U.S. Department of the Interior
Office of Inspector General

AUDIT REPORT

OIL AND GAS TRANSPORTATION ALLOWANCES AND GAS PROCESSING ALLOWANCES, MINERALS MANAGEMENT SERVICE

REPORT NO. 00-I-290
MARCH 2000

EXECUTIVE SUMMARY

Oil and Gas Transportation Allowances
and Gas Processing Allowances,
Minerals Management Service
Report No. 00-I-290
March 2000

BACKGROUND

The Minerals Management Service (MMS) is responsible for collecting and accounting for rental and royalty payments received under all Federal and Indian oil and gas leases and determining whether royalties received for products represent fair and equitable value. To fulfill these obligations, MMS promulgates regulations concerning the sales and payment of royalties on crude oil, natural gas, and liquid products from Federal and Indian leases. The Code of Federal Regulations (30 CFR 202 and 206) contains regulations that pertain to MMS's transportation and gas processing allowances. The regulations allow royalty payors to reduce royalties by claiming deductions for reasonable and actual costs of transporting oil and gas and processing gas on allowance reports.

MMS's automated allowance tracking system is used to monitor transportation and processing allowances to determine whether deductions exceed regulatory limits on allowances. The system identifies those leases for which the allowance deduction exceeds a specified maximum percentage of the oil or gas value at the point of sale. This system also identifies and bills payors for additional royalties when allowances have been deducted from royalties due and the required forms to deduct the allowances have not been filed. MMS officials said that the tracking and billing program portion of the system was terminated in 1994 because the system required too many resources and generated too many errors.

During calendar years 1996 through 1998, MMS collected revenues of more than $17.8 billion from approximately 25,471 Federal and Indian mineral leases, of which $11.4 billion was for oil and gas royalties. Royalty payors deducted about $222.5 million in oil and gas transportation allowances and $111 million in gas processing allowances from royalty payments for the 3-year period. For calendar years 1996 through 1998, MMS oversaw collections ofroyalties of $331 million on approximately 3,723 Indian leases with gas ($203 million) and oil ($128 million) production.

OBJECTIVE

The objective of the audit was to determine whether MMS satisfactorily implemented the recommendations made in our 1994 report and ensured that royalty payors deducted only the appropriate amount of oil and gas transportation allowances from royalties due.

RESULTS IN BRIEF

We **found** that two of the three prior recommendations in our August 1994 report were no longer valid for Federal leases or Indian gas leases after December 3 1, 1999, because of revisions to the valuation regulations and that MMS had implemented the remaining recommendation. In addition, based on our limited audit of both offshore and onshore transportation allowances and offshore gas processing allowances on selected leases, we found that royalty payors had deducted the appropriate amount of oil and gas transportation and processing allowances from royalties due. However, MMS was not maintaining an accurate filing system for tracking allowance reports for oil production on Indian leases. We believe that MMS should maintain a filing system so that it can provide information from the allowance reports, copies of the arm's-length contracts, or actual cost information to the tribes when requested by tribal officials. At a State and Tribal Royalty Audit Committee meeting, MMS presented steps it will take for filing, tracking, and distributing data and forms for Indian leases. The steps were accepted by Committee members.

RECOMMENDATIONS

The report did not contain any recommendations.

AUDITEE COMMENTS

In our March 9, 2000, exit conference with officials from MMS headquarters and the Royalty Management Program, the officials agreed with the conclusions presented in a draft of this report.

C-IN-MMS-003-99-D

United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20240

MAR 2 7 2000

AUDIT REPORT

Memorandum

To: Director, Minerals Management Service

From: Roger La Rouche
Acting Assistant Inspector General for Audits

Subject: Audit Report on Oil and Gas Transportation Allowances and Gas Processing Allowances, Minerals Management Service (No. 00-I-290)

INTRODUCTION

This report presents the results of our followup review of recommendations contained in our August 1994 audit report entitled "Transportation and Processing Allowance Deductions, Minerals Management Service" (No. 94-I-l 110). The objective of the followup review was to determine whether the Minerals Management Service (MMS) satisfactorily implemented the recommendations made in our 1994 report and ensured that royalty payors deducted only the appropriate amount of oil and gas transportation allowances from royalties due.

BACKGROUND

According to the Federal Oil and Gas Royalty Management Act of 1982 (30 U.S.C. § 1711 (a)), the Secretary of the Interior is required to "establish a comprehensive inspection, collection and fiscal and production accounting and auditing system to provide the capability to accurately determine oil and gas royalties, interest, fines, penalties, fees, deposits, and other payments owed, and to collect and account for such amounts in a timely manner."

MMS is composed of two specialized programs: the Royalty Management Program and the Offshore Minerals Management Program. All mineral revenue functions are centralized within the Royalty Management Program, which collects, accounts for, and distributes revenues generated from Federal and Indian lands and the Outer Continental Shelf MMS's Offshore Minerals Management Program conducts leasing activities for and provides oversight of mineral operations on the Nation's Outer Continental Shelf. MMS is responsible for collecting and accounting for rental and royalty payments received under all Federal and Indian oil and gas leases and determining whether royalties received for products represent fair and equitable value. To fulfill these obligations, MMS promulgates regulations concerning the sales and payment of royalties on crude oil, natural gas, and liquid products from Federal and Indian leases. The Code of Federal Regulations (30 CFR 202 and 206) contains regulations that pertain to MMS's transportation and gas processing allowances. The regulations allow royalty payors to reduce royalties by claiming deductions for reasonable and actual costs of transporting oil and gas and processing gas on allowance reports (Form MMS-4 110, "Oil Transportation Allowance Report"; Form MMS-4295, "Gas Transportation Allowance Report"; or Form 4109, "Gas Processing Allowance Report"). Payors are required to file Form MMS-2014, "Report of Sales and Royalty Remittance," which identities royalties due and deductions for these allowances.

MMS's automated allowance tracking system is used to monitor transportation and processing allowances to determine whether deductions exceed regulatory limits on allowances. The system identifies those leases for which the allowance deduction exceeds a specified maximum percentage (50 percent for oil and gas transportation and 66.7 percent' for gas processing) of the oil or gas value at the point of sale. This system also identifies and bills payors for additional royalties when allowances have been deducted from royalties due and the required forms to deduct the allowances have not been filed. MMS officials said that the tracking and billing program portion of the system was terminated in 1994 because the system required too many resources and generated too many errors.

During calendar years 1996 through 1998, MMS collected revenues of more than \$17.8 billion from approximately 25,471 Federal and Indian mineral leases, of which \$11.4 billion was for oil and gas royalties. Royalty payors deducted about \$222.5 million in oil and gas transportation allowances and \$111 million in gas processing allowances from royalty payments for the 3-year period. For calendar years 1996 through 1998, MMS oversaw collections of royalties of \$33 1 million on approximately 3,723 Indian leases with gas (\$203 million) and oil (\$128 million) production.

SCOPE OF AUDIT

The scope of this self-initiated audit was to follow up on the actions MMS had taken to implement the three recommendations made in our August 1994 report and to determine whether MMS has ensured that royalty payors deducted only the appropriate amount of oil and gas transportation allowances and gas processing allowances from royalties due. To accomplish our objective, we performed audit work at MMS's Royalty Management Program in Lakewood, Colorado, and the offshore operations in Santa Maria, California. We also visited the offices of Chevron Oil Company in San Ramon, California; Marathon Oil Company in Findlay, Ohio; and Yates Petroleum Corporation in Artesia, New Mexico.

In performing our audit, we reviewed MMS's allowance limit exception processing system; examined selected lease data and transportation allowances for both onshore and offshore operations for calendar year 1997; interviewed MMS officials regarding implementation of our prior recommendations; and reviewed Indian annual allowance forms for calendar years 1996, 1997, and 1998 for 14 judgementally selected leases based on leases that had a significant amount of royalties.

Our audit was made in accordance with the "Government Auditing Standards," issued by the Comptroller General of the United States. Accordingly, we included such tests of records and other auditing procedures that were considered necessary under the circumstances. As part of our audit, we evaluated the system of internal controls to the extent we considered necessary. We also reviewed the Departmental Report on Accountability for fiscal year 1998, which includes information required by the Federal Managers' Financial Integrity Act of 1982, and MMS's annual assurance statement on management controls for fiscal year 1998 to determine whether any reported weaknesses were within the objective and scope of our audit, Neither the Accountability Report nor the assurance statement addressed oil or gas transportation allowances.

PRIOR AUDIT COVERAGE

The General Accounting Office has not issued any audit reports during the past 5 years on MMS's oil and gas transportation allowances or gas processing allowances. Our August 1994 report "Transportation and Processing Allowance Deductions, Minerals Management Service" (No. 94-I-l 110) contained three recommendations to the MMS Director. We recommended that MMS monitor transportation and processing allowances deducted by royalty payors; notify royalty payors of any allowance reporting differences and request that they explain the allowance differences; and implement an allowance limit exception processing enhancement to the automated allowance tracking system. MMS concurred with the report's three recommendations.

RESULTS OF AUDIT

We found that two of the three prior recommendations in our August 1994 report were no longer valid for Federal leases or Indian gas leases after December 3 1, 1999, because of revisions to the valuation regulations and that MMS had implemented the remaining recommendation. In addition, based on our limited audit of both offshore and onshore transportation allowances and offshore gas processing allowances on selected leases, we found that royalty payors had deducted the appropriate amount of oil and gas transportation and processing allowances from royalties due. However, we found that MMS was not maintaining an accurate filing system for tracking allowance reports for oil production on Indian leases. We believe that MMS should maintain a filing system so that it can provide information from the allowance reports, copies of the arm's-length contracts, or actual cost information to the tribes when requested by tribal officials.

Prior Audit Report Recommendations

Recommendation 1. Monitor the transportation and processing allowances deducted by royalty payors to determine whether the deductions exceeded the actual allowance costs reported to the Service.

Recommendation 2. Notify royalty payors of the allowance reporting differences and request that they explain the allowance differences and correct the allowance reports or pay additional royalties.

We found that Recommendations 1 and 2 from our 1994 audit report (No. 94-I- 1110) were no longer applicable to Federal leases as of March 1996 and do not apply to Indian gas leases after December 31, 1999. MMS's "Revision of Valuation Regulations Governing Oil and Gas Transportation and Processing Allowances, and Coal Washing and Transportation Allowances," effective on March 1, 1996, and "Amendments to Gas Valuation Regulations for Indian Leases" effective on January 1, 2000, eliminated the requirement of submitting allowance reports' that estimated deductions to royalties due. However, payors that report actual allowances for Indian gas leases based on an arm's-length contract will be required to file a copy of the contract with MMS within 2 months of the date the payor deducts the allowance on Form MMS-2014. Payors of Indian leases that do not have arm's-length contracts* are required by 30 CFR § 206 to submit actual cost information to support the allowance on Form MMS-4295, "Gas Transportation Allowance Report," within 3 months after the end of the 12-month period to which the allowance applies. As a result, MMS will receive allowance information on some Indian leases and will need to maintain that data for use by tribal officials.

MMS published the final rule titled "Amendments to Gas Valuation Regulations for Indian Leases" in the "Federal Register" (64 FR 43506, dated August 10, 1999), which became effective on January 1, 2000. This new rule shifted the emphasis from estimated allowances to actual allowances for gas transportation and gas processing allowances. Payors that report the value of gas to MMS using index-based values, majority prices, or the alternative methodology for dual accounting include a 10 percent factor for transportation that does not require additional support to be submitted by the payor. Changes in requirements for filing forms are summarized in the Appendix.

To implement the new rule, an MMS official told us that the document entitled "Strategy on Implementation of the Indian Gas Rule," which included the steps for filing, tracking, and distributing data and forms under the new regulations, was presented to and accepted by the State and Tribal Royalty Audit Committee at a meeting held in January 2000. These steps included the establishment of a database to identify leases, fund codes, effective dates, and payor codes. MMS's State and Indian Compliance Division will tile and track letters for transportation, valuation notices, and arm's-length transportation and processing contracts, and it will distribute these documents to Indian tribes if requested.

<u>Recommendation 3. Implement the allowance limit exception processing enhancement for the automated allowance tracking svstem to identify allowance deductions that exceeded the regulatorv limitations without the reauired approval from the Service and to identify</u>

'Prior to March 1, 1996, all royalty payors had to file an initial allowance report based on estimated or actual costs if known at the time of submission before any allowance could be deducted on Form MMS-2014. Effective in March 1996, the "Revision of Valuation Regulations Governing Oil and Gas Transportation and Processing Allowances, and Coal Washing and Transportation Allowance" eliminated the requirement for tiling annual allowance reports for Federal leases. However, payors are still required to submit annual allowance reports and report differences based on actual costs to MMS for Indian oil leases.

[2]The Code of Federal Regulations (30 CFR § 206.15 1) describes an arm's-length contract as "a contract or agreement that has been arrived at in the marketplace between independent, nonaffiliated persons with opposing economic interests regarding that contract."

allowance deductions that eauaied or exceeded 100 percent of the rovaltv value. Also, rovaltv payors should be reauired to nay additional royalties and interest where annlieable.

The Allowance Limit Exception Processing enhancement was implemented in November 1997. We obtained a data base of onshore royalty payments for calendar year 1997 and reviewed oil and gas transportation allowance and gas processing allowance deductions to determine whether the enhancement prevented payors from taking allowances that exceeded 99 percent of the royalty values. We found that no allowances exceeded 99 percent of the royalty value. In addition, we performed limited testing to determine whether allowances in excess of regulatory limitations were deducted by payors without an approved payor allowance limit request. We found no instances of allowances taken in excess of regulatory limitations for which a request had not been approved. In addition, we found, for the allowances reviewed of $20.7 million for calendar year 1997, which consisted of $19.8 million from offshore operations and $.9 million from onshore operations, that the payors were able to support the allowances claimed.

In our March 9, 2000, exit conference with officials from MMS headquarters and the Royalty Management Program, the officials agreed with the conclusions presented in a draft of this report.

Since this report does not contain any recommendations, a response is not required.

Section 5(a) of the Inspector General Act (5 U.S.C. app. 3) requires the Office of Inspector General to list this report in its semiannual report to the Congress. In addition, the Office of Inspector General provides audit reports to the Congress.

APPENDIX

CHANGES IN REQUIREMENTS FOR FILING ALLOWANCE REPORTS

Period	Oil (Federal)	Gas (Federal)	Oil (Indian)	Gas (Indian)
March 1988 to March 1996	Allowance forms required to be filed prior to taking allowance.	Allowance forms required to be filed prior to taking allowance.	Allowance forms required to be filed prior to taking allowance.	Allowance forms required to be filed prior to taking allowance.
March 1996 to **January 2000**	No form filing requirements unless over regulatory maximums.	No form tiling requirements unless over regulatory maximums.	Allowance forms required to be filed prior to taking allowance.	Allowance forms required to be filed prior to taking allowance.
After January 2000	No form filing requirements unless over regulatory maximums.	No form filing requirements unless over regulatory maximums.	Allowance forms required to be tiled in advance of taking allowance.	For arm's-length contracts, copies of the contracts to be filed within 2 months of taking allowance. For non-arm's-length contracts, allowance forms to be tiled within 3 months after end of period* based on actual cost information.

* In compliance with MMS's "Amendments to Gas Valuation Regulations for Indian Leases," payors may choose the actual or the alternative method of dual accounting (dual accounting refers to the requirement to pay royalty based on a value that is the higher of the value of gas prior to processing less any applicable allowances as compared with the combined value of drip condensate, residue gas, and gas plant products after processing less applicable allowances). If the alternative method is used, royalty payments and allowance deductions are based on a formula predetermined by MMS. In addition, payors in a designated index zone (index zone is an area with an active spot market and published indices applicable to that field or area that are acceptable to MMS) report under MMS's formula. In these situations, contracts or other supporting documentation does not have to be filed.

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