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Testimony

Before the Subcommittee on Interior,  
Environment, and Related Agencies,  
Committee on Appropriations, House of  
Representatives

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## **OIL AND GAS MANAGEMENT**

# **Federal Oil and Gas Resource Management and Revenue Collection In Need of Stronger Oversight and Comprehensive Reassessment**

Statement of Frank Rusco, Director  
Natural Resources and Environment



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Highlights of [GAO-09-556T](#), a testimony before The Subcommittee on Interior, Environment, and Related Agencies, Committee on Appropriations, House of Representatives

## Why GAO Did This Study

In fiscal 2008, the Department of the Interior (Interior) collected over \$22 billion in royalties and other fees related to oil and gas. Interior's Bureau of Land Management (BLM) and Minerals Management Service (MMS) manage federal onshore and offshore oil and gas leases, respectively. Acquiring a federal lease gives the lessee the rights to explore for and develop the oil and gas resources under the lease, including drilling wells and building pipelines that may lead to oil and gas production.

This statement focuses on findings from a number of recent GAO reports on federal oil and gas management. GAO has made numerous recommendations to Interior, which the agency generally agreed with and is taking steps to address. However, two important issues remain unresolved. Specifically, GAO made one recommendation and one matter for Congressional consideration that together call for a comprehensive re-evaluation of how Interior manages federal oil and gas resources. Interior has not undertaken such a comprehensive review and until this is done, the public cannot have reasonable assurance that federal oil and gas resources are being appropriately managed for the public good.

View [GAO-09-556T](#) or [key components](#). For more information, contact Frank Rusco at (202) 512-3841 or [ruscof@gao.gov](mailto:ruscof@gao.gov).

## OIL AND GAS MANAGEMENT

### Federal Oil and Gas Resource Management and Revenue Collection In Need of Stronger Oversight and Comprehensive Reassessment

#### What GAO Found

In recent years, GAO has conducted numerous evaluations of federal oil and gas management and found many material weaknesses. Specifically:

In September 2008, we reported that

- Neither BLM nor MMS were meeting statutory obligations or agency targets for conducting inspections of certain leases and metering equipment used to measure oil and gas production.
- MMS's royalty IT system and processes lacked several important capabilities, including monitoring adjustments made by companies to their self-reported production and royalty data and identifying missing royalty reports in a timely manner.
- MMS's use of compliance reviews, which are more limited in scope than audits, led to an inconsistent use of third-party documents to verify that self-reported industry data are correct.
- MMS's annual reports to the Congress did not fully describe the performance of the royalty-in-kind program and, in some instances, may have overstated the benefits of the program.
- The federal government receives one of the lowest shares of revenue for oil and gas resources compared with other countries and Interior has not systematically re-examined how the federal government is compensated for extraction of oil and gas for over 25 years.

In October 2008, we reported that

- Some states do more than Interior to structure leases to reflect the likelihood of oil and gas production, which may encourage faster development.

In June 2005, we reported that

- BLM has encountered persistent problems in hiring and retaining sufficient and adequately trained staff to keep up with workload as a result of rapid increases in oil and gas operations on federal lands and poor workforce planning.

In recent reports, GAO has made a number of recommendations to improve the accuracy of royalty measurement and collections and the overall management of federal oil and gas resources. Interior generally agreed with our recommendations and is trying to implement them but implementation is ongoing and it is too early to assess the effectiveness these efforts.

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Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to participate in this hearing to discuss the Department of the Interior's management of federal oil and gas leases. In fiscal year 2008, the Department of the Interior (Interior) collected over \$22 billion in royalties for oil and gas produced on federal lands and waters, purchase bids for new oil and gas leases, and annual rents on existing leases, making revenues from federal oil and gas one of the largest nontax sources of federal government funds. Within Interior, the Bureau of Land Management (BLM) manages onshore federal oil and gas leases and the Minerals Management Service's (MMS) Offshore Energy and Minerals Management (OEMM) manages offshore leases, while MMS is responsible for collecting royalties for all leases. In recent years, GAO and others, including Interior's Inspector General, have conducted numerous evaluations of federal oil and gas management and revenue collection processes and practices and have found many material weaknesses. These weaknesses place an unknown but significant proportion of royalties and other oil and gas revenues at risk and raise questions about whether the federal government is collecting an appropriate amount of revenue for the rights to explore for, develop, and produce oil and gas on federal lands and waters. Specifically, our recent work has found the following:

On September 12, 2008 we reported that<sup>1</sup>

- Neither BLM nor OEMM were meeting statutory obligations or agency targets for conducting inspections of certain leases and metering equipment used to measure oil and gas production, raising uncertainty about the accuracy of oil and gas measurement. Specifically, although BLM and OEMM are statutorily required to annually inspect leases "producing significant quantities of oil and gas" and those with a "history of noncompliance", according to BLM staff, they are not completing all the inspections required by law and agency policy, in part because their workload has substantially grown because of increased onshore drilling. Similarly OEMM is not meeting its agency targets for inspections because, according to OEMM staff, inspectors are still conducting cleanup activities in the Gulf of Mexico--where almost all of the offshore oil and gas production occurs-- in the wake of Hurricanes Katrina and Rita. Finally, neither BLM nor OEMM were

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<sup>1</sup>GAO, *Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk*, [GAO-08-893R](#) (Washington, D.C.: Sept. 12, 2008).

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consistently and accurately recording data to document the production inspections that were completed.

- MMS's royalty IT system cannot yet monitor adjustments made to production and royalty data by companies. While MMS is working to address this issue, companies may continue to adjust their previously self-reported production and royalty data without prior MMS approval or review. This includes adjustments made by companies to data after MMS completes audit work, meaning that while the royalties paid were accurate at the close of an audit, they may not remain so. Furthermore, MMS is unable to identify instances, in a timely manner, in which a royalty report has not been submitted by a company and, as a result, MMS cannot be entirely confident that it is receiving all the royalties when they are due. Finally, MMS lacks a clear process to determine that royalties are accurately paid in instances when OEMM or BLM identify volume discrepancies during their production inspections and verification work. For example, when BLM identifies an over- or underreporting of production volumes, BLM notifies the production reporting section of MMS. While MMS staff may work to correct the production numbers, staff do not relay this information to the royalty reporting section so that staff can check that the appropriate royalties were paid.
- While MMS continues to strengthen its compliance efforts, MMS's use of compliance reviews, which are more limited in scope than audits, has led to an inconsistent use of third-party documents to verify that self-reported industry production and payment data are correct, thereby placing royalty collections at risk. MMS has historically relied on audits to determine whether a company accurately paid its royalties by examining third-party documents that contained information on prices, volumes, and deductions. More recently, MMS has relied more heavily on compliance reviews, which assess whether the royalties paid by a company are reasonable, and do not always include an examination of third-party documents. Furthermore, while MMS's compliance reviews of offshore leases include a systematic comparison between a company's reported production volumes and independent pipeline company documents, an analogous process does not exist for onshore leases. The absence of a consistent check on self-reported data—such as comparing the data with third party documents—when conducting onshore compliance reviews raises questions about the accuracy of royalty payments.

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On September 26, 2008 we reported that<sup>2</sup>

- Under the royalty-in-kind program, MMS's oversight of its natural gas production volumes is less robust than its oversight of oil production volumes. As a result, MMS does not have the same level of assurance that it is collecting the gas royalties it is owed. For instance, for oil, MMS compares companies' self-reported oil production data with third-party pipeline meter data from OEMM's liquid verification system, which records oil volumes flowing through pipeline metering points. Using these third-party pipeline statements to verify production volumes reported by companies provides a check against companies' self-reported statement of royalty payments owed to the federal government. While analogous data are available from OEMM's gas verification system, MMS does not use these third-party data to verify the company-reported production numbers.
- MMS's annual reports to the Congress do not fully describe the performance of the royalty-in-kind program and, in some instances, may overstate the benefits of the program. For example, MMS's calculation that from fiscal years 2004 to 2006 MMS sold royalty oil and gas for \$74 million more than it would have received in cash was based on assumptions, not actual sales data, about the prices at which royalty payors would have sold their oil or gas had they sold it on the open market. MMS did not report to the Congress that even small changes in these assumptions could result in very different estimates. Also, MMS's calculation that the royalty-in-kind program cost about \$8 million less to administer than the royalty-in-value program over the same period did not include certain costs, such as information technology costs shared with the royalty-in-value program, that would likely have changed the results of MMS's administrative cost analysis. In addition, these annual reports lacked important information on the financial results of individual oil sales that the Congress could use to more broadly assess the performance of the royalty-in-kind program.

On October 3, 2008 we reported that<sup>3</sup>

- Interior does less to encourage development of federal oil and gas leases than some state and private landowners. Interior officials cited one lease

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<sup>2</sup>GAO, *Oil and Gas Royalties: MMS's Oversight of Its Royalty-in-Kind Program Can Be Improved through Additional Use of Production Verification Data and Enhanced Reporting of Financial Benefits and Costs*, [GAO-08-942R](#) (Washington, D.C.: Sept. 26, 2008).

<sup>3</sup>GAO, *Oil and Gas Leasing: Interior Could Do More to Encourage Diligent Development*, [GAO-09-74](#) (Washington, D.C.: Oct. 3, 2008).

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provision that may encourage development—escalating rental rates. For example, the rental rates for 10-year onshore federal leases increase from \$1.50 per acre per year for the first 5 years to \$2 per acre per year for the next 5 years. Compared to Interior, the eight states we reviewed undertook more efforts to encourage development on their oil and gas leases, using increasing rental rates as well as shorter lease terms and escalating royalty rates. Some states also do more than Interior to structure leases to reflect the likelihood of oil and gas production, which may encourage faster development. Specifically, while Interior uses varying lengths for offshore leases, with deeper waters receiving longer lease terms, this provision is not explicitly related to the expected productivity of the lease. On the other hand, five of the states that we reviewed—Alaska, Louisiana, Montana, New Mexico, and Texas—vary lease lengths or royalty rates to reflect the likelihood that the lease will produce. We also found that private landowners have used various leasing methods to encourage faster development, including lease terms as short as 6 months.

- The annual number of federal oil and gas leases issued and the pace of development have generally increased in recent years. Over the past 20 years, the total number of oil and gas leases Interior issued has varied each year but generally increased in recent years, as has the amount of development activity, and industry officials told us that a range of factors influence their decisions to acquire and develop leases. The number of offshore leases issued annually from 1987 through 2006 had two large peaks—in 1988 and 1997—and has generally been increasing since 1999. Onshore leases peaked in 1988 and then declined until about 1992, remaining at these lower levels until about 2003 when they increased, coinciding with rising oil and historically higher natural gas prices. Drilling and production activity on federal leases was higher from 1997 through 2006 than from 1987 through 1996, but the increase was more dramatic for onshore leases. Industry officials told us that several factors influence their decisions to acquire and develop federal oil and gas leases, including oil and gas prices; the availability and cost of equipment; the geology of the land underlying the lease; and regulatory issues, such as limitations on when drilling can occur.
- Development and production activity in a sample of leases issued from 1987 through 1996 varied considerably. We reviewed data on about 55,000 offshore and onshore federal leases issued from 1987 through 1996—those that have exceeded their primary 10-year lease terms. We then tracked development activity on that sample of leases through 2007 to determine what, if any, development activity occurred, and at what point in time. We identified three key findings regarding development. First, development

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occurred at some point during the period 1987-2007 on about 26 percent of offshore and 6 percent of onshore leases in the sample. Production was less frequent, with about 12 percent of offshore leases and 5 percent of onshore leases ultimately achieving production. Second, shorter leases were generally developed more quickly than longer leases, but not as frequently during the term of the lease. Finally, for those leases that eventually produced oil or gas, a substantial amount of the initial drilling activity—about 25 percent onshore—took place after the scheduled expiration of the lease, following a lease extension.

- MMS and BLM employ different practices for deciding which federal properties to lease and when, determining the initial length of the lease, and determining the price at which the leases are sold. In addition, some states and private resource owners use more tools than the federal government, including incentives for early development or penalties for later development, to encourage rapid development, particularly of leases that are deemed to be likely to contain significant oil and gas resources. In this regard, we found that Interior could do more to encourage faster development of certain federal oil and gas leases that are relatively more likely to have significant oil and gas resources.

On September 3, 2008 we reported that<sup>4</sup>

- The federal government receives one of the lowest shares of revenue for oil and gas resources compared with other countries. For this and other reasons, the United States is an attractive country for investment in oil and gas development. Specifically, in 2007, the revenue share that the federal government collects on oil and gas produced in the Gulf of Mexico ranked 93rd lowest of 104 revenue collection regimes around the world that were studied. However, despite significant changes in the oil and gas industry over the past several decades, Interior has not systematically re-examined how the federal government is compensated for extraction of oil and gas for over 25 years. In contrast, some other countries have recently increased their shares of revenues as oil and gas prices rose and, as a result, will collect between an estimated \$118 billion and \$400 billion, depending on future oil and gas prices.

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<sup>4</sup>GAO, *Oil and Gas Royalties: The Federal System for Collecting Oil and Gas Revenues Needs Comprehensive Reassessment*, [GAO-08-691](#) (Washington, D.C.: Sept. 3, 2008).

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On June 5, 2008 we reported that<sup>5</sup>

- In 1995, a time when oil and natural gas prices were significantly lower than they are today, Congress passed the Outer Continental Shelf Deep Water Royalty Relief Act (DWRRA), which authorized MMS to provide “royalty relief” on oil and gas produced in the deep waters of the Gulf of Mexico from certain leases issued from 1996 through 2000. This “royalty relief” waived or reduced the amount of royalties that companies would otherwise be obligated to pay on the initial volumes of production from leases, which are referred to as “royalty suspension volumes.” We recently reported that litigation over this royalty relief for deep water leases sold between 1996 and 2000 could cost the public in the range of \$21 billion to \$53 billion in forgone revenue over the next 25 years, depending on how much oil and gas is eventually produced on these leases and the prices at which the oil and gas is sold.

Finally, on June 17, 2005 we reported that<sup>6</sup>

- BLM has encountered persistent problems in hiring and retaining sufficient and adequately trained staff to keep up with an increasing workload as a result of rapid increases in oil and gas operations on federal lands. For example, between 1999 and 2004, when applications for permits to drill more than tripled, BLM was unable to keep up with the commensurate increase in its workload, in part, as result of an ineffective workforce planning process, the lack of key data on workload activities, and a lack of resources. As a result of this staffing shortfall, BLM was unable to meet its requirements to mitigate environmental impacts of oil and gas development. More recently, we reported that BLM’s inability to attract and retain sufficient trained staff have kept the agency from meeting requirements to inspect drilling and production of oil and gas on federal lands. This puts federal revenues at risk because when inspections are made, violations have been found, including errors in the volumes of oil and gas reported by operators to MMS.

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<sup>5</sup>GAO, *Oil and Gas Royalties: Litigation over Royalty Relief Could Cost the Federal Government Billions of Dollars*, [GAO-08-792R](#) (Washington, D.C.: June 5, 2008). The Department of Interior has since lost the case on appeal. *Kerr-McGee Oil & Gas Corp. v. Dept. of Interior*, 554 F. 3d 1082 (5th Cir. 2009).

<sup>6</sup>GAO, *Oil and Gas Development: Increased Permitting Activity Has Lessened BLM’s Ability to Meet Its Environmental Protection Responsibilities*, [GAO-05-418](#) (Washington, D.C.: June 17, 2005).

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In response to recommendations made by GAO, the Department of the Interior's Inspector General, and others, Interior has put into place a wide-ranging plan to significantly modify its current practices. We acknowledge Interior's efforts to change and improve many of its current practices as an important first step to address material weaknesses in the existing system. For example, OEMM plans to have definitions for leases having "significant production" and a "history of non-compliance" by November, 2009. Additionally, MMS is developing a system to assist in monitoring adjustments made by companies to previously entered self-reported royalty data, and plans to have the system finalized in early 2010. However, we remain concerned that Interior may lack the resources and skills to simultaneously address significant changes in its practices while effectively meeting its routine responsibilities. If steps are not taken to effectively manage these challenges, the agency may face a decline in staff morale, continued employee turnover at its senior levels, and ongoing challenges hiring qualified new staff, further putting federal revenues at risk.

More importantly, we believe that Interior needs to fundamentally reexamine the way in which federal oil and gas resources are managed. Specifically, we recommended that Interior develop a strategy to encourage faster development of oil and gas leases on federal lands for those leases deemed to be more likely to produce oil and gas. In developing this strategy, Interior could benefit from evaluating alternative leasing practices used by some states and private land owners, as well as other countries, to determine what changes to federal leasing practices and the law are needed to speed up development of some specific leases that are likely to be highly productive. While Interior generally agreed with our recommendation and is looking at some of these issues in a study, we do not believe Interior's study is sufficiently comprehensive to meet the needs we identified. As a result, we believe this puts at risk the agency's mission to effectively manage federal oil and gas resources in the public interest.

In addition, we believe that a comprehensive reassessment of how much revenue the federal government collects from oil and gas produced on federal lands and waters, and in what manner, is long overdue, and we recommended to Interior that it undertake such a reassessment in our draft report, *Oil and Gas Royalties: The Federal System for Collecting Oil and Gas Revenues Needs Comprehensive Reassessment*. However, in commenting on this recommendation, Interior stated that such a reassessment would be premature in light of a study the agency had under way that was looking at some aspects of these issues. Because we believe

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Interior's ongoing study is too limited in scope and scale, in the final report we proposed that Congress consider directing the Secretary of the Interior to convene an independent panel to perform a comprehensive review of the federal system for collecting oil and gas revenue. In the event that the Secretary of the Interior convenes a panel, the panel and Interior should utilize available information about the share of oil and gas revenues that other resource owners, including states and other countries, collect and the ways in which they structure these collections to create more stable investment environments in their oil and gas industries. Until this comprehensive reassessment is undertaken and completed, the federal government will not have reasonable assurance that it is collecting an appropriate share of revenue from oil and gas produced on federal lands and waters.

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Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions that you or other Members of the Subcommittee might have.

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## GAO Contact and Staff Acknowledgement

For further information on this statement, please contact Frank Rusco at (202) 512-3841 or [ruscof@gao.gov](mailto:ruscof@gao.gov). Contact points for our Congressional Relations and Public Affairs offices may be found on the last page of this statement. Other staff that made key contributions to this testimony include, Divya Bali, Lee Carroll, Glenn C. Fischer, Jon Ludwigson, and Barbara Timmerman.

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