



# United States Department of the Interior



MINERALS MANAGEMENT SERVICE

Washington, DC 20240

JAN 24 2006

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

Dear Mr. Chairman:

The article published in the *New York Times* yesterday, under the title As Profits Soar, Companies Pay U.S. Less for Gas Rights, deserves a response.

Generally speaking, the article compares prices that are not comparable. We, at the Minerals Management Service, base royalties on the value of the product at the lease where the gas is produced, or, if you will, at the wholesale level. The price that companies are reporting to the Securities Exchange Commission is akin to a retail price. The sales prices of the companies include the cost of processing and transporting the gas. Companies average their receipts for all gas they sell from private, State and Federal lands and other venues at the point of sale, which is often far from the where the gas is produced. For the first 10 months of 2005, the Energy Information Administration shows an average differential of \$1.15 per thousand cubic feet between the lease price and the delivery price at destination, reflecting the type of difference one might expect to see between the prices reported to the SEC and the royalty values reported to MMS. The article alleges that we should have collected an additional \$700 million in royalties. We assume this is calculated using the price reported to the SEC. The objection therefore is to the calculation of the value of the gas at the lease, which is an approach that has been used for over 70 years and has been codified in many rules.

The article states that the amount of royalties collected on natural gas has not increased at the same rate as gas prices have increased. There are a number of factors that affect the reported royalties and must be considered in making these types of comparisons. One issue is related to Hurricanes Katrina and Rita. Companies with New Orleans-based operations were unable to submit the required royalty reports at the end of August and September due to hurricane damage. While these reports have since been made, they will appear in the FY 2006 data when the reports were received, rather than with the FY 2005 data, thereby making 2005 royalty collections appear to be less than what we will actually receive for 2005 production.

Another reason royalties have not increased as quickly as gas prices is that a large share of production from Federal leases has shifted to properties with lower royalty rates. Over the past few years, a greater proportion of Federal production has come from deep water Gulf of Mexico leases and onshore leases, where royalty rates are typically 12.5 percent,

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while gas production from shallow water offshore leases, where the royalty rate is 16.67 percent, has fallen. Since 1990, production of natural gas in the shallow-waters of the Gulf of Mexico has fallen by more than 50%. In addition, in order to encourage companies to invest in high-risk areas, Congress enacted the Deep Water Royalty Relief Act of 1995, which allows for certain volumes of deep water oil and gas to be produced royalty-free. Although today most of that production is not enjoying any royalty-free volumes due to high market prices, leases issued in 1998 and 1999 are not subject to a price threshold cap and are still enjoying the royalty relief.

The article questions our auditing practices. A few years ago we implemented a new management strategy that increases efficient use of our internal resources, and, in fact allows us to do as many or more audits with fewer auditors. We do compliance reviews of a broad universe of properties, and, depending on the results of these reviews, we then focus on specific properties. As a result, our auditors and our State and Tribal audit partners have accomplished a great deal. For example, in FY 1998, 123 audits were completed by MMS auditors and by State and Tribal auditors under delegated audit agreements. Over the last 3 fiscal years, audit numbers have increased. In FY 2005, 129 new audits were completed in addition to 376 old audits that were caught up and completed, for a total of 505 audits. Three thousand, three-hundred and ninety-five properties were reviewed for compliance. In addition, this administration asked us to tighten our audit and compliance cycle from a five year cycle to a three year cycle. We are reaching this goal. In FY 2005, 71% of 2002 royalties were reviewed for compliance and audit, as compared to 46% of the properties reviewed in FY 2003 for 2000 royalties.

We have also implemented fundamental changes in the way we collect royalties, as we are now taking a greater share of our offshore royalties in-kind. In this program, MMS collects royalties as oil and gas, rather than as cash payments, and sells the production in competitive markets. We are now taking 80 percent of the royalty oil and 20 percent of the royalty gas in the Gulf of Mexico in kind. Since this oil and gas is sold by MMS, there are no cash royalty payments from producing companies, and therefore no need for valuation audits and accompanying litigation for this production. This program, along with the efficiency gains discussed previously, has allowed us to reduce the number of auditors on staff. Congress included this method in the Energy Policy Act of 2005.

We have not relaxed our valuation rules, although we have clarified some requirements. Indeed, oil sales between affiliated companies (i.e., non-arms length transactions), for the first time, are valued using the New York Mercantile Exchange index price. This is a more transparent and objective way to value the product and avoid extensive conflicts over previous complex valuation approaches. We have asked our Royalty Policy Committee to study a similar approach for natural gas. We are waiting for their report. After the Federal Energy Regulatory Commission deregulated natural gas pipeline transportation, there had been confusion for many years about the allowable deductions. The gas rule was amended in 2005, after public notice and comment to clarify these issues. The case of Burlington Resources, which the article mentions, is one that has been in litigation for 5 years. It is an example of disagreement over application of a complex and difficult set of regulations.

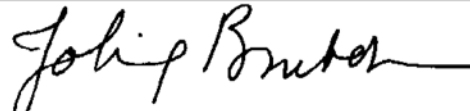
The Department values natural gas according to more than 85 years of practice under the Mineral Leasing Act of 1920 and more than 50 years under the Outer Continental Shelf Lands Act. The long-standing regulations of the Department allow for calculating value of gas at the lease, not at a market center downstream of the lease where gas may be sold. Allowable deductions in determining royalty value appeared in the earliest regulations issued in 1920, which provided that the cost of certain treatment shall first be deducted from the amount received for it before royalty is computed.

If an audit finds that companies have not complied with a rule, the companies are ordered to pay the correct amounts, plus interest and potential civil penalties. For example, regarding the issue of certain "price threshold" levels on deepwater leases mentioned in the article, the companies have been notified that royalties are due. Approximately 60 companies have paid the right amounts. The 30 that are deficient have been notified and those that did not remit are now receiving formal orders to pay before litigation is initiated, if they do not comply.

Finally, MMS has fully implemented the recommendations of the Inspector General's 2003 review of the royalty audit program. In 2005, an independent auditor conducted a 4-month peer review of our royalty audit program and gave it a clean bill of health.

A similar letter is being sent to Representative Rahall, Ranking Member, Committee on Resources. If you have any additional questions, please feel free to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read "Johnnie Burton". The signature is fluid and cursive, with a long horizontal stroke at the end.

R. M. "Johnnie" Burton  
Director

cc: Members of Committee on Resources