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Testimony

Before the Subcommittee on Energy and
Mineral Resources, Committee on Natural
Resources, House of Representatives

For Release on Delivery Expected
at 10:00 a.m. EDT
Tuesday, March 17, 2009

OIL AND GAS LEASING

Federal Oil and Gas Resource Management and Revenue Collection in Need of Comprehensive Reassessment

Statement of Frank Rusco, Director
Natural Resources and Environment



GAO

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Highlights of [GAO-09-506T](#), a testimony before The Subcommittee of Energy and Mineral Resources; Committee on Natural Resources; 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.

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OIL AND GAS LEASING

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What GAO Found

In recent years, GAO has conducted numerous evaluations of federal oil and gas management and found many material weaknesses. Key among the findings in these reports are:

- Interior does less to encourage development of federal oil and gas leases than some state and private landowners. For example, the eight states GAO reviewed used more tools 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.
- The annual number of federal oil and gas leases issued and the pace of development have generally increased in recent years. Several factors influence industry's 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. Development occurred on about 26 percent of offshore and 6 percent of onshore leases issued, but production was less frequent, with about 12 percent of offshore leases and 5 percent of onshore leases ultimately achieving production. Shorter leases were generally developed more quickly than longer leases, but not as frequently.
- MMS and BLM employ different practices for deciding which federal properties to lease and when, and 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..
- 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.
- 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 recent reports, GAO has made a number of recommendations to improve the accuracy of oil and gas royalty measurement and collections and to improve the overall management of federal oil and gas resources.

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, 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 (MMS) 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:

- Interior does less to encourage development of federal oil and gas leases than some state and private landowners. Interior officials cited one lease 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 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.¹

¹GAO, *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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- 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.² 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.³
 - 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.⁴
 - 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

²GAO, *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).

³GAO, *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).

⁴GAO, *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).

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.⁵

- Interior’s verification of federal oil and gas production is insufficient. Specifically, we found that Interior is not meeting statutory or agency targets for inspections of certain onshore and offshore leases and metering equipment for measuring oil and gas production, raising questions about the accuracy of company-reported oil and gas production figures. In addition, we found that MMS’s management of cash royalty collection lacks key controls, such as the ability to effectively monitor and validate oil and gas company adjustments to self-reported royalty data including those made after audits have been completed, which could have implications for the amount of revenue collected. Further, we found that MMS’s royalty compliance efforts rely too heavily on self-reported data and that the more consistent use of available third-party data as a check on self-reported data could provide greater assurance that royalties are accurately assessed and paid.⁶ We have an ongoing engagement further examining production verification issues expected to be completed later this year.
- More could be done to verify production levels for Interior’s royalty-in-kind (RIK) program, in which companies provide the federal government with oil or gas in lieu of cash royalty payments. Specifically, we found that under the RIK program, MMS’s oversight of natural gas volumes is less robust than its oversight of oil volumes—a finding that raises questions about the accuracy of company-reported volumes of natural gas from which MMS must determine whether it is receiving its appropriate share of production. In addition, we found that MMS’s annual reports to Congress do not fully describe the performance of the RIK program and, in some instances, may overstate the benefits of the

⁵GAO, *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).

⁶GAO, *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).

program.⁷ We also have an ongoing engagement examining the RIK program expected to be released later this year.

In response to recommendations made by GAO 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. However, we are 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.⁸ 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 is 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*

⁷GAO, *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).

⁸GAO, *Oil and Gas Leasing: Interior Could Do More to Encourage Diligent Development*, [GAO-09-74](#) (Washington, D.C.: Oct. 3, 2008).

*Reassessment.*⁹ 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 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.

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.

GAO Contact and Staff Acknowledgement

For further information on this statement, please contact Frank Rusco at (202) 512-3841 or 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 Shea Bader, Glenn C. Fischer, Jon Ludwigson, Alison O'Neill, Barbara Timmerman, and Maria Vargas.

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GAO, Oil and Gas Royalties: The Federal System for Collecting Oil and Gas Revenues Needs Comprehensive Reassessment, GAO-08-691 (Washington, D.C.: September 3, 2008).

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