



United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Washington, DC 20240



FEB 2 2006

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

Dear Mr. Chairman:

Thank you for your letter of January 23, 2006, to Secretary Norton regarding the article published in the *New York Times* (NYT) on January 23, 2006, under the title As Profits Soar, Companies Pay U.S. Less for Gas Rights. You asked for the Secretary's immediate assistance in providing the House Committee on Resources with all the relevant data so that you can ensure the public is getting full compensation for the production of oil and gas on lands belonging to them. Secretary Norton asked me to respond.

Immediately upon reviewing the published article and then subsequent to receiving your letter, the Minerals Management Service (MMS) began compiling documentation refuting the many faulty comparisons made and the article's overriding premise that the Department of the Interior failed to properly account for the value of production for royalty purposes.

In my January 24, 2006, letter to you and other Members of Congress (Enclosure 1), we provided information on our royalty collection and auditing process refuting the NYT article. The next day, MMS representatives met with staff of the House Committee on Resources to further discuss the information presented in the letter.

I would like to reiterate the point I made in the January 24 letter that the NYT article made a faulty data comparison leading to the erroneous conclusion that royalties had been underpaid by \$700 million. In a discussion with the NYT, we were told that the article used an average weighted spot price of \$6.45 provided by Energy Information Administration and compared it to their calculation derived from Fiscal Year 2005 numbers on the MMS website that showed an average weighted unit price of \$5.62. The article concluded that the differential between these two prices resulted in a \$700 million royalty discrepancy. That is an inappropriate comparison. The Fiscal Year 2005 numbers on the MMS website include sales numbers attributable to prior fiscal years. However, if sales numbers are used that are attributable only to FY 2005 production, the resulting average unit price is \$6.59. Using just sales in Fiscal Year 2005 numbers, there is no \$700 million difference.

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We continue to compile data from our records in a format that will provide a clear picture to all interested parties of natural gas production from Federal lands, the value of that production for royalty purposes and the amount of appropriate royalties due.

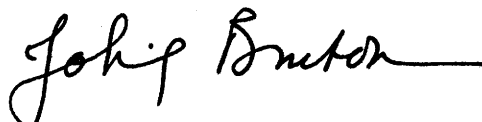
In response to the questions posed by you in your January 23 letter, we are also enclosing charts detailing the disbursements to states under the Mineral Leasing Act and the Outer Continental Shelf Lands Act for Fiscal Years 2001 through 2005 (Enclosure 2) and the reported sales volumes of natural gas and oil produced from Federal lands for Fiscal Years 2001 through 2005 (Enclosures 3 and 4). Please note that Enclosures 3 and 4 show sales volumes that include adjustments for prior reporting periods and those that exclude adjustments for prior periods. Payors typically make adjustments to previously reported royalty lines, sometimes over the course of several years, to account for the normal variances in production and sales. We believe that the natural gas and oil volumes in Enclosures 3 and 4 under the heading "Excludes Adjustments for Prior Periods" give a picture of the sales volumes that are specific to a given fiscal year. Finally, the last column of the natural gas and oil sales volumes charts shows the calculated royalty rate attributable to the appropriate percentages of sales volume.

I cannot emphasize the point clearly enough that we will not let this matter rest until once again, the American taxpayer is satisfied that MMS and the Department are aggressively pursuing its mission to safeguard public resources and to assure a fair return on America's precious natural resources.

We look forward to working closely with your Committee in the coming days and will continue to provide information. We appreciate the opportunity to demonstrate the integrity of the Department's royalty collection and auditing processes.

If I can be of further assistance, please call me at 202-208-6734 or call Ms. Lyn Herdt, Chief, MMS Office of Congressional Affairs, at 202-208-3502.

Sincerely,



R. M. "Johnnie" Burton
Director

Enclosures

cc: Nick J. Rahall, Ranking Member



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JAN 24 2006



The Honorable Richard W. Pombo
 Chairman, Committee on
 Resources
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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.

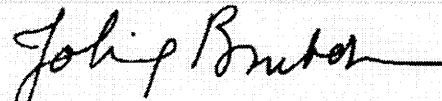
The Department values natural gas according to more than 85 years of practice under the Mineral Leasing Act of 1920 and more than 50 years under the Outer Continental Shelf Lands Act. The long-standing regulations of the Department allow for calculating value of gas at the lease, not at a market center 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,



J. M. "Johnnie" Burton
Director

cc: Members of Committee on Resources

**Total Disbursements to States
Fiscal Years 2001 through 2005**

State	FY 2001	FY 2002	FY 2003	FY 2004	FY2005
Alabama	\$ 21,374,723.00	\$ 7,994,908.93	\$ 13,731,749.96	\$ 14,316,126.95	\$ 15,639,279.25
Alaska	\$ 21,784,713.00	\$ 9,086,246.67	\$ 12,763,199.27	\$ 17,543,934.90	\$ 22,970,593.41
Arizona	\$ 122,920.00	\$ 96,588.23	\$ 121,898.09	\$ 152,313.83	\$ 37,828.60
Arkansas	\$ 2,154,407.00	\$ 895,464.88	\$ 4,108,480.76	\$ 2,365,307.98	\$ 7,059,071.16
California	\$ 61,083,258.00	\$ 14,475,115.74	\$ 25,464,318.71	\$ 28,931,791.00	\$ 23,413,641.66
Colorado	\$ 68,253,029.00	\$ 43,708,125.38	\$ 53,947,136.92	\$ 80,531,107.18	\$ 106,651,980.11
Florida	\$ 4,432.00	\$ 95.21	\$ 369,513.73	\$ 24,956.06	\$ 286,271.15
Georgia	\$ 55.00		\$ 54.50		
Idaho	\$ 4,451,885.00	\$ 1,891,671.94	\$ 1,792,864.42	\$ 2,172,060.51	\$ 1,664,997.94
Illinois	\$ 126,666.00	\$ 73,092.34	\$ 109,312.47	\$ 113,909.46	\$ 145,218.18
Indiana			\$ 6,379.25	\$ 59.25	\$ 59.25
Kansas	\$ 2,360,673.00	\$ 1,033,728.04	\$ 1,823,378.27	\$ 1,519,882.03	\$ 1,967,826.59
Kentucky	\$ 85,460.00	\$ 31,472.06	\$ 50,131.79	\$ 90,388.49	\$ 78,999.77
Louisiana	\$ 42,122,961.00	\$ 12,593,379.84	\$ 30,746,695.00	\$ 39,621,446.37	\$ 32,470,327.47
Michigan	\$ 562,505.00	\$ 250,489.85	\$ 430,602.31	\$ 405,313.79	\$ 488,694.35
Minnesota	\$ 13,030.00	\$ 16,700.85	\$ 17,910.30	\$ 11,184.66	\$ 10,234.88
Mississippi	\$ 1,866,882.00	\$ 695,220.04	\$ 1,156,632.94	\$ 1,165,828.73	\$ 1,893,029.51
Missouri	\$ 790,847.00	\$ 601,979.44	\$ 331,638.48	\$ 711,804.67	\$ 553,836.99
Montana	\$ 31,232,896.00	\$ 22,328,619.35	\$ 25,535,373.25	\$ 30,294,622.99	\$ 35,562,307.12
Nebraska	\$ 15,133.00	\$ 8,821.22	\$ 12,992.19	\$ 20,027.38	\$ 21,277.88
Nevada	\$ 3,502,534.00	\$ 3,405,888.42	\$ 5,054,856.88	\$ 2,651,061.97	\$ 7,771,837.14
New Mexico	\$ 385,050,441.00	\$ 191,353,402.42	\$ 297,904,626.15	\$ 364,957,736.42	\$ 444,295,200.43
North Carolina	\$ 119.00	\$ 79.80	\$ 118.50	\$ 118.50	
North Dakota	\$ 6,556,305.00	\$ 4,425,418.00	\$ 4,944,294.84	\$ 6,155,004.55	\$ 13,549,513.53
Ohio	\$ 218,914.00	\$ 260,928.40	\$ 280,731.76	\$ 350,453.94	\$ 370,254.89
Oklahoma	\$ 3,549,370.00	\$ 1,381,894.13	\$ 2,370,848.20	\$ 4,756,477.44	\$ 4,230,519.79
Oregon	\$ 35,880.00	\$ 10,932.51	\$ 32,573.32	\$ 11,469.56	\$ 13,064.75
Pennsylvania	\$ 27,399.00	\$ 17,318.77	\$ 20,339.11	\$ 27,852.04	\$ 32,757.66
South Carolina			\$ 102.00	\$ 102.00	\$ 277.50
South Dakota	\$ 559,509.00	\$ 404,865.82	\$ 393,042.67	\$ 473,552.76	\$ 607,348.41
Tennessee				\$ 99.00	\$ 99.00
Texas	\$ 34,145,585.00	\$ 8,958,116.92	\$ 17,075,473.74	\$ 15,212,840.87	\$ 15,839,435.30
Utah	\$ 50,321,926.00	\$ 31,627,940.95	\$ 50,614,416.24	\$ 69,013,576.08	\$ 87,444,534.43
Virginia	\$ 208,472.00	\$ 20,922.76		\$ 21,774.43	\$ 322,282.01
Washington	\$ 2,610,285.00	\$ 692,800.58	\$ 1,088,464.15	\$ 472,266.23	\$ 267,609.65
West Virginia	\$ 327,093.00	\$ 194,975.85	\$ 414,101.68	\$ 264,171.98	\$ 831,320.03
Wyoming	\$ 448,774,537.00	\$ 359,386,326.41	\$ 467,266,554.93	\$ 564,332,554.31	\$ 878,524,871.11
Total	\$ 1,194,294,844.00	\$ 717,923,531.75	\$ 1,019,980,806.78	\$ 1,248,693,178.31	\$ 1,705,016,400.90

**Reported Sales Volumes for FY2001 - FY2005
Natural Gas**

Federal Offshore Reported Gas Sales Volume for Fiscal Years 2001-2005 Excludes Adjustments for Prior Periods as of 01/06/2006			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
2001	Gas	4,530,840,167.35	0.155840
2002	Gas	3,835,229,744.46	0.152678
2003	Gas	3,900,394,813.79	0.152490
2004	Gas	3,753,778,927.26	0.149903
2005	Gas	3,102,610,612.01	0.150158

Federal Onshore Reported Gas Sales Volume for Fiscal Years 2001-2005 Excludes Adjustments for Prior Periods as of 01/06/2006			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
*2001	Gas	3,287,232,483.06	0.117833
2002	Gas	2,130,052,766.45	0.110461
2003	Gas	2,240,802,421.24	0.108549
2004	Gas	2,338,267,951.13	0.115906
2005	Gas	2,446,618,915.51	0.117559

All Federal Reported Gas Sales Volume for Fiscal Years 2001-2005 Excludes Adjustments for Prior Periods as of 01/06/2006			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
*2001	Gas	7,818,072,650.41	0.144949
2002	Gas	5,965,282,510.91	0.141489
2003	Gas	6,141,197,235.03	0.139192
2004	Gas	6,092,046,878.39	0.138092
2005	Gas	5,549,229,927.52	0.136919

All Reported Gas Sales Volume for Fiscal Years 2001-2005 Excludes Adjustments for Prior Periods as of 01/06/2006			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
*2001	Gas	8,102,063,836.72	0.145124
2002	Gas	6,238,567,270.64	0.141738
2003	Gas	6,420,812,254.89	0.139515
2004	Gas	6,396,450,696.26	0.138363
2005	Gas	5,864,759,782.26	0.137267

*For Sales Months in FY01, a reporting error was made by a payor overstating approximately 1.2 billion Mcf for onshore reporting. The MMS's audit and compliance program identifies such errors and have directed the company to correct the reporting. The correction will be reflected in the FY06 MMS Published Statistics and in the FY2001 sales

All Reported sales volume includes both Federal and Indian reporting.

Federal Offshore Reported Gas Sales Volume for Fiscal Years 2001-2005 Includes Adjustments for Prior Periods (Published on MMS website)			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
2001	Gas	4,625,268,651.54	0.156388
2002	Gas	4,342,758,986.48	0.153452
2003	Gas	3,500,727,912.77	0.153191
2004	Gas	3,941,215,221.64	0.148764
2005	Gas	3,504,438,263.00	0.148738

Federal Onshore Reported Gas Sales Volume for Fiscal Years 2001-2005 Includes Adjustments for Prior Periods (Published on MMS website)			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
2001	Gas	2,066,854,795.17	0.118643
2002	Gas	2,157,135,171.36	0.110849
2003	Gas	2,226,850,534.62	0.112998
2004	Gas	3,133,668,253.58	0.111282
2005	Gas	2,872,692,618.95	0.117072

All Federal Reported Gas Sales Volume for Fiscal Years 2001-2005 Includes Adjustments for Prior Periods (Published on MMS website)			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
2001	Gas	6,692,123,446.71	0.145746
2002	Gas	6,499,894,157.84	0.142370
2003	Gas	5,727,578,447.39	0.141887
2004	Gas	7,074,883,475.22	0.136051
2005	Gas	6,377,130,881.95	0.136333

All Reported Gas Sales Volume for Fiscal Years 2001-2005 Includes Adjustments for Prior Periods (Published on MMS website)			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
2001	Gas	6,979,914,516.23	0.145803
2002	Gas	6,777,997,238.31	0.142601
2003	Gas	6,005,237,427.68	0.142081
2004	Gas	7,382,669,564.50	0.136354
2005	Gas	6,698,767,260.70	0.136354

Reported Sales Volumes for FY2001 - FY2005
Oil

Federal Offshore Reported Oil Sales Volume for Fiscal Years 2001-2005 Excludes Adjustments for Prior Periods as of 01/06/2006			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
2001	Oil	583,660,257.14	0.141153
2002	Oil	511,747,868.02	0.143619
2003	Oil	272,719,250.11	0.147096
2004	Oil	254,641,209.69	0.144323
2005	Oil	328,252,138.69	0.138222

Federal Onshore Reported Oil Sales Volume for Fiscal Years 2001-2005 Excludes Adjustments for Prior Periods as of 01/06/2006			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
2001	Oil	103,902,994.07	0.095397
2002	Oil	103,493,012.06	0.093472
2003	Oil	100,566,605.49	0.093700
2004	Oil	97,329,142.99	0.093267
2005	Oil	96,077,261.61	0.091238

All Federal Reported Oil Sales Volume for Fiscal Years 2001-2005 Excludes Adjustments for Prior Periods as of 01/06/2006			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
2001	Oil	687,563,251.21	0.134249
2002	Oil	615,240,880.08	0.135261
2003	Oil	373,285,855.60	0.132821
2004	Oil	351,970,352.68	0.130391
2005	Oil	424,329,400.30	0.127654

All Reported Oil Royalty Revenues for Fiscal Years 2001-2005 Excludes Adjustments for Prior Periods as of 01/06/2006			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
2001	Oil	699,346,339.44	0.103383
2002	Oil	626,169,397.64	0.101540
2003	Oil	383,427,988.55	0.100758
2004	Oil	361,700,545.04	0.100278
2005	Oil	434,142,390.98	0.098603

Federal Offshore Reported Oil Sales Volume for Fiscal Years 2001-2005 Includes Adjustments for Prior Periods (Published on MMS website)			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
2001	Oil	566,048,068.24	0.142228
2002	Oil	530,868,884.79	0.142682
2003	Oil	310,535,344.18	0.148764
2004	Oil	247,803,238.74	0.142463
2005	Oil	331,913,162.58	0.137596

Federal Onshore Reported Oil Sales Volume for Fiscal Years 2001-2005 Includes Adjustments for Prior Periods (Published on MMS website)			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
2001	Oil	99,195,742.13	0.095956
2002	Oil	107,477,779.83	0.094135
2003	Oil	100,987,240.93	0.093423
2004	Oil	98,201,242.75	0.093367
2005	Oil	97,280,387.55	0.091022

All Reported Federal Oil Sales Volume for Fiscal Years 2001-2005 Includes Adjustments for Prior Periods (Published on MMS website)			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
2001	Oil	665,243,810.37	0.135112
2002	Oil	638,346,664.62	0.134856
2003	Oil	411,522,585.11	0.134866
2004	Oil	346,004,481.49	0.129174
2005	Oil	429,193,550.13	0.127283

All Reported Oil Sales Volume for Fiscal Years 2001-2005 Includes Adjustments for Prior Periods (Published on MMS website)			
Fiscal Year	Commodity	Sales Volume	Calculated Royalty Rate
2001	Oil	676,456,517.14	0.135590
2002	Oil	647,774,058.51	0.135276
2003	Oil	422,598,035.28	0.135510
2004	Oil	356,411,841.48	0.130040
2005	Oil	439,874,016.44	0.128113

All Reported sales volume includes both Federal and Indian reporting.