Committee on Resources

Witness Testimony

Testimony of
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Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to appear today to present testimony on the Royalty Gas Marketing Pilot (pilot), which was implemented by the Minerals Management Service (MMS) in 1995. The pilot was one of the National Performance Review (NPR) labs implemented by the Department of the Interior and represents one of our many efforts to provide better service to the public at reduced cost.

The MMS gas pilot was conducted from January 1, 1995, to December 31, 1995, and tested the concept of MMS taking the Federal Government's royalty share of gas production in-kind from offshore federal leases and selling the gas at or near the leases to competitively chosen gas marketing companies. The royalty gas was provided by 14 lessees on 79 leases who volunteered to participate in, and helped MMS design, the pilot.

The MMS had two objectives in conducting this pilot: 1) to find processes for streamlining royalty collections in a manner that reflects changes that have occurred in the gas market; and 2) to test a process of royalty collection that promises increased efficiency and greater certainty in valuation. We are pleased with the results of the pilot. It has provided the information required by the Federal government to evaluate the potential of using in-kind royalty collection for gas.

During the pilot, MMS took, in kind, approximately 45.6 billion cubic feet of gas, totaling over 6 percent of the Federal government's royalty share in the Gulf of Mexico and sold it to gas marketing companies. The marketers were responsible for all costs downstream of the points of delivery. They also retained all proceeds from selling the gas to their customers in a free market environment.

The MMS plans to issue a report on the pilot results later this summer. My testimony today will address only the main conclusions from the report. We will provide the Committee with a copy of the report as soon as it is completed. Based on the results of this pilot , MMS is considering whether to pursue additional royalty-in-kind efforts, and if so how and where to conduct them. We will keep Congress informed of our progress in deciding whether to proceed and where.

Background

The pilot was a dramatic effort by MMS to do business in a different manner in response to recent changes in the gas marketplace (post FERC-Order 636). The MMS is testing the concept of removing itself from the complex practice of determining the appropriate value of production and auditing whether companies have paid royalties based on an appropriate value. In traditional gas valuation, much of the complexity arises from the difficulty in determining whether a non-arm's-length transaction represents the true value of the gas. We face additional complexity because of the problems inherent with calculating whether and to what extent certain costs incurred after production (e.g., transportation, processing, marketing) are deductible from the royalty value.

In the pilot, the valuation procedure is simplified dramatically. The producer is responsible for reporting only the total gas production from the lease and the royalty share of that gas delivered to the marketer. The marketer reports and pays MMS on the basis of the volume taken and the price/ MMBtu at the lease, which is the price the marketer bid for the gas in the competitive selection. Thus, production volumes become the sole focus of any audits.

The MMS designed, and has evaluated, this project in collaboration with its customers. This is an experimental effort to develop a regulatory approach that complements industry practices instead of adding burdens.

Some of the key features of the pilot include the following:

- The leases included in the pilot were volunteered by the participating lessees.
- The agreement establishing the procedure for taking of royalty gas was negotiated by the MMS and the lessees who volunteered to participate in the pilot.
- The MMS competitively selected marketing companies by issuing an open Invitation for Bids (IFB) on October 21, 1994. MMS opened the bids on November 21,1994.
- The IFB instructed bidders to submit bids for each lease or group of leases identified by MMS. The bids were to be stated in terms of a published index price e.g., plus or minus a differential.
- Bids were based on the value of the gas at the Point of Delivery with the marketer responsible for costs incurred downstream of that point.
- The MMS received 23 bids from 22 companies, and ultimately awarded 13 contracts.

Royalty gas valuation, determination, and collection procedures have been subject to debate and litigation for years. Recently, MMS has undertaken several initiatives to attempt to find ways to streamline these processes without sacrificing royalty revenues. One of the attempts was gas pilot.

The procedures employed in the pilot were made possible by recent deregulation of the gas industry. Since the Natural Gas Policy Act of 1978, the gas industry has experienced several phases of deregulation including the decontrol of wellhead prices, the open access regulations for pipelines contained in Federal Energy Regulatory Commission (FERC) Order 436 and the formal separation of pipeline company sales and transportation services accomplished in 1993 by FERC Order 636.

This deregulation has transformed the U.S. gas market in at least two important ways. First, wellhead prices for gas are now determined by competitive forces to a much greater degree. Second, marketing companies have emerged that provide the services required by buyers and sellers in today's gas market. These changes have improved the efficiency with which gas is marketed and allow the MMS to take advantage of the competition between marketing companies for in-kind royalty gas offered at or near the lease.

Results of the Pilot

In general, we are pleased with the gas pilot. We acquired information and experience that will be invaluable in deciding how to proceed with any future gas royalty in-kind efforts. In particular, I would note the following results:

- The pilot was an operational success, proving that the concept is feasible. Our experience demonstrated to us that the procedures employed in the pilot can function smoothly once producers and marketers have a clear understanding of their respective responsibilities.
- The fact that MMS designed and evaluated the pilot in collaboration with its customers must be considered a critical factor in the pilot's operational success. For example, MMS negotiated directly with lessees on the terms and conditions for accepting the in-kind gas. This cooperative atmosphere also facilitated learning and flexibility.
- We are still working on our revenue impact analysis for the pilot. Our preliminary estimates indicate some royalty revenue loss for the gas production covered by the pilot. However, this is not entirely unexpected or unreasonable because we built in a 5 percent tolerance. The most important aspect of this pilot was to gain information and experience on taking royalty in-kind.
- MMS learned several lessons from the pilot that we feel will be useful in raising revenues in future royalty in-kind efforts.
    1. We know that all of the participants in this pilot needed considerably more lead time than what was allowed. This need was particularly evident for gas marketers bidding for the Federal royalty gas. Also, MMS needs additional time to verify physical gas flow and to determine appropriate gas price indices.
    2. We have learned that additional information must be included in the IFB. For example, future IFB's should include all gas analysis information (including Btu content) and the names of producer contacts who can provide information on transportation costs and gas flow.
    3. Because of time constraints, we started this pilot in the middle of the winter season. We have learned that an auction of royalty gas should be conducted well before the start of the winter season so that gas marketing companies can integrate the availability of the gas into their winter gas contracts. By addressing each of these lessons in future royalty in-kind efforts, we feel that we can reduce the uncertainties faced by bidders and raise the level of bids so that revenue losses are reduced.

       However, even in light of what we have learned, it is unlikely that the revenue losses can be completely eliminated. The reason is that the bids for the in-kind royalty gas reflect the fact that marketing companies must incur certain costs for marketing gas that was normally borne by lessees. Also, the marketing companies must also pay for the use of producer owned pipelines at rates that may be higher than the transportation allowance that lessees are able to deduct when paying gas royalties on an in-value basis.

- The MMS is also conducting an analysis to estimate the internal (MMS) administrative cost savings that can be achieved through the use of gas royalty in-kind procedures instead of conventional royalty valuation.
- Participating lessees indicated that they anticipated administrative savings if MMS were to institute a Gulf-wide gas royalty in-kind program. These savings would be realized through reductions in reporting requirements, audit interface, and litigation.

While MMS intends to consider conducting additional pilot projects, there is one statutory constraint that could limit MMS' ability to conduct such projects on a significant scale on the Outer Continental Shelf (OCS). The problem for MMS arises because of the way in that the OCS Lands Act (OCSLA) defines and uses the term "fair market value." The Act appears to stipulate that in the selling of royalty gas taken in kind, MMS must obtain a price no less than that obtained by the lessee for its share of the production. Based on results of the pilot, it appears that MMS would encounter difficulty meeting this standard for each lease, each month. The MMS would be pleased to work with the Subcommittee to develop clearer legislative language that allows greater flexibility in defining the fair market value standard.

Conclusion

In conclusion I would like to emphasize that this pilot represented the true spirit of MMS's efforts to find ways to make our royalty management efforts more efficient and less burdensome for the industry. We worked with industry to design an efficient program that reflects procedures that have evolved in the industry and serve both their needs and ours. We have also been encouraged by industry's willingness to work with us in evaluating the results of our combined efforts. At the same time, we sought to structure the pilot in such a way as to ensure a fair return to the public from production of its resources.

We are evaluating the results of the pilot carefully to see how we can best move forward to reduce costs, both for government and industry, without compromising royalty collections. Please be assured that we will keep the Subcommittee apprised of our progress in evaluating the pilot and in considering whether to conduct future gas royalty in-kind efforts.

Mr. Chairman, this concludes my prepared remarks. However, I would be pleased to answer any questions you or other members of the Subcommittee may have.