



JOHN CHIANG  
California State Controller

STATE OF CALIFORNIA

10/22/07 10:50

**CORRESPONDENCE 2**

October 22, 2007

William O'Brien  
District 1 County Supervisor  
Stanislaus County  
1010 10th St., Ste. 6500  
Modesto, CA 95354

Re: Oil, Gas and Mineral Royalty Audits

Dear Sir or Madam,

I want to take this opportunity to update you on the results of litigation brought by my office against the United States Secretary of the Department of Interior. As you may know, my office filed litigation against the Department of Interior challenging, among other things, the legality of certain provisions of its 2002 guidelines purportedly applicable to oil, gas and mineral royalty audits performed by my office.

California, along with other western states, receives a percentage of the income from federal land because of federal land retention policies that existed at the time California became a state. The income was to compensate for the fact that federal public lands are not taxable by the state. Because property tax has always been the base for funding education, California, as a matter of state law, dedicated the income from oil and gas revenues from federal lands to the state school fund. Similarly, royalties from other minerals go to the counties where the federal leases are located to offset the impact of production activities.

The Department of Interior through its Minerals Management Services announced a policy of extending the scope of a 7-year statute of limitations Congress enacted in 1996 to royalty audits performed by my office of major oil and mineral producers arising before September 1, 1996. In adopting its policy, the Mineral Management Services stated it would not issue orders to the oil producers to pay the state royalties due and would grant any appeals filed by the oil, gas and mineral producers for audit periods more than seven years before the date of the adoption of the policy. By adopting this policy, Interior ended audit efforts, closed completed audits and said it would grant company appeals whether royalties were owed or not. More importantly, the action deprived California schools and counties from receiving the distribution of royalties that were otherwise due. My office challenged the legality of those Guidelines.

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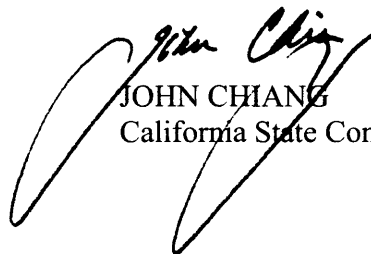
As a result of the litigation, I am pleased to inform you that on August 30, 2007, the United States District Court for the District of Columbia ruled against the Department of Interior finding that the Management Mineral Services policy was arbitrary and capricious. Moreover, the court found that the policy "failed to take into consideration the wasted audit efforts, the loss in revenue from cutting back enforcement, the effect on states who share the revenue and play a significant role in the enforcement process, and the upsetting of settled expectations concerning royalty collections." (*John Chiang v. Dirk Kempthorne*, United States District Court for the District of Columbia, Case No. 04-199 (EGS).)

I have now called on the Department to reopen older royalty audits and take immediate steps to collect what is owed the State of California on behalf of our school children and counties. Essentially, what those Guidelines did was sweep money owed our schools and counties under the rug to the benefit of the oil and minerals industry. It is now time for the Department of Interior to account for its unlawful actions and collect the amounts due as indicated in the audits performed by my office.

Finally, I continue to work with members of Congress in seeking the restoration of audit funds for work in this area. In addition to adopting the policy that was the subject of the litigation, Minerals Management Services has unilaterally cut my office's audit funding for auditing royalties in two consecutive years and we have been told to expect further reductions. Whatever Mineral Management Services' goals and priorities are, they clearly do not include ensuring that California's public schools and counties receive all that they are owed. It is my intent to continue to pursue the restoration of funding for this important endeavor.

If you need further information concerning this matter, please do not hesitate to contact my Chief of Staff, Collin Wong-Martinusen, at (916) 327-1361, or my Chief Counsel, Richard J. Chivaro, at (916) 445-6854.

Sincerely,



JOHN CHIANG  
California State Controller