PREPARED STATEMENT

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Denver, Colorado

OVERSIGHT HEARING BEFORE THE
COMMITTEE ON NATURAL RESOURCES
U.S. House of Representatives

"ROYALTIES AT RISK: ADMINISTRATION OF THE MINERALS MANAGEMENT SERVICE"

March 28, 2007

Good Morning Chairman Rahall, Ranking Member Young and distinguished members of the House Committee on Natural Resources. Thank you Mr. Chairman and Congressman Young for convening this hearing and the strong support you have shown for Indian Tribes and Native people over the years. I am David Lester, the Executive Director of the Council of Energy Resource Tribes (CERT) and an enrolled member of the Creek Nation of Oklahoma.

I appear before you today on behalf of CERT which was formed in 1975 in response to the energy crisis then gripping the United States and our national need to increase domestic production of oil, gas and hard mineral resources. CERT is an organization formed by Indian Tribes to work for Indian Tribes and is a true Inter-Tribal organization. CERT's membership includes 53 Federally-recognized Tribes as well as three First Nations from Canada.

Thirty-two years after its formation, CERT's mission remains the same: to support its member Tribes in their efforts to develop management capabilities and use their energy resources to help build stable, diversified, self-governing economies according to each Tribe's own values and priorities. CERT's programs include policy advocacy, technical assistance, education and capacity-building partnerships. As part of capacity-building and information sharing, CERT disseminates knowledge through www.certredearth.com and other media.

I very much appreciate the opportunity to present testimony to the Committee on a matter of great concern to our member Tribes. Because CERT is a tribal organization, my testimony will focus on mineral activity on tribal trust lands and transactions involving leases between Indian Tribes and their private sector partners. Individual Indians whose lands are leased for mineral activity --- and to whom the MMS also owes a trust responsibility --- have a related but distinct set of issues that I trust the Committee will explore through the testimony of other witnesses. Similarly, my testimony is related primarily to oil and gas leases, rather than issues related to royalties from coal production even though MMS also collects royalties from tribal

coal leases. We do understand there are myriad problems with undervaluation and underreporting on hard rock mineral leases that are similar to oil and gas development.

I am pleased to be accompanied today by David Harrison, an attorney from Albuquerque, New Mexico. Mr. Harrison is also a former director of the Bureau of Indian Affairs trust office and has long experience in dealing with MMS and the issues facing Tribes in the area of royalty accounting. Mr. Harrison is here to assist me in answering questions of a technical nature that the members may have.

ROLE OF THE FEDERAL MINERAL MANAGEMENT SERVICE

At the outset, it is important to note that because the United States (U.S.) holds legal title to the vast mineral estate which lies below Indian tribal lands, the U.S. is bound to act as trustee for the benefit of the Tribes and tribal members.

Federal laws such as the *Indian Mineral Leasing Act* and the *Indian Mineral Development Act* center on Federal participation and involvement when it comes to the terms and conditions under which Indian energy resources are developed, how that development is monitored, and the circumstances surrounding the payment of royalties to the Indian resource owner.

In this situation, Indian Tribes are often dependent on the Minerals Management Service in the Department of the Interior to perform a number of services including an accurate and timely accounting and collection of royalties from gas, coal, and oil companies engaged in mineral activity on tribal trust lands.

The Committee is aware of the evolving nature of Federal Indian law and policy as regards tribal energy resource development. The *Energy Policy Act of 2005* includes as Title V the *Indian Tribal Energy Development and Self Determination Act* which authorized Indian Tribes to negotiate and enter with the Secretary of the Interior "Tribal Energy Resource Agreements" (TERAs) for purposes of energy development, land management, and environmental regulation on tribal lands. The major element of such a TERA, once approved by the Secretary, is that the Indian Tribes themselves will have the decision-making authority over a host of energy and related matters that area currently relegated to the U.S.

Indian tribal regulatory capacity is ever-increasing and that, coupled with the Tribes' business sophistication, harkens a new day in the near future when the advances in tribal authority made possible by Title V might be expanded to include lease monitoring and royalty verification functions that are currently relegated entirely to the MMS.

THE STATE AND TRIBAL ROYALTY AUDIT COMMITTEE EXPERIENCE

CERT believes this hearing is not just timely – it is, in truth, long overdue. Some of the Tribes from whom CERT solicited input for today's hearing have reported long and sometimes very difficult tales about their dealings with the MMS. While issues of concern to Tribes are well known to the officials at MMS, the resolution of these concerns has never been a priority of

that agency and these concerns continue to reside in the never-never land of the Federal bureaucracy.

The experience of the State Tribal Royalty Advisory Committee is illustrative. The State Tribal Royalty Advisory Committee was established in 1986 with the purpose of providing a platform for States and Indian Tribes that receive royalties from production of oil, gas and coal on Federal and Indian tribal lands to advise the MMS on discrete problems and issues of concern to them and to collaborate with the MMS in developing potential solutions to the problems.

Following up on a February, 2006, letter from STRAC to the MMS, in April, 2006, seven Members of Congress – Representatives Carolyn Mahoney, Henry Waxman, George Miller, Raul Grijalva, Edward Markey, Maurice Hinchey, and Rahm Emanuel – wrote to MMS Director R.M. "Johnnie" Burton requesting information about MMS's compliance review program. In particular, the letter sought information and analysis from MMS about the cost and effectiveness of "compliance reviews" (CRs) compared to more traditional audits covering leases of Federal and Indian tribal lands. *See* attached April 3, 2006, letter.

In May, 2006, Director Burton responded and indicated that among other things, in the 5-year period between 2000 and 2005, CRs grew from 34% of agency costs to 63% of agency costs as compared to more traditional audits. Director Burton stated that "[w]ith 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 along." *See* attached May 17, 2006, letter.

The Southern Ute Indian Tribe, which up until the autumn of 2006 had been a member of the State and Tribal Royalty Advisory Committee (STRAC), received a copy of Director Burton's May, 2006, response and, in turn, issued a letter to Director Burton taking exception to the inaccurate information and representations contained in Burton's response. The Tribe refrained from sharing its concerns with Congress and instead requested that Burton and MMS dedicate additional staff and initiate corrective action and communications with those congressional recipients of erroneous information. *See* attached June 21, 2006, letter.

I was encouraged to learn that in July, 2006, the Southern Ute Indian Tribe was notified that additional MMS staff would be dedicated to rectify the erroneous collections information and it is my hope that all States and Tribes that received the May, 2006 letter from Director Burton will receive additional correspondence informing them of the agency's corrective action and including updated information.

I hope and trust that this Committee will provide the guidance that is needed to the MMS to inspire the confidence that Tribes need to assure that the degree of monitoring, audits and accountings and royalty payments owed them are without question accurate and paid in a timely manner.

In addition to the need for accurate accountings and disbursements, Indian Tribes need assurance that when disputes inevitably arise between Tribes and their private sector partners, the Department of the Interior will act to fulfill its obligations to the Tribes and will not be an active impediment to settlements between Tribes and the companies. Tribal officials have asked that

CERT bring to the Committee's attention the following issues of concern. Many of these matters are interrelated but I have tried to organize them so that the potential solutions to each are clear.

THE HONOR SYSTEM FOR OIL VALUATION

At the outset, I want to impress on the Committee that the current legal framework and business model under which companies report their own production --- and therefore the royalties owed tribal resource owners --- can only be described as "the honor system" and remains a major problem for Tribes. The reality is that the conclusions of the Linowes Commission in 1982 that companies were on an "honor system" is still true today, at least as regards royalties payable on tribal leases. You will recall that the Linowes Commission charge was to investigate allegations of Federal mismanagement of oil and gas royalties and its findings led the Congress to enact the *Federal Oil and Gas Royalty Management Act*.

FOGRMA, in turn, led the Department of the Interior to engage in what we in Indian Country have grown accustomed to witnessing over the years in the face of malfeasance or nonfeasance from our Federal trustee: an internal "reorganization" that resulted in no substantial improvement in MMS performance. Consequently, hundreds of millions of dollars were spent on computer systems and automated reporting regimes, scores of pages of fine print regulations were promulgated to deal with valuation and accounting issues and sadly if the Linowes Commission were re-constituted, it would report that the minerals industry is still operating on the honor system.

Since 1998, the Navajo Nation and other Indian Tribes have been urging the MMS to issue regulations governing oil royalty valuation for Indian tribal mineral leases. MMS has issued regulations on oil royalty valuation for Federal leases but the regulation governing Indian tribal mineral leases has been withdrawn. The result is that oil production on tribal leases is still valued under rules that went into effect on March 1, 1988. As the Committee might guess, the oil marketing practices of the industry were vastly different 19 years ago than they are today but Indian Tribes and Indian allottees still have to rely on "posted oil prices" that are set by the industry itself. These prices do not represent fair market value and the Committee should understand this as it moves ahead with its oversight efforts.

The honor system <u>unfailingly</u> results in underpayment of amounts owed, and sometimes the underpayments are huge. In the 1980s, MMS proposed as a conclusive presumption that an operator in an arms length transaction with an Indian Tribe was dealing in the best interest of the royalty owner as well as himself. The royalty owners, including Tribes, were successful in persuading the MMS to reject the idea of a conclusive presumption. The MMS abandoned the notion that the interests of producers and royalty owners are co-terminus and it also abandoned the notion that posted prices represent the true value of crude oil. The MMS changed the regulation with respect to production of oil from Federal leases but has not acted with respect to Indian tribal royalty owners. Thus, the honor system persists but only to the detriment of Indian royalty owners. I believe the Committee will agree that this is unconscionable and needs to be revisited.

RELEASE OF CLAIMS AGAINST THE UNITED STATES

Because the U.S. holds title to Indian-owned energy resources such as oil, gas and coal, when either the U.S. or the Tribe discovers that a company has underpaid significant amounts of royalties, the MMS makes demand for compensation against the company. When settlements are reached, MMS lawyers routinely insist that settlements contain hold harmless provision protecting the US from any other claims relating to that same production that are not covered by the particular settlement agreement.

In all cases it is the task of MMS to value and collect royalties accurately. Only when they fail to do so and the underpayment is discovered, usually by the Tribe, does this issue arise. While the U.S. retains responsibility for the enforcing the terms of the leases, it does not accept any liability for failure on its part to its job. Claims may be unknown to the Tribe at the time of settlement and it is an onerous burden to require Tribes to pursue and prosecute after-discovered issues. I recommend that the Committee direct the MMS to accept settlement agreements without also requiring release by Tribes of collateral claims against the USG.

MAJOR PORTION PRICING

Standard Bureau of Indian Affairs Indian tribal mineral leases require that royalties be paid on not less than the highest price paid for a "major portion" of like quality production on the same field or area during the production period. In trying to apply this requirement over the years, it has been agreed to apply it only to arms length agreements. The problem is that the MMS has never collected the information necessary to perform any analysis of either "major portion" or what constitutes an "arms length" agreement. Whether this failure to act is caused by understaffing or by simple neglect, the fact is that Indian tribal leases continue to be significantly undervalued and thus underpaid.

The data collected by the MMS regarding production under Indian tribal leases is not sufficient to support or fulfill the trust obligation of the United States. Revenue collected by the MMS from Indian leases is only about two percent (2%) of the total production income from all leases on Federal or tribal lands. However, in our view it is the most important percentage of collection because it represents a fraction of the value on resources that are not renewable. I respectfully suggest that this Committee take the necessary steps --- whether in the form of additional funding for the MMS or in clarifying the law --- to ensure that Indian Tribes (and individual Indians) are be paid accurately and fully for the value of their resources because once they are extracted, those resources are not replaceable.

NEGATIVE PAYMENTS

Federal offshore mineral leasing laws prohibit companies from claiming recoupment of overpayments for a prescribed number of years. This is not the case with leases on Indian lands. Thus, if a company decides in 2007 that it overpaid for minerals extracted in 2006, it can simply reduce currently-owed payments by the amount it claims it overpaid the year before. These unilateral adjustments are often made without the Tribes' knowledge and, more importantly, without review or oversight by the MMS. Similarly, a recoupment might occur at any time as a

mineral lessee might seek to recoup overpayments against 2007 production from years ago. If an Indian Tribe is not in a position to know about these calculations and private company decisions, negative payments just happen. The current system – if left untouched – will continue to fail tribal resource owners.

COOPERATIVE AGREEMENTS AND LOCKBOXES

On a positive note, the MMS has entered into cooperative agreements with several Indian Tribes under which companies simultaneously issue production reports to the U.S. and to the Indian tribal mineral owner. In these situations, royalty payments are sent directly to the Tribe's financial institution. At one time, it took some Tribes years to get duplicates of lease payment reports and consequently money transfers and confirmations were not made in a timely fashion resulting in confusing and often wildly inaccurate bookkeeping on the underlying production.

Not all Tribes have cooperative agreements but those that do seem genuinely pleased with the timeliness of the payments and the lockbox system. I recommend the Committee encourage these types of cooperative agreements and expand their use.

RESISTANCE TO WELL-BY-WELL REPORTING

A mineral operator can keep a lease in force in perpetuity, even after the primary lease term has expired, as long as the lease is producing "in paying quantities" on a major part of the lease. This is true whether the lease is 160 acres or 250,000 acres, and regardless of the number of wells. However, if the operator does not report on a well-by-well basis, there is no accurate way to know whether the production is "in paying quantities". When the "major part" of the lease is not producing "in paying quantities", the wells must be shut in and the lease expires. Once wells are shut in, the only way to resume production is to negotiate a new lease. To ensure correct pricing, the mineral operator's production on a well-by-well basis should be recorded.

AUDIT COMPLIANCE

The MMS has established an audit compliance and review program related to its royalty accounting system. At the outset, most Tribes believe that the MMS' reliance on voluntary submission by the company of their respective oil and gas sales contracts is misplaced. CERT Tribes agree with such an assessment based on the past and present performance of the industry. Further, technical compliance tools that are being used successfully by Onshore and Indian Compliance Asset Management organizations at the Minerals Revenue Management offices simply do not work from the desk stations of auditors located in remote tribal headquarters. In these cases, Tribes rightly place little faith in data generated by MMS' system to perform audits.

CONCLUSION

At least one person who audits company-reported oil and gas payments for a Tribe in the Southwest routinely reports a 30% underpayment for natural gas produced on tribal lands. Any system that allows such underpayments --- especially underpayments of this magnitude --- is immoral and untenable. As with so many other activities and functions in other areas that are

supposed to be performed by the U.S., the only way some Indian Tribes have been able to monitor the payments is by doing it themselves.

Some Tribes actually do it under contract with the MMS but because these are MMS responsibilities and if Tribes are routinely finding these kinds of underpayments, it makes one seriously question the ability --- or willingness --- of the MMS and the U.S. to account for the other 98 percent of mineral leases where royalty payments are supposed to go to the United States Treasury.

On behalf of the member Tribes of CERT, I again thank you for the opportunity to appear before you today on this very important matter and would be happy to answer any questions you might have.

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