STATE OF MICHIGAN
DEPARTMENT OF NATURAL RESOURCES
LANSING

RICK SNYDER
GOVERNOR

RODNEY A. STOKES
DIRECTOR

July 12, 2012

To: Rodney A. Stokes, Director

Information: Natural Resources Commission

Transaction: Mineral Audit Program Fees - For Information Only

Authority: Part 5, Department of Natural Resources, Section 502, of the Natural Resources and Environmental Protection Act, 1994 PA 451, as amended (NREPA), authorizes the Director of the Department of Natural Resources (DNR) to enter into contracts for mineral extraction.

Discussion: The State of Michigan owns 4.1 million acres of combined surface and mineral rights, and an additional 2.3 million acres of mineral rights only. Under the provisions of 1994 PA 451, the DNR is responsible for managing these lands and mineral resources to ensure protection and enhancement of the public trust.

In 1997, the DNR established an audit program to examine lessee royalty payments and post-production cost deductions to assess whether the State of Michigan was receiving its proper economic share under the terms of the lease. A fee was established to cover the cost of the audit program, including the hiring of independent contractors who would review the lessees' records and report their findings to the DNR.

The fee was established by increasing the minimum bonus bid of $10 to $13 per acre, with the first $3 (Audit Fee) over $10 going to the audit fund.

On April 5, 2012, after staff completed an initial assessment of the audit program, the Director approved staff's interim recommendation to reduce the Audit Fee to $2 per acre for implementation with the May 8, 2012 Oil and Gas Lease Auction.

Staff have completed their analysis of the Audit Fees collected and related expenditures of the program, finding that:

> The Audit Fee directly correlates to the total number of acres leased, with the amount collected during the first ten years of the program being nearly $1,742,000. During this same period of time, program costs were just under $2,548,000.

Over the past five years, the number of acres leased increased substantially, resulting in about $2,797,000 in Audit Fees collected. At the same time, the cost of the program decreased to $631,000.

The recent increase in Audit Fee collection was primarily related to three auctions that leased in excess of 150,000 acres each. The cost of the program decreased for various reasons, including:

1. Competitive bidding for audit contracts,
2. More knowledgeable contractors,
3. Most settlements being reached without the need for litigation, and
4. Fewer contracts issued while staff provided assistance to another program.

The DNR believes that these large auctions can not be consistently sustained. However the DNR also recognizes that program costs are expected to be maintained at or near their current level into the foreseeable future. Therefore, after completion of the program analysis and confirmation that the Audit Fees were collected based upon on all acres leased, staff recognized there is a sufficient balance in the audit fund to enable a recommendation that the Audit Fee be temporarily suspended.

The audit program and proposed temporary suspension of the Audit Fee was reviewed with representatives of the Michigan United Conservation Clubs and Michigan Oil and Gas Association. Mutual agreement was reached on recommendations that the Director could:

Temporarily suspend the Audit Fee to $0 per acre for the anticipated auctions to be held October 2012, May 2013, October 2013, and May 2014,

Direct staff to evaluate the audit program every two years with the re-evaluation to include the scope of the program, analysis of the audit fund balance and expenditures, and presentation of recommendations to the Director regarding:

1. Any changes to the audit program objectives, and

2. What the proposed Audit Fee amount would be, based upon anticipated costs and existing fund balance, for the subsequent four anticipated auctions.
3. In early 2014, staff would provide specific recommendations for the anticipated October 2014, May 2015, October 2015, and May 2016 auctions.

Notice: This item will appear on the July 2, 2012 DNR Business Calendar for information only. It will be published again on the July 30, 2012 Calendar for action and will be eligible for approval on August 9, 2012.

Recommendation: Proceed with submitting the Audit Fee proposal to the Director for action at the August 9, 2012 NRC meeting. Upon approval of the Director, the Audit Fee will be temporarily reduced to $0 per acre in additional bonus, effective September 1, 2012, for the four anticipated auctions to be held October 2012 through May 2014. Thereafter, every two years staff will re-evaluate the audit program, bringing additional recommendations to the Director regarding the scope of the program and the proposed Audit Fee for the subsequent four anticipated auctions.

William O'Neill, Acting Chief
Forest Resources Division

Russ Mason, Ph.D., Chief
Wildlife Division

James L. Dexter, Chief
Fisheries Division

William E. Moritz, Ph.D.
Natural Resources Deputy

I approve the staff recommendation.

Rodney A. Stokes
Director

Approval Date