Department of the Interior
Office of Inspector General

AUDIT REPORT

MINERALS MANAGEMENT SERVICE'S COMPLIANCE REVIEW PROCESS

Report No. C-IN-MMS-0006-2006 **December 2006**

This report contained information that was redacted pursuant to 5 U.S.C. §§ 552(b)(2) (high) and (low) and (b)(6) of the Freedom of Information Act.

Executive Summary

Why We Did This Audit

We conducted this audit at the request of the U.S. Senate Committee on Energy and Natural Resources. The audit addresses concerns raised by the news media and the State and Tribal Royalty Audit Committee (STRAC) about MMS' increasing use of compliance reviews as part of its CAM Program.

Historically, MMS has relied on audits to verify companies' reported royalties. In the late 1990s, MMS began reengineering its royalty verification processes, which included the establishment of the compliance review process. A compliance review is less intensive than an audit and is designed to determine the reasonableness of reported royalties without obtaining detailed source documentation or conducting site visits.

Audit Objectives

Our objectives were to determine (1) whether compliance reviews are an effective part of the CAM Program and (2) whether MMS is effectively managing the compliance review process.

What We Found

Compliance reviews can serve a useful role as part of the Minerals Management Service's (MMS) Compliance and Asset Management (CAM) Program. Compliance reviews are a legitimate tool for evaluating the reasonableness of company-reported royalties and allow a broader coverage of royalties while requiring fewer resources than audits. However, compliance reviews do not provide the same level of assurance as an audit and therefore should only be used in conjunction with audits in a coordinated compliance strategy.

While we concluded that compliance reviews can be an effective part of MMS' CAM Program, our audit disclosed weaknesses that may prevent MMS from maximizing the benefits of the compliance reviews. These weaknesses related to management information, the compliance review process, and the performance measures used to evaluate the CAM Program's effectiveness.

<u>Management Information</u>

MMS lacks reliable information for managing the CAM Program. Audit and compliance review data are maintained in multiple information systems that we found to be inaccurate and incomplete. As a result, MMS cannot:

- effectively use existing systems for day-to-day management and reporting purposes;
- develop an effective strategy for deploying personnel and other resources between audits and compliance reviews;
- provide accurate information on CAM Program operations and results to stakeholders, including the Congress and state and tribal audit organizations; and
- determine the true cost and benefits of compliance reviews and audits.

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Compliance Review Process

We found that MMS developed extensive policies and procedures for conducting compliance reviews and that MMS generally followed the guidance. Our audit disclosed some areas where the compliance review process should be strengthened. For example:

- Compliance reviews do not adequately evaluate company-reported volume and allowance data. This increases the risk that MMS may not detect underpaid royalties.

- MMS does not always inform companies when compliance reviews begin. Standard notices would give greater visibility to the CAM Program and deter inaccurate reporting.

- MMS' methodology for establishing threshold amounts for pursuing potential underpayments is not consistent and could result in uncollected royalties.

- MMS does not have detailed guidance identifying when compliance reviews should be referred to audits.

- MMS' selection process to identify properties for compliance reviews or audits does not take into account which companies have the highest risk for underpaying royalties.

- The ability of state and tribal auditors to conduct effective compliance reviews is hindered because they do not have full access to MMS' automated tools.

Performance Measures

We found that MMS should reassess the CAM Program's Government Performance and Results Act performance measures.

- The compliance index, which attempts to assess whether companies are paying the proper amount of royalties, should be eliminated because it is computed with incomplete data.

- The compliance coverage measure inappropriately treats audits, compliance reviews, and royalty-in-kind analyses equally. Also, the measure's focus on dollar coverage results in many of the same companies and properties being reviewed year after year. MMS should revise this measure to report separately on each activity and should modify its CAM strategy to expand the coverage of companies and properties subjected to review.

- MMS should also develop new measures that address the efficiency of its operations.

We made three recommendations to the Director of MMS. The Director's response to the draft report, included as Appendix 2, expressed general concurrence with the findings and recommendations and provided the actions in process for implementing the recommendations. MMS stated that it will provide a final action plan within 30 days after receipt of the final Office of Inspector General (OIG) report. The Director's response included several areas of disagreement. We agreed with management's comments in three areas and revised the recommendations contained in our draft report concerning activity-based costing and source document review; we corrected our recommendation concerning collections to reflect the correct entity within MMS which holds responsibility for that function.

Concurrent with conducting this audit we also compiled information to answer additional questions posed by the U.S. Senate Committee on Energy and Natural Resources. These questions related to MMS' auditor positions, the number of royalty audits initiated by MMS, the adequacy of MMS' resources, and the funding for state and tribal audit organizations. We did not evaluate the substance of the audits or audit work conducted. Our answers are presented in Appendices 4 and 5. As noted above, MMS has data reliability issues related to audit and compliance review information. Accordingly, our answers are based on the best available data.

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INTRODUCTION

AUDIT OBJECTIVES

Our audit objectives were to determine:

- Are compliance reviews an effective part of the Minerals Management Service's (MMS) Compliance and Asset Management (CAM) Program?
- Is MMS effectively managing the compliance review process?

BACKGROUND

MMS is responsible for collecting, accounting for, and distributing royalties paid by companies that extract oil, gas, and other minerals from leased federal and Indian properties. MMS collected $9.9 billion in royalties in FY2005. About 2,600 companies[1] reported and paid royalties from approximately 27,800 producing leases.

MMS' CAM Program is responsible for ensuring that companies are accurately reporting and paying royalties in compliance with applicable laws, regulations, and lease terms. This is accomplished by conducting audits and compliance reviews. The CAM Program is divided into four components:

- Onshore Oil and Gas
- Offshore Oil and Gas
- Indian Oil and Gas
- Solids & Geothermal

The CAM Program had a FY2006 budget of $42.7 million and employs approximately 380 personnel. To assist in verifying royalties, MMS has cooperative agreements with audit organizations representing 11 state and 7 tribal governments. MMS reimburses these organizations for all of their costs to conduct compliance work. The tribes retain 100 percent of collections resulting from their compliance work, and the states retain a portion of collections as statutorily allowed, which is generally 50 percent. The State and Tribal Royalty Audit Committee (STRAC) represents the state and tribal audit organizations in its coordination with MMS.

> A **royalty** is the landowner's share of the mineral production. MMS collects royalties either in cash (**royalty-in-value**) or in product (**royalty-in-kind**).
>
> Royalties collected from federal properties are distributed to other Department of the Interior bureaus, the Department of the Treasury, and other federal agencies. Additionally, state governments receive a portion of royalties from minerals produced within their state borders.
>
> Royalties collected from Indian-owned properties are distributed to the applicable tribal governments or individual Indian owners.

[1]A company refers to an organization that pays royalties to MMS. This includes a corporation, partnership, sole proprietorship, or individual.

MMS began a reengineering initiative in the late 1990s to establish a more efficient and effective process for verifying royalty payments. As part of this reengineering effort, MMS developed the compliance review process to complement traditional audits and accomplish a broader coverage of reported royalties. MMS began using compliance reviews in 2000.

A compliance review is an analysis that determines the reasonableness of company reported royalty and production data. An analyst compares the company reported data to MMS' "expected values." If the reported data are not within a reasonable range, the variance is pursued with the company. Unlike audits, compliance reviews are not conducted in accordance with the *Government Auditing Standards*. Compliance reviews generally do not obtain and review company source records, review company systems or internal controls, or result in formal reports. Additionally, compliance review procedures do not include issuing engagement letters or conducting entrance and exit conferences. In fact, MMS may not contact companies at all when compliance reviews are conducted unless discrepancies are found.

THE ROYALTY EQUATION

To determine whether royalties have been accurately paid, MMS reviews the four elements of the "royalty equation:"

Volume:	Amount of minerals produced and sold.
Value:	Sales price of minerals produced and sold.
Allowances:	Deductions for transportation and processing.
Royalty rate:	Landowner's share of minerals produced and sold.

Compliance reviews and audits are generally conducted for royalties paid in-value. For royalties paid in-kind, the Royalty-in-Kind (RIK) Program is responsible for verifying that the producing company delivered the correct volume and the buyer paid the correct contract price. In the mid-1990s, MMS began exploring the potential for expanding the RIK program and in recent years, has increased the royalties taken in-kind rather than in-value. In its FY2005 report on the RIK Program, MMS reported that the value of RIK gas and oil was $3.7 billion.

In January 2006, a New York Times article criticized the effectiveness of the CAM Program and asserted that MMS undercollected approximately $700 million in gas royalties in FY2005. Subsequently, the Times raised concerns expressed by STRAC members about MMS' increasing use of compliance reviews instead of audits. The U.S. Senate Committee on Energy and Natural Resources (Committee) requested that our office and the Government Accountability Office (GAO) look into these issues. This report responds to the Committee's request for us to look at the effectiveness of MMS' compliance reviews. The Committee also requested that we provide answers to specific questions concerning the number of audits that were initiated since 2000 and the levels of staffing and funding for those years. Our answers to those questions are addressed in Appendices 4 and 5. GAO addressed the Committee's questions regarding the alleged underpayments of royalties in its June 2006 report "Royalty Revenues: Total Revenues Have Not Increased at the Same Pace as Rising Oil and Natural Gas Prices due to Decreasing Production Sold."

Appendix 1 contains information on the audit scope and methodology and Appendix 6 lists prior reviews that were related to our audit.

Results of Audit

Compliance reviews can serve a useful role as part of the CAM Program. Our research showed that other federal and private sector entities use similar procedures to verify reasonableness of reported information. The Internal Revenue Service (IRS), for example, extensively uses automated procedures to analyze tax returns and has established "compliance checks" to determine whether taxpayers adhere to recordkeeping and reporting requirements. When properly designed and implemented, compliance reviews can effectively evaluate the reasonableness of company-reported royalties. For example, one compliance review recovered $4.5 million in underpaid gas royalties for an offshore property. Compliance reviews also allow greater coverage of the royalty universe while requiring fewer resources than audits because MMS can:

- complete compliance reviews in less time and usually cover more reporting months than audits,
- complete compliance reviews without traveling to company locations, and
- coordinate audits and compliance reviews to use its resources more efficiently.

However, compliance reviews are only a test of the reasonableness of royalties paid and do not provide the same level of royalty verification as an audit. To a large extent, compliance reviews rely on company-reported information instead of source documentation. For example, MMS may consult general industry pricing publications rather than the company's specific sales contract to help assess the reasonableness of the company's reported value. A compliance review should not be used as a substitute for an audit, but rather, as one part of a comprehensive compliance strategy that incorporates both activities.

Our audit disclosed weaknesses in MMS' management of compliance reviews and its overall CAM Program. Specifically:

- MMS lacks reliable management information to adequately develop a compliance strategy, monitor progress, and assess results of its CAM Program.
- MMS needs to improve its compliance review process to maximize outcomes.
- MMS' performance measures are inadequate and need to be revised.

MMS Lacks Reliable Management Information

MMS lacks the information it needs to adequately manage compliance reviews and its overall CAM Program. Audit and compliance review data are maintained in multiple information systems that we found to be inaccurate and incomplete. Specifically, we found errors in data relating to audit and compliance review tracking and the costs and benefits of the CAM Program.

CAM Program Data Are Not Adequately Tracked

MMS maintains management information on the CAM Program primarily in its Compliance Information Management (CIM) system and in four separate databases maintained by the CAM components to accumulate data for Government Performance and Results Act (GPRA) reporting. However, we found that these systems do not maintain certain basic information that could aid CAM Program managers in monitoring the day-to-day operations and assessing results. We found the following problems:

- **Incomplete and Inconsistent Compliance Review Data in CIM:** The CAM components were inconsistent in their tracking of compliance reviews in CIM. Two CAM components did not have complete information on all compliance reviews because data is only entered if the reviews result in monetary findings. The other two components recorded all compliance reviews in CIM. This practice prevents MMS management from accurately tracking and reporting on all compliance reviews.

- **Lack of Status Information on Compliance Work in Progress:** The current status of each compliance review is not tracked within CIM. Supervisors oversee multiple concurrent compliance reviews and some supervisors were managing over 100 reviews at a time. We found that the information systems do not provide sufficient information to allow supervisors to adequately track the progress of compliance reviews and manage their workloads. For example, supervisors do not have automated access to information such as phase of reviews, anticipated completion dates, status of potential issues, and status of communications with companies on identified potential underpayments. We found that CIM also lacks status information for audits.

- **Original Monetary Findings Not Tracked:** CIM contains data fields to record the original monetary findings from audits and compliance reviews and the subsequent collections from companies for underpayments. However, we found that MMS' process for recording collections resulted in the inappropriate substitution of the collected amount into the original monetary finding field. This results in the amount of the monetary finding equaling collections. MMS should retain data on the original monetary findings so that it can assess the effectiveness of audits and compliance reviews by determining the recovery rates.

- **Inaccurate Data on Completion of Audits and Compliance Reviews:** MMS could not accurately count the number of audits and compliance reviews that were completed each fiscal year. We attempted to independently determine the statistics on audit and compliance review completions; however, we found that data fields needed to perform these analyses were often not used. For example, the audit report issuance field in CIM was frequently not populated. We also found that the GPRA databases did not always indicate whether the compliance activity had been conducted as an audit or as a compliance review.

- **Offshore GPRA Database Contains Inaccurate and Incomplete Information:** We found that the Offshore GPRA database contained inaccurate or incomplete information that prevented MMS from accurately reporting on performance. This database is designed to accumulate data on compliance coverage on properties. We found that some properties were identified as having completed compliance reviews when those reviews had not been completed. We selected for review five properties identified in the GPRA database as having completed compliance reviews. MMS had not completed a review for three of those five properties. In fact, one of the reviews had not even been started. MMS detected the same issue during an internal control review performed in 2006. However, we found that MMS' corrective action plan was not sufficient to ensure the accuracy of the data. Instead of requiring that the data be validated, the plan called for the Compliance Review Manual procedures to be communicated to all supervisors.

COSTS AND BENEFITS OF AUDIT AND COMPLIANCE REVIEWS ARE UNKNOWN

MMS cannot effectively evaluate the costs and benefits of compliance reviews. A valid cost and benefit analysis would demonstrate the value of compliance reviews to stakeholders. STRAC, which represents the state and tribal audit organizations, has expressed skepticism that compliance reviews are a wise use of limited resources.

MMS could not provide accurate royalty collection data from its CAM Program activities. MMS provided us with a summary of CAM Program collections for October 1999 to March 2006 distributed by audits, compliance reviews, and other activities. MMS reported collections from compliance activities totaling $699 million of which approximately $293 million were attributed to compliance reviews. MMS stated that although it was confident about the collection totals for each year, it could not vouch for the accuracy of the distribution to CAM Program activities. We found the following:

- CIM contained 12,800 lines of unmatched findings and collections that have not been reconciled to a specific audit or compliance review. Until these lines have been reconciled, collection data are not complete.

- The data include duplicated collection amounts. We scanned the database and selected eight instances of collections for the same amount that appeared to be duplicate entries. After further tests and confirmation by MMS, we determined that six of the eight were actual duplicate entries. These six entries totaled $2.2 million.

MMS' collection data also included approximately $134 million resulting from "qui tam" royalty settlements, representing 19 percent of the total reported collections. Qui tam settlements do not directly result from an MMS-initiated audit or compliance review and, accordingly, their inclusion overstates program accomplishments.

Qui tam refers to a case filed under the Federal Civil False Claims Act by a private citizen in the name of the U.S. Government, charging that a government contractor or other entity has defrauded the government. The person shares in any money recovered.

MMS computed a cost benefit analysis in 2006 which showed that compliance reviews were more cost effective than audits. However, we found that the data used in the analysis did not always agree with the supporting documentation and that the methodology was flawed. For example, MMS' analysis considered only its labor costs instead of total costs for compliance reviews, which would better reflect the true costs of conducting compliance activities. Consequently, an uninformed reader of MMS' analysis could easily be misled about the true benefits of compliance reviews.

We also found that the cost to conduct an individual audit or compliance review is unknown because MMS' activity based costing system does not provide detail at the individual audit or compliance review level. In addition, MMS cannot provide an accurate count of completed audits and reviews.

MMS needs to ensure that it has the necessary data to determine the effectiveness of both audits and compliance reviews. MMS would benefit from activity based costing information with line item detail at the individual audit and compliance review level.

CONSEQUENCES OF UNRELIABLE DATA

As a result of the issues identified above, MMS cannot:

- effectively use existing systems for day-to-day management and reporting purposes;
- develop an effective strategy for deploying personnel and other resources between audits and compliance reviews;
- provide reliable information on CAM Program operations and results to stakeholders, including the Congress and state and tribal audit organizations; and
- determine the true cost and benefits of compliance reviews and audits.

Additionally, we noted that MMS must query multiple information systems to compile CAM Program data and much of the data are redundant. This is not an efficient business practice; MMS would benefit from consolidating its information into a single system.

Compliance Review Process Does Not Maximize Outcomes

We found that MMS developed extensive policies and procedures for conducting compliance reviews and that MMS generally followed the guidance. Our audit disclosed some areas where the compliance review process should be improved to maximize the benefits. The following paragraphs describe these areas and present our proposals for improving the effectiveness of the process.

Insufficient Volume Analysis

To test the reasonableness of reported volumes, MMS compares company royalty reports to company production reports to identify discrepancies. This procedure does not provide an independent verification of volume. Without additional analytical steps, MMS has no assurance that the reported production amounts are reasonable.[2] We identified several additional procedures that could be performed to verify the reasonableness of oil and gas volumes. These include:

- Request companies to provide actual source documents (for example, run tickets, tank gauging reports, and oil and gas sales summary statements) for at least one test month. This would allow a more precise expected volume amount to be established for the property.

- Coordinate with the Bureau of Land Management's (BLM) Energy and Minerals Program, which maintains inspection and enforcement data that can be used to help validate the reasonableness of reported volumes for onshore properties. The Program is responsible for overseeing the mineral industry's exploration, development, and production operations on federal and Indian lands. This includes regular inspections of production facilities and enforcement of laws, regulations, and lease terms. BLM's Automated Fluid Minerals Support System (AFMSS) tracks property and well data for each federal onshore and Indian lease. The Compliance Review Manual states that MMS has access to AFMSS, but we saw no evidence that MMS used the system in conducting compliance reviews.

- Use the Liquid Verification System (LVS) and Gas Verification System (GVS) to validate the reasonableness of production volumes for offshore leases. These systems, which are maintained by MMS' Offshore Minerals Management Program, provide actual oil and gas volume data that are based on company-provided source documents. Before implementing this procedure, MMS will need to address known data reliability issues with the LVS and GVS. MMS has allocated resources during FY2006 to help address this matter.

[2] This issue does not apply to solid mineral leases. The Solids CAM obtains inspection reports from BLM and actual sales volume reports from the mining company to independently verify the volumes.

Inadequate Analysis of Allowances

MMS performs an important test to determine whether reported transportation and processing allowance deductions exceed statutory limits. However, source documents are not obtained to enable a precise determination of what the allowances actually should be for oil and gas leases. Consequently, other than checking that the maximum permissible limits were not exceeded, compliance reviews have not assessed whether companies improperly claimed allowances. Requesting companies to provide actual source documents for at least one test month would allow a more precise expected amount to be established.

The Compliance Review Manual states that transportation allowances can be checked for reasonableness by using online sources such as TariffMaster, the Federal Energy Regulatory Commission (FERC), and the Petroleum Information Grid (PI Grid), but we saw no evidence that MMS was using them. We did note that one CAM component instituted revised steps in April 2006 requiring staff to access these information resources. All CAMs should make this research mandatory as part of the allowance analysis.

In addition, MMS could test the reasonableness of allowances by compiling historical trends from audit-verified data and comparing this to the reported amounts.

Rationale for Variance Thresholds Not Documented

Variance thresholds are a critical element of the compliance review process because they are the determining factor for whether MMS accepts the reported royalties. We found, however, that MMS could not explain the rationale or methodology used to establish thresholds for the CAM components. Each CAM has set its own threshold which differs significantly in the dollar amounts and methodology. For example, one CAM applies both a monthly and annual limit, one has just an annual limit, and another simply uses "professional judgment." We concluded that the [Ex. 2 (high)] threshold at one CAM is set so high that significant underpaid royalties may not be collected.

A **variance threshold** is the pre-determined percentage or value set by each CAM for the acceptable difference between the reported and expected values for each element of the royalty equation. If the threshold is exceeded, the company is first notified to obtain comments about the findings. If this does not resolve the matter, MMS follows up with formal communications, such as an order to pay or an order to provide records.

MMS needs to fully define the compliance review process, including variance thresholds. For onshore leases, MMS should work with state and tribal governments in establishing thresholds because all parties have an interest in the distribution of royalties. When setting the thresholds, MMS should also weigh the estimated costs of pursuing the variance issue versus the expected return.

GUIDANCE FOR AUDIT REFERRALS NOT DEVELOPED

We found that the Compliance Review Manual does not provide analysts with specific guidance or trigger points for determining when compliance review issues should be referred to full scale audits as this decision is left to individual judgment. In addition, MMS could not provide complete data on the number of compliance reviews that have been referred because one of the CAMs has not maintained this information. MMS should develop detailed guidance, such as addressing systemic issues found in compliance reviews that more appropriately warrant audits and should track all referral actions.

COMPANIES NOT NOTIFIED WHEN COMPLIANCE REVIEWS PERFORMED

For oil and gas properties, MMS does not typically notify the company when a compliance review is conducted unless a discrepancy is detected that exceeds an established variance threshold. Accordingly, if no discrepancy results, the company will generally be unaware that its royalty reporting had been subjected to regulatory oversight.

MMS should notify companies when compliance reviews begin to increase the visibility of the CAM Program and promote a deterrence effect that may motivate companies to more accurately report and pay royalties.

COLLECTION FOLLOW UP PROCEDURES NOT ENFORCED

MMS' Compliance Review Manual does not have procedures to verify that underpayments identified by compliance reviews are actually billed and collected. For example, our sample of 20 compliance reviews disclosed one instance where a $12,400 underpayment issue had not been collected 8 months after the review was completed. This was caused by a lack of coordination and communication between the compliance review team and the accounting team responsible for collecting the underpayment.

ADHERENCE TO QUALITY CONTROL PROCEDURES NOT ENFORCED

Our review of a sample of 20 compliance reviews disclosed instances in which MMS did not follow required procedures in its Compliance Review Manual. Specifically:

- File summaries did not always provide sufficient detail of the work conducted.

- Supervisory reviews often were not done or not timely performed.

- Independent math verifications were not always documented.

MMS needs to address the above issues to ensure the quality of its work.

ADDITIONAL RISK FACTORS NOT USED IN COMPLIANCE STRATEGY

MMS employs a risk-based strategy in selecting the properties and companies subjected to compliance work. This strategy is driven by MMS' performance measures and focuses on the properties with the highest royalty dollars. MMS should consider additional risk factors for selecting companies and properties for compliance work, such as chronic erroneous reporting and the possibility of fraudulent reporting. In selecting companies for review, MMS should identify companies that have:

- historically underreported royalties to MMS or
- falsely reported information to other federal agencies such as the Environmental Protection Agency and IRS.

MMS should also incorporate "fraud indicators" into its compliance review procedures to help identify intentional false reporting. It could develop the fraud indicators from the results of prior audits and compliance reviews. MMS should also publicize that it has a comprehensive compliance program that includes randomly selected company audits. This would help enhance the deterrence effect by making companies aware that they could be chosen for audit.

STRAC NOT PROVIDED ACCESS TO ALL COMPLIANCE REVIEW TOOLS

MMS has requested that the state and tribal audit organizations include compliance reviews as part of their compliance activities. STRAC has expressed reluctance to perform any work other than audits. STRAC has questioned the benefit of compliance reviews and some STRAC members question MMS' legal authority to direct state and tribal audit organizations to perform compliance review work. However, the Federal Oil and Gas Royalty Management Act provides legal authorization for MMS to contract with state and tribal audit organizations to perform a wide variety of compliance work including both audits and compliance reviews.

Despite MMS' request for STRAC members to perform compliance reviews, MMS has been slow to provide the tools necessary to effectively perform them. While MMS has been implementing Compliance Program Tools (CPT) to help conduct compliance reviews, it has not yet shared these tools with the states and tribes. MMS has been working to resolve information security concerns to provide STRAC members access to the data. STRAC members cannot effectively perform compliance reviews until MMS resolves this access issue.

PERFORMANCE MEASURES NEED REVISION

Performance measures are management tools that provide agencies with the information they need to assess program accomplishments. MMS has two performance measures related to the CAM Program that we found to be flawed. In addition, MMS needs to establish measures to evaluate the efficiency of its Program operations.

COMPLIANCE INDEX NOT RELIABLE

The compliance index is intended to indicate overall industry compliance with MMS' regulations and reporting guidelines and the effectiveness of MMS' compliance efforts. The measure calculates the percentage of the predicted revenues from a production year that is collected within 3 years. For example, the FY2005 performance goal was that by the end of the fiscal year, MMS would have collected 98 percent of calendar year 2002 predicted revenues.

This measure suggests a high rate of compliance by reporting that MMS collected 98 percent of royalties that should have been paid. Unfortunately, MMS cannot know the total dollar amount of royalties that should have been paid. Therefore, MMS uses a prediction of those royalties to calculate the compliance index. MMS' methodology for predicting revenues does not provide a valid figure for calculating the compliance index. MMS' methodology is based solely on information from offshore and some Indian oil and gas leases. The formula excludes onshore federal oil and gas, solid minerals, and geothermal leases. MMS officials recognize the limitations of this measure and they have not used the measure to manage program operations. MMS should stop using this measure to present program results.

COMPLIANCE COVERAGE MEASURE IS MISLEADING

MMS measures the percentage of reported royalty dollars that it addresses with its compliance activities. The compliance coverage measure calculates the percentage of reported royalties from a production year for which MMS will have conducted compliance work within a 3-year period. For example, the FY2005 performance goal was to complete compliance work on 71 percent of calendar year 2002 reported royalties.

The compliance coverage measure is misleading because it weighs audits, compliance reviews, and RIK analyses equally, when they provide very different levels of assurance. We agree that there is a need to measure compliance coverage; however, we believe that MMS needs to modify its measure to report these activities separately.

Further, the use of the compliance coverage measure has negatively affected the number of companies and properties subjected to compliance work. The measure focuses solely on royalty dollars, and as a result, many of the same companies and high dollar properties have been reviewed year after year. For example, in the past 3 years, MMS has reviewed only 9 percent of its properties and 20 percent of companies as illustrated in Figure 1 below. For the Onshore CAM alone, 92 percent of the properties selected for review in FY2006 had been reviewed in the previous 2 years. As such, most companies and properties are not likely to be selected for compliance work. MMS should consider modifying its CAM Program strategy to ensure appropriate coverage of properties and companies within a reasonable timeframe even if this results in a reduction in the overall percentage of dollars covered.

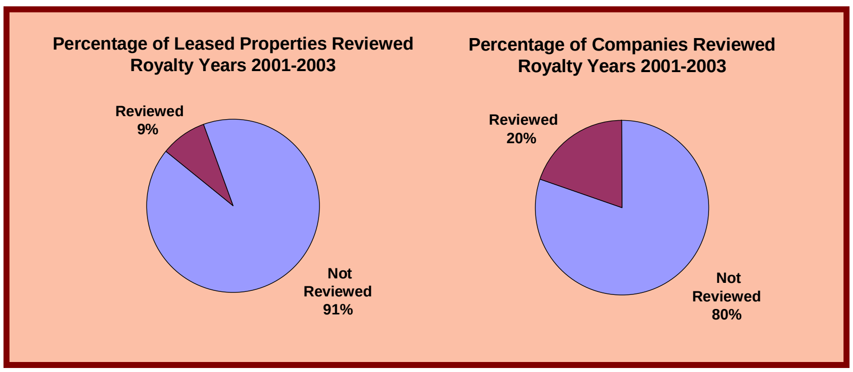

Figure 1. Compliance Coverage of Leased Properties and Companies

The measure also is not fully representative of all CAM Program activities because compliance reviews that do not cover the entire royalty equation (known as "limited scope" compliance reviews) are excluded. For example, the Indian CAM performs extensive limited scope reviews to assess the reasonableness of reported prices. Accordingly, MMS should have a performance measure for these types of activities.

Efficiency of Compliance Activities Not Measured

MMS should consider adding additional performance measures and goals to assess efficiency of its operations. The IRS has multiple measures related to processing tax returns and resolving compliance issues, which help evaluate performance. For example, in FY2005 one IRS efficiency measure was calculated by dividing the total number of examined tax returns by the number of employees. MMS could compute similar efficiency rates for its own audits and compliance reviews.

In discussions with MMS management, MMS does recognize that the GPRA goals for these particular issues need improvement, and MMS is reconsidering all of its current goals and measures. To develop performance measures that are more useful and meaningful, MMS needs to link work activities to CAM Program goals and establish better output and outcome measures to serve as indicators of CAM Program performance.

RECOMMENDATIONS

We recommend that the Director, Minerals Management Service:

1. **Develop and implement a plan to provide reliable data for managing and reporting on CAM Program operations. This plan should include:**

   - **addressing the data reliability issues in CIM, GPRA databases, LVS, and GVS; and**

   - **consolidating systems where appropriate.**

MMS Response:

MMS concurred with our recommendations to address the data reliability issues and to consider consolidating its various systems. MMS did not concur with the recommendation in the draft report to develop activity-based costing information at the individual audit and compliance review level. MMS explained that it manages a very large number of these activities and providing this information would not be cost effective. MMS also stated that it is appropriate to record qui tam settlement collections in the compliance tracking system.

OIG Analysis of MMS Response:

Based on MMS' response, we deleted the draft report's recommendation that activity-based costing information should be provided at the individual audit and compliance review level. While we believe that management would benefit from this information, we recognize that maintaining such detail could be burdensome.

Although we agree that MMS should track qui tam settlements, the amounts should not be included in the cost and benefit analyses for audits and compliance reviews. As stated in the report, MMS should not take credit for qui tam settlements because these findings did not result from MMS-initiated work.

2. **Strengthen the compliance review process by:**

   - **including additional procedures to provide greater assurance concerning the reasonableness of:**

     - **volumes by requesting actual source documents for at least one test month, or using inspection and enforcement data, or using production data from LVS and GVS; and**

- **allowances by requesting actual source documents for at least one test month, or using online sources (such as TariffMaster, FERC, and PI Grid), or compiling historical trends;**

- **documenting the rationale for determining thresholds for pursuing potential underpayments;**

- **developing additional guidance for audit referrals and by tracking referral actions;**

- **notifying companies undergoing compliance reviews to give greater visibility to the CAM Program and to deter them from inaccurately reporting royalties;**

- **improving adherence to quality control procedures;**

- **using risk-based criteria for selecting companies for CAM Program coverage; and**

- **ensuring that state and tribal auditors have access to all necessary compliance review tools, including the CPT.**

MMS Response:

MMS concurred with most of our proposals to strengthen the compliance review process. However, MMS did not agree that it should request source documents for one test month for the volume and allowance analyses, stating that alternative procedures of accessing other information was, or would soon be, available. MMS also did not agree that it needs to document the procedures related to the billing and collections process, because adequate procedures were already in place.

MMS concurred with our recommendation to use a risk-based strategy for selecting companies for CAM Program coverage, but the response did not specifically mention that procedures would include inquiring whether companies have falsely reported information to other federal agencies.

OIG Analysis of MMS Response:

We revised our recommendation to reflect that obtaining source documentation is only one of several means to improve the review of volume and allowances. We agree that the other sources identified should be sufficient to meet MMS' need; however this information may not always be available. In cases where MMS cannot obtain the necessary information on volume and allowances from other existing sources, it should request actual source documentation.

Because we found an instance where an underpayment had not been collected, we originally recommended that CAM Program analysts establish procedures to follow up on collections. MMS' response correctly points out that the Financial Management Program has responsibility for collecting identified underpayments and has written procedures for billing and collecting. We therefore deleted this element of the recommendation to the CAM Program.

Concerning MMS' risk-based strategy, a company's historical reporting record with other federal agencies could be a valuable resource in identifying habitual noncompliance with regulations and requirements. Accordingly, we ask that MMS affirm that it will incorporate this step into its risk-based strategy.

3. **Revise performance measures to better reflect CAM Program operations. Specifically, MMS should:**

    - **eliminate the compliance index performance measure;**
    - **separate the compliance coverage measure for audits, compliance reviews, and royalty-in-kind compliance activity;**
    - **develop separate performance measures for companies and properties subjected to compliance coverage; and**
    - **develop performance measures to monitor the efficiency of audits and compliance reviews.**

MMS Response:

MMS agreed to implement all recommendations regarding the performance measures except our recommendation to separate the compliance coverage measure by the type of compliance activity. MMS stated it would track the information internally along with some of its limited scope compliance reviews, but would not report the measures separately to the Department.

OIG Analysis of MMS Response:

The various compliance activities provide different levels of assurance. The compliance coverage measure does not fully disclose the different levels of coverage and is therefore misleading and easily manipulated by changing the ratio of the different compliance activities. We continue to recommend that MMS separate the measure for audits, compliance reviews, and royalty-in-kind.

SCOPE AND METHODOLOGY

Our audit scope addressed compliance review activities from FY2000 to June 2006. It included a review of MMS' design and implementation of compliance reviews, as well as its overall management of the CAM Program. Our scope included MMS' CAM Program and its four component offices. Our scope did not include the Royalty In-Kind program activities.

To accomplish our objectives, we:

- Reviewed MMS' policies and procedures for the compliance review program and performed walkthroughs of the compliance review process for each CAM.

- Held meetings with senior management and the four CAM managers to discuss how they implement their compliance review program and assess and monitor results.

- Gained an understanding of each CAM's audit and compliance review strategy.

- Selected a haphazard sample of 20 compliance reviews to determine if MMS followed its policies and procedures.

- Gained an understanding of MMS' information systems used to manage the CAM Program. We analyzed the data provided by the Compliance Information Management (CIM) system and the four GPRA databases and performed limited data verification steps that we considered necessary. Specifically we looked at data regarding:
  - collections resulting from audits and compliance reviews,
  - audit and compliance review completion data,
  - GPRA property and company information, and
  - obligations and disbursements for STRAC cooperative agreements.

- Reviewed information in MMS' cooperative agreements with the states and Indian tribes for fiscal years 2001 through 2006 to determine the amount of funding provided to conduct audits.

- Reviewed other federal and private entities, including the Internal Revenue Service, that have comparable activities to MMS' compliance reviews for the purpose of identifying best practices.

- Reviewed the Department of the Interior's Annual Report on Performance and Accountability for fiscal years 2003 to 2005. The reports contained no reported weaknesses within the objectives and scope of our audit.

- Reviewed the Department of the Interior’s Strategic Plan for fiscal years 2003-2008 to determine the goals and measures related to the CAM Program.

We performed our audit from April through June 2006 at MMS’ Minerals Revenue Management offices in Lakewood, Colorado, and Washington, DC. We conducted our audit in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States.

Concurrent with conducting this audit we also compiled information to answer additional questions posed by the U.S. Senate Committee on Energy and Natural Resources. These questions related to MMS’ auditor positions, the number of royalty audits initiated by MMS, the adequacy of MMS’ resources, and the funding for state and tribal audit organizations. Our answers are presented in Appendices 4 and 5.

MMS' RESPONSE TO DRAFT REPORT

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Washington, DC 20240

NOV -9 2006

Memorandum

To: Anne L. Richards
Assistant Inspector General for Audits

NOV 14 2006

Through: C. Stephen Allred
Assistant Secretary – Land and Minerals Management

From: R. M. "Johnnie" Burton
Director

Johnnie Burton

Subject: Draft Audit Report, Minerals Management Service's Compliance Process (Assignment No. C-EV-MOA-0006-2006)

Thank you for the opportunity to respond to the subject draft audit report dated October 2, 2006. We generally concur with the findings and recommendations presented in the draft report. Our detailed response, including actions planned or underway, is presented in Attachment 1.

We appreciate the draft report's overall conclusion that Minerals Management Service's (MMS) compliance reviews are a legitimate tool for evaluating the reasonableness of company-reported royalties. Such reviews allow a broader coverage of royalties while requiring fewer resources than audits. We concur that by implementing most of the recommendations proposed by the Inspector General we can further improve the compliance process. We concur with the draft report's finding that MMS has developed extensive policies and procedures for conducting compliance reviews and that MMS generally followed the guidance. Further, we agree that compliance reviews should be used in conjunction with audits in a coordinated audit strategy. The MMS's current compliance strategy effectively utilizes a combination of audits, compliance reviews, and royalty-in-kind property reconciliations to ensure that Federal and Indian mineral royalty payments are accurately reported and paid consistent with applicable laws, regulations and lease terms.

Through implementation of a compliance strategy that includes both audits and compliance reviews, during FY 2006 MMS ensured compliance on 72.5 percent of revenues paid in calendar year 2003 (approximately $5.8 billion). As the Office of Inspector General (OIG) noted in its draft report, in the past 3 years MMS has reviewed 20 percent of companies. To put this in perspective, in FY 2005, the Internal Revenue Service audited, on average, 20 percent of larger corporations. The MMS applies procedures that provide reasonable assurance of detecting

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violations of laws, lease terms, and regulations, consistent with the requirements and guidance of the Government Auditing Standards.

We also concur that we must improve in some areas. We appreciate the recommendations from the OIG. Attachment 2 provides a list of actions we will take to address these recommendations. While some of the actions can be implemented near-term, others will require longer-term solutions. Consequently, MMS has undertaken the development of a comprehensive plan to address the implementation path for all actions. This action plan will provide detailed steps and targeted completion dates. The MMS will provide this action plan to the OIG within 30 days after receipt of the final report.

We appreciate the OIG's acknowledgement that MMS has policies and procedures in place such as the Compliance Review Manual, issued in January 2006, with the full intent of conducting an Internal Quality Control Review in FY 2007. Additionally, MMS's Minerals Revenue Management program initiated a program-wide strategic business planning effort in FY 2006 to identify and address opportunities for improving program performance over the period 2007 through 2012. The MMS has already addressed a number of the OIG recommendations in the compliance area of the planning initiative, while others will need to be added to these efforts. The action plan that we will be providing to the OIG will detail each of the actions that are responsive to the OIG report recommendations.

The draft report also cites a January 2006 New York Times article criticizing the effectiveness of the CAM Program and asserting that MMS undercollected approximately $700 million in gas royalties in FY 2005. The U.S. Senate Committee on Energy and Natural Resources (Committee) requested that the OIG look into the effectiveness of MMS's compliance reviews and the Government Accountability Office (GAO) address the allegation of underpayment of royalties. In a March 2006 briefing to the Committee, GAO concurred with MMS's analysis that there was no $700 million shortfall and stated "GAO Agrees with MMS's Reasons for the Decline in Gas Royalty Revenues from 2001 to 2005." Further in its June 21, 2006, final report the GAO concluded: "In summary, federal and Native American royalty revenues did not increase at the same pace as oil and natural gas prices between 2001 and 2006 principally because the volumes upon which royalty are based declined substantially during this time."

We appreciate the opportunity to respond to this draft report and look forward to working with the OIG in implementing the recommendations. Please contact [Ex. 2 (low) and 6] [redacted] if you have any further questions.

Attachments

cc: Daniel Fletcher, Director, Office of Financial Management

This report contained information that was redacted pursuant to 5 U.S.C. §§ 552(b)(2) (high) and (low) and (b)(6) of the Freedom of Information Act.

Attachment 1

Response to Office of Inspector General Draft Report

<u>Bureau</u>: Minerals Management Service (MMS)

<u>Audit Title:</u> Draft Audit Report, Minerals Management Service's Compliance Review Process

<u>Job Code Number</u>: C-EV-MOA-0006-2006 **<u>Draft Report Date</u>:** October 2, 2006

<u>Initiator</u>: Office of the Inspector General (OIG)

<u>Audit Scope</u>: (1) Are compliance reviews an effective part of the MMS Compliance and Asset Management (CAM) Program. (2) Is MMS effectively managing the compliance review process?

<u>Findings and Recommendations:</u>

Findings: (1) The MMS lacks reliable management information to adequately develop a compliance strategy, monitor progress, and assess results of its CAM Program. (2) The MMS needs to improve its compliance review process to maximize outcomes. (3) The MMS' performance measures are misleading and need to be revised.

Recommendations:

1. Develop and implement a plan to provide reliable data for managing and reporting on CAM Program operations;
2. Strengthen the compliance review process and;
3. Revise performance measures to better reflect CAM Program operations

<u>Program/Organizational Component Where Weakness or Issue Resides:</u>

Minerals Revenue Management (MRM): Compliance and Asset Management Program

<u>Accountable Officials:</u>

- Headquarters: Lucy Querques Denett, Associate Director, MRM [Ex. 2 (low)]
- Field: Theresa Walsh Bayani, Program Director, Compliance and Asset Management, [Ex. 2 (low)]

<u>Target Completion Date:</u>

The MMS will address the recommendations through an action plan to be provided to the OIG within 30 days after receipt of the final report. Additional information is detailed in the milestones below.

Milestones to Address the Recommendations:

OIG's Recommendations:

1a) Develop and implement a plan to provide reliable data for managing and reporting on CAM Program operations, to include addressing the data reliability issues in the Compliance Information Management System (CIM), Government Performance and Results Act (GPRA) databases, the Liquid Verification System (LVS), and Gas Verification System (GVS).

MMS Response:

The MMS generally concurs. Following is additional data on each system or tool listed in the recommendation.

Compliance Information Management System (CIM)
Two court-ordered shutdowns over the last several years delayed the design of a new compliance tracking system and created a significant backlog of status updates. The MMS is currently diligently working to update the status of compliance reviews and audits in the tracking system. The MMS will enhance existing procedures to ensure consistency in the entering and maintenance of data and the use of this system for compliance review tracking purposes. The MMS will establish additional controls to ensure these procedures are effective.

The OIG recognized that this tracking system's database includes collections resulting from qui tam royalty settlements and stated that these settlements do not directly result from an MMS-initiated audit or compliance review, and accordingly, their inclusion overstates program accomplishments. We disagree. These qui tam settlements often involve related compliance reviews or audits already conducted by MMS, state and tribal auditors. Further, MMS, states, and tribes perform significant work over long periods of time to determine settlement amounts in these qui tam settlements. Therefore, MMS believes it is appropriate to continue recording qui tam settlement collections in the compliance tracking system.

Government Performance and Results Act (GPRA)
The MMS will continue to use the Government Performance and Results Act database to track the revenues by property for the completed compliance reviews and audits; the compliance tracking system is not designed to track royalty revenues needed for the Government Performance and Results Act measure. The MMS will expand existing procedures to include consistent instructions on the appropriate methods to update the Government Performance and Results Act database. Additional controls will be established to ensure these procedures are effective.

Gas Verification System (GVS) and Liquid Verification System (LVS)
The Offshore Minerals Management (OMM) compares actual source metering data (run tickets, meter proving reports, and gas metering statements) to the Oil and Gas Operations Report production volumes in the Gas Verification System and the Liquid Verification System. The Gas Verification System came online in January 2004 and was not available for compliance reviews for calendar year 2003, the time period covered by the OIG audit. For offshore leases, CAM is currently resolving Liquid Verification System volume exceptions for calendar year 2005, and OMM is resolving all Gas Verification System exceptions. By resolving volume exceptions for the calendar year 2005, the Liquid Verification System and the Gas Verification

System will provide MMS accurate data for use in volume analysis for upcoming compliance reviews. In addition, MMS will expand our current procedures to use the Gas Verification System and the Liquid Verification System to verify volumes where applicable. The MMS will also establish additional controls to ensure these procedures are effective.

1b) Develop and implement a plan to provide reliable data for managing and reporting on CAM Program operations, to include developing activity based costing information at the individual audit and compliance review level.

MMS Response:

The MMS does concur and will develop and implement a plan to provide more reliable data for managing and reporting on CAM Program operations as part of the MRM's strategic planning initiative.

The MMS does not concur with developing activity based costing information at the individual audit and compliance review level. Annually there are thousands of compliance reviews and audits underway. Requiring additional individual cost codes would not be cost effective and likely not supported by the Department at this time. The current MMS activity based system provides separate codes for time spent on audits, compliance reviews, and RIK activity which was used in our 2006 cost/benefit study. The MMS has directed managers and supervisors to directly charge the time spent on audit, compliance, and RIK activities to the respective activity codes for these activities. This allows MMS to directly account for management labor costs in the total costs for each compliance activity. However, the MMS is exploring avenues to enhance our current compliance cost/benefit analysis and is currently seeking expert contractor support to provide assistance in this process.

1c) Develop and implement a plan to provide reliable data for managing and reporting on CAM Program operations, to include consolidating systems where appropriate.

MMS Response:

The MMS concurs that this recommendation is an area that needs to be evaluated. We do recognize the need and agree to track compliance review and audit information in the compliance tracking system. However, the tracking system is not currently designed to track initial royalties paid on a property or the total royalties reviewed for compliance which is the basis for measuring the MMS Government Performance and Results Act 3-year compliance goal. Therefore, MMS must continue to track this information through the Government Performance and Results database. The MMS is evaluating other potential redundancies as part of MRM's strategic planning initiative.

2a) Strengthen the compliance review process by including additional procedures to provide greater assurance concerning the reasonableness of:

- **Volumes by requesting actual source documents for at least one test month, using inspection and enforcement data, coordinating with other agencies including the Bureau of Land Management (BLM) and the Bureau of Indian Affairs (BIA) for onshore, and the Offshore Minerals Management, for offshore and using production data from the Liquid Verification System and the Gas Verification System.**

This report contained information that was redacted pursuant to 5 U.S.C. §§ 552(b)(2) (high) and (low) and (b)(6) of the Freedom of Information Act.

- **Allowances by requesting actual source documents for at least one test month, using online sources (such as TarriffMaster, the Federal Energy Regulatory Commission (FERC), and PI Grid), and compiling historical trends.**

MMS Response:

Volumes:
The MMS concurs with using inspection and enforcement data and production data from the Liquid Verification System and the Gas Verification System. The MMS does not concur with requesting one month of source data. The OIG suggested that MMS request source data such as run tickets and metering statements but this verification of production volumes is the responsibility of another MMS program, OMM for offshore and another agency, the BLM for onshore. These offices obtain the source metering and run ticket statements and independently verify production volumes to the production reports. In response to recommendation 1a), MMS concurred with the use of the Liquid Verification System and the Gas Verification System for offshore compliance reviews. The BLM requests the same data for onshore properties as part of their production accountability program and compares the data to the production reports. Having MMS request source data for one month during a compliance review would be a duplication of effort.

The MMS review process is intended to assure reasonable compliance. For volume verification, the process determines if all volumes reported as sold on production reports are also reported and paid by the payors on the royalty report. Another reason for not requesting the source data is that the operator is typically not the same company as the payors and in many cases, there are multiple payors independent from each other reporting royalties on the same property. If the royalty report volumes in total match the operator's production report volume, there is reasonable assurance that the volumes as reported are correct.

As acknowledged by the OIG in its report, the Solids CAM already obtains inspection reports from the BLM and actual sales volume reports from mining companies to independently verify the volumes. The reasons that Solids CAM obtains source data for volume verification in the compliance review process are because typically the operators and the payors for mining operations are one and the same, and the universe of leases for Solids CAM is smaller than the other CAMs.

The MMS will continue to coordinate directly with BLM on our compliance strategy and their inspections of onshore production facilities. The BLM stores inspection and enforcement data in the Automated Fluid and Minerals Support System. For many years, MMS had access to BLM's system but since the two court-ordered system shutdowns and continued security issues associated with the Automated Fluid and Minerals Support System, MMS still does not have direct access. The direct access provided us with information on inspections and enforcement actions without having to contact BLM directly. We will continue to work with BLM to restore the MMS access to Automated Fluid and Minerals Support System.

Allowances:
The MMS does not agree that requesting allowance source documents for one test month will provide the needed information to ensure reasonable compliance. Allowance deductions provided by regulation can be complicated and not easily addressed by the OIG's recommended

strategy. For example, in non-arm's-length[1] situations, allowable transportation costs are based on a calculation of capital expenditures, allowable expenses, and through-put for the transportation system as a whole. One month's documentation will not provide the needed detail to support such a deduction.

Obtaining allowance source documents is typically performed in the audit process; however, the MMS agrees that if pertinent and available, MMS could access tariff information, and, in fact, Chapter 5 of the Compliance Review Manual provides procedures for accessing tariff databases.

The MMS CAMs have access to the following transportation-related information, which provides sufficient data to ensure reasonable compliance on allowances including:

- Indian Leases – Regulations require the submission of the actual contracts for arm's-length[2] transportation and processing allowances, and separate MMS transportation and processing forms detailing the calculation of the costs for non-arm's-length allowances. The MMS routinely uses this information in the compliance review process for Indian leases.
- Federal Oil and Gas Leases - For interstate transportation, FERC published rates are available through tariff databases.
- All CAM Leases – Prior audit findings, other payors' rates, and royalty report information are available for analysts to perform historical analysis.

2b) Strengthen the compliance review process by documenting the rationale for determining thresholds for pursuing potential underpayments and including procedures to verify underpayments are billed and collected.

MMS Response:

The MMS concurs with the need to document the rationale for determining tolerances. The MMS is exploring avenues to enhance our current compliance cost/benefit analysis and is currently seeking expert contractor support to provide assistance. The results of these enhancements will assist MMS in developing materiality or tolerance limits for pursuing potential underpayments.

The MMS does not concur with the need for documentation of procedures related to our billing and collection process. The MMS believes all necessary documentation for issuance and collection of bills, and the follow-up debt collection is in place. The billing and collection process is a function of the Financial Management (FM) group within MMS. CAM develops an issue to the enforcement document (order) stage, and the FM Billing Section mails both the order and the invoice to the payor/operator. This process is documented in Chapter 7 of the Compliance Review Manual. The MMS has established billing, bill collection, and follow-up debt collection processes and procedures. During FY 2006, we modified our debt collection processes to include further controls to ensure that any debt over 180 days old and not under appeal or bankruptcy would be referred to Treasury for collection.

[1] A non-arm's length allowance is generally defined as an allowance resulting from a contract or agreement that has been arrived at in the market place between non-independent and affiliated persons.

[2] Arm's-length allowance is generally defined as an allowance resulting from a contract or agreement that has been arrived at in the market place between independent, non-affiliated persons with opposing economic interests regarding that contract.

This report contained information that was redacted pursuant to 5 U.S.C. §§ 552(b)(2) (high) and (low) and (b)(6) of the Freedom of Information Act.

2c) Strengthen the compliance review process by developing additional guidance for audit referrals and by tracking referral actions.

MMS Response:

The MMS concurs. Currently, MMS uses the Management Tracking Tool to document referrals. The MMS will amend the Compliance Review and Audit Manuals to provide additional instruction on referral documentation. Additional controls will be established to ensure the procedures are effective.

2d) Strengthen the compliance review process by notifying companies undergoing compliance reviews to give greater visibility to the CAM Program and to deter them from inaccurately reporting royalties.

MMS Response:

The MMS concurs. In the near future, MMS will send a letter annually notifying those companies in general where compliance reviews will likely occur.

2e) Strengthen the compliance review process by improving adherence to quality control procedures.

MMS Response:

The MMS concurs. To ensure quality controls for the compliance review process, MMS issued a formal Compliance Review Manual in January 2006, effective for compliance review work completed from that point forward. In addition, to ensure quality control in all areas of its compliance review process, MMS has scheduled an Internal Quality Control Review of the compliance review process for FY 2007.

2f) Strengthen the compliance review process by using risk-based criteria for selecting companies for CAM Program coverage.

MMS Response:

The MMS concurs and in fact MMS had already begun this process in early calendar year 2006. As part of MRM's strategic planning initiative, MMS began pursuing the development of a risk-based strategy for compliance. The MMS sought expert contract support to provide assistance. This strategy will provide a process to rank payors/properties according to particular risk identifiers such as the number of properties, prior compliance history, credit and payment history with MMS, disputes with MMS, BLM and the Office of Surface Mining and non-arm's length activities, etc., and is expected to address the different levels of compliance provided by the different compliance activities. It is anticipated that this strategy will provide the detail to identify properties or payors where audits or compliance reviews are warranted. The MMS anticipates implementing a pilot to further develop and implement these strategies.

2g) Strengthen the compliance review process by ensuring that state and tribal auditors have access to all necessary compliance review tools, including the Compliance Program Tools (CPT).

MMS Response:

The MMS concurs. We are working on implementing the systems to provide the necessary compliance review tools to the states and tribes. The MMS anticipates the delivery of the tools in February 2007 and will provide access to states and tribes after completion of training. The MMS provided the OIG an update on the delivery of the tools during their review. The Department of the Interior (Department) limitations regarding the access to Indian data and the Cobell litigation have placed strict security requirements on system access to any tools MMS can provide to our state and tribal auditors.

3a) Revise performance measures to better reflect CAM Program operations. MMS should eliminate the compliance index performance measure.

MMS Response:

The MMS concurs. The MMS will take the administrative steps with the Department to recommend removal of the Government Performance and Results Act compliance index performance measure.

3b) Revise performance measures to better reflect CAM Program operations. The MMS should separate the compliance coverage measure for audits, compliance reviews, and royalty-in-kind compliance activity.

MMS Response:

The MMS generally concurs that our performance measures need revision; however, we do not concur with reporting three separate measures for audit, compliance reviews, and royalty-in-kind compliance activities to the Department. Currently, the MMS must report a single overall Department Government Performance and Results Act goal that addresses compliance effectiveness. However, MMS agrees to continue to internally track separate measures for each of the three compliance activities. The MMS will also continue to track some limited scope reviews for internal measures.

In FY 2006, MMS covered 72.5 percent, or $5.8 billion of our calendar year 2003 royalty universe through the three compliance activities. We believe this high percentage coverage of royalty dollars is an important measure for the Treasury. As noted in our response to recommendation number 2f, in early calendar year 2006 as part of MRM's strategic planning initiative, MMS began pursuing the development of a risk-based strategy for compliance. The MMS anticipates that the risk-based strategy would expand the universe of companies reviewed to include smaller companies and properties in addition to the coverage of royalty dollars. Future performance measures that are developed will require approval by the Department.

3c) Revise performance measures to better reflect CAM Program operations. The MMS should develop separate performance measures for companies and properties subjected to compliance coverage.

MMS Response:

The MMS concurs. The MMS believes that specific information relating to payors and properties will aid in the risk-based determination of our compliance strategy. As noted in our response to recommendation number 2f, in early calendar year 2006 as part of MRM's strategic planning initiative, MMS began pursuing the development of a risk-based strategy for compliance. We will continue this effort and take into account specific OIG recommendations on performance measures.

3d) Revise performance measures to better reflect CAM Program operations. MMS should develop performance measures to monitor the efficiency of audits and compliance reviews.

MMS Response:

The MMS concurs with this recommendation. The MMS is exploring avenues to enhance our current compliance cost/benefit analysis and is currently seeking expert contractor support to provide assistance. From this process we will develop efficiency measures for these compliance activities.

Attachment 2

Summary and Status of OIG Recommendations
Regarding MMS' Compliance Review Activities
October 2006

Within 30 days after receipt of the final OIG report, MMS will provide an action plan by to provide the timeline for the completion of the following actions:

OIG Recommendations	Actions in Process
1) **Develop and implement a plan to provide reliable data for managing and reporting on CAM Program operations, to include:**	
a. Addressing the data reliability issues in the Compliance Information Management System (CIM), the Government Performance and Results Act (GPRA) databases, the Liquid Verification System (LVS), and the Gas Verification System (GVS);	a. The MMS will enhance existing policies to ensure consistency in the entering and maintenance of data and the use of CIM for compliance review tracking purposes. Additional controls will be established to ensure these procedures are effective. b. The MMS will expand existing GPRA procedures to include consistent instructions on the appropriate methods to update the GPRA database. Additional controls will be established to ensure these procedures are effective. c. The MMS will expand our current procedures to direct MMS analysts to use LVS and GVS to verify volumes. Additional controls will be established to ensure these procedures are effective.
b. Developing activity based costing information at the individual audit and compliance review level; and	d. The MMS is exploring avenues to enhance our current compliance cost/benefit analysis and is currently seeking expert contractor support to provide assistance in this process.
c. Consolidating systems where appropriate.	e. The MMS is evaluating potential redundancies as part of MRM's strategic planning initiative.
2) **Strengthen the compliance review process by;**	
a. Including additional procedures to provide greater assurance concerning the reasonableness of: ○ Volumes by requesting actual source documents for at least one test month, using inspection and enforcement data, coordinating with other agencies	a. The MMS will expand existing procedures to direct analysts to use LVS and GVS for volumes analysis. Additional controls will be established to ensure these procedures are effective. b. The MMS will continue to coordinate. directly with BLM on our compliance

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including the Bureau of Land Management (BLM) and the Bureau of Indian Affairs (BIA) for onshore, and the Offshore Minerals Management for offshore and using production data from the Liquid Verification System (LVS) and the Gas Verification System (GVS). o Allowances by requesting actual source documents for at least one test month, using online sources (such as TarriffMaster, FERC, and PI Grid), and compiling historical trends.	strategy and their inspections of onshore facilities. We will also continue to work with BLM to restore the MMS access to the Automated Fluid Minerals Support System which provides access to inspection and enforcement data.
b. Documenting the rationale for determining thresholds for pursuing potential underpayments and including procedures to verify underpayments are billed and collected.	b. The MMS is exploring avenues to enhance our current compliance cost/benefit analysis and is currently seeking expert contractor support to provide assistance. The results of these enhancements will assist MMS in developing materiality or tolerance limits for pursuing potential underpayments.
c. Developing additional guidance for audit referrals and by tracking referral actions.	c. The MMS will amend the Compliance Review and Audit Manuals to provide additional instruction on referral documentation. Additional controls will be established to ensure the procedures are effective.
d. Notifying companies undergoing compliance reviews to give greater visibility to the CAM Program and to deter them from inaccurately reporting royalties.	d. The MMS will send a letter annually notifying those companies in general where compliance reviews will likely occur.
e. Improving adherence to quality control procedures.	e. The MMS will continue to stress adherence to quality control procedures through the completion of a FY 2007 Internal Quality Control Review of the compliance review processes.
f. Using risk-based criteria for selecting companies for CAM Program coverage.	f. The MMS will implement a pilot to further develop and implement risk-based strategies.
g. Ensuring that state and tribal auditors have access to all necessary compliance review tools, including the Compliance Program Tools (CPT).	g. The MMS will continue with the testing, training, and implementation of CPT tools to states and tribes.
3. Revise performance measures to better reflect CAM Program operations. MMS should:	
a. Eliminate the compliance index	a. The MMS will take the administrative

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performance measure.	steps with the Department to recommend removal of the compliance index performance measure.
b. Separate the compliance coverage measure for audits, compliance reviews, and royalty-in-kind compliance activity.	b. The MMS will implement a pilot to further develop and implement risk-based strategies. The MMS will continue to internally track separate measures for each of the three compliance activities.
c. Develop separate performance measures for companies and properties subjected to compliance coverage.	c. The MMS will implement a pilot to further develop and implement the risk-based strategies.
d. Develop performance measures to monitor the efficiency of audits and compliance reviews.	d. The MMS is exploring avenues to enhance our current compliance cost/benefit analysis and is currently seeking expert contractor support to provide assistance. From this process we will develop efficiency measures for these compliance activities.

This report contained information that was redacted pursuant to 5 U.S.C. §§ 552(b)(2) (high) and (low) and (b)(6) of the Freedom of Information Act.

Status of Recommendations

Recommendations	Status	Action Required
1	Management partially concurs - additional information needed.	Consider the revisions made to the recommendation and provide an action plan with target dates and title of official responsible for implementation.
2	Management partially concurs - additional information needed.	Consider the revisions made to the recommendation and provide an action plan with target dates and title of official responsible for implementation. Also, clarify whether the risk-based strategy will consider how companies have complied with other federal agencies.
3	Management partially concurs - additional information needed.	Provide an action plan with target dates and title of official responsible for implementation. Also, reconsider the response related to the separate reporting of audit, compliance review, and RIK compliance activities.

OIG RESPONSE TO QUESTIONS POSED BY THE U.S. SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

Question 1. Has MMS reduced the number of auditor positions? If so, how many positions have been cut? Why?

MMS has reduced the number of auditor positions since 2000 as illustrated in Figure 1 below. MMS reduced the number of its auditors located in the Compliance and Asset Management (CAM) Program by 35 or 20.7 percent (from 169 to 134). During the same period, the approximate number of state and tribal auditors funded by MMS decreased by 10 or 8.5 percent (from 118 to 108)[3]. The total number of auditors decreased by 45 or 15.7 percent (from 287 to 242).

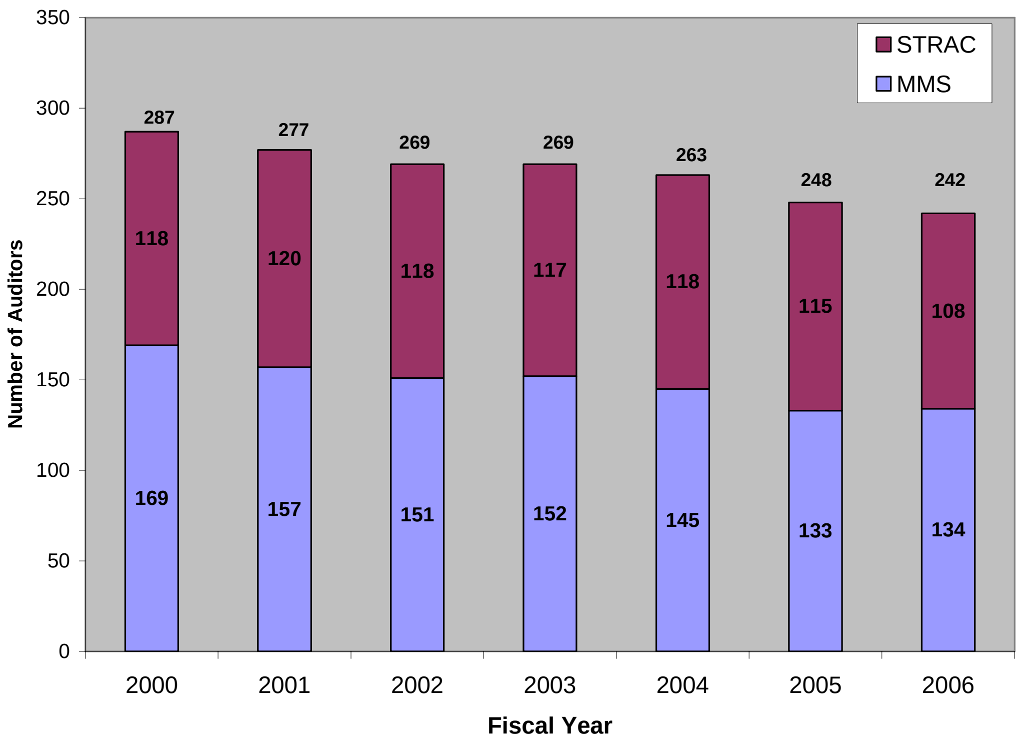


Figure 1. *Number of auditors for MMS and STRAC.*

MMS provided the following three reasons for the decline in audit staff:

- A steady growth of royalties being taken in-kind instead of in-value has resulted in personnel being transferred to the Royalty-In-Kind Program.

[3] MMS did not have data on the actual number of state and tribal auditors; however, it provided a calculated estimate based on the number of hours provided by the state and tribal audit organizations.

- MMS reengineered its compliance processes and developed more efficient methods to augment the traditional audit approach. In particular, the recently developed compliance review process has enabled MMS to provide broader coverage with fewer resources.

- MMS has not been fully funded for growth in pay and benefits, which has reduced overall staffing levels by nearly 9 percent since 2001.

Question 2. Has MMS reduced the number of audits that it undertakes? How many audits were initiated in 2005 as compared to each of the five preceding years?

Because of errors in MMS' data, we were unable to compare audit initiation data on an annual basis. Specifically, some audits started in FY2004 were inappropriately identified as FY2005 audits. This occurred because MMS was implementing a new tracking system. We were unable to reasonably adjust for this error. Therefore, for purposes of answering this question, we combined the audits initiated figures into biennial periods.

The overall number of audits initiated by MMS (including state and tribal audit organizations) decreased during this period as shown in Figure 2. MMS initiated 595 audits in FYs 2000/2001 and 461 audits in FYs 2004/2005, a decrease of 22 percent. We did not evaluate the substance of the audits or audit work conducted.

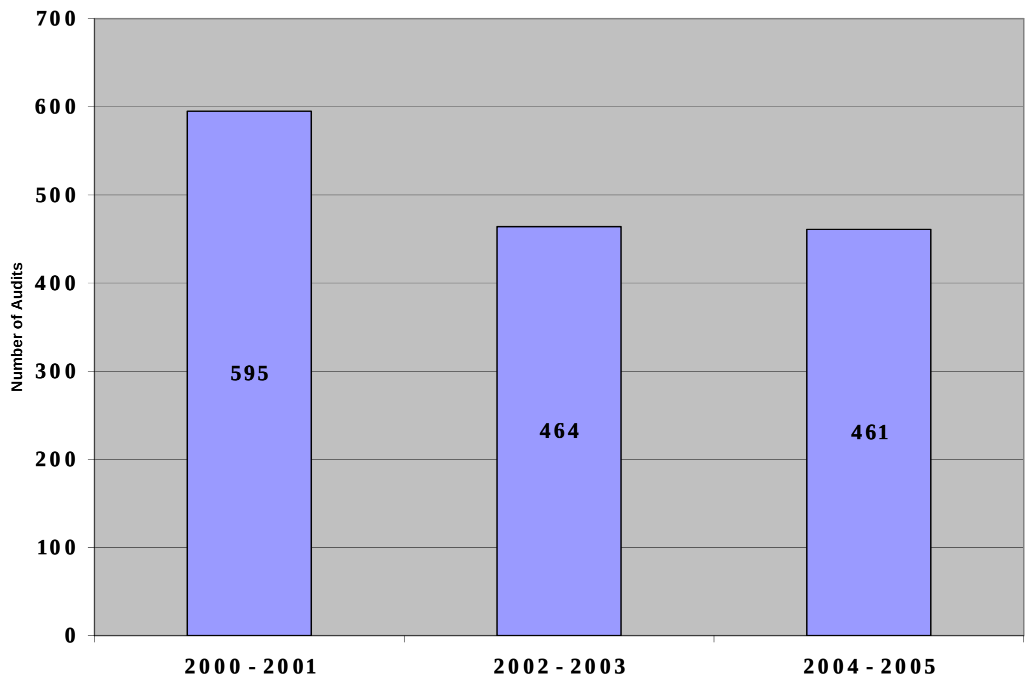


Figure 2. *Number of audits initiated.*

This report contained information that was redacted pursuant to 5 U.S.C. §§ 552(b)(2) (high) and (low) and (b)(6) of the Freedom of Information Act.

Question 3. Does MMS have adequate resources to ensure that the royalties are properly collected on Federal and Indian leases?

We were unable to determine whether MMS has adequate resources to ensure that royalties are properly collected because MMS lacked reliable management information to allow us to conduct such an analysis. Our audit report disclosed the lack of reliable information on compliance activities and the costs and benefits associated with those activities.

FY2006 funding for the CAM Program was $42.7 million supporting 380 staff. MMS stated that it has sufficient resources to conduct an effective audit and compliance program and added that its annual percentage goal for confirming "reasonable compliance" of mineral royalties (e.g. 71 percent for FY2005) "constitutes a significant level of compliance coverage." The use of compliance reviews together with audits helps MMS achieve this level of coverage. MMS further indicated that it would not be practical to request full funding to enable 100 percent audit coverage of the royalty dollars due to the extreme expense. MMS estimated that it would cost about $430 million and require over 4,000 staff to audit 100 percent of the royalties. MMS stated that it is significantly covering royalties, but could increase coverage if more funding was provided.

Question 4. Have funding levels for state and tribal cooperative agreements for auditing been reduced? If so, please provide information regarding the amount of the reductions. How has this affected the amount of production that can be audited by states and tribes on an annual basis?

Since FY2001 there have been small fluctuations in the overall planned budgets for state and tribal cooperative agreements. The budgets increased from $9.1 million in FY2001 to $9.5 million in FY2003 and then decreased to $9.0 million in FY2006. The actual obligations were significantly lower than the budgets for some of those years because the states and tribes did not always use all the funds allocated to them. For example, in FY2001, $9.1 million was funded but only $7.7 million was actually obligated. MMS stated that this occurred because, in the past, MMS obligated only about 85 percent of the funds based on the amount the states and tribes historically used. However, MMS stated that it now obligates 100 percent of the budget. Figure 3 below provides the budget and obligations for FY2001 to FY2006. FY2006 obligations are as of June 2006.

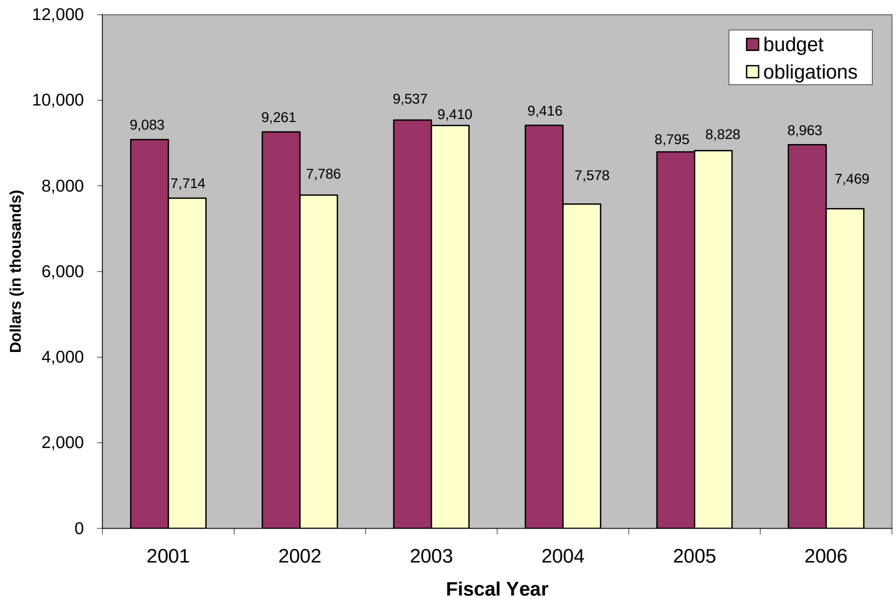


Figure 3. *Combined state and tribal budget and obligations.*

Although the combined funding level for all state and tribal activities has remained relatively stable over the past 5 years, there have been significant fluctuations in funding provided to individual states and tribes. For example, in FY2006 when MMS reallocated funding amongst states and tribes, budgets for California and Colorado decreased 21 percent and 25 percent, respectively. In contrast, budgets for Wyoming and Louisiana increased 23 percent and 43 percent, respectively. MMS attributed this reallocation to the need to cover higher risk properties. Appendix 5 illustrates the budgets and obligations for each state and tribe for FY2001 to FY2006.

We did not analyze the impact the reallocation of funding had on individual states and tribes. Collectively, audits initiated by the states and tribes have increased since FY2000 as shown in Figure 4.

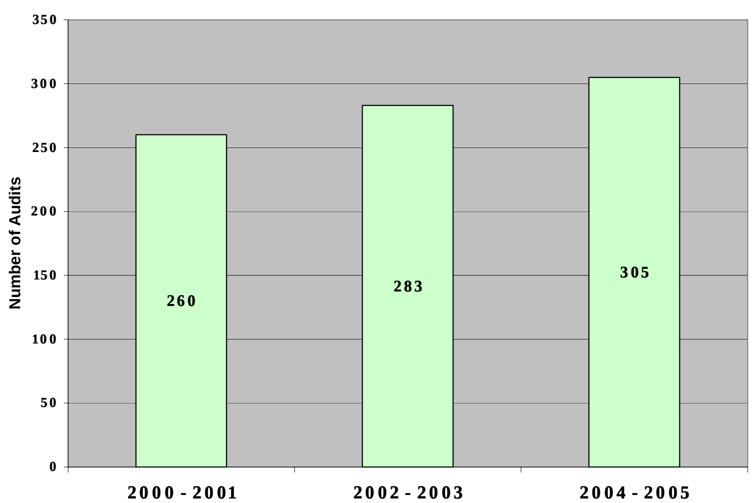
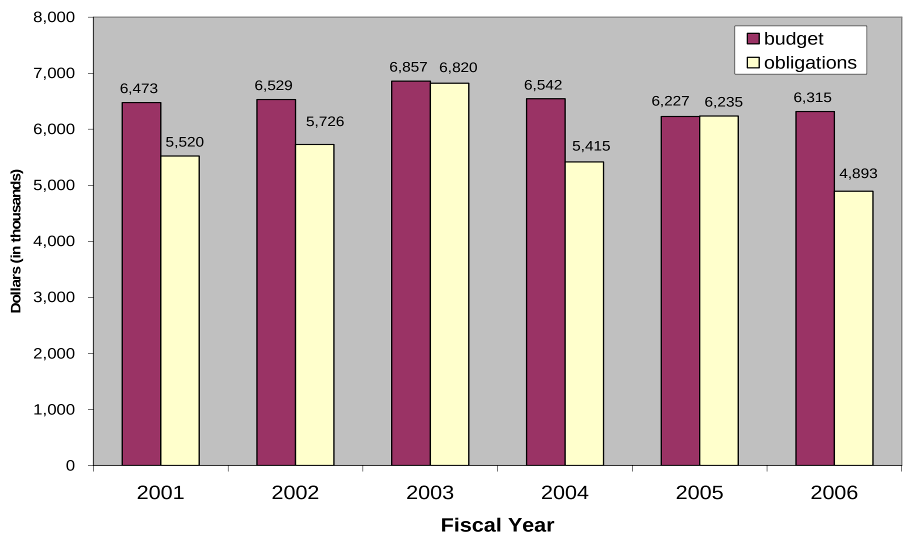


Figure 4. *Number of STRAC audits initiated.*

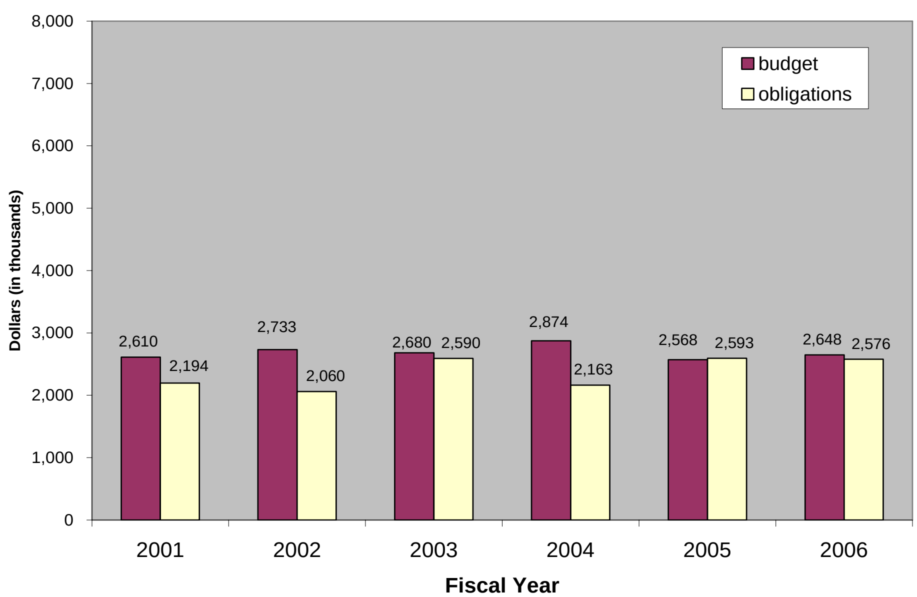
State and Tribal Audit Organization Funding
Total Original Budget (Planned Funding) and Obligations
FYs 2001-2006

Generally, budgets exceeded obligations for most organizations. However, in some cases, obligations exceeded budget amounts because unspent funds in one year carried forward to future years or adjustments were made for the payment of prior year administrative costs. Additionally, for several states, the budget amounts were based on the federal fiscal year while obligations were made based on the state's fiscal year.

States

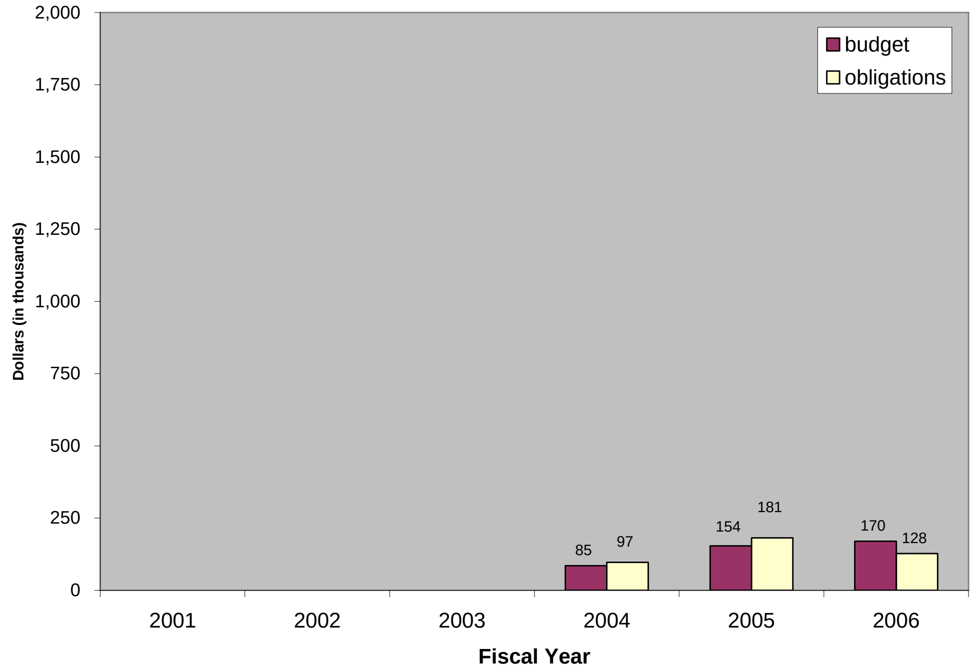


Tribes



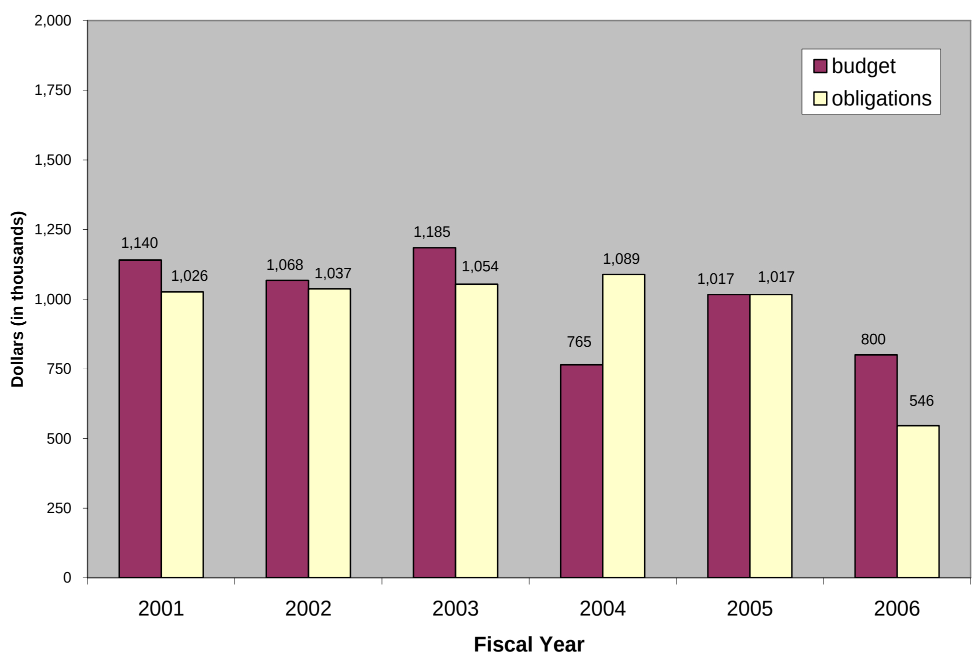
State and Tribal Audit Organization Funding
Total Original Budget (Planned Funding) and Obligations
FYs 2001-2006

Alaska



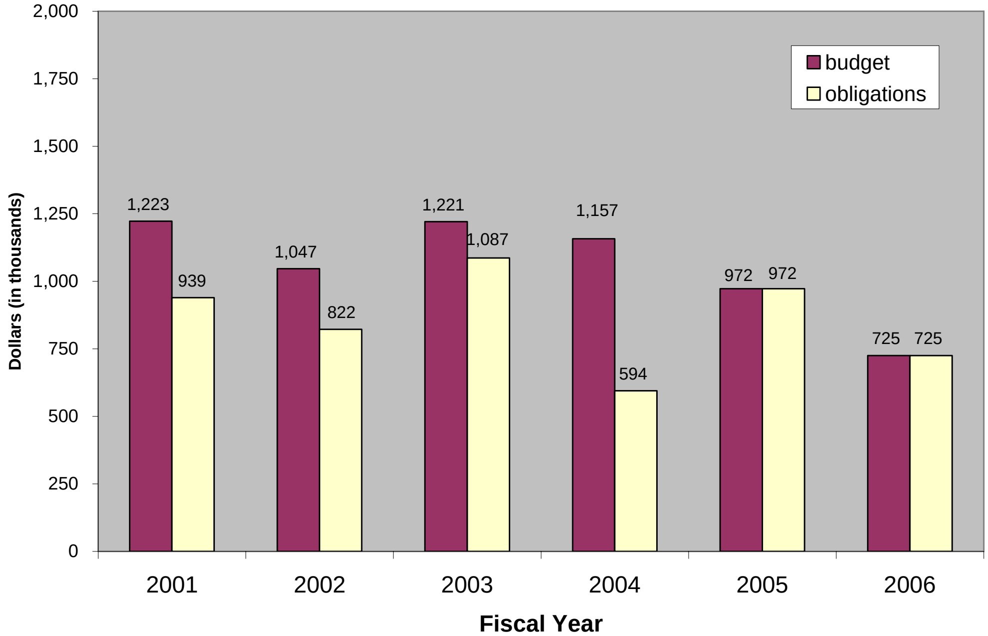
*Alaska did not enter into a cooperative agreement with MMS until 2004.

California

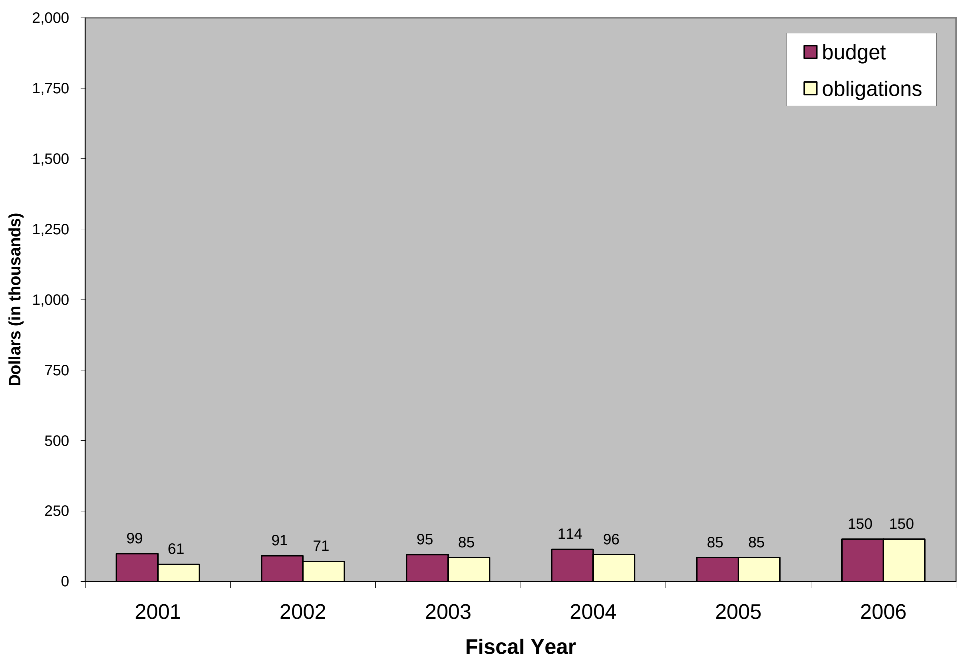


State and Tribal Audit Organization Funding
Total Original Budget (Planned Funding) and Obligations
FYs 2001-2006

Colorado

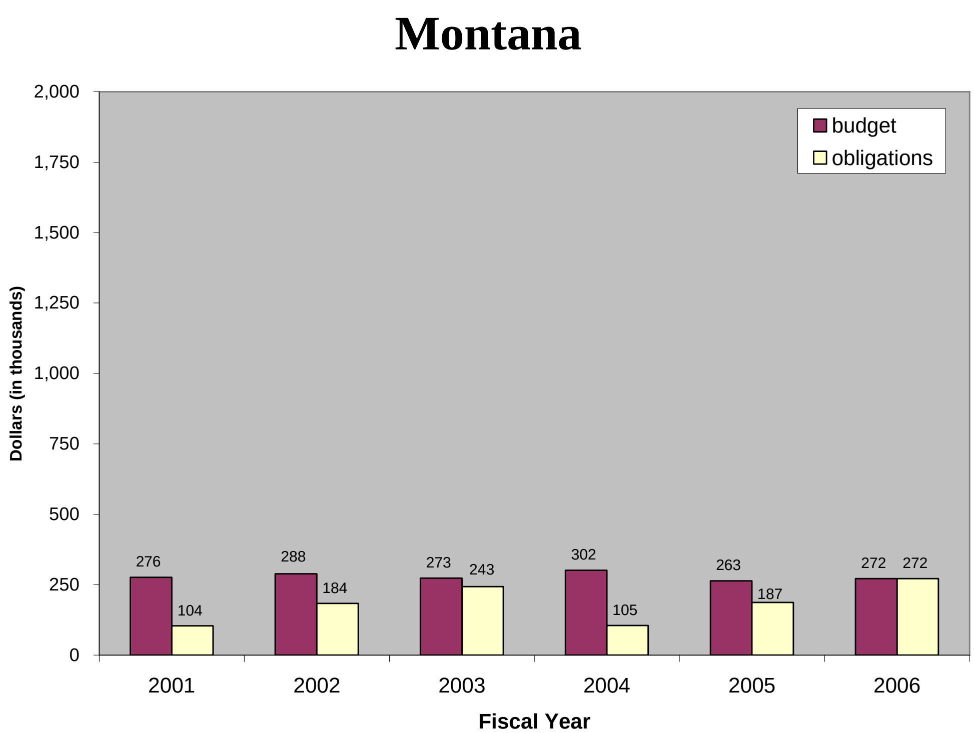


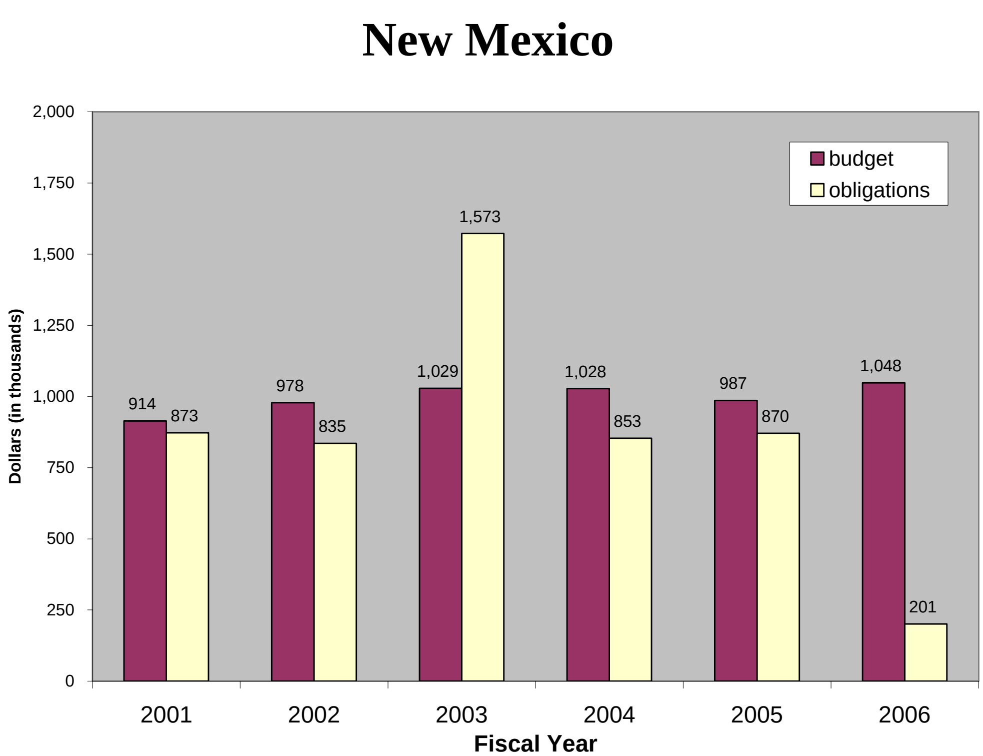
Louisiana



This report contained information that was redacted pursuant to 5 U.S.C. §§ 552(b)(2) (high) and (low) and (b)(6) of the Freedom of Information Act.

State and Tribal Audit Organization Funding
Total Original Budget (Planned Funding) and Obligations
FYs 2001-2006





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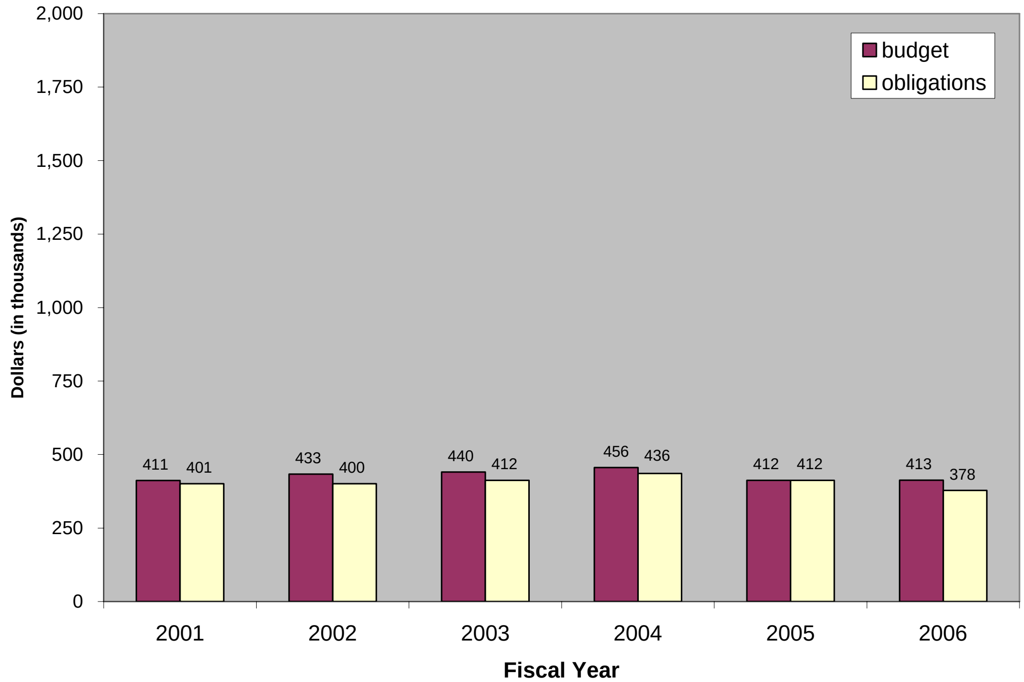
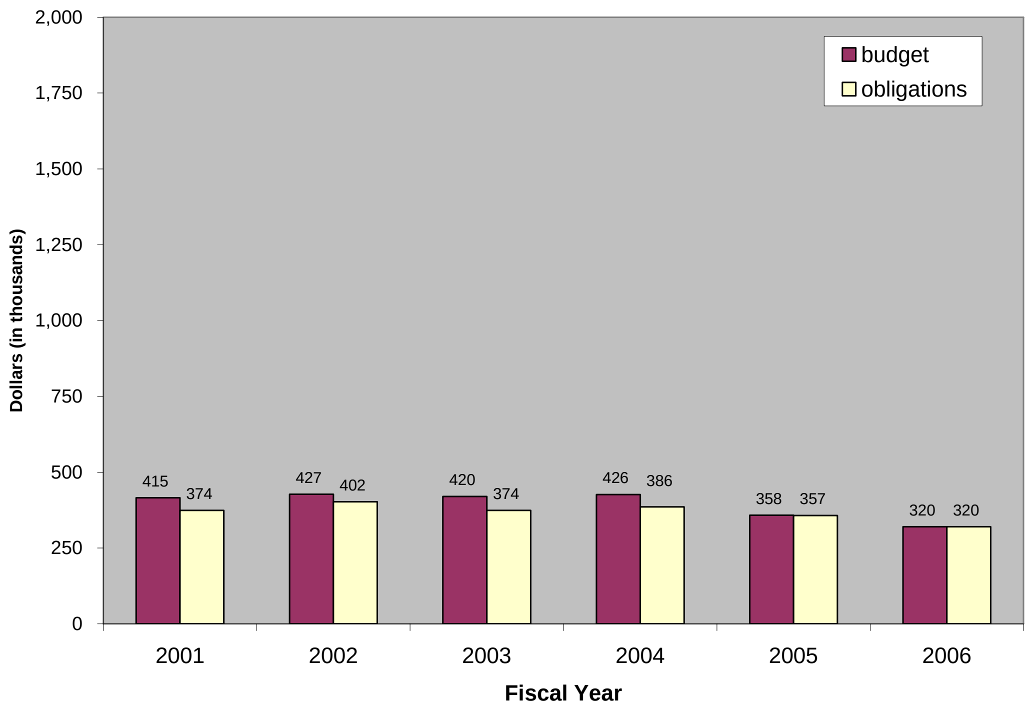
State and Tribal Audit Organization Funding
Total Original Budget (Planned Funding) and Obligations
FYs 2001-2006

North Dakota



Oklahoma



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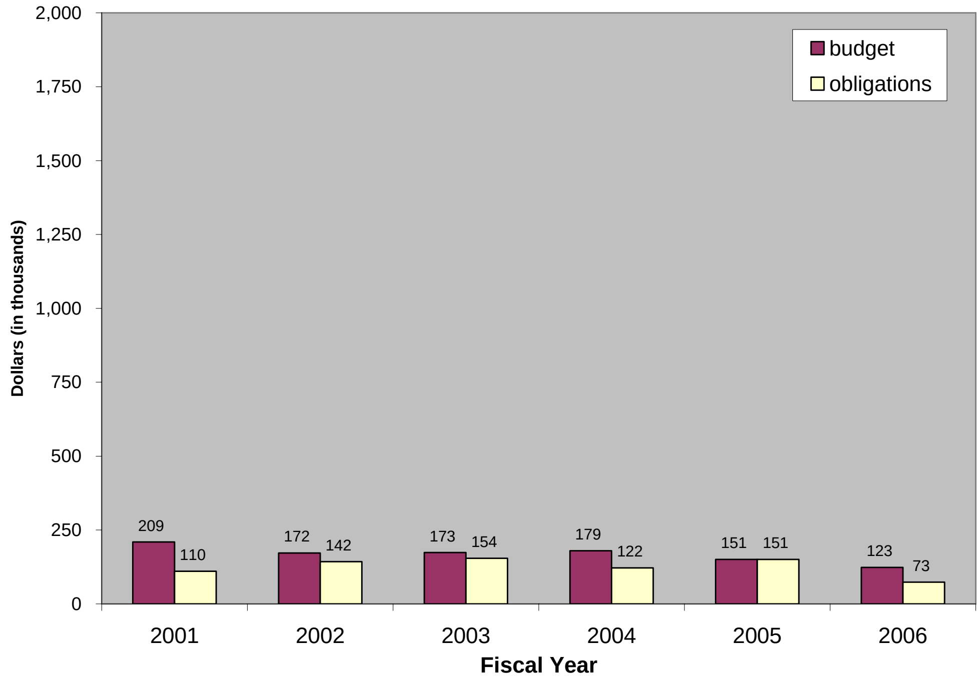
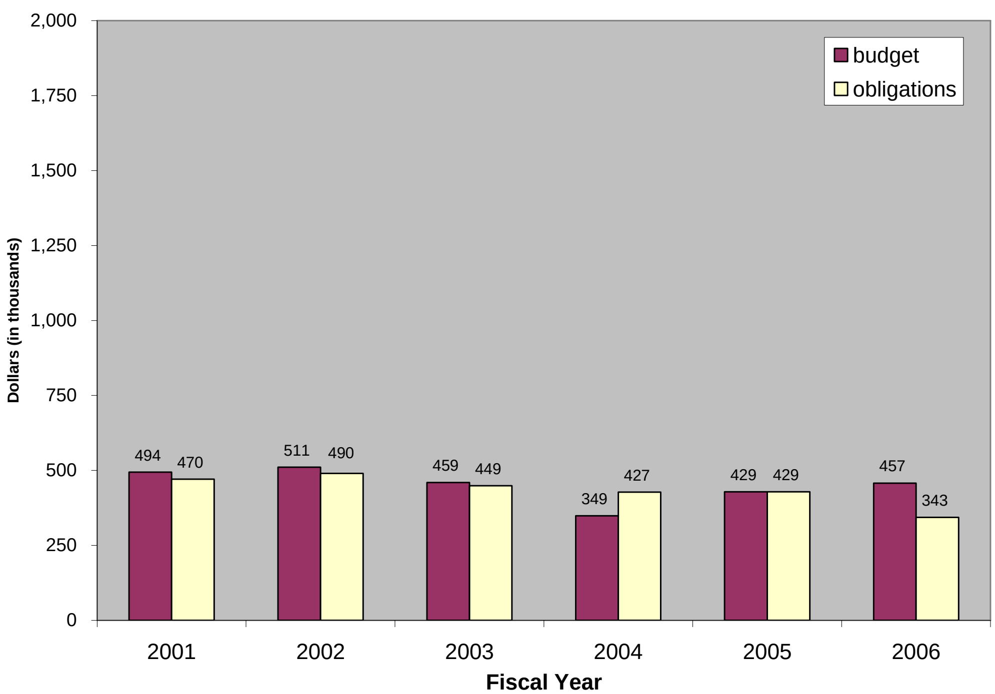
State and Tribal Audit Organization Funding
Total Original Budget (Planned Funding) and Obligations
FYs 2001-2006

Texas



Utah



Wyoming

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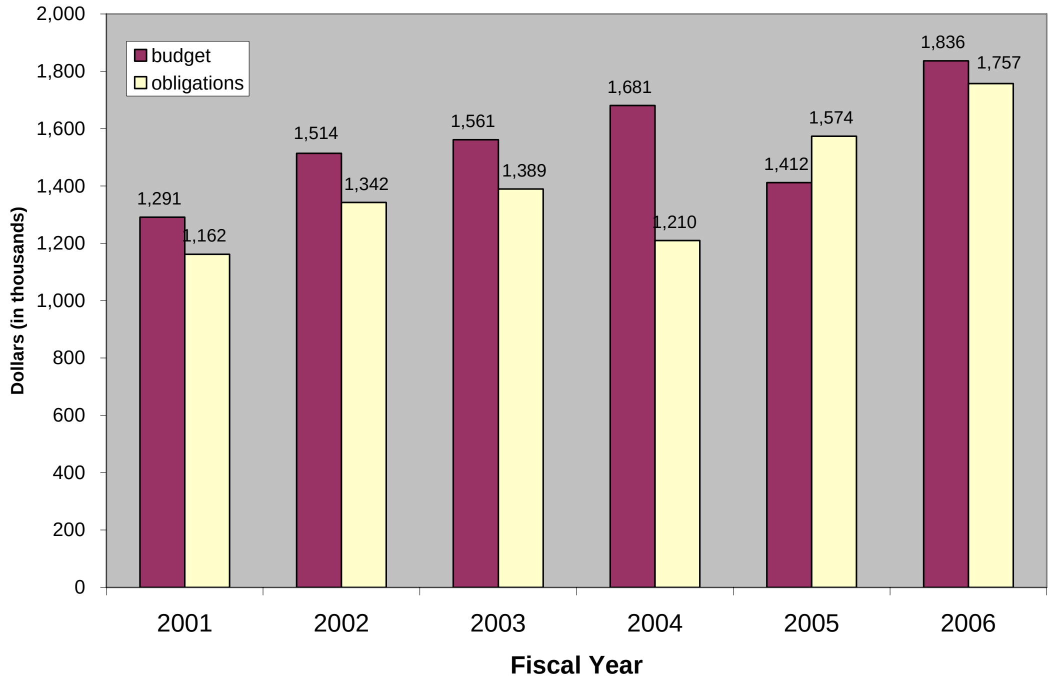
State and Tribal Audit Organization Funding
Total Original Budget (Planned Funding) and Obligations
FYs 2001-2006



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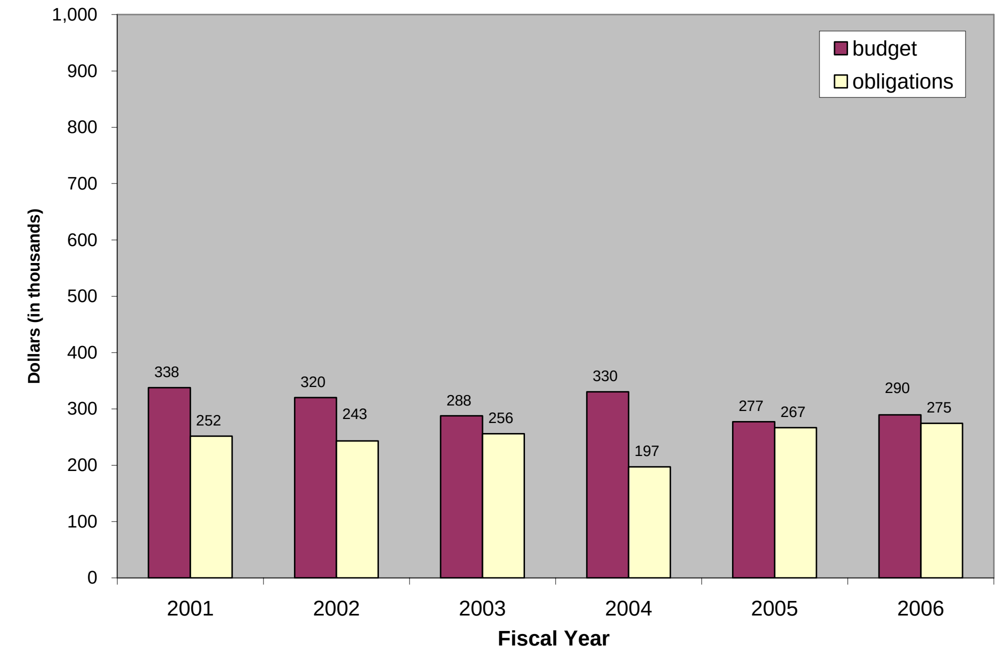
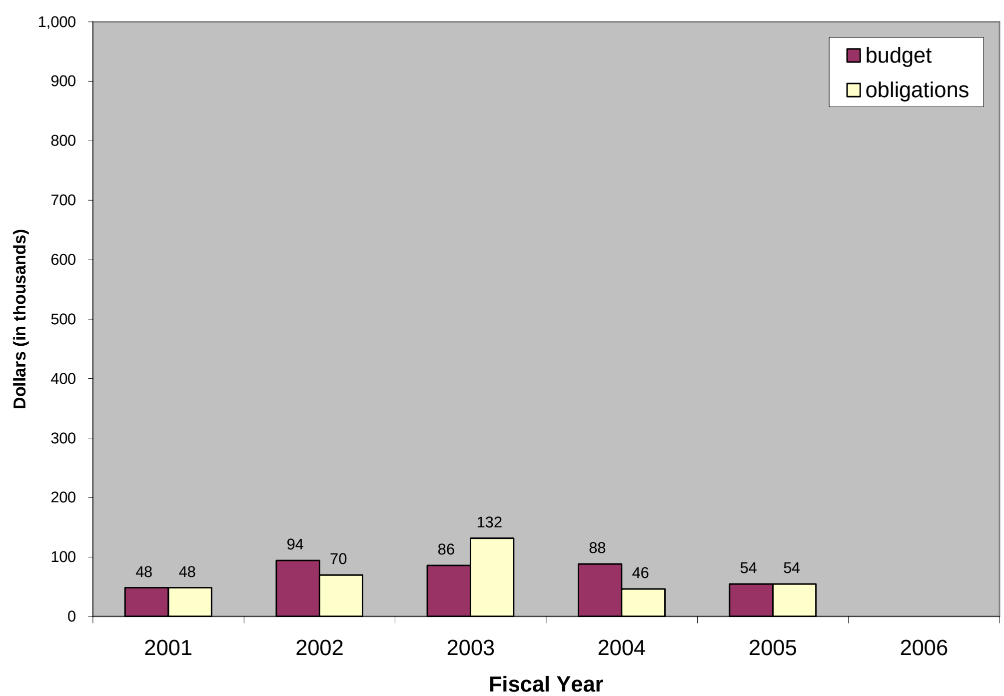
State and Tribal Audit Organization Funding
Total Original Budget (Planned Funding) and Obligations
FYs 2001-2006

Blackfeet



Crow

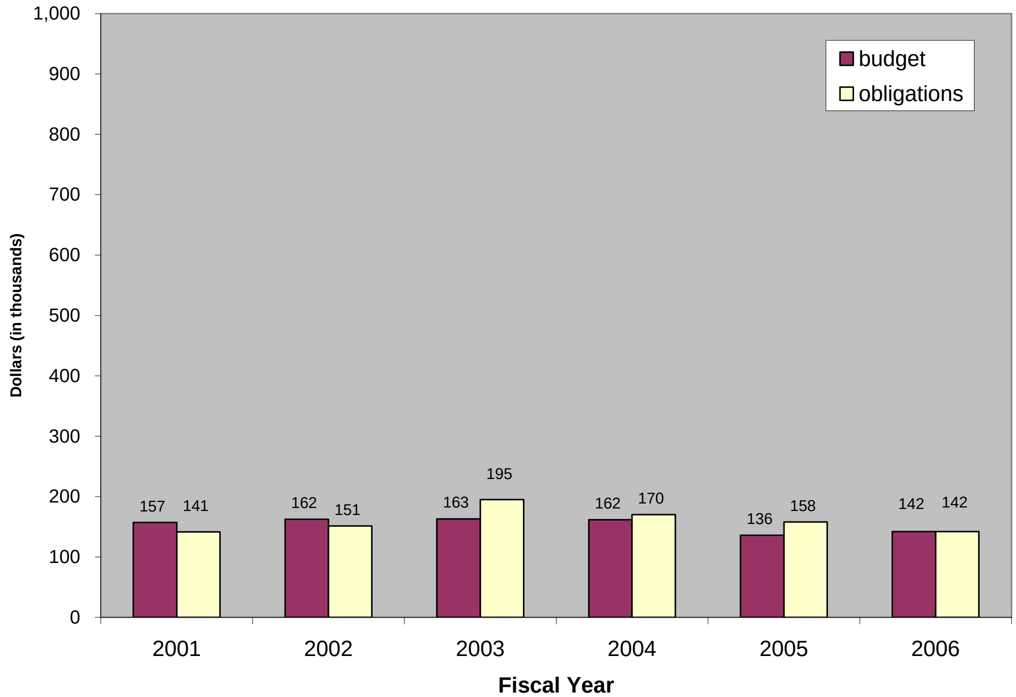


*The cooperative agreement with Crow was terminated in 2005.

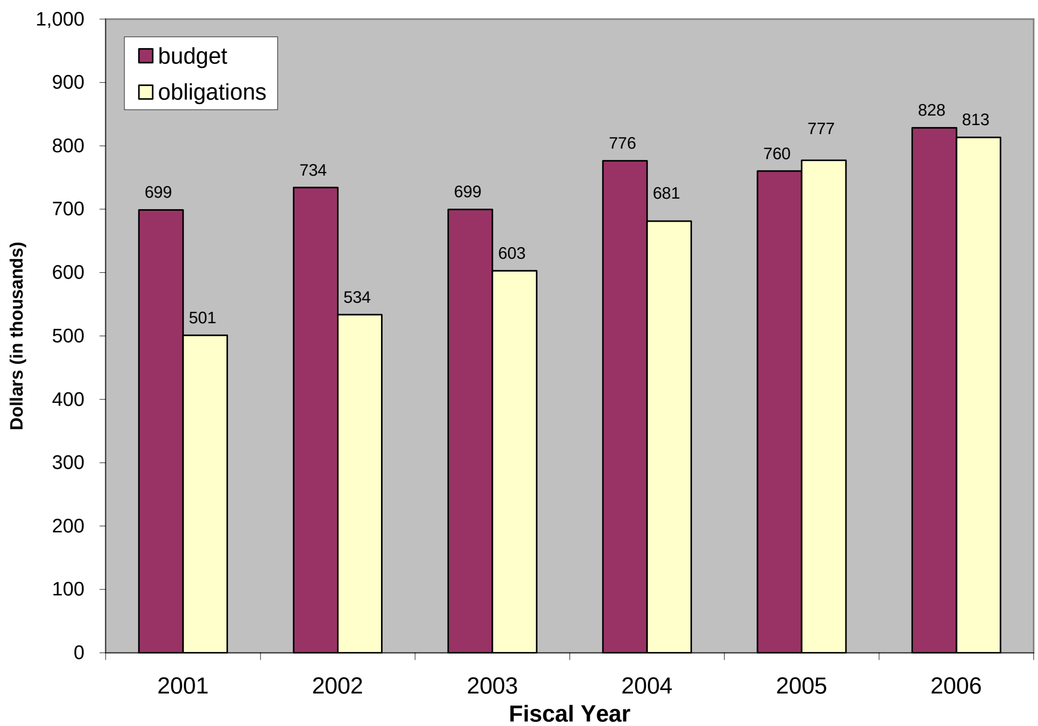
This report contained information that was redacted pursuant to 5 U.S.C. §§ 552(b)(2) (high) and (low) and (b)(6) of the Freedom of Information Act.

State and Tribal Audit Organization Funding
Total Original Budget (Planned Funding) and Obligations
FYs 2001-2006

Jicarilla

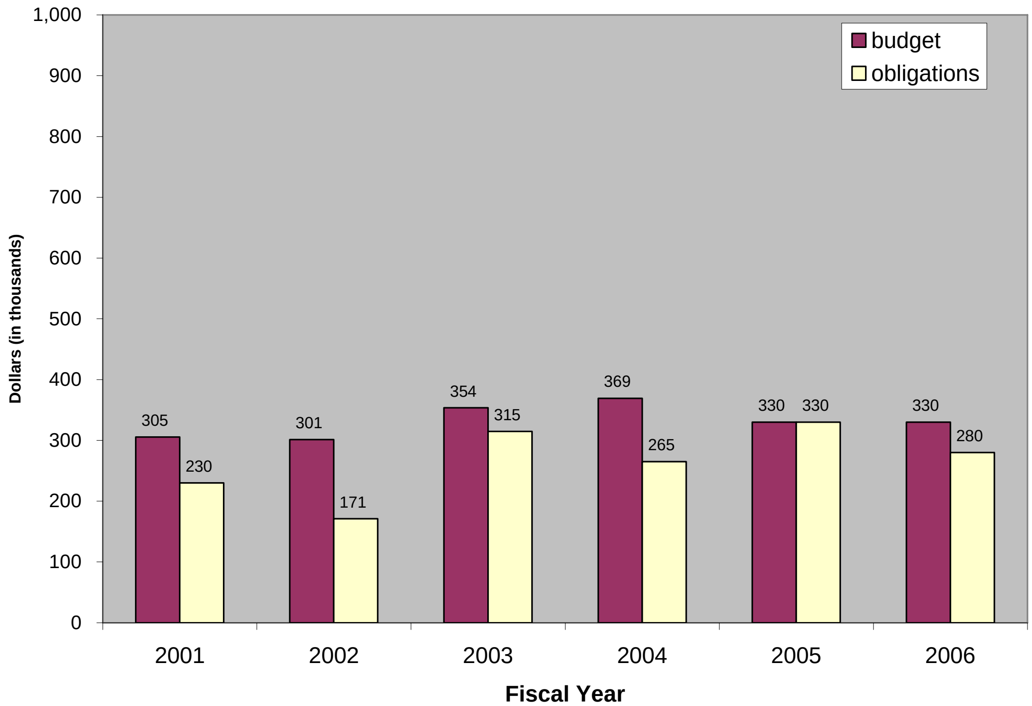


Navajo

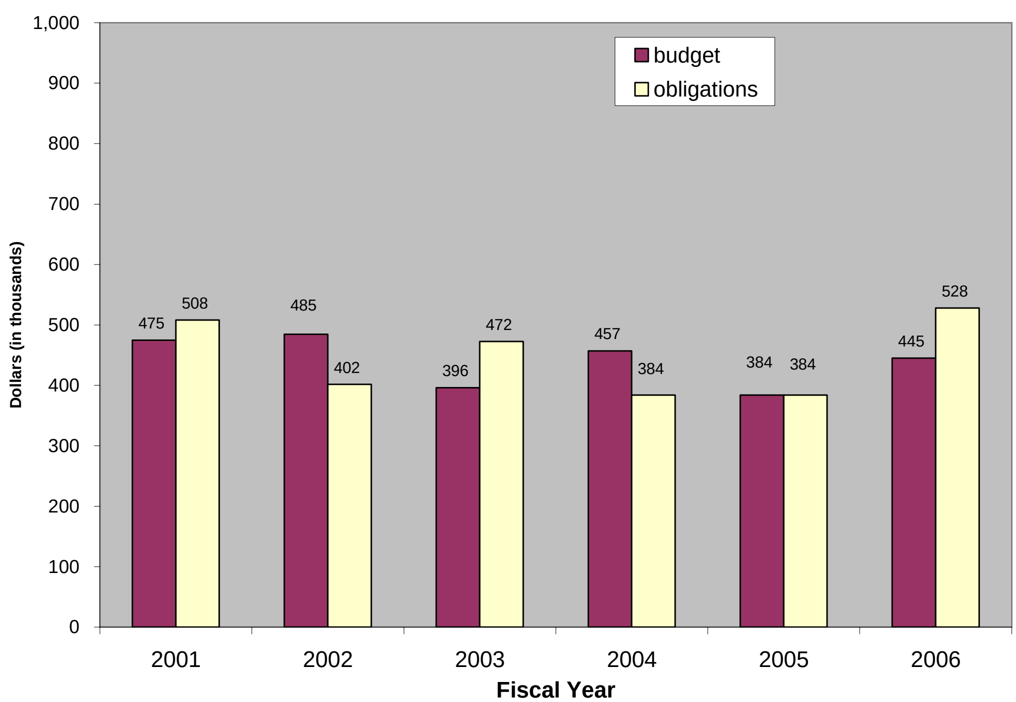


State and Tribal Audit Organization Funding
Total Original Budget (Planned Funding) and Obligations
FYs 2001-2006

Northern Ute



Southern Ute



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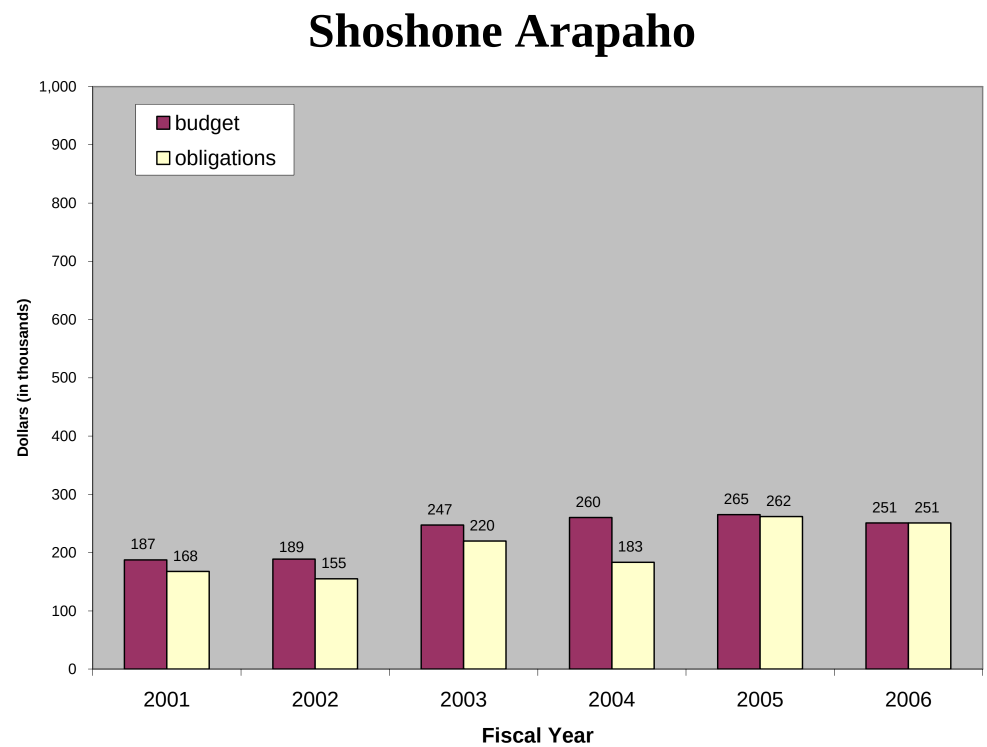
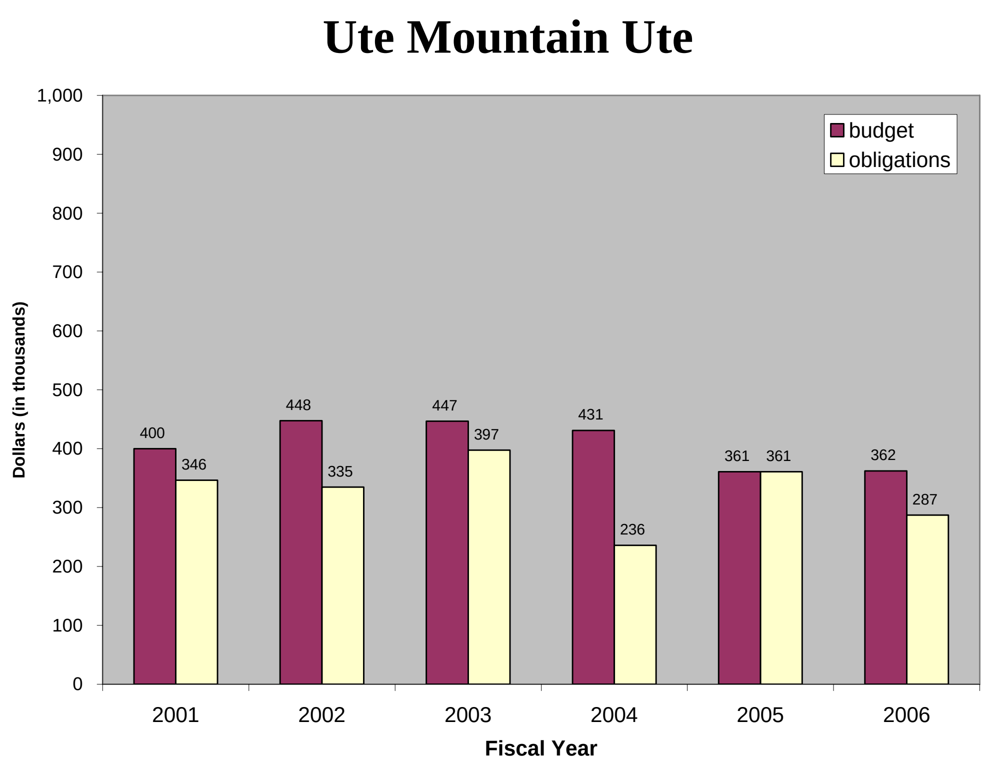
State and Tribal Audit Organization Funding
Total Original Budget (Planned Funding) and Obligations
FYs 2001-2006





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Related Reviews

Reports Issued by the Office of Inspector General

During the last 5 years, we issued three reports that relate to our audit objectives and scope.

- **"Audit of Oversight Performed by Minerals Management Service of Non-Federal Auditors," Report No. 2003-I-0061, August 2003.**

  We concluded that MMS' oversight of non-federal auditors was reasonably effective to ensure states and tribes complied with the *Government Auditing Standards*. However, we found that (1) some cooperative agreements contained outdated provisions, (2) audits of Jicarilla tribal leases were not covered by internal quality control reviews, and (3) neither the MMS internal quality control reviews nor the state peer reviews had a formal follow-up process.

  The MMS Director agreed with three of the four recommendations and with all five of the suggested improvements.

- **"Audit of the Minerals Management Service Audit Offices," Report No. 2003-I-0023, March 2003.**

  During our audit, MMS was designing and implementing a re-engineered compliance process. The new process shifted the focus from auditing on a company basis (auditing all of a company's leases at the same time) to a property basis (auditing leases grouped in one producing geographic location). Overall, we concluded that MMS' internal quality control system was not sufficient and that MMS' audits did not always comply with the *Government Auditing Standards*. Specifically, we found that:

  - MMS' internal audit process was ineffective because it lacked accountability, did not cover all audit work, and was incomplete.
  - MMS auditors recreated a set of workpapers that had been lost.
  - Not all MMS auditors met their continuing education requirements.

  MMS generally agreed with the report's findings and concurred with all recommendations.

- **“Evaluation of Vulnerabilities to Underreporting: Royalty-in-Value Versus Royalty-in-Kind,” Report No. 2002-I-0044, August 2002.**

  At the request of the Deputy Secretary, we performed this evaluation to determine whether MMS' royalty-in-value (RIV) program or its royalty-in-kind (RIK) program was more vulnerable to underreporting. We concluded that the RIV program was more vulnerable because the lessor established the basis for product valuation as well as the transportation and processing costs. The RIK program was less vulnerable because MMS received actual proceeds from product sales and paid actual transportation and processing costs. Nevertheless, RIV was preferable in certain instances. In addition to these findings, we concluded that MMS could improve its controls over the RIK program in the areas of gas imbalances, credit lines of approval, manual data entry, and sales contract limitations.

  MMS officials generally concurred with our conclusions and had initiated actions to address the control issues noted in our report.

Reports Issued by the Government Accountability Office (GAO)

During the last 5 years, GAO issued three reports that relate to MMS’ CAM Program.

- **“Royalty Revenues: Total Revenues Have Not Increased at the Same Pace as Rising Oil and Natural Gas Prices due to Decreasing Production Sold,” Report No. GAO-06-786R, June 2006**

  GAO found that federal and Native American royalty revenues did not increase at the same pace as oil and natural gas prices between 2001 and 2005 principally because the volumes upon which royalties are based declined substantially during this time.

- **“Mineral Revenues, Cost and Revenue Information Needed to Compare Different Approaches for Collecting Federal Oil and Gas Royalties,” Report No. GAO-04-448, April 2004.**

  GAO reported that although data was limited, RIK realized substantial administrative cost savings over RIV. Further, MMS used these cost savings to audit additional RIV leases but could not quantify the benefit. Also, MMS had not yet implemented the recommendations contained in GAO’s 2003 report. GAO suggested that Congress consider directing MMS to establish a systematic evaluation of the revenue impacts of all future RIK sales and quantify overall changes in the administration of royalty collections. MMS agreed with the report’s conclusions and recommendations.

- **"Mineral Revenues, A More Systematic Evaluation of the Royalty-in-Kind Pilots is Needed," Report No. GAO-03-296, January 2003.**

  GAO reported that MMS had made substantial progress in establishing an RIK program, but that more work was needed before the program could be adequately assessed and expanded. In particular, MMS needed to establish clear strategic objectives linked to statutory requirements and to collect the necessary information to enable effective monitoring and evaluation of the RIK program. MMS generally agreed with the reports conclusions and recommendations.

ACRONYMS AND ABBREVIATIONS

AFMSS	Automated Fluid Minerals Support System
BLM	Bureau of Land Management
CAM	Compliance and Asset Management
CIM	Compliance Information Management
CPT	Compliance Program Tools
FERC	Federal Energy Regulatory Commission
FY	Fiscal Year
GAO	Government Accountability Office
GVS	Gas Verification System
GPRA	Government Performance and Results Act
IRS	Internal Revenue Service
LVS	Liquid Verification System
MMS	Minerals Management Service
OIG	Office of Inspector General
PI Grid	Petroleum Information Grid
RIK	Royalty-in-kind
RIV	Royalty-in-value
STRAC	State and Tribal Royalty Audit Committee

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