

# State of Montana

Marc Racicot, Governor



Department of Revenue

Mick Robinson, Director

Natural Resource and  
Corporation Tax Division

May 28, 1997

David S. Guzy, Chief  
Rules and Procedures Staff  
Minerals Management Service  
Royalty Management Program  
P. O. Box 25165, MS 3101  
Denver CO 80225-0165

Dear Mr. Guzy,

RE: "Delegation of Royalty Management Functions to States" published in Federal Register April 24, 1997, 62 F.R. 19967

The State of Montana (Montana) appreciates being given the opportunity to provide the following comments on the above-referenced Federal Register notice.

## **GENERAL COMMENTS**

At its March 21, 1997, meeting, the Royalty Policy Committee approved a resolution requesting the Minerals Management Service (MMS) to have the Solicitor's Office issue a formal opinion on the legal basis for extending the Federal Oil and Gas Royalty Simplification and Fairness Act (RSFA) amendments on 205 delegations to solid minerals. Montana believes the proposed regulation on 205 delegations should not be finalized until this opinion has been issued. Notwithstanding, Montana supports the concept of increased delegation of functions to States.

MMS relies on the fact that it held State outreach meetings to discuss the regulations and the forthcoming *MMS Standards for Delegation* as justification for limiting the time of response to the Federal Register notice. MMS should not rely too heavily on this outreach. The majority of States are simply unable to allocate resources to attend meetings and/or study the ramifications of various options for functions they may never assume. Because of this, regulations and standards must be both general and flexible. Changes should be able to be made quickly and easily to standards, rather than regulations, because, as we all know, the trial and error associated with implementing something new provides greater knowledge than mere contemplation. A great degree

of flexibility is required so that unanticipated problems can be smoothed out with little effort once a State has begun to assume additional responsibilities.

In general, we find this proposed rule to be more specific than it needs to be given that MMS will have additional guidance in the form of *Standards*. We recommend that a significant part of this information be moved from the regulation(s) to the *Standards* or some other administrative policy paper. For instance, § 227.103(e) doesn't just state that the delegation proposal must address personnel, facilities, equipment, etc., but also goes into great detail about each of these. The level of detail causes problems for two reasons: 1) it makes the proposal format rigid, requiring information that may not be needed in the future, and, 2) it requires information which is unlikely to affect the decision of whether or not a proposal will be granted, i.e. how convenient the location is to the leases.

Montana has experience with 205 delegations, having been delegated audit functions under the Federal Oil and Gas Royalty Management Act, Section 205, since 1985. Based on this experience, we are concerned with the repeated use of the word "must" throughout the regulations. We have generally found that there is more than one acceptable way to accomplish a desired outcome and that a certain degree of flexibility allows delegations to make the most effective use of limited resources. If the regulations *require* (and presently they do) programs operate in one particular way, then a program that applies a better approach would be out of compliance, and the contract could be withdrawn or the findings negated. Below, we point out some of the more pressing examples of this concern and offer alternative language. We recommend, however, that MMS reexamine the entire regulation to assure that it does not restrict the use of other, perhaps more efficient, methods to accomplish objectives.

#### **SECTION BY SECTION ANALYSIS**

In the preamble, § 207.102 implies that MMS will handle settlements as it currently does. That consists of the number of states involved in negotiations being deliberately limited in order to facilitate discussions. MMS, however, must depart from its current settlement procedures in order to comply with RSFA. RSFA expands the authority of all States concerned, not just those with delegations of authority, granting them the ability to veto compromises of royalty obligations. Under RSFA, each State will need to represent itself.

Section 207.103(c) requires legislation or an Attorney General's opinion stating "which State entity" is responsible for performing delegated functions. It is unrealistic to expect that States are organized such that only one State agency could perform all these functions. Therefore, we recommend changing the language from "entity" to "entity or entities." Language in this section and elsewhere in the rule could be construed as to require a separate State appropriation in order to perform delegated functions, rather than a general appropriation under which many states with 205 contracts currently

operate. In addition, § 227.103, following part (i) is incomplete. This section ends with the word "and."

Although § 227.110 subsequently adds clarity, § 227.105 does not make it clear whether a hearing is required in every instance. Will hearings be required for programs converting from 205 delegations under the original provisions of FOGRMA if they make no changes? What if they make only minor changes, i.e. assume signature and subpoena authority? We recommend that the rule have some flexibility. Therefore, we recommend inserting the language "as appropriate" into the first paragraph after the word "hearing."

Section 227.108 contains strong language with regard to "standards and requirements the State must comply with..." This section does not cross reference §§ 227.200 and 227.201, in which standards are discussed. As a result, the question of whether the standards the State must comply with under § 227.108 are different from those under § 227.201 remains open. We recommend cross referencing, unless different standards are anticipated. If that is the case, we'd like to see those standards spelled out.

Section 227.109 does not address a State's ability to appeal if it is denied a delegation of authority. RSFA grants States the right to appeal this administrative decision at a judicial level; review of the decision at the administrative level is a logical first step.

Section 227.112(b) states "compensation may not exceed the reasonably anticipated expenditures that MMS would incur to perform the same function." MMS' cost accounting system leaves much to be desired. States recognize that there will be no additional revenues to them as they take on additional responsibilities, unless fewer MMS expenses are deducted from royalties through net receipts sharing. Will MMS' cost accounting system improve such that MMS can inform States of the benefits to them if they assume various responsibilities? The language quoted above would indicate that MMS has some idea of the costs they would incur to perform the same function. Where MMS has not been performing the function, however, such as audit in Montana because Montana has had a delegation of authority for 12 years, how will MMS determine whether State costs exceed what it would have cost MMS to perform audits at the same level of coverage that has historically been provided?

With regard to the compensation portion of the rule, § 227.112(b), MMS must maintain some degree of flexibility in making any cost comparisons by looking at the whole picture, rather than a single part. MMS provides the example that if it performed error correction for \$1,000, it would expect that a State's cost to perform error correction would not exceed \$1,000. The reality, at least with regard to travel expenses, is that some costs will be higher for states. For instance, it might cost MMS only \$250 per auditor to fly to Houston to perform on-site work because the federal government has a contract with airline carriers. The same flight might cost States \$800 per auditor, yet States might be able to perform the overall work at a lower cost due to other factors. If

the scrutiny with regard to costs is at a micro, rather than macro, level, there will be problems delivering a quality product.

In addition, § 227.112(d) states "you must provide vouchers detailing your expenditures..." Delegations are not, at this point, required to provide copies of all vouchers and generally only provide copies of vouchers pertaining to equipment in their requests for reimbursement. We do not support requirements that are more stringent than those currently in effect. Therefore, we recommend modifying that language to read: "you must make available for review vouchers detailing..."

We are concerned about the language in § 227.200 which states "you must submit a written request for guidance..." The need for guidance is a judgment call on the part of the delegation. Restricting the method for asking for guidance, i.e., precluding an oral request or potential informal requests, potentially inhibits communication. In addition, the language "you must follow the interpretation or guidance given" suggests disincentives or penalties in asking for information. A delegation may decide not to follow the guidance due to discovery of new pertinent facts and may elect, for purposes of effective use of resources, to not have MMS issue new guidance. We recommend this language be removed.

While §§ 227.200 and 227.201 make reference to *MMS Standards for Delegation* and require compliance with those *Standards* (to the extent that the delegation agreement will be terminated if compliance does not occur), it is not clear how those are to be developed, the extent to which input will be obtained from States, how easily those *Standards* can be modified, and whether compliance with those *Standards* will require States to perform at a higher level than MMS is expected to perform. We recommend two additional statements be added to one of these sections: 1) input from States will be encouraged in the development and evolution of the *Standards*; and, 2) under no circumstances will States be required to perform at a level higher than MMS performs.

Section 227.300 *requires* entrance conferences, on site visits, and closeout conferences. We have not found such audit functions to be necessary in every instance and do not recommend that these be required. Further, Section 227.300(h) *requires* the States to issue records releases and audit closure letters, something MMS has not done recently. We do not think it appropriate for States to be held to a higher standard than that at which MMS performs. Montana recommends changing the wording from "must" to something that allows more flexibility for responding to specific situations.

Section 227.301(b) requires following the annual audit work plan, without allowance for potential work plan adjustments. We find such adjustments to be necessary frequently. Part (e) requires audit reports at a time when MMS is questioning the need to provide audit reports as it reengineers its processes. We recommend MMS revisit the use of the word "must" in the first line. We prefer to see general expectations spelled out, allowing States to depart from the general process with adequate justification. In

addition, part (e) may be missing some words or need some correction. It is not clear if the *Standards* require audit reports and work plans or if it is intended to say "and other documents the *Standards* may require."

The sections beginning with § 227.400 describe a State's ability to assume responsibilities relating to processing and identifying errors on royalty reports. Many of the errors identified by MMS currently relate to unreconciled payments and reports. However, MMS does not propose that States receive or process royalty payments, something which could be accomplished through the creation of processes similar to Indian tribes' lockbox systems. Having royalty reports sent to one location and payments to another is guaranteed to create inefficiencies. We recommend MMS revisit the decision to not have royalty payments accompany royalty reports when the reports are received by States.

Section 227.600 requires automated verification of production and royalty reports as if every potential discrepancy will yield sufficient collections to cover the cost of such comparison, when in fact automated verification seldom yields results for Montana properties because the volumes are so small. In fact, most discrepancies MMS currently identifies are not pursued by MMS because they fall into the tolerance range. We question the need for resources to continually do comparisons that have been proven to yield so little benefit. Therefore, we recommend allowing States to develop a customized approach to automated verification, subject to MMS approval, that factors in such considerations as volume and return on resources but that can be used as an audit tool.

Section 227.801 requires that States "verify through research and analysis all identified exceptions" (emphasis added), when in fact MMS does not examine 100% of identified exceptions, given the tolerance range discussed in the previous paragraph. Montana is strongly opposed to States being required to perform at a standard higher than MMS currently performs. We recommend substituting the word "all" in every part of this section with terminology more reflective of the work done by MMS.

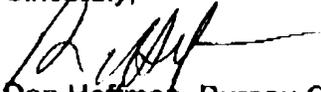
Section 227.801 does not allow for an administrative appeal of MMS' potential finding that a State is not performing in accordance with the *Standards* or statutory requirements. We believe there should be: 1) initial notice, 2) the opportunity for corrective action, and 3) subsequent notice by MMS that the corrective action is not sufficient. The subsequent notice should allow for appeals and should spell out that appeals process. The ability to appeal should also be worked into the language at §§ 227.802 and 227.803.

Again, we believe that these regulations should not be formalized until the Solicitor's Office has generated an opinion on the applicability of RSFA to solid minerals. In addition, we believe that States should have additional opportunity to comment after this opinion is provided and as MMS considers comments on the proposed rule.

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Montana appreciates being given the opportunity to respond. If you have any questions with regard to these recommendations, please contact me or Wanda Fleming at (406) 444-2441.

Sincerely,



Don Hoffman, Bureau Chief  
Natural Resource & Corporation Tax Division