • State of Montana • Navajo Nation • State of New Mexico  
State of North Dakota • State of Oklahoma • Shoshone & Arapaho Tribes • Southern Ute Indian Tribe • State of Texas  
State of Utah • Ute Indian Tribe • Ute Mountain Ute Tribe • State of Wyoming

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Lisa Dockter, *Chair* (970) 563-5559  
Dennis Roller, *1st Vice Chair* (701) 250-4682

*Former Chair, Ex Officio:*  
Joe Vintz

February 21, 2006

The Honorable Richard W. Pombo  
Chairman, Committee on Resources  
House of Representatives  
Washington, D.C. 20515

Dear Mr. Chairman:

This letter is to clarify points addressed by Ms. Johnnie Burton, Director of the U.S. Department of Interior's Minerals Management Service (MMS), in her letter to you dated January 24, 2006. The Director's letter was an attempt to address issues raised in an article published in the *New York Times* on January 24, 2006, under the title As Profits Soar, Companies Pay U.S. Less for Gas Rights.

The State and Tribal Royalty Audit Committee (STRAC) is an organization comprised of eleven (11) states and nine (9) Indian tribes that, under agreements with the Secretary, audit leases within their respective jurisdictions to ensure proper payment of royalties from oil, gas and solid mineral companies. The agreements are authorized under Sections 202 and 205 of the Federal Oil and Gas Royalty Management Act (FOGRMA), as amended by the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 (FOGRSFA). STRAC has provided accountability for the money owed to their jurisdictions in a cost efficient manner. STRAC also has considerable knowledge regarding MMS's computer systems, its prior audit programs and its current "compliance review" initiative. For that reason, most STRAC members would like to provide you with the following information.

1. The article questioned the MMS's auditing practices. In order to cover a larger percentage of the royalties paid, MMS has geared its compliance efforts away from conducting audits in accordance with Government Auditing Standards (GAS) to completing compliance reviews. A compliance review is an analysis designed to determine the reasonableness of company-reported royalty and production data on properties. They do not involve independent verification of the accuracy of the reported information. In other words, compliance reviews do not involve getting underneath the

reported information to look at company books, records (e.g., invoices, run tickets) to confirm whether the company reported correctly on any of its reports.

2. A compliance review incorporates steps that, under normal circumstances, should be completed through automated verification. MMS' new computer system was to provide tools for automated verification for production volumes and royalty rate. The computer system originally delivered does not have automated verification capabilities. As a result, since November 2001 the compliance reviews have been performed manually, using data downloaded and manually input into Excel. We understand that the MMS is currently developing an online compliance module with the tools being made available to the delegations during the summer of 2007. Very little coordination has occurred between the States/Tribes and the MMS on this module and it is unclear how effective the tools will be based upon questionable MMS data and limitations of sharing data across land ownerships. We would recommend that the MMS initiate an Independent Validation and Verification (IVV) contract to ensure that the module will work.

3. As initially designed in the new computer system, with the input of States and Tribes, the "company profiles" – part of the "automated" compliance system – would have included data from SEC reports. SEC reports can be of value to a compliance process. Although there was other evidence of oil undervaluation, SEC reports helped expose that companies were actually receiving NYMEX prices for production and sometimes NYMEX plus bonuses. MMS in fact relied on this information in its evaluation of the flaws in the oil rules.

4. Several STRAC delegations have received in writing from the MMS that they are to do compliance reviews and reduce the number of audits because MMS has "shifted a large portion of its audit resources to compliance review work". In fact, in January 2006, MMS informed STRAC that its jurisdictions would be "*required to request*" the compliance review function in our future contracts. In the request format provided by MMS, the compliance review is referred to as automated verification. Jurisdictions were to request this additional function with no additional funding. If no additional funding is provided, part of the audit function will have to be sacrificed. This is on top of some STRAC organizations already losing some audit positions due to MMS reallocating funds.

5. In order for STRAC organizations to determine the efficiency and effectiveness of compliance reviews, STRAC on numerous occasions has requested that MMS provide statistics. MMS still has not provided STRAC with information regarding how much it has collected as a direct result of the compliance review program, hours per review, and the cost/benefit analysis (see attached). MMS used to publish separate statistics on the collections attributable to its various collection systems, e.g. audit, exceptions processing, financial compliance, etc. MMS stopped publishing these statistics in 2001, the year it obtained a new computer system and started compliance reviews.

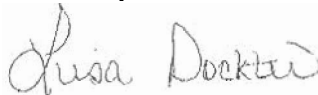
6. The 2005 "peer review", referred to in Ms. Burton's letter did not include an audit or opinion on the validity of the compliance review process. It did not review the economy or efficiency of the compliance review process. It only covered audits.

7. Although MMS made some improvements in the federal oil regulations by adopting NYMEX/WTI prices, the current Administration has not applied these changes to Indian leases, despite repeated public promises that this was a "priority" because of the Trust obligation. A new rule for Indian leases has been stalled for 5 years.

STRAC jurisdictions aggressively strive to fulfill their fiduciary responsibilities. If used properly, compliance reviews can be an effective supplement to our primary responsibility to complete GAS audits on properties selected by States and Tribes based on their independent audit judgment and experience. Given limited resources compliance reviews can be used as an efficient way to determine if "second tier" properties as determined by States and Tribes are in reasonable compliance or if they should be selected for a GAS audit. STRAC still needs to ensure their various jurisdictions they are receiving the highest value permitted by the regulations for natural resources. This cannot be accomplished by forsaking GAS audits for compliance reviews. STRAC needs additional funding in order to ensure their fiduciary responsibility to their various jurisdictions and the American people can be fulfilled. Your consideration of our request will be greatly appreciated.

If you have any questions, please contact us. STRAC's next meeting is currently scheduled for May 2-4, 2006 in Albuquerque, New Mexico. We welcome the attendance of you or your staff.

Sincerely,



Lisa Dockter  
Southern Ute Indian Tribe  
STRAC Chair



United States Department of the Interior  
MINERALS MANAGEMENT SERVICE  
Washington, DC 20240



Ms. Lisa Dockter  
STRAC Chair  
State and Tribal Royalty Audit Committee  
Southern Ute Tribe  
P.O. Box 737  
Ignacio, Colorado 81139

MAR 15 2006

Dear Ms. Dockter:

This letter responds to your February 2, 2006, letter (Enclosure 1) sent on behalf of the 11 states and 7 tribes who participate in the State and Tribal Royalty Audit Committee (STRAC). Your letter continues the ongoing dialogue the Minerals Management Service (MMS) has had with STRAC and its members over the past few years regarding the compliance review (CR) concept.

The MMS compliance program, supported by its state and tribal partners, is very successful and continues to make improvements. I am very proud of our collective achievements, detailed in a recent summary that I sent to the Assistant Secretary for Land and Minerals Management (Enclosure 2).

The MMS uses CR's to increase compliance coverage, shorten the compliance cycle, and improve efficiency. STRAC has been involved in every stage of the development of the CR approach, including the reengineering model teams in the late 1990s, numerous briefings, and the development of the compliance review manual. Given this interaction, we were surprised that some of your members would mischaracterize CR as "little more than partial data entry verification." We would be pleased to provide additional demonstrations and training to any state or tribal delegation interested in gaining a better understanding of CRs.

Some of the key advantages MMS has seen through the use of compliance reviews (CR) are:

- Using automated analysis, CRs are less costly than traditional audits, which rely on manual review of source documents.
- CRs have helped MMS and its partners significantly expand coverage and complete compliance work more contemporaneously.
- Previously audited properties can receive continuing, cost-effective compliance coverage using CRs.
- CRs can identify systemic problems and company-level issues for referral to audit.
- CRs have resulted in additional collections of tens of millions of dollars since FY 2001 from unpaid and underpaid royalties.

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Enclosure 4

No doubt you would agree that collectively we simply have too many Federal and Indian leases to rely on the traditional audit approach alone. Only a select few states or tribes have sufficient resources to use audits alone for all the properties in their jurisdictions. Therefore, other approaches are going to be necessary. As you know, MMS has not abandoned audits nor reduced the rigor of its overall compliance program. In fact, by including CRs, strategically integrated with audits, we believe the overall compliance program is much stronger.

We strongly encourage you and the other delegations to begin planning how you will incorporate these concepts to improve compliance coverage in your jurisdiction. I want to personally thank those delegations that are being proactive about incorporating CRs in their overall strategies. Compliance coverage will be incorporated as a performance expectation in future STRAC delegation contracts.

The MMS does not agree with your assertion that states and tribes cannot be delegated the authority to perform CRs. Although parts of the current regulations refer to 1990's processes that have been overtaken by new technology, the regulations clearly cover all the essential elements of CRs. We do not believe the current regulations bar MMS and its partners from "working smarter" within the intent of the underlying statutes—the Federal Oil and Gas Royalty Management Act and the Federal Oil and Gas Royalty Simplification and Fairness Act.

Regarding your question concerning collection statistics, MMS is now able to begin publishing statistics again. Since 2001, when MMS implemented its new core systems, MMS has not published comprehensive statistics on dollar collections from audits, CRs, bills, settlements, etc. This was because system resources were needed for higher priority projects. We have now completed implementation of the Compliance Information Management (CIM) system and resolved most of the backlogs. Preliminary results show that additional collections from compliance activities (audits, CRs, settlements, and projects) totaled over \$400 million during fiscal years 2001-2005. At the May 2006 meeting, MMS plans to present these statistics along with additional information that will address the points in your letter.

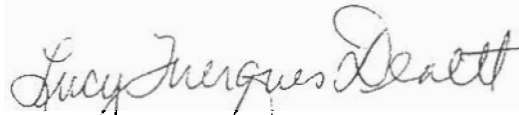
Systems access is an important part of operating an effective compliance program. The compliance managers and I are committed to providing states and tribes the full suite of tools and features that are needed to perform CRs in the most efficient manner possible. As you know, access to the centralized system by states and tribes has been complicated by security requirements—building special walls to ensure the confidentiality of each states' and tribes' royalty data. We are enhancing the centralized system to streamline the process and make it accessible for all compliance staff, including states and tribes. This project should be completed by approximately mid-2007. In the interim, alternative tools are available to you that are quite satisfactory for conducting CRs and have been used successfully for years by our Onshore and Indian Compliance and Asset Management (CAM) organizations.

Ms. Lisa Dockter:

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Mr. Sykora will be sending a separate letter to you and the other STRAC members requesting certain information regarding your compliance coverage, audit quality peer reviews, and audit progress. Mr. Sykora will represent MMS at the May session. He and the other CAM managers and staff are looking forward to a productive session.

Sincerely,



Lucy Querques Denet  
Associate Director  
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Enclosures

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MINERALS MANAGEMENT SERVICE  
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FEB - 7 2006

Memorandum

To: Director, Minerals Management Service

From: Associate Director, Minerals Revenue Management  
Minerals Management Service

*Lucy Inerques Denett*

Subject: Achievements in the Minerals Revenue Management Audit and Compliance Program

A recent New York Times article raised issues regarding the Minerals Management Service's (MMS) performance in conducting audits and compliance reviews of mineral royalty payments. Because that article did not acknowledge our work of the past few years, I am taking this opportunity to summarize for you recent achievements in our audit and compliance program.

Let me first say that we maintain a strong and comprehensive audit program strengthened by the combined efforts of professional, hard-working auditors and other professionals in MMS and State and Tribal governments. Since 1982, the combined efforts of these auditors have resulted in the collection of more than \$2.6 billion in additional royalties. Following are examples of our more significant accomplishments in the last four to five years:

- During the past five years, our audit and compliance program was responsible for ensuring that royalty payments were in compliance with lease terms, statutes, and regulations for reported royalties totaling \$36.8 billion. Of the \$36.8 billion, \$5.9 billion was disbursed to the states. There was a 42 percent increase in disbursements to States from FY 2001 (\$1.2 billion) to FY 2005 (\$1.7 billion).
- Over the past four years (FY 2002 to FY 2005), MMS and State and Tribal auditors have completed 1,214 audits. That compares to 784 audits completed for the prior four-year period (FY 1998 – FY 2001).
- In November 2005, an independent certified public accounting firm issued a clean audit opinion of MMS's audit program with no material weaknesses, and no reportable conditions. In its opinion, the accounting firm stated:

“In our opinion, the system of quality control for the Federal Audit Function of MMS in effect for the 2-year period ending December 31, 2004, has been

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designed to meet the requirements of the quality control standards established by the Comptroller General of the United States for a Federal Government audit organization and was complied with during the 2-year period ending December 31, 2004, to provide MMS with reasonable assurance of conforming with applicable auditing standards, policies, and procedures.” |

- We implemented new aggressive compliance goals aimed at shortening the compliance cycle. This means that we are completing our compliance work within 3 years after the royalty payment is made. That compares to a previous compliance cycle of six years or more. Under this shortened cycle, we increased the percentage of revenues being reviewed and/or audited from 10 percent in FY 2003 to 71 percent in FY 2005. In FY 2006, our goal is to review and/or audit 72 percent of all 2003 Federal and Indian royalty payments. To meet that goal, we will be working jointly with our State and Tribal audit partners. |
- We modified our compliance strategy to include not only audits, but also compliance reviews. This strategy is the result of a multi-year initiative that we started in 1996 to shorten the compliance cycle. With the active involvement of State and Tribal auditors, as well as advice received from Norway, Canada and industry, we used operational pilots to model a new strategy for providing greater coverage of Federal and Indian mineral revenues at less cost. This led to our decision to augment our audits with compliance reviews of royalty payments. |
- We developed and implemented new reengineered compliance tools to support our compliance strategy. These tools can be effectively used by MMS, State, and Tribal auditors to determine if all aspects of a royalty payment including volume, valuation, royalty rate, and allowances are within acceptable parameters. We are working to enhance these tools to maximize their capabilities and meet mandated security requirements. |
- We collaborate with 11 States and 7 Tribes through delegated and cooperative audit agreements as authorized by the Federal Oil and Gas Royalty Management Act of 1982, as amended in 1996. The audit agreements with the States and Tribes are a crucial part of our overall compliance strategy and we value the partnerships we have with the State and Tribal auditors. Total funding for the State and Tribal audit programs for the last five years has been over \$42 million; over \$30 million for State agreements and \$12 for Tribal agreements. We will be maintaining the same overall funding level for the State and Tribal programs in FY 2007 that was in effect in FY 2006. We will continue to make sure that the dollars allocated to the various State audit programs are justified by the number of leases and royalty revenues at risk. |
- We are operating a Royalty-in-Kind (RIK) program in which we are taking in kind and directly selling 80 percent of royalty crude oil and 30 percent of royalty natural gas from the Gulf of Mexico. This effort has generated an additional \$18 million to the United States Treasury in FY 2004 and an additional \$29 million in FY 2005. The RIK program has simplified and lightened our audit and compliance workload because we do not have

to audit or review the valuation. The market price is received directly by the Government through a competitive sale. The only audit work required focuses on production volumes. This can now be done in 180 days instead of the three years it takes when the lessee pays royalties in cash. Therefore, the RIK Program has substantially decreased the number of properties requiring audits.

- We continue to maintain a professional, well-trained compliance staff. The efficiencies created by our current compliance strategy and by the RIK program have allowed us to reduce our overall compliance staffing level from 435 in FY 2001 to 385 in FY 2005. However, the number of MMS and State and Tribal auditors has remained relatively stable (165 MMS auditors in FY 2001 and 152 in FY 2005; 98 State and Tribal auditors in FY 2001 and 96 in FY 2005).
- We implemented all of the recommendations from the March 2003 Office of Inspector General Report and initiated and completed a 39 item Action Plan for Improved Audit Quality. Some of the more significant action items completed include 1) issuing policies, procedures, and checklists for properly documenting audits, 2) developing standard templates for audit enforcement documents and reports, 3) providing training to MMS and State and Tribal auditors on current audit standards, policies, and procedures, 4) reviewing audit case files to ensure compliance with audit standards, 5) implementing a centralized system to monitor, track, and document required Continuing Professional Education for all auditors and compliance staff, and 6) developing a new audit case tracking system to monitor and track audits in process.
- We updated our Audit Manual containing the procedures and processes necessary that MMS and State and Tribal auditors must follow to ensure that our audits meet all of the requirements of the Generally Accepted Government Auditing Standards.
- We developed detailed procedures and documentation standards for conducting compliance reviews using our Audit Manual as our model. Our experience has shown that compliance reviews are an effective and efficient way to target our audit resources towards areas with the greatest risk.
- We established an Internal Quality Review Team within the Office of the Deputy Associate Director to conduct internal audits of all of our audit offices including the States and Tribes to ensure that our audits are meeting the requirements of the Generally Accepted Government Auditing Standards. The MMS staff assigned to perform Internal Quality Control Reviews (IQCR's) collectively possess the necessary professional credentials for this task. The IQCR Coordinator has a BS Degree in Finance; over ten years experience in various MMS offices and private sector accounting/auditing positions; and is a Certified Internal Auditor (CIA). Additionally, the Alternative Management Review Coordinator has a BS Degree in Accounting; over ten years experience in MMS and other accounting/auditing positions; and is a licensed Certified Public Accountant (CPA).

- We implemented several regulatory reforms aimed at clarifying our rules, ensuring receipt of fair market value and increased royalties:
  - Indian gas valuation regulations issued effective January 2000 added an alternative valuation methodology to ensure Indian lessors optimize their natural gas royalty revenues. We estimated an annual increase of \$2.4 million in Indian natural gas royalties from this rule.
  - In August 2004, we issued new valuation regulations for Federal crude oil production that require value to be based on transparent, well-established New York Mercantile Exchange (NYMEX) future prices in cases where oil is not sold at arm's-length. We estimated an increase of \$5.3 to \$8 million in additional annual royalties from this rule.
  - In June 2005, we updated our Federal gas valuation regulations to comply with recent judicial decisions and provide certainty regarding allowable transportation deductions. We estimated an annual increase of \$2.3 million in natural gas royalties from this rule.
  - We will be issuing proposed regulations for valuing oil produced from Indian leases.

While we have made substantial progress in implementing regulatory reforms, we continue to evaluate the effectiveness of our regulations. We have asked the Royalty Policy Committee, a Federal Advisory Committee Act group chartered by the Secretary, to evaluate ways to improve the existing Federal gas valuation regulations. Their recommendations are expected this fall. In the years to come, we will accelerate efforts to track and report on our collections from audits and compliance reviews. We will continue to work tirelessly to maintain and improve the level of quality of all of our programs.

If you need any additional information regarding the MMS compliance and audit program, please do not hesitate to let me know.