MINERAL ROYALTY PAYMENTS
DEPARTMENT OF NATURAL RESOURCES

PERFORMANCE AUDIT
ISSUED SEPTEMBER 11, 2013

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FOR QUESTIONS RELATED TO THIS PERFORMANCE AUDIT, CONTACT EMILY WILSON, PERFORMANCE AUDIT MANAGER, AT 225-339-3800.

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LOUISIANA LEGISLATIVE AUDITOR
DARYL G. PURPERA, CPA, CFE

September 11, 2013

The Honorable John A. Alario, Jr.,
President of the Senate
The Honorable Charles E. "Chuck" Kleckley,
Speaker of the House of Representatives

Dear Senator Alario and Representative Kleckley:

This report provides the results of our performance audit on the collection of mineral royalty payments by the Department of Natural Resources (DNR).

The report contains our findings, conclusions, and recommendations. Appendix A contains the department's response to this report. I hope this report will benefit you in your legislative decision-making process.

We would like to express our appreciation to the management and staff of DNR for their assistance during this audit.

Sincerely,

Daryl G. Purpera, CPA, CFE
Legislative Auditor

DGP/ch

DNRMRP 2013

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Louisiana Legislative Auditor

Daryl G. Purpera, CPA, CFE

Mineral Royalty Payments
Department of Natural Resources

September 2013

Audit Control # 40120018

Introduction

This performance audit determines whether the Office of Mineral Resources (OMR) within the Department of Natural Resources (DNR) ensured that the state received complete, accurate, and timely mineral royalty payments during fiscal years 2008 through 2012. We conducted this audit in response to our July 2010 performance audit report (2010 report) that identified weaknesses with OMR's auditing of mineral royalties.[1]

Mineral royalty payments are made to the state when companies extract minerals, primarily crude oil and natural gas, from state-owned land or water bottoms. OMR is responsible for assisting the State Mineral and Energy Board (Board) in collecting and auditing royalty payments to optimize state revenue. In fiscal year 2013, Louisiana received approximately $537 million in mineral royalties. On average, mineral royalties account for approximately 7% of the state's annual general fund revenue, making it one of the largest non-tax sources of state revenue. Appendix A contains DNR's response to this report, Appendix B details our scope and methodology, and Appendix C summarizes background information. Our objective was as follows:

Did OMR ensure that the state received complete, accurate, and timely mineral royalty payments during fiscal years 2008 through 2012?

[1] The report can be found at http://app1.lla.state.la.us/PublicReports.nsf/B6B5DE331E9D48818625776E005CFDA5/$FILE/00018070.pdf.

Objective: Did OMR ensure that the state received complete, accurate, and timely mineral royalty payments during fiscal years 2008 through 2012?

We determined that the Office of Mineral Resources (OMR) did not always ensure the state received complete, accurate, and timely mineral royalty payments during fiscal years 2008 through 2012. As a result, Louisiana may not have received all the royalty revenue owed by companies that extracted minerals from state-owned land and water bottoms. Our findings are discussed in detail below.

During fiscal years 2008 through 2012, the percentage of royalties on which OMR conducted field audits and the amount of potentially underpaid royalties identified by OMR has decreased.

Two years after royalty payments are received, OMR conducts field audits to ensure the accuracy and completeness of these payments. OMR field auditors work on-site at company offices and review supporting documentation such as meter statements, check details, and wire transfers to verify the volume and price of oil and gas sold to detect underpaid royalties.

The percentage of total royalties that OMR audited in the field steadily decreased from approximately 23% to 12.75%, for an average of 18% over the five-year period. One of OMR's performance objectives is to increase the percentage of royalties on which it conducts field audits by 1% each year until it reaches 25%. However, OMR's performance steadily decreased from approximately 23% in fiscal year 2008 to 12.75% in fiscal year 2012.[2] According to OMR, this decrease was caused by staffing turnover and additional duties resulting from the transfer of the severance tax field audit responsibility from the Louisiana Department of Revenue (LDR) in fiscal year 2011. Exhibit 1 shows the total royalties received by OMR, the percentage of royalties audited by OMR, and OMR's field audit performance objective. On average for the last five fiscal years, OMR conducted field audits on approximately 18% of royalties paid each year.

[2] Measured by the performance indicator "Percentage of Total Royalties Paid Which are Audited."

Exhibit 1
Percentage of Royalties Paid that were Field Audited
Fiscal Year 2008 through Fiscal Year 2012

Fiscal Year	Total Royalties Received in Audited Year* (Two-Year Lag)	Total Amount Field Audited	% Field Audited	Performance Objective
2008	$445,171,703	$102,193,175	22.96%	To increase the percentage of royalties audited to royalties paid by 1% each year until it reaches 25%.
2009	519,377,804	96,652,761	18.61%	
2010	687,659,342	127,405,030	18.53%	
2011	689,689,990	123,408,889	17.89%	
2012	421,160,164	53,718,149	12.75%	
Total	**$2,763,059,003**	**$503,378,004**	**18.22%**	

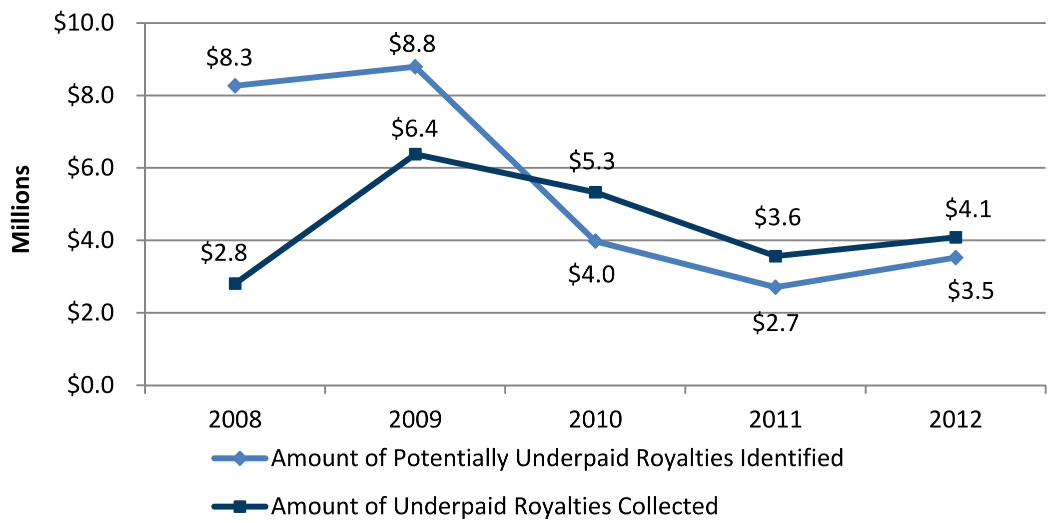
*The total royalties received differs from the total royalty revenue amounts in Appendix C because audits are based on royalties received two years back. For example, the audits conducted in FY 2008 are on royalties received in FY 2006.

Source: Prepared by legislative auditor's staff using information obtained from OMR.

Overall, the amount of potentially underpaid royalties identified by OMR through field audits decreased from $8.3 million to $3.5 million. From fiscal years 2008 to 2009, the amount of potentially underpaid royalties identified by field audits increased from approximately $8.3 million to $8.8 million. This amount steadily decreased to approximately $2.7 million in fiscal year 2011 and then increased to $3.5 million in fiscal year 2012. This overall decrease of approximately 57.4% from fiscal year 2008 through fiscal year 2012 could be an effect of OMR's decreasing percentage of royalties audited in the field during the same time period, but may also be attributed to other factors such as a decrease in the amount of royalties owed to the state.

Overall, the amount of underpaid royalties collected by OMR increased from $2.8 million to $4.1 million. However, this may decrease in the future because of OMR's decreased audit coverage and identification of fewer underpaid royalties. Upon identifying potentially underpaid royalties through its field audits, OMR conducts further investigations to determine the actual amounts, if any, the companies owe the state. According to data provided by OMR, the amount of underpaid royalties collected during fiscal years 2008 through 2009 increased by approximately 127%, from $2.8 million to $6.4 million. This amount steadily decreased to approximately $3.6 million in fiscal year 2011 and then increased to $4.1 million in fiscal year 2012. As illustrated in Exhibit 2, this pattern generally mirrors the trend of potentially underpaid royalties identified by OMR except the amount of underpaid royalties collected was greater than the amount identified during fiscal years 2010 through 2012. However, the amount of underpaid royalties collected during a given year includes underpaid royalties identified in prior years. Now that OMR has decreased its audit coverage and is identifying fewer potentially underpaid royalties, the amount OMR collects in future years may decrease.

Exhibit 2
Potentially Underpaid Royalties Identified and Underpaid Royalties Collected Through Field Audits Fiscal Years 2008 through 2012



Source: Prepared by legislative auditor's staff using information obtained from OMR.

Volume audits could help the Office of Mineral Resources (OMR) identify underpaid royalties. Volume audits identify discrepancies in oil and gas volume data by comparing the volume that companies report to OMR to the volume that well operators report to the Office of Conservation within the Department of Natural Resources (DNR).[3] Since companies use the volume of oil and gas sold to calculate royalty payments, volume audits help ensure that all producing companies make complete and accurate royalty payments. The federal government and other states such as Texas conduct volume audits. In fiscal year 2012, the federal government recovered $6.8 million and Texas recovered $1.8 million in underpaid royalties by conducting volume audits.

In January 2013, OMR resumed conducting volume audits, which we recommended in our 2010 report. Prior to January 2013, OMR had not conducted volume audits since 2000. Agency officials stated in May 2013 that it was too soon to quantify the amount of underpaid royalties identified and collected since resuming volume audits. However, we conducted an analysis similar to volume audits of all royalties paid during fiscal years 2008 through 2012. We found 5,861 exceptions for oil and 9,261 exceptions for gas where sales volume was reported to the Office of Conservation but not to OMR. These exceptions may indicate that companies did not pay royalties due to the state, but could also be caused by companies reporting incomplete or

[3] The Office of Conservation is responsible for auditing reports from producers, transporters, plants, and refineries that serve as a basis for the collection of severance taxes by LDR and the basis for the collection of royalty income by OMR.

inaccurate royalty data[4]; therefore, some exceptions may not result in additional royalties. We provided these exceptions to OMR and it researched and followed up with companies on 70.5% and 66.9% of the questionable volume for oil and gas, respectively. OMR identified a total of $686,900 in underpaid royalties.

Recommendation 1: OMR should evaluate its field audit function and increase the percentage of royalties audited each year, considering that the amount of potentially underpaid royalties identified has decreased.

Summary of Management's Response: OMR agrees with this recommendation and concurs that the percentage of royalties audited decreased between fiscal years 2008 and 2012. In its response, OMR also referred to a recommendation we made in our 2010 report regarding OMR's selection criteria for audits. While the department did not agree that its audit selection criteria should be changed, it complied with the report's recommendation to add small royalty payors to the audit schedule. According to OMR, its efforts to implement that recommendation was partially the reason that the performance target was not met in fiscal year 2012. OMR states that they will resume using their previous audit selection criteria, which was most cost effective and provided the greatest audit coverage. The criteria will also include cost-beneficial and high-risk small audits as well as ensure that the performance indicator is met each year. See Appendix A of the report for OMR's full response.

LLA Additional Comments: While OMR refers to its annual *performance targets* in its response, our finding was based on OMR's overall *performance objective*. In addition, to clarify OMR's mischaracterization of the recommendation we made in our 2010 report, we offer the recommendation in its entirety: "OMR should consider adjusting its selection criteria for audits to provide the most comprehensive audit coverage as possible, which includes periodically auditing smaller companies." We did not recommend that OMR should select smaller payor companies without considering audit risk and cost, nor did we recommend that OMR audit smaller payor companies instead of larger payor companies. Finally, based on the audit work we conducted for the 2010 report, we found that OMR's audit selection criteria did not provide the greatest audit coverage, which led us to make the recommendation noted above.

Recommendation 2: OMR should continue to conduct volume audits to identify underpaid royalties. If discrepancies are due to incomplete or inaccurate royalty data, OMR should make corrections and assess applicable penalties. Doing so would enhance the effectiveness of conducting volume audits in identifying underpaid royalties.

[4] We found instances where companies paid or adjusted royalties to the wrong LUW Code or wrong month, or failed to submit required royalty reports. We also found instances where the Office of Conservation assigned the same LUW Code to more than one property. In addition, we estimated that at least 6% of OMR's oil royalty data and at least 13% of OMR's gas royalty data submitted by companies between fiscal years 2008 through 2012 contained data entry errors.

Summary of Management's Response: OMR agrees with this recommendation. According to OMR, it concurs that volume auditing is a valuable auditing tool. The volume audit program, which offers comprehensive audit coverage for all payors, was implemented in January 2013 and will continue. See Appendix A of the report for OMR's full response.

From fiscal year 2008 through fiscal year 2012, OMR did not penalize all of the companies that made late mineral royalty payments. In addition, OMR and the Board waived $5.8 million (45%) of the $12.8 million in penalties that were assessed.

Louisiana Revised Statute (R.S.) 30:136 authorizes the Office of Mineral Resources (OMR) to assess penalties to companies that pay royalties late, fail to pay, underpay, or submit royalty reports with errors.[5] Department policy further requires its auditors to assess a late payment penalty of 10% of the state royalty amount due, not to exceed $1,000. To ensure OMR assessed late payment penalties in accordance with its procedures, we selected a random sample of 48 late payments from fiscal years 2008 through 2012. These late payments should have resulted in OMR assessing penalties totaling approximately $29,810. However, we found eight (17%) instances, totaling $2,375, where OMR failed to penalize companies for their late payments. While these eight instances only accounted for 8% of the $29,810 that should have been assessed for the payments in our sample, OMR receives over 4,900 payments each year. As a result, the financial impact of OMR not penalizing companies for late payments could be more significant. According to OMR, the department is currently in the process of penalizing these companies.

R.S. 30:136 also authorizes the Board to partially or fully waive penalties assessed by OMR. In turn, the Board delegated to OMR the authority to waive penalties that meet criteria established by the Board in its penalty waiver policy and are less than $10,000.[6] For amounts greater than $10,000, the Board makes penalty waiver decisions. Of the $12.8 million in penalties assessed to companies that paid royalties late, failed to pay, underpaid, or submitted erroneous royalty reports during fiscal years 2008 through 2012, OMR and the Board waived $5.8 million (45%). The Board approved approximately 92% of the total $5.8 million in waived penalties. Although OMR and the Board penalized companies for noncompliance, almost half of these penalties were ultimately waived. This practice may not deter companies from paying royalties late, failing to pay, underpaying, or submitting inaccurate royalty reports. According to OMR, waiving penalties encourages companies to self-report underpaid royalties. However, OMR does not track the reasons why penalties were waived. Therefore, we could not determine how much in penalties were waived because of companies self-reporting their underpaid

[5] Companies are required to submit monthly royalty reports that document their sale of oil, gas, and other mineral products and the amount of royalty due to the state. OMR reviews each report for obvious errors and recalculates the totals.
[6] For example, OMR may waive a certain percentage of a company's penalty depending on how late that company is in making its royalty payment to the state.

royalties to OMR. Exhibit 3 summarizes the amount of penalties assessed and waived either by OMR or the Board.

Exhibit 3
Penalties Waived by OMR and the Board
Fiscal Years 2008 through 2012

Fiscal Year	Penalties Assessed	Penalties Waived by the Board	Penalties Waived by OMR	Total Penalties Waived	% of Penalties Waived
2008*	$3,591,264	$876,085	$154,057	$1,030,142	29%
2009**	3,011,038	1,891,252	64,410	1,955,662	65%
2010**	1,759,583	974,725	109,035	1,083,760	62%
2011	2,745,188	992,882	63,790	1,056,672	38%
2012	1,736,631	637,286	46,515	683,801	39%
Total	**$12,843,704**	**$5,372,230**	**$437,807**	**$5,810,037**	**45%**

*A total of approximately $1.8 million of the penalties assessed in fiscal year 2008 were still outstanding as of March 2013.
** According to OMR, hurricanes Gustav, Ike, and Ida as well as the BP oil spill that occurred in fiscal years 2009 and 2010 caused extreme circumstances for royalty payors. As a result, the Board waived more penalties during these years.
Note: Penalty amounts assessed do not include related interest. OMR and the Board do not waive interest.
Source: Prepared by legislative auditor's staff using information obtained from OMR.

Recommendation 3: OMR should assess late payment penalties on all companies that do not submit royalty payments on time in accordance with department policy.

Summary of Management's Response: OMR agrees with this recommendation. According to OMR, it is their intent to assess penalties on every late royalty payment. Additional review procedures have been implemented to ensure that no penalty assessments are missed. OMR further stated that these penalty billings have since been issued and the penalties have been collected. See Appendix A of the report for OMR's full response.

Recommendation 4: The Board and OMR should evaluate their current penalty waiver practices to ensure that they are effectively deterring companies from paying royalties late, failing to pay, underpaying, or submitting inaccurate royalty reports.

Summary of Management's Response: OMR agrees with this recommendation. According to OMR, the current penalty waiver policy has been reviewed and adopted by the Board to achieve the goals of voluntary compliance and maximizing revenue to the state. The policy avoids additional costs associated with litigation and collection for the state. Although the Board is confident that the policy is effective to encourage voluntary compliance and to maximize revenues, they will present this report to the Board for consideration. See Appendix A of the report for OMR's full response.

OMR did not collect at least $1.7 million in royalty payments from companies that incorrectly deducted severance taxes from their mineral royalty payments.

The Office of Mineral Resources (OMR) did not collect at least $1.4 million from companies that received severance tax refunds but did not amend their royalty payments accordingly. When calculating mineral royalty payments due to OMR, companies are allowed to deduct severance taxes paid to the Louisiana Department of Revenue (LDR).[7] Conversely, when companies receive severance tax refunds from LDR, they must increase their mineral royalty payments to OMR. However, when we compared OMR's royalty payment data to LDR's severance tax data, we found 558 instances where companies paid severance taxes to LDR and later received severance tax refunds, but did not amend their mineral royalty payments accordingly. These instances resulted in 10 companies underpaying royalties of at least $1.4 million from fiscal years 2008 through 2012. We provided these instances to OMR, and it is currently in the process of collecting the $1.4 million in underpaid royalties from these companies.

OMR did not collect at least $323,450 in royalty payments from companies that deducted more in severance taxes than they should have when calculating their royalty payments. As stated previously, companies are allowed to deduct the severance taxes they paid to LDR when calculating their royalty payments. R.S. 47:633 outlines how severance taxes are to be calculated.[8] The more severance taxes companies pay to LDR, the lower the amount of royalties they owe to the state. According to OMR, it has an edit check in its mineral royalty database to detect instances where companies deduct more in severance taxes than they should have, based on the calculation outlined in state law. However, this edit check did not always function as designed. For example, we identified instances when companies deducted more in severance taxes than they should have when calculating their royalty payments. As a result, OMR did not collect at least $176,685 and $146,765 in oil and gas royalty payments, respectively, from fiscal years 2008 through 2012 for a total of at least $323,450.

In addition, companies can apply for severance tax reductions or exemptions that are approved by LDR and the Department of Natural Resources' (DNR) Office of Conservation, respectively. While R.S. 47:1508 requires LDR to maintain the confidentiality of tax information, the law does allow LDR to share severance tax information with DNR for the verification of mineral royalty revenue. However, OMR does not coordinate with either LDR or the Office of Conservation to determine which companies should not deduct severance taxes, or should deduct less, from their mineral royalty payments. As a result, OMR may not detect instances when companies deducted more severance taxes than they actually paid to LDR. Increased coordination among OMR, LDR, and the Office of Conservation regarding severance tax refunds, exemptions, and reductions could help OMR detect and collect underpaid royalties in a more timely and efficient manner.

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[7] The formula used to calculate royalty payments is outlined in Appendix C.
[8] Per R.S. 47:633, severance taxes are calculated (1) for oil by multiplying price by volume by the applicable severance tax rate and (2) for gas by multiplying volume by the applicable severance tax rate.

Recommendation 5: OMR should coordinate with LDR to identify companies that incorrectly deduct severance taxes from their mineral royalty payments and collect any underpaid royalties and applicable interest and penalties.

Summary of Management's Response: OMR agrees with this recommendation. However, OMR does not agree that a systematic or widespread problem exists regarding severance tax deductions. Two companies were responsible for $1,388,593 (96%) of the potentially underpaid royalties. According to OMR, it is implementing a computerized solution for identifying potential excessive severance tax deductions. OMR is confident that its system, which uses the same information as LDR, will be effective and efficient and will provide sufficient coordination. See Appendix A of the report for OMR's full response.

LLA Additional Comments: The approximately $1.4 million we identified in severance tax deductions is a conservative amount, as we had to eliminate erroneous and incomplete data that may have resulted in additional underpaid royalties.

Recommendation 6: OMR should ensure the edit check in its mineral royalty database is working properly so it can identify companies that deduct more severance taxes than they should when calculating their royalty payments.

Summary of Management's Response: OMR agrees with this recommendation, but states that the $323,450 in royalty underpayments has not been confirmed and that payors may have valid explanations for the apparent discrepancies. In addition, OMR states that no action is required on this recommendation since this issue has been previously resolved. Mandatory online royalty reporting was implemented in October 2012 for most payors. Online reporting contains error checking for many things, including severance tax deductions, and field audits are in place to identify severance tax discrepancies. OMR also states that auditors did not take into consideration instances where wellhead volume was used to calculate the allowable amount of severance tax for processed gas. See Appendix A of the report for OMR's full response.

LLA Additional Comments: OMR stated that field audit procedures are in place to identify severance tax discrepancies. However, as noted in our report, the percentage of total royalties OMR field audited has steadily decreased over the past five years. OMR also stated that we did not take into consideration instances where wellhead volume was used for severance tax calculations related to processed gas. However, this statement is inaccurate. We did not include such instances in our final analysis and notified OMR on several occasions of the change to our methodology.

Recommendation 7: OMR should coordinate with LDR and the Office of Conservation to identify companies that received severance tax exemptions or reductions so it can ensure that these companies do not deduct more severance taxes than they should when calculating their royalty payments.

Summary of Management's Response: OMR agrees with this recommendation. According to OMR, it is implementing a computerized solution for identifying potential excessive severance tax reductions. OMR is confident that its system, which uses the same information as LDR and the Office of Conservation, will be effective and efficient and will provide sufficient coordination. See Appendix A of the report for OMR's full response.

APPENDIX A: MANAGEMENT'S RESPONSE

BOBBY JINDAL
GOVERNOR

STEPHEN CHUSTZ
SECRETARY

State of Louisiana

DEPARTMENT OF NATURAL RESOURCES

OFFICE OF MINERAL RESOURCES

STATE MINERAL AND ENERGY BOARD

August 23, 2013

Mr. Daryl Purpera, CPA
Louisiana Legislative Auditor
Post Office Box 94397
Baton Rouge, Louisiana 70804-9397

Dear Mr. Purpera:

The Department of Natural Resources has reviewed the revised draft of your office's performance audit report on the process of auditing mineral royalties. The Department, for the most part, concurs with the findings and recommendations contained in that report. As requested, we have included the enclosed completed checklist. Our comments regarding the weaknesses identified in the report are as follows.

Finding #1: Over the last five fiscal years, the percentage of royalties on which OMR conducted field audits and the amount of potentially underpaid royalties identified by OMR has decreased.

DNR's Response: We concur that the percentage of royalties audited decreased between fiscal years 2008 and 2012. Except for 2012, the performance target for percentage of royalties audited was met in each fiscal year. The office's effort to implement the recommendation of the Legislative Auditor from its performance audit dated July 28, 2010 was partially the reason that the performance target was not met in 2012. In that report, OMR was cited for not auditing small royalty payors. In fiscal year 2012, 14 small royalty payors were added to the audit schedule. Consequently, the percentage of royalties audited declined and our performance target was not met. We will resume our prior audit selection practices to ensure that the performance target is met each year.

Finding #2: From fiscal year 2008 through fiscal year 2012, OMR did not penalize all of the companies that made late mineral royalty payments. In addition, OMR and the Board waived $5.8 million (45%) of the $12.8 million in penalties that were assessed.

DNR's Response: We concur that penalty billings in the amount of $2,375 for eight late royalty payments were not issued. The $2,375 not billed represents 0.7% of the total interest and penalties collected for the audit period. These penalty billing have since been issued and the penalties have been collected. Additional review procedures have been implemented to ensure that no penalty assessments are missed.

We also concur that 45% of the late royalty penalties were waived. However, we do not agree that this represents a loss of revenue to the state. The State Mineral and Energy Board has established a penalty waiver protocol to encourage voluntary compliance and to to ensure consistency in its consideration of penalty waiver requests. Voluntary compliance decreases litigation and audit costs to the state and increases revenues. Penalty waiver requests are never considered by the staff or the board until the requestor has paid the royalty and interest due in full. The Board has periodically reviewed its policy and revised it as necessary. (adopted April 1995, May 2006 and March 2008 and reaffirmed in December 2007 and September 2010). Although, we believe that the current penalty waiver protocol policy is fair and in the best interest of the state, we will present this report to the Board for consideration.

Finding #3: OMR did not collect at least $1.7 million in royalty payments from companies that incorrectly deducted severance taxes from their mineral royalty payments.

DNR's Response: We concur that 10 companies deducted severance taxes for which it appears that there was no severance tax liability. If there were, in fact, no severance tax liability in the amount of the deductions, we concur that $1,445,943 would be due, which represents 0.05% of the $2.9 billion in royalty collected during the audit period. We do not agree that a systemic or widespread problem exists regarding severance tax deductions. Two companies were responsible for $1,388,593, or 96%, of the potentially underpaid royalties. Both companies were contacted, asked to research the potential underpayments, and take corrective action, if necessary. To date, the confirmed amount of excessive deductions totaled $783,382, is 0.027% of the $2.9 billion in royalty collected during the audit period. These confirmed royalties have been paid as well as interest totaling $235,339.46. The remaining $605,212 in potential royalty underpayments are disputed by the companies. We confirmed with LDR that one of the companies disputing the additional royalty did not receive a severance tax refund on the property in question. This issue will be included in the next scheduled field audit of each of those companies.

We concur that it appears as though $323,450 in royalty underpayments occurred due to payors deducting more severance taxes than allowed. However, none of these underpayments have been confirmed. The payors may have valid explanations for the apparent discrepancies. These types of potential errors are no longer a risk. The online reporting system prevents this with an upfront validation; a payor is unable to submit a first time payment on a property if severance exceeds the allowable amount. Severance tax for processed gas will exceed the allowable amount because wellhead volume is used for the severance tax calculation which exceeds the volume at the point of sale which is used for royalty calculations. This was not taken into consideration in the test items noted above. Field audit procedures are in place to identify severance tax discrepancies.

In closing, we greatly appreciate the professional efforts of your office in the preparation of this report. We are proud that our office contributes significant revenues to the state and we continually strive to improve our operations. We believe that the report's recommendations will be useful in our efforts to continually improve our audit program.

Sincerely,

Robert D. Harper
Executive Administrator

Enclosure

cc: Stephen Chustz, Secretary

Louisiana Legislative Auditor
Performance Audit Division

Checklist for Audit Recommendations

Instructions to Audited Agency: Please check the appropriate box below for each recommendation. A summary of your response for each recommendation will be included in the body of the report. The entire text of your response will be included as an appendix to the audit report.

RECOMMENDATIONS	AGREE	DISAGREE
Recommendation 1: OMR should evaluate its field audit function and increase the percentage of royalties audited, considering that the amount of potentially underpaid royalties identified has decreased. **(p. 5 of the report)** **DNR Comments:** As stated in our response to the performance audit dated July 28, 2010, we did not agree that our audit selection criteria should be changed. Nevertheless, we complied with the report's recommendation to add small royalty payors to the audit schedule. We will resume using our previous audit selection criteria, which was most cost effective and provided the greatest audit coverage. The criteria will also include cost-beneficial and high-risk small audits as well as ensure that the performance indicator is met each year.	✓	
Recommendation 2: OMR should continue to conduct volume audits to identify underpaid royalties. If discrepancies are due to incomplete or inaccurate royalty data, OMR should make corrections and assess applicable penalties. Doing so would enhance the effectiveness of conducting volume audits in identifying underpaid royalties. **(p. 5 of the report)** **DNR Comments:** We concur that volume auditing is a valuable auditing tool. The volume audit program, which offers comprehensive audit coverage for all payors, that was implemented in January 2013 will continue.	✓	

Recommendation 3: OMR should assess late payments on all companies that do not submit royalty payments on time, in accordance with department policy. **(p. 6 of the report)** **DNR Comments:** It is our intent to assess penalties on every late royalty payment. Additional review procedures have been implemented to ensure that no penalty assessments are missed.	✓	
Recommendation 4: The Board and OMR should evaluate their current penalty waiver practices to ensure that they are effectively deterring companies from paying royalties late, failing to pay, underpaying, or submitting inaccurate royalty reports. **(p. 6 of the report)** **DNR Comments:** The current penalty waiver policy has been reviewed and adopted by the Board to achieve the goals of voluntary compliance and maximizing revenue to the state. The policy avoids additional costs associated with litigation and collection for the state. Although, the board is confident that the policy is effective to encourage voluntary compliance and to maximize revenues, we will present this report to the board for consideration.	✓	
Recommendation 5: OMR should coordinate with LDR to identify companies that incorrectly deduct severance taxes from their mineral royalty payments, and collect any underpaid royalties and applicable interest and penalties. **(p. 7 of the report)** **DNR Comments:** We are implementing a computerized solution for identifying potential excessive severance tax deductions. We are confident that our system, which uses the same information as LDR, will be effective and efficient and will provide sufficient coordination.	✓	
Recommendation 6: OMR should ensure the edit check in its mineral royalty database is working properly so it can identify companies that deduct more severance taxes than they should when calculating their royalty payments. **(p. 7 of the report)** **DNR Comments:** No action is required by OMR since this issue has been previously resolved. Mandatory online royalty reporting was implemented in October 2012 for most payors. Online reporting contains error checking for many things, including severance tax deductions.	✓	

Recommendation 7: OMR should coordinate with LDR and the Office of Conservation to identify companies that received severance tax exemptions or reductions so it can ensure that these companies do not deducted more severance taxes that they should when calculating their royalty payments. **(p. 7 of the report)** **DNR Comments:** We are implementing a computerized solution for identifying potential excessive severance tax deductions. We are confident that our system, which uses the same information as LDR and the Office of Conservation, will be effective and efficient and will provide sufficient coordination.	✓	

APPENDIX B: SCOPE AND METHODOLOGY

We conducted this performance audit under the provisions of Title 24 of the Louisiana Revised Statutes of 1950, as amended. We conducted this audit in response to our July 2010 performance audit report (2010 report) that identified weaknesses with the Department of Natural Resources (DNR) Office of Mineral Resources' (OMR) process of auditing mineral royalties. Therefore, we expanded our review to include the collection of mineral royalties. Our audit focused on whether OMR ensured the state received complete, accurate, and timely mineral royalty payments and covered fiscal years 2008 through 2012. The audit objective was as follows:

Did OMR ensure that the state received complete, accurate, and timely mineral royalty payments during fiscal years 2008 through 2012?

We conducted this performance audit in accordance with generally accepted government auditing standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide reasonable basis for our findings and conclusions based on our audit objective. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. To answer our objective, we reviewed internal controls relevant to the audit objective to mitigate the risk of inaccurate data and performed the following audit steps:

- Researched Louisiana Revised Statutes, Administrative Code, Executive Budget documents, and DNR website to understand DNR's legal authority, responsibilities, mission, goals, and objectives.

- Interviewed OMR and Office of Conservation staff and obtained policies and procedures related to oil and gas regulation, royalty and production reporting, and auditing.

- Interviewed LDR staff and obtained policies and procedures regarding severance tax reporting and auditing.

- Followed up with our recommendations in our 2010 report related to OMR's mineral royalty audits.

- Documented OMR's and the Office of Conservation's processes of reporting and auditing mineral royalty and production data.

- Conducted file reviews and reviewed source documentation to determine whether OMR staff and Office of Conservation staff conduct mineral royalty audits and production audits in accordance with their auditing policies and procedures.

- Reviewed formal agreements between OMR/Office of Conservation and OMR/LDR that specify the frequency and types of communication that should take place.

- Interviewed staff from OMR, the Office of Conservation, and LDR to determine if they are coordinating to ensure the state is collecting accurate mineral royalties.

- Reviewed OMR's and the Office of Conservation's internal controls related to ensuring the completeness, accuracy, and timeliness of mineral royalty payments and production data.

- Reviewed the general controls (e.g., edit checks and exception reports) in DNR's mineral royalty database (called SONRIS) to assess if in-depth review of system controls was necessary to ensure data reliability.

- Obtained mineral royalty, production, and severance tax data and tested it with ACL to ensure reliability and traced sample to supporting documentation if necessary.

- Identified and excluded erroneous mineral royalty data and compared it to the Office of Conservation's production data and LDR's severance tax data to ensure that mineral royalty payments are accurate, complete, and submitted on time.

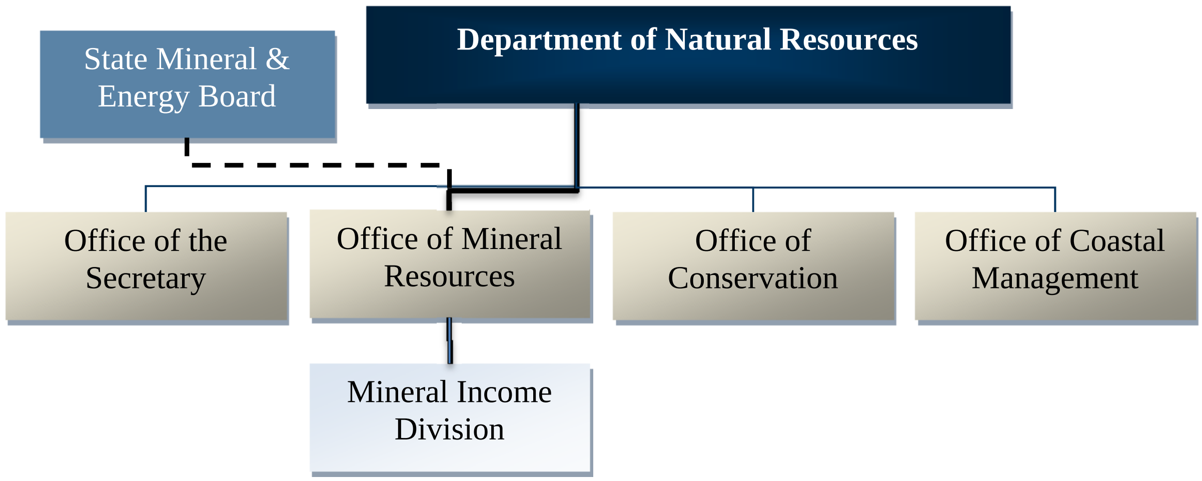
- Compared severance taxes deducted from mineral royalties to those paid to LDR to identify instances where royalties were calculated based on incorrect severance taxes.

- Interviewed OMR staff and reviewed applicable laws, policies, and procedures to determine what constitutes a penalty, what gives OMR or the State Mineral and Energy Board the right to waive penalties.

- Analyzed payment and penalty data to determine how many instances when the companies did not pay royalties to the state on time and were not penalized, as well as the amount in penalties that were assessed, collected, and waived. For the analysis of late payments, we chose a random, non-statistically valid sample because our purpose was to evaluate OMR's compliance with assessing penalties for late payments, not to project the results to the entire population.

APPENDIX C: BACKGROUND

Overview of DNR. One of DNR's goals is to manage the state's natural resources to maximize revenues, directly and indirectly, to the state from oil, gas, minerals, and other sources. Within DNR, the Office of Mineral Resources (OMR) serves as the staff to the State Mineral and Energy Board (Board). The Board administers the state's proprietary interest in minerals and is comprised of the governor, the secretary of DNR, and nine members appointed by the governor. The following exhibit shows the organizational structure of DNR.



Source: Prepared by legislative auditor's staff using information provided by DNR.

Budget and Staffing for OMR. For fiscal year 2013, the operating budget for OMR was approximately $12 million with 64 authorized positions. Within OMR, the Mineral Income Division, which houses 26 of these positions, is responsible for collecting mineral royalties and conducting audits to ensure the state received complete, accurate, and timely royalty payments.

Mineral Royalty Payments. When companies extract minerals, primarily crude oil and natural gas, from state-owned land or water bottoms, they must make royalty payments to the state. According to DNR, as of November 2012, there were 1,888 active state leases on over 840,000 acres of state lands and water bottoms.[9] The following exhibit shows the calculation used to determine the amount of royalties owed to the state. This calculation is outlined in the terms of each mineral lease.

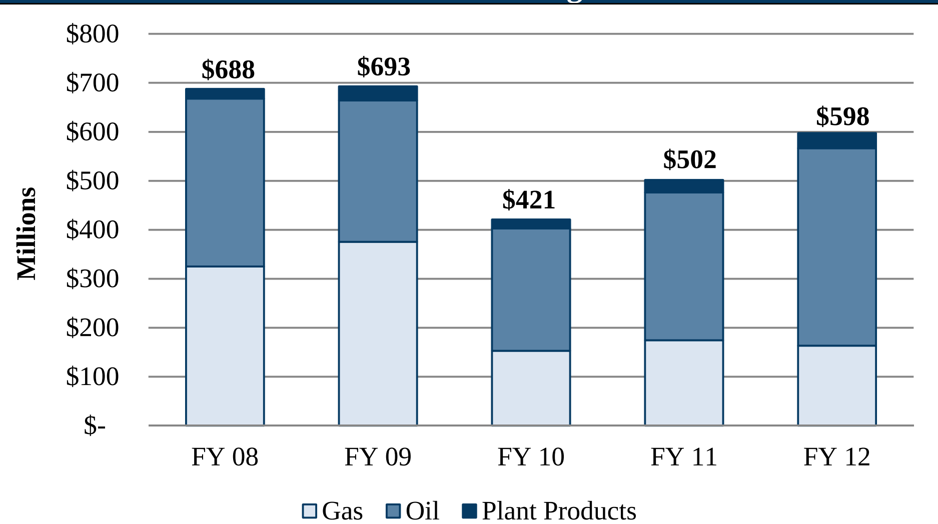
[9] For more information on state mineral leases and the leasing process, see our April 2013 report found at http://app1.lla.state.la.us/PublicReports.nsf/DB918AD8E33411F286257B490074B82A/$FILE/00031C97.pdf.

Royalty Calculation Formula
(Price x **Volume) – Severance Tax – Allowable Expenses** = **Net Value**
Net Value x **State Decimal* (up to 25%)** = **Royalty Payment**
*The state decimal is calculated by multiplying the state's share of land in the oil/gas drilling unit by the royalty percentage agreed upon in the oil/gas lease. **Source:** Prepared by legislative auditor's staff using information provided by DNR.

One-tenth of royalty revenue each month is distributed to the parishes where the production occurs. Mineral income from certain properties is also statutorily dedicated to the Wildlife and Fisheries Conservation Fund. However, most royalties go to the state General Fund in accordance with Article VII, Section 9 of the Louisiana Constitution.

Mineral Royalty Revenue. The accuracy of royalty payments is important because royalties provide one of the largest non-tax sources of revenue to the state. Over the last five fiscal years, the state received approximately $2.9 billion in royalty payments from gas ($1.2 billion), oil ($1.6 billion), and plant products ($124 million) which consist mostly of natural gas liquids. In fiscal year 2012, oil ($403 million) and gas ($163 million) royalty payments comprised $566 million or 95% of all royalties collected. As a result, this audit focused on oil and gas royalty payments. The following exhibit summarizes the total amount of royalty revenues the state received from fiscal year 2008 through fiscal year 2012.

Total Mineral Royalty Revenue
Fiscal Years 2008 through 2012*



*This information is as of October 2012. These numbers can change if companies submit adjustments or OMR's field auditors identify and collect underpaid royalties.
Source: Prepared by legislative auditor's staff using information provided by DNR.