

AUDIT MANUAL

MINERALS REVENUE MANAGEMENT

Release 4.0

March 2010

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Minerals Revenue Management**



6. AUDIT PROGRAM

This chapter provides a general overview of an audit program. The objective of an audit is to determine if the lessee reported and paid royalties in compliance with applicable laws, regulations, and lease terms.

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7.10 & 7.51(c)

An audit program provides the general steps to collect evidence and to determine if reporters correctly reported and paid royalties and related revenues on a lease. The auditor prepares the audit program during the planning stages of the audit. Based on the auditor's professional judgment and the circumstances in each audit, the audit program is tailored to the given scope and objectives and allows insertion of additional audit steps as the audit proceeds. The auditor must address audit steps and support conclusions in the workpapers. If it is later determined that the auditor will not be completing certain program steps, the auditor should record sufficient documentation to support why the step was not completed or applicable. The auditor and supervisor must sign and date the audit program during the planning stages of the audit, as well as after all steps are complete.

6.1 EVIDENCE

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Evidence is gathered and documented in the fieldwork stage of the audit. Auditors must obtain sufficient, appropriate evidence to provide a reasonable basis for the audit findings and conclusions. GAGAS standards classify evidence as follows:

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- Physical
- Documentary
- Testimonial
- Analytical

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The sources of evidence can be in the form of data gathered, such as the following:

- By auditors
- By supervisors
- From third parties
- Through computer systems

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If the auditor relies on an auditee's computer systems, the auditor should obtain sufficient, competent, and relevant evidence that the computer-processed data is valid and reliable when this data is significant to the auditor's findings. Refer to Chapter 5 for additional information related to assessing the validity and reliability of computer-processed data.

6.1.1 GATHER EVIDENCE FROM INTERNAL SOURCES

MRM policy is to obtain audit evidence from government sources whenever possible before approaching the auditee. Chapter 8 provides additional detail on how to access this data. Most of the following documents are available from internal government sources:

- Leases and lease assignments
- Operating agreements and designation of operator
- Unit and communitization agreements
- Lease plats
- Transportation and processing allowance forms
- Lease inspection records

- Lease reference information, production, and payment history
- Production verification reports (BLM)

6.1.2 GATHER EVIDENCE FROM THE AUDITEE

The auditor can initially request data from the auditee through the engagement letter or through a data request. The following are examples of documents that the auditee may request:

- Meter statements
- Purchaser statements
- Contracts
- Imbalance statements
- Run tickets
- Well tests
- Allocation reports
- Remittance statements
- Bonuses/premiums
- Company sales summaries

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6.1.3 VOLUME AND VALUE ANALYSIS

Using the evidence obtained in the preceding sections, the auditor may determine the following:

- Royalty measurement point
- Volume produced
- Volume sold
- Valuation of the sales volume
- Royalty due as compared to royalty paid
- Rent and minimum royalty lease requirement
- Rent and minimum royalty paid

VOLUME ANALYSIS

In verifying oil, gas, and geothermal volumes, the auditor should perform a comparison of produced, metered (third-party volume statements), and reported sales volumes on Form MMS-2014. For solid minerals volume analysis, the auditor can compare reported produced volumes from the Production (Form MMS-4430), BLM production verification reports, and company sales summaries. To perform a volume analysis, the auditor should perform the following steps:

- Verify proper measurement methods (i.e. gravity and pressure base, measurement point, commingling approval, etc.). For example, the auditor may request inspection reports from the appropriate BLM or OEMM office or, if none are available, request that BLM or OEMM perform an inspection.

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- Identify and reconcile missing volumes.
- Identify lease use and determine if it is allowable under the lease terms.

Additional steps may be necessary if any of the following are true:

- The audited lease is involved in a unit agreement.
- The lease is involved in an imbalance situation.
- Other reporters/payers of lease production are involved.
- The lease contains unusual royalty provisions.

VALUE ANALYSIS

The auditor should verify contract pricing against gross proceeds and reported values and consider any special valuation issues, such as the following:

- Spot market/daily index contract pricing
- Approved allowances
- FERC Order 636 transportation elements
- Unusual royalty valuation terms
- Percentage-of-proceeds (POP) contract valuation
- Bonuses/premiums
- Geothermal net-back valuation
- Non-arm's-length sales

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- Index/major portion pricing (Indian only)
- Dual accounting

ROYALTY DUE AS COMPARED TO ROYALTY PAID ANALYSIS

After verifying volume and value, the auditor should calculate royalties due on Federal or Indian obligations based on standard lease terms and unique lease provisions (See Chapter 11). Additional audit steps may be necessary if the lease(s) in the audit scope are as follows:

- Schedule B competitive lease(s)
- Step or sliding scale royalty lease(s)
- Reduced royalty rate—either temporarily or permanently—because of stripper, royalty relief, or net profit share incentives
- Section D lease(s)

The auditor should compare the royalties due calculation to actual royalties paid. If the lessee underpaid royalties, the auditor should document the auditee's calculation and determine if the error is systemic and will affect other leases.

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6.2 AUDIT SUMMARY

When the audit analysis is complete and the conclusions documented, the auditor should summarize the audit results for the individual audit in a workpaper summary document. See Chapter 4 for additional discussion of workpaper summaries.

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9.3 RECORD-GATHERING PROCESS

Auditors will routinely make written requests for information from reporters/payors, operators, lessees, gas plant owners or operators, transportation system owners or operators, purchasers, and others.

Auditees furnish significant quantities of accounting records, contracts, reports on field operations, and other data during the course of an audit. Auditors should retain all data requests and auditee responses in the audit files.

To ensure a consistent and timely process for obtaining records, auditors should follow the general guidelines outlined in the following list; however, always consider the specific circumstances of each audit when establishing response times:

- The auditor should make a good faith effort to obtain any records provided previously that the auditee already gave to any Federal agency, office, or State. For Federal oil and gas. This is a requirement per RSFA, Section 115 (f).
- The auditor should request all required records, in writing, from the “addressee of record” for audit matters, as specified in 30 CFR 218.500 through 218.580.
 - Auditors should note that FOGRMA authorizes auditors to examine the original records and make a copy. If the auditee-provided record copies are unreadable or questionable, the auditor can request to see the original document. FOGRMA also specifies that records within DOI be available to auditors.
- Preferably at least 30-60 days before fieldwork begins, notify the auditee(s), in the engagement letter, of the types of records needed, and the expected time-frames.

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- For subsequent data requests or for specific documents, specify a response period applicable to the situation. The auditor should keep accurate records of the records requested and received.

When an auditee refuses or delays access to needed records, the auditee is in violation of 18 USC 1516 “Obstruction of Federal Audit,” which states:

“Whoever, with the intent to deceive or defraud the United States, endeavors to influence, obstruct, or impede a Federal auditor in the performance of official duties relating to a person receiving in excess of \$100,000, directly or indirectly from the United States in any 1 year period under a contract or subcontract, shall be fined under this title* or imprisoned not more than 5 years, or both.” (Includes audits performed under FOGRMA Sections 202 and 205.)”

** - \$250,000 for individual and \$500,000 for corporations*

The auditor should contact OE to determine the appropriate course of action. The following options are available:

- Issue an Order for Records to the auditee with appropriate penalty and appeal language
 - Be aware that an Order for Records is subject to the first level of the Administrative appeal process and may delay obtaining the records.
- Issue an NONC action with possible civil penalties. This will not toll the 7-year statute of limitations. Refer to Chapter 24 for more information.
 - OE will contact the company to determine why they did not provide the requested records in a timely fashion and mediate an informal agreement. If the company does not reasonably keep the agreement, OE will proceed with a Notice of Noncompliance (NONC) and/or Civil Penalty.

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9. ACCESS TO RECORDS

- Issue a Subpoena
 - OE will provide assistance in issuing a subpoena (see below). Subpoenas are most beneficial when the statute of limitations threatens the audit periods, as Subpoenas become tolling instruments under RSFA.

The options above apply to oil and gas records, and civil penalty authority was extended to solid minerals and geothermal records by Pub. L. No. 111-88, § 114, 123 Stat. 2928 (2009) (codified at 30 U.S.C. 1720a).

9.3.1 SUBPOENAS

MRM, State, and Tribal compliance offices develop subpoenas; however, the Director, Assistant Secretary, or highest State official having ultimate authority over the collection of royalties from Federal leases within the State (RSFA, section 4) must issue subpoenas for Federal oil and gas leases. Authority to issue subpoenas for all Indian leases and Federal solid mineral and geothermal leases falls under the Program Manager level delegation. While subpoenas have the advantage of tolling the statute of limitations in RSFA, the Department of Justice must enforce unfulfilled subpoenas.

Effective with production after August 31, 1996, [RSFA, section 4(a)], a subpoena cannot be issued unless the auditor has requested the records in writing from the lessee or its designee, and the lessee did one of the following:

- Failed to respond within a reasonable time period
- Denied access to the records in writing
- Unreasonably delayed producing the records

OE requires that the auditor maintain and provide the following documentation for issuing a NONC:

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- Engagement letter and all requests for the information
- Evidence that the requests were received by the contact identified in writing by the company, consistent with 30 CFR 218.500 through 218.580
- Annotated copies of the requests showing what information was provided, if any
- Records of any follow-up calls, letters, etc. and the outcomes

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16. OIL AND GAS VALUATION STANDARDS

Calculating royalties due is often a complex process that depends on the facts of each sale. Auditors should review the lease agreement and applicable regulations in effect for the audit period to determine the audit criteria.

If any lease provision or any provision of a Federal statute, treaty, or settlement agreement between the United States and a lessee is inconsistent with these regulations, then the statute, treaty, settlement agreement, or lease provision governs the inconsistency.

MMS Dear Payor letters and MMS decisions provide interpretation of lease terms, laws, regulation, or MMS policy; therefore, a review of these sources is advisable before drawing any audit conclusion.

The total gross proceeds accruing from the disposition of production provides the basis for the minimum acceptable value for royalty purposes. The determination of gross proceeds can be a relatively straightforward or a very complex process depending upon whether the production disposition involves an arm's-length or a non-arm's-length transaction.

16.1 ARM'S-LENGTH SALES

Arm's-length gross proceeds is an amount usually based on the consideration transferred between independent purchasing and selling parties in accordance with a sales contract's pricing provisions. The consideration can be in the form of a payment or services performed. Auditors should look for additional consideration associated with placing the product in marketable condition. Marketing is the lessee's responsibility and is not allowable as a deduction from royalty value.

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16. OIL AND GAS VALUATION STANDARDS

Refer to the following regulations for guidance on determining values for arm's-length sales:

30 CFR 206.152(b)(1)(i) for Federal gas

30 CFR 206.102 for Federal oil

30 CFR 206.172 & 206.174(b) for Indian gas

30 CFR 206.52 for Indian oil

If the lessee enters into arm's-length exchange agreement(s) and, following the exchange(s), sells the oil received in the exchange(s) under an arm's-length contract, the lessee may use either 30 CFR 206.102 (a) or 206.103 to value the product for royalty purposes.

OPPOSING ECONOMIC INTERESTS

In order for an auditor to accept a contract as arm's-length, it must be between persons with opposing economic interests regarding that contract which means that the parties are acting in their economic self-interest with respect to the contract at issue.

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16.3 NON-ALLOWABLE COSTS

Auditors should be cautious of non-allowable costs that may reduce the royalty value, such as the following:

- **MARKETING FEES**

The cost to market the products is the lessee's responsibility and is not allowable as a deduction from royalty value.

- **MARKETABLE CONDITION**

Marketable condition means lease products that are sufficiently free from impurities and otherwise in a condition a purchaser will accept under a sales contract typical for the field or area.

For gas, the costs of placing the products in a marketable condition may include gathering, compression, dehydration, and/or "sweetening" (removal of acid gases). The sales value for royalty purposes cannot be reduced by these costs as supported by the numerous court cases, most notably *Devon Energy Corporation v. Norton, Civil Action No. 04-CV-0821 (D.C. Court, 2007)*

For oil, the lessee must place oil in marketable condition and market the oil for the mutual benefit of the lessee and the Indian lessor at no cost to the lessor unless the lease agreement provides otherwise. The lessor cannot reduce the gross proceeds by the cost of services performed on behalf of the lessor that would normally be the lessor's responsibility.

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24. ENFORCEMENT PROCEDURES

In cases where the auditee fails to cooperate with an audit or comply with an order, MRM may foster compliance through MRM OE enforcement actions. Such compliance-inducing actions include warning calls, formal notices, and civil penalties. However, enforcement actions may only be taken in oil and gas cases under FOGRMA and for solid minerals and geothermal cases for the Fiscal Year 2009 under the Omnibus Appropriations Act, 2009 (P.L. 111-08), and for the Fiscal Year 2010 and thereafter under the Omnibus Appropriations Act, 2010 (P.L. No. 111-88), which extends FOGRMA civil penalty provisions to solid minerals and geothermal leases.

Appealed orders are resolvable through OE's Alternative Dispute Resolution (ADR) program. Teams comprised of representatives from MMS audit, OE, affected states and tribes, and others meet with auditee representatives to reach a compromise position. This approach generally assures more-timely closure and less risk to the parties than if the case proceeded through the administrative and judicial systems.

The following sections generally explain enforcement actions and the ADR process, as well as additional information about those processes.

24.1 LAWS, REGULATIONS, AND OTHER CRITERIA

FOGRMA and other statutes require MMS to enforce and enhance reporting and payment practices to ensure proper mineral revenue collection. The following authorities are the basis of MMS enforcement practices and procedures:

- FOGRMA, Section 109 (30 U.S.C. 1701) provides the general framework for MMS civil penalties

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24. ENFORCEMENT PROCEDURES

- FOGRMA, Section 109 was extended to solid minerals and geothermal leases by Pub. L. No. 111-88, § 114, 123 Stat. 2928 (2009) (codified at 30 U.S.C. 1720a)
- 30 CFR 241 (1996) implemented the civil penalty provisions of FOGRMA
- ADR Act of 1990 (5 U.S.C. 572) established requirements for Federal agencies to practice ADR
- The Debt Collection Act (DCA) of 1982, as amended in 1996
- Federal Oil and Gas Royalty Simplification and Fairness Act requires one settlement consultation for disputes involving Federal oil and gas leases, 30 USC 1724 (i), but MMS asks all lessees who appeal orders if they would like settlement consultation

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24.2 ENFORCEMENT ACTIONS

FOGRMA provides that civil penalties may sanction violations of applicable mineral revenue laws, regulations, or lease terms. It provides for two classes of violations subject to penalty. The first, often called “curable” violations, may be resolved within a stated time period without penalty liability. Certain violations, when committed knowingly or willfully, make up the second class of violations. In those cases, civil penalties attach immediately rather than after the expiration of a cure period. Civil penalties for such immediate liability violations are much more substantial than for curable violations, and two such violations may expose a company or individual to criminal penalties under FOGARMA. In addition, several criminal statutes in Title 18, United States Code, may be applicable to royalty (i.e. false statements, thefts, fraud, and audit obstruction).

FOGRMA provides for somewhat different procedures in pursuing the curable and immediate liability violations. MMS must issue NONCs for either class of violation; however, these documents combine with civil penalty notices (CPs) in immediate-liability cases. Unlike orders to comply with regulations, lessees may not appeal NONCs. However, NONC and civil penalty recipients may request a hearing before an administrative law judge to contest NONCs and civil penalties.

24.2.1 REFERRAL OF VIOLATIONS TO THE OFFICE OF ENFORCEMENT AND/OR THE OFFICE OF INSPECTOR GENERAL

Violations relating to audit information often involve decisions on whether the behavior was knowing or willful and generally require Office of Inspector General (OIG) notification. Auditors must refer false statements or any other potential criminal violations to the OIG as soon as practicable. The Office of Enforcement (OE) will assist in making such referrals, upon request, and auditors must notify OE of any such cases that involve minerals revenue payment or royalty/production reporting. Violations involving non-

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24. ENFORCEMENT PROCEDURES

compliance with audit demand letters, or other unbilled orders requiring performance, often include multiple or complex issues and auditors should refer them to OE. Auditors should provide OE or the OIG with sufficient information to support an enforcement action.

24.2.2 SUSPENSION OF ACTIVITIES

OIG will normally advise the DAD and OE of case acceptance or remand within 10 days. For accepted cases, the OIG frequently asks that direct communications with the company, orders, and enforcement actions be suspended pending completion of the investigation. However, routine efforts, such as ongoing audits or compliance reviews and automated financial follow-up activities, may continue. OE maintains case acceptance/suspension of activities letters and related information in an e-Room accessible to all members of the QSC and others with need-to-know (as identified by the QSC) access. Of course, OE will suspend all investigative and action efforts on referred cases until OE remands them for such action.

24.2.3 OFFICE OF ENFORCEMENT INQUIRY

For un-referred or remanded cases, the Office of Enforcement (OE) will generally conduct a brief investigation to verify that the violations occurred, determine why the violation occurred (whether the auditee were knowing or willful), and to identify or confirm the responsible parties. If appropriate, this step will also include a warning call that urges the company to avoid any potential sanctions through immediate compliance. Of course, neither warnings nor NONCs can, in and of themselves, force companies to provide records or comply with orders. However, companies appear to prefer compliance to the very substantial civil penalties awarded to MRM. In audit records cases, this aversion to risk may make the enforcement process preferable to the lengthy subpoena process.

24.2.4 WHO ISSUES NOTICES OF NON-COMPLIANCE

The MRM Associate Director delegated the issuance of Notices of Non-Compliance (NONCs) to OE. The auditor should contact OE when an auditee or other party is not responding to data requests or other orders and demands. The auditor should expect to provide OE with the case history and documentation, such as a copy of the audit engagement letter, order letters, data requests, emails, phone conversations, etc. so that OE has sufficient proof that an enforcement action is appropriate.

24.2.5 ADMINISTRATIVE HEARINGS

Regulations in 30 CFR part 241 provide that the NONC/CP recipient may request a “hearing on the record” regarding the basis of the violations before the Office of Hearings and Appeals within 30 days of the date of service (receipt or personal service date). OE generally suspends further enforcement actions pending the decision. If OE issues a CP, recipients may also request a stay of the accrual of civil penalties and/or a hearing on the record contesting the amount of civil penalties.

For more information on procedures for issuing CPs or NONCs, as well as referrals to the OIG, see the Office of Enforcement, Enforcement Operations e-Room folder, “Core Procedures.”

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27.1 LAWS AND REGULATIONS

Various sections of Title 18, U.S.C., and Section 109 of FOGRMA criminalize certain illegal acts that may surface during an audit. The most likely encountered intentional acts during royalty audits involve the following:

- Obstruction of an audit, including failure to provide essential information (18 U.S.C. 1516)
- Provision of altered or false documents in response to an audit request (18 U.S.C. 495, 1516, and/or 1001)
- Under-reporting of sales values or volumes or over-claiming allowances on the Form MMS-2014 or Form MMS-4430 to reduce royalty obligations (18 U.S.C. 1001 and/or 495)
- Claims of minimal production and royalties on nonproducing wells to avoid the costs of plugging and abandonment (18 U.S.C. 1001)

MRM regulations addressing administrative actions are available in 30 C.F.R. 241

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27.2 REPORTING SUSPECTED ILLEGAL ACTS

During the performance of an audit assignment, the auditor must be aware of—and consider the requirements for—reporting possible illegal acts involving minerals lease laws, regulations, and violations specified in 355 Departmental Manual 2.2 (355 DM 2.2), as well as MRM policy guidance in this regard.

Consistent with 355 D.M. 2.2, MMS requires employees to report all potential criminal violations to the OIG and report those criminal violations that are also FOGRMA violations to OE, such as false statements and audit obstruction. Upon request, OE will assist employees in fulfilling their OIG reporting responsibilities. Further guidance on what specific illegal acts the auditor must report to the OIG and the OE, and the current procedures for making such reports, is available through AD letters to employees and periodic training sessions conducted by the OE. Such letters and guidance are available on the MMS Pipeline.

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27.3 INVESTIGATIONS OF ILLEGAL ACTS

In the context of Minerals Revenue Management, OIG receives and investigates referrals of suspected criminal acts and false claims. The OE pursues other illegal acts.

The OIG evaluates such reports and investigates those that meet its criteria. The OIG returns the remainder to the OE for administrative action under FOGRMA (Notices of Non-compliance and Civil Penalty as appropriate). The OIG will also remand cases to the OE that the OIG has investigated but that the Office of the U.S. Attorney did not accept for prosecution. The OIG sometimes forwards cases to BLM for lease action.

Upon selection of a case for investigation, the OIG may request that MRM do the following:

- Limit its communications with involved companies
- Refrain from issuing orders or pursuing enforcement actions
- Notify the OIG of any pending audits, compliance reviews, or issues that may impact the investigations

The OE will ensure that the QSC is aware of these requests, clarify any ambiguities with the OIG, and post overall status information in an e-Room available to the QSC and others with appropriate OE e-Room clearance. The OE will also assist in resolving conflicts that may arise from such constraints and MRM operational responsibilities. Such conflicts may include audit periods threatened by the statute of limitations or overly broad constraints in view of the scope of the actual investigations.

Upon the OIG's remand of referred cases, the OE may proceed with investigations and actions as appropriate (See Chapter 24 and Enforcement Operations e-Room folder, "Core Procedures").

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27.4 FRAUD AWARENESS TRAINING

The OE, with the assistance of the OIG and other law enforcement agencies, periodically conducts fraud awareness training sessions covering minerals revenue crimes. The tailoring of the training is for MRM personnel and State and Tribal auditors.

The training emphasis is on fraud-related and “lesser included” crimes that might surface during an audit. These training sessions emphasize identifying potential crimes, developing the information necessary for an adequate referral, making referrals to the OIG and the OE, the OE’s role after the referral, and providing assistance to outside investigators and law enforcement authorities.

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