

Written Testimony of Beth Daley Director of Investigations, Project On Government Oversight to the House Government Reform Committee

*Interior Department: A Culture of Managerial Irresponsibility and
Lack of Accountability?*

September 14, 2006

The Project On Government Oversight (POGO) applauds the efforts of House Government Reform Chairman Tom Davis and House Energy and Resources Subcommittee Chairman Darrell Issa to take a much-needed look at the Department of Interior's oil and gas leasing and royalty collections. In addition, we applaud the efforts of Ranking Member Henry Waxman and Committee member Representative Carolyn Maloney who have conducted investigations and led many initiatives over the years to ensure that the oil and gas industry pay their fair share for royalties on federal and Native American leases.

We sincerely hope that yesterday's and today's hearings are the beginning of more Congressional oversight to come, particularly given the history of these issues and indicators today that point to the need for much more vigorous efforts to protect Native Americans and the taxpayers from waste, fraud, abuse.

Founded in 1981, POGO is a nonpartisan and independent nonprofit organization that investigates and exposes corruption and other misconduct in order to achieve a more accountable federal government. POGO is committed to honest, accountable, and open government.

Department of Interior (DOI) Inspector General Earl Devaney's testimony yesterday outlined in part how an "institutional culture of managerial irresponsibility and lack of accountability" – as the Subcommittee put it – allowed a complacent Minerals Management Service (MMS) to fail to collect royalties owed to the taxpayer. In POGO's experience spanning more than a decade of investigating in this topic area, aggressive Congressional and watchdog oversight has played a central role in ensuring that the MMS adequately protects the financial interests of the federal government and Native Americans.

The Oil and Gas Industry: a History of Fraud

In the 1990's, POGO issued a series of investigative reports documenting how the oil industry had shortchanged the government by as much as several billion dollars in oil royalties. Some of that money was ultimately recovered as a result of a False Claims Act lawsuit filed by POGO and whistleblowers as well as by audits conducted by MMS. In 1998 to 2001, companies reached settlements totaling roughly \$500 million with the Justice Department in lawsuits alleging that they shortchanged on oil and gas royalties owed to tribes and the federal government.¹

In 2002, POGO identified more than \$11 billion in lawsuit settlements that the oil and gas industry had reached with states, tribes, the federal government, and private parties concerning royalty underpayments.² Dozens of cases involving gas and oil royalty underpayments illustrate that a variety of players in the oil and gas industry may be engaged in widespread oil and gas royalty fraud.

Auditing and Enforcement: How is MMS Doing?

Since 1981, the Minerals Management Service has operated an auditing and compliance division which conducts audits and oversight of mineral leases. Collections from the auditing and compliance division of MMS have declined in recent years. In the four years from 2002 to 2005, MMS's auditing and compliance program collected an average \$48 million annually, less than half the average \$115 million collected annually in the division's first 20 years.³

The decline in funds collected has occurred on the heels of changes in the way the MMS compliance programs provide accountability and oversight over royalty collections. Since 2000, MMS has altered its priorities, shifting resources away from auditing to a computerized checking system based upon information provided from the industry, known as "compliance review." In FY 2000, \$22 million was spent on auditing and \$12 million was spent on compliance review. By comparison, in FY 2005, the priorities were reversed: just \$12 million was spent on auditing while \$22 million was being spent on compliance review.⁴

The most recent budget from MMS indicates that since 2001 it has reduced its auditing and compliance

¹ "Unocal to Pay U.S. More Than \$21 Million for Underpayment of Oil Royalties," Justice Department Press Release, December 3, 2001, and Shell Oil to Pay United States \$56 million for Underpayment of Gas Royalties, September 28, 2000. http://www.usdoj.gov/opa/pr/2001/December/01_civ_624.htm & <http://www.usdoj.gov/opa/pr/2000/September/571civ.htm>

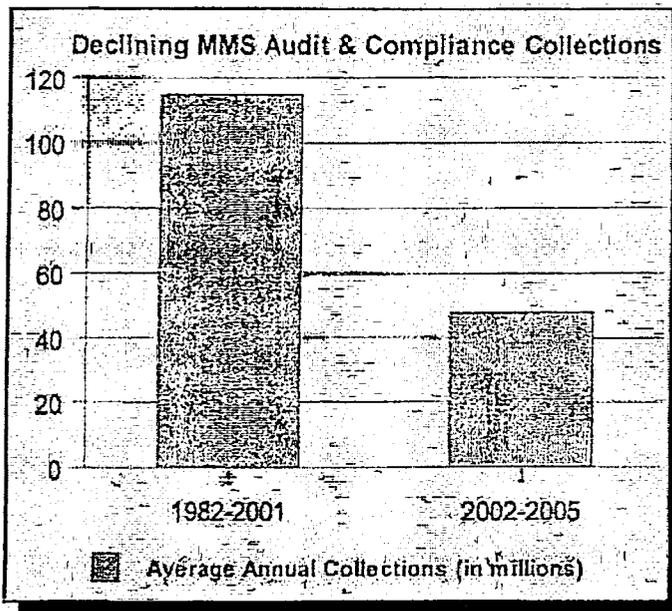
² Federal Natural Gas Royalty Underpayment Litigation, Project On Government Oversight, January, 2002. <http://pogo.org/p/environment/ea-020101-gas.html>

³ In deriving this figure, POGO analyzed auditing and compliance revenue collections from FY 2002 through FY 2005 then compared that to collections for the twenty-year period from FY 1982 to FY 2001. Auditing and compliance revenue collections from FY 1998 to FY 2001 were larger due to collections made in part as a result of POGO's investigations, outside litigation, and effective audits performed by MMS.

⁴ Letter to Representative Carolyn Maloney from MMS Director Johnnie Burton, May 17, 2006.

staff by 65 full-time employees, or 26% of its then-total staff of 250.⁵ While POGO supports efforts to make the government more efficient, cut backs in the number of auditors at this particular juncture is hard to justify given the evidence of underpayments which surfaced in the late 1990s.

MMS argues that the growing use of Royalty-in-Kind has minimized royalty uncertainty and resulted in the need for fewer audits. This may or may not be true. An independent analysis of this issue would ensure that MMS' assumptions on this point are correct.



In addition, as will be discussed later, a variety of whistleblowers have raised substantial questions about whether the Interior Department is meeting its full potential in overseeing royalty collections.

In response to questions about how many random and referral audits are conducted, MMS replied in a letter to Representative Carolyn Maloney (D-NY): "While we remain committed to the strategies, MMS has not yet made full use of random audits and referrals as means to improve our compliance process. As we continue to adapt and refine our processes, we expect to make greater use of these approaches in the future."⁶

MMS added: "During FY 2002, MMS initiated 13 such random audits – 1 Indian, 9 offshore, and 3 onshore. The MMS has 49 more such random audits underway or planned for FY 2006-2007, including 1 Indian, 15 onshore, and 33 offshore...Additional random audits are performed periodically as resources are available. For example in FY 2003, 15 Federal onshore properties were selected for audit randomly from those states without delegated compliance and audit authority."⁷ One unresolved question is whether this minimal amount of audit activity has a deterrent effect against possible fraud for the 27,000 producing federal and Indian mineral leases under MMS' jurisdiction.

Since 2000, the MMS has not published on its web site its annual "Report on Royalty Management and Delinquent Account Collection Activities," which had previously outlined the agency's activities to audit, monitor, and enforce collection of royalties for products taken from federal and Indian lands. Congress should consider requesting that the MMS revive the annual web publication of this document so that

⁵ Budget Justifications and Performance Information Fiscal Year 2007, U.S. Department of Interior Minerals Management Service. <http://www.mms.gov/PDFs/2007Budget/FY2007BudgetJustification.pdf>

⁶ Letter to Representative Carolyn Maloney from MMS Director Johnnie Burton, May 17, 2006.

⁷ Ibid.

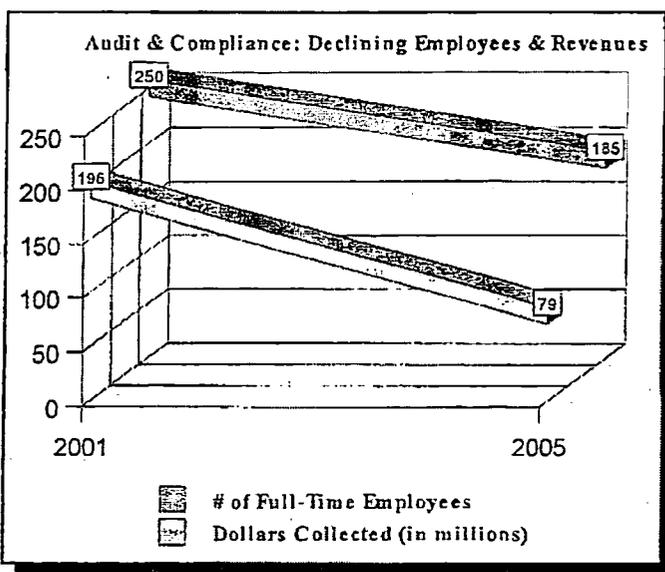
appropriate oversight can be conducted.

Congress should also examine incentives which are being used in the auditing and compliance division of MMS. Are MMS' employees rewarded for actually finding underpayments? Or are they rewarded for fulfilling meaningless quotas? Preliminary information received by POGO suggests that the bonus systems could be altered to be more closely aligned to outcomes that benefit the taxpayer. Bonuses for MMS increased in 2005 with 15 Senior Executives receiving \$77,000 or an average of \$5,000 each.

Whistleblowers, States, Tribes Raise Concerns: Is Anyone Listening?

A variety of industry and government whistleblowers, states, and tribes have come forward to express concerns about oil and gas royalty underpayments and the MMS' commitment to exposing and correcting those underpayments. In recent years, two senior Interior Department auditors were fired after they sought to improve royalty collections. Retaliation against whistleblowers may be part of a wider cultural problem within the agency of silencing voices who would seek to strengthen the agency's ability to fairly collect what is owed from the oil and gas industry.

In September 2004, Bobby Maxwell, a senior auditor in MMS' Offshore Auditing and Compliance, filed a False Claims Act lawsuit alleging that Kerr-McGee under reported the value of the oil it had drilled from federal lands from 1999-2003. That lawsuit has now passed all its legal hurdles and is poised to go to trial in federal court in November, 2006. POGO applauds the efforts of Mr. Maxwell, an auditor with MMS since 1983 who had received numerous awards for his federal service. Mr. Maxwell was fired by the MMS just a few weeks after his False Claims Act lawsuit was unsealed and made public. Mr. Maxwell's case suggests that MMS may not be issuing demands to pay to oil and gas companies in cases where there are substantial audit findings. In correspondence to Congress, MMS has indicated that despite its maintenance of data on audits and compliance reviews, it "does not maintain statistics on the numbers or amounts of orders [referring to orders to pay issued to companies] issued."⁸



In addition, attention should be paid to the firing of whistleblower Kevin Gambrell, the former director of the Federal Indian Minerals Office in Farmington, New Mexico from 1996 to 2003. Mr. Gambrell

⁸ Ibid.

was a talented and successful auditor within MMS until he was pushed out for raising concerns about whether MMS was fulfilling its duty to collect royalties for Indians. While in his position, Mr. Gambrell was able to renegotiate settlements between MMS and the oil industry so that Navajos would receive eight times more than MMS had determined was owed. According to Mr. Gambrell, MMS had not relied on audits to determine what the oil industry owed the Navajos. In February 2003, Mr. Gambrell began disclosing his concerns to the Court-appointed Special Master overseeing the Indian Trust Fund. In September 2003, MMS fired Mr. Gambrell.

In a June 2006 segment on PBS, Mr. Gambrell said: "I think the American taxpayers are losing billions of dollars....I don't think the American people should walk away from this. I think they need to really question the government that is currently auditing oil and gas royalties and make sure that they do it correctly. I think there needs to be independent review, I mean separate from the government, a review of the agencies that collect royalties, manage the oil and gas properties. There needs to be better oversight and there needs to be independent audits of these agencies."⁹

Oil industry tycoon Jack Grynberg has also filed a False Claims Act lawsuit, this one alleging more than a dozen ways that companies can underpay gas royalties, particularly by manipulating the volumes of gas downward. Mr. Grynberg estimates that oil and gas companies may end up owing \$35 billion as a result of his lawsuit.¹⁰

Native Americans are also concerned. In a May 2006 *Washington Post* article, Roger Fragua, deputy director of the Council of Energy Resource Tribes said: "We are convinced that there is serious underreporting of production and serious underpayment of royalties owed to the tribes...The federal government, at least in this administration, is not protecting our interests. So we are looking for ways to go after the companies ourselves."¹¹

In 2006, the Minerals Management Service has stifled criticism from states and Indian tribes which have questioned the wisdom of replacing auditing with computer checks, called "compliance review" in a series of letters.¹² At a meeting of state and Indian auditors in August 2006, the MMS informed the group that it was eliminating the ability of the states and tribes to meet independently, a move that some felt was designed to gut the organization and silence its criticisms. A September 2006 letter from concerned members of Congress concluded: "MMS is retaliating against STRAC [State and Tribal Royalty Audit Committee] for voicing its concerns to Congress about dysfunction in the royalty

⁹ "Crude Awakening," PBS NOW, June 16, 2006.
<http://www.pbs.org/now/shows/224/indian-oil-royalties.html>

¹⁰ "Independent Oilman Takes on Oil Giants," National Public Radio, May 31, 2006.
<http://www.npr.org/templates/story/story.php?storyId=5441272>

¹¹ "Firms Harvesting Energy From Public Land May Owe U.S.: Under the False Claims Act, Groups Sue for More Fees," *Washington Post*, May 7, 2006.
<http://www.washingtonpost.com/wp-dyn/content/article/2006/05/06/AR2006050600905.html>

¹² Letter to Lucy Querques Dennett, Associate Director, Minerals Management Service from State and Tribal Royalty Audit Committee, February 2, 2006. <http://www.pogo.org/m/ep/ep-StateandTribal-02202006.pdf>

management program.”¹³

State and tribal participation in audits was authorized by Congress in 1982 after congressional findings that Interior was operating the royalty program as an “honor system,” under which federal lessees (oil companies) were allowed to report and pay whatever they wanted. An independent commission, whose findings Congress adopted, told Interior to implement independent cross checks of industry representations and to avoid blind acceptance of industry “bookkeeping.”¹⁴

POGO urges incoming Interior Secretary Dirk Kempthorne to change the dynamic at the Interior Department described by Inspector General Devaney where those responsible for the failures to do their job and collect what is owed the American taxpayer are held accountable. However, we would urge Secretary Kempthorne to take that suggestion one step further and seek out and reward whistleblowers who bring forward evidence of negligence, waste, fraud, or corruption. Firings such as that of Mr. Gambrell and Mr. Maxwell have a chilling effect on employees at the MMS, re-enforcing a culture where wrong-doing is covered up rather than addressed.

Finally, POGO urges the Congress and Secretary Kempthorne to investigate the concerns of states and tribes and do everything possible to ensure that their concerns are being adequately addressed by MMS.

¹³ Letter to the Honorable Johnnie Burton, Director, Minerals Management Service, from members of Congress August 31, 2006. <http://www.pogo.org/m/ep/ep-08312006-Burton.pdf>

¹⁴ “Comments on Proposed Federal Oil Valuation Rule,” Project On Government Oversight, November 10, 2003. <http://www.pogo.org/p/environment/el-031101-oil.html>

Response of the Minerals Management Service (MMS) to Factual
Inaccuracies Contained in Testimony Submitted by the Project On
Government Oversight (POGO) to the House Government Committee
For the Hearing Record of September 14, 2006

POGO Statement:

The most recent budget from MMS indicates that since 2001 it has reduced its auditing and compliance staff by 65 full-time employees, or 26 percent of its then-total of 250. While POGO supports efforts to make the government more efficient, cut backs in the number of auditors at this particular juncture is hard to justify given the evidence of underpayments which surfaced in the late 1990s.

MMS Response: POGO did not correctly interpret MMS's FY 2007 Budget Justification. In that document (page 112), MMS cites efficiency gains realized by moving large volumes to royalty in kind (RIK), which does not require the audits that industry receipts require, and reengineering of the compliance process. The reduction in 65 full-time employees (FTE) cited in the FY 2007 Budget Justification applies only to the Offshore and Federal Onshore compliance and audit FTE. Of that 65 FTE, 14 were redeployed to MMS Indian compliance program.

Since the end of FY 2001 (September 2001) to October 2005, MMS's overall audit and compliance staff decreased from 420 full-time employees to 369 (down 51 FTE, or 12 percent, not 26 percent). These numbers were confirmed by the Office of Inspector General in their recent review of MMS's compliance activities. Over this same time period, MMS implemented aggressive compliance goals aimed at shortening the compliance cycle and increasing the percentage of revenues being reviewed and/or audited within 3 years. In FY 2006, our goal is to review and/or audit 72 percent of all Federal and Indian royalty payments within 3 years from the date of receipt of the payment.

POGO Statement:

In the four years from 2002 to 2005, MMS's auditing and compliance program collected an average \$48 million annually, less than half the average \$115 million collected annually in the division's first 20 years.

MMS Response: The amounts of additional revenues MMS collects as the result of compliance activities tend to fluctuate year-to-year. In most cases, the collections applicable to compliance activity in one year will be reflected one or more years later, depending on whether the cases were resolved by voluntary payment, litigation, or settlement.

The POGO makes an arbitrary comparison of the average of the last 4 years of collections compared to the previous 20 years. The POGO even acknowledges that its average for the 20-year period from FY 1982 - FY 2001 is skewed by including large settlements collected from FY 1998 to FY 2001.

If a comparison is made of the average annual collections for the past 6 years (FY 2000-FY 2005), \$120 million, to the average annual collections for the previous 18 years (FY 1982 to FY 1999), \$127 million, the difference is insignificant.

Likewise, if the comparison were to fairly exclude the anomalous large settlements (\$400 million) from FY 1998 to FY 2001, the average annual collections for FY 1982 to FY 2001 is \$95 million, compared to \$78 million for FY 2001 to FY 2005.

The POGO failed to report to the Committee several relevant facts regarding the quality and rigor of MMS's audit and compliance program:

- Over the past 4 years (FY 2002 to FY 2005), the MMS and State and Tribal auditors have completed 1,214 audits. That compares to 784 audits completed for the 4-year period (FY 1998 – FY 2001).
- In November 2005, an independent certified public accounting firm issued a clean audit opinion of MMS's audit program with no material weaknesses, and no reportable conditions. In its opinion, the accounting firm stated:

“In our opinion, the system of quality control for the Federal Audit Function of MMS in effect for the 2-year period ending December 31, 2004, has been designed to meet the requirements of the quality control standards established by the Comptroller General of the United States for a Federal Government audit organization and was complied with during the 2-year period ending December 31, 2004, to provide MMS with reasonable assurance of conforming with applicable auditing standards, policies, and procedures.”

The MMS goal is to see a gradual decline in compliance collections year-to-year as companies increase their voluntary compliance. This is not a reflection of reduced rigor of the compliance program, but rather an indication that the deterrent effect is working. The major reasons for improved compliance are as follows:

- **More effective regulations** – The MMS has made significant progress in developing and implementing clearer regulations, and eliminating much uncertainty and ambiguity that previously resulted in major findings. For example, oil sales from Federal leases between affiliated companies (i.e., non-arm's-length transactions) are now valued using the New York Mercantile Exchange index price. This is a more transparent and objective way to value the product and avoid extensive conflicts over previous complex valuation approaches, thereby reducing the findings and collections that would have otherwise occurred.

- **Royalty in Kind (RIK)** – The MMS is receiving an increasing percentage of revenues through its RIK program, thereby eliminating the valuation issues that previously resulted in major findings. During FY 2001, for example, MMS took about 34 percent of its offshore crude oil and 14 percent of its offshore natural gas in kind. In contrast, in FY 2005 MMS took about 80 percent of its offshore crude oil and 30 percent of its offshore natural gas in kind.
- **More effective compliance strategies** - Compliance reviews have allowed MMS to cover more properties than were possible using audits alone, thereby increasing the deterrent effect. Because companies know there is a high likelihood that their payments will be reviewed, these companies have a significant incentive to properly report and pay. These changes account for the increased collections in FY 2005 when the effects of the new procedures that were fully implemented in 2003 are recognized in additional collections.
- **Formal reporting and payment agreements** - As a result of the lawsuits filed by the MMS and DOJ, many lessees are proactively seeking certainty in their methodology for valuing future production from Federal and Indian leases. The MMS may enter into a future valuation agreement with a company as long as the agreement provides fair market value and is consistent with the regulations. The MMS reviews any such agreement on a routine basis to ensure that it continues to provide fair market value.

POGO Statement:

MMS argues that the growing use of Royalty-in-Kind has minimized royalty uncertainty and resulted in the need for fewer audits. This may or may not be true. An independent analysis of this issue would ensure the MMS' assumptions on this point are correct.

MMS Response: The fact that the growing use of Royalty in Kind has minimized royalty uncertainty is true and an independent analysis performed by the Government Accountability Office (GAO) validates MMS statements on RIK effectiveness. The GAO closely examined RIK revenue and administrative metrics and concluded in January 2006 that RIK efforts in developing and executing this measurement system satisfy and close recommendations from their April 2004 report titled "Cost and Revenue Information Needed to Compare Different Approaches for Collecting Federal Oil and Gas Royalties." The RIK metrics endorsed by GAO indicate that in FY 2005 the RIK program brought in \$32 million in incremental revenues that would not have been realized had those royalties been paid in value; cost nearly 50 percent less than the cash royalty approach; closed accounting periods within 180 days (providing significant increases in certainty for government and industry); and generated no appeals or litigation.

POGO Statement:

A variety of industry and government whistleblowers, states, and tribes have come forward to express concerns about oil and gas royalty underpayments and the MMS' commitment to exposing and correcting those underpayments. In recent years, two senior Interior Department auditors were fired after they sought to improve royalty collections. Retaliation against whistleblowers may be part of a wider cultural problem within the agency of silencing voices who would seek to strengthen the agency's ability to fairly collect what is owed from the oil and gas industry.

MMS Response: The MMS did not retaliate against either of the two individuals as POGO claimed. As for Mr. Gambrell, there is no validity to his claims. He agreed to resign in a confidential settlement agreement. (The confidential agreement prevents the government and Mr. Gambrell from discussing his case in detail.) It is important to note that, in fact, Indian records were destroyed under his supervision. Mr. Gambrell was not an auditor.

The Department did not retaliate against or fire Mr. Maxwell, who had earlier retired from the MMS and had been rehired as a reemployed annuitant. The MMS implemented a reorganization within the Minerals Revenue Management program to streamline the Offshore Compliance and Asset Management organization within a new office in Houston. The new position in Houston was advertised, and Mr. Maxwell did not apply to be considered for the consolidated, permanent position. When the position was filled as part of the reorganization, Mr. Maxwell's position in Denver no longer existed.

POGO Statement:

Mr. Maxwell was fired by the MMS just a few weeks after his False Claims Act lawsuit was unsealed and made public. Mr. Maxwell's case suggests that MMS may not be issuing demands to pay to oil and gas companies in cases where there are substantial audit findings. In correspondence to Congress, MMS has indicated that despite its maintenance of data on audits and compliance reviews, it "does not maintain statistics on the numbers or amounts or orders [referring to orders to pay issued to companies] issued."

MMS Response: To reiterate the response above, MMS did not fire Mr. Maxwell. He had been rehired as a reemployed annuitant and chose not to apply when a permanent position became available. The MMS and the Department of Justice investigated and analyzed Mr. Maxwell's claim, and the United States declined to intervene in the *qui tam* lawsuit that Mr. Maxwell brought under the False Claims Act (*U.S. ex rel. Maxwell v. Kerr-McGee Chemical Worldwide, LLC*, No. 04-F-1224 (D. Colo.)). Because that litigation is currently pending, we cannot comment on the merits of the case or the legal

theories on which Mr. Maxwell's claim is founded. The validity of his claims remains to be determined by the court.

While MMS does not maintain statistics on the number of orders issued to companies for a number of reasons, as indicated by POGO, MMS and State and Tribal auditors completed 1,214 audits in the four years FY 2002 – FY 2005. That compares to 784 audits completed for the previous four-year period (FY 1998 – FY 2001).

POGO Statement:

In addition, attention should be paid to the firing of whistleblower Kevin Gambrell, the former director of the Federal Indian Minerals Office in Farmington, New Mexico from 1996 to 2003. Mr. Gambrell was a talented and successful auditor within MMS until he was pushed out for raising concerns about whether MMS was fulfilling its duty to collect royalties for Indians. While in his position, Mr. Gambrell was able to renegotiate settlements between MMS and the oil industry so that Navajos would receive eight times more than MMS had determined was owed. According to Mr. Gambrell, MMS had not relied on audits to determine what the oil industry owed the Navajos. In February 2003, Mr. Gambrell began disclosing his concerns to the Court-appointed Special Master overseeing the Indian Trust Fund. In September 2003, MMS fired Mr. Gambrell.

MMS Response: Again, MMS did not fire Mr. Gambrell. While POGO describes Mr. Gambrell as a "talented and successful auditor," he was not, in fact, an auditor. He managed the Farmington Indian Minerals Office, which includes some auditors on its staff. Because Mr. Gambrell was allowed to resign as part of a confidential settlement agreement, MMS and Mr. Gambrell cannot fully explain all the circumstances that were involved in the individual situation. The MMS can state in fact, however, that Indian records were destroyed under Mr. Gambrell's supervision.

POGO Statement:

In 2006, the Minerals Management Service has stifled criticism from states and Indian tribes which have questioned the wisdom of replacing auditing with computer checks, called "compliance review" in a series of letters.

MMS Response: The MMS has not stifled criticism from State and Tribes nor has MMS "replaced auditing with computer checks, called 'compliance review[s].'"

Over the past few years, MMS and STRAC have had an ongoing dialogue regarding compliance reviews. The MRM compliance reviews are designed to determine if the royalties received are in reasonable compliance with the laws, lease terms, and regulations. Compliance reviews apply a series of tests to the volume, royalty rate, value, and allowances to determine if royalty payments are reasonable on a property basis. The central issue regarding compliance review is "compliance coverage." With over 27,000 producing Federal and Indian mineral leases under our jurisdiction, there are simply too

many properties to rely on the traditional audit approach alone. In order for us to optimize compliance coverage, other approaches are necessary, in combination with audit. Compliance reviews enable the government to cover a larger percentage of royalties paid than by using audits alone.

Compliance reviews have helped MMS cover more properties and complete compliance work more contemporaneously. The MMS has established goals under the Government Performance and Results Act (GPRA) to complete compliance work within 3 years. In fiscal year 2005, MMS completed compliance work on 71 percent of revenues within our 3-year goal. If MMS were to rely on audit alone, it would severely restrict the number of properties that could be covered. Because of our fiduciary responsibilities to the American taxpayer, it is important to validate compliance on a larger and larger percentage of properties and revenue dollars and to do it as expeditiously as possible. These principles are the foundation of the GPRA goals MMS has established.

We have found that:

- Compliance reviews, using automated analysis, are less costly than traditional audits, which rely heavily on manual review of source documents; and
- Compliance reviews have resulted in at least \$225 million additional collections from unpaid and underpaid royalties since FY 2001.

The MMS has not abandoned audits nor reduced the rigor of its overall compliance program. In fact, by utilizing the compliance review process to target audits on systemic issues MRM significantly improves the effectiveness of the audit program.

POGO Statement:

At a meeting of state and Indian auditors in August 2006, the MMS informed the group that it was eliminating the ability of the states and tribes to meet independently, a move that some felt was designed to gut the organization and silence its criticisms. A September 2006 letter from concerned members of Congress concluded: "MMS is retaliating against STRAC [State and Tribal Royalty Audit Committee] for voicing its concerns to Congress about dysfunction in the royalty management program.

MMS Response: Contrary to POGO's allegations, our recent actions regarding STRAC meetings are designed to improve the effectiveness of the partnership.

In a recent meeting in Alaska, MMS announced to its State and Tribal compliance partners that we will be working on improving the effectiveness of our joint meetings. The MMS will fund one national meeting annually at a central location, as well as regional and topical meetings. The national meeting will address issues common to all states and Tribes. Numerous members of STRAC, in various discussions with MMS, have indicated support regarding these changes.

Regional and topical meetings will focus on issues specific to a given region of the country. These meetings will provide additional benefits to all parties and enhance communication among MMS and the delegations. States and Tribes have also requested training on specific issues which are difficult to address in a national meeting, but will be an integral part of our regional sessions. For example, once the final rule implementing the geothermal provisions of the Energy Policy Act of 2005 is published, MMS will hold a topical meeting with those States that have Federal geothermal production to provide training on the rule and to coordinate our compliance efforts. Discussing this topic at a national meeting is not productive when very few States and, no Tribes are affected. An additional advantage of holding meetings in the Region or in State and Tribal offices is that it will offer more State and Tribal employees the ability to participate in these sessions and minimize travel costs.

Scheduling one meeting of all State and Tribal audit managers per year will make the meetings more efficient and less time consuming, while preserving taxpayer dollars. The cost of a full STRAC meeting is approximately \$50,000. The MMS funds all meetings for all participants. The MMS will continue its practice of coordinating with State and Tribal delegations in preparing the agenda. Our decision to restructure the type and number of MMS/STRAC meetings to include regional and topical sessions was based on sound business principles. It will strengthen the compliance and audit program, encourage more open communication with States and Tribes, and reduce costs. We will continue to work closely with States and Tribal delegations to ensure that a robust and aggressive compliance and audit program collects the correct amount of royalties due from energy production that occurs on Federal and Tribal lands.

Also, STRAC does not speak for the States and Tribes, collectively, as a committee. This is confirmed by our experience in consulting with the STRAC organization for input and participation on teams regarding compliance, valuation, or system issues, etc. The STRAC members have consistently asserted that their input only represents the views of their respective state or tribe.

September 27, 2006

Question 1): Your statistics on collections as a result of both auditing and compliance, though up noticeably in 2005, are still well below the levels that were typical through out the 1990's. The CRS has statistics going back to 1989. From 1989 through 2001, there were only two years in which collection were comparable to the \$79 million collected in 2005. What explains the plunge in collections after 2001?

Answer: MMS carries out a comprehensive and aggressive compliance program designed to ensure industry compliance with mineral revenue laws, regulations, and lease terms. The compliance program includes both audits and compliance reviews and often results in additional mineral revenue collections as the result of orders to pay, judgments, and settlements. Following is a recap of compliance collections for the past 10 years:

Compliance Program Collections (\$millions)

	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05
Audits	\$40	\$40	\$85	\$115	\$157	\$65	\$37	\$25	\$19	\$17
Compliance Reviews and other Compliance Activities	\$33	\$39	\$55	\$74	\$174	\$132	\$7	\$11	\$13	\$62
Total	\$73	\$79	\$140	\$190	\$331	\$197	\$45	\$37	\$32	\$79

Note: The table above represents compliance collections for FY 1996 through FY 2005, recorded as of February 2006. The MMS recently redesigned and enhanced the data base it uses to track audit and compliance collections. During the redesign of the system we were unable to enter more recent collection statistics, thereby creating a backlog of collection statistics that still need to be entered into the system. The MMS has redirected resources to clear up the backlog. The elimination of the backlog will increase MMS' collection statistics particularly for periods after 2001 when the backlog occurred as a result of the system redesign.

The amounts of additional revenues MMS collects as the result of compliance activities tend to fluctuate year to year. In most cases the collections applicable to compliance activity in one year will be reflected one or more years later, depending on whether the cases were resolved by voluntary payment, litigation, or settlement.

The most dramatic fluctuation in collections occurred during the FY 1998-2001 timeframe. This spike resulted from resolution of lawsuits against major integrated oil and gas companies for undervaluation of crude oil and natural gas. Settlements during that time period accounted for more than \$400 million.

MMS' goal is to see a gradual decline in compliance collections year- to- year as companies increase their voluntary compliance. This is not a reflection of reduced rigor of the compliance program, but rather an indication that the deterrent effect is working. The major reasons for improved compliance are as follows:

- **Clearer regulations** - MMS has made significant progress in developing and implementing clearer regulations, eliminating much uncertainty and ambiguity that previously resulted in major findings. For example, oil sales from Federal leases between affiliated companies (i.e., non-arm's-length transactions) are now valued using the New York Mercantile Exchange index price. This is a more transparent and objective way to value the product and avoid extensive conflicts over previous complex valuation approaches, thereby reducing the findings and collections that would have otherwise occurred.
- **Royalty in Kind (RIK)** - MMS is receiving an increasing percentage of revenues through its RIK program, thereby eliminating the valuation issues that previously resulted in major findings. During FY 2001, for example, MMS took about 34 percent of its offshore crude oil and 14 percent of its offshore natural gas in-kind. In contrast, in FY 2005 MMS took about 80 percent of its offshore crude oil and 30 percent of its offshore natural gas in-kind.
- **More effective compliance strategies** - Compliance reviews have allowed MMS to cover more properties than were possible using audits alone, thereby increasing the deterrent effect. This increased presence encourages companies to be more vigilant about proper reporting and payment. These changes account for the increased collections in FY 2005 when the effects of the new procedures that were fully implemented in 2003 are recognized in additional collections.
- **Formal reporting and payment agreements** - As a result of the lawsuits filed by MMS and DOJ, many lessees are proactively seeking certainty in their methodology for valuing future production from Federal and Indian leases. MMS may enter into a future valuation agreement with a company as long as the agreement provides fair market value and is consistent with the regulations. MMS reviews any such agreement on a routine basis to ensure that it continues to provide fair market value.

Question 2): What specific cases has MMS resolved in the past three years? Which companies were involved, and for how much money?

Answer: MMS uses a variety of tools in the conduct of its compliance business and any one of these tools may result in the identification of a potential underpayment issue. MMS and the lessee may resolve the potential underpayment issue at any stage in the process. The lessee may agree with MMS and pay when the issue is identified. The lessee may disagree with MMS' position and MMS will issue a demand to the lessee. At the demand stage, the lessee has the right to appeal the demand to the MMS Director, with a further appeal to the Interior Board of Land Appeals (IBLA) if the lessee does not agree with the MMS Director's decision. Following a decision of IBLA, the lessee may seek review in Federal court.

Over the last three years, MMS has aggressively pursued and resolved several significant issues. Examples include:

Coal bed Methane Treating Costs - The MMS pursued the issue of disallowing the costs of transporting and removing excess carbon dioxide from natural gas produced from coal seams. This issue involves more than \$100 million for all of the lessees in the San Juan Basin area of New Mexico and Colorado. In the past three years, we collected \$22 million from Conoco-Phillips and reached an agreement in principle for several million dollars with two other large producers. Recently, we prevailed in court on this issue against BP Amoco and are determining the amount owed by that company.

Sales to Affiliates - Another significant issue that MMS pursued involved the valuation of gas sold to wholly-owned or wholly-commonly owned affiliates. The MMS issued numerous orders to companies for underpayment of Federal and Indian royalties for failure to pay on the gross proceeds accruing to the lessee and its affiliate. While some companies complied with those orders, several appealed those orders through the administrative process and ultimately to court. The MMS collected \$46 million from Shell on this issue. In one particular case involving Fina, the U.S. Court Of Appeals for the District of Columbia ruled against MMS' position that a wholly-owned, or wholly-commonly-owned, affiliate's resale prices were a proper measure of the gross proceeds accruing to the lessee under MMS' valuation regulations. Because of the Appeals Court's ruling, MMS must apply this decision to all similar cases involving sales to affiliates.

Sales to Joint Venture Purchasers – MMS pursued underpayment of natural gas royalties from sales by natural gas producers to joint venture purchasers (cases where the lessee owns less than 50 percent of its purchaser). The MMS aggressively pursued higher values than the prices reported by the several lessees including Oryx, Apache, Mobil, Vastar, and Chevron. In the first case in the Department's administrative process, the IBLA ruled in Vastar's favor; therefore, what MMS viewed as a non-arm's-length contract, was found to be arm's-length by the IBLA. The MMS is looking at each individual case to determine how the IBLA's guidance should apply.

Indian Pricing Provisions - Since the inception of the Indian gas rule, which was effective on January 1, 2000, MMS through its compliance efforts identified and collected nearly \$15 million in additional royalties from several companies for failure to comply with the pricing provisions contained in Indian leases.

Deepwater Royalty Relief – We have issued numerous orders, totaling more than \$140 million, to companies who improperly claimed royalty relief when price thresholds were exceeded. We have collected several million dollars to date; many companies are appealing those orders.

Question 3): It is my understanding that some of the biggest collections of underpayments in the last couple of years came after the Inspector General joined in with qui tam suits brought by outsiders. The IG alluded to this in its 2004 report on "Management Challenges" when it mentioned a \$49 million settlement as a result of its investigation "with assistance from MMS." What company was involved in that \$49

million settlement? Did the case originate as a qui tam case? Why would MMS need to wait for a qui tam suit to chase a big underpayment?

Answer: Following are the facts in this case:

- The company involved was Shell Oil Company.
- **This case was initiated by MMS;** it neither originated from nor became a qui tam case. In 1998, MMS personnel observed flaring at Shell's Platform Auger in the Gulf of Mexico, pursued the matter with Shell and learned that some 6 million cubic feet of gas per day was being flared and vented from that platform without the required MMS authorization. MMS also learned that six other Shell platforms were doing likewise, each in amounts exceeding 50,000 cubic feet per day.
- Minerals Revenue Management's Office of Enforcement promptly issued Shell a \$21.4 million civil penalty for knowing or willful false reporting; i.e., failure to report the flared or vented gas on its monthly production reports.
- MMS also notified the Office of Inspector General (OIG) of the false statement violations which could be prosecuted under Title 18 (U.S. Criminal Code). OIG opened a criminal/false claim investigation of the matter, and the U.S. District Court for the Western District of Louisiana accepted the case for potential prosecution.
- Shell quickly paid \$1.7 million for royalties on the gas at issue and installed the equipment necessary to curtail the unauthorized flaring and venting.
- Shell requested a hearing on the civil penalty.
- A negotiating team headed by MMS that included the U.S. Attorney's Office, and OIG representatives reached agreement with Shell to resolve the dispute. Shell agreed to pay \$49 million, less a credit for the royalties paid, to resolve the civil penalty issued for false reporting, potential penalties for offshore regulatory violations, and any false claim liabilities. In 2003, the Court approved the settlement and dismissed the case.
- No similar violations have since been identified.
- Contrary to your stated understanding in this question, the OIG does not "join in *qui tam* suits brought by outsiders." The OIG is not a relator under the False Claims Act and does not join relators who bring actions under that statute. Most relators are private individuals who possess, or allegedly possess, information that a Federal agency such as MMS does not. *See, e.g., U.S. ex rel. Fine v. Chevron, U.S.A., Inc.*, 72 F.3d 740, 742 (9th Cir. 1995). MMS does not "wait for a *qui tam* suit to chase a big underpayment," as your question expressed it. MMS will

pursue underpayments it learns about, whether through audits or other means, consistent with agency enforcement policies.

Question 4): What are the procedures under which MMS auditors obtain subpoenas for internal company documents and data? How many subpoenas has MMS issued in the past three years? In his qui tam suit against Kerr-McGee, former MMS solicitor Bobby Maxwell says that it became virtually impossible for auditors to get approval for a subpoena, which in turn made it extremely difficult to document underpayments. In the past, he contends, auditors routinely used subpoenas and succeeded in recovering large sums of money.

Answer:

- MMS has used administrative subpoenas in the past to enforce document production; however, we have not found them to be a very effective enforcement tool. Enforcement of subpoenas by the courts can take years and be very costly. Further, because lessees have the right to file for judicial review of the subpoena, the acquisition of the documents is delayed pending appeal. So, MMS has not issued any subpoenas in the past 3 years.
- Instead, MMS has had much greater success in obtaining documents from companies by issuing requests for documents and then issuing a Notice of Noncompliance if the lessee fails to comply with the request. The Federal Oil and Gas Royalty Management Act of 1982 provides civil penalties of as much as \$10,000 per day for knowing or willful failure to cooperate with an audit.
- Under this alternative, the company risks the accrual of civil penalties for failing to provide the documents. A lessee has the right to request a hearing on the record for the Notice of Noncompliance, but civil penalties will still accrue. Thus, this is considered a more effective means of securing the needed documents than a subpoena.
- Due to MMS' unquestioned authority to request and receive documents in support of an audit, companies generally comply with document requests. In fact, during the last three years, only six companies received a civil penalty assessment or warning of such action to promptly provide audit information. Two of those cases are currently being investigated and the remainder has complied.
- MMS has trained its compliance staff as well as the State and Tribal auditors in how to initiate the enforcement process.
- As a further note, Mr. Maxwell is not a "former MMS solicitor." Mr. Maxwell is not a lawyer and has never been employed by the Solicitor's Office.

Question 5): The Maxwell case against Kerr-McGee may be coming to trial in late November. Evidence produced through discovery strongly supports his claim that Kerr-

McGee received a below-market price for oil, thus allowing it to underpay royalties, by selling to Texon in exchange for Texon picking up a substantial amount of Kerr-McGee's marketing and administrative cost.

Mr. Maxwell contends the issue is fairly straightforward. Indeed, the state of Louisiana brought its own case against Kerr McGee over the same issues on state territory, and Louisiana won a court verdict for nearly \$2 million. Why did MMS order Mr. Maxwell to drop the case, and why did it refuse to join his *qui tam* case?

Answer: MMS and the Department of Justice investigated and analyzed Mr. Maxwell's claim, and the United States declined to intervene in the *qui tam* lawsuit that Mr. Maxwell brought under the False Claims Act (*U.S. ex rel. Maxwell v. Kerr-McGee Chemical Worldwide, LLC*, No. 04-F-1224 (D. Colo.)). Because that litigation is currently pending, we cannot comment on the merits of the case or the legal theories on which Mr. Maxwell's claim is founded. Your assertion that "Evidence produced through discovery strongly supports his claim" remains to be determined by the court.

Question 6): Several states and many private landowners have successfully litigated against energy companies over underpayment of royalties or severance taxes as a result of non-arms-length deals between wellhead producers and processing plants. New Mexico sued Chevron over the issue and won a \$2 million court. New Mexico is now pursuing a spate of similar suits on the same issue against Chevron (more recent time period) and other gas producers. Private landowners have won several big settlements involving similar allegations of improper price-shifting between producers and affiliated processing plants (*Shockey v. Chevron*, \$60 million settlement; *Dichter v. Conoco-Phillips*, \$29 million).

Has MMS pursued similar cases over Federal royalties? Has it recovered significant underpayments as a result? Is it pursuing any such cases now?

Answer: We are not aware of the facts surrounding the cases to which you refer, but we have pursued underpayment of Federal and Indian royalties involving sales between producers and affiliate purchasers. As discussed in the answer to Question 2), MMS issued numerous orders to companies for underpayment of Federal and Indian royalties for failure to pay on the gross proceeds accruing to the lessee and its affiliate. While some companies complied with those orders, several appealed those orders through the administrative process and ultimately to court. MMS collected \$46 million from Shell on this issue as a result of settlement.

Subsequently, the U.S. Court Of Appeals for the District of Columbia ruled against MMS' position that a wholly-owned, or wholly-commonly-owned, affiliate's resale prices were a proper measure of the gross proceeds accruing to the lessee under MMS' valuation regulations. In the Vastar case, the IBLA ruled that MMS' view that there were no opposing economic interests between the lessee and its joint venture affiliate purchaser was not supported.

It is important to note that MMS is bound to follow its regulations and statutes, which set forth the valuation requirements for Federal and Indian leases. Often the requirements of State and private leases are different than the requirements established by the Federal statute, lease terms, and regulations. Therefore, it is not uncommon that States and private landowners may pursue, and prevail, on issues that MMS does not.

Question 7): According to a letter last week to Ms. Burton from five House lawmakers, led by Rep. Carolyn Maloney of New York, MMS is severely restricting the activities of the State and Tribal Royalty Audit Committee (STRAC). The letter contends that this action is the result of “retaliation” against STRAC because it criticized MMS’ auditing and enforcement actions. Is this true? If not, why would you oppose this forum of experts for sharing ideas and insights about complex enforcement issues?

Answer: In a recent meeting in Alaska, MMS announced to its state and tribal compliance partners that we will be working on improving the effectiveness of our joint meetings. The MMS will fund one national meeting annually at a central location, as well as regional and topical meetings as required. The national meeting will address issues common to all states and tribes.

Scheduling one meeting of all state and tribal audit managers per year will make the meetings more efficient and less time consuming while preserving taxpayer dollars. The cost of a full STRAC meeting is approximately \$50,000. MMS funds all meetings for all participants. The MMS will continue its practice of coordinating with state and tribal delegations in preparing the agenda. This action is not the result of “retaliation.”

Regional and topical meetings will focus on issues specific to a given region of the country. These meetings will provide additional benefits to all parties and enhance communication among MMS and the delegations. States and tribes have also requested training on specific issues which are difficult to address in a national meeting, but will be an integral part of our regional sessions. For example, once the final rule implementing the geothermal provisions of the Energy Policy Act of 2005 is published, MMS will hold a topical meeting with those States that have Federal geothermal production to provide training on the rule and to coordinate our compliance efforts. Discussing this topic at a national meeting is not productive when very few States and no Tribes are affected. An additional advantage of holding meetings in the region or in state and tribal offices is that it will offer more state and tribal employees the ability to participate in these sessions and minimize travel costs.

Our decision to restructure the type and number MMS/STRAC meetings, to include regional and topical sessions was based on business reasons. We believe it will strengthen the compliance and audit program, encourage more open communication with states and tribes, and reduce costs. We will continue to work closely with states and tribal delegations to ensure that a robust and aggressive compliance and audit program collects the correct amount of royalties due from energy production that occurs on Federal and tribal lands.

Question 8): Besides Bobby Maxwell, have any other current MMS auditors or enforcement officials filed their own *qui tam* suits against energy companies for underpayment of royalties?

Answer: Yes, on September 15, 2006, the DOI was notified of 4 more *qui tam* cases filed by 3 MMS auditors.

Under 31 U.S.C. § 3730(b)(2), MMS may not reveal the existence of any *qui tam* case filed by any relator that is under court seal. Any unsealed *qui tam* cases would be a matter of public record.