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STATE OF NEW YORK  
OFFICE OF THE STATE COMPTROLLER

May 14, 2009

Mr. Alexander B. Grannis  
Commissioner  
State of New York  
Department of Environmental Conservation  
625 Broadway  
Albany, NY 12233

Re: Report 2009-F-1

Dear Mr. Grannis:

Pursuant to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution; and Article II, Section 8 of the State Finance Law, we have followed up on the actions taken by officials of the Department of Environmental Conservation to implement the recommendations contained in our audit report, *Lease of State Land for Gas and Oil Exploration and Production* (Report 2005-S-54).

**Background, Scope and Objectives**

The Department of Environmental Conservation (Department) is authorized by the New York State Environmental Conservation Law (Article 23, Title 11) to lease State lands for oil and gas exploration and development, and for underground gas storage. The Department is not authorized to lease State park lands, including the Adirondack and Catskill Forest Preserves, or lands under the waters of Lake Ontario or Lake Erie for oil development. As of January 15, 2009, the Department had 91 such leases covering more than 45,000 acres, of which 77 leases were for oil or gas exploration and development and 14 leases were for underground gas storage. Since December 31, 2005, the Department has received more than \$17.5 million in lease revenue. About \$17 million came from exploration and development leases, while the remainder came from underground storage leases.

The Department is also responsible for overseeing oil and gas well operations (e.g., drilling, production, and well plugging) on both public and private lands. Specifically, the Department issues permits authorizing the operations and performs inspections of the operations. The Department also requires well operators to maintain financial security such as performance bonds to provide assurance the wells will be plugged when the operations are completed.

Our initial audit report, which was issued on September 13, 2007, examined whether the Department maximized the revenue from leases of State land for gas and oil exploration and

production, and effectively exercised its regulatory responsibility over gas and oil wells. Our report covered the period January 1, 2000 through December 31, 2005, except for lease sales; which it covered for the period March 14, 1990 through December 31, 2005. Our report found that the Department generally complied with guidelines that are intended to promote competition. However, we also identified certain actions that could be taken by the Department to provide additional assurance lease revenue is being maximized. In particular, we recommended the Department obtain independent corroboration of the information used in calculating the leaseholders' royalty payments to the State. The Department is also responsible for monitoring gas and oil well operations on both public and private lands. We examined the Department's monitoring efforts and identified the need for improvement in certain administrative and recordkeeping practices. The objective of our follow-up was to assess the extent of implementation, as of February 10, 2009, of the eight recommendations included in our initial report.

### **Summary Conclusions and Status of Audit Recommendations**

We found that Department officials have made progress in correcting the problems we identified. However, additional improvements are needed. Of the eight prior audit recommendations, five recommendations have been implemented and three recommendations have been partially implemented.

### **Follow-up Observations**

#### **Recommendation 1**

*Periodically perform a formal review of other states' lease terms to determine whether any of these terms can be adopted in New York State.*

Status - Partially Implemented

Agency Action - The Department has not conducted any lease sales since our audit report was issued. However, Department officials told us they intend to formally review other states' lease terms when another New York lease sale is planned. Department officials said that they keep abreast of industry trends, such as lease sales and issuances by other states. They provided us with a copy of correspondence between themselves and Pennsylvania officials regarding a sale in Pennsylvania during August 2008.

#### **Recommendation 2**

*Analyze the potential benefits of (a) sliding royalty rates and scaled royalty rates, and (b) leases in which various strata beneath the land are included in separate leases rather than in the same lease.*

Status - Implemented

Agency Action - Department officials stated that they have analyzed the potential benefit of the suggested lease terms, but believe their current lease terms are more appropriate. In January 2007, Department officials contacted officials at the U.S. Department of the

Interior, Division of Minerals Management Services, regarding their use of sliding royalty rates. They informed Department officials that the sliding scale royalty system had not been used since the early 1980s. The Federal officials explained that the increased costs of monitoring such a system reduced its cost benefits and effectiveness. Additionally, in July 2008 the Department participated in a multi-state survey regarding the royalties system each state used. This survey, conducted by the Interstate Oil and Gas Compact Commission, showed few of the states surveyed used the sliding scale system. When Department officials contacted two states that reported they used a sliding scale, they found both actually used a fixed rate for the majority of their leases. After review of the subsequent facts, Department officials determined using a sliding scale royalty rate would not be appropriate.

Officials also analyzed the potential of entering into separate leases for strata beneath the land, rather than including them in the same lease. They identified safety and liability concerns associated with this practice. For example, the need for additional well pads and separate transportation infrastructure (e.g., natural gas liens) would increase the amount of surface disturbance. Officials stated they considered relevant laws and mandates, as well as management goals, in their analysis.

### **Recommendation 3**

*Monitor lease acreage holdings by company to determine whether competition is being undermined by a concentration of holdings among a few companies, and if so, take appropriate corrective action.*

Status - Implemented

Agency Action - Department officials stated that they have analyzed lease acreage holdings, and, as a result, have taken steps to increase competition. For their most recent sale, in 2006, the Department published announcements in four of the industry's leading publications; held three public meetings on the lease sale; mailed notices to 850 individuals who attended the public meetings; and mailed lease information to 168 parties who expressed interest. These officials report that their efforts resulted in the receipt of 32 bids for that lease sale.

### **Recommendation 4**

*Obtain independent corroboration of the sales and production information reported by leaseholders through some combination of the following or other comparable practices:*

- *Establish lease terms requiring leaseholders to periodically test or reset meter calibration or provide reports confirming that such tests have been performed.*
- *Periodically verify that meters are accurately calibrated.*
- *Periodically take meter readings and verify the readings against the reported production.*
- *Periodically audit leaseholder records.*

Status - Partially Implemented

Agency Action - Officials have established lease terms requiring leaseholders to periodically test meter calibration and provide reports to the Department confirming that such tests have been performed. However, Department officials maintain their inspectors do not have the required training or ability to verify that meters have been accurately calibrated or to compare meter readings against production reports. Further, while officials have identified potential audit areas, they state they do not have the staff, training, or resources to conduct such audits.

#### **Recommendation 5**

*Develop comprehensive written procedures describing (a) all the inspections and other monitoring activities that must be performed over the life of a lease and (b) the various documents and inspection reports that must be maintained in the Department's well monitoring files. In conjunction with these written procedures, develop a checklist that can be used to determine whether all required actions have been performed and documented, and require completed checklists to be maintained in the files.*

Status - Partially Implemented

Agency Action - Department officials created a 25-item checklist that is used to track whether all required actions have been performed. We reviewed all the well files for the 15 wells located on State land and found all but one contained a completed checklist. However, officials disagreed with the need for written procedures, based on the limited number of staff in the regional offices and low turnover in those offices. Instead, the Department relies on informal on-the-job training.

#### **Recommendation 6**

*Periodically review well files to ensure that all required documents are present.*

Status - Implemented

Agency Action - Department officials stated that they periodically conduct reviews of well files to ensure that all required documents are present. We found evidence of supervisory review for 14 of the 15 well files we reviewed.

#### **Recommendation 7**

*Instruct inspectors in regions 6 through 8 to email their inspection reports to the Region 8 Office as soon as the reports are completed.*

Status - Implemented

Agency Action - We reviewed correspondence instructing inspectors in regions 6 through 8 to email their inspection reports. Our review of correspondence and off-site inspection reports for the two years ending December 2008 found that the off-site inspectors have been following these instructions.

**Recommendation 8**

*Create a standard form for documenting inspections of operators' compliance with Temporary Revocable Permit requirements, and ensure that the inspections are documented on the form.*

Status - Implemented

Agency Action - Since the issuance of the original report, Department officials have created standard forms for documenting inspections of operators' compliance with Temporary Revocable Permit requirements. We reviewed the April/May 2008 inspection forms for 43 gas wells and pipeline segments in various stages of production located in Region 8 and found Department officials are using the forms to document the inspections as originally recommended.

Major contributors to this report were Frank Houston, Bob Mainello, Heather Pratt, and W Sage Hopmeier.

We would appreciate your response to this report within 30 days, indicating any actions planned to address the unresolved issues discussed in this report. We also thank the management and staff of the Department for the courtesies and cooperation extended to our auditors during this review.

Very truly yours,

Cindi Frieder  
Audit Manager

cc: Tom Kulzer, DEC Audit Liaison  
Tom Lukacs, Division of the Budget