Committee on Resources,

Subcommittee on Energy & Mineral Resources

energy - - Rep. Barbara Cubin, Chairman
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Witness Statement

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Madam Chairman, I wish to thank you and the members of your Subcommittee for the invitation for the Minerals Management Service (MMS) to be here today to present testimony regarding its royalty in kind (RIK) activities.

Introduction

As you are aware, MMS's mission consists of two major programs: Offshore Minerals Management and Minerals Revenue Management (MRM). The leasing and oversight of mineral operations on the OCS and all mineral revenue management functions for Federal (onshore and offshore) and American Indian lands are centralized within the bureau. In 2000, OCS oil and natural gas production accounted for roughly 25 and 26 percent, respectively, of our Nation's domestic energy production - oil production was over 500 million barrels and natural gas production was over 5 trillion cubic feet. The amount of oil and natural gas production in 2000 was the most ever produced on the OCS. In addition, in fiscal year 2000, MMS collected and distributed about $7.8 billion in mineral leasing revenues from Federal and American Indian lands.

By provisions of law and lease terms, Federal oil and gas royalties can be paid by the lessee either as a share of cash proceeds realized by the lessee (in value) or with a share of production (in kind). The decision as to whether royalties will be paid in value or in kind is solely the lessor's (the Government). Historically, the MMS collected royalty payments in value, except for its Small Refiner Program whereby the Government receives oil royalty payments in kind on selected leases and in turn sells the production to qualified small refiners at fair market value.

RIK Feasibility Study

In 1997, the MMS formed an RIK Study Team to investigate the feasibility of the U.S. Government taking its oil and gas royalties from Federal leases in kind rather than in value. The Study Team concluded that under the right circumstances, RIK could be workable, revenue neutral or positive, and administratively more efficient for MMS and industry. The Study Team also recommended the following:

- Development of a long-term OCS RIK pilot program with input from the States of Texas and Louisiana for the marketing of substantial volumes of U.S. royalty gas.

- Establishment of a joint MMS/Wyoming team to examine the viability of an oil RIK program in Wyoming.
- Establishment of a joint MMS/Texas team to identify and assess a range of possible RIK programs involving OCS 8(g) leases offshore Texas.
- Evaluate the potential for additional RIK pilot programs upon the successful implementation of any pilot project.

In response to the recommendations of the Study Team, MMS aggressively initiated a series of pilot projects with the following goals:

- To determine the circumstances (market conditions) in which RIK makes sense and identify those key success factors.
- To determine if the government (and industry) can save money by reducing the administrative cost and burden of collecting and verifying royalties.
- To determine if RIK can provide accurate, simple and certain royalty collection.
- To determine if RIK can create value (revenue enhancement or neutrality) for the taxpayer.
- To conduct evaluations, which will include the criteria listed above, of each of the pilots and share with all interested parties.

RIK Pilot Program

The RIK pilot program commenced in 1998 with the initiation of its first pilot with the State of Wyoming involving crude oil. Since then, the pilot program has continued to expand in Wyoming and on the OCS in the Gulf of Mexico for both oil and gas. Each of the pilot projects is designed to test a variety of approaches to utilization of the RIK option for managing the Federal royalty asset. Pilot evaluations are being conducted to ascertain pilot successes and lessons learned that are incorporated into succeeding pilot activities. I would like to briefly address each of MMS' RIK pilots and the evaluation work that has been completed to date.

The Wyoming Oil RIK Pilot

Under the Wyoming pilot, the MMS and the State of Wyoming's Office of State Lands and Investments have been cooperatively developing an oil royalty in kind program. Since 1998, MMS has been taking up to 6,000 barrels per day of RIK crude oil produced from Federal leases in the Powder River Basin and Big Horn Basin of Wyoming and competitively selling the production in the open market under 6-month term contracts. The State of Wyoming has also included State lands RIK oil in the pilot sales. Currently approximately 2,000 barrels per day of Federal RIK oil are being sold under the Wyoming Pilot.

In March 2001, MMS issued its evaluation of the Wyoming Pilot for the period October 1998 through March 2000. The report concludes that the Wyoming Oil RIK pilot successfully demonstrates that in some but not all circumstances, taking oil production in kind and selling it through a competitive bid process is a viable alternative to the historical method of taking royalties in value. The following criteria were established as the basis for evaluating its success:

- Simplicity, accuracy, certainty for lessees and government.
- Revenue neutral (or better) for government;
- Reduced administrative burdens for lessees and government.

To summarize the main findings of the report, the Wyoming oil RIK pilot demonstrated:

- Selective use of RIK can be revenue neutral -- MMS received an average premium of 45 cents per bbl over the values reported to the State for royalty and severance tax purposes.
- Lessees benefit from a reduced burden -- an 80% decline in the number of lines reported and the avoided costs of valuation disputes.
- Greater certainty for both lessees and the government -- valuation disputes are avoided and the potential exists for completing the volume reconciliation process in 90-120 days.
- RIK does not work across the board -- MMS stopped offering trucked properties because of the lack of competitive bids and purchaser interest.

The Wyoming pilot also provided the MMS and the State with valuable experience in operating an ongoing RIK program. In several areas, experience from the three sales allowed the MMS and State to review previous results and improve processes for the next cycle. Reviewing the bidding mechanisms and the properties which were receiving bids led to the expansion of the possible bidding and pricing mechanisms and to the elimination of trucked properties from subsequent sales. Feedback from sale participants provided impetus to eliminating burdensome and unnecessary qualification requirements. On the pricing side, MMS gained valuable insights into the complexities of the Wyoming oil market and discovered the need for MMS and the State to further investigate alternative pricing mechanisms and different sales terms. Although the overall value received in kind was at or above the comparable in-value number, this was not the case for every month for every property.

MMS and the State of Wyoming are currently in the planning phase for the next competitive sale of Wyoming RIK oil for deliveries commencing in the Fall 2001.

<u>The Texas 8(g) Gas Pilot</u>

In 1998, MMS in partnership with the State of Texas General Land Office initiated the second RIK pilot project involving OCS natural gas production from Federal leases in the Texas 8(g) zone of the Gulf of Mexico. The 8(g) zone refers to leases within 3 miles of State waters and from which Texas receives 27 percent of the revenues. The primary activity under this pilot was to mutually explore ways to cost-effectively market both Federal RIK gas from the 8(g) zone and State leases. Sales began in June 1999, and initially focused on monthly spot market sales of about 25,000 mmbtu/day of natural gas. Total sales volumes reached 75,000 mmbtu/day with deliveries to both Federal facilities and private purchasers. For reasons of administrative simplicity, the pilot was merged in FY 2001 with the OCS pilot for non-8(g) gas. Sales of 8(g) gas to Federal facilities and other purchasers continues under the overall Gulf of Mexico gas pilot.

The MMS has commenced its evaluation of the Texas 8(g) gas pilot and expects to complete its analysis in

the Fall 2001.

The Gulf of Mexico Gas Pilot

In November 1999, MMS began a third RIK pilot, involving non-8(g) Federal offshore leases in the Gulf of Mexico. Initial activities centered around competitively-offered contracts with successful bidders taking approximately 200,000 mmbtu/day of royalty natural gas from specified offshore locations and delivering natural gas volumes and qualities of equivalent value to a specified onshore location. Much of this gas was sold to the General Services Administration for use in managing its program of supplying natural gas to Federal agencies. As previously mentioned, for reasons of administrative simplicity, the MMS merged the OCS Texas 8(g) and the non-8(g) gas into one pilot in FY 2001. Under the merged gas pilot, the MMS is today selling approximately 380,000 mmbtu/day of natural gas at offshore and onshore delivery points.

An important feature of this pilot is that, with the authority provided in the FY 2001 appropriations bill, MMS began entering into agreements for the transportation of RIK natural gas to pooling points and market centers away from the lease. Because of the strong presence of MMS royalty production throughout the Gulf, the MMS has found this authority to be a cost-effective means for shipping the Government's share of production. In some instances, MMS has been able to negotiate better rates than other shippers along the pipeline. Authority for the payment of processing costs has also proved beneficial for operating this pilot, particularly in situations where MMS was forced to process its royalty share due to operational flow orders. Continuation of this authority beyond FY 2001 is critical to the RIK pilots for testing alternative approaches to selling production at market centers removed from the lease.

The Gulf of Mexico Oil Pilot

In August 2000, the MMS commenced a fourth pilot for the competitive sale of RIK crude oil from Federal offshore leases in the Gulf of Mexico. Under this pilot, MMS is currently selling about 7,600 barrels of crude oil per day through September 2001. We are now in the planning phase for the next sale with deliveries beginning October 2001.

Small Refiner RIK Program

Beyond the RIK pilot program, the MMS continues to operate its existing Small Refiner RIK Program. The objective of the Small Refiner Program is to help assure adequate supplies of crude oil at equitable prices are available to eligible small refiners. The business processes followed in operating the program have historically been complicated and labor intensive. The MMS has worked with parties affected by the Small Refiner Program in the last several years to bring about a number of improvements including:

- introduction of a competitive bidding process that increases price certainty for the small refiner and MMS.
- establishment of a volume nomination process for MMS to manage operators' deliveries of oil to small refiners thereby reducing monthly imbalance problems
- changes in MMS payment requirements to have small refiners pay on actual oil deliveries rather than estimated volumes, thereby reducing problems with small refiners having to pay for oil they did not receive, and

- streamlined information collection by no longer requiring operators to report RIK sales on the MMS royalty report.

Today, MMS is providing three small refiners in the Gulf of Mexico and two small refiners in the Pacific with a total of about 70,000 barrels of RIK oil per day.

Managing MMS's RIK Activities

To provide the needed management focus and visibility to RIK activities for the future, the MMS established through its October 2000 reorganization of the Royalty in Kind Office within the MRM. The RIK Office is the focal point and accountable for the management and coordination of all MMS activities related to the operation of the RIK pilots, the Small Refiner Program, and other RIK activities. The RIK Office is staffed with employees experienced in the pilot program and the Small Refiner Program. The Assistant Program Director for RIK reports directly to the Associate Director for the MRM.

Evolving MMS's RIK Activities

In January 2001, MMS published its *RIK Road Map to the Future*. The Road Map outlines a 3-year business plan for further development and operation of MMS's RIK pilots and Small Refiner Program, and integration of the RIK option into the overall asset management strategies of the MMS.

Closing Remarks

We at the MMS are striving to adopt a balanced approach in developing the RIK option as a viable tool for the management of the Nation's royalty assets. We have been deliberate in exploring new opportunities for optimizing value and gaining market insight, yet have remained cautious to proceed slowly and build upon the lessons learned through experience.

This MMS is continuing to study RIK as a possible business approach for managing oil and gas royalties. MMS is evaluating experiences to date and will continue to explore the potential of RIK through pilot projects and long-term projects.

Madam Chairman, this concludes my prepared remarks. However, I will be pleased to answer any questions Members of the Subcommittee may have.

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