

**MINERALS MANAGEMENT SERVICE  
OFFICE OF POLICY AND MANAGEMENT IMPROVEMENT**

**FINAL STATE BENCHMARKING STUDY**

**FEBRUARY 14, 1997**

# STATE BENCHMARKING STUDY

## I. INTRODUCTION

This document presents results of a study of State royalty management programs conducted by the Department of the Interior's Minerals Management Service (MMS). The study team inventoried, described, and analyzed the functions performed and costs incurred by five programs within four States to manage royalties from mineral leases on State-owned lands.

The study results from a request by MMS Director Cynthia Quarterman for MMS's Office of Policy and Management Improvement (PMI) to "benchmark" the royalty management programs of individual States to compare with the MMS's Royalty Management Program (RMP) and to identify areas of potential improvement for the Nation's mineral royalty management efforts. Benchmarking refers to a deliberate process of identifying, understanding, and potentially adopting business practices of external organizations to improve an organization's own performance.

The objectives of the study are to: 1) describe and compare the five State royalty programs to the MMS's royalty program; and 2) identify State "best practices" for potential MMS adoption. The overall purpose of the study is to identify proven State best practices that could improve the efficiency and effectiveness of the MMS royalty program. The feasibility of adopting these State best practices will be assessed within the RMP's Compliance Reengineering Project.

This report does not assess whether States could manage the Federal mineral royalty functions more efficiently or effectively than the Federal government currently does. Rather, the report provides baseline inventories of the systems and programs of RMP and the selected States; describes the similarities and differences of the various programs; analyzes the differences; and offers recommendations of State best practices that MMS may adopt upon further detailed analysis.

**Background.** The Department of the Interior has managed mineral leasing on Federal lands since the Mineral Leasing Act (MLA) was passed in 1920. The MLA provides for a sharing of lease revenues with States within whose boundaries the leases exist.

The Federal Government's royalty management program has been highly visible for many years due to the magnitude of royalty revenues and the importance of these revenues to Federal and, especially, State treasuries. In earlier years, the program was controversial due to allegations of mismanagement of mineral royalties, as asserted in reports of the General Accounting Office (GAO) and Interior's Inspector General from 1959 to 1979. This era culminated in sweeping organizational and management changes in response to allegations of widespread oil theft and resulting recommendations of the Linowes Commission. These changes included the formation of a centralized MMS, passage of the Federal Oil and Gas Royalty Management Act (FOGRMA), and the development of numerous systems, policies, controls, and programs required by

The net result of these recent events is a cost- and service-competitive environment in which agencies - whether Federal or State - must commit themselves to the best possible service for the least cost. The MMS recognizes that it must continue to uphold the high standards of service and professionalism mandated by FOGPMA and years of oversight recommendations at a cost that is not burdensome to the Federal or State treasuries.

Against this backdrop, MMS Director Quarterman has challenged MMS to continue making improvements in both efficiency and effectiveness. The present study is part of this effort.

**Study Team.** To conduct this benchmarking study, MMS formed a study team comprised of two PMI employees, two RMP employees, and a State employee working with RMP as a coordinator for the State and Tribal Royalty Auditing Committee.

**Scope of the Study.** The study examined five royalty management programs within four States for their mineral leases on State lands. Only royalty revenue-related programs were examined. Severance tax programs were excluded, other than to note systems used for both royalty and tax purposes. Likewise, leasing and operations functions were excluded; thus, comparisons involve only RMP functions, not USFS and BLM functions.

**Approach/Methods.** The study team used a form of benchmarking to compare and contrast the Federal royalty program with the five State royalty programs. Benchmarking has been defined as “the process of continuously comparing and measuring against other organizations to gain information on philosophies, policies, practices, and measures which will help our organization take action to improve its performance.” The four States selected were Louisiana, New Mexico, Texas, and Wyoming. Texas actually has two distinct royalty programs: 1) the General Land Office program that manages mineral revenues from State trust lands, and 2) the University of Texas program that manages minerals from University lands. Each of these programs had been previously identified as having substantial numbers of leases and royalties. The following steps were taken during the study:

- o **Previous Studies.** The study team contacted numerous internal and external parties to identify any previous studies of State royalty management systems. Although some studies had been conducted, they were not on point to the objectives of the current effort.
- o **RMP Program.** The study team obtained and reviewed information on the RMP systems and programs, including program descriptions and detailed cost data for each program component.
- o **State Survey.** The team developed a detailed survey aimed at gathering information on the State royalty programs in the same functional categories as the MMS’s “net receipts sharing” cost data to facilitate “apples to apples” comparisons. The survey was sent to each State, and the team followed up with site visits.

- o Data Analysis. Upon receipt of the State information, the team compiled and organized the data into similar categories, and conducted comparative analyses. Significant difficulties were encountered in reducing the data to similar categories, as State program components rarely coincided with the Federal program.

**Acknowledgments.** The study team expresses its gratitude to the managers and staff of the four States and RMP for their hard work in locating, compiling, and forwarding a large quantity of data to the team, and for answering the numerous follow-up questions from the team. These employees took time out from busy schedules to give the team invaluable assistance. We could not have completed this study without their help.

FOGRMA and oversight committees. The net result of this early history of the Federal royalty management program was a move from smaller, decentralized, mostly manually-performed accounting/auditing to a large-scale, centralized program supported by complex, modern accounting systems.

In more recent years, as the Federal royalty management program has matured and its performance has improved, controversy has shifted to perceptions of its size and budget. The primary catalyst has been appropriations legislation. Before Fiscal Year (FY) 1991, Congress appropriated funds to cover the full cost of the mineral leasing program, without requiring States receiving revenue to share in administrative costs. In 1990, a provision, which required a portion of the costs of administering the mineral leasing program to be deducted from the receipts, or revenues, to be shared with the States, was included in Interior's FY 1991 appropriations. This "net receipts sharing" language was subsequently included in the Omnibus Budget Reconciliation Act of 1993 as a "permanent" fixture. Currently, States bear about one quarter of the costs incurred by the Bureau of Land Management (BLM), U.S. Forest Service (USFS), and MMS for administering onshore mineral leases. The sharing of costs has heightened interest in the budgets for Federal minerals administration.

Net receipts sharing has been consistently opposed by the congressional delegations of Western States. Many have argued that MMS costs are unreasonably high, and that, rather than sharing in such costs, it would be cheaper and more effective if the royalty-receiving States assumed control of the royalty management functions for Federal leases in their States. This environment and other factors resulted in the following:

- o Mineral Transfer Study: A congressional directive contained in Conference Report language in the FY 1992 Appropriations Act for Interior and Related Agencies required the administration to report on the "extent to which mineral leasing royalty collection and distribution functions could be performed by State agencies more efficiently and at lower costs." The resulting "Transfer Study" described mineral leasing functions and costs, including MMS's royalty program, and concluded that only royalty audit and production verification inspection functions could be delegated to States without increasing inefficiencies.
- o National Performance Review Devolution Proposal: On March 27, 1995, the President announced a number of actions to streamline and "reinvent" Federal Government. One of the proposed actions was to abolish the MMS and to transfer its functions to States, Indian tribes, and other Federal agencies. Subsequently, the Department decided to retain MMS as currently organized, and to increase program efficiencies.
- o Federal Oil and Gas Royalty Simplification and Fairness Act (RSFA): On August 13, 1996, President Clinton signed into law the RSFA, which authorized the Secretary to delegate certain royalty functions to States beyond auditing (auditing has been delegable since passage of FOGRMA in 1982).

## **II. DESCRIPTION OF MMS AND STATE ROYALTY PROGRAMS**

This section describes the salient features of MMS's royalty management program and those of the five State royalty programs studied. Detailed functional descriptions are found in Appendix 1, in which each of the major royalty management functions of these organizations is described in the same categories as MMS's net receipts sharing cost allocations. Table 1 summarizes lease and other statistics for the MMS and five State royalty programs. Table 2 summarizes the following discussion by highlighting the general characteristics of the MMS and five State royalty programs.

### **A. MMS Royalty Management Program**

The responsibilities for managing onshore Federal mineral leases are divided among three Federal agencies: USFS - disbursement of revenues from National Forests, grasslands, and certain acquired lands; BLM - regulation of lease operations; and MMS - mineral revenue management from all Federal and most Indian mineral leases. For Indian lands, the Bureau of Indian Affairs (BIA) and Office of Trust Funds Management also play significant roles.

The MMS royalty program manages mineral revenues of the U.S. Government, one of the world's largest royalty owners. The minerals are produced from both offshore and onshore lands in some 38 States and held by 29 Indian tribes and about 20,000 individual Indian mineral owners, governed by multiple lease forms, authorizing statutes, regulating agencies, and legal precedents. Thousands of operators and payors submit reports, and disbursements are made to 38 States, identifying up to 8 different categories of revenues for each State, 6 Federal agencies, 19 Federal Treasury accounts, and thousands of Indian accounts. Complex contractual and ownership schemes involve processing and marketing of several hundred mineral products subject to production royalty payments.

Within MMS, overall executive direction and policy guidance are provided by MMS offices in Washington, D.C. and subordinate offices that provide administrative support and perform functions such as external affairs, appeals review/adjudication, policy studies, budget development, and internal audit. Operational functions related to royalty management are delegated to RMP, whose mission is to ensure that all revenues from Federal and Indian mineral leases are efficiently, effectively, and accurately collected, accounted for, and disbursed to the appropriate recipients in accordance with existing laws, regulations, lease terms, orders, and notices; and to provide support to technical lease management functions.

**STATE BENCHMARKING STUDY**  
**TABLE 1**

Entity	Fiscal Year	Onshore Leases	Total Onshore Production	Lines of Data Processed Per Month	Total FTE
<b>MMS</b>	Oct 1, 1994 - Sep 30, 1995	Producing: 19,920 Non-producing: 41,617	Oil: 120,997,342 bbls Gas: 1,747,273,984 mcf Coal: 323,110,192 short tons NGL's: 1,041,735,141 gal  Note: Other minerals are also produced.	Production lines: 380,000 Royalty lines: 287,000	641  Note: Includes onshore, offshore & Indian. (Estimated 308 FTE for onshore)  Additionally, there are approximately 100 FTE for 202/205 contracted States & Tribes
<b>Louisiana</b>	Jul 1, 1994 - Jun 30, 1995	Producing: 977 Non-producing: 705	Total production volumes are not maintained.	Royalty lines: 25,000  Note: Production reports received by another State agency.	23
<b>New Mexico</b>	Jul 1, 1994 - Jun 30, 1995	Producing: 5,000 Non-producing: 2,960	Oil: 25,401,640 bbls Gas: 230,994,588 mcf CO2: 35,500,000 mcf	Royalty lines: 20,000-25,000  Note: Production reports received by another State agency.	16
<b>Texas General Land Office</b>	Sep 1, 1994 - Aug 31, 1995	Producing: 2,109 Non-producing: 891	Total production volumes are not maintained.	Production lines: 8,000 Royalty lines: 7,100	40  Note: Includes personnel to process & edit production reports.
<b>University of Texas</b>	Sep 1, 1994 - Aug 31, 1995	Producing: 2,040 Non-producing: 726	Oil: 15,508,576 bbls Condensate: 129,933 bbls Gas 23,167,292 mcf Csnghd gas 44,121,397 mcf	Production lines: 26,900 Royalty lines: 32,400	23
<b>Wyoming</b>	Jul 1, 1994 - Jun 30, 1995	Producing: 761 Non-producing: 3,164	Oil 4,809,130 bbls Gas 41,418,821 mcf Coal 5,416,000 tons  Note: Other minerals are also produced.	Royalty lines: 2,660  Note: Production info received by OGCC	12.5

**STATE BENCHMARKING STUDY**  
**TABLE 2**

<b>Program</b>	<b>Appeals Process</b>	<b>Statute of Limitations</b>	<b>Royalty-In-Kind</b>	<b>Lease/Payor Monitoring</b>	<b>Takes or Entitlements</b>	<b>Verification</b>	<b>Performance Standards</b>	<b>Number of Accounts for Disbursement</b>
<b>MMS</b>	Formal	7 Year	Oil; Intended to Supply Small Refiners	Payor	Both	Field audit focus; Compartmentalized organization; performed on monthly basis; Highly automated	Chief Financial Officers Act, GSA stdns., FOGRMA, GAO stdns., etc.	329 Federal accounts; >20,000 Indian accounts
<b>Louisiana</b>	No Formal Process	None	None	Payor	Entitlements	Field audit focus; Integrated processes; performed yearly; Both manual and automated	State Treasury guidelines, Mineral Board policies	50 accounts
<b>New Mexico</b>	Formal	None	None	Payor	Both	In-house focus; Somewhat compartmentalized organization; performed monthly; Automated	Chapter 19 of the NM Statutes, GAAS, NM Dept. of Finance & Admin., Treasury and Land Office guidelines	22 accounts
<b>Texas General Land Office</b>	Formal Process for Audit; No Formal Process of RMD	None	Oil-45%; bids based on postings plus Gas-37%; majority to small gov't facilities	Lease	Entitlements	In-house focus; Integrated processes; performed yearly; Mostly manual	In-house functions- Internal Stnds. and Procedures; Field Audit - GAO Yellow Book Stnds. For auditing	60 accounts
<b>University of Texas</b>	No Formal process	None	Oil - 55%; postings plus, extensive pipeline system, lease studies Gas - 7%; nominations; competitive bidding	Lease	Entitlements	In-house focus; Integrated processes; performed yearly; Automated	Statutes, BFL Policy, OGC Opinion, State Comptroller, Internal Controls, USAS <sup>1</sup>	11 accounts.; 47 subaccounts
<b>Wyoming</b>	No Formal Process	None	Oil-One unit, one party; posted prices; may expand oil program	Lease	Entitlements	In-house focus; Integrated processes; performed monthly; Mostly manual	Technical Directives	20 accounts

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<sup>1</sup>Board of Lease Policy (BFL); Office of General Council (OGC); Uniform Standard Accounting System (USAS)



To support this mission, RMP employs 641 Federal employees located in four States and Washington, D.C. Resident auditors are located in additional States. All functions with the exception of audit and Indian royalty assistance are centrally located in Lakewood, Colorado. The mission is supported by major automated systems: 1) royalty/financial systems: processing and accounting for some 287,000 royalty lines monthly (“lines” of data refers to a series of data elements reported for a single lease or sublease); 2) production accounting systems: processing and accounting for some 380,000 production lines monthly; 3) reference data systems: abstracting, maintaining, and updating a multitude of data on leases, pooling agreements, wells, payors, operators, and other items. Further, MMS and the Department have a comprehensive formal appeals process and RMP has a separate, extensive enforcement program.

The RMP’s overall approach to royalty management is based on monitoring payor accounts, as opposed to lease accounts. This scheme, which is designed to match how information is generated in the energy industry and to streamline reporting and audit efforts, underlies most of the royalty functions of the agency. Payors submit one monthly royalty report (with sublease entries) and payment for all their Federal leases and one monthly royalty report (with sublease entries) and payment for all their Indian leases. After the reports are entered into the system, a series of edits are performed on each line. There are 129 fundamental/fatal royalty edits. However, not all of these edits execute on every line. Many of these edits execute only on specific transaction codes. These edits perform a wide range of validity checks on the data reported. Errors must be corrected before the line will process in the system and distribution will occur. Parallel with this process, operators submit individual production reports for each lease or pooling agreement, specifying well production and disposition. There are 296 data edits performed on production reports.

Once the fundamental errors have been corrected, RMP analyzes information for reasonableness by conducting a series of computer-performed checks on a variety of items necessary for correct royalty payment, including royalty rates, sales volumes, adjustments, recoupment reviews, and allowable deductions for transportation and processing. Each individual automated check is separately run and analyzed monthly for all leases for each sales month. Payors and operators are then separately contacted to resolve any discrepancies.

Another major verification effort is field audit, which focuses on payors. The audit strategy is designed to audit the largest payors on Federal leases generally auditing a 3-year period starting about 4 years after the oldest reporting month. This function is decentralized with residency teams located on-site at the highest revenue payors and some 30 mobile teams auditing the remaining major payors. In addition, there are 17 States and Indian tribes that have cooperative or delegated audit programs under the authority of FOGRMA sections 202 and 205.

In addition to RMP’s system verification and audit efforts, RMP also performs product valuation functions, specifically: 1) ad hoc monitoring of reported product values and associated allowances, 2) review and evaluation of transportation and processing allowances, 3) development and maintenance of product value and allowance regulations, and 4) responses to

questions from Indian tribes, allottees, industry, MMS field personnel, States, royalty-in-kind (RIK) refiners, etc., on issues regarding royalty value.

Performance standards for RMP include compliance with the Chief Financial Officers Act, General Services Administration records maintenance standards, generally accepted accounting principals, FOGRMA, Federal Financial Managers Integrity Act, Debt Collection Act, Treasury Financial Manual, Federal Information Processing Standards Publications, Information Resources Management regulations, and GAO audit standards.

The RMP has an oil RIK program in which some 31 percent of its total oil is provided to small refiners who are responsible for paying RMP for the value of that oil. The oil RIK program is intended to assist small refiners rather than maximizing revenues through aggressively marketing to purchasers. The RMP does not have a gas RIK program

Of MMS's total revenues of \$3,862,700,455 for FY 1995, MMS's Federal onshore mineral revenues totaled \$1,039,582,929 including rents and bonuses for FY 1995. The RMP oversees 19,920 producing Federal onshore leases and 41,617 non-producing Federal onshore leases. The RMP FY 1995 cost for its Federal onshore royalty management program was \$36,806,454. (Note: see the cost comparisons in Section V for an explanation of the normalized RMP cost used in the comparative analyses.) The RMP collected \$71,339,856 in additional royalty collections in FY 1995, including penalties and interest, from its onshore royalty verification processes and field audits. Additional collections from verification efforts have averaged 3 percent annually over the past 10 years.

## **B. Louisiana**

The responsibility for managing both onshore and offshore State leases is held with the State Mineral Board (SMB). The SMB has responsibility for granting and administering leases on State-owned lands and water bottoms for the production and development of mineral resources, primarily oil and gas. External to the SMB, the Office of Conservation regulates production State-wide and performs some duties similar to those of the BLM. Within the SMB, the Office of Mineral Resources (OMR) performs the duties necessary to maximize revenue generated from State leases in the form of royalties, bonuses, and rentals. The OMR is composed of four divisions: Administration, Geological and Engineering, Mineral Income, and Petroleum Lands. The Mineral Income Division (MID) collects and validates all mineral revenues due from State leases, and was thus the focus of the team's study of Louisiana's royalty program.

Louisiana manages mineral revenues for approximately 977 producing leases (Table 1) and distributes to approximately 50 accounts. Louisiana conducts its mineral revenue management using a combination of manual and automated processes. Louisiana's current mainframe royalty system (Louisiana Mineral Information System (LOMIS)) is shared between the SMB and Office of Conservation. Soon after LOMIS was designed, MMS used the same contractor to design its dedicated mainframe royalty system. Much of the initial system design used in LOMIS was also used when designing RMP's system. Many changes have been made to both LOMIS and RMP's

systems since their design. Louisiana is in the process of replacing LOMIS with a new client server system. The new system will not only provide greater automation, but will also provide a more user-friendly environment.

The MID has a staff of 23 people responsible for performing royalty-related functions. To accomplish these functions, the MID is segmented into four sections: 1) field audit; 2) in-house audit, which consists of volume comparisons and royalty rate verification; 3) royalty reporting, which consists of document processing, error correction, allocation, and disbursement; and 4) special audits, which consist of budget, billing, and deposits. Some functions are performed manually. The MID operates under State Treasury guidelines and SMB policies.

Louisiana monitors payor accounts rather than lease accounts. Reporting is based on entitlements. Monthly royalty reports are submitted on a well or lease/unit basis. The MID does not require source documents to be submitted with the royalty report. The MID receives approximately 25,000 lines of royalty data per month. Once the reports have been entered into the system, they are checked against reference data gathered on wells, leases, agreements, and payors to correct errors that affect the disbursement of funds. Payments are matched to the royalty document by the LOMIS system. Unlike MMS, the operator submits production reports to a separate State agency, the Office of Conservation. The Office of Conservation compares production information reported by the operators to volume information reported by transporters, refiners, and plant operators. This information is regularly accessed by MID.

The MID uses information reported to the Office of Conservation, as well as information contained on the royalty report, to conduct a series of automated checks verifying volume, royalty rate, and adjustments. These checks are performed monthly, except for volume verification which is performed on a quarterly basis. The MID also conducts field audits based on major revenue payors/fields. In addition, MID targets areas for audit based on issues and trends. The MID generally audits a 3-year period starting approximately 2 years from the date of royalty payment. During the field audit function, MID obtains source documentation from the company for verification of royalties paid.

The MID does not have a formal appeals process.

The State of Louisiana's royalties totaled \$286,600,000 for FY 1995. In addition to the 977 producing leases, the State also oversees 705 non-producing leases. The MID's FY 1995 budgeted costs were \$970,456. The MID collected approximately \$14,600,000 in additional royalties (including penalties and interest) from all its FY 1995 verification efforts including audit. Louisiana does not take any production in-kind.

### **C. New Mexico**

The responsibilities for managing New Mexico State mineral leases are divided among three agencies: State Land Office (SLO), Oil Conservation Division (OCD), and the Taxation and Revenue Department (TRD). The SLO focuses on their trust responsibilities to maintain current

revenues while preserving the assets of the trust for future generations. The OCD functions include collecting production data and conducting site inspections and other functions similar to those performed by the BLM. In addition, the OCD carries out all the policies of the Oil and Gas Conservation Commission (OGCC) which relate to the regulation of spacing, correlative rights, and production limitations. The TRD collects severance taxes, assigns property numbers, and provides data entry for hard copy royalty reports. The SLO operates under the following performance standards: Chapter 19 of the New Mexico Statutes, generally accepted accounting/auditing standards, and New Mexico's Department of Finance and Administration, State Treasury, and SLO rules and guidelines.

New Mexico's mineral royalty program is the largest of the five State royalty programs examined (Table 1). The State has approximately 5,000 producing leases and distributes to 22 beneficiaries. All royalties are deposited into an interest bearing account until distribution to the beneficiary accounts. New Mexico has developed and is in the process of implementing an automated mainframe system (Oil and Natural Gas Administration and Revenue Database (ONGARD)). The system is designed to increase the oil and natural gas revenue stream of the State by monitoring data reported by industry. The system is shared with other State agencies. The SLO's overall approach is somewhat segmented in that revenue processing, compliance, and audit are performed by separate work groups.

Within the SLO, the operational function related to royalty management is delegated to the Royalty Management Division (RMD). The RMD mission is very similar to MMS's RMP in that it is charged with validating that all mineral revenues due from its State leases are timely and accurately received. The RMD is staffed by 16 employees, divided between the Office of the Director, the Revenue Processing Group and the Audit and Compliance Group.

New Mexico monitors payor accounts rather than lease accounts. Reporting is based on entitlements for leases included in mixed agreements (containing State and/or Federal or Fee lands), or in units or communitized tracts, which do not contain uniform royalty rates or uniform beneficiaries. All other properties are based on the production each remitter takes. Remitters submit monthly royalty reports and payments for all State properties. New Mexico does not require source documents to be submitted with royalty reports. The RMD receives approximately 20,000-25,000 lines of royalty data per month. After the reports are entered into the system, they are subjected to a series of automated edits to detect errors related to reference data and mathematical calculations. All royalty payments are matched to the royalty remittance documents by RMD personnel through the use of ONGARD. Production data is collected by OCD, which subjects the data to a series of up-front edit checks. The production data is directly available to RMD via ONGARD.

The ONGARD is designed to perform a variety of automated checks to verify royalty rate, volume, value, allowances, and adjustments. Although several automated checks are operational, many are still in the process of being implemented. These checks are run and analyzed separately for all leases. Remitters are then contacted to resolve discrepancies identified.

In addition to the automated verification checks, RMD performs issue-based audits. Areas for audit are targeted based on risk analysis. The royalty report contains an arm's-length/non-arm's-length indicator. RMD is currently concentrating on crude oil pricing of the top 20 remitter companies for the period 1985 through 1995. The RMD recalculates State oil royalties utilizing internally developed benchmark prices. Discrepancies identified are settled through negotiations. The RMD plans to review volume variance issues for the same sample companies. The RMD has also identified 120 other arm's-length remitters with crude oil volume variance problems. Audits are mainly performed in-house with occasional audits being performed on-site. During the field audit function, RMD obtains source documentation from the company for verification of royalties paid.

New Mexico has a formal appeals process whereby a lessee in disagreement with a determination may appeal directly to the Commissioner.

The State of New Mexico's total mineral revenues for FY 1995 totaled \$108,898,430 including rents and bonuses. In addition to its 5,000 producing oil and gas leases, New Mexico also oversees 2,960 non-producing leases. The RMD FY 1995 budgeted cost of operations was \$704,800 ( including \$52,800 for a data entry contract). This cost was incurred for a partially implemented ONGARD-based royalty program in FY 1995. The RMD estimated it generated approximately \$3,000,000 to \$5,000,000 in additional royalties (including interest) from all verification efforts, including audit, in FY 1995. New Mexico does not take production in-kind.

#### **D. Texas General Land Office**

The responsibilities for managing both onshore and offshore Texas State leases are shared by the Texas General Land Office (GLO) and the Texas Railroad Commission (RRC). The GLO accounts for revenues generated from publicly-owned oil and gas resources. The RRC collects production information similar to MMS and performs inspections similar to the functions performed by BLM. The GLO is divided into three divisions: Royalty Audit Division (RAD), Royalty Management Division (RMD), and Mineral Leasing Division. The RAD is responsible for performing field audits to ensure the accurate payment of royalties due on State leases, similar to RMP's audit function. The RMD performs all other functions and is similar to RMP. It is responsible for the monitoring and processing of monthly production reports, the collecting and distributing of monthly lease royalty payments, and performing annual reconciliations for its active mineral leases. The RMD does not operate under any performance standards. The RAD operates under GAO's Yellow Book Standards for auditing.

The GLO oversees 2,109 producing leases and disburses royalties to approximately 60 accounts and 3,000 lease accounts. All royalty payments received are deposited into the Permanent School Fund, which is the major beneficiary of State royalties. The royalties remain in this interest bearing fund until disbursement is made during processing. Approximately 8,000 lines of production data and 7,100 lines of royalty data are received each month. Although GLO has an automated system to capture the data reported, its royalty management functions are primarily

manual. The GLO's verification processes are consolidated, that is most individual employees within RMD perform all of the verification processes, except field audit.

The RMD has a staff of 22 employees, organized into 3 teams, responsible for the royalty accounting functions. Each team performs the collection, verification and disbursement functions. The RAD consists of 18 employees that initiated its efforts by conducting detailed field audits of the top 60 royalty payors. Since its inception in 1985, RAD has audited approximately 10 percent of its lease universe. Additional duties included audits of problematic payors, payors involved in bankruptcy, and citizen calls.

The GLO monitors lease accounts rather than payor accounts. Reporting is based on entitlements. Monthly production and royalty reports are submitted for each State lease/unit. Generally, source documents are not received with production and royalty reports. The reports are subject to a series of manual checks to verify reported data to reference data, and to verify royalty rate and mathematical calculations before being entered into the system. Payments are matched to royalty documents by system-assisted manual processes. Volume verification is a manual process that is performed at year end. The process is performed on all leases annually in order to allow adequate time for adjustments to data reported to GLO. In addition, this gives the RRC sufficient time to perform its verification efforts on production information. All other verification is performed during field audit which involves obtaining source documentation from the company for verification of royalties paid.

The RAD has a formal administrative appeals process, set by statute, while RMD does not.

The State of Texas' mineral revenues for FY 1995 totaled approximately \$134,400,000 including rents and bonuses. In addition to overseeing 2,109 producing leases, GLO oversees 891 non-producing leases. The GLO's FY 1995 budget for its royalty management program was \$524,594 and \$1,022,029 for field audit resulting in a total budget of \$1,546,623. The GLO's RMD collected \$366,106 in additional royalty (including penalties and interest) from in-house verification efforts in FY 1995. The RAD generated \$1,940,000 in additional royalties during FY 1995.

The GLO has both an oil and a gas RIK program. The GLO issues notification letters to its lessees of when and where the State will invoke its option to take its production in kind. The GLO takes approximately 37 percent of its gas royalty volumes in-kind and serves approximately 141 customers. The GLO's main customer base is small government facilities whose alternative source of supply is the local distribution company. Excess gas is sold on the spot market and usually involves gas taken at the first pipeline interconnect. The purchaser will net back the price from the applicable index point. The GLO looks at sales history to determine the royalty collection point. Transportation rates are negotiated with each pipeline used. Intrastate pipelines are typically used. Most gas is not processed. For the small amounts of processed gas, GLO takes residue in-kind at the tailgate of the plant and receives natural gas liquids (NGL) royalties in value. A deduction for liquids retained by the processor is allowed. The GLO informed the team

that their gas RIK program results in revenue enhancement of 7 percent more than received in their in-value program.

The GLO also takes approximately 45 percent of their total oil royalty volumes in-kind. Volumes are put up for bid every 6 months and the best offer is taken. Oil is usually taken at the lease automatic custody transfer (LACT) unit where the oil goes into the pipeline or tanks. Typically, a premium over the posting is received when selling RIK oil. The GLO markets their oil themselves.

## **E. University of Texas**

Responsibilities for managing the University of Texas' leases are held with the University Lands West Texas Operations. The West Texas Operations' responsibilities are further divided among four offices: Surface Interests Office; Administrative Services Office; Oil, Gas and Minerals Office; and University Lands Accounting Office (ULAO). The ULAO performs the operational functions related to royalty management, and is thus the focus of this study for university lands. The ULAO operates under the following performance standards: statutes, Board for Lease Policy, Office of General Council Opinion, State Comptroller, internal controls, and Uniform Standard Accounting System standards.

With 2,040 producing leases, ULAO has found it more efficient to perform most of its royalty-related processes on an automated basis. Royalties are allocated to 11 accounts and 47 sub-accounts. The ULAO rents access to University of Texas' mainframe system, which is used to create and maintain computer programs for oil and gas accounting purposes. The approach is one of centralized function where most individual employees perform a full spectrum of royalty-related processes.

To support the operational function related to royalty management, ULAO currently has 23 staff people who are responsible for the collection, disbursement, reporting, and compliance for the University leases. The ULAO has seven staff members who perform all of the functions required to verify that royalties have been accurately paid. Each employee is assigned specific companies.

The ULAO monitors lease accounts rather than payor accounts. Reporting is based on entitlements. Monthly production and royalty reports are submitted for each lease/unit. The ULAO receives approximately 26,900 lines of production data and 32,400 lines of royalty data per month. After the reports are entered into the system they are checked both manually and through computer system edits for errors. All payments are matched to royalty documents by a system-assisted manual process.

Once the errors have been corrected, ULAO performs a variety of automated and manual checks to verify the accuracy of the royalty payment, including volume, value, and royalty rate. In addition to the automated checks performed by the system, ULAO requires purchase statements to accompany production reports. Purchase statements are verified to approximately 50 percent

of the leases annually. These combined efforts allow ULAO to perform the majority of its verification processes in-house.

The ULAO utilizes on-site audit as an additional form of verification. The audit strategy consists of field audits which are similar to a combination of BLM's inspection function and company audits. Company audits are performed on-site and target the largest payors and current issues. The largest payors are further targeted based on in-house research. These audits generally review the most recent 2-year period. Approximately four (out of 300) companies are targeted for audit each year. Additional source documentation not already received in-house is obtained and used to verify the accuracy of production and royalties reported. Allowances are analyzed for reasonableness at this time.

The ULAO does not have a formal appeals process.

The University of Texas' mineral revenues for FY 1995 totaled \$57,115,581 including rents and bonuses. In addition to the 2,040 producing leases, ULAO oversees 726 non-producing leases. ULAO's budget for its royalty management program was \$934,000 for FY 1995. The ULAO has collected an average of \$600,000 per year in additional royalties (including penalties and interest) from all verification efforts, including audit.

The ULAO takes oil and gas in-kind and markets about 55 percent of its production oil volumes and 7 percent of its gas. The RIK oil comes from areas where there is an extensive pipeline system serving the field. Lease studies are performed to check production and to determine if ULAO can make money by taking product.

The ULAO stated that the cumulative total net revenue enhancement of the oil RIK program from July 1990 (established) to December 1995 is slightly over \$5,000,000. This amount represents revenue over and above that which would have been received as traditional cash royalties. The average net enhancement per barrel is \$0.72 for the program or a 4 percent increase (assuming \$18 per barrel). The oil in-kind program is based on entitlements whereby the purchaser pays whether taking delivery or not. Prices are determined using a posted price, selected by ULAO, plus a market bid. Contracts are usually 6 months in length. Transportation is arranged for the purchaser.

For gas, volume nominations are made by lessee/operator. Price is established through competitive bidding. The operator tells ULAO what the nominated volume is; ULAO tells the purchaser what it will receive. The purchaser then pays on that volume.

## **F. Wyoming**

Wyoming carries out mineral leasing, conservation, production and royalty accounting/auditing through three State organizations: the State Land and Farm Loan Office (LO), the Oil and Gas Conservation Commission (OGCC) and the Division of Audit. The Division of Audit's sole royalty-related function is the performance of field audits on State leases. The OGCC regulates



spacing and production limitations. The OGCC also receives monthly oil and gas production information and conducts well, lease, and unit inspections, similar to functions carried out by BLM. One LO division, the Mineral Leasing and Royalty Compliance Division, is responsible for most State mineral-related activities, except field auditing and mineral taxation. The Mineral Leasing and Royalty Compliance Division contains the Mineral Royalty Accounting/Royalty Collections Section that performs some functions similar to MMS's RMP. Wyoming has technical directives setting standards for performance for its royalty accounting activities.

Wyoming's mineral leasing program for its State lands is the smallest of the five State royalty programs examined (Table 1). The State has 761 producing leases and distributes royalties primarily to 2 of 20 beneficiary accounts. Consequently, Wyoming conducts its mineral revenue management in a primarily manual, streamlined manner. The automated system used is a small, LAN-based system. The overall approach is one of a centralized function where most individual employees perform the full spectrum of royalty management functions. That is, the organization is not compartmentalized into subsections performing separate royalty management functions.

The Royalty Accounting Section performs all royalty accounting functions with a staff equivalent to 10½ full time employees. These functions include collection, verification, and distribution of royalties. Companies are divided among staff members. Each staff member performs all of the royalty-related verification functions for assigned companies. The Wyoming Division of Audit performs field audits on State leases with two staff members. Audits are performed at both lease and payor levels and coverage is based on risk analysis.

Wyoming monitors lease accounts rather than payor accounts. Reporting is based on entitlements for mixed agreements (containing State and/or Federal or Fee lands) and on takes for all other properties. Monthly royalty reports and/or check details are submitted for each lease/agreement. Approximately 2,660 lines of royalty data are received each month. Purchase statements are required to be submitted with the royalty reports. Certain data items, including volume and value, are manually checked against purchaser statements and reviewed for accuracy before the information is entered into the system. In addition, as the information on the royalty report/check stub is key entered, an automated comparison is made to the reference data maintained in the system. The system also calculates royalty due based on the royalty report and purchase statements. All payments are manually matched to royalty documents before month end. Royalty payments are posted to 20 accounts. The predominant form of royalty verification is in-house verification, and is mainly performed manually, including review of non-payment, volume, value, adjustments, and rentals. The in-house verification is a subjective review of royalty reports and supporting documentation. Billing is a manual process. Field auditing, which targets both leases and payors (primarily the latter), is not a large component of the overall royalty management effort. The LO has very few appeals and does not have a formal appeals process. However, parties may take grievances to the Board of Land Commissioners.

During FY 1995, the LO collected State mineral revenues totaling \$28,312,381 including rents and bonuses. In addition to overseeing 761 producing leases, Wyoming oversees 3,164 non-producing leases. The total cost of performing royalty management totaled \$472,274 for

FY 1995, which includes \$387,274 for the LO's Royalty Accounting Section and \$85,000 for the Division of Audit. The LO collected approximately \$553,000 in additional royalties (including penalties and interest) from in-house verification efforts in FY 1995. In addition, the Division of Audit generated \$106,046 in additional royalties (including penalties and interest).

Wyoming currently takes oil in-kind from one unit involving 11 leases. There is only one party involved in the RIK program at this time. Contract prices are negotiated using posted prices as the starting point. Studies are underway to expand the oil RIK program and to include gas.

### **III. COMPARISON OF MMS AND STATE ROYALTY PROGRAMS**

This section provides a comparative analysis of MMS and State royalty programs aimed at identifying and explaining the major similarities and differences. The reader may find it convenient to refer to Table 2 for a summary of major similarities and differences.

#### **A. Similarities Between MMS and State Royalty Programs**

In the most general aspects of royalty management, MMS and State royalty programs are quite similar: royalty reports and payments are generally received and distributed monthly and a combination of automated and manual processes are performed to verify the accuracy of royalties.

Royalty payments from industry are made voluntarily, on the honor system. That is, payors are not billed for monthly royalties due. Payors are required to submit reports and royalties due on a monthly basis. Payments are submitted based on the payors' calculations of what is due to the lessor. Royalty receipt, distribution, accounting, and verification rely to various degrees on the use of automated systems. The RMP and the States perform similar processes to verify the timeliness and accuracy of royalty payments, comparing the industry's reported data to internal "reference" data and to "source documents" that accompany sales, processing, and transportation transactions. Reports and payments are reconciled. The most fundamental errors are generally corrected immediately and other, more ambiguous discrepancies are researched and corrected later. In almost all cases, lease numbers, royalty rates, volumes, and arithmetic are checked. Payments are distributed to multiple accounts.

Another notable similarity is the fact that RMP and the States exchange information with sister agencies to facilitate royalty management. Inter-agency exchange of production data - both reference data and monthly reports - is most typical. Each State has an organization that performs functions similar to those that BLM performs in support of royalty management.

The State program most similar to RMP's program is New Mexico, which has designed its ONGARD system in many respects parallel to RMP systems. Payors report all their royalties on a single royalty report. New Mexico also performs its royalty management functions in a segmented, compartmentalized manner similar to the RMP approach; that is, organizational units and/or specific employees perform specialized functions, rather than having individuals perform all functions for certain leases or companies. Interestingly, New Mexico is also the largest State royalty program examined. The team is not able to draw more specific conclusions regarding New Mexico's program because its ONGARD system and associated processes have only been partially implemented. The team also notes that Louisiana's program has many similarities to the RMP program.

## **B. Differences Between MMS and State Royalty Programs**

Although MMS and State royalty programs are similar in the broadest categories mentioned above, the differences are many and striking. Overall, the study team found that there are sound reasons for the many differing philosophies and approaches to the programs of MMS and States, and that, although the team did not evaluate program effectiveness, each program appears to be working well for its circumstances.

At the outset, it is important to note several factors when considering the different approaches used by the various programs. First, the structure and approach used in the Federal program address both onshore (large numbers of leases/wells), Indian (small number of leases/high cost), and offshore (high revenues) areas. Second, there are large differences of scale between the Federal and State mineral leasing programs. The Federal mineral leasing system covers 38 States and 29 Indian Tribes, with some 60,000 total leases, nearly 100,000 wells, and hundreds of produced products. The magnitude of the revenues generated is great: over \$4 billion in annual royalties and bonuses for both onshore and offshore areas. A complex web of differing lease forms, statutes, multi-agency regulations, and legal precedents are navigated in managing the Federal mineral estate. Second, the public environment in which the Federal minerals management process works is markedly different from that in which the States operate. Although State programs certainly have constituencies to address, the Federal mineral programs are responsible to a multitude of public entities which often have divergent policy aims. The Federal constituency comprises both macro- and micro-scale groups ranging from: 1) the U.S. Congress, major oil and gas industry trade groups (e.g., American Petroleum Institute), and mainstream environmental and taxpayer groups at the macro scale; and 2) grass roots environmental groups, local school districts, and tiny independent oil and gas companies at the micro scale. Oversight and public scrutiny are intense at many levels.

With this as backdrop, the team assessed the MMS and State programs in several major areas as follows:

- 1. Approach.** Although the MMS and States are similar in many broad aspects of royalty management, there are several philosophical and legal differences, specifically:
  - o Statutory Mandate. The State organizations responsible for leasing and revenue management for State lands (typically land boards/commissions) are generally mandated to maximize revenues generated by the land, typically to support education. The Department's mineral leasing programs, however, are not operating under a similar mandate for revenue maximization, but rather under a general stewardship concept in which often competing forces like income to the Treasury, domestic economics, local job markets, national defense, and environmental issues must be balanced. Further, the Department's mineral leasing program must maximize overall recovery of the resource through conservation measures. In this environment, the Department looks to a fair return for public resources as the standard.

- o Appeals Process. The Department provides for a formal appeals process that is actively used by lessees. However, three of the five State programs studied have no formal appeals process. Likewise, none of the States has a separately identified enforcement function.
- o Statute of Limitations. The States studied do not have a statute of limitations for identification and collection of royalty underpayments. By contrast, FOGSMA set records retention requirements for lessees at 6 years. Further, the recently-enacted RSFA binds MMS to a 7-year statute of limitations from the date on which the original obligation becomes due.
- o Royalty-In-Kind. The two Texas programs take a substantial portion of their oil and gas in-kind. The other States do not have significant RIK programs. The RMP provides substantial quantities of its oil in-kind to small refiners. This is not a program designed to increase royalty revenues, but rather is set up to assist small refiners while being revenue neutral to the Federal Treasury. By contrast, the Texas RIK programs attempt to increase royalty revenues by aggregating, transporting, and marketing significant volumes for sale to consuming customers.

**2. Reporting and Payment.** While in broad aspect, the MMS and States similarly hold industry to the honor system for reporting and payment, some major differences exist in approach, specifically:

- o Lease/Payor Accounts. The MMS requires one royalty report from each Federal lease/payor and monitors payors rather than lease accounts. Three of the five States are lease account oriented. It is important to note that up until 1982, the U.S. Geological Survey (USGS) also monitored lessee's accounts rather than payors. However, the Linowes Commission found that USGS didn't know who owed it money, or how much it was owed. The USGS and BLM had good records of lessees, but experience showed that royalty payors were often not the lessees. It was decided to develop a system that would accept data and payments from the energy industry more or less as they were generated. It was thought that this would reduce the regulatory burden, result in faster, more accurate information, and reduce the burden on auditors if data submitted closely tracked the backup materials in company files. As a result, decisions were made early on that the structure of MMS accounting systems would be on the royalty payor, rather than the lease or lessee. This also allowed payors to send one check or wire transfer, and one multi-lined report, for monthly payments on all Federal leases.

Three of the five States require a royalty report for each lease and leases are monitored rather than payors, most likely because the lease is the primary contractual instrument that is being monitored and "managed" when it comes to revenue management. It is convenient and desirable for these States to be able to state that royalties from an entire lease have been verified as accurate. It may also

be a scale issue, in that lease accounts can be monitored more efficiently in a State program in which hundreds or only a few thousand leases are being managed rather than tens of thousands.

- o Takes/Entitlements. Under the RSFA, MMS is required to allow payors to report on takes for 100 percent Federal leases and agreements and on entitlements for mixed agreements. On the other hand, three of the five State royalty programs studied require all reporting based on entitlements. These States believe that entitlements reporting facilitates royalty verification by increasing certainty on payment and reporting responsibilities. In-house royalty verification is especially facilitated as all factors required to determine accuracy of lease payments are known to office personnel.
- o Error Correction. General data editing and error correction processes of RMP and the States are similar. However, because RMP requires more data types at a higher level of detail, there are more data edits and error correction activities performed within RMP than within the States.

**3. Verification.** The most striking difference between MMS and State royalty programs is reflected in approaches and processes used to verify royalties paid, specifically:

- o Integrated/Compartmentalized Functions. The RMP is organized primarily by function, with individual divisions/branches/sections performing specific royalty collection, disbursement, and verification activities. The States in the study generally use a more integrated approach to royalty management than MMS. For example, specific individuals and/or teams perform: 1) document processing, error correction, and disbursement (Louisiana); 2) collection, verification, and disbursement functions (Texas GLO and Wyoming); and 3) all in-house verification functions (University of Texas). These functions are typically combined so that individuals or teams are responsible for specific leases, companies, or geographic areas.

The MMS's compartmentalized approach provides technical expertise in specific areas, and may provide efficiencies in individual processes, important qualities in managing large numbers of leases and revenues. On the other hand, the States appear to use an integrated methodology because it develops and utilizes expertise in specific leases, companies, or geographic areas. The integrated approach may be more efficient in that individual transactions are reviewed once by one employee for all royalty elements, rather than being reviewed multiple times by many employees for each royalty element.

- o Manual/Automated Verification. The MMS's in-house royalty verification efforts are based almost entirely on research and resolution of reporting discrepancies detected by automated systems. The MMS has found that this approach is highly

efficient in that it focuses human resources on discrepancies, rather than on manually compiling and checking the majority of data that is reported correctly. While New Mexico and, to a lesser extent, Louisiana use a similar approach, the Texas GLO program and Wyoming rely extensively on manual review and checking of reports for compliance with various lease terms and regulations. The manual review allows these States to analyze elements of the royalty equation that are ambiguous and are more likely to create discrepancies that are more difficult to detect with automated means. The manual review incorporates elements included in field audit efforts.

- o In-House/Field Audit Emphasis. The MMS has historically placed its primary emphasis for royalty verification on field audit; that is, the examination of source documents mostly at the companies' offices to verify royalties. The MMS in-house verification substantially augments the field audit effort, but is not the primary focus. The MMS strategy is to audit companies paying the greatest amount of royalties, focusing on identifying systemic errors in small lease/month samples and extrapolating these to all the major companies' leases. On the other hand, four of the five State royalty programs in the study place their royalty verification focus on performing in-house verification - both manually and via automated means - to detect both systemic and random errors in reporting across the board for all leases, months, and transactions. Most of the States' in-house verification efforts are conducted using source documentation submitted for every lease. Field audit is generally a smaller component of the royalty verification effort, and is oriented toward specific issues.

The MMS approach to verification is an outgrowth of the payor-based system and of the magnitude of revenues; that is, 86 percent of Federal revenues can be reviewed by auditing only the top 126 Federal payors. Considering the scale of the Federal lease and revenue universe, the emphasis on field audit of major payors is efficient and logical. A potential downside to this approach may be a relative lack of royalty verification for smaller companies and a potential for non-detection of non-systematic and random errors. The States' verification mostly on a transaction-by-transaction basis also appears to be a logical approach to a smaller lease universe. That is, without the need to concentrate on the largest revenue payors due to large numbers of leases/payors, the States can adopt a method in which more transactions on fewer leases are comprehensively reviewed.

#### **IV. STATE BEST PRACTICES FOR POTENTIAL ADOPTION BY RMP**

In this section, the team identifies what it believes are the best practices of the various State royalty programs for potential adoption or adaption by RMP. These best practices may or may not actually be practicable for RMP to adopt/adapt depending on further analysis of the feasibility of implementation, a process to be conducted within RMP's Compliance Reengineering Project.

The term "best practices" is used in benchmarking studies to refer to those program components that appear to be working well for the organization being studied.

The team identified the State best practices judgmentally based on several factors: 1) apparent effectiveness and efficiency of the process or approach as represented by State employees; 2) potential to resolve existing problem areas in the Federal royalty program; 3) potential for RMP program streamlining; and 4) potential for success considering the Federal mineral leasing environment. The team stresses that the State programs have many more facets that could be considered best practices than are listed in this section. The practices highlighted herein are simply those that the team believes are potentially appropriate for Federal adoption, depending on feasibility analysis.

Many of the features described below have been considered by RMP for adoption in the past. A few of these have been the subject of analysis and pilot projects. Most have not been implemented for a variety of reasons, while some continue to be examined. They are included in this report for varying reasons, including: 1) the States have implemented some of the practices differently than previously studied by MMS; 2) evolving technologies may make previously dismissed practices practicable; 3) proposed MMS regulations may allow different royalty verification strategies; and 4) the current reinvention tide places all reasonable ideas for change on the table.

##### **A. Overall Approaches**

The team analyzed the States' processes for assuring timely and accurate collection of royalties due. The team recommends that RMP give further consideration to the following approaches:

##### **1. Combine Verification Processes And Assign By Company/Property**

Many of the States verify the timeliness and accuracy of royalties by aggregating their respective verification processes and assigning them to staff by company or property. Therefore, each staff member is responsible for performing multiple processes.

The RMP performs verification processes in separate functional areas. These processes are performed at different times by staff specialized in specific areas. This results in a single royalty line being analyzed numerous times for different attributes. Companies may be contacted by multiple individuals for a single royalty line. The RMP does not review each lease in its entirety



to verify if the royalties were correctly paid, or to determine the royalty status of a lease at any one point in time.

The MMS completed an analysis in 1995 (Compliance Action Plan) which recommended combining certain verification processes and realigning the organization into teams. The study team also developed the “System Analysis Model”, a PC-based program, which performs a simultaneous review of all the discrepancies (volume, value, allowances, and royalty rate) for a particular property. This concept is being evaluated by the Compliance Reengineering Project.

Additionally, one RMP division recently organized into teams which perform multiple verification functions for assigned companies. However, this concept has not been evaluated for implementation in other RMP divisions.

Advantages:

- Enables staff to gain significant knowledge of the company and properties.
- Broadens skills and education in all aspects of royalty verification.
- Provides capability to verify royalty payment on a given property in its entirety.
- Eliminates re-work when correction of one discrepancy causes another.
- Leads to fewer company contacts.
- Eliminates organizational boundary problems typical with a functional approach.

Disadvantages:

- Creates a lack of specialized expertise in specific areas.

2. Perform Verification Processes Less Frequently

Several States perform certain verification processes semi-annually or annually. The States believe that efficiencies are gained from reduced time spent on monthly research, contacts, and resolution efforts. Also, recurring errors are more identifiable and can be dealt with at one time.

The RMP’s automated verification processes are run monthly. Staff members analyze errors and contact the responsible parties to resolve each of the errors. This process may result in a company being asked to resolve recurring exceptions month after month. The RMP could gain the same efficiencies as States by running verification processes in a more efficient timeframe.

The MMS completed a study which recommended decreasing the frequency for verification of royalties from monthly to semi-annually. One RMP division has demonstrated increased efficiency by working some discrepancies quarterly. However, this concept has not been evaluated for implementation in other RMP divisions.

Advantages:

- Results in fewer contacts with the company.
- Achieves greater staff efficiencies.
- Allows trends to be more easily identified.

Disadvantages:

- Delays the resolution of exceptions currently identified every month.
- Requires system changes.

3. Conduct Company Audits Based On Most Recent 2-Year Period

The University of Texas audit strategy is to conduct company audits by reviewing the most recent 2-year period. If errors are detected, the audit period can be expanded to include prior years. This strategy, allows the University to better utilize its resources to detect errors which are considered systemic.

The RMP's audit strategy is to conduct audits on a continuous basis in 3- to 6-year increments for major revenue payor companies. Therefore, no period goes unaudited. Although this leads to a more complete coverage of the top revenue payors, auditing based on the most recent 2-year period may allow for increased coverage of smaller royalty payors. The 2-year concept could provide more certainty that royalties are accurately paid across the lease universe.

Advantages:

- Creates potential for greater coverage of the lease universe.
- Allows more time to be spent on audit of high risk properties or periods.
- Reduces payor burdens to provide additional information for a longer period.
- Allows for the review of more recent data.
- Enables the auditor to look at each sample in more detail.

Disadvantages:

- Increases risk of missing an error in years not audited.

4. Explore Opportunities for Increasing Revenues From Oil and Gas Royalty-In-Kind

The two Texas programs take a substantial portion of their oil and gas volumes in-kind, and appear to be increasing their revenues over and above correlative revenues from in-value payments. The benefits accruing from oil RIK programs in Texas appear to result simply from realizing the uplifts from premia above postings. The GLO gas RIK program benefits from an approach that aggregates large volumes, arranges for transportation and storage, and markets the

volumes to small governmental consumers who otherwise would pay high prices to local distribution companies.

It would appear that there are opportunities for MMS to aggregate some of its large production volumes (especially in the Gulf of Mexico), arrange for transportation/storage, and market in similar niches as GLO has done. MMS could potentially operate at a profit by utilizing aggregators and marketers. Benefits to the Treasury may also be realized if low priced gas is provided to U.S. Government consumers at savings greater than the losses in royalty revenues that would have been received.

**Advantages:**

- Increases potential to enhance revenues to the Federal Treasury.
- Results in administrative cost savings.
- Increases MMS knowledge of gas marketing industry.
- Reduces payors reporting burden.

**Disadvantages:**

- Requires development of high quality in-house RMP marketing expertise.
- Creates potential risk for revenue loss.

**B. Value Verification**

**Perform In-House Automated Value Verification**

Most of the States performed some form of in-house value verification. The University of Texas and Wyoming verify reported values directly to the purchase statement. New Mexico has developed an automated value verification process in the ONGARD system. When the databases are populated, the system will identify discrepancies between “market value” established for an area and value reported by the remitters.

The RMP does not routinely perform in-house value verification. However, the system is accessed on an ad hoc basis for special projects. The RMP does monitor Indian gas valuation through implementation of major portion analysis. An automated valuation verification process would provide RMP the ability to identify value discrepancies as royalties are reported. This process may result in a higher level of confidence that companies are valuing production accurately.

The RMP has conducted several pilots in the past which were developed to detect valuation discrepancies for oil and gas. The oil valuation prototype was developed to determine if oil prices were reported accurately. The system identified numerous exceptions of which most were attributable to production and royalty rate reporting errors. The resolution of the exceptions resulted in minimal additional royalty collections.

Once the current Federal and Indian negotiated rulemakings for gas valuation program are finalized, an automated valuation verification will be more feasible.

Advantages:

- Enables more timely detection of valuation discrepancies.
- Provides more coverage of the lease universe in terms of value verification.
- Provides a potential targeting tool.

Disadvantages:

- Requires more resources to ensure accurate reporting of data not now corrected.
- Requires additional data gathering/reporting.
- Requires additional fields to be reported.

**C. Reporting**

**1. Require Operator To Report Additional Information on Production Reports**

The two Texas programs require the operator to include the general production/disposition information, as well as, the gross value, royalty decimal, royalty due, and transportation rates on the production reports. The operator identifies the responsible working interest owner/purchaser.

The RMP requires the operator to submit production reports with total production and sales volumes. The RMP's system compares the total sales volumes reported by the operator on the production report to the total sales volumes reported by the payor(s) on the royalty report(s). When discrepancies are identified, RMP contacts the operator to identify the volumes taken by each working interest owner/payor. Letters are then sent to the payor responsible for under-reporting.

Requiring the operator to report the volumes attributable to each payor, would eliminate the need to contact the operator for that information. The system could automatically issue an order directly to the responsible payor.

Advantages:

- Provides third-party verification of volume where the operator is not the payor.
- Eliminates contacting of operators to identify who underreported volumes.
- Allows for more timely resolution of volume discrepancies.

Disadvantages:

- Requires changes to production reports.
- Increases reporting burden on the operator.
- Requires system changes.

2. Report And Pay On Gas Sales 60 Days After Month Of Production Without Estimates

Each State's gas production and royalty reports are due 45 to 60 days following the month of production. This allows the lessee additional time in which to obtain and report more accurate information. The States do not have estimated payments.

The RMP's production reports are due in the second month following the month of production, however, RMP requires royalty reports and payments to be submitted by the last day of the month following the month of production. Many payors do not receive sufficient sales information to submit reports and payment within required timeframes.

The RMP currently allows a lessee or its designee to establish an estimated royalty payment with MMS. An established estimate allows a lessee/designee to report and pay actual royalties at the end of the second month following the month the product was removed or sold. Estimates are reported at the lease level. Estimates are established once for a lessee/lease and may be adjusted upwards or downwards at the discretion of the lessee/designee. As a result of RSFA, interest is owed to the lessee or from the lessee when the actual royalty is paid.

Although Congress previously denied a request to allow lessees 60 days due to the permanent loss of one month's royalties, this should not prohibit RMP from exploring ways to prevent a one-month's delay in royalties. For example, payors/leases could be phased into reporting on a 60-day reporting period thereby abating the impact in terms of loss of royalty dollars.

Advantages:

- Reduces input and editing costs due to fewer adjusting lines.
- Shows responsiveness to gas industry environment.
- Gives payors ability for correct initial reporting.
- Reduces cost for industry to generate and submit adjusting lines.
- Reduces administrative costs associated with over- or underpayments.

Disadvantages:

- Results in possible one-month delay of royalty when first initiated.
- Requires regulation and/or statutory change.

## **D. Billing**

### **Include Penalty And/Or Interest With Bills**

The two Texas programs include penalties and interest due when a bill is generated for underpaid royalties. Examples of methods used by the States to calculate interest are: 1) interest is calculated through a 2-week period from the date of the bill. The responsible party must pay within that period to avoid further penalties and interest; 2) interest is calculated through the 15th day following the date of the bill. The responsible party usually has a 30-day period to pay the bill. If the bill is paid anytime within the 30-day period, no additional penalties or interest is due.

The RMP creates a bill for underpaid royalties. When that bill is paid, a separate bill for interest is generated. This results in the issuance and processing of two separate bills.

An option for RMP could be to create a schedule to accompany the bill which calculates the principal amount plus interest for everyday during the 30-day period given to pay the bill. This would enable a company to base its payment according to the day the monies were either sent by electronic funds transfer (EFT) or allow sufficient time for the payment to be mailed. This option is currently being used by a State which was not analyzed during this study.

Including principal and interest/penalties in a single bill eliminates the resources required to process and follow-up on an additional bill. This could result in more timely receipt of monies due to the elimination of the time required to issue a subsequent bill.

#### **Advantages:**

- Reduces the resources required to generate and process multiple bills.
- Results in more timely receipt of interest.
- Resolves all issues (additional royalty due, interest and/or penalty) at one time.
- Reduces manual and system intervention due to the elimination of multiple bills.
- Eliminates the potential for multiple appeals for one issue.
- Saves industry costs associated with processing and responding to only one bill.

#### **Disadvantages:**

- Requires subsequent bill if payors do not remit bill payment on time.
- Confuses the point at which interest is payable; e.g., postmark, receipt of monies.
- Requires system changes.
- Requires issuance of subsequent interest bill if lessee pays less than amount due.

## **E. Supporting Documentation**

### **Perform More In-House Verification Utilizing Supporting Documentation**

Each of the States uses some form of supporting documentation to verify data on production and/or royalty reports. The amount of supporting documentation, as well as the procedures for using the data, vary by State. Two of the States receive purchase statements along with their production or royalty reports. Purchase statements are manually compared to the production/royalty reports. Purchase statements related to arm's-length transactions provide a high degree of accuracy when verifying volume and value. In addition, some States require reports on agency-generated forms including transporter reports, plant operator reports, and/or refiners reports. This information is usually reported to the conservation division in each State and is used in an automated comparison to production reports.

Generally, RMP obtains supporting documentation only during field audit or for special projects. However, MMS does require run tickets to verify offshore oil production and is in the process of developing a similar procedure for offshore gas.

By obtaining more supporting documentation up-front, RMP may achieve more certainty over a broader universe that companies are reporting accurately.

#### **Advantages:**

- Assures that amounts billed are based on accurate and supportable data.
- Reduces potential for appeals by more accurate billing.
- Provides ability to identify errors and collect revenues more timely.
- Resolves underpayment issues earlier leading to less late payment interest.
- Leads to more accurate initial reporting.
- Provides field auditors flexibility to concentrate on issues of higher risk.
- Reduces burden on industry having to research and gather documents years later.

#### **Disadvantages:**

- Increases costs associated with collecting/maintaining large quantities of data.
- Requires manual intervention when documentation is not in a common format.
- Increases burden on industry.

## **F. Enforcement**

### **Request BLM Review Outstanding RMP Bills Prior To Issuing New Lease/Assignments**

Louisiana will not issue a new lease and/or grant an assignment to a payor who has outstanding bills. This procedure provides an incentive to the companies to resolve outstanding issues.

By regulation, a transfer of record title or of operating rights (sublease) in a producing lease shall not be approved unless the lease account is in good standing. Lease Account Status Reports from MMS are forwarded twice a month to all BLM State offices. These reports identify MMS delinquencies of record, but do not include issues not billed.

Although the above regulation exists regarding lease account status, this regulation is applied on a lease basis. The team recommends BLM extend the concept to a payor basis. When an assignment is requested, BLM would not approve the assignment if the assignor or assignee has **any** lease accounts which are not in good standing. By implementing such a policy companies would have increased incentive to resolve any outstanding issues. In addition, problem companies would be eliminated from competing for new leases/assignments.

#### **Advantages:**

- Reduces need to write off bills as uncollectible.
- Provides additional incentive for company to pay outstanding bills more timely.
- Requires agencies to work together to ensure accurate collection of royalties due.

#### **Disadvantages:**

- Requires significant coordination among the two agencies.
- Discourages development if issues are not easily resolved.

## **G. Systems**

### **Share Common System Between Agencies**

Although the responsibilities for managing mineral resources are often performed by multiple agencies, many of the States maintain the data needed to perform royalty-related functions on an integrated system. By sharing a common integrated system, the States experience reduced operating costs, increased data integrity, and enhanced communications.

The MMS, BLM, and BIA have separate systems to support each agency's specific areas of responsibility related to the accurate payment of royalties. Each agency requires certain data from other agency databases and the data are periodically exchanged. The separation of duties has resulted in specialized expertise in the agencies for their areas of responsibility. However, the activities performed to manage minerals cut across the current functionality of the agencies,



presenting coordination difficulties. Currently, database verification programs are run on Federal inter-agency data to identify inconsistent data between systems.

Advantages:

- Provides for more consistent information.
- Shared maintenance costs thereby reducing the burden on a single agency.
- Direct access to all information.

Disadvantages:

- Incurs high start-up costs.
- Requires significant coordination.

## **V. PROGRAM COSTS**

Direct comparison of the total costs of operating the MMS royalty program with those of the five State programs studied is not possible, and could be misleading. The primary reasons are: 1) the team could not collect comprehensive cost data from the States due to State resource constraints and time considerations; 2) the States do not compile their cost data at the same functional level as MMS does; 3) overall program costs for the States typically do not include systems costs (19.6 percent of MMS onshore royalty management costs in FY 1995) because State systems are shared between many agencies; 4) likewise, State costs provided to the team do not include production reporting/processing costs (8.3 percent of MMS onshore royalty management costs in FY 1995) which are part of sister agencies' non-allocable costs (except for GLO which does receive and process production reports); 5) major components of New Mexico's ONGARD system were not yet functional for the year studied; and 6) overhead costs for executive direction, regulatory development, policy analysis, office costs, and general administrative functions are not included in the States' budgets provided to the team. The team notes that the unavailability of comprehensive cost data for the State programs at the same level as corresponding MMS data is not due to lack of cooperation of staff and management of the five State royalty programs. The States are simply not required to compile costs in the same detail.

The team concludes that, even if comprehensive State costs were obtainable at the same level as MMS data, a direct comparison could be misleading because of some fundamental differences in the regulatory and public environments in the two types of programs:

- o State royalty programs are structured to address lease terms, statutes, and regulations grossly different from and generally less complex than the Federal milieu.
- o The Federal royalty program has been developed to manage a truly large annual revenue stream, generated from both a relatively small number of offshore leases produced primarily by major payors, and by a strikingly larger number of onshore Federal and Indian leases generally operated by smaller companies. States without offshore leases are not faced with similar contrasts in lease and payor demographics.
- o Another Federal cost component to manage onshore royalty revenues is incurred by formal appeals and enforcement processes, both of which are not separately performed in each of the corresponding State programs which have those processes.
- o Another component of MMS's onshore costs comes from addressing the large number of oversight and constituency groups, extensive regulatory development and affairs activities, and external reporting to the numerous constituencies, including congressional, IG, GAO, Treasury, and State royalty recipients. States do not incur similar costs.
- o Substantial budgetary outlays are made by MMS to comply with the array of performance standards placed upon Federal revenue collection and management agencies. State standards do not appear comparable in scope.

To address some of the data inconsistencies and basic program differences noted above, the team normalized MMS costs to the State costs provided by subtracting the following costs from MMS's \$36,806,454 in FY 1995 onshore costs: 1) RMP systems costs allocable to onshore Federal leases (\$7,241,314); 2) RMP's costs of production report processing and error correction allocable to Federal onshore leases (\$3,069,828); 3) overhead costs allocable to onshore Federal leases incurred by non-RMP MMS support organizations; i.e., costs for headquarters personnel and general administrative costs (\$1,212,113); 4) costs allocable to Federal onshore leases from RMP's Office of Enforcement (\$293,856); and 5) direct RMP program support costs for facilities, rents, procurement, personnel, and property management (\$5,629,354). Again, these costs were subtracted from MMS costs because they were not compiled within State costs provided to the team. The resulting, normalized RMP cost to perform onshore Federal royalty management is \$19,359,989. The normalized RMP cost is for Federal onshore leases only and does not include the costs to perform Indian royalty management. (Note: To provide a basis for certain comparisons below, the team also performed a similar calculation that normalizes the total royalty management cost for onshore, offshore, and Indian leases from \$80,648,840 to \$48,498,283).

The team comparatively assessed these normalized RMP program costs and the costs of the five State royalty programs studied. However, several qualifying comments are needed before proceeding. First, the cost information provided by the States was not audited or verified in any manner by the study team; it was requested by the team, sent and explained by the States, and used in this report. Second, the team made every effort to obtain State costs that relate to correlative MMS functions, and to understand exactly what functions these State costs are covering. However, the team cannot be absolutely certain that the costs provided by the States cover all State royalty management functions or that the costs provided by the States do not include some non-royalty functions. Lastly, because the States generally do not compile every facet of royalty program costs, there are components of the State-provided costs that are estimated. In conclusion, the observations given below should be considered first-order approximations for general comparative purposes only.

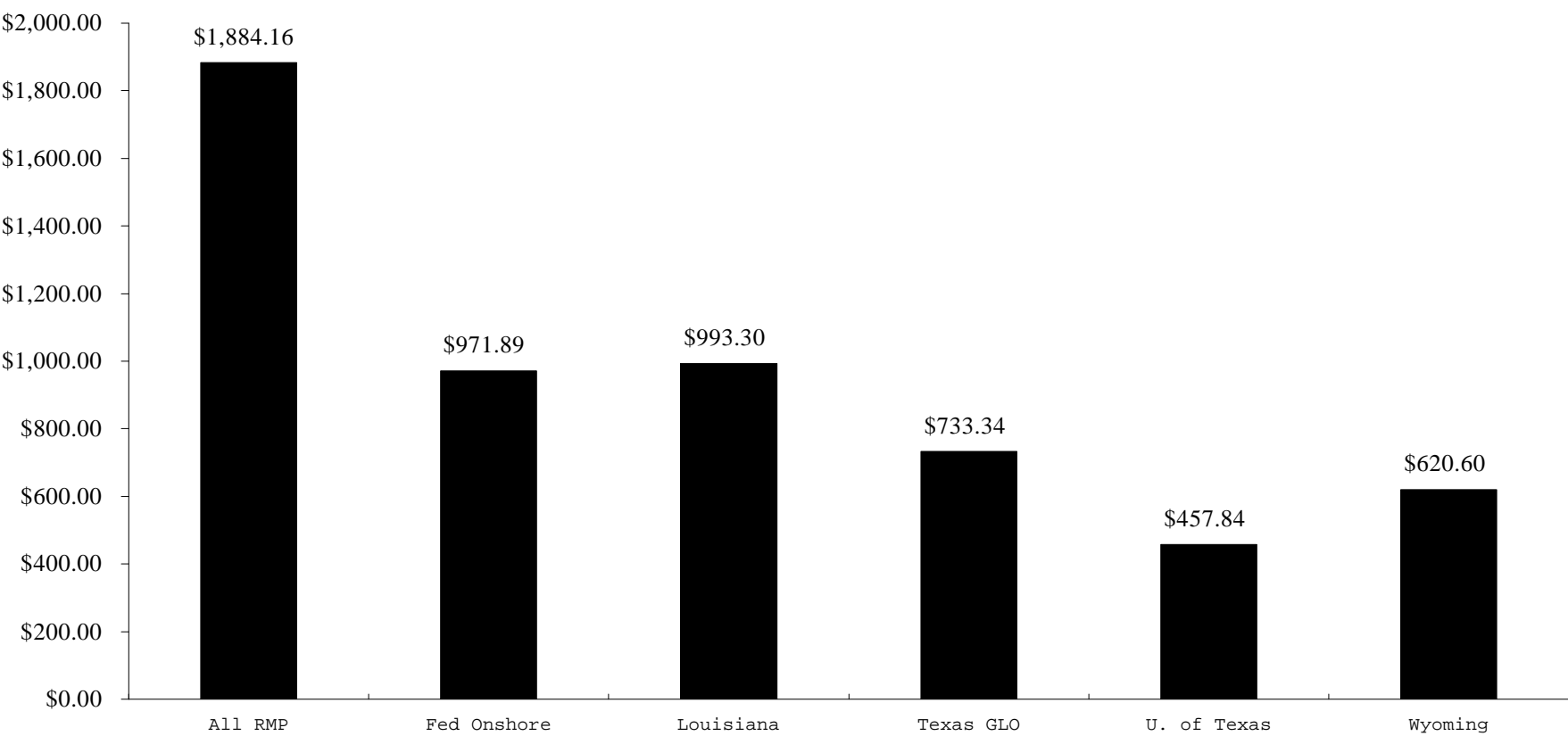
The team also notes that, despite compiling a large amount of data on MMS and State programs, an in-depth analysis of the effectiveness of MMS and State programs was beyond the scope of the study. Thus, although we offer some qualified cost comparisons below, the reader should note that the comparative specifics of what MMS and the States are accomplishing for their program budgets remain unclear. Accordingly, the most meaningful comparison of programs - program results per dollar expended - could not be made.

With these caveats, the team offers the following series of cost comparisons, which are summarized in Figures 1 through 4. All figures are based on FY 1995 data. Comparisons with New Mexico are not made because the ONGARD system was only partially implemented for the year studied.

- o On a cost per producing lease basis, the data for Louisiana (\$993 per lease), GLO (\$733 per lease), and RMP (\$972) are similar (Figure 1). The Louisiana, GLO, and RMP costs are higher than the program costs of the University of Texas and Wyoming, which are \$458 per lease and \$621 per lease, respectively (Figure 1).
- o Figure 2 shows that the costs per thousand dollars collected by GLO (\$11.51), University of Texas (\$16.35), Wyoming (\$16.68), and RMP (\$18.62) are similar, but are substantially higher than that of Louisiana (\$3.39). The cost per thousand dollars collected for all of RMP (onshore, offshore, and Indian leases) is \$12.56 (Figure 2).
- o Figure 3 shows that the revenues collected per dollar cost for GLO (\$86.90), University of Texas (\$61.15), Wyoming (\$59.95), and RMP (\$53.70) are similar but are much less than that of Louisiana (\$295.33). The revenue collected per dollar cost for all RMP (onshore, offshore, and Indian) is \$79.65 (Figure 3).
- o The team compiled a type of benefit/cost ratio for RMP and five State royalty programs, with benefits defined as additional royalties collected from verification activities (Figure 4). The State of Louisiana has the highest ratio of 15.04, followed by RMP onshore (3.68), GLO (2.46), Wyoming (1.40), and the University of Texas (0.64). The MMS offshore ratio is 5.28.

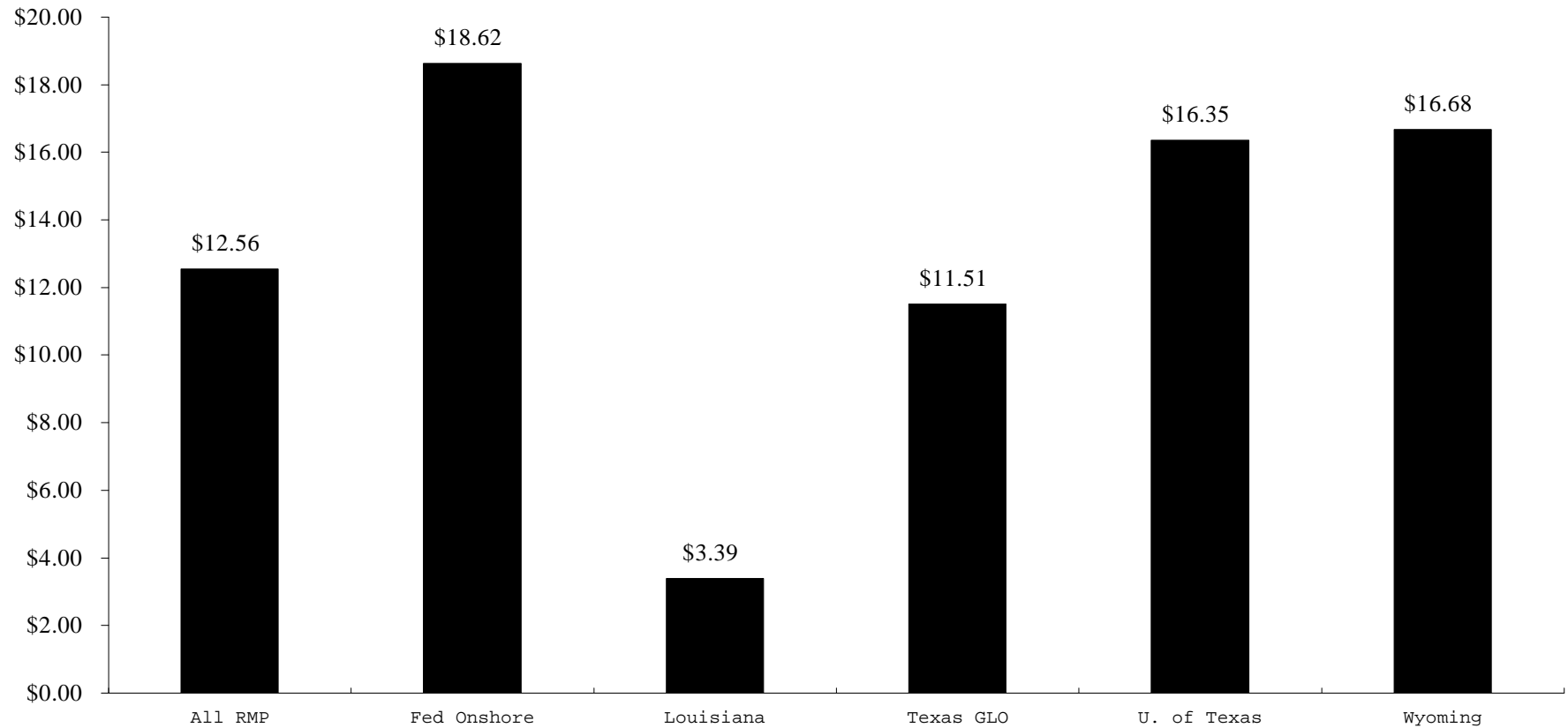
Only general conclusions can be drawn from these comparisons, namely: 1) the program costs of RMP, GLO, University of Texas, and Wyoming are approximately the same when compared to the amount of revenues collected (Figures 2 and 3); 2) the States (except Louisiana) are spending slightly more (when compared to the amount of revenues collected) than RMP is for its total program (onshore, offshore, Indian); 3) Louisiana and, to a lesser extent, RMP appear to rely heavily on royalty verification efforts to bring in additional revenues compared to the other programs studied; the team could not assess whether the low “benefit/cost” ratios of other State royalty programs were due to good initial compliance; 4) Louisiana appears to be spending substantially less than RMP and the other States when compared to the amount of revenues collected; the team could not assess whether this is due to efficiencies or the fact that Louisiana has by far the highest revenues per lease of the programs studied (\$293,347 versus \$52,188 average for RMP and the other State programs - Figure 5) .

**FIGURE 1: Reported Cost Per Lease**



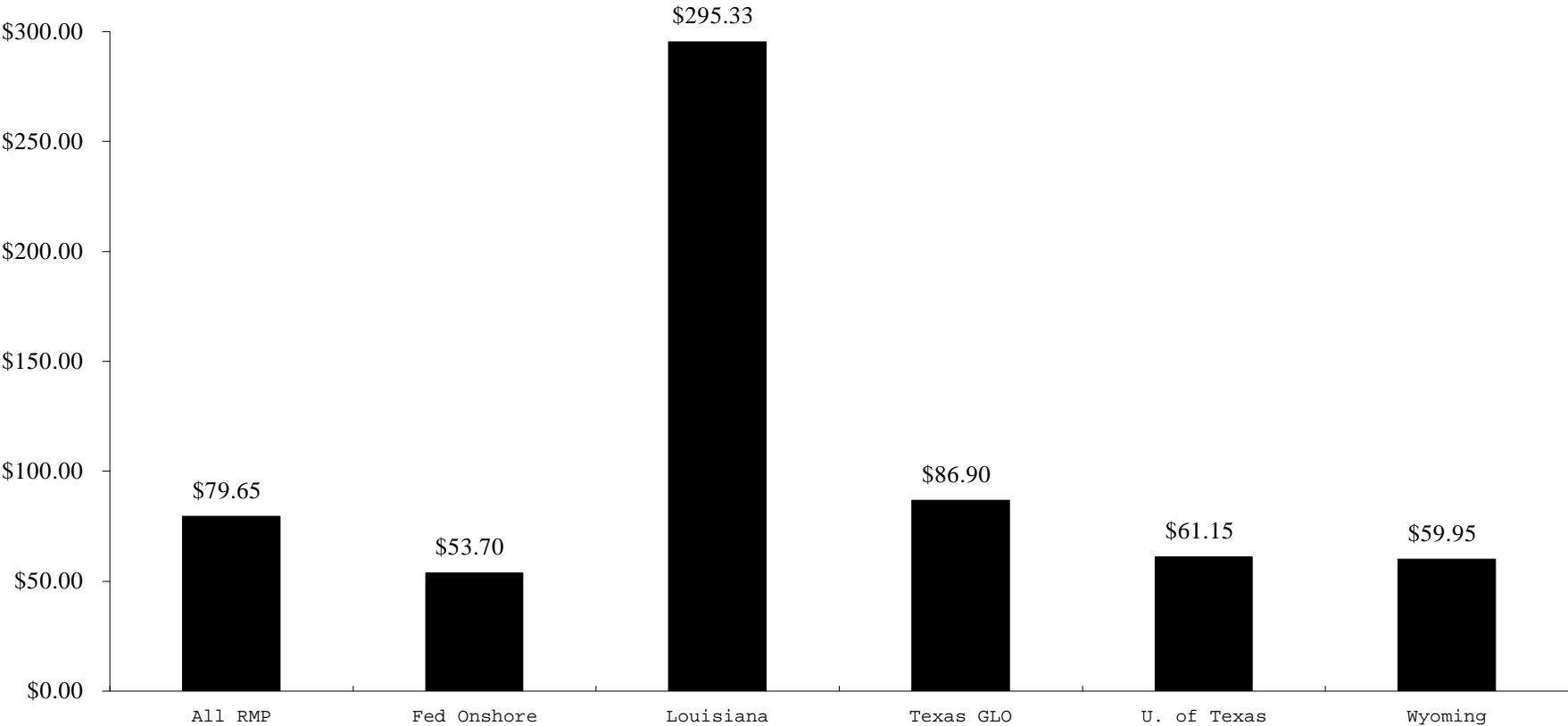
The data provided by each organization has not been verified. No analysis of effectiveness was performed, nor have mission differences been considered within the scope of this study. Material differences do exist among functions performed by the different organizations.

**FIGURE 2: Reported Cost Per Thousand of Revenue**



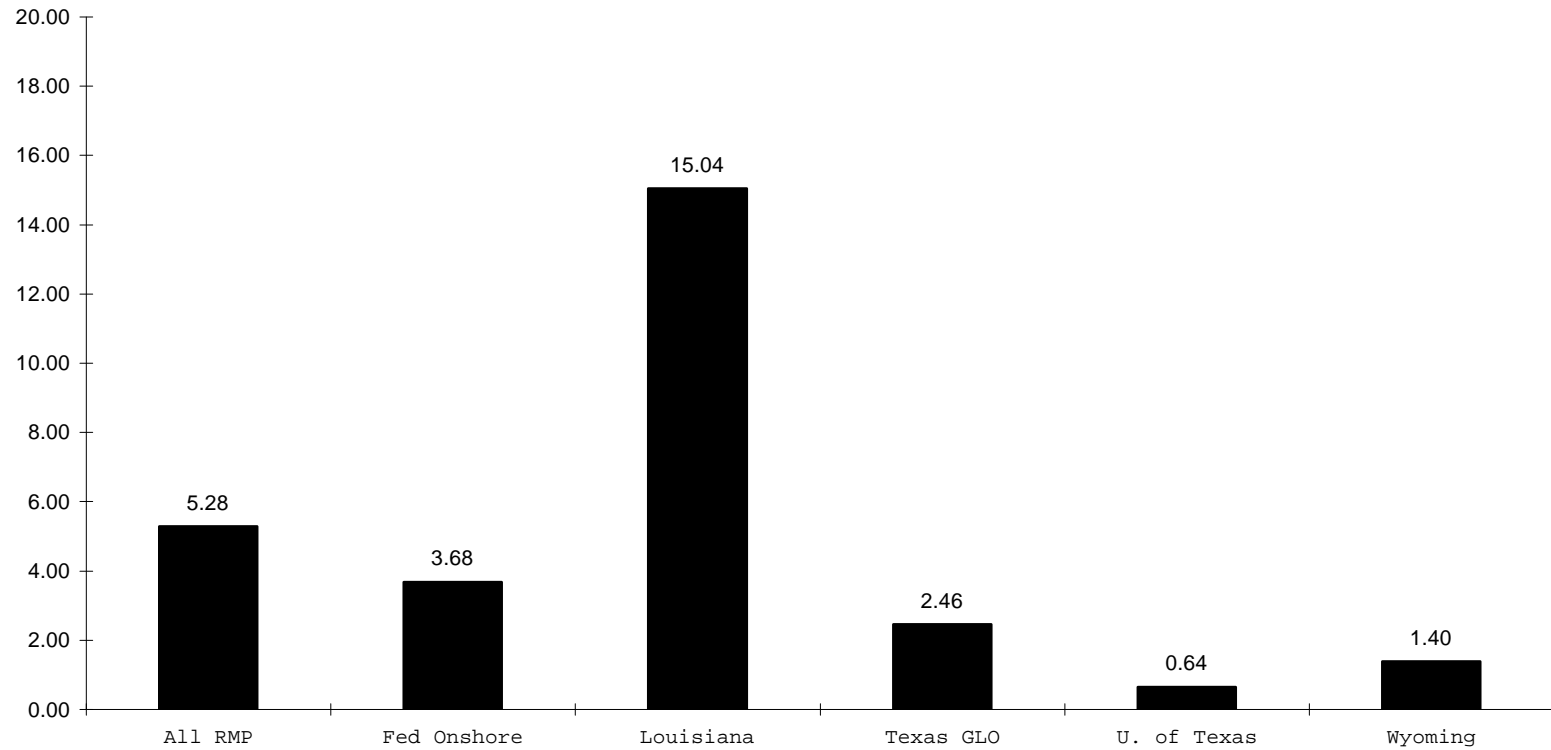
The data provided by each organization has not been verified. No analysis of effectiveness was performed, nor have mission differences been considered within the scope of this study. Material differences do exist among functions performed by the different organizations.

**FIGURE 3: Revenue Per Reported Dollar Cost**



The data provided by each organization has not been verified. No analysis of effectiveness was performed, nor have mission differences been considered within the scope of this study. Material differences do exist among functions performed by different organizations.

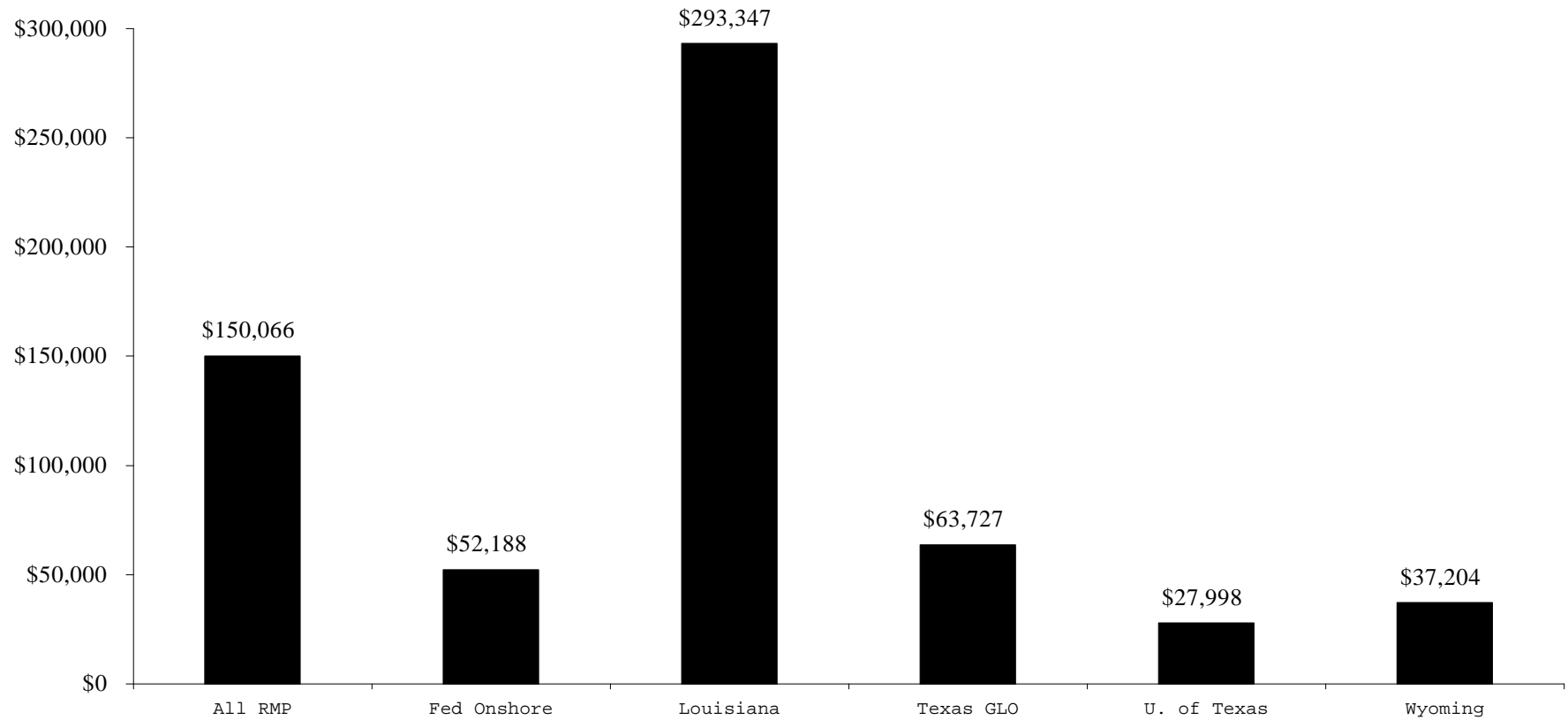
**FIGURE 4: Benefit/Cost Ratios**



The data provided by each organization has not been verified. No analysis of effectiveness was performed, nor have mission differences been considered within the scope of this study. Material differences do exist among functions performed by different organizations.



**FIGURE 5: Revenue Per Lease**



The data provided by each organization has not been verified. No analysis of effectiveness was performed, nor have mission differences been considered within the scope of this study. Material differences do exist among functions performed by the different organizations.

## VI. CONCLUSIONS

The team believes that this report provides a substantial amount of information to MMS and State royalty management personnel on the manner in which the Department and a variety of States manage their royalty management programs.

It became clear to the team during the study that there are numerous ways to approach and manage royalty programs. The major areas of divergent approaches were identified as:

1) revenue maximization or fair return; 2) lease- or payor-based accounting/auditing; 3) takes or entitlements reporting and verification basis; 4) in-kind or in-value programs; 5) in-house or field auditing; 6) manual or automated based work; and 7) integrated or compartmentalized approach. The team reached the following conclusions regarding these divergent approaches:

- o Although the team did not assess program effectiveness, the approaches taken by each of the States studied seem to be working well for their circumstances. There is no single correct method or approach.
- o The primary reason for many of the differing methods may be the scale of operations. New Mexico, Louisiana, and MMS are responsible for managing the largest amount of royalty revenues and/or the largest number of leases. Relative to the other States, these programs (especially the MMS program) rely more on automated systems and a compartmentalized work force, and place greater emphasis on field auditing and payor accounting.

On the other hand, the Texas GLO and, especially, the Wyoming programs have relatively smaller revenues or leases and rely more on manual methods, and place more emphasis on integrated, in-house work functions focusing on leases.

- o Much of the MMS program/approach has been molded by a high public visibility because of the magnitude of revenues and the large number of beneficiaries. This public scrutiny, which is generally not as intense in the State environment, has directly resulted in implementation of large automated systems, payor accounting basis, field auditing emphasis, takes-based reporting, and numerous performance standards.

The team believes that MMS should consider this benchmarking report when working with the States to develop program standards for delegated royalty functions under the RSFA. Although some standards will likely be driven by Federal statutes (e.g., Chief Financial Officers Act and Federal Financial Managers Integrity Act), there may be unique circumstances within a State that would suggest that unique standards be individually applied. Therefore, while the RSFA urges consistency and uniformity in reporting, flexibility is warranted. Thus, we suggest that standards for States should be based as much as possible on results rather than methods or process.

The team cannot make any absolute, unqualified conclusions on the costs of the Federal royalty program compared to State programs due to difficulties in obtaining comparable cost information

and the inherent ambiguities involved in contrasting differing programs without parallel assessments of their effectiveness. The comparisons that are made are approximations.

The primary intent of the study, to compare the Federal and State programs and identify State best practices for potential MMS adoption, has been satisfied - as much as possible when different types of programs are being compared. The MMS now has a better knowledge of selected State royalty programs and some of the factors that contribute to their design and operation. The team believes that this information will be useful to MMS in efforts to interact with and potentially delegate functions to States under the RSFA. The MMS also has a series of State best practices to consider for adoption or adaption within its Compliance Reengineering Project.

During the course of the study, the team found that the States studied were equally interested in improving their royalty programs through examination of other methods of conducting the business. The report and its work papers will also benefit these States should they decide to pursue best practices of other States or certain practices of the Federal program outlined herein. In this spirit, it would be advisable for MMS to allow States as much access as possible to the deliberations and conclusions of RMP's Compliance Reengineering Project, so that the benefits of this innovative project can be shared with our State partners in royalty management.

# STATE BENCHMARKING STUDY

## APPENDIX

### DESCRIPTION OF ROYALTY PROGRAM PROCESSES

The following is a detailed description of each State's royalty management program processes. We begin with a brief definition of each function as it was analyzed.

**Reference Data:** Maintenance of well, lease, and agreement information, as well as, payor/reporter information necessary in the management of royalty accounting, collection, and distribution.

**Document and Payment Processing:** Procedures for control and management of all remitted production/royalty documents and royalty receipts (check, EFT, etc.).

**Verification:** All activities (automated and/or manual) which verify the accuracy of royalty-related data reported.

**1. Error Correction on Production/Royalty Reports:** A process to detect and correct reporting errors on production and royalty reports which would affect disbursement accuracy and other downstream efforts. Examples of errors include incorrect well, lease, or agreement number, payor/reporter identification number, mathematical errors, and missing data, etc.

**2. Royalty Rate Verification:** A process which verifies that accurate royalty rates as established in the lease instrument have been utilized when production and royalty data are reported.

**3. Adjustment Monitoring:** The process of monitoring adjustments to original production and royalty information reported.

**4. Rents/Minimum Royalty:** The process of monitoring rent and minimum royalty obligations for under- or non-payment.

**5. Late Reports/Payment:** The process of identifying late reports and/or royalty payments and billing for those exceptions.

**6. Volume Comparison:** The process of ensuring that volumes on which royalties are paid are accurate.

**7. Valuation Monitoring:** The process of monitoring the accuracy of product values reported.

**8. Allowance Monitoring:** The process of assuring that allowances (transportation, processing, etc.) are properly computed and reported in accordance with existing regulations.

**9. Audit:** The comprehensive verification of volume, value, allowances, and royalty payments to source documents to ensure payors are in compliance with established rules, regulations, and lease terms.

**Payment Receipt and Funds Distribution:** Collection, accounting, and disbursement of mineral bonuses, rents, royalty payments, and other revenues to the appropriate accounts.

**Billing and Debt Collection:** The process of billing, collecting, and following-up on billed actions originating from audits, error correction, and other verification routines. Follow-up involves issuing notices and demands for payments to payors who have failed to pay timely and/or make corrections.

**Enforcement, Appeals, and Rules and Procedures:** Enforcement is the issuance of notices of noncompliance, assessment of civil penalties, litigation support, and coordination of settlements of disputes. Appeals is the process by which a company disputes a bill and the dispute is formally resolved. Rules and procedures is the process of reviewing, developing, and issuing regulations.

**Royalty-In-Kind Program:** The procedures for administering leases where production is taken in-kind and sold versus receiving royalty in-value for the production.

**Systems:** A function responsible for development, integration, maintenance, and operation of all automated systems used by the royalty management program, including system design, application software enhancements, data base administration, information services, technical support, and maintenance of local area network (LAN) environment.

## **I. ROYALTY MANAGEMENT PROGRAM**

### **REFERENCE DATA**

The MMS maintains automated reference files for all Federal and Indian wells, leases, agreements, and associated parties responsible for reporting and paying royalties. The data is mainly collected from BLM, BIA, and industry. This data is translated into an automated format and processed to produce a database file which supports accurate reporting of royalties. The reference data is available to all auditors/analysts through an online system or by report requests. Production information is reported at a lease, unit, and well level. Royalty information is reported at a payor, lease, revenue source, product code, and selling arrangement level.

### **DOCUMENT AND PAYMENT PROCESSING PROCEDURES**

Royalty payments and documents are due by the last day of the month following the month the product was removed or sold, unless lease terms state that royalties are due otherwise. Production reports are due by the 15th day of the second month following the month of production. The RMP receives approximately 72 percent of all royalty reports and approximately 55 percent of all production reports in an electronic format. Data is entered onto the mainframe system via data entry, imaging, optical readers, electronic mail, Electronic Data Interchange (EDI), tapes, and disk. Approximately 287,000 lines of royalty data and 380,000 lines of production data are processed each month. All reported information is available to users online in imaged and data screen formats.

### **VERIFICATION**

#### **1. Error Correction on Production/Royalty Reports**

All royalty and production reports are subjected to a series of edits on a line by line basis as they are entered into the system. There are 129 and 296 fundamental or “fatal” errors that will bar royalty and production lines, respectively, from acceptance into the database and must be corrected before the line is accepted and monies disbursed. Detailed error listings are generated by the system and distributed to staff assigned to that payor/operator. The responsible party is contacted by phone or letter to correct the error. When all fatal errors are cleared, a confirmation report is sent to the payor. The MMS has the authority to assess penalties for erroneous reporting, however, due to an “assessment holiday” no penalties are currently being assessed.

#### **2. Royalty Rate Verification**

Royalty rates are checked for accuracy on a monthly basis. Each royalty line is subject to an automated edit process. The RMP does not require the royalty rate

to be reported on the royalty or production reports. It is calculated by dividing the royalty value by the sales value reported on the royalty report. The calculated royalty rate is checked against the royalty rate contained in the reference database. The software identifies discrepancies for flat royalty rates and deviations from the acceptable range for step and sliding-scale royalty rates. A precise step and sliding-scale royalty rate exception processing program has been designed, but is currently awaiting resources for implementation.

### **3. Adjustment Monitoring**

Adjustments made to previously reported lines are reported on the current royalty report. A separate physical report is not required for adjustments. Adjustments made to lines previously reported generally require a two-line entry. The first line reverses the incorrect data and the second line reports the corrected data.

All adjusting lines must relate to a previously reported line. All adjusting lines are monitored by the system to ensure that a previous line was reported. If the system is unable to detect a previous line, an error report is created and manual research is performed. Once a line has been adjusted it is flagged in the system. If no match is found, the line is rejected.

### **4. Rents/Minimum Royalty**

Approximately 75 days prior to the lease anniversary date, the system will automatically send a two-part Courtesy Notice for each Federal lease in rental status. Rents are reported to RMP along with the Courtesy Notice or on the royalty report, dependent on the type of lease. Minimum royalty payments are payable at the expiration of each lease year and must be submitted on a royalty report on or before the last day of the month of the lease year.

Rent and minimum royalty under-payments are automatically identified and billed by comparing lease term information in the reference database to financial information in mainframe. If the lease term (rent/minimum royalty) amount due is greater than the amount paid, a bill is issued.

### **5. Late Reports/Payment**

An automated system detects late payment of royalties, rents, and bills and generates a bill for late-payment interest. The system will not calculate the interest amount until the entire royalty, rent, or invoice document has cleared.

As part of RSFA, interest will be paid to the payor on royalty over-payments. The RSFA also stipulates that a payor can elect to calculate the amount of interest

due and report it on the royalty report. The RMP is developing methodologies to implement these processes.

The MMS has the authority to assess penalties for late reporting; however, due to an “assessment holiday,” no penalties are currently being assessed.

## **6. Volume Comparison**

The RMP identifies and resolves discrepancies generated from an automated comparison of monthly sales volumes reported on production reports with those reported on royalty reports. This comparison is performed on all products at the lease/agreement level to identify potential under reported volumes and/or under payments. When a discrepancy is identified, the system generates a letter which will request the operator to identify the responsible party and verify the volumes, disposition, and allocation of production. The responsible party is then sent a letter requesting resolution.

While RMP does not currently receive source documentation to verify volumes reported on onshore properties, MMS does receive offshore oil run tickets which the system uses to compare to offshore oil sales volumes reported on the production report. After production reports are verified to the run tickets, the system compares monthly sales volumes reported on production reports with those reported on royalty reports.

## **7. Valuation Monitoring**

The RMP does not routinely perform in-house value verification for Federal production or for Indian oil production. However, the system is accessed on an ad hoc basis for special projects. The RMP does monitor Indian gas valuation through the implementation of major portion analysis.

Product values are manually verified to source documentation during audit. The RMP maintains a library of oil postings and gas index prices which can be accessed by auditors for use in verifying values.

For arm’s-length contracts involving oil, gas, and gas plant products, value is generally based on the gross proceeds accruing to the lessee under its contracts. For non-arm’s-length contracts, a prioritized benchmark system is used.

## **8. Allowance Monitoring**

The RMP allows a deduction for the lessees reasonable, actual, and necessary costs to transport production to an off-lease point of value determination. Processing allowances are allowed for the costs of extraction and recovery of gas



plant products from a gas stream. In addition, various allowances are allowed on solid mineral production. Allowances are reported monthly as a separate line on the royalty report at the payor/lease/revenue source/product code/selling arrangement level. Allowances on oil, gas, and gas plant products are subject to regulatory limitations by an automated system which detects allowances reported above these limitations. The system does not verify that allowances reported on the royalty report are *reasonable*. This function is performed during audit only.

## **9. Audit**

The RMP maintains a 5-year audit strategy designed to cover at least 86 percent of the Federal onshore and offshore total revenues and 90 percent of the Indian revenues. The selection of the audit targets is a combination of automated and manual processes. A royalty payment history is generated for each payor/lease combination which shows historical payment information. Major revenue payors are targeted for review. The highest revenue payors are host to RMP residency teams which reside at the company all year. Possible audit targets also include randomly selected payors and leases, major issues, gas plants, units, and problem reporters. Sample leases and months are chosen for each payor. Generally, most audit work is performed at the company's offices. Audits usually cover a 3-5 year period and are completed within 6 years, which is within the requirements of the statute of limitations imposed by RSFA. In addition to RMP efforts, there are 17 States and Indian tribes who have cooperative or delegated audit programs under the authority of FOGDMA sections 202 and 205. The States and Indian Tribes also target companies and issues which affect their respective State or Tribe.

## **PAYMENT RECEIPT AND FUNDS DISTRIBUTION**

Payments are received by either check or wire transfer and are deposited directly to MMS's account at the Federal Reserve Bank in New York. Approximately 96 percent of all funds are received by EFT. Check payment information is entered into the mainframe by a data entry contractor.

A receivable account is created when the reporting document is received. Each payment received by RMP requires a royalty report or bill document to direct the flow of money to the proper recipients. An account payable is created when the reporting document is matched with a payment and processed by the mainframe. Accounts payable are created for each line on the reporting document.

The mainframe uses fund codes and land classifications to accurately distribute monies collected by RMP to the proper recipient. Disbursements are made to 38 States, with up to 8 different categories of revenues for each State, 6 Federal agencies and 19 Federal Treasury accounts.

## **BILLING AND DEBT COLLECTION**

Bills are created manually and by the automated system. Bill payments must be accompanied by a royalty payment document. In collecting delinquent debt, RMP contacts the companies numerous times through various means including a Notice of Noncompliance. If payment is not received, RMP requests the leasing agencies to demand payment from lease sureties. The RMP writes off the debt - if it is uncollectible - as a last resort. The RMP also reports the delinquent debt to the Internal Revenue Service for taxpayer offset, if RMP has the taxpayer's identification number. Payors may contest a bill by written request.

## **ENFORCEMENT, APPEALS, AND RULES AND PROCEDURES**

The Office of Enforcement issues notices of noncompliance, assesses civil penalties, coordinates settlements and other alternative dispute resolution activity, provides litigation support, and oversees bankruptcy petition filings and collections.

The Appeals Division adjudicates all administrative appeals.

Rules and Procedures drafts all administrative procedure rulemaking and other public notices contained in Federal Register. They also complete steps needed to publish royalty and production reporting forms.

## **ROYALTY-IN-KIND PROGRAM**

MMS's onshore and offshore RIK crude oil purchased by small refiners totaled \$363 million, representing about 31 percent of the nearly \$1.2 billion in oil royalties paid to the Federal Government.

The Secretary may elect to take oil in-kind from a Federal lease when eligible refiners do not have access to adequate supplies of crude oil at equitable prices. When royalties are taken in-kind, affected Federal lease operators are notified in writing to make royalty entitlements available to a refiner. The operators are responsible for notifying appropriate payors of the RIK arrangements. When royalties are taken in-kind, the refiner is responsible for payment. However, reporting responsibility remains with the designated payor who will be notified by RMP of the RIK arrangement. The RMP bills the RIK refiner for the royalties reported by payors on the royalty report.

Payors are required to report the quantities and values of royalties which the refiner is entitled to during the reported sales month. All sales of royalty oil will be priced at the fair market value of the oil including associated transportation costs to the designated delivery point. The MMS bills the refiner using the unit price imputed from the royalty report. The refiner is also billed for an administrative fee which represents program costs for operating the RIK activity.

The purchaser must submit copies of any third-party agreements relating to the method and cost of delivery of the oil from the point of delivery under the contract to the purchaser's refinery. The lessee/operator shall provide a semi-annual report of the RIK oil entitlements which provides MMS, by lease, the monthly entitlements of royalty oil delivered by the lease operators to the purchasers.

The MMS also conducted a royalty gas marketing pilot for the period January 1, 1995, through December 31, 1995. The MMS had two objectives in conducting this pilot: 1) to find processes for streamlining royalty collections in a manner that reflects changes that have occurred in the gas market, and 2) to test a process of royalty collection which promises increased efficiency and greater certainty in valuation without compromising revenue collections.

The MMS took approximately 8 percent of the Federal royalty gas in the Gulf of Mexico and sold it to 14 competitively chosen gas marketers. The MMS received 8 cents less than the published index prices. This result is attributable mainly to the cost of moving the gas to the index point from the point of delivery.

The MMS negotiated volunteer agreements with lessees. The pilot team aggregated the volunteered leases into 36 bid groups that seemed to reflect major pipeline structure in the Gulf. Bidders were instructed to prepare bids based on specified published price indices. Bids were to be stated in terms of the published index prices plus or minus a differential chosen by the bidders. The bidders differential adjustments from the published index price were to cover all costs, including transportation, from the point of delivery at or near the lease to the index point interconnect.

The pilot was an operational success; however, it was concluded that royalties collected during the pilot were approximately \$0.0974/MMBtu less than would have been received had MMS continued to collect the royalties in value.

## **SYSTEMS**

The MMS's automated systems consist of three major components: 1) royalty accounting, 2) production accounting, and 3) common reference data base. The MMS strategy is to automate all possible functions using state-of-the-art hardware and systems design technology. Most programs run on a mainframe computer; however, transition of processing from the mainframe to a rapidly growing client/server network began in 1994. Since then, all new applications have been developed on the client/server environment. The MMS will migrate all mainframe applications to client servers as resources become available. There are 1,022 users of MMS's royalty management system, including States and Tribes.

Sophisticated data communication networks are in place for MMS local and distant offices to access the mainframe computer, client servers applications, E-mail, and imaged

documents. Users are able to access all data either through existing software which contains predefined reports, through the on-line creation of custom reports, or on an ad hoc basis.

## **II. LOUISIANA OFFICE OF MINERAL RESOURCES**

### **REFERENCE DATA**

The MID maintains lease, unit and well information in an automated database to support the accurate reporting and payment of royalties. This information is collected from industry and is maintained by the Land Division. This information includes such items as ownership history, net revenue interest, gross working interest and overrides, and assignment history. Production and royalty data is reported at a lease, unit, or well level.

### **DOCUMENT AND PAYMENT PROCESSING PROCEDURES**

Royalty reports and payments are due by the 25th the month following disposition, for oil or the 25th of the second month following disposition, for gas. The MID receives about 25,000 lines of royalty data per month. The number of lines per form varies according to the size of the payor. Approximately 90 percent of royalty data submitted is via magnetic tape. The MID anticipates 100 percent electronic exchange of royalty reports in the future. The MID is considering the purchase of PC's and software for companies unable to do so on their own. The MID believes the cost savings related to total electronic report filing will far outweigh the cost of purchasing this equipment up-front. Production reports are submitted to the Office of Conservation by the operator.

### **VERIFICATION**

#### **1. Error Correction on Production/Royalty Reports**

All royalty reports are pre-edited by the system for errors. Errors detected are classified as fatal or warning. The system generates a reject report which lists the errors. If the error can be corrected by MID's staff, the payment is accepted and allocated; however, the error will be reported as a rejected transaction for the payor. Errors which cannot be corrected by MID are sent back to the company for correction along with a narrative as to the nature of the error. A penalty based on the amount paid per line item up to a maximum of \$500 per report is assessed. This penalty applies to late or erroneous reports. For new reporters, MID allows one to two errors before penalizing them.

Production reports submitted to the Office of Conservation are also subject to a series of up-front edits.

#### **2. Royalty Rate Verification**

Royalty reporters are required to indicate the State's decimal on the royalty report. The reported decimal is automatically compared to the decimal residing on MID's database. This routine is performed on a monthly basis for all leases. Louisiana

has all fixed royalty rate leases, with one exception. In this instance, the terms of the lease allow for two different royalty rates to apply to a single lease based on depth of production. The MID will set up the different royalty rates as two separate leases. The MID plans on handling this situation manually.

### **3. Adjustment Monitoring**

Net adjustments are allowed on the royalty report unless the adjustment requires a two-line entry, such as correcting the lease/unit/well number or the State decimal. All adjustments must have an original matching line and are rejected if the adjustment results in net negative royalties. Once an adjustment is accepted, a reasonableness check is made on the net price; however, the range in the system is so large that only those price variances which are extreme will be rejected. All adjustments are reported using a single prior period adjustment code. No distinction is made between adjustment types. The MID strongly believes that allowing payors 60 days from the month of production to report and pay for royalties on gas production, significantly reduces the number of adjustments.

The MID is examining the possibility of flagging lines to denote whether the line has been audited, settled, audited for volume/value only, etc., thereby allowing MID to prevent adjustments to these lines. This will give MID a history of a particular lease/unit/well, as well as prevent adjustments to leases/audit periods which have been closed out.

### **4. Rents/Minimum Royalty**

Verification of the rental amounts and anniversary dates is conducted manually. If the rental payment is late or short and there is no activity on the lease, the lease will expire. A payment document is not required to be submitted with a rental payment. Automation of this check is planned for the new royalty system, but only to the extent to identify lease anniversary dates and those leases for which rent is due. The system will not contain an automated billing module for rents. If a rental payment is received prior to the due date and on the due date activity is proven on the lease, MID refunds the rental payment to the company.

### **5. Late Reports/Payment**

Companies are assessed a penalty for late reports, and interest and penalties for late payment of royalties. Interest and penalties are assessed depending on the length of time since payment was due and interest rates that apply. Late payment of royalties is billed 10 percent of the amount paid, or interest and penalties. The penalties are assessed per line item with a maximum amount per report. The receipt date of the payment is not contained in the system and late

payments and reports must be manually detected. The new system will incorporate the receipt date of the payment and this function will be automated.

The MID does not pay interest on royalty overpayments.

## **6. Volume Comparison**

The MID's volume verification process is automated on a by-request basis. The MID tries to look at all properties on a rotating basis by quarter; however, if resources are pulled for other projects, this may not occur. The MID compares volumes reported to the Office of Conservation to volumes reported to MID on the royalty report. The comparison is made at the royalty level on a field basis. Production data is requested from the Office of Conservation. Volume comparisons are performed using the following method: 1) the sales volume reported on the royalty report is multiplied by the royalty factor reported on the royalty report; 2) production volumes obtained from the Office of Conservation are multiplied times the royalty rate and allocation factors contained in the LOMIS system; 3) the result of each calculation is compared and volume discrepancies found at the field level are broken down by lease/unit/well code level. The MID estimates plant fuel, flare, shrinkage, and efficiency factors at a plant when comparing residue gas volumes. No volume verification is performed on NGL's. Louisiana believes performing the comparison at the royalty level eliminates discrepancies resulting from sales volumes being reported at inflated levels on the royalty report.

The payor is billed for any underreported volumes using the price reported for the other volumes that month. If other volumes were not reported, gas price indexes and/or oil postings will be used. The MID believes that using a dollar amount to bill for under reported volumes results in better responses from the company; it provides an added incentive to correct the error. Additional royalties paid must be reported on a separate royalty report. The MID plans to further automate the volume verification process in the new system.

The Office of Conservation also performs volume verification. Conservation obtains production, transporter, plant, and refiner reports. A comparison of these reports is made 6 months after receipt.

## **7. Valuation Monitoring**

Valuation monitoring is performed during field audit only. Oil posting and index prices are maintained on a database for use by the field auditors. Contract prices are accepted for arm's-length sales. For non-arm's-length transactions, the OMR first tries to obtain documentation for the downstream arm's-length sale. However, if the company will not furnish this information, a spot price at a hub,

reduced by transportation, is used to value the product. This price is usually higher than the index or posted price.

In the past, MID maintained a cross reference between contracts and the royalty report. The payor assigned each contract an identification number that was reported in a field on the royalty report. The MID discontinued this process because of the numerous reporting errors in this field.

## **8. Allowance Monitoring**

Deductions for transportation and processing costs from the value of production for royalty purposes are allowed. Payors are to report the allowance amount, by type, deducted from the value on the royalty report. There are no established regulatory limits for allowances. Allowance deductions are reviewed on a case-by-case basis as an audit item. Deductions are reviewed for permissibility and reasonableness of the deduction amount as to actual costs.

## **9. Audit**

The MID targets major payors and some intermediate companies based on total revenue. Audits generally cover a 3-year period. A master file is printed which shows historical information for payors by field. Major revenue fields are targeted for review. Sample leases, units, or wells within a field are chosen. In addition, MID looks at trends and anomalies to target. Transportation systems and gas plants are audited for a payor and expanded to other payors when a problem is detected. The MID also targets based on issues, such as contract settlements. Audit begins approximately 2 years from the date of the royalty payment. For example, audits for the years 1990-1992 are started in 1995 or 1996. Louisiana does not operate under a statute of limitations.

Additionally, MID has a lease fact-finding review whereby leases are reviewed periodically to look at income levels and development of the lease (development is analyzed by geologists).

## **PAYMENT RECEIPT AND FUNDS DISTRIBUTION**

Payments are made by EFT and check. All payments require an associated royalty document. Funds are deposited to the State Treasury and subsequently distributed to parishes within the lease. The system uses lease, parish, and royalty division information to accurately distribute royalties to the appropriate parishes. No interest is paid on monies distributed late.



## **BILLING AND DEBT COLLECTION**

Bills are manually generated by individual auditors/analysts. When additional royalty is due, the payor is sent a notice. If payment is not received, MID bills the lessee. Bills for small amounts are not pursued. When payment for a bill is made, it is submitted on a separate royalty report. Bills currently are tracked manually, however, the new system will automatically track bills. In addition, the lease file and a historical payor file will be part of the system.

The SMB must approve all lease sales and assignments. If unpaid bills exist, the SMB will not approve the payor's lease sale or assignment. There are no civil penalties.

## **ENFORCEMENT, APPEALS, AND RULES AND PROCEDURES**

The SMB handles all enforcement issues. Basically, once a company is put on demand, it has 30 days to respond before the SMB will begin forfeiture proceedings. The MID will resolve issues through settlement negotiations on audited issues only

No formal appeals process is in place. The SMB is not under the Administrative Procedures Act, therefore, a company's only recourse is to appeal to the SMB. The SMB's decision stands. A company can sue the SMB if they disagree with the decision.

The SMB is responsible for administering all rules and regulations. The MID is responsible for writing detailed procedures and guidelines for preparing and submitting royalty reports.

## **ROYALTY-IN-KIND**

Louisiana does not currently have an RIK program.

## **SYSTEMS**

The LOMIS is a mainframe system supporting SMB and the Office of Conservation. There are approximately 50 to 60 regular users. In addition, the public has access to the system via computers set up for that purpose. The possibility of installing dedicated lines for frequent public users has also been discussed.

The LOMIS represents a major operational tool available to MID for performing leasing and lease supervision activities. Major system segments include: Reference Table Maintenance, Property, Managerial Audit, and Lease History, and Development.

Louisiana is in the process of designing a new client server system entitled Production, Transportation, and Mineral System. The new system will be designed using Oracle software, which is user friendly and allows for the creation of online reports, thereby

eliminating the extensive use of programmers to obtain historical information. Many of MID's processes, which are currently manual, will be automated with the implementation of the new system. The costs of design and implementation will be significant, but Louisiana anticipates lower overall costs in the future due to the replacement of manual processes with automated processes.

### **III. NEW MEXICO STATE LAND OFFICE**

#### **REFERENCE DATA**

New Mexico maintains comprehensive well, lease, and agreement history through record systems at OCD, the TRD, and SLO. Production (reported to the OCD) and royalty are reported based on a property identifier. The property identified is defined as a common pool with a common property name and common operator, or a communitization agreement, or a unitization agreement. This identifier is assigned by the TRD and is maintained in New Mexico's royalty system. The reference data also includes point of disposition codes (POD) as identified by OCD for every transaction point in the State. Eighty-seven thousand POD's have been established.

#### **DOCUMENT AND PAYMENT PROCESSING PROCEDURES**

Royalty reports must be filed by the 25th day of the second month after the production month for which the report is required. Lease terms call for payment of royalties within 20 days after the month of production. To attain substantial compliance with lease terms, SLO and industry agreed to use an advanced or accelerated process. As a result, any remitter that remits an average of more than \$25,000 per month has the option to 1) place an advance payment on deposit with SLO and adjust it annually as necessary, or 2) remit the royalties due within 20 days of the month of production. Remitters that average less than \$25,000 are exempt from this process. The SLO receives approximately 20,000 to 25,000 royalty detail lines per month. Production reports are filed with the OCD. The EDI and EFT reports and payments are processed on a mainframe computer. Paper documents are processed manually. Future plans include electronic imaging/microfilming for EDI reports. Data from the documents is made available to the staff on-line and by hard copy, if applicable, or by downloading EDI filings. Data entry of royalty documents received on paper is through a contract with the TRD.

#### **VERIFICATION**

##### **1. Error Correction on Production/Royalty Reports**

Royalty reports are subject to an automated edit error process as they are entered into the system. Error detection notices are generated by the system. Errors are assigned by company and corrected by State employees if possible, or by contact with the remitter, if necessary. New Mexico's lease terms do not provide for penalties on late, missing, or erroneous reports. In extreme cases, action will be taken to threaten lease cancellation. The SLO has not yet had to revert to such extreme measures.

The OCD also performs series of up-front edit checks on production reports.

## **2. Royalty Rate Verification**

Royalty rates are calculated from the data reported on the royalty report and checked through an automated process to reference data maintained in the system. This process is performed on a monthly basis as reports are received. The rate varies depending on lease terms. The system generates an edit error report listing royalty rates that differ from the rates in the system. Staff members verify the royalty rate errors listed on the edit report to the actual lease agreement. Companies are notified of royalty rate discrepancies by correspondence and supporting documentation. Resolution is done on-line by a staff member.

## **3. Adjustment Monitoring**

The RMD requires remitters to submit a 2-line entry for adjustments. The incorrect line must be backed out and the new line reported. However, if the remitter fails to comply with this requirement, the system will accept net entries. The RMD establishes a sub account level for the accumulation of original and amended line entry data. The sub account is accessed to determine the account status. An account balance can never be negative. If accepting an adjustment would result in an account becoming negative, the line is rejected and the company is notified. When credit adjustments are appropriate, the system calculates a credit (by beneficiary) that can be applied to the current month's liability or used against future reporting on any property identifier with the same beneficiary.

## **4. Rents/Minimum Royalty**

The SLO collects rent on both producing and non-producing properties. Rental transactions are processed in a separate division from the royalty transactions, using a separate system module. At least 30 days prior to the anniversary date of the lease, the system issues a courtesy notice to the lessee, or his designee. If the rental payment is not received by the anniversary date, the lessee will be notified in writing. If within 30 days of that notice the rent has not been paid, a notice of lease cancellation will be sent to the lessee. Rental payments are identified, by lease number, on the check stub detail and do not require a royalty report to accompany the payment.

## **5. Late Reports/Payment**

The ONGARD system detects late payment of royalties, rents, and bills. An interest charge is assessed once the payment is received.

Royalty remitters have the option of calculating and reporting late payment interest on the royalty report. If the remitter elects not to calculate and report interest, or

reports less interest than is actually due, the system automatically issues a bill for the amount due.

Interest is not paid on royalty overpayments.

## **6. Volume Comparison**

The ONGARD system design includes a volume comparison process; however, this process will not be operational until certain databases are populated. The system will compare volumes reported on OCD production reports multiplied by the State Net Interest, to volumes reported on the royalty reports. This process will be performed at the lease and property level. Transporters, processors, and storage facility operators are also required to file monthly reports corroborating volumes received and delivered at points of disposition. Discrepancies will be identified on error reports and inquiry screens. Resolution will be by desk reviews, with correspondence and supporting documentation sent to the responsible remitter(s) as identified by the database. If information is insufficient to identify the responsible remitter, the letter will be sent to the operator.

## **7. Valuation Monitoring**

The ONGARD system design includes a valuation monitoring process, however the databases are still being developed. New Mexico's royalty report contains an arm's-length transaction field which must be answered either yes or no. This field is a tool used when determining whether a sale is arm's-length or non-arm's-length. Unit price valuation criteria (benchmarks) will be established for geographical regions, based on SLO Policy. The following processes will be implemented in the new system: 1) For unprocessed gas valuation, the quantity (mcf) from the royalty report and the quality (Btu) from the production report will be used to calculate MMBtu at a point of disposition level. The system uses the remitter line item gross proceeds less mainline transportation to calculate an average price per MMBtu to compare to an acceptable benchmark price. 2) For non-arm's-length residue gas valuation, the system compares the remitter line item gross proceeds less mainline transportation costs to net back to mainline index point. 3) For non-arm's-length valuation of NGL's, the system compares the remitter line item gross proceeds (per composite component gallon) to the Mont Bellevue component gallon price less average transportation and fractionation charges. In addition, gas plant operators are required to report to OCD inventories, production and shipments each month. The TRD's Natural Gas Processors Tax Reports show monthly NGL component volumes sold and product values. These liquids are segregated by their components so that the system can make valuation comparisons back to the gas processing plant for a given non-arm's-length remitter's transactions. 4) For crude oil valuation, if sold under an arm's length contract, the prevailing price shall be the price received under the

contract. If non-arm's length, the price prevailing in the field for oil or condensate of similar quality is applicable.

Remitters will be notified of discrepancies between their reported values and the benchmark values, by correspondence and supporting documentation. Discrepancies will be resolved through negotiation.

## **8. Allowance Monitoring**

New Mexico allows mineral royalty payments to be reduced by allowances for transportation and processing. Deductions are reported on the royalty report. If the value of the product is determined at a place other than the property, a transportation (mainline only for natural gas) deduction may be claimed to determine the royalty value. When the amount received from the sale of natural gas has associated processing-related costs, a processing deduction may be claimed in determining the royalty value. If costs of non-field activities are incurred by the lessee/royalty remitter to produce natural gas, gas plant products, or residue gas for market, then such cost may be claimed as a marketing preparation/other deduction.

The system edits allowances based on a reasonable range or tolerance. If the tolerances are exceeded, an exception report is generated and the company is notified. If the exception cannot be resolved by correspondence with the company a negotiated settlement may be considered.

## **9. Audit**

The RMD's audit function has primarily been issue based. The SLO conducts marketing and other special studies to determine areas of high risk. The SLO is currently conducting crude oil pricing audits. Audits are performed on a remitter, lease, property, and/or product basis and are conducted primarily in-house. However, occasional on-site field audits are performed. New Mexico does not have a statute of limitations.

## **PAYMENT RECEIPT AND FUNDS DISTRIBUTION**

Royalty payments are received by check or EFT and require an associated royalty document. Funds are deposited daily into an interest bearing account. Royalties are disbursed twice a month (EDI cycle and Paper cycle) to the State's permanent fund for the accounts of 22 beneficiaries, based on lease agreement and land location. Interest on delinquent royalty payments is distributed as current income to the respective beneficiaries.

## **BILLING AND DEBT COLLECTION**

Bills are created manually and by the automated system. Payment for bills must be accompanied by the designated portion of the original bill. Unpaid bills are collected through notices/assessment, phone calls and audit. If necessary, lease actions are taken, but this has rarely been necessary. Payors may contest a bill by phone and written request, however, this does not occur often.

## **ENFORCEMENT, APPEALS, AND RULES AND PROCEDURES**

The RMD does not have a separate enforcement function. Enforcement is handled in conjunction with all other RMD duties. The RMD does use settlement negotiations to resolve issues involving valuation.

The RMD has a formal appeals process for companies to appeal to the Commissioner. Specific time requirements apply to both the company and the Commissioner. However, to date the number of appeals has been very limited. No specific personnel within SLO are assigned to work appeals.

Rules and Procedures are written by the Director and limited staff, as well as, the Office of General Counsel. The associated cost is minimal.

## **ROYALTY-IN-KIND**

New Mexico does not currently have a RIK program.

## **SYSTEMS**

New Mexico's royalty management system, ONGARD, is an automated system designed to increase the oil and natural gas revenue stream of the State. All three agencies of the State that directly interact with the oil and natural gas industry use the system. These agencies are the SLO, the TRD, and the OCD.

The ONGARD contains the entire State land database of approximately 77 million acres which is identified down to a quarter/quarter section level ( approximately 40 acres) and is also identified by its ownership of Federal, State, Indian, or fee lands. The original database was obtained from the BLM and modified for ONGARD use.

This system provides a computerized environment where SLO, TRD, and OCD can share information to better coordinate revenue generation and monitoring activities. The integrated system removes the need for duplicate reporting of information by industry, avoiding possible confusion and misreporting. The system also provides the underlying foundation required for processing and monitoring a large number of transactions relating to oil and gas revenues.

The ONGARD assists the following activities relating to oil and natural gas: monitoring of land utilization, monitoring of natural resources, lease management, protection of correlative rights through oil and gas production proration, collection and reconciliation of oil and natural gas production and disposition volumes, collection of oil and gas taxes and royalties, disposition of oil and gas taxes and royalties, accounting for monies received and distributed, and audits of tax and royalty remitters for confirmation of adherence to statutes.

The ONGARD is an on-line system designed to be used daily by State employees working on any of the activities listed above. It provides information for higher efficiency and productivity. Data supplied by is captured electronically using State-appointed VAN, data entry screens and off-line or external systems. The ONGARD system processes this data and provides information on actions to be taken on monies received. It also monitors data reported by different industry reporters and ensures there are no discrepancies. An important component of the ONGARD system is the MIS-Decision Support Module. It provides reports for middle and senior management of the three State agencies and supports the audit/compliance function.



## **IV. TEXAS GENERAL LAND OFFICE**

### **REFERENCE DATA**

The GLO maintains well, lease, and agreement history information in hardcopy permanent files. The lease and agreement information is also maintained on an automated database to support accurate payment of royalties. This information is mainly collected from industry. The GLO also receives division orders which establish who will be remitting royalties to the State.

### **DOCUMENT AND PAYMENT PROCESSING PROCEDURES**

Oil and condensate production and royalty reports must be received by the 5th day of the second month following the month of production and the gas production and royalty reports are due on the 15th day of the second month following the month of production. All reports are filed on a State lease or unit level. Royalty and production documents are received by hard copy, EDI and on tape (currently 99 percent are hard copy, 2 companies currently send electronic data). The GLO receives approximately 3,000 oil production reports/lines and 5,000 gas production reports/lines from operators per month. After a series of manual edits are performed, the production reports are batched and sent for key entry. Approximately 7,100 royalty payment lines are received each month. The royalty payment document is coded with a GLO account number and State lease number and is sent to be key entered. Historical data is maintained on microfilm.

Production documents are received, edited, and sent to a contractor for data entry. Diskettes with the data are given back to GLO and loaded onto a LAN.

### **VERIFICATION**

#### **1. Error Correction on Production/Royalty Reports**

Production and royalty reports received by GLO are sorted and given to the staff for manual error detection and correction. The reports are verified for complete and accurate header information and correct calculations. Errors are corrected by GLO when possible and companies are notified of errors by phone. If GLO is unable to correct the error the reports are returned to the companies for correction. The GLO has the statutory authority to assess penalties for incorrect reporting. The GLO has proposed giving the reporter 3 errors before penalizing; however, this procedure has not been implemented.

#### **2. Royalty Rate Verification**

Royalty rates are reported on the production reports by the operator. Royalty rates may be fixed, variable, logarithmic, etc. The GLO manually verifies royalty

rates on a monthly basis as the oil and gas production reports are received. The royalty rate is verified by multiplying total gross value times the royalty rate maintained on document control sheets. This result is compared to the royalty due reported on the production report. Royalty rates are also verified during year-end lease reconciliation. Values reported on the production reports are multiplied by the royalty rate and compared to royalty payments received. Operators are notified of royalty rate discrepancies by telephone and/or letter.

### **3. Adjustment Monitoring**

Adjustments to GLO's production reports are made on separate adjustment documents. The GLO encourages two-line adjustments whereby only the affected fields are listed as originally reported and as corrected. Although GLO prefers adjustments not to be netted, some payors do net on the royalty report and GLO will accept the line.

### **4. Rents/Minimum Royalty**

Each day, a manual check is made of leases having anniversary dates with rental payments due the previous day. If rental payment has not been received, a check is made to determine current status of the lease. Rental history is maintained on an automated rental ledger.

Rental and minimum royalty payments are submitted by a separate check along with a check stub identifying the payment as such. Royalty reports are not required to be submitted with rental and minimum royalty payments.

### **5. Late Reports/Payment**

Companies are manually assessed penalty and interest for late or missing reports and payments. The penalty for late payments is based on a per-lease, per-month basis. Penalties for late or missing reports are assessed per form. Interest accrues on all delinquent royalties beginning 60 days after the due date. When issuing bills, GLO includes interest and penalties. If the payment is not made on time or is less than the amount due, GLO will manually calculate a bill. Interest is not paid on overpayments of royalties.

## **6. Volume Comparison**

At the time of lease reconciliation, production information reported to GLO is manually compared to information reported to the RRC (performed approximately 6-8 months after the end of the fiscal year). The GLO prefers performing the volume comparison at year end because it allows for adjustments to both GLO and the RRC to clear. The volume comparison is performed by RMD at a lease level for all leases. This is an in-house process.

The GLO works over- and underreported volumes which meet certain thresholds. For “unders” which cannot be resolved by GLO, the company is contacted by telephone or written correspondence for clarification. If additional royalty is due, a “Notice of Underpayment” letter, along with supporting documentation and assessment of penalty and interest are forwarded to the company. The GLO uses the price paid for other sales that month to value the production. If no other sales took place, the sales price for the previous month and/or following months will be used for billing. For overreported volumes, GLO sends the company a letter which states that it appears volumes may be overpaid. If the dollar amount is within certain thresholds, the issue will not be pursued further.

The RRC receives oil transporter reports which are compared to the operator’s production reports. No volume comparison is performed by the RRC on gas production.

## **7. Valuation Monitoring**

All valuation monitoring is conducted during field audit by the RAD. Gross proceeds is considered market value for royalty purposes. The contract price is accepted for arm’s-length sales. Sales in the field or area of similar gas are reviewed to determine if non-arm’s length transactions are reasonable. The GLO establishes field and area by using the Railroad Commission’s district parameters, but the area is difficult to determine and is often an issue of contention with the companies.

## **8. Allowance Monitoring**

The GLO does not generally allow deductions for transportation and processing from the value of gas production for royalty purposes. However, the cost of reasonable transportation for oil is allowed. Allowances are usually netted in the price. Allowances taken are reported separately on the production report for federal leases and reviewed only during field audit procedures for State leases.

## **9. Audit**

The RAD is responsible for conducting on-site reviews (field audit) of select royalty payors. With the inception of the audit program in 1985, the top 60 royalty payors were targeted for audit covering the period 1978 through 1985. Sample leases are selected for each payor. The RAD continues to audit within that original population. Only a few companies have been audited more than once. There is an effort to audit every company before re-auditing other companies. In addition, RAD targets prevalent issues and conducts audits based on referrals from the field operations division, royalty management division and private citizens. Since its inception, RAD has audited approximately 10 percent of its lease universe. Texas does not have a statute of limitations.

### **PAYMENT RECEIPT AND FUNDS DISTRIBUTION**

Royalty payments may be received by cash, check, money order, sight draft, EFT, or in any manner that may lawfully be made to the State Treasury. All payments require an associated royalty document. The GLO disburses royalties to approximately 60 GLO accounts and 3,000 lease accounts, the primary account being the Permanent School Fund. All royalties are initially sent to the Permanent School Fund which is an interest bearing account. Disbursements to other GLO accounts and lease numbers are automatically made each week. The GLO does not pay interest on late disbursements.

### **BILLING AND DEBT COLLECTION**

Bills are created manually. When creating a bill for underpaid royalties, GLO also calculates penalty and interest due and includes these amounts in the bill. For purposes of assessing interest, usually a 2-week window is allowed whereby the company can pay without owing additional interest. If payments are received after the 2-week window, GLO will send a second bill for the additional interest when the payment is received. A copy of the original billing must accompany the bill payment. If payment is not made timely, a follow-up letter will be sent. If the issue remains unresolved a notice is sent to the legal division to start forfeiture proceedings.

Payors may contest a bill by written request, however, this does not occur often. A payment can be suspended if the billing is proven by the company to be in error.

### **ENFORCEMENT, APPEALS, AND RULES AND PROCEDURES**

The GLO does not have a separate enforcement function. The GLO does resolve disputed issues by way of settlement negotiations. Third-party neutrals are used as mediators in the settlement process. The GLO has the authority to assess civil penalties for noncompliance with State royalty reporting or other requirements.

Only the field audit division (RAD) has a formal administrative appeal process. Companies are required to file appeals within a specified time frame; however, GLO doesn't have specific time frames for processing an appeal. The GLO is not required to pay interest to a company if the appeal is granted in favor of the appellant.

The GLO does not regulate oil and gas production. This function is under the jurisdiction of the RRC. However, GLO does promulgate regulations on royalty issues.

## **ROYALTY-IN-KIND**

Approximately 37 percent of gas royalty volumes (serving 141 customers) and 45 percent (2400 bbl/day) of total royalty oil is taken in-kind. The GLO plans on taking 80 percent of gas in kind for a 3-year trial program. If this proves successful for gas, there are plans to do the same for oil.

The Texas lease form states, "Lessor may, at its option, upon not less than 60 days notice to Lessee, require at any time or from time to time that payment of all or any royalties ... be made in kind ..." For leases where Texas takes production in-kind and must pay for transportation, the average transportation costs are \$0.15 per Mcf. Texas has a mandatory RIK policy. The GLO issues a letter to the lessee stating where they want to take the gas and when the process will begin. This is subject to negotiation but companies are usually cooperative. The GLO looks to see if the company has been deducting transportation when paying in value and uses the same basis for the royalty collection point. In general, the gas is taken at the first pipeline interconnect.

Most gas is not processed. However, when it is, GLO takes the residue gas in-kind at the tailgate of the plant and lets the producer pay the liquids royalties in value. When collecting in value, Texas allows no processing cost deduction, but allows a deduction for liquids retained by the processor.

The GLO has five people running their RIK program-- four people located in Austin handle the accounting with producers and pipelines and one person in Houston handles spot sales and sales to end-users. They have to arrange for storage and transportation in order to get gas to distant end-users--this is complicated because of balancing. They also have to deal with cash-outs. They negotiate rates with each pipeline they use; they usually can negotiate discounts from max-IT rates for interstate pipelines.

Spot sales generally involve gas taken at the first pipeline interconnect, and the purchasers net back from the applicable index point. They typically get about 15 cents below index. Nevertheless, GLO maintains that they get about 7 percent more than what the operator is getting. (They can calculate this using the 5/6 method--for them probably a 3/4 method--because operators still have to file royalty reports even if paying in kind. Texas is considering requiring a simplified report for this purpose. Operators also have to file production reports.

The money made by GLO on RIK production is primarily because of sales to a multitude of small government consumers who otherwise would have to pay local distribution company rates.

The GLO also takes oil in-kind. They put volumes up for bid every 6 months and take the best offer. The oil is sold to majors and to Natural Gas Clearinghouse, among others. GLO takes approximately 2400 bbl/day in kind, which equates to 45 percent of their total royalty oil. The GLO takes the oil generally at the LACT unit where the oil goes into the pipeline or tanks.

## **SYSTEMS**

The GLO has a centralized mainframe system dedicated to royalty management. There are 12 major systems: 1) Royalty Accounting Tape Reporting System, 2) Royalty Accounting Reporting System, 3) Royalty Accounting Payment System, 4) Oil/Gas Charge/Credit Voucher System, 5) Royalty Reporting Lease History System, 6) Mineral File Numbers/Railroad Commission Lease/County System, 7) Oil & Gas Production Report Price/County System, 8) State Comptroller/RRC Cross Reference System, 9) Rental System, 10) Land Office Data System, 11) State Real Property System, and 12) School Land Master System. There are approximately 65-70 users of the system.

## **V. UNIVERSITY OF TEXAS**

### **REFERENCE DATA**

The ULAO maintains all well, lease, and agreement history information in an automated database which includes working interest ownership information. The ULAO relies on data provided by the RRC on University wells, operator contacts, and field visits to establish their reference database. Production data is reported at the lease/unit level. Royalty data is reported at a lease level.

### **DOCUMENT AND PAYMENT PROCESSING PROCEDURES**

Oil and condensate royalty payments and royalty and production reports are due by the 5th day of the second month succeeding the month of production. All gas royalty payments and royalty and production reports are due by the 15th day of the second month succeeding the month of production. The ULAO receives approximately 2,200 oil production reports and 2,200 gas production reports per month. This equates to approximately 26,900 production lines per month and 32,400 royalty lines per month. In addition, approximately 550 royalty payment reports/summaries are processed each month. Data is entered via data entry into the mainframe computer. The ULAO notes that the job of sorting and filing individual documents will soon be replaced by imaging.

### **VERIFICATION**

#### **1. Error Correction on Production/Royalty Reports**

Errors on ULAO royalty and production reports are detected through manual review and computer system audits. Companies are assigned to particular analysts and rotated on a 1-2 year basis.

Errors are corrected by either ULAO or the responsible company. If an error is correctable by the analyst, the company is notified by phone. If there are numerous errors or the error cannot be fixed by the analyst, the report is sent back to the company along with a letter explaining the error. Companies are assessed a penalty for errors deemed flagrant or redundant month to month. This is a subjective call by the analyst. All correspondence with a company is noted on audit sheets, which allows for ULAO to maintain complete error history on each company. This enables the analyst to determine if the company has made the same error in the past. The ULAO hopes to automate the audit sheets to allow for more efficient online access to the correspondence information.

## **2. Royalty Rate Verification**

The ULAO requires the royalty rate to be entered on the production reports. Royalty rates are fixed, as established by the lease terms. On a monthly basis, ULAO identifies royalty rate discrepancies reported on the production reports, using an automated program. Gross value reported on the production reports is multiplied by the royalty rate in ULAO's system. The calculated royalty value is compared to royalty values reported on the production report. Variance of \$1 or more will be resolved. The operator is notified of any royalty rate discrepancies that result in incorrect royalty payments.

## **3. Adjustment Monitoring**

Adjustments are made on separate adjustment documents. The ULAO does not allow net reporting and requires supporting documents (e.g., purchase statements) to accompany each report. Adjustments to royalty payments are made directly on the royalty report.

Corrections on the production reports are automatically matched to the original reported line(s). If no match is found the report is sent back to the operator. The total adjustments cannot result in a negative or zero royalty.

The ULAO has a low number of adjustments. The ULAO believes that the low number of adjustments can be attributed to the extended time allowed for filing and to the fact that penalties were added for incorrect reporting.

## **4. Rents/Minimum Royalty**

Rentals and minimum royalties are submitted by a separate check and must be accompanied by a check stub that clearly identifies the payment as such and shows the lease number and complete property description. Royalty reports are not required to be submitted with the payment. The ULAO identifies rental and minimum royalty discrepancies by an automated program that runs on the lease anniversary dates.

## **5. Late Reports/Payment**

If royalty is not paid when due, a penalty (based on a percent of royalty), escalating with time, shall be added to the unpaid amount due. In addition, interest shall accrue on delinquent royalties beginning 60 days after due date. Late-payment penalty and interest payments are to be accompanied by the green copy of the penalty letter and any other requested documents.



If a report or supporting document is not filed when due, a penalty accrues in the amount of \$10 per document per month.

The ULAO's bills include interest and penalties. When a bill is sent, the recipient has 30 days to respond to the bill. Interest is calculated for 15 days of that period. The ULAO splits the difference.

Interest is not paid on overpayments.

## **6. Volume Comparison**

Volumes reported on ULAO's oil and gas production reports are manually compared on a yearly basis against volumes reported on purchase statements or run tickets. Data contained on the purchase statements or run tickets are not entered into the system. This comparison is performed on approximately 50 percent of the leases each year.

The ULAO also has an automated system that identifies volume discrepancies for oil production based on a comparison between ULAO's oil production report and production volumes reported to the RRC. This comparison is performed at a lease level on all ULAO leases producing oil and/or condensate. The ULAO plans to automate this process for gas also.

If volume discrepancies are identified, the operator is contacted to explain the discrepancy. The operator is assessed a penalty if the discrepancy is not resolved. The operator is responsible for reporting 100 percent of the production and royalty payment due whether paying 100 percent or not. If the operator does not pay, ULAO will bill the lessee. A check is made during the yearly reconciliation to ensure the payor adjusts its royalty payment based on the corrected volumes, if volume discrepancy affects royalty. The ULAO works both overs and unders which exceed a set threshold. In working overs, ULAO sends a courtesy letter to the operator stating that there may have been an over payment. The ULAO believes it can bill for unders and send letters on overs with much certainty, due to the fact that source documents must accompany all production reports.

## **7. Valuation Monitoring**

The ULAO does not currently have an automated system which identifies valuation discrepancies. Value is reviewed during the desk and company audit processes.

The ULAO obtains base gas contracts and subsequent amendments which are briefed and entered onto a database. The ULAO uses the contract to match all leases associated with that particular contract. The ULAO maintains a library of

oil posting and gas index prices. In addition, ULAO requires that purchase statements be filed along with the production reports for oil and gas. At yearly lease reconciliation, reported value is compared to contract price and the purchase statement. Operators are notified of valuation discrepancies by assessment letter. The ULAO reviews approximately 50 percent of the leases per year during lease reconciliation based on assigned risk factors.

The ULAO requires the operator to report the unit price for the product on the production report. The operator obtains this information from each working interest owner. If more than one working interest owner is marketing its own gas, the operator must file a schedule showing the appropriate information for gas sold under each contract.

The first point of sale is the proper point to value royalties. Arm's-length transactions for gas are valued at contract price (usually based on an index). Oil is valued at the wellhead and prices are usually tied to postings. Non-arm's length transactions require a review of other sales in the area. The ULAO tries to use the same product stream for comparison; however, when this is not possible, reviews of other contracts in the area of similar quality gas are conducted. The non-arm's sale must be an equal to or higher than the price received for the arm's length sale. If additional royalties are due based on this criteria, ULAO will bill the operator and provide a list of leases that were looked at to determine the appropriate price. It is the responsibility of the company being billed to obtain the relevant information. The ULAO stated that it is difficult to define the area.

## **8. Allowance Monitoring**

Deductions are not allowed up to the point of sale, in most cases. If the value is determined at a point downstream from the point of sale, ULAO will allow deductions for the reasonable costs of transportation to that point. Affiliate deductions are not allowed if ownership of pipelines and plant is the same. Allowance rates for oil are reported on a unit basis on the oil production report, although the unit prices reported on the oil and gas production reports are usually reported net. The ULAO does not have established regulatory limits for allowances. The ULAO has no routine process to monitor allowances. Allowances are reviewed during audit only; however, review is minimal because ULAO usually accepts the contract price and deductions are frequently built into the price.

## **9. Audit**

Companies are targeted based on total royalty revenues and/or problem payors. Company audits are performed on-site at select payor companies. The ULAO has been performing approximately 4 company audits per year, out of 300 companies.

Sample leases and months are chosen for review of the past 2-year period. If discrepancies are detected, the sample period can be expanded. There is no statute of limitations.

The ULAO prepares audit sheets which contain all pertinent information available from ULAO's systems. This enables the auditors to access basic information prior to starting an audit. The audit sheet contains information such as the royalty rate, contract numbers, pricing terms, purchaser, lease numbers, etc.

## **PAYMENT RECEIPT AND FUNDS DISTRIBUTION**

Payments received are by EFT and checks and are deposited daily into UT's Permanent University Fund and Available University funds. All royalty payments require an associated royalty document. Allocations are made to the 2 funds containing 11 accounts and 47 sub-accounts. The payment is allocated based on the royalty report. Payments are reconciled monthly. Refunds are made for overpayments; however, no interest is paid.

## **BILLING AND DEBT COLLECTION**

Bills are created both manually and by the system. When creating a bill for under-paid royalties, ULAO calculates penalty and interest due. The responsible party has 30 days to pay the bill. Interest is calculated through the 15th day, thus splitting the difference. If the bill is paid anytime within the 30-day period, no additional penalties or interest is due. Bill payments must be accompanied by the royalty document, a green copy of the penalty letter, and any requested documents. If payment is not made timely, a follow-up letter will be sent. The ULAO's suggests that operators pay undisputed amounts or unpaid royalty to stop penalty & interest from accruing. Payors/reporters can contest a bill, but ULAO has no firm policy. This is generally not a problem, due to timely audit and reconciliation activities.

In collecting delinquent debt, ULAO notifies the company of its existing obligation. If the issue remains unresolved, the issue is turned over to the legal department to begin the lease forfeiture process.

## **ENFORCEMENT, APPEALS, AND RULES AND PROCEDURES**

The UT System, Office of General Council, and the Attorney General's Office perform the enforcement program for ULAO.

The ULAO receives very few appeals, therefore no formal appeals process exists. Of the few appeals received per year, resolution time is usually within 12 days.

The ULAO follows State statutes and issues a manual as a guide to filing reports.

## **ROYALTY-IN-KIND**

The University has developed an extensive in-kind program involving about 50-60 percent of oil and 15 percent of gas. The in-kind oil comes from areas where there is an extensive pipeline system serving the field. Lease studies are performed to check production and to determine if ULAO can make money by taking product. The ULAO markets its in-kind production itself.

The ULAO markets approximately 3,500 barrels of crude oil per day which represents about 55 percent of University oil production. The cumulative total net revenue enhancement of the RIK oil program from July 1990 (established) to December 1995 is slightly over \$5,000,000. This amount represents revenue realized over and above royalties which would have been received as traditional cash royalties. The average net enhancement is \$0.72 per barrel. All royalties go directly to UT.

Oil RIK is based on entitlements, whereby the purchaser pays whether taking delivery or not. The ULAO has realized a net revenue increase above what would have been received if received in value. Prices are determined via the posted price plus a market bid. Gravity is deemed to be 40 degrees API. Transportation is arranged for by the purchaser. The ULAO uses a single posting, chosen because of the large volumes moved on that posting. Once a bid is received, ULAO only has to look at bonuses/premiums to choose the best price. Contracts are usually 6 months in length.

For gas, nominations are made by lessee/operator. Price is established through competitive bidding. The operator tells ULAO what the nominated volume is; ULAO tells the purchaser what it will receive. The purchaser then pays on that volume. Imbalances are kept with ULAO due to timing issues.

The ULAO requires the lessee to file a production report and the purchasers are required to provide a schedule with the check. The ULAO maintains its RIK history on a PC. A "dummy" lease is credited for distribution. There is a monthly audit which compares purchase statements for other sales against the RIK price received.

## **SYSTEMS**

The University of Texas has a centralized mainframe system. University of Texas System has a department dedicated to maintaining a LAN which serves over 400 users. In addition, the mainframe also supports all University functions and allows access by students. The Data Processing Department is responsible for setting certain standards and maintaining the system. The ULAO rents access to the mainframe system, which is used to create and maintain departmental computer programs for oil and gas accounting purposes. The ULAO also contracts with the Data Processing Department's programmers and expects to upgrade their programs over the next 2 years.

## **VI. WYOMING STATE LAND OFFICE**

### **REFERENCE DATA**

The LO maintains lease, well and agreement information in hardcopy files. This information is used to update LO's automated reference database, which is used by the royalty system for verifying information on royalty reports. Production (reported to the OGCC) and royalty data are reported at a lease, unit, and tract level.

### **DOCUMENT AND PAYMENT PROCESSING PROCEDURES**

Wyoming's royalty and sales data are reported on the same report. The reports are due 30 days after the month of production/sales for oil and 60 days for gas. The LO receives approximately 761 reports per month which equates to 2,660 lines per month. Reporting to the LO is on a lease basis, one report per month for each lease and formation (participating area). The LO receives all of its reports hardcopy. The OGCC receives monthly production information from the operator, by lease, with production shown for each well. Wyoming is currently working on implementing electronic reporting.

### **VERIFICATION**

#### **1. Error Correction on Production/Royalty Reports**

All royalty reports are manually reviewed and compared to purchase statements before they are entered into the automated system. As data is entered, the system compares lease reference information on the royalty report, to the lease data base. The system alerts the technician by emitting an audible tone and flashing the cursor when key data elements do not match. At this time, it also calculates the expected royalty due and produces the same response for errors. Some errors are corrected on-line at the time technicians enter data into system. If the technician cannot correct the error, the company is contacted by a telephone call or occasionally by a letter. No assessment is charged to the reporter for report errors.

In addition, as production reports are received by the OGCC, they are subjected to a series of up-front edit checks to verify consistency with OGCC's lease reference data base. The OGCC reference database is reconciled to the LO database on an as needed basis.

#### **2. Royalty Rate Verification**

Royalty rates are elements of the lease reference file and are all fixed rates. The system identifies potential royalty rate errors as each line is entered. The expected royalty amount is calculated for each line item by multiplying the value times the system royalty rate and other factors (tract allocations and payor responsibilities).

If the expected royalty does not agree with the royalty paid, the item is identified as an exception on-line. In addition, the royalty rate error will be available on a hard copy exception report. Corrections are usually made on-line after a telephone call to the company. A letter is sent to the company to resolve differences which cannot be corrected on-line.

### **3. Adjustment Monitoring**

Adjustments are submitted by backing out the previously reporting line and replacing it with the new line. Adjustments to prior periods are made on the current month's royalty report along with a copy of the original royalty report. Royalty payment adjustment information is noted in a specified area of the report. Source documents are required to be submitted with adjustments. If the adjustment results in a net negative for the current lease/month, the balance is carried forward to subsequent month(s). Large negative adjustments require prior approval by LO.

### **4. Rents/Minimum Royalty**

Separate checks are received for rental payments with the check detail identifying the properties to which the rent applies. Rentals are paid in advance. A manual review is conducted to identify late or incorrectly paid rents and minimum royalty. A demand letter is sent for late or incorrectly paid rental payments. Minimum royalties are paid in advance and rolled forward from year to year. A penalty may be assessed for late payment.

### **5. Late Reports/Payment**

Interest can be assessed on delinquent payments. Usually only companies that are chronic late reporters will be charged interest. As the technician enters royalty data from the check remittance, the system calculates interest for every line item that is identified as late. The system then totals the accrued interest for the lease. The system produces a report that calculates cumulative interest from January 1989 to current. When interest is deemed to be significant, usually \$500 to \$1000, a demand letter is sent to the payor. There is no penalty for late reporting.

Interest is not paid on royalty overpayments.

## **6. Volume Comparison**

Wyoming requires check detail and purchase statements to be submitted with all royalty reports. A sales allocation report is required for all unit and communitization agreements. Two separate processes are performed prior to data entry. Volumes are manually verified by comparing royalty reports to the supporting documents. In addition, for unit and communitization agreements, sales allocation report volumes are manually compared to volumes reported on the royalty reports. Any discrepancies are resolved and the documents are then entered into the system.

At 6-month intervals, a manual comparison is made between volumes reported to LO on royalty reports and production data compiled by the Petroleum Information Corporation. The Petroleum Information Corporation compiles this production data from reports submitted to the OGCC. Differences are referred to the reporting company for report correction. Technicians resolve reporting problems directly with the company, either by a telephone call or letter.

The OGCC obtains gas plant operations reports, which show gross plant intake, buyer and transporters. The gas plant operations reports are compared to related well production information.

## **7. Valuation Monitoring**

Prices are manually verified by comparing royalty reports to the supporting documentation (check detail and purchase statements). The LO also compares posted/index prices to prices reported on the unit/communitization operations report. The reports are then entered into the system.

As the documents are entered, the expected royalty amount is calculated for each line item by multiplying the value times the system royalty rate and other factors (tract allocations and payor responsibilities). If the expected royalty does not agree with the royalty paid, the item will show up as an exception, on-line. The technician will analyze the report to determine if the exception is due to an unreasonable price. At month's end, the system also generates a report which identifies the 25 leases with the highest and lowest lease prices, for each product, for any given month. This report is used to determine if the current price is an anomaly. Companies are contacted by the responsible technician for an explanation when pricing does not appear to be correct.

## **8. Allowance Monitoring**

Transportation deductions are allowed so long as they are reasonable, actual, and supported by appropriate documentation. Processing deductions are allowed so long as they do not exceed set limits. Net royalties cannot be less than those which are received by the US Government for its royalties from the same field. This determination is performed during field audit reviews only. Royalties are reported net of allowances taken and are reviewed only during field audit.

## **9. Audit**

The Division of Audit periodically performs audits of State oil and gas leases when associated State severance tax or Federal lease audits are conducted. Audit targets are selected on the basis of risk analysis and are performed at both the payor and lease level.

Since the State has no statute of limitations for State leases, the period is open-ended, but usually goes back only five years to stay within the Federal statute of limitations. Audits are performed at company locations and at LO using source documents provided with royalty reports.

## **PAYMENT RECEIPT AND FUNDS DISTRIBUTION**

All royalty payments are received by check. Payments and royalty reports are usually received at the same time. Reports are reconciled to payments and entered into the royalty system. Royalties are deposited directly to the State treasury and identified to 20 fund accounts. Two accounts, Common Schools and University of Wyoming, receive most of the money. The reports are checked against the lease reference file with payment identified to the appropriate State fund. Checks are sent daily to the State Treasurers Office with the appropriate funds identified for posting. Some funds may be temporarily posted to a suspense account until checks and reports are reconciled, or until the appropriate fund account is identified for posting of royalties.

## **BILLING AND DEBT COLLECTION**

All bills are created manually. They are sent to the payor along with any supporting documents necessary to justify the amount. Bill payment must be accompanied by check stub detailing relevant information. The LO will send letters to the appropriate lessees should accounts go uncollected. If the account remains uncollected, the bill is turned over to the State Attorney General for collection or legal action. Should the amount be small, the Attorney General will take no action and the amount will remain uncollected.

Bills may be contested in writing to LO, or by requesting an appeal to the Board of Land Commissioners.



## **ENFORCEMENT, APPEALS, AND RULES AND PROCEDURES**

The LO does not have a separate enforcement function. Enforcement is handled in conjunction with all other LO duties. Although disputes are seldom negotiated, LO does issue letters to assess penalties and coordinate settlement of disputes when necessary. Disputed issues which are not settled by LO are referred to the State Land Board.

The LO does not have a formal appeals process in place; however, parties may appeal to the Board of Land Commissioners.

State statutes prescribe reporting requirements and LO promulgates regulations for State royalty reporting purposes.

## **ROYALTY-IN-KIND**

Wyoming currently takes oil in-kind from 1 unit involving 11 leases. No information was available on the percentage of oil taken in-kind. There is only one party involved in the RIK program at this time. The LO negotiates contract price using the posted price as the starting point. Wyoming does not have enough activity to determine if the value received for RIK oil is comparable to oil taken in-value. The operator is responsible for submitting the operations report and the purchaser submits the royalty reports. Studies are underway to expand the program and to possibly include gas.

## **SYSTEMS**

The Royalty Accounting System (RAS) was developed in-house using dBASE software on a microcomputer platform. It has subsequently been upgraded to FoxPro. The RAS contains the following 6 data bases: 1) unit reference, 2) lease reference, 3) company reference, 4) checks, 5) financial transactions, and 6) support. It now serves 12 users through a LAN Novelle system. The RAS contains numerous programs to assist in carrying out the royalty accounting functions. These functions are a combination of integrated manual and automated processes. The data base is available for ad hoc reports and the FoxPro software lends itself to enhancement and modification without using outside experts.