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UNITED STATES GENERAL ACCOUNTING OFFICE

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STATEMENT OF

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116987

BEFORE THE

COMMISSION ON FISCAL ACCOUNTABILITY OF

THE NATION'S ENERGY RESOURCES

ON

PROBLEMS CONFRONTING THE GEOLOGICAL SURVEY IN

COLLECTING OIL AND GAS ROYALTIES

Mr. Chairman and Members of the Commission:

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. We applaud Secretary Watt's establishment of the Commission which is an important step to help resolve the royalty accounting problems that have plagued Geological Survey for over 20 years.

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.

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With oil prices decontrolled on January 30, 1981, this trend can be expected to continue. Annual royalties are expected to be $4 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; hundreds of millions of dollars owed the Government may be going uncollected each year. 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. In order for the new royalty accounting system to be successful, a sustained, high priority effort is needed. Also, since the new system will not determine and collect previously uncollected royalties, Geological Survey needs to develop a separate plan to address this problem.

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.

The matching of production and sales information is a valuable tool, however, it has some limitations because of difficulties in matching this information, and because in most instances the same company prepares both reports. Therefore, Geological Survey must have a means to independently verify what is reported. As discussed in our April 1979 report, Geological Survey personnel who periodically inspect the well sites can evaluate the reasonableness of the production data. Also, production reports show the quantity on hand and can be analyzed to detect sudden changes in production quantities; thereby reducing Geological Survey's reliance on data provided by the oil and gas companies.

Our April 1979 report recommended that field inspection personnel assist accounting personnel in verifying the accuracy of the reported data by determining the reasonableness of inventory and sales data shown on production reports. Accounting personnel were to be informed of any discrepancies noted. The Geological Survey agreed and, in April 1979, issued instructions requiring communication and assistance between field inspection and accounting personnel when inconsistent or questionable data was reported. 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.

Also, there have been questions raised about the lease inspections themselves. Geological Survey's field inspections and monitoring were severely criticized at recent hearings before the Senate Select Committee on Indian Affairs. It was pointed out that because of Geological Survey's insufficient lease inspections and monitoring, violations on Federal and Indian leases have gone undetected. These violations 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. Production must be verified.

Lease account records contain numerous errors and omissions

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. Some 27,000 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.

To determine the accuracy of these accounts, we reviewed 714 randomly selected lease accounts for June, July and August 1977. We noted the following deficiencies which contributed to the inaccuracy of these lease account records.

--In 137 cases, royalty payments totaling $258,000 were recorded in the accounts without amounts being recorded as due.

--In 245 cases, royalties totaling $471,000 were recorded as due without royalty payments being recorded.

--In 469 cases, the royalties due did not equal the royalties paid. Royalties paid exceeded the amounts recorded as due by $122,000.

On the basis of recent follow up work, we determined that lease accounts still are inaccurate. As of September 1980, 19,487 or 73 percent, of Geological Survey's 26,769 lease accounts had a balance. Of these, 9,962 accounts indicated that Geological Survey had been underpaid by $134 million; the remaining 9,525 accounts indicated, for the most part erroneously, that Geological Survey had been overpaid by $153 million.

Our follow up analysis of 275 of the 714 lease accounts we had previously analyzed, for the 3 months ending June 30, 1980, showed that

--In 115 cases, royalty payments totaling $725,336 were recorded in the accounts without corresponding amounts being recorded as due.

--In 97 cases, royalties totaling $276,569 were recorded as due without corresponding royalty payments being recorded.

--In 174 cases, the royalties due did not equal the royalties paid. Royalties paid exceeded the amounts recorded as due by $119,226.

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

3 to 4 years to complete at an estimated cost of $3 million.

Because of the planned auditing project, the Geological Survey is not going 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 reoncile its lease account records thereby providing a sounder financial base for the new royalty accounting system.

<u>Royalties are not being collected when due</u>

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. As far back as 1959, we reported that all royalty payments were not received when due. In addition, in 1975 Department of Interior internal auditors recommended Geological Survey assess interest on late payments.

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.

To the extent the delayed collections involved additional borrowing by the Treasury, additional interest costs of $360,000 may have been incurred.

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 additional interest cost. 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 September 30, 1980, Geological Survey maintained 26,769 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 has been collected for onshore late royalty payments as of July 15, 1981.

Geological Survey has taken the first step by issuing procedures for assessing interest on late payments. Interest should be assessed at the quarterly rate required by the Treasury for delinquent debts. Assessing of interest can essentially be automated with the computer identifying late payments and computing interest charges. 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.

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. Geological Survey's auditing and monitoring of its lease accounts continues to be inadequate to effectively control royalty payments. As previously reported, 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 repeated the importance of auditing in our 1979 report. Additionally, in 1975, the Department of the

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. As set out by Geological Survey, audits are to represent systematic and indepth investigation and appraisal of such things as reported production and sales; oil and gas values; royalties and rentals paid; and compliance with the lease terms, and oil and gas operating regulations. Lease accounts are to be reconciled to identify misapplied or missing charges, underpayments, and overpayments that appear or should appear in the account.

It has not followed through, however, and the situation today is essentially the same as it was in 1979. In fiscal year 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. Audit coverage is not sufficient in terms of numbers of accounts audited, nor does it provide assurance that accounts most needing audits will be included.

According to Geological Survey officials, audit and reconciliation requests from Indian tribes, Federal agencies, companies and individual lease operators occupy available audit staff resources, causing the already insufficient audit staff to audit accounts which have not been selected on a planned or systematic basis. Also other initiatives such as monitoring newly established accounts and reviewing accounts for obvious errors have not proven effective. As we have repeatedly pointed out, lease account problems can be eliminated or reduced if problems are discovered and resolved early in the life of a new account. The Albuquerque office assigned auditors to monitor newly established accounts but abandoned this effort because of higher priority work. Newly established accounts we examined during our current review exhibited the same deficiencies as the older accounts.

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 130 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 27,000 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 and cost benefit analysis for a new system in March 1981. It plans to award a contract in September 1981 for design of the new system. The system will 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 IRS 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 and the production phase by fiscal 1984.

Since the new system has not yet been designed and none of the phases is operational, it is difficult to say whether it will correct Geological Survey's longstanding financial management problems in the collection of oil and gas royalties. If the system is effectively planned, designed, implemented, and adequate resources provided, Geological Survey should be better able to account for and control royalty payments. Until then, however, it seems that Geological Survey will be hardpressed to fully carry out its royalty collection responsibilities.

Historically, Federal agencies have experienced problems in designing and implementing financial management systems because sufficient management attention has been lacking. 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.

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In summary, Geological Survey has been slow in responding to its many longstanding financial management problems. At least 20 years have gone by since GAO first reported that the Geological Survey could not assure that all royalties due from

Federal and Indian leases were being collected. The Geological Survey in its efforts to design and implement a new royalty accounting system is, for the first time, placing emphasis on the need for an effective royalty management program. The ongoing impetus to redesign the system must continue and improved royalty accounting must receive top management attention for the current program to succeed.

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