

STATE OF COLORADO

OFFICE OF THE EXECUTIVE DIRECTOR

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Mr. David Blackmon
Chair, Royalty Policy Committee
RMOGA
Finance and Excise Tax Committee
Burlington Resources
801 Cherry, Suite 700
Fort Worth, TX 76102



Roy Romer
Governor

James S. Lochhead
Executive Director

Ronald W. Cattany
Deputy Director

Dear ~~Mr. Blackmon:~~ *David -*

Over the last several months, the Coal Subcommittee of the Royalty Policy Committee has been discussing and reviewing a number of Federal coal royalty issues. At our December meeting, the Coal Subcommittee prepared a report identifying recommendations for improving coal royalty audits. These recommendations were adopted by unanimous vote of the members present which included four state representatives, two tribal representatives, one representative from the general public, and five industry representatives.

The report identifies three study areas for possible improvements for coal royalty audits:

- audit planning and coordination
- audit process
- audit timing policy and resource allocation

The report identifies three recommendations for audit planning and coordination, eight recommendations for the audit process, and three recommendations for audit timing policy and resource allocation. The attached document identifies the problem and the recommendation in each one of these areas.

I look forward to discussing these recommendations with you at the January meeting of the Royalty Policy Committee. Several members of the Coal Subcommittee will be in attendance to respond to any questions that committee members may have. We would appreciate a favorable response to these recommendations from the Royalty Policy Committee.

Sincerely,

RWC

Ronald W. Cattany
Chair, Coal Subcommittee
Royalty Policy Committee

attachment

cc: Coal Subcommittee Members
Royalty Policy Committee

EXECUTIVE SUMMARY

Background

The Department of the Interior established a Royalty Policy Committee (RPC) in 1995 under the Minerals Management Advisory Board. The RPC's purpose was to provide advice on the Department's management of Federal and Indian mineral leases, revenues and other minerals-related policies. RPC members represent mineral-producing States, Indian Tribes, allottee organizations, minerals industry associations, the general public and Federal departments.

At its first meeting in September 1995, the RPC established eight subcommittees, including the Coal Subcommittee. The Coal Subcommittee defined as its mission "To make recommendations to the Royalty Policy Committee to improve and streamline the valuation, reporting and audit processes for coal." This report sets forth the recommendations for improving coal royalty audits for the consideration of the RPC.

Organization

The Coal Subcommittee includes 19 representatives from the States, Tribes, the general public and industry, plus three nonvoting representatives from the MMS. A quorum of the subcommittee was present at each meeting held where the audit recommendations were discussed. The recommendations to the coal audit process were adopted by a unanimous vote of the members present at the last Coal Subcommittee meeting, which included 4 State representatives, 2 Tribal representatives, 1 representative from the general public and 5 industry representatives.

Scope of Work

The Coal Subcommittee reviewed the RPC's Audit Subcommittee's Report and identified the following three audit-related areas to study for possible improvement of coal royalty audits:

- Audit Planning and Coordination
- Audit Process
- Audit Timing Policy and Resource Allocation

Subcommittee members addressed each area to determine what actions were necessary to improve and streamline coal audits and what recommendations would be appropriate. This report discusses those recommendations.

Recommendations

Each recommendation is stated below:

Audit Planning and Coordination

- States, Tribes and MMS should schedule audit planning and coordination meetings, as necessary, until satisfactory implementation of an automated tracking system providing audit organizations with complete planning and tracking data.
- Audit Engagement Letters to companies should provide maximum advance notification of the pending audit.
- The audit Entrance Conference should facilitate the company's understanding of the audit process and the location and gathering of important audit data. At the Entrance Conference, the audit organization and the company should designate audit coordinators and specify their respective duties.

Audit Process

- Auditors and auditees should consider relevant work experience and training as important criteria when making personnel assignments in the audit process.
- Auditors should prioritize data requests. Company responses to data requests should be timely and thorough.
- For Federal coal leases only, the MMS should implement a net adjustment reporting for prior period adjustments.
- Testing and sampling methods used to audit coal royalties should be flexible and efficient enough to provide the expected audit coverage under current MMS audit procedures.
- In quantifying royalty underpayments and overpayments, the MMS should accept extrapolation and interpolation techniques if agreed to by the parties to the audit.
- MMS should improve communication of the interpretation of regulations by:
 - i. Expanded auditor and payor training;
 - ii. The timely and effective use of the MMS Royalty Policy Board as a means of clarifying valuation/audit issues;
 - iii. The use of "Dear Payor" letters when deliberations result in a change in an existing interpretation of the regulations.
- The Issues Letter should be considered part of the audit process for Coal.
- Auditor Issues Letters should include a cover sheet that highlights pertinent information, and company responses to factual disputes should be timely and thorough. Subsequent enforcement documents should summarize the results of the Issues Letter process.

Audit Timing Policy and Resource Allocation

- MMS should continue to apply the audit timing policy and resource allocation as described in the MMS Director's July 14, 1995, memorandum "Guidelines—Audit Timing and Resource Allocation."
- The audit coordinator should timely notify auditees upon completion of field work.
- When practical, an "in person" field work-closing conference should be held to discuss the preliminary audit finding.

RECOMMENDATIONS FOR IMPROVED COAL ROYALTY AUDITS

Audit Planning and Coordination

Problem: How to improve the planning and scheduling of audit by using resources of the MMS, States and Tribes more effectively, better utilize time spent at audit sites and complete audit in the shortest possible time, thereby minimizing the impact on audit and industry accounting personnel with respect to time and duplication of effort, and improving the efficiencies of the audit resources of MMS, States and Tribes.

Recommendations: MMS, States and Tribes should schedule audit planning and coordination meetings as necessary, until satisfactory implementation of an automated audit tracking system.

Continue to improve the computerized royalty audit tracking system to provide complete planning and tracking data to the audit organizations of MMS, States and Tribes.

Problem: How to improve the process of notifying companies selected for audit.

Recommendations: MMS, States and Tribes should send companies an Audit Engagement Letter at least 30 days prior to the entrance conference to ensure that they receive maximum advance notification of scheduled audits and have adequate time to furnish requested information.

Problem: How to improve the Entrance Conference to enhance the effectiveness of the initial site visit, minimize the impact on accounting personnel of the company under audit and clarify processes regarding confidentiality.

Recommendations: All MMS, State and Tribal audit participants should attend the Entrance Conference to the extent practical and applicable. Information disseminated at the Entrance Conference should facilitate the understanding of the audit process, what to expect at various stages of the audit and the expected response times for information requests, Issues Letters and enforcement documents.

Entrance Conference participants should:

- Describe the duties of both the auditors' and the auditees' coordinators.
- Designate appropriate contact personnel for Issues Letters and enforcement documents.

- Discuss confidentiality, including the positions of MMS, States, Tribes and the company.
- Ensure that the Entrance Conference facilitates data gathering and provides audit information important to all; it should include, but not be limited to:
 - ✓ Questionnaires
 - ✓ A company profile.
 - ✓ Delivery of pertinent company records to the auditors and the location of records not available at the primary audit location.
 - ✓ A review and walkthrough of the company accounting system.
 - ✓ Initial data gathering, to include contracts.

Audit Process

Problem: How to deal with certain levels of inexperience of both the auditors and auditees attributable to lack of training, employee turnover, reorganization, downsizing, reassignment of auditors, etc.

Recommendations: Auditors and auditees should consider work experience as an important criterion when making audit personnel assignments.

Problem: How to encourage auditors and companies to be more responsive to audit data requests.

Recommendations: Auditors should:

- Prioritize the data requests.
- Promptly confirm to the company the appropriateness of the data provided.

Companies should:

- Respond thoroughly and timely to each data request.
- Promptly contact the appropriate auditor(s) for clarification and resolution of any questions or concerns if necessary.

Problem: Prior period adjustments for coal account for 73% to 80% of the monthly Form 2014 lines currently being reported and are generally adjustments to royalty value because of contract price adjustments. Adjustments to production quantities are rare.

Recommendation: For Federal coal leases only, the MMS should implement a net adjustment reporting for prior period adjustments. The net adjustment for each original reporting period would be reported with the appropriate adjustment code to determine if late payment interest is applicable.

Problem: The sampling basis currently used is the only method that would result in the expected audit coverage under the current MMS audit procedures. A "one size fits all" approach to testing and sampling can result in audit inefficiencies.

Recommendation: Testing and sampling methods used to audit coal royalties should be flexible and efficient enough to provide the expected audit coverage under current MMS audit procedures. The Coal Subcommittee would expect field audit supervisors to be experienced enough to use their professional judgement to determine the appropriate testing and sampling methods to adequately audit coal royalties on behalf of the MMS. The MMS should accept the field auditor's judgement with regard to testing and sampling and should not apply a "one size fits all" approach.

Problem: How to use extrapolation and interpolation techniques in appropriate circumstances to improve compliance and result in fewer Orders to Perform, with reduced administrative costs.

Recommendations: Extrapolation and interpolation techniques should be accepted by the MMS for quantifying royalty underpayments and overpayments when:

- An error discovered through testing is repetitive.
- The error rate is relatively constant.
- The auditor and the company both agree on the extrapolation or interpolation method and that the method is reasonable and cost-effective.

Problem: How to improve communication of the interpretation and application of valuation regulations by MMS, States, Tribes and companies.

Recommendations: Improve communication of valuation interpretations by:

- Expanded auditor and payor training.
- The timely and effective use of the MMS Royalty Policy Board as a means of clarifying valuation/audit issues.
- The use of "Dear Payor" letters when there is a change in an existing interpretation of the regulations by the MMS Royalty Policy Board, Royalty Valuation Division or the Director.

Problem: Is the Issues Letter a part of the audit process or a part of the enforcement process?

Recommendation: The Issues Letter should be considered part of the audit process for coal.

Problem: How to improve communication in Issues Letters and Demand Letters to elicit more timely responses from companies.

Recommendations: Auditors should:

- Use an Issues Letter cover sheet (see the appendix for an example) that clearly identifies the key elements of the letter, including:
 - Concise statement of issues.
 - Dollar impact.
 - Due date for response.
 - Name and telephone number of the auditor and the auditor's supervisor.
- Acknowledge the company's response to an Issues Letter within 30 days.

MMS should:

- Provide information in the Demand Letter concerning the auditor's fact position versus the company's response to the Issues Letter. If portions of the original fact issues were dropped or modified based on information or clarification provided by the company in response to the Issues Letter, clearly state that in the Demand Letter.

Companies should:

- Respond thoroughly and timely to factual disputes in the Issues Letter.
- Contact the appropriate audit office for clarification and resolution of any questions or concerns.

Audit Timing Policy and Resource Allocation

Problem: How to complete audits and close periods timely to benefit all parties.

Recommendations: MMS should continue to apply the audit timing policy and resource allocation as described in the MMS Director's July 14, 1995, memorandum "Guidelines—Audit Timing and Resource Allocation."

The audit coordinator should notify the auditee of the field work completion date in a timely manner.

Problem:

Sometimes the royalty payor and the auditor are not on the "same page" regarding the audit facts. The Coal Subcommittee feels that an in person conference is more conducive to making sure that the royalty payor and the auditor are in agreement to the facts of the audit.

Recommendation:

An "in person" field work closing conference should be held to discuss the preliminary audit finding if practical. The auditors should review with the royalty payor the facts used to determine the audit finding. The royalty payor should advise the auditor of any disagreement to the facts and provide additional information to reach agreement on the facts within a reasonable time so that the audit field work can be completed.

**APPENDIX
EXAMPLE OF ISSUES LETTER COVER SHEET**

September 1, 1997

The Best Coal Company
Attn: Coal Miner
One Energy Center
Gillette, Wyoming, 82717

ISSUES LETTER

RESPONSE DUE 30 DAYS FROM RECEIPT

Reference:	Federal lease: WYW 123456 Audit Period: January 1, 1992 - December 31, 1995 Findings Control Number — 4-10000
Issue:	Produced tons price adjustment for deficient tonnage payments
Dollar Impact: or	\$300,000
Order to Perform:	Amount Undetermined
Audit contact:	John Jones 307-687-1234
Audit Supervisor:	Mike Smith 307-777-1234