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STATEMENT OF

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BEFORE THE

CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

AND CHAIRMAN, SUBCOMMITTEE ON MINES AND MINING

HOUSE COMMITTEE ON INTERIOR AND

INSULAR AFFAIRS

ON

PROBLEMS CONFRONTING THE GEOLOGICAL SURVEY IN

COLLECTING OIL AND GAS ROYALTIES

Mr. Chairmen and Members of the Subcommittees:

We are pleased to be here today to discuss our views on Geological Survey's oil and gas royalty accounting system--a system fraught with longstanding financial management problems. Geological Survey is responsible for collecting the royalty income derived from oil and gas produced on Federal and Indian lands. Royalty collections have increased rapidly in recent years primarily because of substantial increases in oil and gas prices. With oil prices decontrolled on January 30, 1981,

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this trend can be expected to continue. Annual royalties are expected to be over $6 billion in fiscal 1982 and could grow to $22 billion by fiscal 1990.

In our 1979 report entitled "Oil and Gas Royalty Collections--Serious Financial Management Problems Need Congressional Attention" (FGMSD-79-24, April 13, 1979), we pointed out that Geological Survey was having great difficulty in accounting for and collecting Federal royalty income. On the basis of more recent work for the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, we have determined that these problems persist.

Geological Survey is not collecting all oil and gas royalties. Moreover, millions of dollars in royalty income are not collected when due, thus increasing Government interest costs. Until Geological Survey improves its financial management, there can be little assurance that all royalty income due from Federal and Indian land is received.

We recognize that Geological Survey's task is complex and that it has to deal with many factors beyond its control such as the proliferation of lease interests, varying royalty rates, and complex oil and gas valuation factors. Also, the monetary amounts Geological Survey is responsible for, have grown tremendously in recent years.

Geological Survey is seeking to improve its financial management capabilities by developing a new royalty accounting system but it will be several years before the system is fully implemented. Also, we applaud Secretary Watt's establishment of the Commission on Fiscal Accountability of the Nation's Energy Resources which is an important step to help resolve the royalty accounting problems that have plagued the Geological Survey for over 20 years. The Commission is charged with developing solutions to mineral management problems with focus on royalty accounting and oil thefts.

PERSISTENT MANAGEMENT PROBLEMS PREVENT ACCURATE COMPUTATION AND COLLECTION OF OIL AND GAS ROYALTIES

Since 1959 numerous GAO and Department of Interior audit reports have pointed out the need for improved management of Geological Survey's royalty accounting system. In our April 1979 report, we recommended both short-range and long-range alternatives to the longstanding financial management problems. On the basis of our current follow up work, we have determined that the problems discussed in our 1979 report not only persist, but have become worse.

In our current review we found that

--unverified data is still used to compute royalties,

--lease account records still contain numerous errors and omissions,

--collection procedures are still inadequate, and

--lease accounts are still not audited on a routine basis.

Geological Survey still relies upon unverified data

Geological Survey relies almost entirely on production and sales data reported by the oil and gas companies. There is little effort to verify the accuracy of the data supplied. Production reports are not regularly compared to reported sales;

communication between Geological Survey accountants and field inspectors is infrequent; and lease inspections are not used to verify production. In short, the oil companies are essentially on an honor system to report accurately and to fully pay royalties when due. We have previously stressed that by matching production data against sales data, Geological Survey could identify situations where oil and gas produced was not properly accounted for. However, this matching is still not being routinely done. Even though the Geological Survey reported 28,283 field inspections during fiscal year 1980, there is no indication that field inspectors and accounting personnel have worked together to verify production. Geological Survey officials confirmed that they continue to accept as accurate what the companies report.

There have also been serious problems with the lease inspections themselves. Because of Geological Survey's insufficient lease inspections and monitoring, thefts and other violations on Federal and Indian leases have gone undetected. These included

--The use of resettable meters,

--Improperly sealed oil storage tanks and valves; and

--Inadequate supervision of lease operations of the oil and gas companies.

At the time of our current review, Geological Survey had only 47 inspectors to review the activities at over 44,000 producing wells. This limited number of inspectors is not sufficient to provide adequate coverage. Geological Survey should devote additional resources to the inspection effort and should require that field inspectors assist accounting personnel in verifying sales data.

<u>Lease account records contain numerous errors and omissions</u>

Compounding the problem of Geological Survey's reliance on information reported by the oil and gas companies was the breakdown of its current automated royalty accounting system. Lease account records are inaccurate and unreliable. They cannot be used to determine if royalties due from Federal and Indian leases are properly accounted for. As a result, royalties due may not be collected in full and other royalties are not being collected timely. We have been reporting on the inaccuracy of lease account records since at least 1959.

Royalties earned and payments made are recorded in lease accounts through an automated accounting system using data reported by oil and gas companies. If the amounts due and the royalties paid in an account do not agree, the account will show a balance. Account balances result when companies

--make an error in computing the amount of royalties owed or amounts paid, or

--fail to pay or report royalties due.

The Geological Survey has also created erroneous account balances by recording charges or payments in wrong accounts and by making other clerical errors.

Our April 1979 report showed that as of July 1978 the lease account records contained numerous errors and could not be relied upon. Despite calling on Geological Survey to reconcile these differences, our recent follow up work shows that the lease account records are just as inaccurate and unreliable as they were in July 1978.

On July 31, 1978, the Geological Survey maintained 22,735 lease accounts. Of these accounts, only 6,569 did not have a balance. Of the accounts with a balance, 9,497 indicated that the amount paid was greater than the royalties due the Government. Although this condition can result from overpayments to the Government by the oil and gas companies, it occurred more frequently because royalties due the Government were understated when company reports were not received and charges were not properly entered in the accounts. The balance of these 9,497 accounts was $49.8 million. The remaining 6,669 accounts which had balances indicated that royalties of $38.8 million were due because the amount collected was less than the amount computed as due.

On the basis of recent follow up work, we determined that lease accounts still are inaccurate. As of May 1981, 20,356 or 73 percent, of Geological Survey's 27,909 lease accounts had a balance. Of these, 9,320 accounts indicated that Geological Survey had been underpaid by $173 million; the remaining 11,036 accounts indicated, usually erroneously, that Geological Survey had been overpaid by $187 million.

It should be noted that these amounts do not necessarily represent underpayments or overpayments, but simply indicate that Geological Survey does not know the amounts due, and clearly indicate the serious problem Geological Survey has experienced in maintaining accurate lease account records. Because of incomplete and inaccurate data entered in these accounts, they cannot be used by Geological Survey to effectively manage royalty collections.

We previously called on Geological Survey to develop a plan for reconciling existing lease accounts and for identifying and collecting uncollected royalties. In June 1981, Geological Survey announced plans to audit 20 to 25 producers of oil and gas on Federal and Indian lands to determine the amount of underpayments and overpayments that have occurred. These companies cover half of the lease accounts maintained and account for over 80 percent of the royalties collected. The audits will cover lease transactions from the past 6 years and are expected to take three to four years to complete at an estimated cost of $3 million.

Because of the planned auditing project, the Geological Survey is not planning to reconcile existing lease account records. We support Geological Survey's efforts to audit the oil and gas companies accounting records for the specific purpose of determining underpayments and overpayments. However, more needs to be done. Geological Survey needs also to develop a plan to reconcile its lease account records thereby providing a sounder financial base for the new royalty accounting system.

Royalties are not being
collected when due

Another longstanding problem centers on Geological Survey's inability to assure that all royalties due are collected on time. Late payments continue to be a serious problem.

In our April 1979 report, we disclosed that in 1977 alone Geological Survey did not collect about $359 million in oil and gas royalties when due. We found payments were not received within the times specified in leases because:

--Geological Survey did not adequately enforce provisions calling for the timely payment of royalties, and

--Geological Survey did not impose appropriate administrative fees or interest charges on those making late payments.

Late royalty payments continue to be experienced by the Geological Survey. Our analysis of 275 randomly selected lease accounts, drawn from the 714 lease accounts examined and reported on in our April 1979 report, showed that for the 3 months ending June 30, 1980, late payments totaled $98 million for that quarter alone. Had these delinquent payers been assessed interest charges equal to the cost of Federal borrowing they would have owed an additional $400,000 for the 3 month period alone. On an annual basis $390 million in royalty payments may have been paid late, costing the Treasury potentially $1.6 million in interest. It should be noted that our current projections for late payments and interest costs are based on the number of leases that existed in our previous review

(22,735 lease accounts as of July 31, 1978). As of May 31, 1981, Geological Survey maintained 27,909 lease accounts. Considering that the number of lease accounts has increased since the 1979 report, it is reasonable to assume the dollar amount of late payments is even greater than projected.

In our April 1979 report, we called for interest to be charged on late payments. Although agreeing to do so, Geological Survey has been slow in acting. Interest was not charged on late payments applicable to offshore leases until September 1980. The Geological Survey did not provide instructions for charging interest on late payments to its field offices handling onshore oil and gas leases until June 1981, and no interest was collected for onshore late royalty payments until July 20, 1981.

Geological Survey has taken the first step by issuing procedures for assessing interest on late payments. But until an adequate automated system is developed, with the capability of identifying late payments and computing interest charges, the agency will be faced with having to provide additional staff to do the job manually. An action plan is needed to identify staff needs and resources. Otherwise we are doubtful as to whether interest will be effectively charged in the immediate future. Also, we have called on Geological Survey in developing its new system to use electronic funds transfer. Under these procedures oil and gas companies would wire their royalty payments directly to the Federal Reserve, eliminating the check clearing process and giving the Treasury immediate use of the funds.

Insufficient auditing of lease account records

Besides needing to establish a reliable royalty collection system, the Geological Survey must increase its auditing and monitoring of lease accounts. Without sufficient lease account audits, the Geological Survey is in the position of having to rely upon unverified data reported by the oil and gas industry. Without a comprehensive auditing program, longstanding financial management problems will continue.

In our 1959 report, we pointed out the importance of having an auditing program to identify and resolve deficiencies in accounting for royalties. We again reported on the importance of auditing in our 1979 report. Additionally, in 1975 the Department of Interior internal audit staff recommended increased emphasis on the auditing of lease account records.

Geological Survey recognized the importance of conducting comprehensive audits by establishing criteria that audits be performed at intervals ranging from once a year to once every 6 years, depending upon the amount of annual royalties paid.

It has not followed through, however, and the situation today is essentially the same as it was in 1979. In fiscal 1980, only 5 percent of the lease accounts were audited nationwide even though the audits have proven beneficial with additional collections of over $7.7 million. Geological Survey officials have acknowledged that audit efforts continue to be inadequate and they have not been able to audit enough accounts to achieve effective control over them. For instance, the Casper and Albuquerque offices, which are responsible for over 18,000 lease accounts, completed only 92 audits during 1979 and 1980. This means that over the 2-year period only 1/2 of 1 percent of the total accounts these offices were responsible for were audited. At this rate, the 18,000 lease accounts will never be completely audited. Even at the fiscal 1980 nationwide rate of 5 percent, it would take 20 years to audit the 18,000 lease accounts in the 2 offices.

At the time of our 1979 report, Geological Survey estimated that it would reconcile all leases by 1981. However, the task essentially has not even been started. Overall efforts by Geological Survey to improve monitoring and auditing of accounts have not been successful.

Geological Survey needs to develop a comprehensive systematic plan for reconciling, auditing and monitoring lease account activities and it must identify the additional resources needed to establish and maintain a continuing auditing program. Milestones for completion of the task are needed. In this regard, the Geological Survey is hiring additional auditors. According to Geological Survey officials, the auditors will initially be used to explain the new royalty accounting system to the oil and gas companies. In addition, the Geological Survey is still not certain if this staff increase is sufficient to audit the almost 28,000 existing lease accounts. In order for the auditing program to be viable, the auditors must adhere to the established program and should not be routinely used for other work.

GEOLOGICAL SURVEY IS MAKING AN EFFORT TO CORRECT ITS FINANCIAL MANAGEMENT PROBLEMS

Geological Survey, recognizing that its existing accounting system was inadequate, formed a task force to recommend system improvements. The task force recommended that a new royalty accounting system be designed and implemented. As you are aware, the system is not yet operational and will not be fully designed and implemented for several years.

Geological Survey completed a feasibility study for the new system in March 1981. The system is to be implemented in three phases over a 5 year period. The three phases consist of (1) the royalty accounting phase, (2) the production phase, which will permit the matching of production and sales data, and (3) the enhanced management phase which will center on developing quality review and management data.

The Geological Survey refers to the new royalty accounting system as a modified Internal Revenue Service system, in that, all data submitted will be assumed to be correct subject to extensive computer analysis, screening, and audit. The agency currently estimates that the royalty accounting phase will be fully implemented by fiscal 1983.

American Management Systems, Inc. was awarded a contract on September 17, 1981, for $4.3 million for the design and implementation of the accounting phase. In addition, the contractor will also be responsible for preparing a preliminary systems design of the production phase. A detailed system design of the production phase is an option of the contract requiring further negotiation between the Geological Survey and the contractor.

We are currently reviewing the request for proposal and the contract for the design and implementation of the accounting phase and the preliminary study design for the production phase. Although our analysis is not yet complete, it appears that many of the longstanding accounting problems have been considered in the preliminary design of the accounting phase. However, since the contract for the design and implementation of the accounting phase has only recently been awarded, it is too early to tell whether the effort will be successful. The development of the accounting phase must be properly managed and to be successful the phase must ultimately interface with the other phases of the system, as well as inspections and audits.

Although we are encouraged by Geological Survey's ongoing efforts, we are concerned that the agency appears to have not given adequate consideration to:

--acquiring data on the number of leases and wells for which it is responsible,

--verifying the royalty computation,

--planning of the production phase, and

--developing a comprehensive plan for audits and inspections.

Before Geological Survey can effectively control and monitor royalty collections, its system must have accurate, reliable, and timely information on the number of leases and wells for which it is responsible. Without such information, the agency has no assurance that all individuals who are responsible for paying royalties are in fact making payments.

Geological Survey, however, has decided to prepare its lease master file--list of leases and payors--from data in the existing system--data the agency is not certain is complete and accurate. If payors are not listed in the current system, chances are they will not be listed in the new system data base. In order to obtain information related to the total number of leases it is responsible for, Geological Survey should consult with the Bureau of Land Management and the Bureau of of Indian Affairs. Unless it can maintain an exact accountability for payors and leases, the agency will be hampered in its efforts to manage and monitor royalty collections.

Besides determining who should pay royalties, Geological Survey must also determine how much is due. In the current system the amount of royalties due is computed and compared with the amount paid by the oil and gas companies. If differences occur, which frequently do, a balance will appear in the lease account. As previously stated, a balance can arise for various reasons, indicating that either an error has been made by Geological Survey and/or the oil and gas company, or that all data has not been received. This accounting control, if properly used, can provide a means of identifying troublesome lease accounts and companies.

In the new royalty accounting system Geological Survey will no longer recompute the royalties owed, placing an even greater reliance on the oil and gas companies for the accuracy of the information received, especially since the same company will be submitting both the royalty payment and the sales report. Although there will always be some reliance on data reported by the oil and gas companies, Geological Survey must reduce this reliance to the extent possible and determine the reasonableness of the data reported. By eliminating this control feature, Geological Survey could be hampering its ability to detect problem lease accounts and/or companies that might be reporting inaccurate or incomplete data.

Another area of concern is Geological Survey's planning for the production phase. This phase is extremely important, because of the need to alleviate the reliance on information reported by the oil and gas companies. The matching of production data and sales data would enable Geological Survey to identify situations where oil and gas produced was not properly accounted for. It would also provide the means to monitor lease activities and identify irregularities in reported production and/or sales, and can be used as an indication of the reasonableness of the reported data.

Geological Survey has an overall concept for the production phase but has not developed any plans as to how this phase is to operate and how it will interface with other phases of the system. Priority has been almost solely on the accounting phase.

In the request for proposal for the accounting phase, Geological Survey asked the contractor to also determine the data requirements for the production phase and how the information will be used, and interfaced with the accounting phase. Geological Survey is totally dependent on the contractor to determine what the production phase will be and how it will work. The contractor, in a letter attached with its offer, stated that the production phase is critical to the improved royalty accounting system, and is so complex in concept itself, so uncompletely defined, that it requires an absolutely all out effort.

Planning is very important in developing and designing an accounting system. If the system is not well planned, the chances of it being fully successful are diminished. We are concerned that Geological Survey has not yet determined how the production phase will interface the accounting phase.

For instance, the accounting phase is being designed to accept sales and remittance report information at the payor level, while production reports are on a lease level. Geological Survey does not know if it can compare the information from the two reports in their present format. It concerns us that this has not been resolved before work begins to design and implement the accounting phase, as it may require major changes to the system at a later date.

As discussed previously, we are also concerned that Geological Survey does not have a comprehensive, systematic plan for monitoring, reconciling, and auditing lease account records; inspecting leases; and verifying production and sales data. The agency has not developed such a plan for the accomplishment of these tasks, although it has recognized the importance of inspections and audits as integral parts of royalty management, and is hiring additional inspectors, auditors and accounting technicians. In this regard under the new system, it will be imperative that Geological Survey seek secondary sources to verify production and sales data. The States are a potential source of this information. Also, Geological Survey should coordinate with the States regarding sharing the auditing and lease inspection function.

Historically, Federal agencies have experienced problems in designing and implementing financial management systems because sufficient management attention has been lacking. In some cases, agencies have spent tens of millions of dollars developing systems which do not adequately work after years and years of development. Slippages and cost overruns are commonplace. In order that its new system does not succumb to the problems encountered by other agencies in designing and implementing new systems, Geological Survey must have a sustained, high priority effort--one with long term top management involvement. An effective accounting and financial reporting system will result only if top management within the Department of Interior and the Geological Survey remain involved. The ongoing impetus to redesign the system must continue.

This concludes my prepared statement. We would be happy to respond to any questions.