NATURAL GAS ROYALTIES: THE FACTS, THE REMEDIES

HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY AND RESOURCES

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

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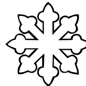

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NATURAL GAS ROYALTIES: THE FACTS, THE REMEDIES

WEDNESDAY, MARCH 1, 2006

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ENERGY AND RESOURCES,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:07 p.m., in room 2154, Rayburn House Office Building, Hon. Darrell E. Issa (chairman of the subcommittee) presiding.

Present: Representatives Issa, Watson, and Higgins.

Staff present: Larry Brady, staff director; Lori Gavaghan, legislative clerk; Thomas Alexander, counsel; Dave Solan, Ph.D. and Ray Robbins, professional staff members; Alexandra Teitz, minority counsel; Richard Butcher, minority professional staff member; and Cecelia Morton, minority office manager.

Mr. ISSA. Good afternoon. A quorum being present, I call this hearing to order.

This subcommittee is conducting a fact-finding hearing to investigate the implementation of the Federal Natural Gas Royalty Payment Program.

Recent news reports suggest that the Government may be unable to collect anywhere from $7 billion to $28 billion in natural gas royalties from leases of Federal lands and waters.

This is particularly troublesome at a time when natural gas companies are continuing to post record earnings.

There are several areas of concern, the first is whether some gas companies have failed to fulfill their contractual obligations to make royalty payments to the Department of the Interior.

There is confusion surrounding figures the industry has supplied to the Interior Department, the accounting methods of the Interior Department, and the degree of oversight provided by Minerals Management Service [MMS].

On this basis alone, the U.S. Government may have been underpaid $700 million worth of royalties in 2005.

Second, there is concern that the United States could be excluded from billions of royalties resulting from the Deep Water Royalty Relief Act. The act was enacted to provide an incentive to companies to explore and extract oil and natural gas from the U.S. waters. This came at a time when oil and natural gas prices were low, and the interest in deep water drilling was lacking.

The act gives the Secretary of the Interior the authority to enter into leases with oil and gas companies with defined volume suspen-

sions and price thresholds so that companies can recover their capital investments before paying royalties on the gross revenues.

Again, this was at a time in which prices were low.

During 1998 and 1999, however, these critical price thresholds were not included as terms of the leases, thereby allowing companies to recoup their capital investments long before the expiration of volume suspensions.

As these wells are now beginning to reap billions in gross revenues because of record gas prices, the effect of the price threshold-free language is coming to fruition.

As a result, the United States may be unable to claim part of the billions in gross revenues for the years 1998 and 1999.

The Department of Interior and the MMS have been very cooperative in responding to all of our requests for information. They assure me—and I emphasize this—they assure me that they can factually explain the situation and that there is no $700 million shortfall.

However, the $700 million is not the only issue. The focus here today is also on the more critical issue: the 1998 and 1999 leases and the billions that the U.S. Government may be precluded from collecting. That is why we are here today and have only one witness to establish the fact in this public forum.

The subcommittee will be diligent in our oversight responsibilities, depending upon the information we find here today. We may followup with hearings that are focused on more specific issues that need further analysis. We may focus on legislation to correct errors that we discover here today or in future hearings.

It is our responsibility to ensure that royalties are collected according to the law and the intent of Congress. I look forward to the hearing, Dr. Cruickshank's testimony today.

I ask unanimous consent that the briefing memo prepared by the subcommittee staff be inserted into the record as well as all relevant materials.

I would now yield to the ranking gentlewoman from California for her opening statement, Ms. Watson.

[The prepared statement of Hon. Darrell E. Issa follows:]

COMMITTEE ON GOVERNMENT REFORM
SUBCOMMITTEE ON ENERGY AND RESOURCES

OPENING STATEMENT OF
CHAIRMAN DARRELL ISSA

"Natural Gas Royalties: The Facts, The Remedies"

MARCH 1, 2006

The Subcommittee is conducting this fact-finding hearing to investigate the implementation of the federal natural gas royalty payment program. Recent news reports suggest that the government may be unable to collect anywhere from $7 billion to $28 billion in natural gas royalties from leases of federal land and waters. This is particularly troublesome at a time when natural gas companies are continuing to post record earnings. There are several areas of concern.

The first is whether some gas companies have failed to fulfill their contractual obligations to make royalty payments to the Department of the Interior.

There is confusion surrounding figures the industry has supplied to the Interior Department, the accounting methods of the Interior Department, and the degree of oversight provided by the Minerals Management Service ("MMS"). On this basis alone, the US government may have been underpaid over $700 million worth of royalties in 2005.

Second, there is concern that the US could be excluded from billions of royalties resulting from the Deep Water Royalty Relief Act. The Act was enacted to provide an incentive to companies to explore and extract oil and natural gas from US waters. This came at a time when oil and gas prices were low and the interest in deep water drilling was lacking. The Act gives the Secretary of the Interior the authority to enter into leases with oil and gas companies with defined volume suspensions and price thresholds so that companies can recover their capital investment before having to pay royalties on their gross revenues.

During 1998 and 1999, however, these critical price thresholds were not included as terms of the leases, thereby allowing companies to recoup their capital investment long before the expiration of volume suspensions. As these wells are now beginning to reap billions in gross revenues because of record gas prices, the effects of the price threshold-free language are coming to fruition. As a result, the US may be unable to claim part of the billions in gross revenues for the years 1998 and 1999.

The Department of Interior and MMS have been very cooperative in responding to all of our requests for information. They assure me that they can factually explain the situation and that there is no $700 million "shortfall." However, the $700 million is not the only issue. The focus here today is also on the more critical issue: the 1998 and 1999 leases and the billions that the US government may be precluded from collecting.

That is why we are here today and have only one witness: to establish the facts in a public forum. The Subcommittee will be diligent in our oversight responsibilities. Depending on the information we find today, we may follow-up with hearings that are focused on more specific issues that need further analysis. It is our responsibility to ensure that royalties are collected according to the law and the intent of Congress.

I look forward to hearing Dr. Cruickshank's testimony today.

COMMITTEE ON GOVERNMENT REFORM

Subcommittee on Energy and Resources

DARRELL ISSA, CHAIRMAN

Oversight Hearing:

Natural Gas Royalties: The Facts, The Remedies

March 1, 2006, 2:00pm
Rayburn House Office Building
Room 2154

BRIEFING MEMORANDUM

SUMMARY

Serious concerns have arisen regarding the implementation of the federal government's natural gas royalty payment program. Recent news reports suggest that the government may be unable to collect anywhere from $7 billion to $28 billion in natural gas royalties from leases of federal land and waters. This is particularly troublesome at a time when natural gas companies are continuing to post record earnings. There are several areas of concern.

The first is whether some gas companies have failed to fulfill their contractual obligations to make royalty payments to the Department of the Interior. There is confusion surrounding figures the industry has supplied to the Interior Department, the accounting methods of the Interior Department, and the degree of oversight provided by the Minerals Management Service. There is a question whether the US government may have been underpaid in excess of $700 million worth of royalties in 2005 on this basis alone.

Second, there is concern that the US could be excluded from billions of royalties resulting from the Deep Water Royalty Relief Act (the "Act"). The Act was enacted to provide an incentive to gas companies to explore and extract oil and natural gas from US waters. This would be accomplished by allowing the Secretary of the Interior and oil and gas companies, between 1996 and 2000, to enter into leases with a defined volume suspension and price threshold so that companies would be able to recover their capital investment before having to pay royalties on their gross revenues. This came at a time when oil and gas prices were low and the interest in deep water drilling was lacking. However, during 1998 and 1999, price thresholds were not included as terms of the leases, thereby allowing companies to recoup their capital investment long before the

expiration of volume suspensions. As these wells are now beginning to reap billions in gross revenues because of record gas prices, the effects of the price threshold-free language are coming to fruition. As a result, the US may be unable to claim part of the billions in gross revenues for the years 1998 and 1999.

This is exacerbated by threatened litigation from Kerr-McGee Exploration and Development, a major industry player. Kerr-McGee maintains that the language of the Act does not grant the Secretary of the Interior the authority to impose price thresholds and that it is not required to pay any royalties based on price thresholds for leases entered into between the years 1996 and 2000. If Kerr-McGee is handed a favorable ruling, it could ultimately force the US government to refund approximately $525 million in royalties to the industry, and preclude it from collecting between $18 and $28 billion over the next five years on leases entered into between 1996 and 2000.[1]

This oversight hearing will attempt to ascertain the facts and explore remedies to assure that the US government receives royalties to which it is entitled.

BACKGROUND

There is considerable confusion surrounding whether, and in what amount, the United States is owed royalties by natural gas companies. Of particular concern are the gross revenues from federal lands and waters leased by the federal government during 1996-2000. Some of this uncertainty is derived from the Department of the Interior's accounting and collection practices, as well as the Department's interpretation and implementation of the Deep Water Royalty Relief Act of 2005. But perhaps the most important issues with respect to royalties are centered around leases entered into in 1998 and 1999. Leases during these two years did not contain the critical price threshold provisions that were present in 1996, 1997, and 2000.

There is also a question as to whether the Secretary of the Interior had the authority to impose price thresholds in addition to the mandatory volume suspensions during the entire 1996-2000 timeframe. Threatened litigation by Kerr-McGee Exploration and Development, if favorable to the company, could preclude the US government from collecting upwards of $28 billion over the next five years, as well as force it to refund approximately $525 million in royalties paid to date.

Royalty Payment Framework

Oil and gas companies are contractually bound to make royalty payments to the US government based upon the value of the oil and gas produced from federal lands and waters. An oil and gas royalty, generally, is defined as a share of the profit from real property, reserved by the grantor of a mineral lease, in exchange for the lessee's right to mine or drill on the land. Put simply, "I give you the right to drill on my land, but you must share your gross revenues with me." In the case of land leased to oil and gas

[1] It must be noted that Kerr-McGee does not challenge the legality of imposed thresholds contained in leases after 2001.

companies by the federal government, the terms of an oil and gas royalty payment structure are governed by statute, enforced by the Minerals Management Service arm of the Department of the Interior, and are set forth in the lease. The terms, however, vary from lease to lease depending on what year the lease was entered into. For example, during the years of 1996-2000, the royalty payment structure is set forth by the Deep Water Royalty Relief Act, an act designed to relax royalty payments prescribed by the Outer Continental Shelf Lands Act. These royalty payment terms were different in 1998 and 1999 and happened to exclude certain provisions contained in other years. Whatever the arrangement, the payment structures have proven to be complex when put into practice and have yielded many questions as to the manner in which they are interpreted and enforced.

The New York Times' Assertions

The *New York Times* recently questioned the accuracy of MMS' calculations for natural gas royalties, ultimately concluding that the US government is owed an estimated $700 million. To arrive at this conclusion, it first derived an average monthly FY2005 price from information listed on the MMS website. It did this by dividing the total value of gas sold, $38 billion, by the total volume of gas sold, 6.7 billion Mcf (thousand cubic feet), reaching an average monthly price of $5.62/Mcf. It then obtained an average of monthly wellhead US natural gas prices from the Energy Information Administration ("EIA") website, which was $6.45/Mcf. Working the equation in reverse, it reached a value of $43.2 billion in FY2005 profits, which exceeded the MMS calculation by $5.2 billion. It then multiplied by a 13.6% royalty rate to reach a difference of roughly $700 million. The Department disputes the *New York Times* methodology, noting the $700 million shortfall is non-existent.

The Department contends that the $5.62/Mcf figure contains adjustments for prior year transactions and can be misleading when applied strictly to FY2005 sales. Oil and gas royalties are generally due by the end of the month following the month production is removed or sold from a lease. For example, royalties on oil produced and sold in January 2006 must be reported and paid to Minerals Revenue Management by February 28, 2006. It is common practice for the industry to submit subsequent adjustments for past periods. Under the Royalty Simplification and Fairness Act of 1996 (P.L. 104-185), industry is allowed to make past period adjustments for up to 6 years. Adjustments are necessary for a number of reasons, including reporting errors, sales contract amendments, retroactive adjustments to leases and agreements, deep water royalty relief, where the threshold for relief is met at year-end, and MMS-directed adjustments resulting from audits, etc. So strictly speaking, the *New York Times'* arithmetic was accurate. However, its methodology was incorrect because it assumed that the data reflected was only from FY2005.

The Department posits that the true volume of gas sold in FY2005 was 5,865 million Mcf. Using this figure, the average monthly price is actually $6.59/Mcf, fourteen cents higher than the EIA figure. This means that oil and gas companies paid royalties on an amount higher than the *New York Times* reported. Hence, there is no shortfall.

Other concerned individuals have pointed out what they believe to be a discrepancy between the gas royalties generated in FY2005 and those generated in FY2001.

The 2005-2001 Discrepancy

Some have expressed a concern that according to MMS data, there seems to be little difference between the gas royalties generated in FY2005 than in FY2001. This is troublesome, especially in a year that, along with record prices, should have generated record royalty payments. The Department of the Interior maintains, however, that any perceived lack of difference can be attributed to several factors. Moreover, had it not been for these factors, royalty revenue would have been $1.3 billion higher.

First, the Department contends that there was an overall decrease of 1Tcf (trillion cubic feet) in natural gas reported sales volume from federal leases due to the general trend of decline in production and the effects of hurricanes Ivan, Katrina, and Rita, and other storms. Another effect was an MMS rule that allowed for delayed reporting in order to give companies based in New Orleans time to access their data. Some of these companies did not report their figures until FY2006. Though these figures will be attributed to, and calculated with respect to, FY2005 royalty payments, some have yet to be processed by MMS.

The second is that some drilling has shifted to cheaper royalty brackets. MMS reports that some gas companies shifted their resources to include more deep water drilling. Although it was offset by a 17% increase in gas prices, this deep water increase resulted in less royalties than from an equivalent Gulf of Mexico shallow water offshore sales volume since royalty rates are lower (1/8 v. 1/6). This would account for an estimated $57.6m in gas royalties over the 2001-2005 period.

The third and most notable factor is the effects of the Deep Water Royalty Relief Act.

The Deep Water Royalty Relief Act

The Deep Water Royalty Relief Act of 1995 (the "Act") was enacted to provide incentives to oil and gas companies to explore and extract oil and natural gas from US waters. This came at a time when oil and gas prices were low and the interest in deep water drilling was lacking. To spur renewed interest, the Act allowed the Secretary of the Interior and oil and gas companies, between 1996 and 2000, to enter into leases with defined royalty suspensions based upon either a period of time, amount of gas or oil produced, or the value of gas or oil sold, in conjunction with a price variable, also known as a price threshold.[2] Since market prices always fluctuate, the Act presumed that, given

[2] ". . . The bidding [for oil and gas leases] shall be by sealed bid and, at the discretion of the Secretary [of the Interior], on the basis of . . . cash bonus bid with royalty at no less than 12 and ½ per centum fixed by the Secretary in amount or value of production saved, removed, or sold, and with suspension of royalties for a period, volume, or value of production determined by the Secretary, which suspensions may vary based on the price of production from the lease . . ." 43 USC §1337(a)(1)(H) (1995).

average wellhead prices, companies would recover their capital investment after attaining a certain volume of production.[3] Presumably, the Act included the price threshold variable as a precaution so that companies would not profit beyond their capital investment if they had not surpassed the volume suspension threshold. For example, investment recovery by a natural gas company would be based upon volume produced so long as the price of gas did not exceed $4/Mcf. If market prices exceeded the threshold, the company would profit at an accelerated rate and the purpose of the Act would therefore be moot. The Act had the desired effect, spawning thousands of new leases.

A number of these leases have entered into production and are partly responsible for the lack of difference between FY2001 and FY2005 profits. MMS reports that due to the time delay between well construction and profit generation, the industry is now seeing the gross revenues generated by these wells. The royalty payments made to the federal government in FY2005, however, were significantly reduced by the royalty suspensions provided for by the Act. This, in turn, lessened the overall royalty collection for FY2005 by approximately $193 million. But this was likely to happen and comes at no real surprise. The seemingly unintended effect of the Act's implementation, however, comes from leases entered into during 1998 and 1999.

1998 and 1999 Leases

Leases entered into in 1998 and 1999, though they included volume suspension provisions, lacked price thresholds. Again, price thresholds were presumably designed to promote and protect the overall policy of the Act by setting a gross revenue ceiling so that companies would not benefit from both high market prices and volume suspensions. The *New York Times* reports that by 2011, the absence of price thresholds could result in approximately $7 billion in royalty payments that the US government may not be able to collect. There is no explanation as to why price thresholds were included in leases in 1996, 1997, and 2000, but not in 1998 and 1999. Were revenues and drilling interest so low during this time that the previous Administration felt it necessary to offer price threshold-free leases? Was this unintentional? How is this in accordance with the policy set forth by the Act? Was this legal? The latter question has implications in litigation challenging the legality of price thresholds in 1996, 1997, and 2000.

Impending Kerr-McGee Litigation

Kerr-McGee Exploration and Development, a major industry player, reads the Act differently than the Interior Department. The Interior Department maintains that the Act gives the Secretary the authority to set price thresholds for the period between 1996 and 2000. Kerr-McGee, however, believes that the language of the Act does not grant the Secretary of the Interior the authority to impose price thresholds and that it is not required to pay any royalties based on price thresholds for leases entered into between the years of

[3] ". . . [I]n no case will that volume be less than 17.5 million barrels of oil equivalent in water depths of 200 to 400 meters, 52.5 million barrels of oil equivalent in 400-800 meters of water, and 87.5 million barrels of oil equivalent in water depths greater than 800 meters." 43 USC §1337(a)(3)(C)(ii) (1995).

1996 and 2000.[4] As such, it has refused to pay these royalties and is challenging the legality of the imposed royalty thresholds. According to the *New York Times*, a favorable ruling for Kerr-McGee could set into motion a series of lawsuits challenging the Interior Department's interpretation and implementation of the Act, thereby precluding the US government from collecting an estimated $28 billion over the next five years. Moreover, MMS reports that this could also force the US government to refund approximately $525 million in royalties already collected and invoiced.

ISSUES TO BE RESOLVED BY THIS HEARING

This oversight hearing will investigate:

- Whether the Interior Department's accounting and oversight practices are adequate and transparent;
- Whether the Deep Water Royalty Relief Act is being interpreted and implemented according to the policy it sought to promote;
- Whether leases entered into during 1998 and 1999 are in accordance with the policy promoted by the Deep Water Royalty Relief Act; and
- Whether, and in what amount, the US government is owed royalty payments from natural gas companies that drill pursuant to federal land and water leases.

WITNESS

- Walter Cruickshank, Ph.D., Deputy Director, Minerals Management Service, Department of the Interior

[4] Again, Kerr-McGee does not challenge the Secretary's authority to impose price thresholds in leases entered into after 2001.

Ms. WATSON. Thank you so much, Mr. Chairman. And I am sorry I am just now arriving—conflicts. But I want to commend you for scheduling this hearing today on the subject matter, and in the 5 years since the Bush administration has taken office, neither the Government Reform Committee nor the Resources Committee has held a single oversight hearing on the management of the Federal Royalty Program or on the validity of the regulations governing collection of natural gas royalties.

So I want to thank the Deputy Director of MMS for attending the first hearing of what should be several meetings to discuss the issue.

Indeed with the gas and oil industry recording the largest revenues in history, Congress must take a hard look at the reasons for royalty relief. The fact of the matter is the policy of royalty relief that the Congress passed was an unwise policy. But the oil companies convinced this Congress to do so, and they have convinced the administration to allow it to continue.

President Bush was quoted in the April 9, 2005 New York Times, "I will tell you with $55 oil, we don't need incentives to oil and gas companies to explore. There are plenty of incentives."

The Bush administration recently acknowledged that the further expansion of their oil royalty relief program was not necessary. Unfortunately, President Bush did not go to such an extent that he insisted that royalty relief be taken out of the energy bill he just signed.

The American taxpayer is the victim in this situation. I understand that there is an accounting controversy surrounding the math that the New York Times used to calculate a $70 million—excuse me—$700 million, in other words, $7 billion pool of uncollected royalties from the oil and gas companies.

So let us get down to transparency and utilize the proper numbers. Why is there an unwillingness to allow a fair and accurate exchange of numbers between government and private industry? Has the manipulation of Enron taught us anything?

Moreover, the bottom line is those companies believed, as the administration has said, that at a minimum, they were not going to get relief from the payment of the rent to the taxpayers if oil was over $35 a barrel.

As we all know, the world price of oil today is hovering around $60 a barrel, and recently it has been on a high and as high as $70. Now, how can we allow companies to exploit public assets and then charge us extraordinary amounts to use the products derived from those assets?

The American public is having a difficult time heating their homes and putting gas in their cars. The country is at an all-time deficit. Projections from the New York Times place uncollected royalties at $65 billion in the next 5 years, utilizing the plan proposed by the Department of Labor.

Leases without any royalty mechanism are driving the largest revenue losses. Americans deserve an answer to the currently inexplicable leases issued in 1998 and 1999 that do not contain price thresholds at all.

Good public policy demands that Congress conduct real oversight and protect the taxpayers' interests.

Recently, Representative Markey introduced legislation to prevent any future royalty holidays for the oil companies. The legislation is designed to seek and direct the Minerals Management Service to renegotiate these leases so that it does include the provision of a minimum of a trigger, hopefully promoting a better royalty policy than that.

The bill dictates that companies who do not want to cooperate with renegotiation should be barred from future bids on the Outer Continental Shelf.

I am interested to hear from the Department of the Interior if this is a step in the right direction. To their credit, some of the major oil companies are struggling that, in fact, they do owe the royalties and that there is a trigger mechanism.

Unfortunately, Kerr-McGee and apparently some other companies have decided that they are going to challenge the whole law.

They believe they are not obligated to pay any of these royalties; also that there is no trigger in this law.

So, Mr. Chairman, I again want to commend you for your leadership in bringing this issue to our subcommittee.

I look forward to the testimony today and subsequent hearings, and I am as dedicated as you are in providing strong leadership and advocacy on behalf of the American public and in particular our drivers in California who have an extra appendage and that is their automobiles.

So, again, thank you, and I yield back.

Mr. ISSA. I thank the gentlelady. I would note for the record that as far as our staff can determine, the first letter that was received and part of the impetus for this hearing here today came from a letter from the minority side, and it is the first that we believe we received in those 5 years you spoke about—on January 23, 2006, calling on both Chairman Pombo and Chairman Davis to look into these issues. I wanted to make sure that credit was given where credit was due. I am delighted to be doing this. To be honest, I looked at those New York Times articles and I looked at this request from the minority in determining that this was an issue that should be quickly scheduled, and we moved what was not on the agenda ahead so that it could, in fact, be done right now. I hope that this will be the first of many.

I would like to now yield 5 minutes to the gentleman from New York, who also is very engaged in this issue and even has his own legislation.

Mr. HIGGINS. I will waive an opening statement.

Mr. ISSA. The gentleman waives an opening statement. So with that, we can get to the meat of this.

Dr. Cruickshank, I am going to be brief and then give you all the time that you need. But I would like to mention that your Ph.D. couldn't be more appropriate, in that your education in geological sciences from Cornell and from Penn State and your mineral—Doctorate in Mineral Economics. Boy, we are talking minerals and money here today—couldn't be more on task. I note that you have been on the job since April 8, 2002, when you were designated Deputy Director of Minerals Management Service. I appreciate the administration providing you. I appreciate your being here today.

Before I swear you in, I would ask unanimous consent that your entire testimony be placed in the record in addition to any materials that you may supply, including your PowerPoint presentation. Without objection, so ordered.

It is the rule of this committee that all Members—or certainly all people testifying and any who may be on your staff that may give you advice, guidance, or may ultimately answer a question also be sworn in.

So I would ask that you and anyone fitting that description please rise and take the oath. Note there is only one.

[Witness sworn.]

Mr. ISSA. Let the record show an answer in the affirmative.

Thank you very much, and, as we talked about earlier—please have a seat. I understand that your testimony will be supported by PowerPoint, we will then take questions and answers, and without objection, take what time you need to do both.

STATEMENT OF WALTER CRUICKSHANK, PH.D., DEPUTY DIRECTOR, MINERALS MANAGEMENT SERVICE, DEPARTMENT OF THE INTERIOR

Mr. CRUICKSHANK. Thank you, Mr. Chairman, and members of the committee for this opportunity to appear today to discuss the various issues that have been raised concerning oil and gas royalties over the last month.

You have noted the plan. I would like to follow. I have a PowerPoint presentation responding to the initial New York Times article of January 23rd. And after walking through that, I would then like to give some additional remarks on Deep Water Royalty Relief—the history and mechanics of that program and the issue of price thresholds and where we are today.

I will start with the PowerPoint. There are 5 issues raised in that initial article that I would like to address. The 5 issues include the first, which is the statement that we could have received $700 million more in royalties had we based royalties on larger market prices; the issue of different prices being reported to MMS and to the SEC. The third issue noted that natural gas prices are higher now than in 2001, but natural gas royalties are less. I would like to go on to the reasons that has occurred. And the fourth issue raised in the article was whether our valuation rules are aggressive enough in seeking to collect royalties on the right basis, and finally discuss the issue of our audit program.

So I will turn to each of those in turn.

But first, a little bit of background on royalties. Royalty is the public share of the value of minerals produced from Federal lands. For oil and gas leases, the royalty rate is generally 12½ percent as a minimum royalty rate in statute, but there are authorities to charge higher royalty rates or to reduce royalties below that 12½ percent on occasion.

The value, for royalty purposes, is based on the value of the production at or near the lease. And that is based on 85 years of practice, of statute, of regulations, of provisions in the lease terms themselves and of judicial decisions.

The basic royalty equation is the value of the royalty production times the volume sold times the royalty rate. The value of royalty

production again is based at the lease, though, and often then does not reflect the price at a market center that may be some distance from the lease.

In those cases, where you are selling at some distance far from the lease, you are allowed to deduct your costs of transporting the production from the lease to the point of sale.

So the value for royalty purposes is the market price, minus what you are allowed to deduct for your cost of transporting to the point of sale, and for natural gas, you may also take deductions for processing that gas to take out royalty bearing liquids.

I would like to start by addressing the issue of the potential $700 million shortfall in royalty collections.

That number arose out of data on our Web site, but the numbers were used in a way that it was really not consistent with what the data on the Web site contained.

What the New York Times did was basically use the data on the Web site to calculate an average value for natural gas produced in fiscal year 2005, compare that to other market prices, to come up with the $700 million shortfall.

But our data on the Web is really not tied to the dates or month of production. Rather, it is based on when we receive payment. Our royalty management program is one that is charged with collecting money and disbursing money, and the data that we put on our Web site really tracks the cash-flows, if you will—the money, when we receive it and when we pay it out, rather than tying it to the year in which it was actually produced.

What typically happens in the oil and gas industry is that there are a lot of adjustments after the initial royalty payments. Royalties are generally paid 30 days after the month of production. But it could be many months, and in some cases years before those numbers are actually locked in stone by the companies. There can be a variety of reasons for this—related to the number of partners on a field, the number of fields tying into a pipeline, the number of pipelines tying into processing plants. And at each stage, the owner of the pipeline or the processing plant needs to allocate the production volumes back to the various entities. It often takes quite a long time for companies to really finalize what the proper volumes were on which royalties are based.

In addition, when we take compliance actions against companies, we are telling them also that they need to correct the reports that they submitted previously.

Under the Royalty Simplification and Fairness Act of 1996, companies are allowed by statue 6 years to make adjustments to their initial reports on royalties.

What we find is that the data that we have for any fiscal year often includes a lot of reports for prior fiscal years. The 2005 data that the New York Times used included by volume 24 percent of the transactions were from prior years, when prices were lower. And as a result, that tended to bias the price that was calculated using that data.

This slide shows the New York Times approach. They took the sales volume and sales value on our Web site to calculate the $5.62 average value, compared that to the Energy Information Administration's wellhead price for the same time period, of $6.45, and ba-

sically that price difference applied to the production volumes, and the royalty rate comes up with the $700 million difference.

Now, what we did is we recognize that the sales volumes used in that calculation included by volume 24 percent transactions from prior years. And so we removed those years and recalculated the numbers using the same method as the New York Times, but including only those volumes sold—produced and sold in 2005, so that we were calculating an average value for 2005 production rather than an average value that encompassed several years.

When you do that, when you remove those prior year adjustments, you end up calculating an average value reported to MMS of $6.59 rather than the $5.62 that the New York Times reported.

That average value is above the benchmark the Times used of $6.45. There really is no price differential between the market price and the values reported to MMS; therefore, there is no $700 million shortfall.

Mr. ISSA. Just to interrupt briefly.

Mr. CRUICKSHANK. Yes.

Mr. ISSA. Would it be amenable to you—and you can continue through your PowerPoint, but I think on behalf of both the majority and the minority staff if the information you have as complete as possible for as many years that shows a pattern of accrual versus cash basis, which is what I understand you are saying. If you could provide us with the data so that both sides of the staff could independently look at the materials that would probably be good. I think as much as I accept how this problem occurred, ultimately I think either somebody on your staff working with the majority and minority staff or the raw data, one way or the other, and the former is preferred, would allow both of us to get a comfort level—and I take you at your word—that this is just the difference between the ease of posting cash versus the complexity of providing the accrual system in real time to a Web site. But I think since this is not primarily what this hearing is about today, but we do have to have a comfort level that all moneys owed are being collected that we could do a lot of this offline—if that is acceptable?

Mr. CRUICKSHANK. That is fine. We will be happy to make that data available.

And as you noted, because of these adjustments that we get every month, posting accrual data would be difficult because we would have to be constantly changing it.

Mr. ISSA. I understand. Please continue.

Mr. CRUICKSHANK. I do want to caveat the numbers I just gave. Because of these adjustments, the numbers we used for 2005 clearly will change over time, as companies adjust their 2005 reports over the coming couple of years. So the $6.59 represents a snapshot of the data as we have it today, and that may vary somewhat as we get additional information that is more representative of the value that we are paid than the $5.62, which encompasses an average over several years as opposed to just 2005 sales.

The second issue raised in the New York Times had to do with the difference in values reported to MMS and to the Securities and Exchange Commission.

The difference really is the basis of the different requirements of the two organizations. But the prices are not inconsistent. SEC re-

quires companies to report the average gross sales price of all their final sales within the country.

This represents a composite of their sales from Federal leases, State leases, private lands, and it is a mix of sales at the lease, at market centers, and in some cases farther downstream, closer to the end users.

In addition, SEC does not allow companies to take any deductions for transportation or processing costs from the prices reported to SEC.

For MMS, we also are receiving a variety of prices that get averaged together. Some of these sales values are from sales at the lease, where transportation is netted out before the value is determined.

In other cases, we are receiving reports of prices from the market centers, and the transportation deductions are taken elsewhere.

As a result, what you have is different reports for SEC, each company's report reflecting its own particular portfolio of sales. For MMS, you have an aggregate of all companies' average sales values from Federal leases, but many of them reported with transportation deducted, which is not the case for SEC.

So you tend to find some variations in the prices simply because of the different rules about what companies are supposed to report to the two agencies. The prices are generally consistent with each other when you focus on similar time periods, but there are variations because of the different portfolios that individual companies may hold in terms of where their gas comes from and where they sell it.

The third issue relates to why natural gas royalties are not higher in 2005 than they were in 2001, given that natural gas prices are so much higher.

The reasons here are several. I am going to walk through 5 reasons in particular, but they basically relate to how the world has changed from fiscal year 2001 to 2005. There is less gas being produced from Federal leases now than 5 years ago. That gas is coming from different leases, leases that have different royalty rates, different royalty relief terms, and coming from parts of the country with different prices.

So I am going to walk through each of these reasons. But what they will total up to is about $1.3 billion in royalty value. In other words, if the world did not change between 2001 and 2005 other than the price of natural gas, we would have expected to see about $1.3 billion more in royalties than we did see in 2005.

These changes that I am going to talk about are responsible for about that much difference in the royalties that we collected.

The first reason has to do with just a general decrease in the amount of natural gas produced from Federal leases over time. This chart shows that decline between fiscal year 2001 and 2005, and the difference is about 1 trillion cubic feet in natural gas.

The largest portion of this just reflects the general decline in the amount of gas being produced from Federal leases over time, but a significant component as well has to do with shut-ins because of hurricanes, staring with Hurricane Ivan in 2004, whose effects were felt well into 2005, as well as 4 other named storms during 2005. We had about 340 billion cubic feet of natural gas that was

shut in due to hurricanes. That, combined with the general decline in production from Federal leases, amounts to the 1 trillion cubic foot decrease in natural gas volumes over time.

Using the New York Times benchmark of $6.45, the royalty value of that gas is equivalent to about $884 million, and is the largest single reason for the change in the amount of natural gas royalties collected between the 2 years.

The second issue deals with the fact that not all leases are created equal. As I mentioned before, most oil and gas leases have a one-eighth royalty rate, or 12½ percent. There is one general exception to that, and that are leases in the shallow water Gulf of Mexico have a royalty rate of 16⅔ percent, a somewhat higher royalty rate, recognizing that has been very prolific area for natural gas production for over 50 years, and was able to bear a higher royalty rate.

However, because it has been producing for a long time, there is just simply not as much natural gas left in the shallow waters of the Gulf of Mexico. As you can see from the yellow bars on this chart, production from shallow waters of the Gulf have been falling. That decline actually started in 1990 and has been fairly steady over time.

Part of that decline has been offset by an increase in production from deep water Gulf of Mexico leases that have a one-eighth royalty rate. So we have had a shift in the share of production, an overall decline in production, but then a shift in the share of production from leases with a one-sixth royalty rate to leases with a lower one-eighth royalty rate.

As a result, the average royalty rate for offshore production has declined over the last 5 years, from 15.6 percent in 2001 to 15 percent in 2005.

That change in average royalty rate alone amounts to a difference in royalty collections of about $136 million, and this is solely from the fact that we are now getting production from a different set of leases than we were 5 years ago.

But the shift in production from shallow water to deep water also is tied to the other issue I will be talking about today, the Deep Water Royalty Relief Act. I am going to return to this topic shortly to talk about the history of this act and the price threshold issue, but for purposes of the PowerPoint, I just want to focus on the fact that during 2005, there were 247 billion cubic feet of natural gas produced from Federal leases on which no royalties were paid. There are two reasons for that, as you have noted. One is that the leases issued in 1998 and 1999 do not have price thresholds and so that production has been royalty free. But then on other leases issued in that time period, between 1996 and 2000, companies have not paid in spite of price thresholds because they want to challenge the legality of those thresholds.

As I said, I will return to those issues shortly, but between those—because of those two reasons, there is about 247 billion cubic feet of natural gas produced on which no royalties were paid. If royalties had been paid on that production, it would have been about $200 million more in royalty collections.

The third reason for this change has to do with greater production on shore. While production from the Outer Continental Shelf

has declined in natural gas, it has grown on shore, increased by about 17 percent. And this has been predominantly in the Rocky Mountain region of the country. There are two issues involved here. One is that these on shore leases also have a one-eighth royalty rate rather than the higher one-sixth royalty rate, but also the Rocky Mountain region has generally lower natural gas prices than the Gulf of Mexico.

This is largely due to the fact that as natural gas production has grown in the Rockies, the capacity of pipelines to take natural gas out of the Rockies to other markets has not grown as rapidly. That is changing. New pipeline capacity is being added, but right now production has grown more rapidly than the pipeline capacity so that gas stays in the Rocky Mountain regions and depresses the price of natural gas that is sold in that area.

The average difference over 5 years between those two regions is about one dollar per million cubic—per thousand cubic feet of gas.

The combined effect of this shift to on-shore leases with the lower royalty rate and a lower value, amounts for about $14 million in royalty collection difference.

The next chart simply illustrates the change in prices between the two regions based on the market center index prices.

The final reason explaining why royalty collections were less in 2005 than might have otherwise been expected has to do with hurricanes. This is not because of hurricanes being shut in. We have talked about that already. But this has to do with the fact that some companies had their royalty payment systems based in New Orleans. So when Hurricane Katrina hit on August 29th, those companies were physically unable to make their payments on August 30th and September 30th.

Those payments have since been made, but the money came in during fiscal year 2006 and are captured in the 2006 data as opposed to the 2005 data. We have gone back and taken a look, and the money received in 2006 that normally would have been collected in 2005 on natural gas is about $60 million.

So these 5 reasons together, we estimate account for about a $1.3 billion royalty difference. If none of these things had occurred, we would have collected about $1.3 billion more in royalties because of the price difference in natural gas. But the world has changed over the last 5 years and our royalty collections reflect that.

The fourth issue raised in the article has to do with whether our valuation regulations have been relaxed over the last few years in terms of the way we collect royalties.

The easiest way to respond to that is to actually take a look at each of the individual rulemakings that we have made over the last few years. With each of those rulemakings, we are required to do an economic analysis that is shared publicly to receive comments on, and that analysis is supposed to try and estimate what the impact on royalty collections will be from the changes in regulations.

For oil, in 2000 and then again in 2004, we made adjustments to our Federal oil valuation regulations, which define how royalties are to be paid on oil. Those rules dealt with changing the basic valuation, the basic prices that are used for determining value.

The first of those rules was estimate to provide an additional $67 million in royalty collections, based on prices of that day. The modi-

fications in 2004 were expected to be revenue neutral; perhaps raise a little bit of money, but generally thought to be a revenue neutral change.

With respect to natural gas royalties, the focus there has been on what companies are allowed to deduct for transportation and what they are not allowed to deduct. We spent some time trying to clarify what is deductible and what isn't. And again, the regulatory analysis for that rule shows that royalty collections will increase as result of the rule changes relative to what they would have been if we had not made the rule change.

That is true for the Indian Gas Regulation as well, so in general all of the rulemaking that we have done over the last 5 years on—for royalty collections for valuing oil and gas for royalty purposes have resulted in either no change in the amount of royalties collected or increases in the amount of royalties collected and are not consistent with the idea that we are somehow relaxing the standards on which we are basing royalties.

The fifth issue raised in the article has to do with our audit and compliance program and how our resources may have changed over time and how the number of audits we have done has changed over time.

This page in the presentation shows the basic data. Our Office of Inspector General has gone over this page, and these numbers are consistent with what our Inspector General is also reporting on these issues.

As you can see, the number of audits completed has jumped around quite a bit, but there really is no apparent trend. The number in 2005 is the highest of the last 5 years, but that, in part, reflects the fact that we had a major initiative in 2005 to try and close out a lot of very old and dated audits, so that number is a little higher than we would normally expect to see.

But generally, we have been able to maintain the number of audits that we are starting and working on, and since every audit takes a different amount of time to complete, the audit completion data jump around a lot. But there is no trend there in either direction, up or down. We have been able to maintain the number of audits we are doing, and I would note that the audits on this line are full audits, following the Government Accounting standards, the Yellow Book standards for conducting audits.

Our funding has gone up for our audit and compliance program by minor amounts, from $32 million to $35 million over the last 5 years, which we consider to be a pretty good record given the budget times that we are in these days.

What I will note, though, is that the article was correct in noting that we have fewer auditors working now than we did 5 years ago. The main reason for that is the growth in our royalty in-kind program. The royalty in-kind program rather than getting our royalties as cash payments from the companies we actually take our percent share as production. We take the oil or we take the natural gas, and we sell it ourselves at the market centers for market prices.

This results in a much easier compliance process. We still have to go out and make sure the companies gave us the right volume of oil, but we no longer have to see whether they used the right

value in calculating royalty—whether they took the right deductions.

The audits are far simpler. There is a lot less to look at.

In 2005, we took about 80 percent of our royalty oil in the Gulf of Mexico in kind, and we are up to about 30 percent of our natural gas royalties being taken in kind out of the Gulf of Mexico. These are substantial volumes, and they have allowed us to shift audit resources away from some of these offshore leases. Some of them have been moved to compliance for on shore leases, but it is also allowed us to reduce the number of auditors overall.

Again, this does not reflect any less coverage. It reflects the fact that royalty in-kind has provided some efficiencies that allow us to reallocate our resources.

Finally, I would note that the article made mention of an Inspector General report in 2003 that suggested a lot of improvements to our internal controls over the audit program.

As a result of that report, we completed a 39-item action plan for improving the audit program. And when we finished that, we brought in an independent CPA firm to review our audit program, the same firm that had been critical of our program along the same lines of the Inspector General a few years before.

That independent review has given us a clean bill of health, an unqualified opinion with no weaknesses, no reportable conditions, no management letter—about as good as you can get from an auditor.

So we are comfortable that the issues the IG has raised have all been fixed.

As of last year, we were able to cover through our compliance program about 71 percent of the revenues collected for the audit year we were targeting, which is a very good sample.

And just to close the PowerPoint, I would like to note that the Government Accountability Office has taken a look at this PowerPoint. They have been asked to dig into the numbers behind it, and we shared our work papers with them, and they are preparing a briefing this afternoon. GAO generally agrees with our conclusions here. They have not had time to dig into the raw data themselves, but they believe our approach in this response is reasonable. They believe our conclusions are correct. They agree with the reasoning here, though, they have not actually opened on the exact numbers within this report.

With that, I would now like to turn to the issue of Deep Water Royalty Relief and briefly talk about the history and purpose of that act and the price threshold issues with which we are dealing with today.

The Deep Water Royalty Relief Act was passed in 1995 and for purposes of the hearing today, there are 2 sections of that act of importance.

Section 303 of the act authorized the Secretary to issue leases with royalty relief. This language basically said that the Secretary could issues leases that provided royalty relief in the form of a volume or value of royalty-free production. Once that volume or value was produced, royalties would be due on all additional production after that fact.

In addition, that section authorized the Secretary to vary relief based on market prices, and that is the authority for the price thresholds that limit the applicability of royalty relief when prices are high.

Section 304 of that act then went on to direct the Secretary to issue leases using that system, that the Department was required to issue leases in the Deep Water Gulf of Mexico for all years, 1996 through 2000, with royalty relief, and the act specified the amount of royalty relief we were to apply. It ranged from 17½ million barrels to 87½ million barrels of oil equivalent.

That section, Section 304, made no reference to price thresholds.

The mechanics of this relief is that the suspension volumes granted by the act allow that production to come online royalty free, but once that suspension volume is produced, then royalties will be paid on all additional production. Where there are price thresholds on the leases, that limits the applicability of the royalty relief. When market prices are above the threshold level, royalties are due on production and that production counts toward the royalty relief volume, the other royalty relief provisions notwithstanding.

The purpose of this act, as you noticed, Mr. Chairman, were to try and encourage companies to move into an area of the Gulf of Mexico that was viewed as very high cost and very high risk, but with substantial potential for new sources of energy. And, as you noted, this was a time when oil and gas prices were fairly low.

For the Deep Water Gulf of Mexico, the geological concepts and the technology had not yet been proven for whether there is actually substantial oil and gas there to be found.

The effects of this act were two-fold: one, the relief made leases very much more valuable than they would have been in the absence of relief and for leases issued between 1996 and 2000, this increase in value we believe resulted in about $2 billion in bonus bids, up-front bonus payments for these leases that would not have been received in the absence of royalty relief.

In addition, oil and gas production from Deep Water has grown dramatically over time. Since the enactment of the Deep Water Royalty Relief Act, deep water oil has grown by about 400 percent and natural gas has grown about 340 percent over that time period.

Today, deep water Gulf of Mexico accounts for about two-thirds of the oil and over one-third of the natural gas coming from the region.

So it has been a very successful region of the country in terms of trying to promote additional supplies of oil and natural gas, and we believe Deep Water Royalty Relief contributed to that success.

When the mandatory provisions of the act expired in 2000, then we were left simply with Section 303 of the act that gave discretionary authority to issue royalty relief.

At that time, the Department chose to continue royalty relief, but to scale it back. They eliminated royalty relief in some water depths and reduced the volumes to 5 to 12 million barrels of oil equivalent depending on water depth. In addition, all of those leases were issued with price thresholds, so at today's market

prices every deep water lease that is producing—that was issued from 2000 is paying royalties.

Finally, we come to the Energy Policy Act of 2005, which again made royalty relief mandatory in the Deep Water Gulf of Mexico. We had been making sale by sale decisions on whether to have royalty relief, but the Energy Policy Act mandated that we continue that relief for the next 5 years in the Gulf of Mexico. It adopted the range of royalty relief that we had been using—the 5 to 12 million barrels, but it added an additional tier for deeper water of 16 million barrels of royalty relief.

Finally, that act continued the policy of allowing set carry to set price thresholds to limit the applicability of royalty relief and that authority is explicit in the Energy Policy Act.

Turning to price thresholds, as I mentioned, when this act was originally enacted, we had to sit down and decide how to implement it, and the Secretary at that time determined that we would have price thresholds on all the leases issued between 1996 and 2000.

But somehow, as you have noted, for the leases issued in 1998 and 1999, those price threshold provisions are not in the lease.

I have looked at all of the decision documents related to lease sales in that time period, as well as all the lease sale documents themselves, and what I have concluded is that there was no affirmative decision to take price thresholds out. It was clear in 1996 a decision was made to have price thresholds as part of the Deep Water Relief clauses in these leases.

When the Director of MMS and the Assistant Secretary were asked to make decisions on the lease sales in 1998 and 1999, they were not asked to change that provision. There is nothing in those documents asking for the elimination or removal of the price threshold clauses. Indeed, those documents suggest Deep Water Royalty Relief would continue as it had in 1996 and 1997.

Now, with the passage of 8 years of time and a large turnover in staff, it is impossible to say exactly what happened, but as near as I can piece together, over the same timeframe, we were putting regulations in final form that implemented the Deep Water Royalty Relief Act.

The language in the lease documents themselves that refer to this program were being revised to reflect the new regulations, and in making those revisions it appears that the price threshold language was inadvertently dropped out for those 2 years.

Clearly, there is a lot of oil and gas production tied up with this. Looking back over the last several years, if the price thresholds had been in place on those leases, we would have been collecting royalties on about 475 billion cubic feet of natural gas and over 50 million barrels of oil that has been produced royalty free because of the absence of those clauses.

That is certainly worth several hundred million dollars of royalty collections, and if prices remain high, will easily move into several billion dollars over the coming years.

In addition to that, we are facing a legal challenge to thresholds, to price thresholds for leases issued in 1996, 1997, and 2000.

On these leases, because of the price thresholds, we have already collected over $425 million of royalties with about $100 million still

due. That money that is due is largely from companies that are challenging whether we could have put price thresholds on in the first place. We clearly believe we have the authority to do so because of Section 303 of the Deep Water Royalty Relief Act. But clearly, there is a lot of money at stake here, not just the $500 million or so looking backward, but if price thresholds remain—if prices remain high as they are today, then clearly there are billions of dollars in royalties that will be collected because of those price thresholds in future years.

Because of the amount of money at stake, we are going to vigorously defend our authority to have price thresholds in these leases so that at the end of the day, we will be able to collect all of those amounts, plus interest.

But this is clearly a piece of litigation where there is a lot of money at stake, and we will vigorously defend our position on this.

That concludes my remarks, and I would be happy to answer any questions that you or members of the committee may have.

[The prepared statement of Mr. Cruickshank follows:]

STATEMENT OF
WALTER CRUICKSHANK
DEPUTY DIRECTOR, MINERALS MANAGEMENT SERVICE
UNITED STATES DEPARTMENT OF THE INTERIOR
BEFORE THE
COMMITTEE ON GOVERNMENT REFORM
SUBCOMMITTEE ON ENERGY AND RESOURCES
UNITED STATES HOUSE OF REPRESENTATIVES

March 1, 2006

Mr. Chairman and Members of the Committee, I appreciate the opportunity to appear here today to discuss oil and gas royalties.

There has been recent media interest concerning natural gas royalty collections from Federal leases and the relationship of royalty incentives for deep water production in the Gulf of Mexico to current high energy prices. My testimony will discuss the development and status of deep water royalty relief and issues surrounding the application of the "price thresholds."

At the outset, I will discuss issues raised by the *New York Times* in its article of January 23, 2006. Attached to my testimony is a PowerPoint presentation on the management of the Nation's natural gas royalty revenues, which addresses these questions. The main conclusions of the presentation are:

- Royalty values paid to the Minerals Management Service are consistent with market prices for natural gas.
- The decline in natural gas royalty revenues is in part the result of changes in the natural gas production profile from federal leases.
- Royalty valuation regulations since 2000 have clarified the rules and increased royalty collections.
- MMS maintains an aggressive and comprehensive audit program.

With respect to deep water royalty relief, it is important to emphasize the following:

- Royalty incentives were established in the Deep Water Royalty Relief Act of 1995 to encourage development of new supplies of energy.
- The purpose of this incentive was to promote investment in a particularly high-cost, high-risk area.

- Since the enactment of the incentive, the deep waters of the Gulf of Mexico have become one of the most important sources of domestic oil and gas production.

- This Administration has taken a conservative approach to implementing the royalty incentives:

  - Once the royalty relief established by the Act became discretionary in 2001, we reduced the amount of royalty relief allowed on new leases.

  - The Administration contested a lawsuit, eventually won by lessees, which increased the magnitude of royalty relief on leases issued between 1996 and 2000.

  - We have ensured that price thresholds limiting royalty relief when oil and gas prices are high have been included in all newly issued deep water leases.

Deep Water Royalty Relief Act and Mandatory Relief for Leases Issued in 1996-2000

The Deep Water Royalty Relief Act of 1995 (Act) (Pub.L. No. 104-58), enacted on November 28, 1995, required the Secretary to grant specified royalty suspension volumes (*i.e.*, specified volumes of royalty-free production), for leases in more than 200 meters of water issued in the central and western Gulf of Mexico in lease sales held within the first 5 years after the statute's enactment. The royalty suspension volumes ranged from 17.5 million to 87.5 million barrels of oil equivalent, depending on water depth. This was not a matter of agency discretion. The Act also granted authority to the Secretary to grant royalty relief to leases in deep water issued after that 5-year period, but did not require the Secretary to do so.

The royalty incentives in the Act were designed to encourage development of new supplies of energy. Specifically, the incentive was intended to promote investment in a particularly high-cost, high-risk area. The deep waters of the Gulf were viewed as having potential for large oil and gas discoveries, but technological advances and multi-billion dollar investments would be needed to realize that potential. The incentive was intended to provide companies that undertook these investments specific volumes of royalty-free production to help recover a portion of their capital costs before starting to pay royalties.

Once the specified volume has been produced, royalties become due on all additional production. There is no royalty relief if there is no commercial production.

The Act also gave the Secretary authority to condition royalty relief on price levels, which I will discuss later in the testimony.

Because the leases were offered with royalty relief, they were more valuable to the lessees than if they had been offered without royalty relief. More leases became worth

acquiring and all deep water leases became more valuable. As one would expect, there were overall increases in both the competition for those leases and in the bonuses bid to acquire them. MMS economic experts estimate that the government received approximately $2 billion more in bonus payments in the lease sales held from 1996-2000 than it would have received had the leases been offered without royalty relief.

MMS' regulations implementing the Act's mandatory provisions for leases issued in 1996-2000 took a conservative approach. The MMS rules conditioned royalty relief for a lease issued in that period on the lease being part of a field that was not producing before the Act was enacted. The rules also provided that the royalty suspension volumes prescribed in the Act applied to a field (that may include more than one lease that is eligible for mandatory relief) and not to each individual lease. Lessees disputed the Department's interpretation of the Act. In the case of *Santa Fe Snyder Corp. v. Norton*,[1] a district court in Louisiana in 2003 held that these provisions of the MMS rules were contrary to the Act. The court therefore struck down the MMS rules. The government appealed, but the Court of Appeals for the Fifth Circuit affirmed in 2004. The result of the court decisions was to greatly increase the royalty relief available under the mandatory provisions.

Discretionary Relief for Deep Water Leases Issued Beginning in 2001

The mandatory provisions of the Act expired in 2001. The Department chose to continue deep water royalty relief, with modifications, for Gulf of Mexico lease sales under the Act's discretionary provisions, but has taken a conservative approach. We reduced the amount of royalty relief allowed on new leases. With some revisions in subsequent years, the royalty relief program was changed to eliminate relief in shallower water depths (200-400 meters) and to set suspension volumes of 5 million to 12 million barrels of oil equivalent for each lease, depending on water depth. These relief volumes are substantially less generous than those offered under the mandatory provisions of the Act, even under the Department's interpretation before the decision in *Santa Fe Snyder*. In all newly issued deep water leases, we have included price thresholds that eliminate royalty relief when oil and gas prices are high. At today's prices, royalties would be due on all production from these leases.

Effect on Gulf of Mexico Deep Water Production

Over the last 10 years, since the enactment of the incentive, deep water discoveries have revitalized the Gulf of Mexico as one of the most important sources of domestic oil and gas production. In 1990, deep water production accounted for less than 5 percent of the oil and 1 percent of the natural gas produced in the Gulf of Mexico. In 2004, it accounted for over 67 percent of the oil (362 million barrels) and 37 percent of the natural gas (1.5 trillion cubic feet) from this region. This growth in deep water crude oil production has offset production declines in shallow water, allowing total Gulf oil production to grow from 283 million barrels in 1990 to 540 million barrels in 2004, substituting for a like amount of imported oil. Roughly 20 percent of deep water oil production and 30 percent

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[1] Reported at 385 F.3d 884 (5th Cir. 2004)

of deep water gas production comes from leases with royalty relief, a share that will grow as leases issued over the last several years come into production. It is important to emphasize that once the royalty suspension volume for a lease is exhausted, the lessee must pay full royalties on all subsequent production.

Deep Water Royalty Relief Mandated under the Energy Policy Act of 2005.

In 2005, in the Energy Policy Act, Congress extended and expanded the deep water royalty relief program. It affirmed the suspension volumes the Department had set administratively, mandated a greater volume of relief for the deepest waters (16 million barrels of oil equivalent in water depths greater than 2000 meters), and required that MMS use these suspension volumes for leases issued in sales held during the next 5 years. It also continued the policy of limiting royalty relief based on market prices, and expressly reaffirmed the Secretary's authority to do so.

The Administration opposed the mandatory royalty relief provisions. The June 14, 2005 Statement of Administration Policy on the energy bill states, "The President believes that additional taxpayer subsidies for oil-and-gas exploration are unwarranted in today's price environment, and urges the Senate to eliminate the Federal oil-and-gas subsidies and other exploration incentives contained in the bill."

Price Thresholds

As I mentioned earlier, the Act gives the Secretary authority to condition the royalty relief on price thresholds. When the market price exceeds the threshold level for any given calendar year, royalties are due on the production for that year, royalty relief notwithstanding. Because the price thresholds are based on the average NYMEX price for the year, a determination of whether or not a threshold has been exceeded cannot be made until after the end of the year. The production volume on which the lessee owes royalty if the price threshold is exceeded also counts against the royalty suspension volume for the lease.

Consistent with thresholds expressly set in the Act for leases issued prior to enactment, in 1996 the Secretary set the price thresholds at $3.50 per million Btu for natural gas and $28.00 per barrel for oil (in 1994 dollars) for leases with mandatory relief, with the thresholds to increase each year based on the underlying rate of inflation. (With inflation, those thresholds for 2005 are $4.34 and $34.71, respectively.) In 1995, natural gas prices (using the Energy Information Administration's monthly data) varied from $1.43 to $1.84 per thousand cubic feet. Oil prices in 1995 (again, using EIA monthly data) varied from $17.32 to $19.03 per barrel. The price thresholds on these leases were exceeded, however, in the years 2000, 2001 and 2003-2005 for natural gas and in 2004-2005 for oil.

In spite of this authority for price thresholds, there continues to be some deep water production on which royalties have not been paid. In FY 2005, this amounted to an estimated 246.5 billion cubic feet of natural gas (and 16.5 million barrels of oil). There are two reasons for this:

1. Leases issued in 1998 and 1999 were issued without price thresholds. Thus, no royalties are due even though prices are high. This accounts for about 160 billion cubic feet (65 percent) of the royalty-free gas volumes reported in 2005.

2. On some leases with price thresholds, a few producers chose not to pay even though the thresholds have been exceeded. These companies argue that the Department does not have authority to establish price thresholds for any leases issued between 1996 and 2000, based on their interpretation of the *Santa Fe Snyder* decision. The Department does not agree with their argument. The Acting Assistant Secretary has issued a final decision for the Department in the first of these cases that requires the lessee to pay royalty for the years in which the price threshold was exceeded. We have been notified that a challenge to that decision will be filed in court in the very near future. I would emphasize that this dispute applies only to leases issued in 1996-2000. The validity of price thresholds for leases issued beginning in 2001 is not in dispute.

In December 2005, MMS sent letters to all companies that held either a record title or an operating rights interest in a deep water lease, reminding them that royalties were due for all production in years when price thresholds were exceeded. As of the end of January,

- Twenty-eight lessees have paid their obligations in full, or nearly so, and did not dispute their obligation to pay. (Three additional lessees had paid in full already and did not receive a notification letter.) These payments amount to $338 million. An estimated additional $5 million is due from some of these lessees and we are working with them to resolve technical issues about the amounts due.

- Two lessees have paid in full, but filed administrative appeals disputing their obligations to pay. These payments total $24 million.

- Five lessees paid in part, and also filed administrative appeals. These companies have paid $63 million, and an estimated $45 million is still due.

- Three lessees have not made any payments. One of these three has notified us that it intends to file a lawsuit to challenge the legality of the Acting Assistant Secretary's decision that I mentioned a moment ago that applies the price threshold. Of the other two, one has filed an administrative appeal and one has not. The estimated royalties due from these companies is $59 million.

If, after all administrative appeals and lawsuits have run their course, the price threshold provisions are upheld, the companies will be required to pay these royalties plus interest.

Conclusion

Mr. Chairman, this concludes my statement. It would be my pleasure to answer any questions you or other members of the Committee may have.

Management of the Nation's Natural Gas Royalty Revenues

The Department of the Interior's Response to NY Times

February 2006

Response to the NY Times

- Natural gas prices reported to MMS are in line with current market prices.
- Royalty values reported to MMS are different than prices reported to SEC.
- The decline in natural gas royalty revenues is the result of changes in the domestic natural gas production profile.
- The Department's regulations are designed to ensure that we collect royalties based on the fair value of the natural gas.
- The Department has an aggressive and comprehensive compliance and audit program.

Background

- Royalty is the landowner's share of the value of the minerals produced and sold from the lease.
- Statutes, regulations, and extensive case law governing mineral royalty management.
- Both onshore and offshore leasing statutes require a royalty rate of at least 12.5% of the value of production. The royalty rate is stated in the lease document. Regulations may reduce that rate in certain limited circumstances.
- Royalties are based on the value at or near the lease.
- Regulations provide the method for valuing production. The value is usually based on the price the lessee receives less prescribed deductions for transportation and processing.
- Lessees must pay royalties monthly, with payment generally due by the end of the month following the production month.

Background

Royalty (in $) = (Market Price – Allowed Deductions)

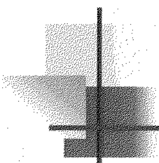
x Volume Sold

x Royalty Rate

<u>Example</u>: (Mcf = 1,000 cubic feet)

Price = $6.00/Mcf
Transportation = $0.30/Mcf
Volume Sold = 1000 Mcf
Royalty Rate = 12.5 %

Royalty = ($6.00/Mcf - $0.30/Mcf) x 1000 Mcf x .125 = $712.50



There is No $700 Million Royalty Shortfall

The New York Times Article

- The New York Times made a faulty assumption leading to the erroneous conclusion that royalties had been underpaid by $700 million in FY 2005.
- The Times assumed that reported natural gas royalty revenues shown on the MMS website included only FY 2005 royalties.
- However, each year's data on MMS' website includes prior year adjustments because it represents all revenues reported during the fiscal year and is consistent with royalty disbursements.
- Adjustments are a common accounting practice. By statute and MMS regulations, the oil and gas industry is allowed to make adjustments resulting from some of the following:
  - sales contract amendments,
  - retroactive adjustments to leases and agreements, and
  - MMS-directed adjustments resulting from audits, etc.

How the NY Times Calculated $700 million

- Derived its FY 2005 price from MMS website:
  - Value of total gas sold: $38 billion
  - Divided by volume of gas sold: 6.7 billion Mcf
  - Equals Average Value of: $5.62/Mcf
- Obtained average of monthly wellhead U.S. natural gas prices from EIA website - $6.45/Mcf
- Applied the $6.45/Mcf to the 6.7 billion Mcf sold to get $43.2 billion as the value of total gas sold
- ($43.2 billion - $38 billion) x 13.6% (royalty rate)= $707 million
- Rounded to $700 million

There is No $700 Million Shortfall

Why is the NY Times Analysis in Error?

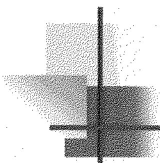
- The NY Times compared the value, calculated from the royalty data on the MMS website ($5.62/Mcf) to the EIA price ($6.45/Mcf).
- The FY royalty data on the MMS website includes adjustments for prior years when the prices for natural gas were lower. For FY 2005 24% of the sales volume published on the website are prior year adjustments.
- When MMS excludes prior year adjustments, the MMS average value is $6.59/Mcf.
- The $6.59/Mcf is the value received for FY 2005 royalty production. The $6.59/Mcf exceeds the NY Times price.
- **There is no "royalty shortfall".**

How MMS Calculated Average FY 2005 Price of $6.59

- NY Times used FY 2005 MMS statistics that included prior year transactions, resulting in an average price of $5.62/Mcf

- MMS calculated the price based on transactions applicable only to FY 2005
  - Total sales value for FY 2005 months — $38,644 million
  - Divided by sales volumes for FY 2005 months — 5,865 million mcf
  - Equals average value for FY 2005 — $6.59/Mcf

- Because prices were lower in prior years, the average value for transactions related only to FY 2005 was higher



Royalty Values Reported to MMS vs. Prices Reported to SEC

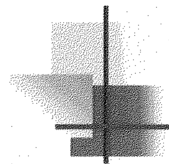
Why are Royalty Values Reported to MMS Different From Prices Reported to SEC?

Royalty Value (At the Lease)

- Value at the lease where the gas is produced
- Value is net of transportation and processing allowances as provided by law and regulation

SEC Filings (At Sales Point)

- Composite prices include revenue from Federal, State, and private lands.
- Sales prices include mix of wellhead and market center sales.
- Transportation and processing costs are not deducted from the sales prices reported to SEC.

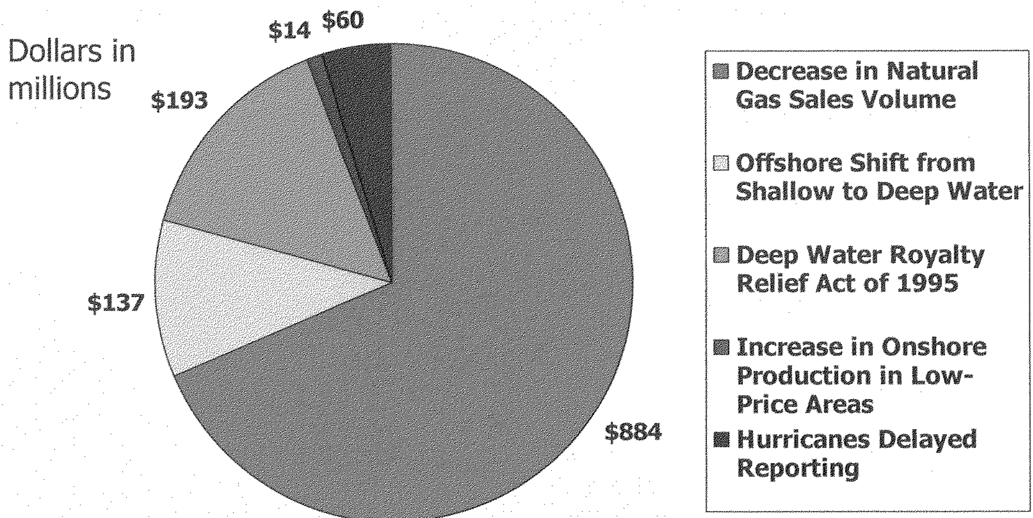


With the Increase in Natural Gas Prices, Why Is the Amount of Reported Royalties in FY 2005 Not Higher Then in FY 2001?

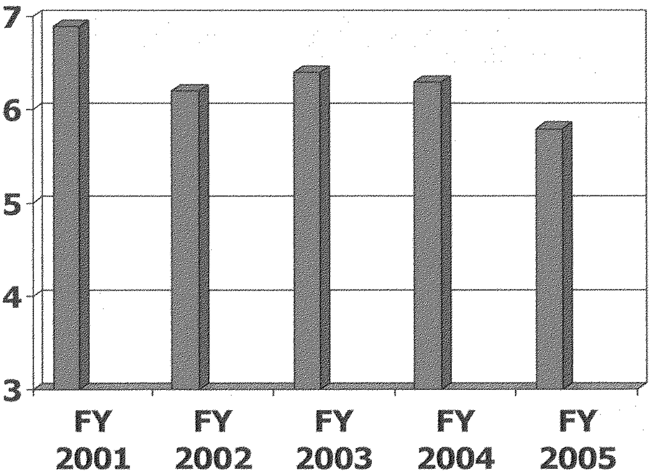
Why are Reported Natural Gas Royalty Revenues Less in FY 2005 Than in FY 2001?

- Overall decrease in natural gas reported sales volume from Federal leases.
- Shift of GOM offshore production from shallow water at 1/6 royalty rate to deep water at a lower royalty rate of 1/8.
- Congressionally mandated offshore royalty relief under the Deep Water Royalty Relief Act of 1995. (P.L. 104-58)
- Onshore natural gas production occurred increasingly in relatively lower price areas.
- Impacts of recent hurricanes on FY 2005 reported revenues, and shut-in natural gas.

If These Changes Had Not Occurred, Natural Gas Royalty Revenues in FY 2005 Would Have Been $1.3 Billion More.

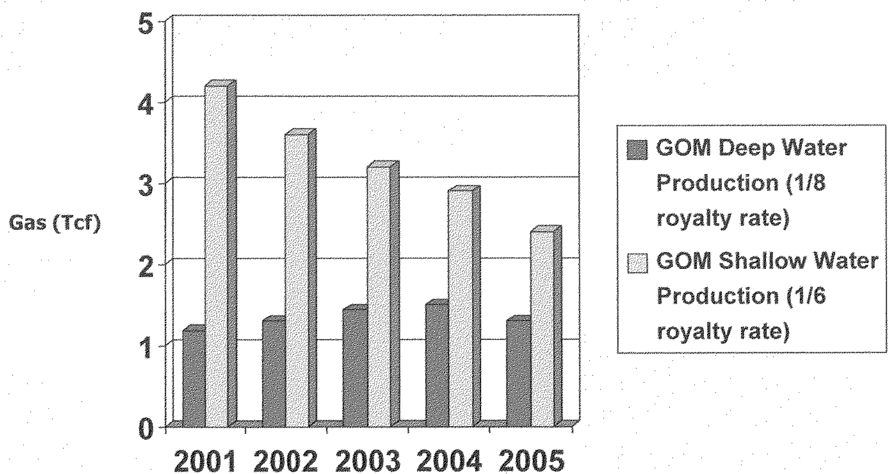


Decrease in Natural Gas Reported Sales Volumes (Tcf) from Federal Leases



- Decrease from 6.9 Tcf in FY 2001 to 5.9 Tcf in FY 2005 is a decrease of 1 Tcf. Over 340 Bcf of this is gas was shut in during FY 2005 due to Hurricane Ivan and 4 other storms.
- **Applying the $6.45/Mcf EIA wellhead price results in a $884 million decrease in gas royalty revenues from FY 2001 to FY 2005.**
- Volumes exclude prior period adjustments.

Shift of Gulf of Mexico Production From Higher Royalty Rate Leases to Lower Royalty Rate Leases



Data based on Oil and Gas Operations Report (Production)

Revenue Impact of Shift of GOM OCS Production to Lower Royalty Rate Leases

- From FY 2001-2005, GOM offshore natural gas production has shifted from the shallow water to deep water.
- Deep water royalty rates are generally 12 1/2% as opposed to 16 2/3 % for leases in shallow water.
- As a result, the overall average royalty rate for offshore natural gas declined:
  - FY2001 - 15.6%
  - FY2005 - 15.0%
- If FY 2005 royalties had been paid using the FY 2001 royalty rate, revenues would have been $136 million higher.

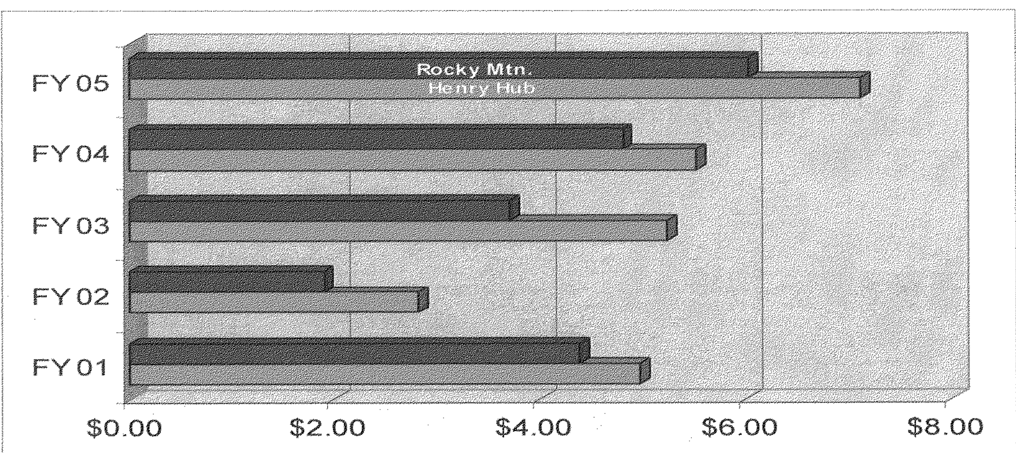
FY 2005 Natural Gas Production Subject To The Deep Water Royalty Relief Act of 1995 (DWRRA)

- During FY 2005, companies reported 247 Bcf of non-royalty bearing natural gas produced under the DWRRA.
- About 65% of the reported gas sales volumes are qualified for deep water royalty relief with no price threshold provisions, from GOM leases let in 1998 and 1999, under the DWRRA.
- Royalties are due on the remaining 35%. Several companies do not intend to pay in order to challenge the legality of the price threshold. GOM leases let in 1996, 1997, and 2000, under the DWRRA.
- If there was no royalty free production from DWRRA leases, an additional royalty value of $193 million would have been reported in 2005.

Onshore Production Occurred Increasingly in Areas with Lower Gas Prices

- Some of the decline in offshore production was offset by a 17% increase in onshore gas royalty sales volumes.
- This onshore increase results in less royalties than from an equivalent GOM shallow water offshore sales volume since royalty rates are less (1/8 vs. 1/6) and prices are lower (Rocky Mountain prices averaged 96 cents less than Gulf of Mexico prices over the FY 2001 – 2005 period).
- The combined effect of these factors results in an estimated $14.4 million decrease in gas royalties over the period.

Comparison of Gulf of Mexico (Henry Hub) Gas Prices to Rocky Mountain Prices



Average difference between Henry Hub and Rocky Mtn. Gas Prices from FY01 – FY05 equals $0.96

Hurricane Impact on Royalty Reporting

- MMS rule allowed delayed reporting and payment to any company impacted by hurricanes.
- June and July sales reports and payments that were due in FY 2005 were made in FY 2006.

Offshore and Federal Onshore Reported Royalty Delayed Due to 2005 Hurricane Activities				
Sales Month/Year	Commodity	Sales Volume	Sales Value	Reported Royalty Revenue
June-05	Gas	6,895,839	$46,517,631	$5,521,747
July-05	Gas	60,862,149	$428,100,985	$54,464,654
Total		67,757,988	$474,618,616	$59,986,401

Offshore and Federal Onshore Reported Royalty Delayed Due to 2005 Hurricane Activities				
Sales Month/Year	Commodity	Sales Volume	Sales Value	Reported Royalty Revenue
June-05	Oil and Gas		$99,052,967	$12,018,837
July-05	Oil and Gas		$569,513,406	$72,430,183
Total			$668,566,373	$84,449,020

Why are Reported Natural Gas Royalty Revenues Less in FY 2005 Than in FY 2001?

Decline in Natural Gas Reported Sales Volume from Federal Leases..............$884 Million

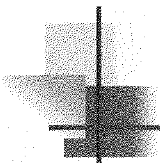
Shift from Offshore Shallow water to Deep water..$137 Million

Deep Water Royalty Relief Act of 1995 Leases..$193 Million

Increase in Onshore Natural Gas Production in Low-Price Areas..............$14 Million

Hurricanes Delayed Reporting and Royalty Payment.................................$60 Million

Total: $1.3 Billion



Regulatory Reforms To Ensure Collection of Royalties Based on the Fair Value of the Natural Gas

Regulatory Reforms

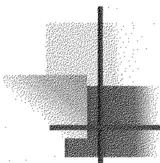
- **DOI has implemented regulatory reforms clarifying the rules, ensuring receipt fair value and increased royalties.**
  - **Federal Oil Regulation**
    - **Effective June 2000**
      - ✓ Relied on spot market prices
      - ✓ Economic analysis estimated an increase of $67 million in annual royalties
    - **Modified August 2004**
      - ✓ Changed basis to NYMEX
      - ✓ Economic analysis indicated revenue neutral
  - **Federal Gas Regulation**
    - **Effective June 2005**
      - ✓ Changed how transportation deductions were calculated
      - ✓ Economic analysis estimated an increase of $2.3 million in annual royalties

Regulatory Reforms

- Indian Gas Valuation Regulation
  - Effective January 2000

✓Added alternative valuation methodology to ensure Indian lessors receive maximum revenues.

✓Estimates of $2.4 million annual increase to royalties.



Aggressive and Comprehensive Compliance and Audit Programs

Compliance and Audit

	FY2001	FY2002	FY2003	FY2004	FY2005
Audits Completed	470	311	466	163	632

Note: Audits often span fiscal years. Audits completed in early FY2005 reflect substantial effort to close prior year audits.

	FY2001	FY2002	FY2003	FY2004	FY2005
Compliance Funding ($ Millions)	$32	$33	$33	$34	$35
Compliance Staff Onboard	437	420	395	390	369
MMS Auditors Onboard	(163)	(153)	(155)	(150)	(140)
State/Tribal Contract Auditors	(99)	(98)	(97)	(98)	(96)

Audit Program Accomplishments

- Implemented all OIG recommendations from 2003 report.
- Completed 39 item action plan for improving audit program.
- Received unqualified opinion on 2005 Peer Review.
- In FY 2005 completed compliance work on 71% of mineral revenues received for FY 2002.
- Collected $3.0 billion in additional royalties since 1982.

Conclusion

- **The $700 million alleged by the NY Times is based on a faulty assumption.**
- **Natural gas prices reported to MMS are in line with market prices.**
- **The decline in natural gas royalty revenues is the result of changes in the domestic natural gas production profile.**
- **The Department has implemented administrative reforms in recent years aimed at ensuring that we collect the fair value of natural gas royalties.**
- **The Department has an aggressive and comprehensive compliance and audit program.**

CONTACT INFORMATION:

Anita Gonzales-Evans, Anita.Gonzales-Evans@mms.gov
or
Lyn Herdt, Lyn.Herdt@mms.gov
Minerals Management Service
Office of Congressional Affairs
(202) 208-3502

2/24/06 2:30pm

Mr. ISSA. Thank you. That was very informative. As Henry Kissinger once said to the press when he appeared on the eve of the President's resignation as the only person trusted to meet the press, he looked at them and said, "I hope you have questions for my answers today."

I will tell you have provided many answers to my questions before I ask them. Certainly, the first and foremost was why were these thresholds not included in 1998. But I do have a followup on that I am concerned about.

There is a trail, there is an electronic trail—there are tapes on who drafted, when it was redrafted, in a Word document or equivalent—there is a way to piece back together when it disappeared from a draft that ultimately was presented. Has there been an investigation either by your own agency, the Department of Justice, or any other agency to try to ascertain, if you will, who, what, where, when this actually occurred?

Mr. CRUICKSHANK. Not to that level of detail at this point, Mr. Chairman. We have gathered the final documents that were used for decisionmaking and for the contracts themselves and looked at those. We have not at this point gone back and tried to locate any preliminary drafts.

Mr. ISSA. At least for this Member, I would think that if not your agency, then the Department of Justice would have a reason to say this is too many dollars and too important a provision not to find out whether, in fact, somebody did it for a beneficiary purpose that would be outside the law and would leave you with that for today.

But certainly, I don't think this committee is going to leave it in our oversight capacity.

I would ask also that you would submit for the subcommittee's review copies of the leases entered into in 1998 and 1999, as well as examples of leases for 1996, 1997 and 2000 so that we would have, if you will, anecdotal examples of the very leases. I know they are public record, but I would appreciate it if you would provide them.

Mr. CRUICKSHANK. We will do so.

Mr. ISSA. You mentioned the leases post the 19 or the 2005 mandating, but you didn't mention whether or not at today's prices they would or wouldn't be paying royalties, assuming they were producing so quickly. Do you have an opinion on that?

Mr. CRUICKSHANK. For the leases issued from 2000 on in the Deep Water Gulf of Mexico, if they are producing, they would all be paying royalties today.

Mr. ISSA. Well, you mentioned that. But the latest act where we remandated, if you will, the elimination—I got the first part of it. I guess it is our energy bill that you now have new requirements. You mentioned that you have made the additional reductions subject to price levels, but you didn't mention the price levels versus today's price levels.

Mr. CRUICKSHANK. I don't off the top of my head know what the price thresholds are where you're using in all of the leases, but all of them are well below today's market prices.

Mr. ISSA. So it would be fair to say that if they produce, when they produce, at today's prices, they would be fully royaltied and the provision of our act would not be place at these price levels?

Mr. CRUICKSHANK. That is correct.

Mr. ISSA. Great. These leases and one of the reasons I ask for copies, they are boilerplate, aren't they?

Mr. CRUICKSHANK. Yes. There—the way that—there is a standard form for the lease, and what the decisionmakers are asked to do is to really fill in the blanks as to what geographic areas, what minimum bids, rental rates, royalty rates—what terms—stipulations we put on operations to protect the environment. So the basic lease form itself is boilerplate, with some fill in the blank language, and then there are addendums to it, attachments to it that spell out some of these additional details on a sale by sale basis.

Mr. ISSA. And these always initiate from your side? In other words, you are the landlord. You deliver the lease?

Mr. CRUICKSHANK. That is correct.

Mr. ISSA. And I am assuming that in the contract way that I am familiar with, you send them electronically to the applicant. They make changes, send it back to you, and there is a series of underlines or some other way that each side is looking at the changes made in those documents?

Mr. CRUICKSHANK. There is no negotiation. These are leases. They take them or leave them.

Mr. ISSA. Excellent. So that is all the more reason that I also would appreciate, to the extent that you can reconstruct, the boilerplate that you were giving out in each of those years in its raw format; in other words, with no names or addresses filled in. And if it changed mid-year or at some point, you can determine a before and after, because I guess it is possible that it was one way in January and another way in February. I am not sure, but I would appreciate knowing that.

Mr. CRUICKSHANK. OK. We will be able to track through all the changes in those documents for you.

Mr. ISSA. Excellent. And this is a difficult question because I realize you came on board in 2002, but to the best of your knowledge, is there any written guidance from anyone in the Department to omit those price thresholds in 1998 and 1999? I believe you said no.

Mr. CRUICKSHANK. There is not. And actually, I took my current job in 2002, but I have been with MMS since 1988.

I did work on the regulations implementing the Deep Water Royalty Relief Act, and I am not aware of any guidance and could not find any directing us to remove those provisions.

Mr. ISSA. And likewise, you would know of no written or oral instructions that may have come from the White House, the Secretary's office, or any other government agency at that time?

Mr. CRUICKSHANK. There has been nothing in writing, and I am not aware of anything orally.

Mr. ISSA. You previously testified that you felt that this omission was, if you will, a word processing error during the revision.

Mr. CRUICKSHANK. I believe that what happened is—yes, the addendums to the lease were being changed to reflect the fact the regulations had changed and in so doing, the price threshold language came out for those 2 years. I have not been able to ascertain who may have actually pushed the button or why they thought that language could come out. My understanding is people believed

at the time the price threshold still applied, but the revisions clearly do not have that effect.

Mr. ISSA. Now, I know that every lease is a little different, but would it be correct to say that during the periods before and after the 1998 and 1999 omission that leases were substantially similar in their value, exploratory value to their price, meaning that there wasn't a discount or a price increase that came with these leases that didn't have this fairly significant threshold included in them?

Mr. CRUICKSHANK. Are you asking about whether there is a change from 1997 to 1998 because of the change in that provision?

Mr. ISSA. Well, usually what—in most contracts the question is was there a quid pro quo? Was there, in fact, some recognition of a value difference for this or was this given away for free by its omission?

Mr. CRUICKSHANK. Well, there was certainly recognition of royalty relief that was factored into how we determined whether to accept bids or not and are reflected in the increased bonuses we received.

There was no additional premium placed on these leases in 1998 and 1999 due to the lack of the price threshold provisions, in part because I don't think we realized at the time the price thresholds didn't apply; and certainly just looking at the track record, the amount of leases issued in those 2 years actually declined from the previous 2 years.

Mr. ISSA. They didn't know——

Mr. CRUICKSHANK. So it is——

Mr. ISSA. OK. And this question I am particularly interested in, and I think it is probably the most important one I will ask today. Do you believe that the lack of price thresholds during 1998 and 1999—this follows up on what you have said is in conflict with the overall intent of the act? Isn't it true that Section 303 and 304 of the act should be read together and not to the exclusion of one another? In other words, and I found this by reading 04 and then going seeing how it read on 03. In other words, doesn't Section 304 merely define Section 303 by providing the specific volume suspensions outlined in the bidding section in 303?

Mr. CRUICKSHANK. That is how we read the act, and for that reason, we believe that the authority in 303 to have price thresholds remains intact under that construct.

Mr. ISSA. The assessment at this point is or isn't that you—as to 1998 and 1999—this perhaps $7 billion or more that over the life of the lease is you will not get because of this absence of writing, do you believe that you have a right or any opportunity or any chance under existing law to collect those lost revenues?

Mr. CRUICKSHANK. I am not a lawyer, but my understanding is that these leases represent contracts entered into by two parties and cannot be unilaterally changed by one party or the other.

Mr. ISSA. Well, I think I will ask the opposite, though, isn't it true that the parties, many of the same parties are disputing what is in the language of the other 3 years—well, basically saying a deal is a deal unless we didn't get the better part of it, in which case a deal isn't a deal and we want to set aside the contract?

Mr. CRUICKSHANK. Well, we are being challenged on the price threshold provisions for those other 3 years, and presumably on the

grounds that they feel that the contract is inconsistent with the law, in which case I suppose the law would override.

Mr. ISSA. Well, isn't it true that the absence of those thresholds may be in conflict with both the intent of Congress and the stated policy of your department?

Mr. CRUICKSHANK. Well, Congress certainly made price thresholds discretionary, and at the time these leases were being put in effect, oil and gas prices were much lower, and I am not sure if people really gave a lot of thought to when thresholds might kick in. That clearly was—had been the policy of the Department to include price threshold provisions and certainly those do exist in every other year.

Mr. ISSA. OK. Now, we are going to have to make one quick vote and come back. And fortunately, it is only one vote. Ms. Watson, do you want to come back and ask a series of questions?

Ms. WATSON. I just have one, because you have covered many of the questions I was going to ask.

Mr. ISSA. I am trying to get to as many of your questions as I can. With that, I would yield to the gentlewoman from California.

Ms. WATSON. Thank you. I am perplexed because the oil industry is enjoying the highest profits in history. And I really feel it was outrageous that the oil industry benefited after Katrina, and their quarterly reports showed benefits in the billions of dollars.

My questions go to the audits. In your testimony, you indicated that compliance funding has increased slightly in the nominal dollars since fiscal year 2001. Yet, the New York Times reported today that spending on compliance and asset management has fallen since 2001 from $51.3 million to a proposed $43.1 million in fiscal year 2007.

Could you explain the difference in those numbers—and the thought came to me when you said you had been there since the 1980's and now you are the Chief, I guess Director. You have to really watch what you wish for. You might get it.

But anyway, if you can explain that and then if you can followup and let us know us know why MMS auditors and the tribal auditors have been cut, the number of auditors has been cut. So you can tie those together. Those are my questions, because I think the Chair is raising all the issues that I wanted to raise in addition.

Mr. ISSA. We are a team.

Mr. CRUICKSHANK. OK. On the first issue of the dollar amounts, the New York Times was reporting a budget line item that captures not only what is done in the terms of audit and compliance, but also has the budget for our Office of Enforcement, which is the office that goes out and bills and collects the money, as well as some IT system dollars in it.

The numbers that were in this PowerPoint reflect the dollars actually spent on audit and compliance activities, and the Office of Inspector General has confirmed those numbers.

I would suspect that the number of auditors—the number of audits for Indian leases has not changed. The number of State auditors has not changed dramatically. It is within 2 or 3 or where it was and really reflects an on board number rather than an FTE number.

Where there has been a decline in the number of auditors is on the Federal audit staff, and that reflects the growth in the royalty in-kind program in the Gulf of Mexico, because we don't have as many audits to do offshore now because of the RIK Program, we have been able to decrease the number of auditors looking at offshore leases.

Ms. WATSON. I would think that because we have all these different ways of calculating, and as you said, the Times calculated one way and you calculated another way and so on, I would think that you would need more auditors to be able to set the standard. The Markey bill I think has some provisions in that would be useful and helpful, but I do think you need a team so MMS can catch these differences beforehand.

I don't feel that the answer is satisfying, because I do think that a lot rests on your shoulders and because you have been sued and I understand that the awards have been quite large. We might want to do a better job of making the figures kind of coincide with what the reality is and so that was my response, Mr. Chairman. I will be going to the floor, and I don't see that I need to return, so you can finish asking your questions at this time.

Mr. ISSA. Excellent.

Ms. WATSON. Thank you so much, Mr. Chairman. I yield back.

Mr. ISSA. Thank you very much, and because several Members have expressed an interest to supply questions in writing, I would ask would you respond to those in writing. What I will do, because I think we have made a fairly good jab at the record here today, although I think that we are going to ask you to come back, undoubtedly, sometime in the future. I would ask that the record, by unanimous consent, be kept open for 2 weeks, subject to extension based on Members who do ask you additional questions and your response.

I would like to thank you for being here and for dedicating your time. I am going to save you the greatest burden of all, which is hanging out here while we wander off to vote and then come back. Whenever possible, it is nice to do it in one felled swoop.

So with the reservation that undoubtedly, we are not done, but we are certainly for today and the foreseeable future, this hearing is adjourned. Thank you.

[Whereupon, at 3:11 p.m., the subcommittee was adjourned.]