

**OVERSIGHT OF THE MINERALS MANAGEMENT
SERVICE'S ROYALTY VALUATION PROGRAM**

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION, AND TECHNOLOGY

OF THE

COMMITTEE ON
GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

—————
MAY 19, 1999
—————

Serial No. 106-90

Printed for the use of the Committee on Government Reform



Available via the World Wide Web: <http://www.gpo.gov/congress/house>
<http://www.house.gov/reform>

—————
U.S. GOVERNMENT PRINTING OFFICE

62-931 CC

WASHINGTON : 2000

COMMITTEE ON GOVERNMENT REFORM

DAN BURTON, Indiana, *Chairman*

BENJAMIN A. GILMAN, New York	HENRY A. WAXMAN, California
CONSTANCE A. MORELLA, Maryland	TOM LANTOS, California
CHRISTOPHER SHAYS, Connecticut	ROBERT E. WISE, Jr., West Virginia
ILEANA ROS-LEHTINEN, Florida	MAJOR R. OWENS, New York
JOHN M. McHUGH, New York	EDOLPHUS TOWNS, New York
STEPHEN HORN, California	PAUL E. KANJORSKI, Pennsylvania
JOHN L. MICA, Florida	PATSY T. MINK, Hawaii
THOMAS M. DAVIS, Virginia	CAROLYN B. MALONEY, New York
DAVID M. McINTOSH, Indiana	ELEANOR HOLMES NORTON, Washington, DC
MARK E. SOUDER, Indiana	CHAKA FATTAH, Pennsylvania
JOE SCARBOROUGH, Florida	ELIJAH E. CUMMINGS, Maryland
STEVEN C. LATOURETTE, Ohio	DENNIS J. KUCINICH, Ohio
MARSHALL "MARK" SANFORD, South Carolina	ROD R. BLAGOJEVICH, Illinois
BOB BARR, Georgia	DANNY K. DAVIS, Illinois
DAN MILLER, Florida	JOHN F. TIERNEY, Massachusetts
ASA HUTCHINSON, Arkansas	JIM TURNER, Texas
LEE TERRY, Nebraska	THOMAS H. ALLEN, Maine
JUDY BIGGERT, Illinois	HAROLD E. FORD, Jr., Tennessee
GREG WALDEN, Oregon	JANICE D. SCHAKOWSKY, Illinois
DOUG OSE, California	-----
PAUL RYAN, Wisconsin	BERNARD SANDERS, Vermont (Independent)
JOHN T. DOOLITTLE, California	
HELEN CHENOWETH, Idaho	

KEVIN BINGER, *Staff Director*

DANIEL R. MOLL, *Deputy Staff Director*

DAVID A. KASS, *Deputy Counsel and Parliamentarian*

CARLA J. MARTIN, *Chief Clerk*

PHIL SCHILIRO, *Minority Staff Director*

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION, AND TECHNOLOGY

STEPHEN HORN, California, *Chairman*

JUDY BIGGERT, Illinois	JIM TURNER, Texas
THOMAS M. DAVIS, Virginia	PAUL E. KANJORSKI, Pennsylvania
GREG WALDEN, Oregon	MAJOR R. OWENS, New York
DOUG OSE, California	PATSY T. MINK, Hawaii
PAUL RYAN, Wisconsin	CAROLYN B. MALONEY, New York

EX OFFICIO

DAN BURTON, Indiana

HENRY A. WAXMAN, California

J. RUSSELL GEORGE, *Staff Director and Chief Counsel*

BONNIE HEALD, *Director of Communications*

MASON ALINGER, *Clerk*

FAITH WEISS, *Minority Counsel*

CONTENTS

	Page
Hearing held on May 19, 1999	1
Statement of:	
Kladiva, Susan, Associate Director, Energy, Resources, and Science Issues, Resources, Community, and Economic Development Division, U.S. General Accounting Office; Sylvia Baca, Acting Assistant Sec- retary for Land and Minerals Management, U.S. Department of the Interior; Lucy Querques Denett, Associate Director, Royalty Manage- ment Program; Robert Williams, Acting Inspector General, U.S. De- partment of the Interior; and John Sinclair, Assistant Inspector Gen- eral, U.S. Department of the Interior	142
McCabe, James, deputy city attorney, city of Long Beach, CA; Alan Taradash, attorney at law, Nordhaus, Haltom, Taylor, Taradash & Frye, LLP, Albuquerque, NM; David Deal, assistant general counsel, American Petroleum Institute; and Ben Dillon, vice president, Inde- pendent Petroleum Association of America	32
Letters, statements, et cetera, submitted for the record by:	
American Petroleum Institute, the Independent Petroleum Association of America, the Domestic Petroleum Council, and the U.S. Oil and Gas Association, prepared statement of	61
Baca, Sylvia, Acting Assistant Secretary for Land and Minerals Manage- ment, U.S. Department of the Interior, prepared statement of	157
Davis, Hon. Thomas M., a Representative in Congress from the State of Virginia:	
Letter dated February 12, 1999	14
Prepared statement of	21
Horn, Hon. Stephen, a Representative in Congress from the State of California:	
Flow of royalty chart	192
Letter dated May 19, 1999	133
Prepared statement of	3
Kladiva, Susan, Associate Director, Energy, Resources, and Science Issues, Resources, Community, and Economic Development Division, U.S. General Accounting Office:	
Information concerning an automated system	190
Information concerning management of the Indian trust	190
Prepared statement of	145
Maloney, Hon. Carolyn B., a Representative in Congress from the State of New York:	
Information concerning oil settlements	122
Letter dated February 26, 1997	6
Prepared statement of	11
McCabe, James, deputy city attorney, city of Long Beach, CA, prepared statement of	34
Taradash, Alan, attorney at law, Nordhaus, Haltom, Taylor, Taradash & Frye, LLP, Albuquerque, NM, prepared statement of	39
Turner, Hon. Jim, a Representative in Congress from the State of Texas, prepared statement of	29
Williams, Robert, Acting Inspector General, U.S. Department of the Inter- ior, prepared statement of	173

OVERSIGHT OF THE MINERALS MANAGEMENT SERVICE'S ROYALTY VALUATION PROGRAM

WEDNESDAY, MAY 19, 1999

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION, AND TECHNOLOGY,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2247, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn, Davis, Turner, and Maloney.

Staff present: J. Russell George, staff director and chief counsel; Randy Kaplan, counsel; Bonnie Heald, director of communications; Mason Alinger, clerk; Faith Weiss, minority counsel; and Earley Green, minority staff assistant.

Mr. HORN. The House Subcommittee on Government Management, Information, and Technology will come to order. Today we will look at the Department of the Interior's management of the collection, valuation and distribution of revenues, or royalties, from oil produced on Federal lands.

The Federal Government has been collecting royalties associated with mineral production on Federal onshore lands since 1920 and from offshore lands since 1953.

The Minerals Management Service, an agency within the Department of the Interior, was established in 1982. The agency, through its Royalty Management Program, ensures that all royalties from Federal and Indian mineral leases are accurately collected, accounted for, and disbursed to the appropriate recipients in a timely manner.

Royalties from oil and gas leases on Federal lands are one of the largest sources of nontax revenues for the Federal Government. According to the Minerals Management Service, since 1982, nearly \$100 billion has been disbursed from Federal onshore and offshore leases. In fiscal year 1998, for example, the Royalty Management Program generated nearly \$6 billion from more than 26,000 mineral leases. Of that amount, \$550 million was distributed to the States and used for schools, roads, and public buildings.

Given the significance of this program, on June 17, 1996, this subcommittee held a hearing to examine whether the government was receiving a fair return from oil leases on Federal lands. The subcommittee heard from witnesses who testified that between

1978 and 1993, oil companies had underpaid royalties on crude oil by as much as \$856 million. We also learned that the Minerals Management Service was not sufficiently addressing this problem.

Concerns were raised that the Minerals Management Service had delayed collecting oil royalty revenues and had entered into global settlements with oil companies that failed to protect the financial interests of the Federal Government and the American taxpayer.

In response to recommendations from an interagency task force convened by the Department of the Interior to study the undervaluation issue, in 1995 the Minerals Management Service began an effort to revise its oil valuation regulations. Currently oil values for royalty purposes are based on gross proceeds or a series of benchmarks depending on whether or not the oil is sold in an arm's-length transaction. "At arm's-length" refers to oil that is bought and sold by parties with competing economic interests, and the price paid establishes a market value for the oil.

Transactions that are not at arm's length typically involve a transfer of oil between companies that have both production and refining capabilities. The price of oil in these transactions is often a price posted by the buyer, who is often an affiliated subsidiary of the seller. There is concern that these posted prices tend to be below fair market value.

Since 1995, the Minerals Management Service has held at least 17 public workshops and meetings across the country; received over 4,000 pages of comments from interested parties; and reopened the comment period at least seven different times.

On two occasions in 1998, Congress passed legislation temporarily delaying the implementation of a final rule. Congress attached a third continuance to this year's emergency supplemental appropriations bill that passed the House of Representatives on Tuesday. We are having a hard time nailing this one down.

Today we will hear from a number of experts on the issue. We will examine whether the Minerals Management Service has been effective in obtaining a fair return from oil-producing leases on Federal lands. We will also ask whether the existing rulemaking process can result in a regulation that simplifies the process, minimizes disputes and ensures a fair return for the American taxpayer.

We welcome our panelists, and we look forward to their testimony.

[The prepared statement of Hon. Stephen Horn follows:]

DAN BURTON, INDIANA
 CHAIRMAN
 BENJAMIN A. GELMAN, NEW YORK
 CONSTANCE A. MIRELLA, MARYLAND
 CHRISTOPHER SHAYS, CONNECTICUT
 ELIANA ROSS-LEHTINEN, FLORIDA
 JOHN M. MANCINI, NEW YORK
 STEPHEN HORN, CALIFORNIA
 JOHN L. NICK, FLORIDA
 THOMAS H. DAVIS III, VIRGINIA
 YVIE H. WHITFISH, INDIANA
 ARK E. SOUDER, INDIANA
 JOE SCARBOROUGH, FLORIDA
 STEVEN C. LA TOURETTE, OHIO
 MARSHALL HARRIS, CHARLOTTE, SOUTH CAROLINA
 BOB BARR, GEORGIA
 DAN MILLER, FLORIDA
 ASH HUTCHINSON, ARKANSAS
 LEE TERRY, NEBRASKA
 JULY ROBERT, ILLINOIS
 OREG WALDEN, OREGON
 SCOTT LEE, CALIFORNIA
 PAUL RYAN, WISCONSIN
 JOHN T. DODDLE, CALIFORNIA
 HELEN CHENOWETH, IOWA

ONE HUNDRED SIXTH CONGRESS

Congress of the United States
House of Representatives

COMMITTEE ON GOVERNMENT REFORM
 2157 RAYBURN HOUSE OFFICE BUILDING
 WASHINGTON, DC 20515-6143

MAJORITY (202) 225-5074
 MINORITY (202) 225-5051
 TTY (202) 225-0922

HENRY A. WADSWAN, CALIFORNIA
 HARVEY MANDRY, MEMBER
 TOM LANTOS, CALIFORNIA
 ROBERT E. WISE, JR., WEST VIRGINIA
 ALBIO P. DUNNE, NEW YORK
 EDOLPHUS TOWNES, NEW YORK
 PAUL E. HANCOCK, PENNSYLVANIA
 PATSY T. MINK, HAWAII
 CHRISTY B. BRADLEY, NEW YORK
 ELEANOR HOLMES NORTON
 DISTRICT OF COLUMBIA
 CHAKA FATTEH, PENNSYLVANIA
 ELLIOTT E. LEMBERG, MARYLAND
 DENNIS J. RUCINSKI, OHIO
 ROD R. BLAGOJEVICH, ILLINOIS
 DENNIS P. DAVIS, ILLINOIS
 JOHN F. TIERNEY, MASSACHUSETTS
 JIM BURRIS, TEXAS
 THOMAS H. ALLEN, MAINE
 HAROLD H. FORD, JR., TENNESSEE
 JANICE D. SCHAKOWSKY, ILLINOIS

BERNARD SANDERS, VERMONT,
 INDEPENDENT

**“Oversight of the Minerals Management Service’s
 Royalty Valuation Program”**
 CHAIRMAN STEPHEN HORN (R-CA)
 OPENING STATEMENT
 May 19, 1999

A quorum being present, the hearing of the House Subcommittee on Government Management, Information and Technology will come to order. Today, we will look at the Department of the Interior’s management of the collection, valuation and distribution of revenues – or royalties – from oil produced on Federal lands.

The Federal Government has been collecting royalties associated with mineral production on Federal onshore lands since 1920, and from offshore lands since 1953.

The Minerals Management Service, an agency within the Department of the Interior, was established in 1982. The agency – through its Royalty Management Program – ensures that all royalties from Federal and Indian mineral leases are accurately collected, accounted for, and disbursed to the appropriate recipients in a timely manner.

Royalties from oil and gas leases on Federal lands are one of the largest sources of non-tax revenues for the Federal Government. According to the Minerals Management Service, since 1982, nearly \$100 billion dollars has been disbursed from Federal onshore and offshore leases. In fiscal year 1998, for example, the Royalty Management Program generated nearly \$6 billion dollars from more than 26,000 mineral leases. Of that amount, \$550 million dollars was distributed to the States and used for schools, roads, and public buildings.

Given the significance of this program, on June 17th, 1996, this subcommittee held a hearing to examine whether the Government was receiving a fair return from oil leases on Federal lands. The subcommittee heard from witnesses who testified that between 1978 and 1993, oil companies had underpaid royalties on crude oil by as much as \$856 million dollars. We also learned that the Minerals Management Service was not sufficiently addressing this problem.

Concerns were raised that the Minerals Management Service had delayed collecting oil royalty revenues and had entered into global settlements with oil companies that failed to protect the financial interests of the Federal Government and the American taxpayer.

In response to recommendations from an interagency task force, convened by the Department of the Interior to study the undervaluation issue, in 1995 the Minerals Management Service began an effort to revise its oil valuation regulations. Currently, oil values for royalty purposes are based on gross proceeds or a series of benchmarks depending on whether or not the oil is sold in an arm’s-length transaction. “At arm’s-length” refers to oil that is bought and sold by parties with competing economic interests, and the price paid establishes a market value for the oil.

Transactions that are not at arm's length typically involve a transfer of oil between companies that have both production and refining capabilities. The price of oil in these transactions is often a price posted by the buyer who is often an affiliated subsidiary of the seller. There is concern that these posted prices tend to be below fair market value.

Since 1995, the Minerals Management Service has held at least 17 public workshops and meetings across the country; received over 4,000 pages of comments from interested parties; and reopened the comment period at least seven different times.

On two occasions in 1998, Congress passed legislation temporarily delaying the implementation of a final rule. Congress attached a third continuance to this year's Emergency Supplemental Appropriations bill that passed the House of Representatives on Tuesday. We are having a hard time nailing this one down.

Today, we will hear from a number of experts on this issue. We will examine whether the Minerals Management Service has been effective in obtaining a fair return from oil producing leases on Federal lands. We will also ask whether the existing rule-making process can result in a regulation that simplifies the process, minimizes disputes and ensures a fair return for the American taxpayer.

We welcome our panelists, and look forward to their testimony.

Mr. HORN. I am now delighted to yield time for an opening statement to the gentlewoman from New York, Mrs. Maloney, who took a very active interest in the preceding hearing 3 years ago, and we are delighted to have her with us today. Mrs. Maloney.

Mrs. MALONEY. Thank you so much, Mr. Chairman, and I thank you very much for holding that hearing 3 years ago and for today's hearing and for your fine leadership on this and so many issues.

As you know, this is the second hearing in 3 years that this subcommittee has held on the issue of the Minerals Management Service's royalty valuation program. Our first hearing held back in 1996 explored allegations of undervaluation of oil by several major oil companies and MMS's efforts to collect the full amount of royalties that were owed to the American taxpayer.

Since that time much has changed. MMS has finally decided that a new oil valuation rule was necessary in order to prevent big oil companies from continuing to rip off the American taxpayer. The Justice Department decided that the allegations against many of these oil companies were so strong and significant that it intervened in a lawsuit alleging that companies had violated the False Claims Act by deliberately undervaluing oil produced on Federal lands as a means of avoiding royalty payments to the Federal Government.

As a result, one company, Mobil, decided to settle with the government and paid \$45 million. Numerous other companies have settled similar claims brought by States and private royalty owners for millions and, in one case, billions of dollars; and finally, those same oil companies that vigorously defended posted prices as a legitimate means of determining oil value have begun to admit that posted prices are not the issue and are finally negotiating with the Department on a new rule. But as much as things have changed, I am not sure if we have really made much progress.

When I was preparing for this hearing, I came across a letter that I had almost forgotten about, but I think it is very relevant to this issue before us. It is a letter dated 2 years ago, February 26, 1997, and I would like to put it in the record.

Mr. HORN. Without objection, it will be put in the record at this point.

[The information referred to follows:]

PAT S. HOLLOWAY
Attorney and Counselor
105 E. AUSTIN, SUITE 204
P. O. Box 56 GIDDINGS, TEXAS 78942

Office: (409) 542-4061

Fax: (409) 542-4179

February 26, 1997

Mr. Bob Armstrong
Assistant Secretary, Land and Minerals Management
United States Department of the Interior
Washington, D.C. 20240

Re: API and IPAA Opposition to Proposed Oil Valuation
Regulations

Dear Mr. Armstrong:

On February 20, 1997, I attended by telephone an open, 3-1/2 hour meeting of the IPAA's valuation task force. I did so at the request of my client, Gene Wright, an active member of the IPAA and a former member of its Executive Committee. He had been invited to attend or have a representative present. Although this was an IPAA meeting, lawyers and lobbyists representing Chevron, Amoco, Conoco and other major oil companies attended.

At the meeting it was reported that the major oil companies' CEOs' Club had just met and decided that the API must become active in opposing the proposed new market value oil royalty valuation regulations.

Every oil producer, without any question, has an unrestricted right to oppose the government's proposal on its own behalf, on any grounds it deems appropriate. But it would appear to be a violation of the antitrust laws for the chief executive officers of the major oil companies to meet and combine (i.e., conspire) among themselves to try to keep federal royalty oil prices depressed below market values. That is the only possible purpose to be served by combined opposition, in the name of the API, to the proposed market value pricing regulations.

The strategy discussed at the meeting was to seek to delay the proposed regulations as long as possible, and then file suit in the name of the IPAA ("another IPAA v. Rabbitt case") to prevent them from becoming effective on whatever procedural (not substantive) grounds are available. It was suggested that the IPAA-API should consult with the tobacco industry on legal tactics, since that industry has so much more experience in litigating against government regulations than the oil industry.

The Chevron representative said he was attending the meeting to offer Chevron's financial support to the IPAA to delay and oppose the proposed market value regulations, on procedural, not substantive, grounds. On one or more occasions he said "he did not feel comfortable" with the discussions of pricing, a "substantive" matter, and he cautioned against portions of the agenda on pricing, mentioning that matters discussed here were not subject to the attorney-client or other privilege. He said some of the pricing matters on the agenda would best be taken up at a private meeting the following day.

The Chevron man said they were checking with their Democratic friends on the Hill to see if the recent statements by Senator Boxer (calling the major oil companies "deadbeats") and by Rep. Carolyn Maloney had somehow emanated from the White House, the DNC or Vice President Gore's office. (This seems an interesting manifestation of apparent paranoia. I wonder whether if I, a Republican, were able to prevail upon Bill Archer and John Kasich to support a federal production tax on Gulf OCS production equal to the Texas or Louisiana production taxes, in order to help pay for Medicare, Chevron would attribute the idea to a Machiavellian plot by the DNC or the White House?)

The Chevron man said the strategy would be to fund opposition, including litigation, against the proposed regulations in the name of IPAA, as representative of the "small producers," rather than in the name of the "giants." He said this could also provide "a forum for taking political initiatives." There was a whole series of meetings scheduled for that week and this week, including with members of Congress, to lay the groundwork for public support of litigation, and to coordinate the political and litigation aspects of the pricing problem.

There was mention of the fact that the Department of Justice had sent out more than 100 letters to different producers. There was speculation that a likely source of the DOJ list of such producers was some list Cynthia Quarterman must have, of the 125 producers she apparently mentioned, in Congressional testimony, whose royalty reports MMS would be examining for possible underpayments. I did not volunteer another possible explanation for the source of the DOJ list.

A representative of one of the majors present, Conoco I believe, mentioned it was meeting with Dodge Walls at the Justice Department the following week, and it was generally agreed that Dodge Walls must be "The Man" at the Justice Department in charge of royalty pricing matters. Someone mentioned that Shell had filed suit in federal court "in the Northern District of Oklahoma" to block subpoenas.

There was talk of using influence on the Appropriations Committee to block the expenditures needed to implement the proposed regulations. There seemed to be a consensus that there will be a coordinated FOIA request to DOI to obtain the underlying data, studies and information used by DOI in preparing the proposed regs, following a simple letter request for the information. Then there will probably be a federal suit to block the regulations on all procedural grounds devisable.

One of the female lawyers discussed the two meetings scheduled with Cynthia Quarterman the following week, the one on Tuesday to involve other matters besides pricing, but with the Wednesday afternoon meeting to be exclusively on royalty pricing, with Ms. Quarterman and her staff, including "Lucy." When there was a lot of trouble and noise on the conference call, and some of the participants were temporarily cut off, one of the ladies said, to general laughter, "that's Lucy," and I gather these ladies seem to think "Lucy" is one of the industry's main problems. (On behalf of my client, I felt somewhat slighted, but after hearing the discussion I know I would like to meet this mysterious bogey-woman).

Someone (either the IPAA or one or more of its members) has retained Attorney Marshall Doka with the law firm of Gardere & Wynne to advise the group on the False Claims Act. He was introduced as an expert on the False Claims Act, being a Past President of the ABA Section on the FCA and a life-long practitioner in the area of government contracts. (Before Doka began reading dull government contracts, when he was a younger associate of mine at the Thompson Knight firm in Dallas, he was expert at drinking beer and fair-to-middling at touch football).

The eminent Mr. Doka opined that "we think the government will file an FCA case if they think they can make it stick." He alluded to the fact that the FCA provides criminal as well as civil penalties, and he warned that even if the government can't make an FCA case stick, there is a False Statements Act that make any kind of false statement to the government actionable. Doka was careful not to make any false statements in his short speech, or to openly solicit further business in my possibly competitive presence.

I thought you might be interested in some of these matters. Enclosed is the agenda of the meeting. I am forwarding a copy of this letter to Mr. Dodge Wells.

Sincerely,

Pat S. Holloway

PSH:lw
cc w/ encl. Dodge Wells, Esq.
also to Ms. Quarterman + "Lucy"

Mrs. MALONEY. An attorney named Pat Holloway to Bob Armstrong, the Assistant Secretary of Land and Minerals Management. Mr. Holloway had the opportunity to participate in a meeting of the Independent Petroleum Association of America's valuation task force by phone where members of the IPAA, along with several lawyers and lobbyists representing Chevron, Amoco, Conoco and other major companies, discussed how they would fight Interior's efforts to collect the royalties that the taxpayers were owed, and I think it is very relevant, and I want it in the record, Mr. Chairman, because exactly the strategy which they outlined in this document or in this letter to stop the government from collecting the rightful amount owed, the market price owed to the taxpayers, to stop that so that the oil companies could continue ripping off the American public by undervaluing their oil.

And I quote from the letter,

The strategy discussed at the meeting was to seek to delay the regulations as long as possible, and then to file suit under the name of the independent petroleum—IPAA—independent producers, to prevent them from becoming effective on whatever procedural, not substantive—they literally write out, we are not going to fight them on substantive grounds, we are going to fight them on procedural grounds. It suggested that the IPAA/API should consult—this is the worst line—that they should consult with the tobacco industry on legal tactics since that industry has so much more experience in litigating against government regulations than the oil industry.

The letter goes on to explain how a representative from one major company, Chevron, offered to lend financial support to the IPAA to fight the proposed rule. It states, "the strategy would be to fund opposition, including litigation, against the proposed regulations in the name of the IPAA," the independents, "as representatives of the, 'small producers,' rather than in the name of the 'giants.'"

And the letter adds, "There was talk of using influence on the Appropriations Committee to block the expenditures needed to implement the proposed regulations." Well, they succeeded last night in blocking legislation on the floor coming out of Appropriations.

I must say that they picked a strategy, and they stuck to it, consulting with the tobacco industry, fighting the rule on procedural grounds, not substantial or substantive grounds, using the appropriations process to attach writers, blocking Interior from implementing the rule, avoid the real issue as much as possible and doing all of this in the name of the small producers, despite the fact that MMS has repeatedly stated over and over and over again that the independents will not be harmed by this rule. And so far it seems that the strategy is working, and even if the rule was implemented, they say, don't worry, we will just go to court and block them in court and continue to sue them so they can never do anything.

Yesterday some of my colleagues in the Senate held a hearing on proposed legislation that would amount to a massive giveaway to the oil industry. At that hearing supporters of the oil industry once again tried to take attention away from the real issue through yet another red herring, this time concerning alleged impropriety on the part of the Interior official who had nothing whatsoever to do with the rule.

And, Mr. Chairman, this type of attempt to divert attention from the real issue, I think, is shameless. I'd like to put in the record the article that appeared in Congress Daily—where is that article?

Mr. HORN. Without objection, it will be put in the record at this point.

Mrs. MALONEY. Where they—the acting head of MMS stated, “the employees did not work on the oil valuation change and, therefore, did not have a conflict.” That was his quote.

And I—I just have a very lengthy statement. I would like to put the entire thing—

Mr. HORN. Put it in as read, without objection.

Mrs. MALONEY [continuing]. Because I would like to hear what everyone has to say, unless you really want to hear my entire statement, Mr. Chairman.

Mr. HORN. We will take your word for it.

Mrs. MALONEY. Everybody like to hear my entire statement?

Mr. HORN. It will be in there as if you read it.

Mrs. MALONEY. I am afraid it would go on for another 10 or 20 minutes because I have a lot to say on this issue, but I would rather hear from the Members at hand, and I thank you for putting the statement in.

Mr. HORN. Thank you.

[The prepared statement of Hon. Carolyn B. Maloney follows:]



Congresswoman

14th District • New York

Carolyn Maloney

Reports

2430 Rayburn Building • Washington, DC 20515 • 202-225-7944
1651 Third Avenue • Suite 311 • New York, NY 10128 • 212-860-0606

**Opening Statement of the Honorable Carolyn B. Maloney
Subcommittee on Government Management, Information, and Technology
Hearing on Oversight of the Minerals Management Service's Royalty Valuation Program**

Mr. Chairman, I thank you for holding today's hearing, and for your leadership on this and so many other issues. As you know, this is the second hearing in three years that this subcommittee has held on the issue of the Minerals Management Service's Royalty Valuation Program. Our first hearing, held back in June of 1996, explored allegations of undervaluation of oil by several major oil companies and MMS's efforts – or lack thereof – to collect the full amount of royalties that were owed to the American taxpayer.

Since that time, much has changed. MMS finally decided that a new oil valuation rule was necessary, in order to prevent big oil companies from continuing to rip off the American taxpayer. The Justice Department decided that the allegations against many of these oil companies were so significant that it intervened in a lawsuit alleging that companies had violated the False Claims Act by deliberately undervaluing oil produced on federal lands as a means of avoiding royalty payments. As a result, one company, Mobil, decided to settle with the government, and paid forty-five million dollars. Numerous other companies have settled similar claims brought by states and private royalty owners for millions -- and in one case billions -- of dollars. And, finally, those same oil companies that vigorously defended posted prices as a legitimate means of determining oil value, have begun to admit that posted prices are not the issue, and are finally negotiating with the Department on a new rule.

But as much as things have changed, I am not sure if we have really made much progress. When I was preparing for this hearing, I came across a letter that I have almost forgotten about, but that I think is very relevant to the issue before us today. This is a letter dated February 26, 1997, from an attorney named Pat Holloway to Bob Armstrong, the Assistant Secretary for Land and Minerals Management. Mr. Holloway had the opportunity to participate, by telephone, in a meeting of the Independent Petroleum Association of America's valuation task force, where members of the IPAA, along with several lawyers and lobbyists representing Chevron, Amoco, Conoco, and other major companies, discussed how they would fight Interior's efforts to collect the royalties that the taxpayer is owed.

Let me read to you from that letter:

"The strategy discussed at the meeting was to seek to delay the proposed regulations as long as possible, and then file suit in the name of the *IPAA* . . . to prevent them from becoming effective on whatever procedural (not substantive) grounds are available. It was suggested that the IPAA-API should consult *with the tobacco industry* on legal tactics, since that industry has so much more experience in litigating against government regulations than the oil industry." (Italics added.)

The letter goes on to explain how a representative from one major company – Chevron – offered to lend financial support to the IPAA to fight the proposed rule. It states: "The strategy would be to fund opposition, including litigation, against the proposed regulations in the name of the IPAA, as representative of the 'small producers,' rather than in the name of the giants"

Finally, the letter adds: "There was talk of using influence on the Appropriations Committee to block the expenditures needed to implement the proposed regulations."

I really have to hand it to some of these companies: they picked a good strategy and stuck with it. Consulting with the tobacco industry. Fighting the rule on all procedural grounds possible. Using the appropriations process to attach riders blocking Interior from implementing the rule. Avoid the real issue as much as possible. And doing all of this in the name of the small producers, despite the fact that MMS has repeatedly said that true independents will not be harmed by this rule. So far, this strategy seems to have worked.

Yesterday, some of my colleagues in the Senate held a hearing on proposed legislation that would amount to a massive giveaway to the oil industry. At that hearing, supporters of the oil industry once again tried to take attention away from the real issue through yet another red herring – this time concerning alleged impropriety on the part of an Interior official who had nothing whatsoever to do with this rule. Mr. Chairman, this type of attempt to divert attention from the real issue is shameless, pure and simple. For anyone who is unclear, let me state for the record what the real issue is here: Major oil companies were caught stealing from the American taxpayer. They were forced to pay nearly \$3 billion because of it. And now that MMS is finally demanding that they pay what they owe, they have decided to once again change the subject.

So, in light of this record, I don't think we should bend over backwards to accommodate the interests of industry, when industry for years refused to admit that there was an underpayment problem, denied that there was a need for a new oil valuation rule, refused to cooperate with Interior in drafting a new rule, and, only when it actually looked as if Interior might go ahead and implement a rule which would have required companies to pay royalties based on the true value of the oil they produce, only then, did industry finally come to the table. But even when industry representatives came to the table – which they did very reluctantly – they did not do so in good faith. Because, as industry representatives were negotiating with MMS on the one hand, they were following their planned strategy and prevailing on their allies in Congress to attached slick riders to appropriations bills which blocked Interior from taking any action to institute a new rule. In fact, I am sorry to admit, just last night, this House passed another such rider on the emergency supplemental appropriations bill -- a bill that was intended to support our troops and provide disaster relief -- that will block Interior from implementing a new rule for another four months.

Let me stress that I sincerely hope that the two sides can reach an agreement on this matter. But I must also add that, in my view, the time for continued negotiations on this issue has long since passed. I have looked at Interior's proposed rule, and I believe it is sound. Interior should move to implement it as soon as Congress permits, regardless of the political pressure that is brought to bear.

Earlier today I released a report illustrating how several major oil companies have defrauded the American taxpayer, as well as state and tribal governments, of millions of dollars, through elaborate underpayment schemes which serve to conceal the true value of oil produced on federal property. This report is based on an analysis of documents produced from the Long Beach litigation, dealing with underpayment of royalties in California from the 1980's. While I don't want to dwell on the past, it is important to remember how we got to this point in the first place. We're not here because industry admitted there was a problem expressed a willingness to work with the Department on a new rule that was fair to everyone. We're here only because industry had to be dragged, kicking and screaming, to the negotiating table. And even then, when industry was caught stealing from the American taxpayer and forced to pay millions in settlements, these same companies tried to claim that this was all MMS's fault, because the rules were somehow too confusing for them to follow.

I will soon be re-introducing legislation that will avoid the problem of riders entirely, by simply legislating a new oil valuation rule. My bill is based on the simple premise that companies should be required to pay royalties based on market value, minus legitimate transportation expenses. I know that some of my colleagues here are concerned about the impact of this issue on small independent producers, so my bill specifically exempts them. I believe that my proposal is a strong bill that will settle this issue once and for all, and I hope some of my colleagues here can support it.

Mr. Chairman, I thank you again for holding today's hearing, and I look forward to hearing from our witnesses.

Mr. HORN. I now yield for opening statement to the gentleman from Virginia Mr. Davis.

Mr. DAVIS. Right. Let me just ask if we put in the record a letter from Martin Frost to the chairman, I think, of the Democratic conference in the House and Gene Green endorsing delaying of these standards and put that in the record.

[The information referred to follows:]

Handwritten mark

Congress of the United States
House of Representatives
Washington, DC 20515
February 12, 1999

President William Clinton
The White House
1600 Pennsylvania Ave. N.W.
Washington, DC 20505

Dear Mr. President:

We wrote to you on December 15, 1988 regarding Title I, Section 130 of the Omnibus Consolidated and Emergency Appropriations Act for Fiscal Year 1999, (P.L. 105-277) which prohibits the Department of the Interior (DOI) from implementing final rulemaking regarding the valuation of crude oil for royalty purposes. As we previously indicated, the Congress, with bipartisan support, included Section 130 in order to provide an opportunity for the appropriate stakeholders to reach an agreement on a new workable royalty valuation regime. We encouraged your Administration to seize this opportunity to resolve this complex accounting issue in a rational, prudent manner which would result in a clear, certain and fair rulemaking assuring the proper collection of royalties under the law without placing significant new burdens on domestic producers.

We are perplexed and disappointed to learn from media accounts that Secretary Babbitt has unilaterally rejected substantive talks to resolve this problem despite an unreserved willingness on the part of the industry to cooperate with the DOE and bipartisan sentiment in the House and the Senate that talks aimed at resolving this issue take place.

The DOI continues to confuse us about the ultimate purpose of their proposed rulemaking. Last year, the MMS Director testified in the House Resources Committee that the proposed rule would be revenue neutral. Now, DOI is claiming the proposed rule would raise new revenues of \$66 million a year.

We find DOI's approach to a complex and significant rulemaking to be unacceptable. Thousands of oil and gas workers continue to lose their jobs as the domestic petroleum industry sinks deeper into a recession unmatched since the Great Depression of the 1930s. Oil imports at near 60% threaten our national security. Higher cost domestic production competes head to head with lower cost foreign production. Instead of discouraging U.S. producers through attempts to promulgate controversial and burdensome royalty valuation rulemakings, we

believe that the Administration should be taking steps to prudently encourage domestic petroleum production in order to put oil and gas workers back to work. At the very least the Administration, in our opinion, should adopt the policy of "Do No Harm".

DOI may not be that interested in rising petroleum related job losses in our states. However, the Administration must be concerned about declining federal revenues from oil and gas leases. As a result of lower crude oil prices, DOI's budget proposal for FY 2000 projects a significant net decline in revenues from onshore and offshore oil and gas rents, bonuses and royalties. The proposed valuation rulemaking, coupled with record low prices, could accelerate the decline in federal revenues as companies decide to invest and develop more petroleum resources outside of the U.S.

We again ask that you work with us to assure that this significant royalty oil valuation rulemaking problem is resolved in a manner which protects the national security, the federal revenue stream and at the same time, protects petroleum industry workers, contractors and suppliers all across the nation.

Sincerely,



Hon. Martin Frost



Hon. Gene Green

Congress of the United States
House of Representatives
Washington, DC 20515

December 15, 1998

The Honorable William Jefferson Clinton
The President of the United States
The White House
1600 Pennsylvania Avenue, NW
Washington, D.C. 20500

Dear Mr. President:

We are writing in regard to Title I, Section 130 of the Omnibus Consolidated and Emergency Appropriations for Fiscal Year 1999, which prohibits the Department of the Interior (DOI) from implementing final rulemaking regarding the valuation of crude oil for royalty purposes.

Section 130, which enjoyed bipartisan support in the House and Senate, provides an opportunity for industry and DOI to negotiate differences and reach an agreement on a new royalty valuation regime. We acknowledge that the current crude oil valuation regulations need improvement. They should be revised in a manner that results in clarity, certainty, and fairness to the U.S. government and to lessees, while ensuring revenue neutrality. MMS Director Cynthia Quarterman stated these principles as DOI's goals in testimony earlier this year before the House Resources Committee.

However, we do not believe that DOI should promulgate a rulemaking which makes radical changes that place significant new burdens on producers, especially at a time of record low oil prices and a substantial loss of jobs in the domestic oil and gas exploration and production industry.

Some groups have mischaracterized the rulemaking as an environmental issue. In reality, the issue solely involves difference about complex accounting procedures, not the environment. Not one dollar of revenues from oil and gas production on federal lands that is currently dedicated to funding the Land and Water Conservation Fund is compromised by the moratorium.

We are also concerned that recent actions by the MMS violate the spirit of the rulemaking moratorium contained in Section 130. Specifically, we note that the MMS has proposed changes in the wording of lease forms that would implement some of the ill-advised changes the MMS has been barred from making in a final crude oil valuation rulemaking, such as requiring producers to market oil free of charge.

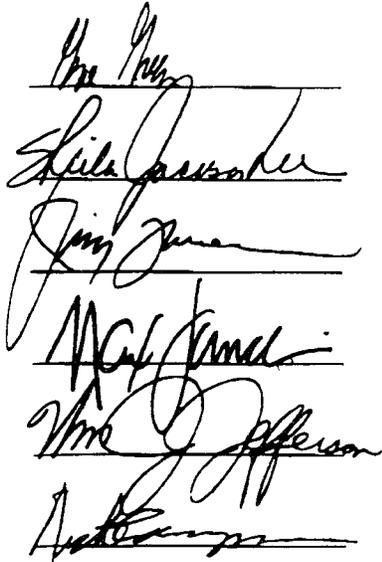
President Clinton
December 15, 1998
page 2

For almost a year now, we have been pressing the MMS and the industry to sit down, bring new ideas to the table, and resolve their differences on royalty valuation. We very much want that process to continue—and to prove successful. So far, we have not been impressed with MMS' efforts to reach a workable compromise regarding this matter, which is extremely important to our states' economies.

We are writing to request the Administration's support for good-faith negotiations on this important issue, and we ask that you act expeditiously to prevent any attempt to circumvent the moratorium through the language of revised lease forms.

We look forward to hearing from you on this matter.

Sincerely,



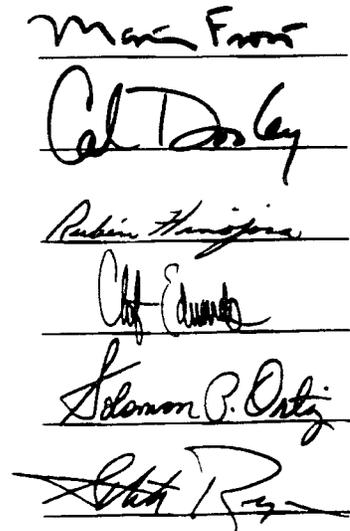
Phil Gossaker

Jim Juman

Mark Jones

Vern Jefferson

Nathaniel



Mark Frost

Cal Dorley

Rubin Thompson

Ch Edwards

Solomon B. Ortiz

Chad R

President Clinton
December 15, 1998
page 3

Charlie Stenholm

Chf

Cin D Rodriguez

Walter Dornier Johnson

As. Sec

Mr. DAVIS. And then would just say that recent developments in a current False Claims Act or "qui tam" suit have really called into question the integrity of the testimony presented before this subcommittee on June 17, 1996, concerning the subject before us again today: Federal crude oil valuation.

Danielle Brian of the Project on Governmental Oversight [POGO], admitted earlier this month that POGO has paid to two government employees \$700,000 for actions they took as Federal employees to change the Interior Department's interpretation of its royalty value rules.

In its June 17, 1996, hearing this committee heard testimony on the subject of oil valuation. Bob Berman of the Department of Interior's Office of Policy Analysis and Robert Speir of the Department of Energy were the two star witnesses who testified that MMS had enabled oil companies to pay royalties on less than the full value of crude oil from the Federal leases.

Our own report concerning the 1996 hearing cites Berman as testifying that either NYMEX or, on the west coast, Alaskan North Slope [ANS], crude prices provide the best benchmarks for crude oil prices. In our report, Mr. Berman is also quoted as having testified that he had initiated a study into whether posted prices outside of California reflected market value and that his preliminary finding was that the posted prices might have understated the market value of crude oil from 3 to 10 percent. Bob Speir, who had been DOE's representative on the interagency task force which investigated allegations that Federal crude oil was undervalued in California, also supported the use of ANS prices for California oil.

We now know that the positions of Berman and Speir were in secret support of positions being taken by private relators under the False Claims Act in Federal court in Texas, a case already filed under seal 4 months before this subcommittee's June 1996 hearing. POGO later joined in that suit, seeking a percentage of any recovery the Federal Government might obtain. In 1996, POGO attempted to have Berman and Speir join in the suit, although both declined.

We now know that POGO's involvement in the crude oil issue was prompted in 1993 by the chairman of POGO's board of directors, a Washington, DC, lawyer representing the State of California in its dispute against the Interior Department over Federal royalty issues. At least as early as 1994, Mr. Berman had frequent contact with POGO and later with POGO's trial lawyers. We know that POGO's annual budget is only one-third of the amount of money paid to these two Federal employees. So it is fair to infer, at least until someone is willing to prove otherwise, that POGO paid the money with the approval of its board of directors, apparently still headed by California's private counsel, and with the approval of POGO's trial counsel.

I should add one qualification to that statement. POGO's local counsel in Texas did not know of the payments in advance. He obtained the court's permission to withdraw from the case as soon as he learned of the payments last month.

The inherent conflicts of interest present in Berman and Speir's acceptance of the money should have been glaring. Berman and Speir were central policymaking figures in the creation and work

of the interagency task force that examined allegations of underpayments in California in 1994–1995. The government has listed the two as potential witnesses for the False Claims Act litigation.

Not surprisingly, Bob Berman and POGO are now apparently under investigation for possible violations of at least two Federal criminal statutes. At a recent deposition in the civil case, Berman was asked whether he had informed this subcommittee when testifying of his personal financial interest in seeing Interior's interpretations changed. He answered by asserting his fifth amendment right not to incriminate himself.

But the clouds grow still darker. POGO reports that it told the U.S. Department of Justice of its intention to make these payments in October 1998. Although the Justice Department is specifically authorized by statute to file for an injunction against prospective payments to Federal employees, it did not do so. In fact, it did not advise the Federal judge in Texas that POGO had made these payments until after POGO's Texas counsel asked the judge for permission to withdraw from the case. The government knew about POGO's intent to make the payment for 7 months and did not disclose to the court, the public or the defendants that they were going to be made. Only last month did all this come to light when the Federal judge directed the government to disclose the payments to the defendant.

It is incumbent on our subcommittee to fully investigate this situation. The outrageous conduct occurring in the *U.S./Johnson v. Shell* qui tam action has raised questions not only about the integrity of that particular legal action or the rulemaking that resulted from Berman's and Speir's work on the interagency task force, but also concerns the integrity of a hearing held before us today. Until these issues are resolved and all pertinent facts brought to light, there can be no fair consideration of the issue of crude oil valuation either in court, at the MMS or in the Congress.

It appears that the Department of the Interior's proposed oil valuations regulations may very well have been substantially tainted by cash payments approaching \$1 million to government officials or former government officials and by blatant interference by outside parties, including trial lawyers who could possibly reap millions in proceeds from pending lawsuits.

If it becomes commonplace for government policymakers in the Interior Department or other agencies to take large sums of cash from outside parties who have a financial interest in the outcome of the government policy in question, we are going to have a scandalized, corrupted system that has absolutely no credibility with the public or with Congress.

Mr. Chairman, I look forward to these hearings.

Mr. HORN. I thank the gentleman.

[The prepared statement of Hon. Thomas M. Davis follows:]

REP. TOM DAVIS
MAY 19, 1999
MINERALS MANAGEMENT SERVICE HEARING
OPENING STATEMENT

Recent developments in a current False Claims Act or “qui tam” suit have called into question the integrity of testimony presented before this Subcommittee on June 17, 1996, concerning the subject before us again today: federal crude oil valuation. Danielle Brian of the Project on Governmental Oversight (POGO) admitted earlier this month that POGO has paid to two government employees \$700,000 for actions they took as federal employees to change the Interior Department’s interpretation of its royalty value rules.

In its June 17, 1996 hearing, this Committee heard testimony on the subject of oil valuation. Bob Berman of the Department of the Interior’s Office of Policy Analysis and Robert Speir of the Department

of Energy were the two star witnesses who testified that MMS had enabled oil companies to pay royalties on less than the full value of crude oil from federal leases. Our own report concerning the 1996 hearing cites Berman as testifying that either NYMEX or, on the West Coast, Alaskan North Slope (ANS) crude prices provide the best benchmarks for crude oil prices. In our report, Mr. Berman is also quoted as having testified that he had initiated a study into whether posted prices outside of California reflected market value and that his preliminary finding was that posted prices might have understated the market value of crude from three to ten percent. Bob Speir, who had been DOE's representative on the interagency task force which investigated allegations that federal crude oil was undervalued in California, also supported the use of ANS prices for California oil.

We now know that the positions of Berman and Speir were in secret support of positions being taken by private relators under the False Claims Act in federal court in Texas, a case already filed under

seal four months before this Subcommittee's June 1996 hearing. POGO later joined in that suit, seeking a percentage of any recovery the federal government might obtain. In 1996 POGO attempted to have Berman and Speir join in the suit, though both declined.

We now know that POGO's involvement in the crude oil issue was prompted in 1993 by the chairman of POGO's board of directors, a Washington DC lawyer representing the State of California in its disputes against the Interior Department over federal royalty issues. At least as early as 1994, Mr. Berman had frequent contact with POGO and later with POGO's trial lawyers. We know that POGO's annual budget is only one-third of the amount of money paid to these two federal employee's, so it is fair to infer - at least until someone is willing to prove otherwise - that POGO paid the money with the approval of its Board of Directors, apparently still headed by California's private counsel, and with the approval of POGO's trial counsel. I should add one qualification to that statement. POGO's local counsel in Texas did

not know of the payments in advance. He obtained the Court's permission to withdraw from the case as soon as he learned of the payments last month.

The inherent conflicts of interest present in Berman and Speir's acceptance of the money should have been glaring. Berman and Speir were central policy-making figures in the creation and work of the Interagency Task Force that examined allegations of underpayments in California in 1994-5. The government has listed the two as potential witnesses for the False Claims Act litigation. Not surprisingly, Bob Berman and POGO are now apparently under investigation for possible violations of at least two federal criminal statutes. At a recent deposition in the civil case Berman was asked whether he had informed this Subcommittee when testifying of his personal financial interest in seeing Interior's interpretations changed. He answered by asserting his Fifth Amendment right not to incriminate himself.

But the clouds grow still blacker. POGO reports that it told the

U.S. Department of Justice of its intention to make these payments in October 1998. Although the Justice Department is specifically authorized by statute to file for an injunction against prospective payments to federal employees, it did not do so. In fact, it did not even advise the federal judge in Texas that POGO had made these payments until after POGO's Texas counsel asked the judge for permission to withdraw from the case. The government knew about POGO's intent to make the payment for seven months and did not disclose to the court, the public, or the defendants that they were going to be made. Only last month did all this come to light when the federal judge directed the government to disclose the payments to the defendants.

It is incumbent on our Subcommittee to fully investigate this situation. The outrageous conduct occurring in the U.S./Johnson v. Shell qui tam action has raised questions not only about the integrity of that particular legal action or the rulemaking that resulted from Berman's and Speir's work on the Interagency Task Force, but also concerns the

integrity of a hearing held before us. Until these issues are resolved, and all pertinent facts brought to light, there can be no fair consideration of the issue of crude oil valuation, either in court, at the MMS or in the Congress.

It appears that the Department of the Interior's proposed oil valuation regulations may very well have been substantially tainted by cash payments approaching 1 million dollars to government officials or former government officials and by blatant interference by outside parties including trial lawyers who could possibly reap millions in proceeds from pending lawsuits.

If it becomes commonplace for government policy makers in the Interior Department or other agencies to take large sums of cash from outside parties who have a financial interest in the outcome of the government policy in question, we are going to have a scandalized, corrupted system that has absolutely no credibility with the public or the Congress.

Mr. HORN. I now yield to Mr. Turner, the ranking member on the subcommittee, for an opening statement.

Mr. TURNER. First, I'd like to thank the chairman for structuring this hearing in a fair manner, and which I believe will be beneficial to the committee, bringing in all parties to this issue to be heard before us. This is a very complex issue, and I think this hearing is very important in terms of trying to deal with the issue at hand.

I understand we'll be hearing today from representatives of a city that filed suit against the major oil companies, and Indian tribes that have also sued the oil companies. Additionally, we'll have the opportunity to hear from the major and independent oil companies, and also we'll have testimony from the Department of Interior and the Inspector General of Interior, as well as the General Accounting Office.

The focus of the hearing will be on the Minerals Management Service, with specific regard to their management of the oil royalty program, their efforts to collect past due royalties and their progress in finalizing a new regulation on oil valuation for royalty.

The issue of oil royalty valuation is, as I said, exceedingly complex, and I have some concern with the latest proposal issued by the Minerals Management Service, one of which involves the independent oil companies. There are a number of independents who operate in my congressional district, and I am very interested in the Minerals Management Service proposal and its effect on those independents.

Another point that bears mentioning is that the Department of Interior is looking to impose these new pricing regulations on the industry at a time when it is suffering from record low petroleum prices and sustaining record job losses. Therefore, I think this committee, the Congress and the agencies should be very sensitive at this particular time with regard to the industry.

While the Department of Interior estimates that the new proposal that is currently on the table will increase revenues from the oil companies by 66 million each year, it's my belief that we should proceed with caution and ensure that we understand the implications of the proposal, especially given its timing and effect.

My interest also is in assuring that the Department of Interior focuses on forging a productive and useful relationship with the oil companies and in reaching a consensus solution that will both protect the taxpayer and provide a fair deal for the oil companies. It is time that we look to the future and try to put past disputes behind us in order that we might resolve this situation. The current climate of continual litigation across the country does not benefit anyone, especially the taxpayer.

To further complicate an already complex matter, a Federal judge in my congressional district where the litigation is pending has released, as Mr. Davis referred to, some troubling information which was recently brought to light.

As the other members of this subcommittee are aware, a current government employee, as well as a former government employee, who acted as whistle-blowers in an oil valuation investigation, accepted extremely large monetary payments from a public interest group that had a financial stake in the outcome of the lawsuit alleging royalty underpayments by the oil companies named in that

suit. One such employee is currently within the Department, and the other is previously at the Department of Energy. Therefore, I am very concerned about these relationships and whether these individuals were actually in a position to intervene in the actions of the government and perhaps to influence the oil royalty valuation regulatory changes that are currently on the table.

Certainly we should not allow the propriety of these payments to obscure the real issue at hand, and I do not intend to allow that information to unfairly skew my judgment. However, it is a problem that must be dealt with and resolved before a final decision can be made with regard to the oil valuation regulation.

I look forward to the hearing. I look forward to hearing from all the witnesses, and again, I thank the Chair for scheduling this hearing and for the manner in which it has been structured.

Thank you, Mr. Chairman.

Mr. HORN. I thank the gentleman very much.

[The prepared statement of Hon. Jim Turner follows:]

STATEMENT OF THE HONORABLE JIM TURNER
GMT: "OVERSIGHT OF THE MINERALS MANAGEMENT SERVICE'S
ROYALTY VALUATION PROGRAM"
MAY 19, 1999

I would like to thank Chairman Horn for structuring this hearing in a fair and what I believe to be an extremely beneficial manner. Given the complexity of the issue before us, it is critical that all interested parties are provided with the opportunity to fully present their position, and I believe that the hearing is structured in a manner conducive to this goal.

We will be hearing from the representatives of a city that filed suit against the major oil companies and Indian tribes that have also sued the oil companies. Additionally, we will hear from the major and independent oil companies and will receive testimony from the Department of Interior and the Inspector General of Interior, as well as the General Accounting Office. I look forward to hearing from all of these relevant parties.

As I understand, the focus of this hearing will be on the Minerals Management Service (MMS) with specific regard to their management of the oil royalty program, their efforts to collect past-due royalties, and their progress on finalizing a new regulation on oil valuation for royalties.

The issue of oil royalty valuation is exceedingly complicated, and I have some concerns with the latest proposal issued by the Minerals Management Service—one of which involves the independent oil companies. There are a

number of independents in the Second District of Texas, and therefore, I am particularly interested in the manner in which the MMS proposal will affect those companies.

Another point that bears mentioning is that the Department of Interior is looking to impose these new pricing regulations on an industry at a time when it is suffering from record low petroleum prices and sustaining a record number of job loss. While the Department of Interior estimates that the new proposal will increase revenues from the oil companies by \$66 million each year, it is my belief that we should proceed with caution and ensure that we understand the implications of this proposal, especially given its timing and effect.

Further, my interest is in assuring that the Department of Interior is focused on forging a productive and useful relationship with the oil companies and in reaching a consensus solution that will protect the American taxpayers and provide for a fair deal for the oil companies. It is time that we look to the future and put the past disputes behind us in order that we might resolve this situation. The current climate of continual litigation across the country does not benefit anyone, especially the American taxpayer.

To further complicate an already complex matter, a federal judge—who presides over a portion of my congressional district—has released some troubling information brought to light by an ongoing False Claims Act cause of action against the majors.

As the other members of this Subcommittee are aware, a current

government employee as well as a former government employee—who acted as whistleblowers in an oil valuation investigation—accepted extremely large monetary payments from a public interest group that had a financial stake in the outcome of a lawsuit alleging royalty underpayments by the oil companies named in that suit. One such employee is currently within the Department of Interior and the other was previously employed at the Department of Energy, and therefore, I am somewhat concerned by these relationships and whether these men were actually in the position to intervene in the actions of the government and influence the decision-making process.

Now, certainly we should not allow the propriety of these payments to obscure the real issue at hand, and I do not intend to allow this information to unfairly skew my judgment; however, it is a problem that should be dealt with and resolved before a final decision is made with regard to the oil valuation regulation.

Therefore, I look forward to hearing from all of our witnesses in attendance here today, and I am hopeful that we will succeed in addressing some of the concerns that I have outlined.

Mr. HORN. And let's see, we have no other Members present yet. Any other statements will be put in the record as if read.

Let me describe some of the procedure here for the first panel. We are an investigative subcommittee of the Committee on Government Reform, and as such, all witnesses are sworn before they give their statement. We're going to introduce you based on your position on the agenda that was passed out, and we will hope that—your full statement automatically goes in the record at that point, and we would hope you would be able to summarize it.

Now, we have two panels here, and I don't mind giving you at least 8 minutes to summarize it. We want to spend the time with dialog, and with four Members here, there's a lot of dialog that occurs and questions and answers. I think we get to things a little faster that way than if everybody just reads their statement. Don't read it. Summarize it.

So, gentlemen, if you would stand, raise your right hands and take the oath.

[Witnesses sworn.]

Mr. HORN. The clerk will note all four witnesses have affirmed the oath, and we will start with you, Mr. McCabe. We're delighted to have you here again. You are a real expert in this area, and you're deputy city attorney of the city in which I happen to live, which is the beautiful city of Long Beach, CA. I don't know why you would come back here and leave that environs, but you're here, so we're delighted to have you again.

STATEMENTS OF JAMES McCABE, DEPUTY CITY ATTORNEY, CITY OF LONG BEACH, CA; ALAN TARADASH, ATTORNEY AT LAW, NORDHAUS, HALTOM, TAYLOR, TARADASH & FRYE, LLP, ALBUQUERQUE, NM; DAVID DEAL, ASSISTANT GENERAL COUNSEL, AMERICAN PETROLEUM INSTITUTE; AND BEN DILLON, VICE PRESIDENT, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Mr. MCCABE. Thank you, Mr. Chairman. I'm happy also, having worked on many of the items that have been going on in Long Beach that have been so positive recently, including the new convention center and the new—

Mr. HORN. Get that microphone closer to you.

Mr. MCCABE. Chairman Horn, members of the subcommittee, many thanks for your invitation today. I—I won't go on about Long Beach's experience as I might have in my summary, but we do have much experience in this area. We have collected over 2 million documents, internal documents, from the major oil companies in California, detailing how they do business there.

As plainly as I can, the city and State have long believed that their valuable oil resources should be sold on the open and competitive oil market. We believe that oil should not be sold at posted prices, prices which are virtually picked out of the air by the major oil companies to maximize their profits. There are publicly quoted markets from which oil prices can be logically and rationally derived that will ensure that lessors, be they Federal, State or private companies, receive fair market value for their oil.

The major integrated companies have long fought this rational process, advocating that royalties should be based on prices they

pick, which are almost invariably below fair market price. In order to protect their ability to underpay, lessees have successfully lobbied Congress to pass moratoria and have done other things to slow the process up generally.

Our powerful economic system is built on competition in the marketplace, competition that in the oil industry occurs at well-known locations in Oklahoma, Texas, California, where oil is freely traded on the open market, and we believe this is a rational—the only logical choice for—for a way to price Federal royalty oil that will be fair to all concerned. Long Beach has recovered over \$320 million on this basis. The State of Alaska has recovered \$3.7 billion for the same reason.

Congressman Turner has pointed out his sensitivity to the position of the independents. The proposed regulations do not work to the detriment of the independent oil producers. They will benefit them because, unlike major oil companies, they do not enter into complex exchange agreements designed to hide the true value of crude oil. These companies do not have affiliates through which oil transactions can be funneled obfuscating the real value of that crude oil. In contrast, the majors do engage in exchange agreements, do have affiliates through which they filter this crude oil, all without this crude oil ever seeing the light of a competitive market.

As I said, the city has extensive experience with documents produced by the majors for the period of 1980's. These documents support the contention that posted prices in California do not reflect the value of that oil in the open market. ANS crude is sold in Long Beach at prices which exceed posted prices for comparable California crude. ANS oil is sold in—Alaskan North Slope oil is sold in Long Beach for prices that have ranged from \$3 to \$5 a barrel above the same grade of oil produced in Signal Hill, which Congressman Horn knows is a city entirely encompassed by the city of Long Beach.

Despite the delay tactics of the majors, the problem still exists. For example, comparable grades of ANS crude still sell at prices that are substantially in excess of our posted prices. How can the majors maintain that posted prices reflect the true market value when higher prices are set by open trades in the free market at the same time, in the same place? Our experience proves that we cannot have the major oil companies pay royalties based on what amounts to an honor system.

I urge both you and the committee to support these regulations as a logical solution to the undervaluation caused by prices posted by the major oil companies. I have been to perhaps a dozen workshops hosted by MMS on this subject, and virtually no one suggested posted prices have any rational link to market realities.

I want to thank you for your interest in protecting the public and, in particular, the schoolchildren of the State of California who are the beneficiaries of our share of these—of this oil revenue. Thank you.

Mr. HORN. Thank you very much.

[The prepared statement of Mr. McCabe follows:]



OFFICE OF THE CITY ATTORNEY
Long Beach, California

ROBERT E. SHANNON
City Attorney

HEATHER A. MAHOOD
Assistant City Attorney

PRINCIPAL DEPUTIES

Barbara D. de Jong
Richard L. Landes
Michael J. Mims
Daniel S. Murphy

DEPUTIES

William A. Reider
Richard A. Alessi
Alan D. Bennett
Everett L. Glenn
Dennis F. Green
Robert T. Wright
Dorothy T. Holsman
Richard P. Lopez
Lisa Pesky Melstrom
Bridget R. Mayes
James N. McCabe
Susan C. Okley
J. Charles Parkin
Michael M. Peters
Carol A. Shaw

STATEMENT OF JAMES MCCABE, DEPUTY CITY ATTORNEY FOR THE CITY OF LONG BEACH TO THE SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION AND TECHNOLOGY OF THE HOUSE GOVERNMENT REFORM COMMITTEE

May 19, 1999

Chairman Horn and Members of the Subcommittee:

Thank you for your invitation to appear as a witness on behalf of the City of Long Beach and the State of California on oil valuation issues. As you well know, the City has a long history of trying to collect the fair market value for the oil it sells from State holdings because this money goes to the school system of the State of California.

I am a Deputy City Attorney for the City of Long Beach. The City acts as trustee for the State of California with regard to one of the largest oil fields in the State, offshore of the City, and with regard to related oil matters such as crude oil pricing. I have been actively involved in examining oil pricing transactions for the last fifteen years. In litigation against the major integrated oil companies in California, the City has recovered in excess of \$320 million for the state's schools.

Put as plainly as I can, the City and State have long believed that their valuable oil resources should be sold at open and competitive market prices. That oil should not be sold at posted prices, prices which are picked out of the air by the major oil companies to maximize their profits. There are publicly quoted markets from which oil prices can be logically and rationally derived which will insure that lessors, be they federal, state or private companies, receive fair market value for their oil.

The major integrated oil companies have long fought this rational process, advocating that royalties should be based on prices *they pick* which are almost invariably below the fair market prices. In order to protect their ability to underpay lessees, they have successfully lobbied Congress to pass moratoria and have tried every way they could to stop the Department of the Interior from using such a rational process to determine how much in royalties they owe. Our powerful economic system is built on competition in the open marketplace. There is no reason that the major oil companies' crude oil pricing should be exempt from it.

The City of Long Beach has recovered over \$320,000,000 of underpayments for the State of California on the grounds that "fair market value" means prices paid on the open market. The State of Alaska has collected \$3.7 billion dollars for the same reason.

The proposed regulations do *not* work to the detriment of independent oil producers. They will benefit from them because, unlike the major oil companies, they do not enter into complex exchange agreements designed to hide the true value of crude oil. These companies do not have affiliates through which oil transactions can be funneled, obfuscating the real value of the crude oil. In contrast, the majors do engage in exchange agreements and have many affiliates that can hide the true value of crude oil. Most importantly, they have refineries in which they can use crude oil without that oil ever seeing the light of a competitive market.

The City has extensive experience with documents produced by the majors for the period of the 1980s. These documents support the contention that posted prices in California did not reflect the value of that oil on the open market. ANS crude oil is sold in Long Beach at prices which exceed the posted price of comparable California crude oil. And the problem still remains. For example, comparable grades of ANS crude still sell at prices that are substantially in excess of posted prices for California crude. How can the majors maintain that posted prices reflect the "true market value" when higher prices are set by open trades in the free market at the same time? Our experience proves that we can not have the major oil companies pay oil royalties based on what amounts to an "honor system."

I urge both you and your committee to support these regulations as a logical solution to the undervaluation caused by prices posted by the major oil companies. I have been to perhaps a dozen workshops hosted by MMS on this subject and virtually no one suggests that those posted prices have any rational link to market realities. On behalf of the State of California and the City of Long Beach, I want to thank you for your interest in protecting the public and, in particular, the school children of California.

Mr. HORN. We now go to Mr. Alan Taradash, attorney at law, Nordhaus, Haltom, Taylor, Taradash and Frye, from Albuquerque, NM. Thank you for coming.

Mr. TARADASH. Thank you, Mr. Chairman, members of the committee. My name is Alan Taradash, as the chairman indicated. Our firm is general counsel to the Jicarilla Apache Tribe, which is currently the largest gas-producing tribe in the country, and it also produces a fair amount of oil.

Before I go into our concerns in this, I do want to make a special note that we do appreciate the uniqueness of this opportunity to address the committee, Mr. Chairman, and rather than go into a lot of detail on the particulars of the proposed oil valuation regulations that others will cover, I wanted to address the committee to the unique situation that the tribal producers are in, because that all too often is forgotten in the equation.

We have a situation that most Members of Congress barely have to deal with where the United States acts on behalf of Indian tribes with regard to their mineral estate as a trustee, as well as a government regulator. When the United States, on the other hand, operates as a regulator and as an owner of its own resource, it operates in a very different environment with very different legal obligations.

It is important to remind the Congress, as well as administrative agencies, of this reality because it is far too often forgotten, and I would like to go into a few examples of how that inadvertence, if it is that, adversely affects the value of the tribal mineral estate and the collections that are properly due to a tribe from the disposition of its nonrenewable resources.

I have been involved on behalf of tribes and individual LITs in litigation in Win River with regard to the oil theft that occurred there, with regard to the failure of the government and companies to comply with lease terms in the context of what is referred to as the Supron case and the case filed in 1984 against the Secretary to try to get the Department of the Interior and the Secretary to comply with the Federal Oil and Gas Royalty Management Act of 1982.

We currently still are engaged on a daily basis in the details of audit work, along with the tribal auditor, through a cooperative audit arrangement with the Minerals Management Service, and I want to state at the outset that notwithstanding the very critical nature of my remarks and our experience, there are some very excellent people within the agencies I am about to criticize as well as our industry partners.

Having said that, however, I think it is important in looking at these valuation regulations to keep in mind what the overall objective is. If one is engaged in the disposition of nonrenewable resources, and one is not interested in the substance itself, then the only question is the fair and equitable split of the economic profit that can be gained from the activity. The royalty, like any other expense to the operator, is an expense. To the royalty recipient, that is the lessor of the property, it is not an expense. It is the income and the only income that is going to be received from that property.

The whole issue of how to best determine value, if one really thinks about it in the abstract, there are some inherent limitations

on what the government can do. Availability, the supply of oil; if we're talking about oil, control over the supply and control over markets are factors which directly affect this whole process. On the other side of the dynamic tension that exists is a government as regulator in a supposed free market. These are mutually inconsistent things that cause a great deal of the difficulty in coming to grips with the problems in proper royalty valuation.

I would ask also that the idea that there are abuses is something that while obviously it is true, one should not paint the entirety of the industry with that brush. When we litigated, for example, the oil theft of Win River, in every possible way oil was being stolen physically from the field, as well as through improper reports. When I deposed week after week many of the operators, employees in that area, they perjured themselves because we later found out through tracking down the truckers who have been taking the oil from the field at night, and through finding the pipelines that bypassed the lock meter, through finding the resettable lock meter, which was not supposed to be resettable, through finding the jury-rigged heater tank valve which could be turned without breaking the USGS seals, oil was being stolen in every conceivable way from that field. The USGS at that time, the regulatory agency, along with the BLM, did nothing, absolutely nothing, to put a damper on the most outrageous of abuses.

I don't want to go into too much of that detail. I recognize that there is limited time, but the Linowes Commission, as you know, covered that. The Federal Oil and Gas Royalty Management Act was supposed to be therapeutic of these problems in many ways. In the consent decree in the case that I did against the Secretary on behalf of the Navajo LITs, *Shii Shi Keyah v. Babbitt* in the U.S. District Court for the District of New Mexico, the court retained superintendent jurisdiction after the 1989 consent decree was entered to look at the compliance that was occurring.

In 1992, I received from MMS as part of that settlement agreement the so-called major portion pricing data. I didn't bring it with me. It's two volumes. It sits this high. The government had spent at that point in time in trying to correct the deficiencies in its system over \$100 million on its computer systems, over \$100 million. The error rate in those reports, that I was provided by the government's Minerals Management System which processed the information, which means that it was determined to be accurate, with huge parameters that I employed for accuracy, was over 46 percent.

Let me give you but one example of the nature of the erroneous information. These reports have columns because of the value nature of the report. One column is BTU value. The other column way to the side is the price per MCF of that particular BTU quality; zero BTU quality gas listed as having been sold for 660,000 per MCF. Now, that's not in combustible air.

My point in raising that is this: I have looked at the GAO reports. I have looked at the IG reports. They do not do the auditing that the tribe has begun to do in many of these instances.

They agree a tribe's rate of recovery, for example, in its audit work over the last 10 years is four-ninths additional royalties, and for the tribe that's over \$40 million in money that has never been paid.

My point in raising those issues is this: If the government is going to look at new systems to employ, it has to look at and be instructed by its past performance on fundamental things. If the Congress looks at the Federal Managers' Financial Integrity Act report that the Secretary has filed in the past, it sees the admission that there is no onshore fluid, meaning oil and gas, control, and hence the inability to have a closed accounting system results in acute deficiency in the government's ability to determine to a certainty it's been paid right.

Now, my last point, and I want to close with this, is this: Congress has passed in 1996 the Royalty Simplification and Fairness Act, preceded in the prior year by the Deep Water Royalty Relief Act and the Alaska North Slope Act, which created new markets for oil that was produced there abroad. Congress—the Deep Water Royalty Relief Act authorized the Secretary—has since provided relief in the way of royalty relief that will exceed hundreds of millions of dollars for deep water production.

Tribal minerals are being devalued by Federal largesse that's intended to promote the security of the domestic oil industry. We do not take issue with the government's policy decisions to do that, but what we ask of this committee and of Congress is to recognize that when the government acts on its own behalf to dispense such largesse, and as a consequence it reduces the value of the tribal mineral estate, then the government has to consider ways to level that playing field.

And as I've detailed in my written testimony, which I understand has been admitted to the record, what we would ask of this committee in addition to the work that it is doing in valuation is to seriously consider tax credit relief for our industry partners, for our reservation oil and gas development and production, and to the extent that the committee or its staff may be interested in further exploring that, we would welcome the opportunity to do so.

I'd be happy to answer any questions, Mr. Chairman, that you and the members of the committee may have. Thank you.

Mr. HORN. Thank you very much. It's a very helpful statement. We'll get back to a number of things later.

[The prepared statement of Mr. Taradash follows.]

Congress of the United States
House of Representatives
Committee on Government Reform
Subcommittee on Government Management, Information, and Technology

OVERSIGHT HEARING ON OIL ROYALTY VALUATION
May 19, 1999

Prepared Statement of Alan R. Taradash, Esq. on behalf of the Jicarilla Apache Tribe

Alan R. Taradash, Esq.
Norhaus, Haltom, Taylor, Taradash, & Frye, LLP
500 Marquette Ave. NW, Suite 1050
Albuquerque, NM 87102
(505) 243-4275
(505) 243-4464 facsimile
e-mail = ARTaradash@aol.com

Executive Summary

Indian mineral properties have long been highly regarded and coveted by the United States and private companies. The number of cases is far too great to require particular citation or elaboration here on the lengths to which the United States and its courts have gone to rationalize divesting Indians of their mineral properties. What little remains of these mineral properties still owned by their tribal owners has been entrusted to the United States, by its own acts, as trustee for the beneficial tribal owners. The recent history of the Department of Interior and its attempts to properly account for tribal mineral development has been a not particularly distinguished one. A summary of some of those actions is discussed below as a necessary factual predicate for understanding why separate regulations and systems are necessary for tribal oil and gas leasing activity as opposed to federal leasing. This need becomes even more obvious when one examines the underlying reality of the conflict of interest of the United States as a mineral resource owner on its own account and that of the behavior to which it ought to rise as a trustee of tribal mineral resources.

When the United States acts with regard to its own vast mineral estate on public lands and offshore properties, it affects directly and indirectly the value of tribal mineral assets. As a trustee for tribal mineral properties, the United States is in a very difficult conflict of interest which is all too often forgotten when it has acted to benefit the development of its own mineral estate and the domestic energy industry which has been elevated to the status of a key ingredient of our national security.

The economic burden that tribal mineral development now suffers under due to dual taxation (states and tribal taxes) is further exacerbated when Congress authorizes, and the Secretary of Interior awards, huge economic incentives designed to guarantee oil and gas industry profitability. It is now time for Congress to examine this history and to offer encouragement to tribal mineral resource owners and their industry partners by providing a flexible tax credit that will reward the exploration, development and production of tribal energy minerals. Providing this relief will benefit tribal economic self sufficiency as well as the regional economies wherein such energy development will take place. Properly structured, such Congressional relief will assist and encourage joint Indian and non-Indian energy development from which all will benefit. In turn, Congress will have vindicated the federal government's trust responsibility to tribal resource owners and will have created the climate within which regional prosperity will be encouraged. This will, in turn, enhance the tax base both regionally and nationally. Now is the time for such Congressional action.

I. Introduction

The Jicarilla Apache Tribe (the "Tribe") is located in north central New Mexico adjacent to the Colorado border. Its homeland, guaranteed to it by Executive Order, encompasses approximately 800,000 acres of land. These lands contain significant oil and gas reserves. In fact, the Tribe is currently the largest producer of natural gas of any tribe in the country. Revenues from the Tribe's oil and gas production (and the attendant taxes) account for over ninety percent (90%) of annual tribal operating revenues. The oil and gas leases (the "leases") on these tribal lands are administered by the United States Department of Interior as the trustee for the Tribe. Unfortunately, the Department of Interior ("DOI" or "Interior" or the "Department"), through its Bureau of Indian Affairs ("BIA"),¹ Minerals Management Service ("MMS"), and Bureau of Land Management ("BLM"),² has demonstrated a long-standing, consistent, blatant, and extraordinary disregard of its statutory and judicially-mandated fiduciary duty to completely

¹ *Jicarilla Apache Tribe v. Supron Energy Corp.*, 479 F.Supp. 536, 547 (D.N.M. 1979) (Secretary breached fiduciary duty to ensure for the Tribe "that its lessees have complied with the term of the leases which requires diligent development"), 728 F.2d 1555 (10th Cir. 1984) (Seymour, J. concurring in part and dissenting in part), *concurring and dissenting opinion* adopted as modified, 782 F.2d 855 (10th Cir.) (en banc), modified on other grounds, 793 F.2d 1171 (10th Cir.), cert. denied, 479 U.S. 970 (1986).

² *Northern Cheyenne Tribe v. Hodel*, CV 82-116-BLG, Memorandum Opinion at 21-30 (D.Mont. 1985), cited as law of the case in *Northern Cheyenne Tribe v. Lujan*, 804 F.Supp. 1281, 1285 (D.Mont. 1991).

and accurately account for all production³ from the leases, appropriately determine value consistent with the lease terms, and to timely collect and disperse royalty payments to the Tribe. These problems are systemic failures of long standing of the Secretary of the Interior (the "Secretary"). These Secretarial failures result in significant underpayment of royalties due on both tribal as well as federal leases because the same deficient systems are employed by the Secretary to "account" for both tribal and federal leases. There are no exceptions other than the Osage Tribe which unfortunately for years has fared even worse under the exclusive trusteeship of the BIA.⁴ Indeed, Congress was moved to act when the Linowes Commission report was submitted in 1982,⁵ documenting the gross underpayment, under-reporting, and even outright theft as the oil and gas industry was found to be "essentially on an honor system."⁶ These shocking revelations moved Congress to pass the Federal Oil and Gas Royalty Management Act of 1982 ("FOGRMA").⁷

FOGRMA mandates "the development of enforcement practices that ensure the prompt and proper collection and disbursement of oil and gas revenues owed to the United States and Indian lessors"⁸ Under FOGRMA, the Secretary of the Interior is charged with the establishment of "a comprehensive inspection, collection, fiscal and production accounting and auditing systems to provide the capability to accurately determine oil and gas production, royalties, interest, fines, penalties, fees, deposits, and other payments owed, and to collect and account for such amounts

³ See The Federal Managers' Financial Integrity Act, Secretary's Annual Statement and Report to the President and the Congress (U.S. Dep't. of the Interior, December 1994) at 3 (the most critical weaknesses facing the Department include oversight of oil and gas production and accountability), C-2 (Failure to Effectively Inspect and Enforce Fluid Materials), and C-44 ("lack of effective onshore oil and gas production accountability program could affect the ability to monitor the approximately \$0.5 billion in royalties received by the Department each year").

⁴ The history behind the exclusion of Osage lands from almost all federal oil and gas legislation which otherwise applies to Indian lands is shameful. In the early part of this century, significant reserves of oil were discovered on Osage lands. Non-Indians immediately sought to gain control of the oil reserves and over the Osage Indians. Instead of protecting the Osage and their valuable mineral resources, Congress passed legislation which facilitated the non-Indians' land grab. Osage tribal members who objected to the loss of their lands and resources were murdered by neighboring non-Indians. This tragedy and its legacy are chronicled in D. McAuliffe, Jr., *The Deaths of Sybil Bolton: An American History* (1994).

⁵ Report of the Commission on Fiscal Accountability of the Nation's Energy Resources (Linowes Report) (January 1982).

⁶ *Id.* at 15.

⁷ 30 U.S.C. §§ 1701 et seq.

⁸ 30 U.S.C. § 1701(b)(3).

in a timely manner.”⁹ Congress explicitly directed the Secretary of the Interior to “aggressively carry out his trust responsibility in the administration of Indian oil and gas.”¹⁰

The directives of FOGRMA have yet to be fulfilled and the Jicarilla Apache Tribe submits this statement to demonstrate to the Committee (1) the absolute necessity of the passage of separate and comprehensive oil valuation regulations for Indian lands and (2) the development within MMS of a separate and distinct accounting system which will ensure that oil royalties collected from mineral leases on Indian trust lands are correctly valued, timely collected, and properly administered. Moreover, given the duty of the federal government to ensure that Indian tribes receive the maximum benefit from mineral deposits on their lands through leasing, the federal government must also provide tangible and significant financial incentives to encourage production on Indian tribal and allottee lands to offset the significant inducements that Congress and the Secretary have provided on federal lands (including, of course, offshore properties) to industry lessees. These inducements include, among other things, lower and more flexible royalty valuation lease provisions and regulations which apply to federal lands.

II. Comparison of Principles Governing Tribal Leases and Those Governing Federal Leases; Trust Responsibility to Indian Tribes Results in Royalty Valuation Concerns Which are Separate and Distinct From Those Which Come Into Play On Federal Leases

The Department, principally through the MMS and its functional predecessor in this regard, the United States Geological Survey (the “USGS”), has erroneously treated Indian and federal leases similarly in terms of royalty valuation, and related accounting and auditing practices. This approach ignores the fact that federal and Indian lease provisions differ in critical respects and that the federal government has an exacting and legally enforceable fiduciary duty to ensure that tribes receive the maximum benefit from mineral deposits on their lands through leasing.¹¹ Stated another way, “the only client or constituent group to which the federal government owes a duty in the context of tribal mineral development is the tribe for whom the United States serves as legal fiduciary.”¹²

⁹ 30 U.S.C. § 1711(a).

¹⁰ 30 U.S.C. § 1701(a)(4).

¹¹ *Jicarilla Apache Tribe v. Supron Energy Corp.*, 728 F.2d 1555, 1563 (10th Cir. 1984) (Seymour, J. concurring in part and dissenting in part), concurring and dissenting opinion adopted as modified, 782 F.2d 855 (10th Cir.) (en banc), modified on other grounds, 793 F.2d 1171 (10th Cir.), cert. denied, 479 U.S. 970 (1986).

¹² Thomas H. Shipp, *Oil and Gas Lease Operation and Royalty Valuation on Indian Lands: What is the Difference in Federal and Indian Leases?* at 13-19, Rocky Mtn. Min. L. (continued...)

By contrast, there are many constituent groups in the context of federal mineral development. They include “federal citizens and taxpayers who beneficially own the resource and who have a right to expect careful, environmentally sound, and efficient resource use; national energy consumers who rely upon energy fuels to be reasonably available in supply and reasonably priced for consumption; oil and gas companies which must realize sufficient return on risk and investment to continue production and continue technological improvement in order to maintain the industry and the nation’s security.”¹³

Courts have also recognized that different principles govern Indian mineral leases. In *Mobil Oil Corp. v. Albuquerque Area Director*, an administrative law judge rejected the application of reasoning utilized in the context of federal leases and correctly observed that the

Federal policy governing Indian mineral resources includes a Federal trust responsibility to manage those resources for the benefit of the Indian owners and a rule requiring interpretation of ambiguities in the relevant statutes and regulations in favor of those Indian owners. The characteristics clearly distinguish the federal policy for Indian mineral resources from the policy concerning mineral resources on the public lands.

(Emphasis added.)¹⁴ This trust responsibility obligates the United States “to develop a mineral lease program which [will] provide the highest possible financial return” to Indian mineral owners.¹⁵

The principal acts of Congress which currently govern the leasing of tribal mineral lands are the Indian Mineral Leasing Act of 1938 (1938 Act),¹⁶ the Indian Mineral Development Act of 1982 (1982 Act),¹⁷ and the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA).¹⁸ The United States Supreme Court has held that the basic purpose of the 1938 Act is “to maximize

¹ ² (. . . c o n t i n u e d)
Foundation (1992) [“Shipps”].

¹³ Shipps, *supra* n. 12 at 13-19.

¹⁴ 18 IBIA 315, 326, 97 I.D. 21 (July 2, 1990).

¹⁵ *Navajo Tribe of Indians v. United States*, 9 Cl.Ct. 227, 238 (1985).

¹⁶ 25 U.S.C. §§ 396a-g.

¹⁷ 25 U.S.C. §§ 2101-08.

¹⁸ 30 U.S.C. § 1701 *et seq.*

tribal revenues from reservation lands.”¹⁹ The specific goals and purposes of the 1938 were described in a 1981 case from the Ninth Circuit. There, the Ninth Circuit Court of Appeals discussed the Act’s legislative history and explained:

The 1938 Act was designed to achieve three goals . . . First, the Act sought to achieve uniformity in the law governing mineral leases on Indian lands. Prior law had been a statutory hodgepodge that imposed different requirements for mineral leases on different Indian lands. Second, the 1938 Act was designed to help achieve the broad policy of the Indian Reorganization Act . . . that tribal governments be revitalized. In the mineral leasing context, this meant giving tribal governments control over decisions to lease their lands and over lease conditions, subject to the approval of the Secretary of the Interior, where before the responsibility for such decisions was lodged in large part only with the Secretary. Third, the 1938 Act was intended to encourage tribal economic development, an important objective of the Indian Reorganization Act of 1934.²⁰

The 1938 Act requires that the Secretary of the Interior “manage Indian lands as to make them profitable” and imposes a clear duty to “maximize lease revenues.”²¹ Stated another way, the “evident purpose” of the 1938 Act “is to ensure that Indian tribes receive the maximum benefit from mineral deposits on their lands through leasing.”²²

It was not until 1982 that another significant congressional act regarding Indian mineral leasing was passed by Congress.²³ The 1982 Act was designed to accomplish two objectives. The first was to “further the policy of self-determination.”²⁴ The second was “to maximize the financial return tribes can expect for their valuable mineral resources.”²⁵ In recognition of these goals, the 1982 Act sought to “clarify tribal authority to enter into agreements other than leases

¹⁹ *Kerr-McGee Corp. v. Navajo Tribe of Indians*, 471 U.S. 195, 200 (1985).

²⁰ *Crow Tribe of Indians v. Montana*, 650 F.2d 1104, 1112-1113 (9th Cir. 1981), modified, 665 F.2d 1390 (9th Cir.), cert. denied, 459 U.S. 916 (1982).

²¹ *Kenai Oil & Gas, Inc. v. Department of the Interior*, 671 F.2d 383, 386 (10th Cir. 1982).

²² *Supron*, supra n.11, 728 F.2d at 1565.

²³ Indian Mineral Development Act of 1982, 25 U.S.C. §§ 2101-08.

²⁴ S. Rep. No. 97-472 at 2 (1982).

²⁵ *Id.*

under the 1938 Mineral Leasing Act.”²⁶ In the 1982 Act, Congress expanded tribes’ ability to negotiate directly with companies and to enter into risk-sharing ventures but in so doing, Congress expressly refused to diminish the Secretary’s trust duty.²⁷

The royalty provisions of both the standard federal and the standard Indian lease reflect the differences in the federal government’s specific trust responsibility to Indian tribes and the broader principles which animate its stewardship of federal lands. The standard tribal lease²⁸

²⁶ Id. See generally Paul E. Frye, “A Travesty of a Mockery of a Sham”: The Federal Trust Duty and Indian Self-Determination at 2B-30 through 2B-32, Rocky Mtn. Min. L. Foundation and the American Bar Association (1999) [“Frye”].

²⁷ 25 U.S.C. §§ 2102(a), 2103(e); Frye, *supra* n.26 at 2B-31.

²⁸ BIA Form 5-157 (1962), paragraph 3(c). That paragraph states:

Rental and Royalty. To pay, beginning with the date of approval of the lease by the Secretary of Interior or his duly authorized representative, a rental of \$1.25 per acre per annum in advance during the continuance hereof, the rental so paid for any one year to be credited on the royalty for that year, together with a royalty of 16 2/3 percent of the value or amount of all oil, gas and/or natural gasoline, and/or all other hydrocarbon substances produced and saved from the land leased herein, save and except oil, and/or gas used by the lessee for development and operation purposes on said lease, which oil or gas shall be royalty free. During the period of supervision, “value” for the purposes hereof may, in the discretion of the Secretary, be calculated on the basis of the highest price paid or offered (whether calculated on the basis of short or actual volume) at the time of production for the major portion of the oil of the same gravity, and gas, and/or natural gasoline, and/or all other hydrocarbon substances produced and sold from the field where the leased lands are situated, and the actual volume of the marketable product less the content of foreign substances as determined by the oil and gas supervisor. The actual amount realized by the lessee from the sale of said products may, in the discretion of the Secretary, be deemed mere evidence of or conclusive evidence of such value. When paid in value, such royalties shall be due and payable monthly on the last day of the calendar month following the calendar month in which produced; when royalty on oil produced is paid in kind, such royalty oil shall be delivered in tanks provided by the lessee on the premises where produced without cost to the lessor unless otherwise agreed to by the parties thereto, at such time as may be required by the lessor It is understood that in determining the value for royalty purposes of products, such as natural gasoline, that are derived from treatment of gas, a reasonable allowance for the cost of manufacture shall be made,

(continued...)

requires the Secretary of the Interior to determine royalties based on the highest price paid or offered for like or similar production contemporaneously produced from the same field or area. Federal leases have no similar provision. By contrast, federal leases expressly give the Secretary the authority to reduce or waive royalties.²⁹ This authority to reduce or waive royalties is predicated on the fact that the United States, as owner of the mineral estate on federal lands, can consider various factors such as the national security or promotion of the domestic oil and gas industry in setting and valuing royalties. When acting as trustee for the Indian tribes in the context of oil and gas leasing, the United States has no such discretion.

Despite the clear and unequivocal statutory and judicially-mandated fiduciary duty of the United States to maximize tribal oil and gas royalties, it has consistently and consciously failed to do so. Interior's current oil valuation regulations for Indian leases flaunt the express valuation provisions of tribal leases and ignore controlling court decisions which articulate the trust responsibility. Moreover, the Department has chosen to minimize the differences in the accounting and lease administration of tribal and federal oil and gas leases and has instead adopted a policy of treating these leases in a uniform fashion.³⁰ With regard to product valuation regulations, the single value program which Interior has heretofore relied upon has been overly solicitous to its federal lessees, which has led to a dilution of the federal trust responsibility to

²⁸(...continued)

such allowance to be two-thirds of the value of the marketable product unless otherwise determined by the Secretary of the Interior on application of the lessee or on his own initiative, and that royalty will be computed on the value of gas or casinghead gas, or on the products thereof (such as residue gas, natural gasoline, propane, butane, etc.), whichever is the greater.

²⁹ BLM Form 3100-11 (1992) at section 2 provides that the "minimum royalty may be waived, suspended, or reduced, and the above royalties rates may be reduced for all or portions of this lease if the Secretary determines that such action is necessary to encourage the greatest ultimate recovery of the leased resources, or is otherwise justified." BLM Form 3120-7 (1977) at section 2(d)(4) provides that "rentals or minimum royalties may be waived, suspended, or reduced; and royalties on the entire leasehold or any portion thereof segregated for royalty purpose may be reduced if the Secretary of the Interior finds that, for the purpose of encouraging the greatest ultimate recovery of oil and gas and in the interest of conservation of natural resources, it is necessary, in his judgment, to do so in order to promote development, or because the lease cannot be successfully operated under the terms fixed herein."

³⁰ See generally Shipps, *supra* n.12, at 13-44 through 13-49 (discussing gas regulations as well as the failure of the Department of the Interior to conduct a proper major portion analysis which is mandated in tribal oil leasing provisions)

Indian tribes by factors which are not relevant to the trust relationship.³¹ This approach has resulted in the loss of millions of dollars of tribal royalties and represents an actionable and clear breach of trust by the federal government. The fact that such an approach might result in administrative convenience to the Department and its agencies cannot justify the federal government's abdication of its trust responsibility to maximize tribal revenues.³²

The federal administration of oil and gas development is divided between three Interior agencies — the MMS, the BIA, and the BLM. The MMS is charged with collection of rents, royalties and other payments, accounting for payments received, valuation of royalty and auditing.³³ The BIA is responsible for the maintenance of real property records, approval of leases and mineral agreements, granting rights for surface use and distribution of collected revenues to Indian allottees.³⁴ The BLM generally fulfills the role of technical supervision with respect to subsurface management, which includes operational inspection and monitoring.³⁵ The inability of these agencies to work cooperatively and function effectively for their tribal constituents led a special committee of the Senate to conclude:

Despite the federal government's longstanding obligation to protect Indian natural resources, they have been left unprotected, subject to, at best, benign neglect and, at worst, outright theft by unscrupulous private companies.³⁶

A similar investigation in 1982, commonly referred to as the Linowes Report, documented the failure of the federal government to adequately manage the Nation's energy resources which allowed the oil and gas industry to avoid paying royalties it rightly owed for a period of over two decades. Among other monumental failures documented by the report was a royalty record keeping system for federal and Indian oil and gas leases which was in complete disarray. The record keeping was (and remains) so inadequate that the "government's royalty records are too

³¹ Shippo, *supra* n.12, at 13-49.

³² *Hodel v. Irving*, 481 U.S. 704 (1987).

³³ 30 CFR Parts 201, 206, 217 (July 1, 1998).

³⁴ 25 CFR Parts 150, 211, 162, 169, and 115 (April 1, 1998).

³⁵ 25 CFR Part 211 (April 1, 1998); 43 CFR Part 3161 (Oct. 1998). See generally Shippo, *supra* n.12 at 13-28 through 13-29.

³⁶ *Final Report and Legislative Recommendations*, Special Committee on Investigations, United States Senate, Select Committee on Indian Affairs (November 1989).

unreliable to provide an overall estimate” of the amount of underpayment.³⁷ In short, the federal government has allowed the oil and gas industry to operate “essentially on an honor system” when literally billions of dollars in federal and Indian oil and gas revenues are at stake.³⁸ In response to the Linowes Report and the abject state of federal royalty management, Congress passed FOGRMA.³⁹ FOGRMA was intended to provide a comprehensive solution to royalty management problems on federal, tribal and allotted leases.⁴⁰ And, as discussed above in Part I, Congress directed the Secretary to “aggressively carry out his trust responsibility in the administration of Indian oil and gas.”⁴¹ Neither the Secretary nor the Department nor any of its agencies has come close to carrying out the trust responsibilities, much less making any aggressive effort to carry out these responsibilities.

III. Selected Examples of the Department of Interior’s Failure to Carry Out Its Trust Responsibility in the Administration of Indian Oil and Gas Leases

The Linowes Report documented massive and sustained management failures on the part of the Interior in the context of federal and tribal mineral leasing. Incredibly, massive and sustained management failures within MMS remain the status quo. In the context of Indian mineral leasing, the chronic and grossly negligent management of Indian minerals such as oil and gas violates the federal government’s fiduciary duty to maximize tribal revenues from non-renewable resources such as oil and gas. This fiduciary duty applies by force of law to the Interior and is acknowledged in current and proposed departmental valuation regulations.⁴² Yet Interior’s

³⁷ Report of the Commission on Fiscal Accountability of the Nation’s Energy Resources (Linowes Report) at 13 (January 1982). Cf. *Cobell v. Babbitt*, 37 F.Supp.2d 6, 19 (D.D.C. 1999) (with regard to Individual Indian Money (IIM), which is held in trust by the United States, “there is no reliable inventory of IIM documents, items for any one [of at least 300,000 beneficiaries] could be found in any box in which IIM documents are housed throughout the country.”).

³⁸ Linowes Report, *supra* notes 5, 36 at 15.

³⁹ 30 U.S.C. § 1701 *et seq.*

⁴⁰ See Linowes Report, *supra* notes 5, 36.

⁴¹ 30 U.S.C. § 1701(a)(4).

⁴² See Part II, above. See also 30 CFR § 206.50(d) (7-1-98) (current valuation regulations “intended to ensure that the trust responsibilities of the United States with respect to the administration of Indian oil and gas leases are discharged in accordance with the requirements of the governing mineral leasing laws, treaties, and lease terms”); Proposed Regulations for Establishing Oil Value for Royalty Due on Indian Leases, 63 Fed. Reg. 7089, 7099 (Feb. 12, 1998) (proposed regulations regarding audit and adjustment of royalty payments intended to ensure (continued...))

management of Indian minerals, including oil and gas, is alarmingly disingenuous. The fiduciary duty is acknowledged on paper, yet the Department continues to value and manage tribal oil royalties in ways which fail to ensure that tribes receive the maximum benefit from their mineral resources.

With the passage of FOGRMA, Congress required the Secretary to fully account for all production and payments due from Indian and federal oil and gas leases. The Secretary has never done this. In fact, the auditing and accounting systems currently utilized by MMS for both federal and Indian leases were designed without an examination of all the relevant Indian lease terms which the systems need to account for. This approach (or lack thereof) is particularly harmful given the fact that the accounting and auditing procedures necessary to ensure compliance with current lease terms and regulations, as well as the proposed valuation regulations, are inherently complex and that the information necessary for accounting and auditing is often in the sole custody and control of the lessee or operator.

The Department through the MMS cannot begin to determine whether tribes are receiving the maximum benefit from their mineral resources when it has failed to develop management practices and accounting and auditing systems which can completely and accurately gather and evaluate all pertinent information necessary to assure compliance with Indian oil and gas lease terms, the 1938 Act, FOGRMA, and the Secretary's trust responsibility to the tribal lessor. This department-wide failure has resulted in the loss to tribal lessors of hundreds of millions of dollars in the sixteen-year history of MMS.⁴³ These losses are in addition to the millions and millions of dollars of losses suffered during the time of its predecessor agencies, which are documented in the Linowes Report.

Selected examples of MMS deficiencies in administering tribal oil and leases are instructive. The examples presented focus on accounting and auditing procedures within the

⁴²(...continued)

that the United States discharges its trust responsibilities for the administration of Indian oil and gas leases under the governing mineral leasing laws, treaties, and lease terms); Valuation of Oil from Federal and Indian Leases, 60 Fed. Reg. 65610 (Dec. 20, 1995) ("MMS may issue separate regulations to value oil from Indian leases because of the Secretary's trust obligation in the administration of Indian oil and gas leases. In view of this obligation, the Secretary **must ensure that Indians receive the maximum benefits from mineral resources on their lands.**") (emphasis added).

⁴³ The Minerals Management Service was created in the wake of the findings of the Linowes Report and the passage of FOGRMA to assume the functions of its predecessor agency, the United States Geological Survey. When Congress passed FOGRMA, it sought a remedy to the department's practice of letting the oil and gas industry value and remit royalties on what was essentially an honor system.

Interior. Without proper accounting and auditing procedures in place, the Department cannot determine whether proper valuation calculations are being made or whether oil and gas producers are paying appropriate royalties. Proper accounting and auditing procedures are particularly critical when, as in the context of Indian oil royalties, lease terms and current regulations require MMS to conduct a major portion analysis and compare the value of that analysis with the gross proceeds reported by the producers.⁴⁴ Royalties are to be calculated on the higher of the two values. In the current proposed Indian valuation regulations, valuation is to be determined based on the highest of three different values -- (1) the NYMEX futures prices adjusted for location and quality differences, (2) the lessee's or its affiliate's gross proceeds adjusted for appropriate transportation costs; and (3) the MMS-calculated major portion value based on prices reported by lessees and purchasers in MMS-designated areas typically corresponding to reservation boundaries.⁴⁵ In the absence of an accounting and auditing system that is specifically designed to account for these valuation calculations, MMS has no way of determining whether valuation and royalty calculations are correct. Under that scenario, which represents the current state of affairs, MMS has no way to ensure that tribes are receiving the maximum benefit for their oil and gas royalties and is thus breaching its fiduciary duty to all tribes.

MMS relies on the Automated Financial System (AFS) and the Production Accounting and Auditing System (PAAS) which experts from Arthur Andersen LLP and from the Council of Energy Resource Tribes have independently confirmed were not designed to account for statutory and lease requirements on Indian leases.^{46, 47} This fundamental flaw -- designing from the AFS

⁴⁴ Reduced to its essence, a major portion analysis is one which compares lease sale proceeds with sales contemporaneous in time and location and similar in chemical as well as legal characteristics to establish value.

⁴⁵ Establishing Oil Value for Royalty Due on Indian Leases, 63 Fed. Reg. 7089, 7090 (Feb. 12, 1998).

⁴⁶ In March 1989, in the case of *Shii Shi Keyah Assoc. v. Babbitt*, Civ. No. 84-1622 (D.N.M.), a consent decree was entered which required the Secretary to make, among others, systems changes to comply with FOGRMA's accounting and auditing provisions. It was in that case that the experts for the plaintiffs and for the Council of Energy Resource Tribes reached the same conclusion regarding the MMS system's failure to take into consideration statutory and lease requirements on Indian mineral leases.

⁴⁷ A third system, the Bonus Rental Automated Accounting System ("BRAAS") was never implemented. The problems that the MMS encountered in implementing its AFS system were so great that it never implemented the BRAAS system and delayed for years any attempt to implement the PAAS system. An objective, detailed examination of the AFS and PAAS systems unfortunately compels the conclusion that neither of those systems produces accurate and complete information upon which the Secretary can rely to assure performance of his obligations under
(continued...)

and PAAS from the "top down" rather than from the "bottom up" -- has never been cured. In fact, it has been exacerbated by the audit system that the agency has employed. The current audit system is a "payor-based" system. It simply takes self-reported and unaudited data from the payors, on an MMS form, and attaches to the data the imprimatur of approval of accuracy which remains unchanged unless specifically reviewed in the context of auditing. Given the small sampling actually conducted during auditing, the likelihood that these self-reported numbers would ever be changed is extremely remote. Moreover, the payors on a given lease (and there can be many) and the payments made are never tied together to the lease; nor is there any system utilized to tie the total payments and related production information to independently-produced third party information on production and sales. Rather, the admittedly incestuous data in the PAAS system is compared to that in the AFS system.

In the early days of MMS' existence, it was subjected to severe criticism by Congress, the General Accounting Office (GAO) and others due to the large number of payments that triggered various error edit codes which were purportedly designed to assure accuracy within its AFS systems. When these codes were triggered, the payments that accompanied the triggering report were kicked into "error suspense." MMS responded to this criticism by disingenuously reporting that it had significantly reduced the "rate" of such error suspense occurrences. What it neglected to inform the oversight bodies was that it achieved this "rate" reduction by deactivating much of the computer code that triggered an error suspense occurrence. The errors were still present. They just went unidentified and uncorrected. Similar types of misleading information about MMS' problems and its response (or lack thereof) to those problems has been intentionally misleading and costly to both the Indian and federal lessor.

In 1987, MMS proposed new valuation regulations. Indian lessor tribes objected that the proposed regulations violated standard Indian lease terms that clearly set forth the manner in which royalties were to be computed. Tribes feared that these obvious violations of tribal lease terms would cost Indian lessors millions of dollars. MMS responded to Congressional oversight by asserting that the valuation regulations were "revenue neutral." It was not until 1991 that MMS revealed to the GAO just what it meant by "revenue neutral." MMS admitted, and GAO reported, that MMS concluded that the potential gains in offshore royalty collections by implementing the new regulations would offset the royalty losses that Indian lessors would suffer. Thus, MMS took

⁴⁷(...continued)

FOGRMA. For example, the Secretary routinely reported to the President and the Congress under the Federal Managers' Financial Integrity Act that one of his most significant material weaknesses was his inability account for onshore fluid mineral production (oil and gas) that resulted in perhaps as much as \$500,000,000.00 or more of money due on federal and Indian leases left unaccounted for. See supra n.3. This inability to establish "closed" accounting systems has never been corrected by MMS.

the position that the regulations could fairly be described as "revenue neutral."⁴⁸ Since Indian lessors do not share in offshore royalties on federal leases, this MMS justification was fundamentally dishonest.

In May 1998, MMS implemented a new policy and methodology to apply to certain types of late payments upon which interest is due (Modified Rolled Up Reporting). Instead of applying the statutory requirements of FOGRMA, the new policy ties the running of interest to an artificial date unrelated to the date when specific sums of money are due. An artificial date is selected that is related to the numerosity of late payments, not the amounts. Thus, not only is the statutory mandate ignored, but the artificial point in time that is selected is not even related to the economic concept of the time value of money. The "solution" was achieved out of the overriding mandate of "institutional" or "bureaucratic" ease. Similarly, the Secretarial response to the industry designed and driven (and euphemistically labeled) Royalty Simplification and Fairness Act of 1996 ("RSFA") is astounding.⁴⁹

Vice President Gore champions the "Re-engineering Government." The DOI, like all other federal agencies, has been hard pressed to comply with this clarion call for government efficiency. While there are certainly some areas of governmental activity which could benefit from this approach, mindlessly reducing information collected and utilized for all government activities will assure government misfeasance. By way of example, the oil and gas industry has tirelessly lobbied Congress for less and less reporting on oil and gas leases with the platitude "trust us, the payment is correct." In the wake of that industry's efforts and the Vice President's emphasis on "Re-engineering Government," Congress passed the Royalty Simplification and Fairness Act of 1996, which amended FOGRMA.⁵⁰ This Act reduces reporting and recordkeeping requirements in federal oil and gas leases but does not, by its explicit terms, apply to Indian mineral leases.⁵¹

⁴⁸ GAO Report on Mineral Revenues, Interior Used Reasonable Approach to Assess Effect of 1988 Regulations at 2 (May 1991).

⁴⁹ Pub. L. No. 104-185, 110 Stat. 1700 (August 13, 1996).

⁵⁰ See Pub. L. No. 104-185 (Aug. 13, 1996).

⁵¹ Section 9 of RSFA, entitled "Indian Lands," states in its entirety: " T h e
a m e n d s
m a d e
b y t h i s
A c t
s h a l l
n o t
(continued...)

⁵¹(...continued)

apply
with
respect
to
Indian
Lands,
and the
provisi
ons of
the
Federal
Oil and
Gas
Royalt
y
Manag
ement
Act of
1982,
as in
effect
on the
day
before
the
date of
enactm
ent of
this
Act
shall
continu
e to
apply
after
such
date
with
respect
(continued...)

But in July 1998, the Secretary issued his long-awaited report detailing how he intended to correct the long standing deficiencies in his management and trusteeship of Indian trust property, including Indian oil and gas leases. On pages 44-48 of his Trust Management Improvement Project: High Level Implementation Plan (July 1998), the Secretary discusses implementing the requirements of RSFA in the context of Indian mineral leasing. In short, the Secretary is taking a position which is contrary to the express provisions of a duly-enacted Act of Congress and which is certain to result in a breach of trust to Indian tribes.

Following the Secretary's lead, MMS solicited comments on reducing information collection in a number of areas, including production accounting information for Indian oil and gas revenues. Indian leases are value based leases. Thus, it is necessary to monitor (*viz.* report) both the quality and quantity of production in order to properly determine the accuracy and completeness of any proffered payment. Soliciting comments on reducing the requested information without knowing what factors will be necessary for accurate and complete accounting for all oil and gas produced from the leases is an ill-considered request and yet another example of how DOI and MMS cavalierly disregard their trust responsibilities to tribes.

In addition to the chronic accounting and auditing problems which virtually guarantee that the Secretary's fiduciary duty to Indian tribes goes unfulfilled, MMS' own regulations and its interpretations of those regulations flaunt the explicit provisions of Indian oil and gas leases. Two noteworthy examples of the indifferent (and perhaps cavalier) disregard with which Indian oil and gas leases and the trust duty owed to the tribes by the federal government are treated by the Department are the manner in which MMS performs the major portion analysis and the extremely generous treatment of manufacturing and transportation allowances (one of which is expressly permitted, but limited, in the leases, and the other, not expressly permitted in the leases but created by the Department through regulation).

Under the leases, the Secretary must value production for purposes of determining royalties due based on, among other things, the higher of the gross proceeds received by the lessee or the value as determined by a "major portion analysis."⁵² Under this analysis, lease sale proceeds are

⁵¹(...continued)

t o
Indian
lands."
(Emph
a s i s
added).

⁵² "[V]alue may . . . be calculated on the basis of the highest price paid or offered . . . at
(continued...)

compared with other relevant sales to establish value. Royalties actually paid to an Indian lessor, however, are also affected by allowances. As deductions for these allowances are taken directly from royalties which would otherwise have been paid to the Indian lessor, it is not surprising that “creativity” and abuse have become a matter of routine for many Indian royalty payors. MMS “scrutiny” of this area is generally a matter of benign neglect, although it has on occasion risen to the level of facilitating such abuses.

Notwithstanding the unambiguous tribal lease terms, the current Indian oil valuation regulations contain provisions which are inconsistent with these terms and which, once again, ensure that tribes do not get the maximum benefit from their oil and gas leases.⁵³ The proposed regulations do not fully remedy these problems.

For example, the current valuation regulations redefine “major portion” (the language of the leases) to “majority portion” (a fundamentally different concept in its secondary or tertiary definition)⁵⁴ and then restrict the “majority portion” analysis to situations which MMS considers “practicable.”⁵⁵ The terms of the leases contain no such restriction, and in fact use a different word which carries with it a different concept and thus practice that the Secretary ought to be utilizing. Moreover, in looking at prices paid for the “major portion” of oil production, MMS looks at “that price at which 50 percent (by volume) plus 1 barrel of the oil (starting from the bottom) is sold.”⁵⁶ By using this median pricing methodology, MMS thereby guarantees that Indian lessors will never receive royalties based on the lease terms, *viz.*, “the highest price paid or offered.” In the proposed regulations, MMS still relies on the bottom of the array but proposes

⁵²(...continued)

the time of production for the major portion of the oil of the same gravity, and gas . . . and/or other hydrocarbon substances produced and sold from the field where the leased lands are situated.” BIA Lease Form 5-157 (1962).

⁵³ See 30 CFR Part 206, Subpart B (7-1-98 ed.).

⁵⁴ “Major” has been defined to mean “[g]reater in number, quantity, or extent,” or “[g]reater in dignity, rank, or importance; superior in quality or position.” “Majority,” on the other hand has been defined in its secondary definition as “the number greater than half; more than half of any total” “Loosely,” a plurality.” Webster’s New International Dictionary p.1484 (2d ed. 1943).

⁵⁵ 30 CFR § 206.52(a)(2)(i).

⁵⁶ *Id.* at § 206.52(a)(2)(ii) (emphasis added).

to look at the value at which 75 percent of the oil (starting from the lowest value) is bought or sold.⁵⁷

Current regulations allow certain Indian lessees to take transportation allowances for the reasonable, actual costs incurred by the lessee for transporting oil. These transportation allowances can be up to 50 percent of the base price of the product.⁵⁸ As one commentator has dryly noted, given that tribal leases make “no express mention of transportation allowances, yet do mention processing allowances, the practice of permitting these deductions from royalty seems a generous concession of tribal revenues by the Secretary.”⁵⁹ The proposed valuation regulations would not allow transportation costs within Indian reservations but still provide for an allowance to move production away from reservations.⁶⁰

IV. Problems and Possible Solutions Regarding the Competitiveness of Indian Oil and Gas Leases

To fully and effectively fulfill its fiduciary duty to maximize revenues from tribal leases, the federal government must ensure that tribal leases are competitive with federal leases. MMS recognizes that under the current statutory and regulatory scheme, Indian leases may not be as competitive as federal leases. In its words, maximizing royalty revenues from Indian leases could affect “the economics of mineral resource development.”⁶¹ MMS has solicited comments on whether the proposed Indian oil valuation regulations would decrease leasing on Indian lands or otherwise affect the competitiveness of Indian leases but “believes that specific royalty values should be independent of this concept and not effectively lowered as a result.”⁶² MMS suggests examining the issue “in the context of lease term adjustments by the [BIA] and the Indian lessor.”⁶³

MMS’ suggestion that lease term adjustments can resolve the competitiveness problem does not begin to address the depth and breadth of the competitiveness issue. As noted above in Part II, there are significant and far-reaching differences in the legal and practical principles which

⁵⁷ 63 Fed. Reg. 7092-7093, section 206.52 (Feb. 12, 1998)

⁵⁸ 30 CFR § 206.55(a)(1)(i) and (b).

⁵⁹ Shipps, *supra* n.12 at 13-54.

⁶⁰ 63 Fed. Reg. 7094, § 206.60 (Feb. 12, 1998).

⁶¹ 63 Fed. Reg. 7093 (Feb. 12, 1998).

⁶² *Id.*

⁶³ *Id.*

govern federal leases and those which govern tribal leases. In the stewardship of its own lands, the United States can and does consider broad issues of national concern, including those which affect the national economy and national security. The development and maintenance of a domestic energy supply which reduces or eliminates this country's need to import oil and gas from foreign nations has been long been considered a critical component of the national economy and national security. In this context, a robust, private oil and gas industry has been perceived by the federal government as a crucial component of the nation's energy policy. The oil and gas industry has successfully impressed upon Congress its view that the development and maintenance of a domestic energy supply sufficient to provide for all the nation's energy needs can only be had with the assurance of adequate profits for the industry and the existence of domestic oil and gas reserves which can be profitably developed. With regard to the development of new oil and gas offshore fields, such as those located on the Alaska North Slope (ANS) or offshore on the Outer Continental Shelf (OCS), the federal government has enacted statutes which provide tremendous subsidies for the industry and allow it to market its oil and gas in ways which would otherwise be prohibited.⁶⁴ These concessions are in addition to the standard federal lease terms which allow the Secretary to waive, suspend or reduce royalty payments when the Secretary determines, for example, "that such action is necessary to encourage the greatest ultimate recovery of the leased resources, or is otherwise justified."⁶⁵

While the Jicarilla Apache Tribe does not take issue with the nation's energy policy or statutes that have been passed to subsidize domestic oil and gas production, it is critical that the effects of these policies and statutes do not go unheeded in the context of Indian oil and gas leasing. As a result of the concessions afforded the domestic oil and gas industry in the context of federal leases, industry has much more incentive to enter into federal leases than it does to enter into tribal leases. Alternately stated, tribes have not been given the benefit of a level playing field when it comes to oil and gas leasing. Without a level playing field, or at least one that is not quite so radically skewed, tribal leases will not be competitive with federal leases. It thus becomes reasonable to pose the question as to whether the United States as a trustee can, without violating its fiduciary duties of absolute loyalty and the prohibition against self dealing, make its own minerals so much more attractive than those of its beneficiaries to whom the courts and Congress have said the federal government has a trust duty to maximize revenues for tribes from the leasing of their non-renewable energy resources. Therefore, it may well be that the federal government could be deemed to have violated its duties as a trustee, thus perhaps making itself liable to lawsuits for money damages, which can result in multi-million dollar judgments for tribes and tribal entities.⁶⁶ Clearly, some balancing is necessary.

⁶⁴ Pub. L. No. 104, Titles II and III (Nov. 28, 1995).

⁶⁵ BLM Form 3100-11 (Oct. 1992).

⁶⁶ See generally Supron, *supra* n.11; *Cheyenne-Arapaho Tribes of Oklahoma v. United*
(continued...)

The federal government must provide subsidies and incentives for tribal leasing just as it does for federal leasing. By way of example, Congress passed in 1995 two acts which provide tremendous incentives and subsidies to the oil and gas industry to develop the ANS and the OCS. In an amendment to section 28 of the Mineral Leasing Act,⁶⁷ which governs federal mineral leasing, Congress has authorized the export out of the United States of ANS crude oil "unless the President finds that exportation of this oil is not in the national interest."⁶⁸ This is a tremendous concession to industry and greatly augments its ability to reap profits from ANS crude oil since its market is not restricted to California or other lower 48 states and now includes countries such as Japan which has virtually no domestic oil and gas industry.

Congress has also provided the oil and gas industry with tremendous incentives and multi-million dollar subsidies in the context of offshore exploration, drilling, and production on the Outer Continental Shelf in the Gulf of Mexico. The Outer Continental Shelf Deep Water Royalty Relief Act⁶⁹ was passed to "promote development or increased production on producing or non-producing leases" and "encourage production of marginal resources on producing or non-producing leases" by reducing or eliminating any royalty or net profit share that was provided for in the applicable federal leases.⁷⁰ Needless to say, assuming the existence of significant reserves and the ability to access the reserves, the wholesale elimination of royalties on these offshore leases is a virtual guarantee of profitability to producers. While there initially may have been some question of the technological feasibility and economic viability of deep water exploration and development, by 1994 the technological feasibility of such exploration and development, as well as a virtual guarantee of massive reserves, had been conclusively established.⁷¹ That there is little risk and enormous profits to be had from offshore drilling in the locales encompassed by the Act

⁶⁶ (. . . c o n t i n u e d)
 States, 966 F.2d 583 (10th Cir. 1992), cert. denied, 507 U.S. 1003 (1993); *Cheyenne-Arapaho Tribes of Oklahoma v. United States*, 33 Fed. Cl. 464 (1995); Frye, *supra* n.26 at 2B-8 through 2B-9. See also *Pawnee v. United States*, 830 F.2d 187 (Fed. Cir. 1987) (recognizing right to money damages against the United States for breach of the 1938 Act), cert. denied, 486 U.S. 1032 (1988).

⁶⁷ 30 U.S.C. § 185.

⁶⁸ Pub. L. No. 104, Title II, sec. 201, 109 Stat. 557 (Nov. 28, 1995).

⁶⁹ Pub. L. No. 104, Title III, 109 Stat. 563 (Nov. 28, 1995).

⁷⁰ The Act applies to any lease or unit which is located in water depths of 200 meters or greater in the Gulf of Mexico Western and Central Planning Areas and portions of the Eastern Planning Area. *Id.*

⁷¹ See, e.g., Caleb Solomon & Peter Fritsch, "Mission to Mars: How Shell Hit Gusher Where No Derrick Had Drilled Before," *The Wall Street Journal* at A1 (April 4, 1996).

should come as no surprise to the federal government. When the government put out to bid leases which were in the vicinity of the enormously productive Mars Platform in the Gulf of Mexico, it anticipated modest interest. Instead, it was inundated with bids. Royalty relief afforded by MMS to one of the successful bidders will likely be as high as \$143 million.⁷²

V. Conclusion

The United States has a long and regrettably undistinguished history of coveting Indian minerals either for itself or for private industry to enjoy. The small percentage of minerals left to tribes from the entirety of this vast continent that once was theirs has been left to the federal government by its own action to safeguard. A part of this obligation is that which requires that when such resources are developed that the tribal owner receives maximum monetary benefit from the severance. There is only so much of an economic burden that such an activity can bear. Given the dual taxation (both state and tribal) that such mineral activity suffers from, and given the competing federal largesse that the development of tribal minerals face, it is required of Congress to provide a solution that will begin to redress these inequities. Although the Secretary can and should promulgate separate regulations that deal with issues such as valuation and reporting for Indian leases, it is peculiarly in Congress' domain, and its alone, where the remedy should be made available to begin to "level the playing field."

In light of the subsidies and incentives that the federal government is willing to provide industry in the context of federal leasing, it should provide similarly effective incentives for the exploration, development and production of tribal oil and gas. While reduction or waiver of tribal royalties would obviously not be appropriate, the creation of alienable federal tax credits for producers who enter into tribal leases or other agreements to undertake exploration, development, and production of tribal mineral lands is an important and crucial step in the fulfillment of the federal government's trust responsibility to ensure the tribes receive maximum benefit from their oil and gas leases.

⁷² News Release, U.S. Department of the Interior, Minerals Management Service, Office of Communications (July 17, 1998) (citing royalty relief for one company and quoting MMS Director Cynthia Quarterman as stating: "Once again, this is a win-win situation for both the United States and industry.").

Mr. HORN. Mr. David Deal is the assistant general counsel for the American Petroleum Institute, which is the overriding group in which all of the petroleum industry is represented, as I recall. So thank you very much for coming.

Mr. DEAL. Thank you, Mr. Horn.

Mr. Chairman and members of the subcommittee, I am David Deal, assistant general counsel of the American Petroleum Institute. Joining me today is Ben Dillon, IPAA's vice president for public resources. Our respective trade associations—and many others which Mr. Dillon will enumerate for you—are a blend of State and national trade associations whose members are actively involved in oil and gas exploration and production on Federal lands. Our trade associations' memberships overlap, and together our members are responsible for the production of virtually all Federal oil and gas production on Federal lands and virtually all of the Federal oil and gas royalties paid every month.

Over the course of the MMS crude oil valuation rulemaking, the MMS has stated it seeks revised valuation regulations that arrive at the value of production in a way which is simpler and more certain, which decreases the cost of administration and leads to less controversy, fewer appeals and less litigation. We applaud these objectives, and we embrace them. But we believe the MMS proposal, as it stands right now, falls so much short of reaching them.

At the core of the rulemaking is the MMS belief that royalty valuation for most crude oil transactions should begin downstream of the lease. In a nutshell, industry believes that a downstream starting point for valuation is the wrong starting point for most transactions and leads to many problems.

A copy of the cover letter summarizing industry's most recent comments is attached to our written statement, and we're submitting for the record today a complete set of the comments themselves. But today, we can share with you the gist of our present thinking.

Overall our problems—

Mr. HORN. May I just say, without objection, that exhibit will be in the record at this point.

[The prepared statement of the American Petroleum Institute, the Independent Petroleum Association of America, the Domestic Petroleum Council, and the U.S. Oil and Gas Association follows:]

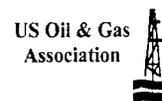
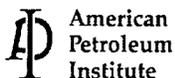
**Before the United States
Department of the Interior
Minerals Management Service**

**Comments
of
American Petroleum Institute
Independent Petroleum Association of America,
Domestic Petroleum Council
and
United States Oil & Gas Association**

**Minerals Management Service
Federal Crude Oil Valuation Rulemaking**

30 CFR Part 206

April 27, 1999



April 27, 1999

Lucy Querques Denett
 Associate Director, Minerals Management Service
 United States Department of the Interior
 1849 C Street, NW
 Washington, DC 20240

Comments in Minerals Management Service
 Federal Crude Oil Valuation Rulemaking

Dear Lucy:

On behalf of the American Petroleum Institute (API), the Independent Petroleum Association of America (IPAA), the Domestic Petroleum Council (DPC) and the United States Oil and Gas Association (USOGA), these comments augment the discussions held at the MMS public workshops held March 23 (Houston), March 24 (Albuquerque) and April 6-7, 1999 (Washington, DC).

We were encouraged at the MMS staff's willingness to discuss the substance of the MMS' present proposal and industry's recommended changes. We believe these efforts can lead to a sound resolution of core issues presented by this rulemaking. To the fullest extent possible, the attached comments assemble in one package the elements of industry's point of view and answer questions that arose in the course of our discussions.

Our specific comments are organized along the lines of the key issue areas used as the organizing structure for the workshops:

For **arm's length transactions**, we urge the MMS to adopt in the regulations more specific criteria to guide lessee application of the control-based definition of "affiliate" in order to arrive at valuation methodology certainty at the outset of the process.

For **non-arm's length transactions**, we urge the MMS to expand its valuation methodology options to include comparable sales as a measure of value if the lessee satisfies prescribed information and sales volume requirements.

For **adjustments off downstream values**, we urge the MMS to adopt adjustments for transportation, location and quality, and midstream activities sufficient to make it possible to net back from downstream values (index or otherwise) and calculate a value for royalty purposes which more accurately approaches the value of production at the lease. Given the MMS's inclination to continue its reliance on a cost of capital

recovery approach instead of commercial value, transportation allowances are especially problematic and we again urge the MMS to convene another workshop or a symposium to take a hard look at this complex issue which significantly affects the economics of OCS development. Such a forum would be an ideal opportunity to examine computation methodologies but, more important, would allow the MMS to ascertain how its transportation policy conforms with the exploration and development promoting elements of recent legislation and Administration initiatives, such as the Comprehensive National Energy Strategy.

For **second-guessing**, we urge that the MMS adopt language making it clear that the use of gross proceeds as the valuation methodology by lessees operating in good faith and engaging in arm's length transactions will not be set aside in favor of some other methodology (e.g., indexing) simply because some other entity was able to obtain a higher value for the sale of production. A strong presumption in favor of arm's length transactions would recognize that the lessee and the lessor have a mutual interest in obtaining the highest price for the sale of production and that a range of prices characterizes "market value." Such a presumption would, of course, in no way shield a lessee from full audit and would not permit demonstrable misconduct.

For **binding determinations**, we urge the MMS to adopt an explicit process by which lessees can procure timely valuation methodology determinations. Such determinations would be akin to IRS letter revenue rulings and the comparable rulings of other agencies. For example, they would be limited to the facts presented and have no precedential value. While binding, they would be revocable, although any changes would apply prospectively only.

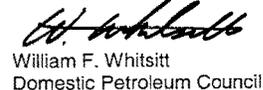
* * * * *

Overall, we believe these recommendations as a package would move the MMS proposal closer to a final crude oil valuation rule that is workable and fair, while decreasing the cost of administration, decreasing appeals and litigation, and satisfying the legal requirement that royalty obligations be based on the value of production at the lease. To the extent the MMS still has concerns about achieving its objectives in this rulemaking, we submit that royalty-in-kind remains a powerful option that could avert many of the ambiguities inherent in any valuation methodology. In any event, we urge the MMS to carefully consider these recommendations and welcome any further questions you might have to reach a satisfactory resolution of this important rulemaking.

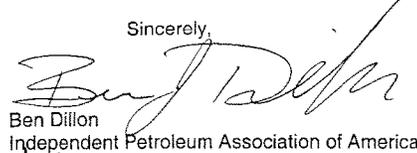
Sincerely,



David T. Deal
American Petroleum Institute



William F. Whitsitt
Domestic Petroleum Council



Ben Dillon
Independent Petroleum Association of America



Albert Modiano
United States Oil & Gas Association

**American Petroleum Institute, Independent Petroleum Association of America,
Domestic Petroleum Council and
United States Oil and Gas Association Comments in
Minerals Management Service Federal Crude Oil Valuation Rulemaking
64 FR 12267 (March 12, 1999)**

To complement industry participation in the MMS public workshops in Houston (March 23, 1998), Albuquerque (March 24), and Washington, DC (April 6-7, 1999), industry submits the comments below. To the fullest extent possible, these comments do not repeat the voluminous comments we submitted earlier in the rulemaking that we incorporate by reference. These comments do, however, include as Appendix "A" materials (now paginated) employed during the 1999 workshops and as Appendices "B" – "D", new materials generated as a result of the workshop discussions.

At the outset, we should be clear that industry continues to believe that there is an active market at the lease which makes it unnecessary, except in extraordinary circumstances, to use netback-type valuation methodologies like the market center spot price methodology proposed by the MMS. This active market at the lease makes the universe of arm's length transactions far larger than the MMS rulemaking implies. This fact should make more transactions eligible for valuation as arm's length transactions themselves and should also make it practicable for valuation of non-arm's length transactions without recourse to the MMS' flawed indexing approach which the MMS would apply except for special situations in the Rocky Mountain region.¹

A. Arm's Length Transactions

The gist of industry's recommendation is that MMS retain regulations that use control as the central principle, and augment the present percentage levels with specific criteria to help lessees seeking to determine whether the affiliation test is met.

Specifically, we recommend that the MMS adopt guidelines that state that the lessee has rebutted the presumption of control if he can demonstrate that:

- The affiliated entity can take any relevant action without an affirmative vote of the lessee; or
- If the lessee is a partner in a partnership but is not a general partner; or
- The lessee is a natural person not related within the fourth degree to the affiliated natural person; or
- The lessee has directors on the affiliated company's board of directors but the lessee's director cannot block any relevant action by the board.

See Appendix "A" at 2-4.

¹ While too numerous to cite in these comments, the administrative record for this rulemaking is full of comments from large and small producers, crude oil marketers and respected economists that vigorously support the thesis that there is an active market at the lease which makes it unnecessary to use a downstream point as the starting point for valuation of most crude oil transactions.

At the April 7, 1999 workshop, two questions arose with respect to Industry's recommended criteria for rebutting the presumption of control. One involves the fiduciary responsibility of partners. The other one involves satisfying the proposed "opposing economic interests" requirement.

Fiduciary responsibility of partners. One of the participants at the workshop contended that a partner owning 10-50% of a partnership who is not a general partner could nevertheless "control" the partnership because a general partner is a fiduciary of the partnership and the other partners. Industry believes this concern is unfounded.

A general partner having a fiduciary duty to the partnership and the other partners must place the interests of the partnership and the other partners ahead of his own. However, if the partnership enters a contract with a partner acting in his or her individual capacity, the general partner's fiduciary duty would require him to place the partnership's interest ahead of those of the partner acting in his or her individual capacity.

For example, where the lessee is a partnership and contracts to sell lease oil production to an individual who also owns 10-50% of the partnership, the general partner's fiduciary duty to the partnership would require that the interests of the partnership be placed ahead of those of the partner dealing in an individual capacity with the partnership. In fact, a general partner placing a limited partner's individual interest ahead of the partnership's interests would actually breach his fiduciary duty.

Opposing economic interests. The proposed definition of arm's-length contract contains an "opposing economic interests" element: "*Arm's-length contract* "means a contract or agreement between independent persons who are not affiliates and who have opposing economic interests regarding that contract. . . ."²

Specifically, the MMS asked how a lessee who successfully rebutted the presumption of control might satisfy the "opposing economic interests" requirement. In contrast to the presumption of control that exists when a lessee owns a 10-50% in another entity, the proposed rule imposes no presumption of lack of opposing economic interests that the lessee must rebut.

A lack of opposing economic interests cannot be presumed; it must be established by MMS based on the facts surrounding the transaction. A lessee who has successfully rebutted the presumption of control should have no further burden of proof with respect to the "opposing economic interests" requirement. Where the presumption of control has been successfully rebutted, it would be illogical and unfair to use the affiliation of the parties in order to establish the lack of opposing economic interests. The criteria for establishing the lack of opposing economic interests should be no different for parties who have successfully rebutted the presumption of control than for those who have contracted with unaffiliated entities. Simply put, lack of opposing economic interests should be established based on criteria other than mere affiliation between the parties.

² 30 CFR 206.101, as proposed at 63 FR 6113, 6126 (February 6, 1998).

As a separate but related arm's length transaction matter, Industry endorses MMS' efforts to accommodate the desire of lessees to pay royalty based on their arm's-length gross proceeds, less appropriate deductions. However, the MMS could give lessees the option of utilizing index netback methodology to value royalties, even for arm's length sales, if the lessee preferred to avoid the complexity of tracing production downstream.

B. Non-Arm's Length Transactions

The gist of Industry's recommendation is that the MMS adopt a menu of valuation options that should include a comparable sales option and could include a net back/index-type option for valuation of production in non-arm's length transactions. Overall, Industry believes that the market at the lease is active enough to generate sufficient comparable sales that would make recourse to a netback-type methodology unnecessary in most cases for valuation of production at the lease.

As presented at the workshops, the Industry-recommended comparable sales model would have the following elements:

- At least 20% of the lessee's production must be purchased or sold at arm's length to serve as the basis for valuation of non-arm's length production.
- Where a tendering or bid out-type system is used, a minimum of three bids would be required.
- The value used for valuation of the non-arm's length production would be based on weighted average prices of third party transactions.
- The value would be adjusted as necessary for transportation and quality.
- The valuation methodology would be subject to annual review by MMS.

See Appendix "A" at 5-9.

Such an approach builds on the MMS' own proposal for use in the Rocky Mountain region³ and tracks the approach used by states and the MMS for royalty-in-kind. It avoids the unavailability of data problem identified by the MMS in connection with use of the current regulations' comparable sales benchmarks. It takes advantage of the high production volumes in the Gulf of Mexico. And using a large representative sample of arm's length transactions makes it possible to avoid the inherent complexity of calculating lease-market center differentials while focusing on the value of production at the lease.

³ The MMS proposal for non-arm's length valuation in the Rocky Mountain region is unduly limited in many significant respects but does recognize the value of alternative valuation pathways. See, e.g., API's April 1998 comments on the MMS' February 1998 supplementary proposal at 2-5.

At the March-April 1999 MMS workshops, the MMS posed two questions: One involved the 20% production volume minimum. The other involved which arm's length transactions would be included in the weighted average of comparable sales.

Minimum production volume. The MMS has suggested that a production volume threshold higher than the 20% might make a comparable sales approach more acceptable. Following its own February 1998 proposal, and relying on a Rocky Mountain Oil and Gas Association (RMOGA) survey of state severance taxes,⁴ the MMS suggested a 30% hurdle; this hurdle is somewhat higher than the sum of the onshore federal royalty rate and the highest onshore state severance tax rate (i.e., 14.2% for Montana). In response to this suggestion, industry is amenable to a 25% hurdle for onshore and 20% for offshore. For onshore, a 25% hurdle rate is just below the 27% sum of the onshore royalty rate of 12 1/2% and the highest state severance tax rate, but well above the sum if the average severance tax rate (about 7.5%) is used. For offshore, where no state severance tax rates apply, 20% is higher than the 16 2/3% OCS royalty rate and substantially higher than the 12 1/2% rate in the deep water Gulf of Mexico. Significantly, the principal production growth area offshore is the deep water Gulf of Mexico, further obviating the need to have a volume percentage hurdle greater than the 20% recommended.

Weighted average. The MMS also asked if the comparable arm's length transactions included in the weighted average would include transactions at the lease and downstream as well. Industry believes that if volumes are sufficient to reach the minimum the weighted average should include only transactions at the lease since these best reflect value as at the lease without the need for adjustments to adjust for downstream additions of value. On the other hand, if the transactions at the lease do not reach the percent production volume hurdle, downstream transactions could be added on case-by-case basis, if agreed to by the lessee and the MMS in the course of the annual review.

C. Adjustments to Downstream Values - Transportation

The gist of Industry's recommendations on adjustments generally is that the MMS-proposed scheme for adjustments does not fully capture downstream additions to the value of production at the lease and leads to unlawfully higher royalty obligations. Significantly, these adjustments have applicability whether indexing or gross proceeds (for sales away from the lease) is employed.

For transportation, the basic difference is that the MMS' proposal is grounded on pegging transportation allowances to an insufficient cost of capital recovery estimate and operating and maintenance whereas Industry would peg transportation allowances on a commercial value of service determined in the marketplace. Although the problems with the transportation aspect of the MMS' current proposal were addressed in prior Industry comments,⁵ they have not yet been addressed by the MMS. Moreover, the

⁴ Rocky Mountain Oil & Gas Association, "Tax Comparison Report (Draft 9/97)."

⁵ See April 1998 API comments at 7-9.

MMS-Industry exchanges at the March-April 1999 workshops makes it important to revisit the outlines of this significant issue,

1. Character of the MMS Proposal for Transportation

MMS divides transportation allowance into two distinct categories: (1) arm's-length transportation in which the transported party is not related to the party owning the line; and (2) non-arm's-length transportation which involves transportation of lease production when an affiliate of the lessee owns the pipeline. There is no controversy over arm's-length transportation since the agency generally accepts the cost paid to a non-affiliated party as the appropriate transportation allowance. The focus of controversy centers on non-arm's-length transportation for which MMS has proposed an allowance that is not related to the market value of service.

The foundation of the MMS transportation proposal for non-arm's-length transportation is that a lessee's transportation allowance should be based primarily on the recovery of the original capital investment in the oil pipeline plus operation, maintenance, and overhead expense. Capital recovery is provided by lessee selection of one of two methods: (1) depreciation of capital investment by straight line or unit of production methodology plus a fixed rate of return on the undepreciated capital, or (2) fixed rate of return on the original capital investment.

In both cases the rate of return employed is the very low Standard and Poor's BBB Bond rate. And, once the pipeline is fully depreciated, only the operating and maintenance expenses remain, which are minimal in comparison to capital costs. Pipelines may be depreciated only once and, if sold after full depreciation, cannot be depreciated again by the new owner.

To compound matters further, the MMS proposal reflects the agency's categorical rejection of FERC oil tariffs as a measure of oil allowances. FERC tariffs were expressly accepted under the 1988 regulations and have only been recently rejected by MMS because of confusion caused by several FERC decisions on the issue of whether FERC had jurisdiction over pipelines on the OCS.

This approach is flawed for the following reasons:

a. Different Valuation for the Same Oil from the Same Lease.

Under the MMS proposal, oil production from a lease owned by two lessees produced on the same day and traveling through the same pipeline owned in part by one of the co-lessees would have different royalty value merely by application of the regulation and solely as a result of one lessee owning some percentage of a line transporting the oil production. As a result, a pipeline user/non-owner (Lessee A) would be allowed to take as a deduction the commercial cost or value paid to move through the pipeline. However, the pipeline owner (Lessee B), who owns all or only a part of the pipeline would be limited to recovery of capital cost in the line. As a result, the lessee/owner would pay more royalty than the user/non-owner on the same pipeline. This would be true even if the lessee were only affiliated with the pipeline owner and paying commercial transportation rates to the affiliated pipeline owner, since the lessee

receives no revenue stream from the operations of the pipeline. Such an approach is discriminatory and puts Lessee B at a competitive disadvantage.

b. Royalty Assessed on Transportation Not on Production

Although the MMS concedes that value is to be determined at the lease, MMS' proposal focuses on values away from the lease and then uses transportation as an adjustment to net back to the lease. The downstream value which MMS uses as the starting point for value is based on the commercial value of the transportation used to get oil to the away from lease value point. For example, Platt's spot price at St. James is based on commercial transportation to the index point.

Yet when the MMS ignores the commercial value of transportation and limits transportation deductions to that downstream point to capital recovery costs for lessees owning an interest in the pipeline, the royalty is overstated and assessed not only on the oil production but on an increment of its transportation too. Under mineral leasing statutes, royalty--for all lessees-- must be based on the "value of production" and cannot lawfully include any increment of transportation.

c. Adverse Competitive Impact on Lease Sales

Royalty obligation is one of the elements entering into the calculation of expenses by bidders at OCS lease sales. However, for those bidders who own a pipeline, or are affiliated with a pipeline owner, in the Gulf of Mexico, the economics of their bid may be adversely impacted. Since mere ownership of a part of the pipeline would mean that the royalty expense must be calculated on a different and higher basis than those who do not own an interest in the pipeline, the hurdle for profitability is raised. But for those not owning the line, there is no impact. This discriminatory result could interfere with competition, adversely affecting individual bidders and the Federal Government as lessor.

d. Disincentive for OCS Exploration and Development

Under §3 of Outer Continental Shelf Lands Act (OCS Lands Act) the MMS must foster and encourage exploration and development of the OCS. Even though the development of pipeline infrastructure is a vital element in the orderly and expeditious development of the OCS, the MMS' current transportation methodology penalizes the lessee who takes the initiative and risk and makes the capital investment in pipelines. By requiring the lessee who owns an interest in the pipeline, or is affiliated with a pipeline owner, to pay a higher royalty expense than a competitor who merely later used the pipeline, the MMS creates a disincentive to install new pipelines which impacts all lessees operating in the affected area.

If the MMS transportation policy is at odds with the core of the OCS Lands Act, the exploration and development policy disincentive it creates is also incongruous with recent legislation and even more recent Administration initiatives aimed at encouraging development. It does not mesh with Congress' public policy recognizing the need for royalty relief as an incentive for certain offshore development under the Outer

Continental Deep Water Royalty Relief Act.⁶ Nor does it advance elements of the Administration's Comprehensive National Energy Strategy (CNES) adopted by the Department of Energy last year which, among other things, promotes development of oil and gas resources on federal lands.

e. Discrimination on the OCS

Section 5 of the OCSLA specifically addresses pipelines and discrimination in their administration by the Interior Department as follows:

. . .and upon the express condition that oil and gas pipelines shall transport or purchase without discrimination oil or natural gas produced from submerged lands or Outer Continental Shelf lands in the vicinity of the pipelines. . . .⁷

and later:

(A) The pipeline must provide open and non-discriminatory access to both owner and nonowner shippers.⁸

The clear intent of these portions of the Act is to specify that movement on OCS pipelines is not to result in discrimination among shippers. Yet by requiring a reimbursement for movement of the royalty portion below that paid by other parties similarly situated, the MMS proposal for transportation plainly discriminates in violation of the spirit, if not the express terms of the Act.

f. MMS Use of Other Approaches

Over the past forty years the MMS has not always used its present capital recovery approach to determine the value of allowances for transportation. Prior to the 1988 regulation, MMS approved under the "other considerations" provisions of the regulations and lease the cost paid by third parties moving through the pipeline. This approach recognized that the measure of value for the allowance could reasonably be based on what other non-related parties paid to move through the same pipeline during the same monthly accounting period.

2. Industry Proposal

In an effort to reach closure with the MMS on the transportation adjustment issue, Industry offered a new, pragmatic recommendation at the recent workshops. Stripped to its essence, the Industry-recommended approach comprises the following:

- For arm's length transportation, the actual rate paid would be used (as the MMS proposal already provides).

⁶ Outer Continental Shelf Deep Water Royalty Relief Act, P.L. 104-58, 109 Stat.563, codified at 43 USC § 1337(a) and OCS Lands Act § 8(a).

⁷ OCS Lands Act 5(e).

⁸ OCS Lands Act 5(f).

- For non-arm's length transportation, where more than 20% of the pipeline volume is arm's length transportation, an annualized volume-weighted average of the arm's length rate would be used.
- Where less than 20% of the pipeline volume is non-affiliated, a rate corresponding to twice the Standard & Poor's BBB bond rate for undepreciated capital, but never less than 10%⁹ of the capital cost of the original line plus operating and maintenance expenses, would be used.
- Timely issuance of subsea guidelines for the Gulf of Mexico.

See Appendix "A" at 10-13.

Industry's transportation recommendation would sidestep the jurisdictional question altogether and the FERC tariffs issues now in litigation, drawing no distinction between jurisdictional and non-jurisdictional pipelines. It would use objective, verifiable, comparable payments by non-affiliated parties as the cornerstone. It recognizes that transportation is a service for which all similarly situated parties should be treated the same to avoid discrimination and avoid interference with competition. It avoids the merchantability issue, provides certainty in administration and facilitates audits.

At the March-April 1999 MMS workshops, several questions about the Industry-recommended approach arose in three areas: the risks of pipeline operation, the cost of capital recovery, and the MMS' proposed S&P BBB bond rate itself.

Pipeline risk. MMS asked industry to further elaborate on the "risks" surrounding oil pipelines, contending that there appeared to be little risk in operating an oil pipeline after discovery of reserves. Several witnesses appeared and responded to this issue.

These witnesses established for the record that there are very real risks surrounding pipeline operation. Pipelines, especially those in the Gulf, are built at great distances for more than movement of one lease's production. Pipelines may be sized well above that needed for single lease affiliate production. This alone increases cost, but once the line is laid there is the risk of underutilization, i.e., less oil is available than the line size anticipated to operate profitably. An example of underutilization of a pipeline with increased costs and less profit was discussed.

Competitive conditions created by installation of other lines can upset planned economic premises by lowering transportation rates charged due to competition. In fact, it was demonstrated in response to MMS inquiry that there is a competitive market for transportation.

Technology challenges and changes were also cited. Technology development, especially for deepwater lines, is a very significant capital expenditure and an integral part of a resource development project. Deepwater lines cost today around one million

⁹ The proposed 10% minimum, is best viewed as a management fee, appropriate even if the pipeline is fully depreciated. Absent such a fee, the owner would have limited incentives to manage the operations for the pipeline and manage the risks of continuing to operate the pipeline

dollars per mile because of the hostile conditions of water depth (i.e., extraordinary variations in temperature, pressure and undersea topography). Even today work is still underway to technically solve tie-ins below water in deeper waters of the Gulf. Overall, the MMS should take into account that there is substantial risk in operating pipelines.

Cost of capital and S&P BBB bond rate. The rate of return necessary to reasonably operate a pipeline was discussed and it was pointed out that Standard & Poor's BBB bond rate coupled with eventual zero depreciation failed to provide that return. The essential problem with the MMS methodology is that it ignores the use of higher cost equity financing. By arbitrarily assuming 100% debt financing, the MMS methodology fails to provide firms a return commensurate with the rate of return expected by investors or a return that covers the firm's cost of raising capital. Further, once a pipeline is depreciated, the firm receives no return on its investment and is merely paid a transportation rate that covers variable operating expenses. The management fee approach, used by the FERC, may be one way to rectify this problem.

Appendix "D" to our comments reviews the cost of capital concept and the way in which regulatory authorities (other than the MMS) typically determine the allowed return on investment in regulated industries. Our purpose here is not to suggest a particular regulatory approach for the determination of transportation rates, and certainly not to accede to a capital recovery approach in principle. Rather, the weighted average cost of capital estimates presented in the appendix show that the conventional approach for determining the cost of capital results in cost of capital estimates that exceed the estimates generated by the MMS approach. A review of estimates by others undoubtedly would show the same.

Lest there be any misunderstanding, Industry does not endorse the MMS' flawed capital recovery methodology. Industry's recommendation is really two-fold. First, if the MMS is wedded to a capital recovery approach, the MMS should adopt a rate of recovery substantial higher than the proposed Standard & Poors BBB rate. This would be more in line with the expected return required by an investor that would take into account the significant risks associated with such projects. Second, and more fundamental, the MMS should undertake a hard look at the complex transportation allowance issue and consider another workshop or a symposium. With such an opportunity, the MMS could avail itself of available expertise among other federal agencies, Industry and the public which we believe would help the MMS align its transportation allowance policies with economic realities.

D. Adjustments to Downstream Values - Quality and Location

As with adjustments for transportation, the current MMS proposal does not allow adjustments for location and quality sufficient to calculate a reasonable value of production at the lease. Specifically, the current MMS proposal:

- Relies on Form MMS-4415 that is unduly burdensome and results in the collection of information not usable for the purpose intended.

- Uses MMS-published location/quality differentials that are likely to be as much as 24 months out of date.
- Does not include all appropriate adjustments (e.g., quality adjustments between aggregation point and the lease).
- Includes as a starting point an index that in some cases may be far from reflecting the quality of crude oil being valued (e.g., some streams may have as much as a 20 degree difference in quality).
- Provides for several publications without addressing the situation publication where somewhat different spot prices for the same crude are quoted in multiple publications.

See Appendix "A" at 14.

To address these problems, industry recommended at the March-April 1999 workshops an approach with the following elements:

- Consistent with the MMS proposal, actual location/quality differentials would be used by lessees having such transactions.
- Industry and MMS would develop a uniform monthly report based on a combination of actual location/quality differentials and location/quality differentials calculated from gross proceeds transactions. This report would represent a methodology that reflects value at the lease versus index price normalized to index gravity. Reported location/quality differentials would be aggregated by the MMS on a periodic basis, at least quarterly, for use by companies without alternative means to value non-arm's length transactions.

See Appendix "A" at 18.

Industry also suggests that in developing the form, the MMS:

- specify one publication per crude;¹⁰
- use nationwide the nearest index point with like quality; and.
- allow adequate adjustments for transportation.

Such an approach offers several distinct advantages. It uses more current data to better reflect the dynamic crude oil market and arrives at a more accurate value of production at the lease. It uses information on crude oil quality at the lease based on transactions that are auditable. It would be less costly to administer than Form MMS-4415 because it would not require the collection of unnecessary, difficult to assimilate information. Finally, the information collected is not proprietary and would be available to industry and the MMS. See Appendix "A" at 16.

¹⁰ As an alternative, the MMS could establish a seriatim list for each crude, identifying more than one publication but specifying their order of use depending on availability of publication.

E. Adjustments for Downstream Values – Midstream Activities

In addition to the transportation, quality and location adjustments described above, further adjustments to a market center index may be necessary to accurately calculate the value of production at the lease. These adjustments are for midstream costs that are incurred whenever crude oil is sold away from the lease market, at some downstream point such as the market center index point.

Many of the midstream costs are components of an overall transportation cost, such as scheduling of transportation volumes, pipeline fill, pipeline loss allowances, risk of transport failure, risk of pipeline spill, oil distribution fees, scheduling of storage volumes, maintaining inventory, and the time value of money associated with the delivery of volumes. At the March 25, 1999 workshop in Albuquerque, MMS acknowledged that costs of transportation-related midstream activities should be allowed as an adjustment. Industry requests that MMS, having acknowledged the propriety of such adjustments in the workshops, expressly allow for such adjustments in the final rule.

There are other non-transportation-related costs of midstream functions that help account for the difference in spot market center indices and value of production at the lease. These midstream functions include securing division orders, disbursing production proceeds, complying with regulatory and reporting requirements, aggregating supplies, staffing and salaries, and office facilities and equipment. If MMS does not permit all appropriate adjustments, it would be assessing royalty on the value of those midstream functions and would be unlawfully determining the market value at the lease, since royalty is due on the "value of production."

MMS has also recognized that other midstream adjustments from index may be taken into account. In its own contract with small refiners under the royalty in kind program, the MMS admits to the "arm's length negotiation" of a flat \$0.35 per barrel adjustment off index for production delivered to the small refiners at the market center (where transportation, quality and location differentials would not be at issue). It would logically follow that further adjustments which include the cost of midstream functions would be necessary to arrive at the value of production at the lease. Furthermore, 43 USC 1353 (b)(2) requires that federal production taken in kind and delivered to small refiners shall be at "fair market value." This negotiated adjustment in its contract with small refiners is recognition by MMS that spot index prices do not represent "fair market value" even at the market center.

F. No Second-Guessing

At its core, the industry recommendation would emphasize that the lessee deserves a presumption in favor of good faith where a lessee enters into an arm's length transaction. The mere existence of a higher price in another transaction should not suffice to have the transaction deemed non-arm's length or to disallow the price received as the value for royalty purposes. See Appendix "A" at 19-20.

Underlying this recommendation is the fact that economic interest drives the lessee to seek the highest price wherever possible; after all the lessee's share is 5/6 offshore and 7/8 onshore whereas the lessor's royalty share is 1/6 offshore and 1/8 onshore. Moreover, a presumption of good faith would not, of course, shield lessees from audit and would not be license for misconduct or fraud. Lessees operating in good faith simply need a reasonable threshold before their normal business transactions can be set aside.

In the course of the workshops, specific regulatory language was developed to strike a balance on this important issue, drawing on industry proposals and the earlier comments of the State of California. See Appendix "B"; see also Appendix "A" at 21-22.

F. Binding Determinations

The gist of industry's recommendation is that lessees trying to comply with MMS valuation regulations need an explicit process by which they can obtain timely MMS determinations of valuation methodology that can be relied on for satisfying royalty obligations.

In earlier comments, API alluded to the IRS' regulations for private letter rulings¹¹ but at the recent workshops, Industry offered a specific recommendation having several specific features:

- Limited to the specific facts presented for a specific property (i.e., no hypothetical cases);
- No precedential effect;
- Requires MMS determinations within a prescribed time period (i.e., 180 days);
- Prescribes default in absence of MMS action (i.e., lessee could rely on proposed methodology until MMS decides otherwise); and,
- Could be revoked prospectively (i.e., lessee would have determination it could rely on until MMS changed its mind; prospective MMS change would involve no revision of records and payments and would be subject to challenge).

See Appendix "A" at 24-27.

As the MMS knows, several federal agencies have procedures in place to generate case-by-case rulings to assist regulated entities to comply with agency regulations.¹² For example, United States Customs Service regulations contemplate the issuance of a variety of rulings at the request of a regulated party. The Customs Service regulations make the rulings inapplicable to hypothetical questions,¹³ limit the rulings to actual prospective transactions described by specific facts,¹⁴ and permit the applicant to

¹¹ See API April 1998 comments at 11-12.

¹² See, e.g., Internal Revenue Service regulations at 26 CFR 601; Department of Treasury regulations at 17 CFR § 400.2; Customs Service regulations at 19 CFR Part 177; Department of Energy regulations at 10 CFR Parts 205 and 490; Contract Disputes Act, 48 CFR § 33.211; Security and Exchange Commission, 17 CFR §140.99 (a)(2); Department of Justice, 28 § 80; Government Ethics Standard of Ethical Standards of Ethical Conduct, 5 CFR Part 2635.

¹³ 19 CFR § 177.7.

¹⁴ 19 CFR § 177.2(b).

propose a particular ruling.¹⁵ Although the Customs Service rulings may be narrowly limited in application,¹⁶ they are binding upon issuance,¹⁷ and are subject to administrative appeal.¹⁸ The Customs Service rulings can be revoked or modified but, so changed,¹⁹ do not apply retroactively, provided several reasonable conditions are met (e.g., no misstatement or omission of relevant facts, good faith reliance).²⁰

In addition, several agency regulations prescribe a period of at least presumptive length for agency disposition of the ruling request.²¹ This is especially significant for lessees who are subject to fines for failure to make accurate and monthly royalty payments. Moreover, lessees are situated quite differently from most other regulated parties who seek rulings from other agencies, because crude oil production is not an isolated event but a continuing process where any delays in valuation could necessitate substantial retroactive changes in records and royalty payments which are costly to perform.

During the March-April 1999 workshops, certain questions arose in connection with the problems with non-binding determinations: participation by states in the process; the difficulty of arriving at determinations; the lack of MMS resources.

Problems with non-binding determinations. At the April 7, 1999 workshop, Industry representatives explained, non-binding determinations pose a dilemma for a lessee. If the MMS determination is adverse, but not binding, the lessee has no recourse except to accede to it or ignore it and face the prospect of an order to pay, possible penalties, and potentially allegations of False Claims Act violations. Even if the determination is favorable, its non-binding character in no way constrains auditors from later issuing demands leading to the same consequences. Thus, future non-binding determinations would be of dubious value, but binding determinations would be of great value.

State participation. Industry is unaware of any agency ruling procedure that expressly provides for participation by other parties such as the states. However, Industry believes such provisions are unnecessary. Industry suggests instead that the MMS adopt procedures comparable to Department of Energy regulations that require that interpretive rulings be placed in a public file.²²

MMS resources and difficulty. At the April 7, 1999 workshop, the MMS voiced reservations about the establishment of an explicit process beyond the proposal that the

¹⁵ 19 CFR § 177.2(b)(6).

¹⁶ 19 CFR § 177.9(b)(3).

¹⁷ 19 CFR § 177.9(a).

¹⁸ 19 CFR § 177.2(b)(2)(B).

¹⁹ 19 CFR § 177.9(a).

²⁰ 19 CFR § 177.9(d)(2). *See also* Department of Energy regulations at 10 §490.5(h)(1) specifying that a person relying on an interpretive ruling shall not be "subject to an enforcement action for civil penalties or criminal fines for actions taken in reliance thereon. . . ."

²¹ Contract Disputes Act decisions at 48 CFR sec33.211 (60 days); Department of Justice Foreign Corrupt Practices Act opinions at 28 CFR § 80.8 (30 days); Department of Justice Foreign Agents Registration Act opinions at 28 CFR §5(i).

²² See DOE regulations at 10 CFR §490.5(k).

Assistant Secretary or his delegate be empowered to issue binding determinations.²³ Underlying its reservations, the MMS said that necessarily required substantial agency involvement, consideration of comparable situations, and staff resources well beyond the existing complement.

Without trivializing MMS' resource and decision making concerns, Industry would only observe that lessees have the obligation to report production and pay royalties within 30 days, and face imposition of interest, penalties, and even allegations of False Claims Act violations, if strict compliance with the MMS' complex valuation regulations--often determined through audits years later--does not occur. Industry does not quarrel with the strict compliance, only that the MMS is best situated to make the determinations lessees need to rely on. To the extent there is a staff resource problem, we submit that this is attributable to the inherent complexity of fair valuation regulations which could be eliminated through adoption of royalty-in-kind in lieu of valuation. However, if the MMS needs additional resources to do its job, Industry urges the MMS to raise this during the congressional appropriations process.

Industry simply urges the MMS to craft its own procedures, tailored to deal with the realities of oil and gas production and the associated royalty reporting and payment obligations. Royalty determinations so obtained would, of course, not be substitutes for audits but would, we believe, lead to far fewer controversies, appeals and litigation, all of which consume lessee and government time and dollars.

#

List of Appendices

Appendix A: Compilation of Joint Industry Recommendations Offered at March 23, March 24 and April 6-7, 1999, MMS Workshops on Crude Oil Valuation Rulemaking

Appendix B: Additional Industry Recommendation on Second-Guessing Issue Developed at April 6-7, 1999 MMS Workshop on Federal Crude Oil Valuation Rulemaking

Appendix C: ABC Company's December 1998 Location/Quality Differential for Federal Crudes

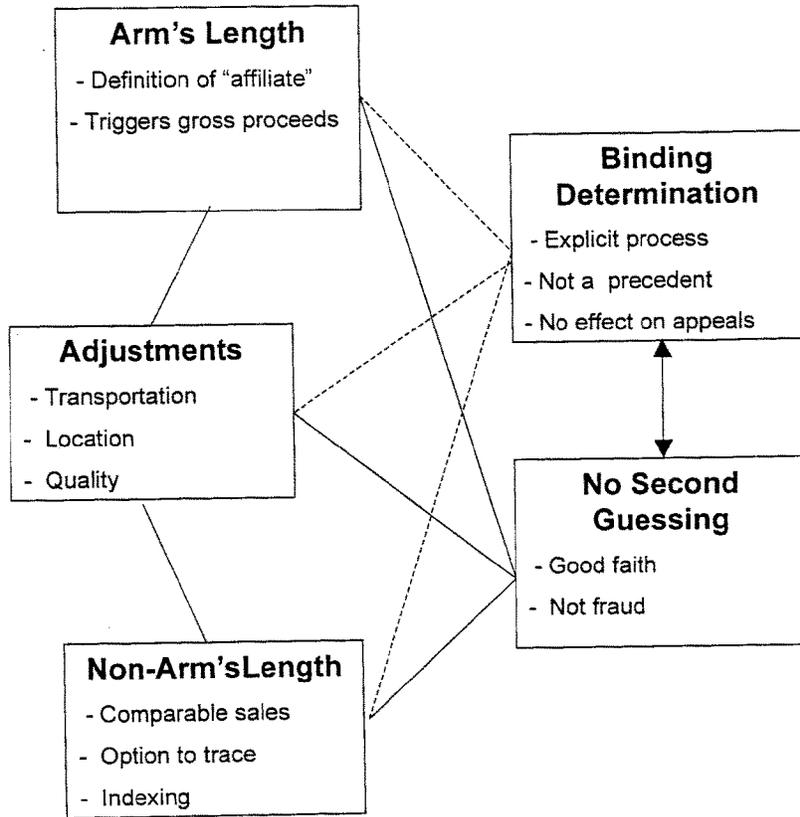
Appendix D: The Cost of Capital vs. the Return on Investment Allowed by the MMS

²³ See 64 FR 12267,12269 (March 12, 1999), citing the letter of the Assistant Secretary, Land and Minerals Management, to Members of Congress, dated August 31, 1998.

Appendix A

Compilation of Joint Industry Recommendations Offered at March 23, March 24 and April 6-7, 1999 MMS Workshops on Federal Crude Oil Valuation Rulemaking

Oil Valuation Overview



DEFINITION OF AFFILIATE
BACKGROUND

- Current language outlines arm's length versus non-arm's length
- Includes presumption of control/non-control without guidelines on how to rebut
- MMS has agreed to accept current definition of control/non-control to define "affiliate"
- Proposed rule uses definition more broadly than current rule

**DEFINITION OF AFFILIATE
INDUSTRY PROPOSAL**

Sets forth generally applicable guidelines for rebutting presumption in the following manner:

- If affiliated entity can take any relevant action without affirmative vote of lessee, then no control
- If lessee is not general partner of a partnership, then no control
- If lessee is a natural person not related within the fourth degree to the affiliated natural person, then no control
- If lessee's directors on board of affiliated company cannot block any relevant action of affiliated company, then no control through interlocking directorates
- Use same percentages as existing regulations

**DEFINITION OF AFFILIATE
MERITS OF INDUSTRY PROPOSAL**

- Implements MMS' stated goal of providing guidelines using current control/non-control guidelines with same percentages
- Establishes objective guidelines not existing in current regulations
- Add clarity and certainty to existing regulations

COMPARABLE SALES MODEL BACKGROUND

- Goal is value of production at the lease
- Builds on MMS comparable sales benchmark in the Rockies
- Builds on recognized concept of arms length value of similar production
- Intrinsically simpler than netback

**COMPARABLE SALES MODEL
COMPONENTS OF MODEL**

- Premised on third party arm's length transactions at the
- At least 20% of production must be sold / purchased arms length within comparable production area
- Objective data for validation is maintained by lessee
- Minimum number of bids (3) for bid outs
- Value based on weighted average prices of third party transactions
- Adjustments for quality and transportation as necessary
- Annual review with MMS

83

**COMPARABLE SALES MODEL
MERITS**

- Resolves MMS perceived concerns with comparable sales/purchase as incorporated in current benchmarks
- Captures the unique values at individual leases (preferred point for lessor and lessee)
- Avoids complexity of calculating differentials between lease and market center
- Used by states and MMS in RIK programs
- Builds on MMS limited proposal in Rockies
- Solves audit issues through simplified procedures

COMPARABLE SALES MODEL
CONCESSIONS

- Stricter qualifications for participation addresses MMS' past criticisms
- Increases required lessee record keeping
- Increased percentage to risk company production over royalty burden
- Minimum number of bids required to demonstrate active market

Example of a Comparable Lease Sales Program

Produced from Field -----	1050 Bbls
Portion Sold -----	250 Bbls
Weighted Average Price of Portion Sold -----	\$3000
Average Price Per Bbl Sold -----	\$12 / Bbl
Value of Portion Not Sold -----	\$9600

TRANSPORTATION BACKGROUND

History & Impact

- Recovery of capital and O & M
- 1988 Regs Tariff was compromise
- Dispute over tariffs
- Rate of return inadequate

TRANSPORTATION PROPOSAL

Service is provided – value of service

- Avoids jurisdictional issue
- Use arm's length comparables as cornerstone
- For arm's length use actual rate paid
- For non-arm's length use dual approach
 - More than 20 % non-affiliate – annualized volume weighted average rate paid
 - Less than 20% non-affiliate use modified MMS approach:
 - 2X triple B
 - Never less than 10% capital cost of original line + O&M

88

**TRANSPORTATION
SUBSEA**

- Industry proposal previously provided
- Status of subsea transportation guidelines?

**TRANSPORTATION
MERITS OF INDUSTRY PROPOSAL**

- Sets aside tariff jurisdictional dispute
- Recognizes that transportation is a service
- Uses comparability to validate – good for product value – good for transportation
- Focus on non-arm's length sale and concedes lower rate for non-arm's length
- Treats all parties similarly situated the same
- Certainty & ease for audit
- Provides for Subsea guidelines
- Avoids merchantability issue
- Important element of fair netback

ADJUSTMENTS OFF DOWNSTREAM VALUES: LOCATION/QUALITY DIFFERENTIALS
BACKGROUND

- Goal is value of **production at the lease**
- Current MMS proposal does not adequately reflect adjustments off index or downstream value to approximate lease value
- Form MMS-4415 is administratively burdensome; information collected may not be useable for purpose intended
- MMS-published differentials would be as much as 24 months out of date
- Current MMS proposal for California uses a starting point (ANS) that is vastly dissimilar from most California crudes even though other published market prices exist that more closely match federal crude quality
- MMS proposal does not allow for all appropriate adjustments such as allowing an adjustment for quality between "aggregation point" and lease

ADJUSTMENTS OFF DOWNSTREAM VALUES: LOCATION/QUALITY DIFFERENTIALS
INDUSTRY PROPOSAL

- Where it can be established that there are no arm's length or comparable sales, can use an netback methodology to approximate lease value
- Uses actual location / quality differentials where available
- Industry and MMS to develop report or contemporaneous tables by region incorporating differentials reflective of recent market conditions
- Differentials to be applied as an adjustment to appropriate index
- Differentials based on actual crude quality at the lease as compared to downstream quality

ADJUSTMENTS OFF DOWNSTREAM VALUES: LOCATION/QUALITY DIFFERENTIALS
MERITS OF INDUSTRY PROPOSAL

- Use of more current data makes differentials more reflective of dynamic market
- Uses actual crude quality data at the lease
- Information is not proprietary as reported and is auditable
- Replaces Form 4415 with a more workable method
- Methodology is improvement over quality adjustment to market center indices which MMS appears to accept

93

ADJUSTMENTS OFF DOWNSTREAM VALUES: LOCATION/QUALITY DIFFERENTIALS
CONCESSIONS

- Specifies adjustments (e.g., transportation and location/quality differentials) for use with an index netback calculation method to better approximate lease value
- Proposal makes a prospective netback adjustment method less objectionable to industry as an option when there are no arm's length sales or comparable sales

Basic Formula

Formula	Comments
Downstream Sales or Appropriate Market Center Index +/- Gravity +/- Sulfur - Transportation +/- Location Differential, includes: - Midstream costs +/- Spot to Term +/- Location	Nearest Index Point with like quality (1) Use actual; if no actual, use table such as Gravcap in GOM Use actual; if no actual, use prevailing practice such as Gravcap in GOM See Proposed Transportation Adjustments on Page Eight Options include: (1) Use buy/sell on a portion of a company's crude as a comparable for crude without buy/sell and not sold (2) Create a "table" adjustment based on internal information on a company by company basis w/ some actual transactions (3) Compile #1 and/or #2 and turn in on a current basis to MMS; MMS consolidate from multiple reporters and publish

Calculated Approximate Lease Value

(1) For Index: One publication per crude or a seriatum list per crude -- use first, if no longer published, use second, third, etc.) should be declared by MMS. Starting point for California would be Kern River or other "nearest index point with like quality."

**NO SECOND-GUESSING
BACKGROUND**

- Rule appears to contain several opportunities where language can be made more certain for both the lessor and lessee
- Industry and MMS concur on stated objective of certainty for arm's length sellers
- Appears to be some misunderstanding between MMS and industry over whether or not to include no second guessing language

**NO SECOND-GUESSING
BACKGROUND**

- Rule appears to contain several opportunities where language can be made more certain for both the lessor and lessee
- Industry and MMS concur on stated objective of certainty for arm's length sellers
- Appears to be some misunderstanding between MMS and industry over whether or not to include no second guessing language

**NO SECOND-GUESSING
INDUSTRY PROPOSAL**

1. Further define gross proceeds as those accruing to lessee
2. Move any references to non-arm's length sales from gross proceeds section to the non-arm's length section
3. Eliminate the reference to examples of services performed at no cost, e.g. marketing
4. Evaluation of breach of duty will be comprised of the following:
 - (a) whether or not the total consideration was actually paid, and/or,
 - (b) a comparison of other comparable sales
5. Place the options to either value in accordance with non arm's length provisions or upon first arm's length transaction beyond an exchange or affiliate transaction in non arm's length section
6. Parallel current gas valuation language beginning "You must base value..."

**NO SECOND-GUESSING
MERITS OF PROPOSAL**

- Preserves debate over duty to market
- Provide guidance for evaluation of gross proceeds that both lessee and lessor can understand
- Greater certainty and clarity
- Restricts MMS' broad ability to audit and interpret

**BINDING DETERMINATION
BACKGROUND**

- Timely Valuation determinations are needed to reasonably conduct business
- MMS and Industry agree that a binding determination process should be included in new rule
- Need a process to implement

**BINDING DETERMINATION
INDUSTRY PROPOSAL**

- Lessee proposes valuation method for a specific property
- Determinations on a case-by-case basis
- Determination has no precedential value beyond the facts in request
- MMS given 180 days to decide on Lessee's proposal; decision subject to existing appeals procedures
- Subject to later adjustment, the Lessee pays royalty on the proposed method until MMS renders a decision
- Failure to respond within the 180-day period results in automatic adoption of the Lessee's proposed valuation.
- MMS may still act after 180 days but change prospective only

**BINDING DETERMINATION
MERITS OF INDUSTRY PROPOSAL**

- Industry proposal set forth above resolves an issue acceptable to both MMS and lessees
- Provides timely mechanism to conduct business with certainty
- Eliminates future disputes on audit – simplifies administration
- Builds on MMS 1988 regulation authorizing a lessee to request valuation determination

BINDING DETERMINATION

- (a) A lessee or delegee may request that DOI approve a specific valuation methodology that is consistent with applicable statutes and regulations. In its request, the lessee or delegee shall submit all pertinent information respecting the disposition of production subject to the proposal.
- (b) If DOI concludes that the lessee or delegee failed to provide all of the information required under paragraph (a), DOI shall, within forty-five (45) days of receipt of the valuation proposal, request that the lessee or delegee provide the omitted information.
- (c) DOI shall act on the requested valuation proposal prior to the latter of (i) 180 days after the lessee's or delegee's submission of the proposal or (ii) 135 days after receipt of the additional information submitted by the lessee pursuant to paragraph (b). Any order issued pursuant to this paragraph (c) shall be applicable only to the disposition of production described in the lessee's or delegee's valuation proposal and shall not otherwise have precedential value. In acting on the valuation proposal, DOI shall choose the valuation methodology most applicable under applicable laws and regulations to the disposition of production described in the proposal.
- (d) A lessee or delegee who submits a proposal under paragraph (a) may pay royalties pursuant to the methodology outlined in the proposal until and unless DOI rejects or modifies that proposal. In the event that DOI, prior to the applicable deadline set forth in paragraph (c), prescribes a modified or different methodology which results in additional amounts being due for the period during which royalties were paid pursuant to the proposal,

- the lessee or delegee shall pay the additional amounts due with interest calculated pursuant to 30 U.S.C. § 1721(a).
- (e) A lessee or delegee aggrieved by an order issued pursuant to paragraph (c) may appeal the decision under the procedures provided under 30 U.S.C. § 1724(h)(1). If the order is not appealed within thirty (30) days of its receipt by the lessee or delegee and if the lessee or delegee complies with such order, the lessee or delegee shall be deemed to have fulfilled its royalty payment obligations with respect to the disposition of production subject to such order for all periods between the date of the lessee's or delegee's submission of its request and the date, if any, that the Department revokes or modifies the order.
- (f) If MMS fails to act within the applicable period prescribed by paragraph (c) and if the lessee or delegee utilizes the methodology set forth in its proposal as the basis for the payment of its royalties on the disposition of production described in the proposal, then the lessee or delegee shall be deemed to have fulfilled its royalty payment obligations with respect to such disposition of production for the period between the date of the submission of the proposal and the date when DOI orders the lessee or delegee to adhere to a different or modified methodology.
- (g) The Secretary of Interior or Assistant Secretary for Land and Minerals Management may act on the requested valuation proposal pursuant to paragraph (c), in which event any such timely issued order will constitute final agency action, subject to judicial appeal by the lessee or delegee.
- (h) Nothing contained herein shall limit the authority of the Secretary or Assistant Secretary for Lands and Minerals Management to enter into any settlement agreement with a lessee or delegee establishing a valuation methodology which binds the lessee or delegee and DOI.

Appendix B

**Additional Industry Recommendation on Second-Guessing Issue
Developed at April 6-7, 1999 Workshop**

**Additional Industry Recommendation on Second-Guessing Issue
Developed at April 6-7, 1999 Workshop on Federal Crude Oil Valuation**

§206.101

- Retain the current definition of "gross proceeds."

§206.102

- Replace the term "seller" with "lessee."
- Move reference to non-arm's length sales to non-arm's length sales section.
- Provide option to trace through affiliate resale or use other non-arm's length method in non-arm's length section.
- Rewrite §206.102(c) as follows:

You must value the oil under section 206.103 if MMS determines that the value under paragraph (a) of this section does not reflect the reasonable value of the production due to either:

- (i) misconduct by or between the parties to the arm's length contract; or
- (ii) breach of your duty to market the oil for the mutual benefit of yourself and the lessor.

MMS shall accept arm's length transactions entered into by the lessee as the appropriate basis for federal royalty payments even though that value may not be the same as spot prices, NYMEX prices, or other index prices, or other prices received in other good faith arm's length transactions, provided that the value for royalty payments is the total consideration the lessee actually received at the lease for oil produced from federal oil and gas leases which has been placed in marketable condition, less applicable allowances.

- Add preamble language, to wit:

The MMS will not evaluate the method used by the lessee to market its oil when determining whether the lessee marketed in "good faith." For example, if a lessee decides to sell its oil at the wellhead instead of selling it at a downstream point, the mere fact that the lessee receives a lower price than he may have received at another point of sale, absent other factors indicating fraud, illegality or bad faith, would not indicate lack of good faith by the lessee, and would not be a circumstance that would require royalty adjustments in any potential future audits.

§206(d)(3)

- Rewrite §206(d)(3) as follows:

Value must be based on the highest price a prudent lessee can receive through legally enforceable claims under its contract. Absent contract revision or amendment, if the lessee fails to take proper or timely action to receive prices or benefits to which it is entitled, it must pay royalty at a value based upon that obtainable price or benefit. Contract revisions or amendments must be in writing and signed by all parties to an arm's length contract. If the lessee makes timely application for a price increase or benefit allowed under its contract, but the purchaser refuses, and the lessee takes documented reasonable measures, to force purchaser compliance, the lessee will owe no additional royalties unless monies or consideration resulting from the price increase or additional benefits are received. This paragraph will not be construed to permit a lessee to avoid its royalty payment obligation in situations where a purchaser fails to pay, in whole or in part or timely, for a quantity of oil.

§206.106

- Revise §206.106 to read as follows:

The lessee is required to place oil in marketable condition at no cost to the lessor unless otherwise provided in the lease agreement or this section. When the value of hydrocarbons is determined by gross proceeds, the gross proceeds will be increased to the same extent that the gross proceeds are reduced by the purchaser, or other party, providing certain services to the lessee when the cost of these services are ordinarily part of the lessee's responsibility to place the oil in marketable condition.

Appendix C

**ABC Company's December 1998 Location/Quality
Differential for Federal Crudes**

ABC Company's December 1998 Location/Quality Differential for Federal Crudes

The following table depicts the differential that ABC Company did or would have used in transactions involving Federal crudes relative to various market center index crudes.

Index Crude - WTI at Cushing as measured by the average of NYMEX quotes during the month of December, 1998 - assumes 40° API gravity.

<u>Crude</u>	<u>Delivery point</u>	<u>Location/Quality vs index</u>	<u>Other Quality Adjustments</u>
NM, WT, Ok intermediate sweet crudes	@ lease	(\$0.66)	Gravity adjustment table.
Wyo Sweet	@ lease	(\$1.66)	Gravity adjustment table.
Wyo SW Sweet	@ lease	\$0.14	Gravity adjustment table.
ND Sweet	@ lease	(\$2.61)	Gravity adjustment table.
Utah 4 Corners	@ lease	(\$0.91)	Gravity adjustment table.

Index Crude - WTS at Midland as measured by the average of Platts quotes during the month of December, 1998 - assumes 34° API gravity.

<u>Crude</u>	<u>Delivery point</u>	<u>Location/Quality vs index</u>	<u>Other Quality Adjustments</u>
WT, NM, Ok sour crudes	@ lease	(\$0.61)	Gravity adjustment table.
WT Yates	@ lease	(\$0.36)	Gravity adjustment table.
Wyo Asph sour	@ lease	(\$0.71)	Gravity adjustment table.

Index Crude - LLS at St. James as measured by the average of Platts quotes during the month of December, 1998 - assumes 35° API gravity.

<u>Crude</u>	<u>Delivery point</u>	<u>Location/Quality vs index</u>	<u>Other Quality Adjustments</u>
SoLa Sweet	1st on-shore point	(\$0.31)	Gravity adjustment table.
SoLa Sour	1st on-shore point	(\$0.94)	Gravity adjustment table.

Index Crude - Kern River delivered into the pipeline as measured by the average of Platts quotes during the month of December, 1998 - assumes gravity of 13° API

<u>Crude</u>	<u>Delivery point</u>	<u>Location/Quality vs index</u>	<u>Other Quality Adjustments</u>
SJV	@ lease	(\$X)/B	Gravity adjustment table.
Off-shore Calif.	from lease into AAPL 20°API gravity 5% sulphur	(\$Y)/B	Gravity @ x° Sulphur @ y/SB

Appendix D**The Cost of Capital vs. the Return
on Investment Allowed by the MMS****The Cost of Capital vs. the Return on
Investment Allowed by the MMS****Introduction**

The cost of capital is typically represented as the weighted average cost of a firm's equity and debt. Thus, a firm's existing capital structure (which comprises the respective proportions of its issued debt and equity), as well as its cost of issuing additional debt and equity, determine its overall cost of raising capital.

This appendix explains the cost of capital concept and how the cost of capital is calculated. Next, the procedure used by the MMS for determining the return on invested capital is reviewed. The MMS provides pipelines a return on their undepreciated investment equal the return on BBB bonds. A comparison of the petroleum industry's cost of capital, adjusted for taxes, highlights the fact that the current MMS methodology restricts returns on invested capital to rates that are below the oil and gas industry's weighted average cost of capital (WACC). Finally, the problem of depreciation and the concept of a management or service fee, used to compensate owners of fully depreciated pipelines, are discussed.

The Cost of Capital

In general terms, the cost of capital is the minimum rate of return necessary to attract capital for investment. It also can be defined as the expected rate of return prevailing in capital markets on alternative investments of equivalent risk. Firms invest in projects expecting to earn a rate of return that equals or exceeds their cost of capital. If firms cannot earn at least enough to cover their variable operating costs *and* their cost of capital, they will not be willing to raise funds for project investments. A firm that fails to earn a return that at least covers its cost of capital and variable operating costs is not viable in the long run.

In addition to keeping the above economic principles in mind, legal rules require regulators to carefully evaluate a firm's cost of capital.¹ The traditional rationale for cost-of-service rate regulation (e.g., by the FERC and state public utility commissions) is that the regulated company is a monopolist. Since competitive forces are not considered fully operative, cost of service regulation seeks to generate a rate of return that is "reasonable", i.e., one that would be earned if competition reigned. Thus, regulatory agencies have long adhered to the requirements laid out in leading court cases.² Cost-of-service methodologies also typically allowed firms to charge rates that covered variable operating costs.

¹ Pipelines transporting royalty production should not be treated as if they are public utilities.
² See *Bluefield Water Works v. P.S.C.*, U.S. 679 (1923); *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

The Weighted Average Cost of Capital

Firms typically raise capital by issuing debt and equity. The cost of issuing debt instruments normally is lower than issuing equity. Given this relationship, one might ask why firms ever resort to equity financing. Both debt and equity are issued because a firm's access to debt markets (i.e., its "debt capacity") is limited by the fact that investors perceive an excessive debt level as risky. From the investors's perspective, one advantage of purchasing a debt instrument over equity is that the firm is obligated to pay off debt holders before equity holders should bankruptcy ensue. If the firm is financed entirely by debt, the ability of debt holders to recover their investment if bankruptcy occurs would be weakened. For this reason, there is a limit on a firm's reliance on debt for financing.

The cost of capital is properly calculated as the weighted average of the various types of funds used by a firm to raise funds, *regardless of the specific financing used by the firm to fund a particular project*. Suppose debt alone was earmarked to finance a specific project. The cost of debt financing allocated by the firm to the project does not reflect the cost of capital because the firm has "used up" part of its debt capacity and will be forced to direct equity capital to other projects.

A General Approach for Determining the Cost of Capital

One recognized methodology for measuring a firm's (or an industry's) cost of capital is based on the weighted average of debt and equity costs.³ The weighted cost of capital, k_w , is given by the expression:

$$(1) \quad k_w = w_d k_d (1 - t) + w_e k_e$$

where w_d and w_e represent the respective proportions of debt and equity; k_d and k_e represent the cost of debt and equity; and t is the corporate tax rate. The cost of debt for a firm or industry is represented by the return on bonds that investors require, given the perceived riskiness of the firm or industry. For example, the return offered on a Standard & Poor's BBB rated corporate bond is sometimes used as a measure of the cost of debt (as opposed to the total cost of capital) for an average firm.⁴

³Most finance texts present the basic model described here. See, for example, Eugene F. Brigham, *Financial Management: Theory and Practice*, 4th ed. Dryden Press, 1985; Richard Brealey and Stewart Myers, *Principles of Corporate Finance*, 2nd ed., 1984; and Kolbe et. al., [1984].

⁴Determining the rate to use is complicated by a bond's date of maturity. As the date of maturity extends into the future, the return on a bond of a given grade usually increases since investors perceive increased financial and business risk the longer it is before the bond matures.

Determining the Cost of Equity Capital

The Capital Asset Pricing Model (CAPM) and the Discounted Cash Flow Model (DCF) are two widely used methods for estimating the cost of equity capital, although there are others. The CAPM model takes into account the "systematic" financial risk associated with the firm's stock. Systematic risk is a measure of the extent to which changes in the returns from holding a firm's stock is correlated with changes in the returns from holding a portfolio that reflects the entire stock market. Systematic risk is referred to as a firm's Beta. Most empirical measures of Betas are based on movements in stock prices over the previous 60 months. The cost of equity is given by the expression:

$$(2) \quad k_e = R_f + \beta(k_m - R_f)$$

where R_f is the return offered by a risk free investment (e.g., a Treasury Bill), β is the firm's beta, and k_m is the return offered by investing in a portfolio representative of the entire market. The term in parentheses, the difference between k_m and R_f , is a measure of the long-term risk premium afforded by investing in equities.

In contrast to the backward looking CAPM, the DCF model is forward looking. The DCF methodology estimates the rate of return on a stock that investors expect (and that the firm must attempt to provide) by looking at how the dividend yield is expected to grow. In its basic form, the DCF model can be expressed as:

$$(3) \quad k_e = D/P + g$$

where D is expected dividends; P is the current price of the firm's stock; and g is the rate at which dividends are expected to grow in the future.

The MMS Methodology for Determining Transportation Charges

When a lessee providing transportation for royalty production has a non-arm's-length contract or no contract, the transportation charge is based on the lessee's "reasonable actual costs". The MMS recognizes operating and maintenance (O&M) costs. These costs include tangible variable costs such as labor, fuel, utilities, rent, and ad valorem taxes (but not income taxes), as well as expenses related to operations supervision and engineering. Overhead expenses directly attributable to and allocable to the operation and maintenance of the pipeline also are allowed.

With respect to the fixed investment in the pipeline, the lessee can elect to include annual depreciation plus a return on undepreciated investment or it can include a cost based on the undepreciated portion of its investment multiplied by a rate of return equal to the yield on BBB bonds. Under the MMS regulations, it is

unclear whether the lessee can earn a return on the capital invested during the period prior to construction. Regulatory agencies permit such a return to be recovered once the facility is placed into service through use of an "Allowance for Funds Used During Construction". As the pipeline ages, the transportation rate for royalty production falls and finally approaches a floor determined by variable O&M costs. The MMS rationale is that it doesn't want "to pay for a pipeline twice".

The notion that the MMS is "paying" for the pipeline makes little economic sense since most firms use debt and equity to raise capital. As was explained above, the cost of capital takes into account the higher cost of equity as well as the cost of debt. Further, there is no rationale for ignoring the cost of capital used during the construction phase. Thus, the MMS methodology results in a transportation charge on royalty production that is below the real cost of providing transportation services. In effect, the MMS is assessing a royalty on transportation as well as production.

Comparing Estimates of the Petroleum Industry's Weighted Cost of Capital with the MMS' Currently Allowed Return on Invested Capital

In comparing data on the cost of capital, income taxes must be taken into account. The cost of equity capital is the return that investors require if they are to invest in an enterprise. For the corporation to pay dividends and offer the return, *as calculated above*, to investors, they must earn an even higher rate on invested capital since they must first pay corporate income taxes before they can pay dividends. Thus, the actual rate of return that must be earned on investment is higher than what the third party surveys set forth as the cost of capital (i.e., these surveys report after tax returns). For example, if the corporate income tax rate is 35%, then, as an approximation, an after tax return on equity of 12% is equivalent to a pretax return of 16.2%.

Rather than express the required rate of return on equity in pretax terms, regulatory commissions, when determining the allowed return using the CAPM or DCF methodologies, allow the firm to treat income taxes as a cost of operation. This convention compensates firms for income taxes, but it masks the fact that firms must earn more than what is implied by the CAPM or DCF methodologies. Since the MMS does not permit firms to treat income taxes as an expense of operation, any return based on an estimated cost of capital must be adjusted upward to compensate firms for income tax effects.

Numerous organizations (academic, investment firms, and investor newsletters) estimate the cost of capital for individual companies and for industry groups. Most estimates are proprietary and cannot be reproduced. However, in broad terms, current estimates of the petroleum industry's weighted average cost of capital range typically range from 9.5% to 11.6%. It should be recognized that the

cost of capital for individual companies, depending on their size and borrowing capacity, could fall outside this range. Further, the cost of capital can vary over time in response to changing economic conditions as well as individual company circumstances.

As just explained, these estimates represent after tax calculations. Because the MMS does not allow firms to treat income taxes as an expense, these estimates must be adjusted upward to generate equivalent pretax returns that the firm must earn to meet investor expectations, as indicated by the above range of estimates. Assuming an average corporate tax rate of 35%, the industry's effective cost of capital (for pipelines subject to the MMS rate methodology) ranges from 12.8% to 15.7%.

In contrast, the return on BBB bonds averaged 7.2% in 1998 and is averaging 7.4% this year.⁵ Thus, there is at present a gap of some 5.4 to 8.3 percentage points between what the MMS allows on pipeline investment and a rate that is similar to the industry's actual cost of capital.

The Problem of Depreciation

Once a lessee has fully depreciated a pipeline, the transportation charge is limited to operating and maintenance costs. This presents a problem for the owners of these pipelines who point out that the transportation charge will be lower than the actual costs of running a pipeline efficiently once a pipeline is fully depreciated. They further argue that their true costs are not adequately reflected in allowed operating and maintenance costs. Pipelines with depreciated rate bases have at times suggested the adoption of an additional charge called a "management" fee or a "service" fee.

To address this problem, the FERC has approved the collection of management fees. One instance in which this was done occurred in Tarpon.⁶ MMS should consider concepts such as this if it is to provide a fair transportation allowance when full depreciation has occurred.

Summary

This paper has illustrated the cost of capital concept and reviewed estimates of the industry's effective cost of capital for pipelines subject to MMS rate methodology. The industry's estimated cost of capital exceeds the return allowed by MMS by 5.4 to 8.3 percentage points. Thus, the transportation allowance provided by the MMS does not even approach the level provided highly regulated public utilities.

⁵ Data on Standard & Poor's BBB rates were supplied by the MMS.

⁶ Tarpon Transmission Company, Docket No. RP84-82-004 (Remand) December 26, 1991.

The essential problem with the MMS methodology is that it ignores the use of higher cost equity financing and fails to compensate for income tax effects. By assuming 100% debt financing, the MMS methodology fails to provide firms a return commensurate with the rate of return expected by investors or a return that covers the firm's cost of raising capital. Further, once a pipeline is depreciated, the firm receives no return on its investment and is merely paid a transportation rate that covers variable operating expenses. The management or service fee approach, a form of which has been adopted by the FERC, is one way to address this problem.

Mr. DEAL. Thank you, Mr. Chairman.

Overall our problems stem from the MMS's inclination to use a downstream starting point for royalty valuation.

What are the problems we see? First of all, starting downstream is unnecessary given the active market at the lease and the availability of comparable sales at or near the lease as a sound measure of value. In lieu of the three different downstream-skewed methodologies proposed by the MMS, we've suggested major revisions to the existing valuation rules. Industry changes would permit full usage of a lessee's own comparable sales for valuation of non-arm's-length transactions while eliminating perhaps all of the practical problems the MMS has identified in the past.

Second, starting downstream isn't wise because it requires adjustments which inject an inherent complication into the calculation of value and, in the case of transportation, we believe, can lead to palpably unfair results. In this case, industry has suggested, where some sort of netback is required, specific methodologies for the calculation of transportation, quality and location adjustments, these would lead to values closer to the lawful value of production, which leads to my third point.

Starting downstream can lead to unlawful results. To the extent valuation through indexing captures postproduction values, and I emphasize postproduction values, added downstream of the lease, the MMS proposal leads to an outcome at odds with the law. Royalty is due on the value of production at the lease. Postproduction activities associated with marketing can add value and these values are not properly part of the value of production. Together, industry's suggestions for better use of comparable sales and more properly calculated adjustments can solve this problem.

Fourth, the proposed downstream-skewed approach is shot through with ambiguities that make compliance unduly difficult and frustrate the MMS's objective of certainty. To eliminate this problem, industry has suggested that the MMS adopt regulations which clarify the term "affiliate" to make it clear up front what valuation pathway a lessee should use. We've also suggested that the MMS adopt regulations that preclude the threat of second-guessing good faith marketing decisions and imposing some indexing requirements simply because a higher price might have been obtained elsewhere by some other lessee. Likewise, we have suggested that the MMS adopt an explicit process by which lessees can early on seek timely and reliable determinations of value. If the MMS can't answer these valuation questions, who can we ask?

Notwithstanding these reservations, we think the rule can be fixed if certain key changes along the lines I've described are made. Over the course of the rulemaking, industry has submitted voluminous comments, and the MMS, to their credit, has made some important changes to the valuation proposal.

Within the last year, we have—industry—has sharpened our focus on the remaining core issue areas. We've had a common view on the rulemaking from the outset, but in late 1998 we formed an industry task force that includes API, IPAA and two of the other signatories to our written comments, namely, the Domestic Petroleum Council and the U.S. Oil and Gas Association.

This task force took a hard look at the present proposal, and we took a hard look at our own industry concerns. Task force members presented our recommendations at the MMS workshops held in March and April this year, and on April 27th we submitted the detailed written comments I alluded to earlier. These comments assemble in one package the elements of industry's point of view, proposed solutions and answers to many specific questions that arose in the course of our discussions.

We're frankly encouraged at the MMS staff's willingness to discuss both sides of the core issues, and we continue to believe these efforts can lead to a sound resolution of this rulemaking.

I would conclude by saying overall adoption of industry's recommendations as a package would move the MMS proposal a lot closer to realizing a final crude oil valuation rule that satisfies the MMS' own objectives. A revised rule should and can be workable and fair. The revised rule should and can decrease the cost of administration and decrease the appeals and litigation that have plagued all of us in the past, and a revised rule must satisfy the legal requirement that royalty obligation be based on the value of production at the lease.

To this I would add just one other thing—to this we would add only that Congress and the MMS should continue to explore an alternative that can avoid altogether many of the ambiguities inherent in any valuation methodology. If the MMS were to take its royalty-in-kind at the lease instead of in dollars, valuation questions could be avoided altogether. The MMS could try to realize for itself the highest selling price for the crude oil it has taken, or if the MMS were to assume the postproduction activities now performed by industry, it might even be able to increase its revenues.

I'll turn now to my colleague Mr. Dillon. Together we can answer any questions you have, Mr. Chairman.

Mr. HORN. Mr. Dillon, Ben Dillon is vice-president of the Independent Petroleum Association of America. You might want to differentiate what your group's membership is compared to the American Petroleum Institute.

Mr. DILLON. Thank you, Mr. Chairman, members of the committee. IPAA, the Independent Petroleum Association of America, primarily represents some 8,000 independent oil and gas producers across the country. I'm pleased to be here today, and I submit for the record a list of some 22 additional State associations, mostly independents, endorsing the industry's written and oral statements for this hearing, including, I might note, the California Independent Petroleum Association.

Mr. HORN. Without objection, they will be put in the record.

Mr. DILLON. Thank you.

Mr. Chairman, IPAA appreciates the opportunity to appear here today. Your examination of MMS's oil royalty rules could not be more timely. The past year has been devastating for America's oil producers. With record number layoffs and shut-in wells, approximately \$2 billion has been lost in tax and royalty revenues, part of which is dedicated to education. Even though prices have recovered somewhat, a number of bold steps need to be taken to save the domestic oil industry. Prices remain unstable, and recovery time will be lengthy.

However, fair and certain valuation regulations are needed, irrespective of the economic climate. Yes, MMS's claim to have made improvements to the rulemaking is solving a number of concerns. For this we are grateful. However, the rule as outlined last August by MMS still significantly impacts independents. I submit for the record a September 1998 letter signed by some 272 independent producers discussing how they're impacted by the rule and how these concerns represent the views of the vast majority of IPAA's 8,000 members.

Mr. HORN. Without objection, that will be put in the record at this point.

Mr. DILLON. Thank you.

Consider an excerpt from the letter, "The rulemaking will cripple independent producers because the government can second-guess the proceeds I receive from a third party. If a government auditor decides my proceeds aren't reasonable or I've breached newly delivered duties, they will subject me to their complex and costly bureaucratic formulas." The letter concludes, "To survive in this business climate when oil prices are extremely low, I must dedicate my scarce resources to matters that affect my bottom line. That's not speaking on behalf of the majors; it's stopping arbitrary regulations that will harm my business."

Independents are not asking for more favorable royalty calculations because of low oil prices. We are simply asking that the rulemaking, especially during these challenging times, be fair and predictable and thereby eliminate uncertainty and reduce litigation.

In a letter to MMS on April 27th, Senator Bingaman recognized the impact of this rule on independents by proposing regulatory language that would not allow MMS to reject wellhead sales when compared to other transactions. We have no indication that MMS will accept this language unless MMS repropose the rule and seeks comment.

In his letter Senator Bingaman discussed another component of second-guessing creating uncertainty for all producers. MMS wants to be able to challenge bona fide wellhead sale contracts in search of what it thinks are hidden marketing costs. The wellhead producer has no control or knowledge of these costs.

An additional unresolved issue affecting all producers is binding determinations. Every producer, regardless of size, wants to be able to ask the Department a simple question: Am I paying my royalties correctly? They want to receive a timely answer and an answer that is binding. To date, MMS has stated it may, not will, issue binding guidance, again creating more uncertainty.

You may be surprised to learn that many independents are marketing their production downstream of the lease. The proposed rule affects them due to MMS's failure to allow proper deductions and expanded duty to market and the use of index for the offshore and New Mexico. Even wellhead sellers don't want to create regulatory disincentives for entering into downstream businesses. Royalty ought to be paid on the value of production at the lease regardless of where you produce for the size of your company.

Independents strongly support and participated in the development of the industry proposal outlined by Mr. Deal. During a recent MMS workshop in Washington, DC, public interest groups

seemed bewildered by our endorsement of this proposal. Unfortunately, the so-called experts left the workshop as soon as the discussion turned technical and demonstrated how each component of the industry proposal affects independents.

Mr. Chairman and members of the committee, if all sides are flexible, we can find a solution that allows implementation of a final rulemaking in a timely manner. IPAA believes that a comprehensive royalty-in-kind program with possible valuation language similar to §. 925 is a permanent solution to the royalty debate.

I'll be happy to answer any questions you or the committee may have.

Mr. HORN. Thank you very much. We appreciate that statement.

We're going to give each Member 5 minutes for questioning. We'll have another round if it's needed, and I'll start out the questioning.

Let me ask the whole panel. Have you been satisfied with the rulemaking process, and if you haven't, what are the major barriers toward implementing a new rule that is both simple and fair? Mr. McCabe.

Mr. MCCABE. Chairman Horn, on the whole, the rulemaking procedure has been taxing and long, but, you know, that's something we're willing to go through. What has been particularly vexing obviously are the continued moratoria on any rule at all. We deeply believe that the major oil companies will agree to no rule at all that references market value at—at the recognized market centers. You can ask the oil industry representatives if they care to comment on that. I don't think they will flat out say they will agree to a market-based judgment of—of oil prices. It's—it's been hectic but manageable.

Mr. HORN. Mr. Taradash, what's your answer to that? Are you satisfied with the rulemaking process, and what are the major barriers that are implementing a new rule, and how do we get one that's simple and fair?

Mr. TARADASH. Well, the process itself, Mr. Chairman, initially was very unacceptable. Tribes were called to a meeting at MMS, and this was on the heels of the tentative agreement, at least on the Federal oil rulemaking, and we were asked virtually to respond without any opportunity to examine the issues as to whether a modified version was acceptable to us. Now, to its credit, after some objection, MMS did change that approach. However—

Mr. HORN. How did they change it?

Mr. TARADASH. Well, they—they offered more opportunity for input, and the notion was that expanded time and activity was functionally equal to a substantive examination of the issues, which is a falsehood. But nevertheless, the process contained, the elements of fairness in that sense, but it remains, however, though—what the committee, I think, really should address in some way is in looking at the way and the effectiveness that MMS and the government itself, even before MMS, has enforced lease terms through regulation and otherwise. Is it reasonable to expect that venturing off into a different version of valuation regulations is going to be any more successful than the past version?

And let me just quickly add, Mr. Chairman, one of our major producers at Jicarilla filed an extremely large claim for recoupment a

number of years ago which resulted in ultimately negotiations and a settlement agreement through which a different valuation methodology other than that which MMS has—was agreed upon between our industry partner and the tribe. Instrumental in that at the time was Mr. Dillon, who was working for MMS, and Albie Moriano, who is its Deputy Director. The creativity involved in that solution lent certainty, simplicity and closure, increased tribal royalties over 17 percent, and the company has requested and has been given three additional amendments to that agreement for the sole purpose of adding additional leases under a valuation methodology that they know increases their payment.

My point, Mr. Chairman, is this: In cooperation and with a little bit of creativity, and in cooperation with industry, and when MMS can be flexible, we have arrived at different methodologies that do work, that industry is satisfied with, that offer certainty and closure.

Mr. HORN. Mr. Deal, what's your answer to the question as to how satisfied you are with the rulemaking process, and what are the major barriers toward implementing a new rule that is both simple and fair?

Mr. DEAL. Well, a few thoughts which overlap some of my colleagues here, like Mr. McCabe. We've certainly found this rather taxing, rather long. We've submitted, at least by my count, seven sets of voluminous comments, which I have been centrally involved in writing. It has been taxing, but it's been worth it. It was a slow start. It took us a while to figure out what the rule was about and where it was coming from. In the course of this, I think we—our initial feeling was the barrier we were confronting was what we perceived as the MMS' preoccupation with indexing, indexing, indexing; we don't want to talk about anything else.

I think in the course of the rulemaking, things have changed. I think there's been a willingness to—to look at more information. I think there has been some movement on some key issues so as to sharpen the issues.

I, like Mr. Taradash, look at the valuation regulations, and while we have offered suggestions that we think will make the regulations work, I guess our—if you take us a few steps away from the rulemaking, we would look at valuation and say no matter what you do, it's inherently complicated, and that leads us to believe that perhaps something like royalty-in-kind might be really the answer we're all looking for.

Mr. HORN. Mr. Dillon, do you want to add anything to that?

Mr. DILLON. Yes, Mr. Chairman. As well we have found the process to be long and taxing, especially to my members who typically don't engage in such lengthy rulemaking processes. However, we've come a long way. We started the proposal in 1997 by saying every producer because of a provision that said if you buy oil, you will be on NYMEX, and all my members buy oil for one reason or another. It impacted the entire producing community. That is no longer the case today. We're down to the type of concerns that I highlighted in my statement and that are covered in the industry proposal and find that these last set of workshops were quite productive.

We are a bit frustrated that the outside critics won't spend time with us trying to come up with the creative type of solutions that Mr. Taradash talks about. Every time we go to these sessions, there's a lot of demagoguing on each side. We have some proposals out there that we truly believe will satisfy the independent concerns, and there is no exchange as to how we can find a compromise in that area. But again, even though it has been a long process, much improvement has been made.

Mr. HORN. Thank you.

We're going to increase the question period time to 6 minutes because I went over on that, but any time a Member asks the panel as a whole, we will finish that out.

I want to ask the gentleman from Texas, Mr. Turner, as to who the ranking member is today. Is it you or Mrs. Maloney, and I will call on whoever Mr. Turner says.

Mrs. MALONEY. Mr. Turner.

Mr. HORN. OK. I yield 6 minutes to the gentleman from Texas, Mr. Turner.

Mr. TURNER. Thank you, Mr. Chairman.

This is very troublesome to me, and the only thing I can really relate it to and maybe most of us can relate to the valuation of a home for tax purposes. You can always have different experts come in and give different opinions, and it seems that what has happened in this particular area, to me, is that we have had difficulty because there are differing opinions, and any time we have differing opinions, there's room for litigation. And, of course, when we're talking about valuing the biggest house on the block owned by the wealthiest person the block provides for interesting litigation.

So it does seem to me that it's incumbent upon the Congress and the agency to try to take a common-sense approach to this issue and to be sure that we set forth some rules that everybody can understand that can be followed, and that once a valuation is set and the taxes are collected, that at some point the door closes and we move on.

And it seems to me that we may be getting close, but we're not quite there yet, and I guess maybe I might have one question, Mr. Deal, for you. You mentioned several things that you thought were good about the efforts that are being made, and yet I don't see how the door ever closes, how there's ever a point where there's not an opportunity to second-guess by some party that will claim that they haven't gotten their fair share of royalty payments to come in, file a lawsuit and begin, once again, the process of going through this very expensive type of litigation on valuation.

Do you have any suggestions on what we could do or what the agency ought to be doing to be sure that once they do have a set of rules that are workable, that the door will shut at some point where there will be no further litigation?

Mr. DEAL. We do have a few suggestions, and I would say on this issue, I have my fingers crossed here. I hope that we're close to closure with the MMS on this. This threat of second-guessing has surfaced among both Ben Dillon's and my own members, but I'd say especially among the small companies who would enter into what they believe are good faith, arm's-length transactions, and they fear an auditor or whomever later on simply looking at it and perhaps

finding a higher price somewhere that either happened or could have happened, and using that as the basis to unpack the whole transaction, and then thrusting the lessee into the morass of indexing and that sort of thing.

The suggestion we've had is that might there not be some regulations, something in the regulations themselves, which creates a more explicit hurdle for this. We're not talking about anything that in any way undercuts the ability, the proper ability, of the MMS and its State delegates to audit. We're not talking about that, and we're certainly not talking about anything which in any way shields a lessee from bona fide misconduct.

All we're asking for is something explicit in the regulations which would recognize that absent some compelling evidence of misconduct or some other—well, basically misconduct, absent evidence, compelling evidence, of that, that there would be a presumption in favor of the transaction being an arm's-length transaction. This would permit, I think, those people who do operate in good faith to move ahead, conduct their business and pay every penny that's due to the Federal Government.

Like I say, I have my fingers crossed, but I think we—we may be close to closure on this. I think the MMS has conveyed to us that they have no interest in their approach to—to second-guessing, and I think maybe we need some more assurance of that. So I hope that answers your question.

Mr. TURNER. I understand that at some point the Director of MMS testified to the Congress that the proposed regulations were going to be revenue-neutral, and yet now I hear that they're supposed to generate \$66 million more a year. What is your understanding of the objective here of these regulations?

Mr. DEAL. Well, we've heard those numbers, too, of course, and we are quite mindful of that kind of conflicting reports. We're a little puzzled, frankly, about the \$66 million, or whatever the number may be. We think the numbers should be revenue-neutral. We think it should be zero. If indeed the regulations are intended to clarify the law, it seems to us they should be revenue-neutral. They shouldn't change the royalty obligation.

If, on the other hand, the regulations involve a change in the royalty obligation, well, I think if those regulations, if those expanded regulations, aren't promulgated, that would be a loss of revenue, but we would say it's a loss of revenue that the Federal Government was not entitled to in the first place.

So we think Cynthia Quarterman was right in saying that these regulations should be revenue-neutral.

Mr. TURNER. Mr. Dillon, Mr. McCabe said that these regulations as now proposed didn't affect the independents, and I'd stepped out of the room, so I didn't hear your testimony, and I'd like to ask you, No. 1, if that's the case; and No. 2, from an independent's perspective, if you end up with complicated regulations that are hard to enforce or follow, it seems to me you might end up with a possibility of getting less Federal revenues than more, and I want you to comment on both those questions.

Mr. DILLON. To recant what I had said earlier, Congressman, we have about 20 State associations signing off today on our statements here, and most of them are independents, and the reason

they're doing that, including the IPAA, is to say, yes, these rules continue to impact us, they continue to cause uncertainty.

As I mentioned earlier to the chairman, we started with a process where they told independents that if they bought oil, they were on NYMEX. They haven't forgotten that. They wondered why, why wasn't government accepting their wellhead sale. Well, they have now said, well, that is not the case unless we come in and examine your wellhead sale and decide that you have breached some new duty or that the price is unreasonable.

Well, as you can imagine, that really concerns the membership because if the government did, in fact, determine that, and, again, this is very exclusive of fraudulent or misconduct, we wholeheartedly agree, the wellhead seller has entered into some fraudulent or misconduct, then obviously the MMS should take the appropriate action which they already have available to them today under current law. But just because they have looked to someone else's sale and said, well, Mr. Dillon, you didn't get as much as your neighbor, so that's not a reasonable value, therefore you have to go on a government formula, you're exactly right. All of a sudden your costs go up, you're possibly litigating. My members don't have in-house counsel. They're in the courtroom going through a lengthy process.

What do they tell me that means to them? Obviously the risk on developing on Federal lands goes up, and therefore, they'll try to look elsewhere, and Federal lands become the last course of action, which would result, in our mind, in a decrease in Federal royalties to the Treasury.

Mr. MCCABE. Congressman, if I might respond very briefly?

Mr. TURNER. Yes, sir.

Mr. MCCABE. The text of the proposed regulations make it clear that no one need base the price of their crude oil on a market basis that Mr. Dillon would object to. No one need use that system who has affiliates through whom they make exchanges of crude oil, and no one need be hampered by those regulations who—excuse me, the question of whether they have affiliates or whether they engage in other kinds of transactions that could lead to hiding the value of the oil. The independents don't have affiliates. They don't have refineries. They are not impacted by this law. They do not behave in a way that—that engages the terms of the law.

Mr. DILLON. If I can respond to that. Mr. Congressman, I am not speaking about affiliates as he is describing. In MMS's latest proposal of July 16th of last summer, it clearly stated that, in regulatory language, if you sell at the well, gross proceeds, not about affiliates, and that MMS decides that that sale was not reasonable or in good faith or was inappropriate or substantially below market value, boy, those are subjective words, you're going to be placed on index. It has nothing to do with an affiliate, and that is why we continue to be frustrated with the process because that simple message is not being received.

Mr. TURNER. Mr. Chairman, I don't see the time there, so I don't think—

Mr. HORN. You've only taken 9 minutes, don't worry. No. We wanted to round that question out.

So, Mrs. Maloney, you have 6 minutes now. I figure you'll go to 9.

Mrs. MALONEY. Mr. Chairman, again, I want to thank you and Mr. Davis and my good friend and colleague Mr. Turner for his very thoughtful questions and statements on this. This is an issue that's incredibly important to me because I feel that at the heart of all government is trust, whether or not it's being done well and honestly. And how I got interested in it was allegations that major oil companies, not independents, were valuing their oil at a lower price than—than what they paid for oil on the market, or when they bought it, or when they sold it, and that the government lost hundreds of millions, possibly billions, of dollars that should be going to the schoolchildren of this Nation. And I think that all of us want honesty and fairness.

And that is why I have worked on this, because I think the dollar should go to the people who deserve it, and why should an oil company get a better price than the taxpayers and the schoolchildren in this Nation? That's where I'm coming from, and I just want to put in the record that there were a number of investigations, litigation reports, that have stated in an undisputed way that the oil companies were paying less to the Federal Government than they paid in the open market, and there have been recent oil settlements based on this premise where Mobil settled for \$45 million; Alaska, \$2.5 billion. I'm talking about the major—various major oil companies, to the tune of \$2.9 billion has been settled in oil royalty payments on the basis that they were underpaying the schoolchildren or the Federal Government.

Now, that's a fact. That's an absolute fact, and I want to put it in the record. I would also—

Mr. HORN. Without objection it will be put in at this point.
[The information referred to follows:]

RECENT OIL SETTLEMENTS

Mobil (Justice Department): \$45 million
Alaska: \$2.5 Billion
California: \$350 Million
Texas: \$17.5 Million
Louisiana: \$10 Million
New Mexico: \$8 Million
Private Royalty Interests: \$15 Million

Total: More Than \$2.9 Billion, So Far

Mrs. MALONEY. All of the various oil settlements that were based on undervaluation of oil.

I would also like to put in the record a study on the California oil undervaluation, and it's a review, an analysis of the discovery documents that were produced in the Long Island case—excuse me, the Long Beach case, and it basically—

Mr. HORN. We have a Long Beach. You have a Long Island.

Mrs. MALONEY. I know, I know. And he's selling all the oil, and my State's buying it all, but it basically—

Mr. HORN. We want to get you all in taxis in New York.

Mrs. MALONEY. But basically what this report shows is that there are two sets of books. There's one set of books on the posted prices which the oil companies, and I mean large oil companies, not

independents, pay the Federal Government, and there's a different set of books that they pay each other, and this is documented in this, and I'd like this put in the record.

And I'm sorry that we're being called to a vote, and I'm sorry that Mr. Davis, my colleague on the other side of the aisle, is not here with me because we have worked very well on many other bills before Congress, and we had a task force that just had a positive conclusion in another committee, and I'd like a bipartisan task force on the independents because I want to understand it better myself, because certainly the intent, as was told to me, by MMS was not in any way to hurt the independents, but only to hit at the two sets of books.

And basically, oil companies when they sell oil to each other or when they sell oil, they base it on whatever is the market price. The market price is usually determined by NYMEX on the east coast, Alaska North Slope in Alaska and in California.

So, for me, I think the simplest way to handle this is let's just go to market prices. Let's not have some complicated rule that everyone's objecting to. Let's just have the oil companies pay the Federal Government and the schoolchildren what they pay each other. I think that's fair, and that's basically where I'm coming from.

I regret that we've been called to a vote, but I would like to start with a question, and I really want to understand the independents' point of view because it was my understanding they were not hurt. And maybe that's a longer discussion than what we can go in today, and MMS officials have said that they in no way touch the independents, so I want to understand that.

But, first, I'd like to ask Mr. McCabe, can you in just common, everyday language give us an example of how the majors price oil in California? How does this all work? How do the majors price oil, and how do the independents price oil? Could you—

Mr. HORN. I want to say that you are under oath and—and common, everyday language might be difficult for lawyers. Go ahead, make your stab at it, Mr. McCabe.

Mr. MCCABE. That's a good question. The classic California case—the largest part of California oil is produced in the San Joaquin Valley. San Joaquin Valley oil is of little value—San Joaquin oil is of little value unless you get it to a market in Los Angeles or San Francisco, and to get it there, you have to take it through a pipeline, for all practical purposes. And in the classic case, a producer in the San Joaquin Valley finds him- or herself at the pipeline saying, I want my oil transported, and the owner of the pipeline says, no way, you can sell it to me, or your oil isn't transported at all.

So, they arrive at a price, and the price is the posted price. There is no negotiation, and the posted price is an arbitrary number obviously picked out by the major oil companies.

It is no more accurate to suggest that there is an active market at that location or—or a free market than it is to suggest that an inmate in our county jail that's next door to my office is free because he's free to walk about the cell from one end to the other. These producers are captives of that particular market in which they have no choice but to sell at the posted price. In those instances, under these regulations, obviously those independent pro-

ducers aren't held to the higher price. They only need pay on the price they get from the majors. But if the major transports that oil to Los Angeles or San Francisco, we have thousands of documents that suggest the way they value that oil internally is by comparing it to Alaska North Slope oil that has already been brought to California.

Mr. HORN. May I ask, what's the sulfur content of San Joaquin oil versus Alaska North Slope oil?

Mr. McCABE. There is no single answer to that, Congressman, because obviously there are various sources for that oil, but the—it is clear from the internal documents of these companies that San Joaquin Valley oil or heavy or light sulfur are much more valuable to them than is Alaskan North Slope oil despite the fact that it's of generally the lighter grade and perhaps sometimes of the lower sulfur content.

Mr. HORN. Is that simply because they're closer by transportation and they reduce those costs compared to—

Mr. McCABE. No. When they make those comparisons, all transportation is netted out. All factors of how good the crude oil are netted out. It's just clear that under all circumstances they would rather have California oil than Alaskan oil.

Mr. HORN. You can get another question or so, then we'll leave for the floor.

Mrs. MALONEY. OK, but I really want to ask Mr. Deal and Mr. Dillon some questions, but I wanted to followup on what you said, Mr. McCabe. You talk about your documents. Why can't your documents from the oil companies be made public so that we can all study this and get a better understanding of it?

Mr. McCABE. Also a good question. We'd like to make them public, obviously. There—there is a discovery agreement entered in long ago under which those are to be kept confidential within the context of litigation. We're perfectly willing to—to give up copies of those—those documents. All we need is the agreement of the major oil companies involved.

Mr. Deal is here. He represents some major oil companies. Perhaps he could shed some light on that.

Mrs. MALONEY. But Mr. Deal actually in his testimony talked about his commitment to fairness and honesty, too, and supporting fair audits, and at the very least, if you don't want to publish to the public, could you release for the oil companies this information for the audits that are taking place so that they can use these internal documents on the audits? Following up Mr. McCabe's—

Mr. HORN. I'm going to let you answer that question, but we're in recess after that question is answered until 3:45. We have one vote that's winding down to 15 minutes, and we have three 5-minute votes following that.

Mrs. MALONEY. Thank you, Mr. Chairman. That sounds like a lively discussion while we go to vote. You can talk about internal documents and whether or not they can be released for audits. We're going to be coming back to this panel.

[Recess.]

Mr. HORN. OK. Let me wind up with a few questions here and then we will move to panel two. Mr. McCabe, could you tell me

under California law what deductions can oil companies take when determining the price of oil for royalty purposes?

Mr. MCCABE. Mr. Chairman, I think I can shed light on that. We don't deal generally in explicit royalty situations. Our situation is affected by posted price but is not expressly a royalty contract.

Nevertheless, we have looked at thousands of pages of documents from the major oil companies in California. We have never seen anything to suggest through all of these thousands of documents that the major oil companies believe that marketing is a significant item in valuing crude oil. I have never seen any mention of marketing as a factor.

Under California law, there is a duty of good faith and fair dealing in all contracts involving crude oil and all contracts involving any subject. In terms of crude oil, that obviously implies that the party valuing the crude oil has a duty of good faith to find, under reasonable effort, the maximum value that can be got for that crude oil. That's the lessee's situation; that's for the mutual benefit of the government and the lessee. The lessee obviously wants to find the highest possible price for its seven-eighths share of the oil.

Mr. HORN. Thank you for that answer. Mr. Dillon and Mr. Deal, Senator Nickles recently introduced S. 924, the Federal Royalties Certainty Act. This bill would, among other things, allow the oil companies to be reimbursed by the Federal Government for their marketing cost. What are typical marketing costs for oil on a per-barrel basis? Can we calculate it that way, and do States generally permit lessees to deduct the cost of marketing oil from the State royalty payments?

Mr. DILLON. Mr. Chairman, I can speak a little bit to some of the midstream—what we would call marketing or midstream costs that independents are involved with. I think that is one of the confusions around this issue.

We have members across the country that have decided to enter into these markets and take the risks and costs associated with that activity. They do believe that they are important and significant. We in comments to MMS on the record—I'm not going to have the exact number, but have said these costs as far as a range per barrel might be somewhere in the area of 7 cents to 15 or to 20 cents per barrel as a minimum. We have tried to put some numbers around that in a very quick fashion. They may not be quite accurate.

We have provided MMS lengthy lists of what those activities entail. I think that we were pleased to hear in some of the workshops that maybe MMS is going to recognize some of these activities. They might call it transportation; we might call it marketing.

I also want to point out that it is not just a per-cent per-barrel matter. It's a matter of uncertainty about, as you move downstream away from the lease, what is in and what is out so that we can bring certainty to that and just give a calculation.

Given that, given its importance, IPAA has filed a lawsuit on a similar issue, a similar situation, that MMS has taken in the gas case called *IPAA v. Armstrong*.

Mr. HORN. Mr. Taradash, let me ask you this one. In your testimony you have stated that the oil companies have more incentives to enter into Federal leases than it does to enter into tribal leases.

The tribes are, therefore, operating at a disadvantage when competing for industry's business. What are some of the incentives offered to oil companies on Federal leases that they do not receive on tribal leases?

Mr. TARADASH. Well, if you were to go to the Deep Water Royalty Relief Act and take a look at the first three grants of relief given to Amoco—

Mr. HORN. That's the Walter—

Mr. TARADASH. The Deep Water Royalty Relief of 1995. It expressly authorizes the Secretary of the Interior at depths beyond 200 meters, I believe it is, to grant extraordinary relief. That has been indeed granted. It's in excess of \$100 million calculated for at least one recipient of such relief.

The Secretary has, through the BLM leases on Federal lands, the authority in those leases anyway to suspend reduced royalty payments if, in the Secretary's view, there are national interests that are promoted to do so.

As a trustee under tribal leases, the Secretary has no such authority. The other disability, however, results from the dual taxation that the tribes suffer from. States have been permitted to tax on reservation production of private companies producing tribal minerals.

Tribes who have now had to stand on their own economically as a matter of self-sufficiency, have introduced their own taxes. So the tribal and State taxes cumulatively burden the economic activity. Federal leases don't suffer from such a burden.

Mr. HORN. Earlier in your testimony you noted that the Federal Government and the Department of Interior have failed their trust responsibility to administer Indian oil and gas leases. In terms of dollars, how much is owed to the tribes or individual Indians? Do you have any estimate of that, any work done on that?

Mr. TARADASH. For the period of 1988 to 1998 for the Jicarilla Apache tribe through the work of its auditor and in fairness with the cooperation of senior MMS staff and its audit staff, often times over their objection initially and through a lot of rocky meetings, we have recovered four-ninths additional royalties. That means in that period of time, the royalties paid up front were approximately \$91.2 million. The tribe has recovered almost 42 million additional dollars that the government had not collected. That amount is to the underpayment of four-ninths, the royalties that should have been paid.

Mr. HORN. Are there tribes that have similar situations in either oil or minerals, whatever? Do they get together and compare notes? Do their attorneys get together and compare notes?

Mr. TARADASH. Yes and no. But it's very, very difficult for a lot of complex reasons. The fact is every tribe is affected by the same institutional deficiencies. By the way, the Federal Government's systems are exactly the same. So when I'm pointing out to you systemic errors, these systemic errors also apply to the lack of ability to account for and properly collect under Federal leases.

So the complexity of it is such that when we have talked with people at the GAO, for example, the question was asked earlier about whether these would be revenue neutral regulations. In 1987 and early 1988 when MMS was talking about its new valuation

regulations, it then went into effect March 1, 1988. It represented to the GAO and to congressional oversight committees that those regulations are going to be revenue neutral.

In the 1991 GAO report entitled Interior Used Reasonable Measurement—whatever the rest of the title is, MMS admitted to the GAO at that point—and it's reported in that report that when it made the representation that the revenue, that the regulations, were going to be revenue neutral it did so because it made the assumption based upon some data that there would be an increase in offshore collection.

It knew there would be a decrease in Indian royalty collections, but because those two offset one another, they made the assertion that they were going to be revenue neutral. The difficulty and the dishonesty in that answer, though, is that Indian tribes don't get any of the offshore collections. So it's totally irrelevant from that standpoint.

Mr. HORN. In other words, if they had land up to the sea coast, you are saying that if the State gets some but the Indian tribe might co-exist with the State obviously and they don't get any? Explain that to me some more.

Mr. TARADASH. Offshore production is solely a matter of royalties going to the Federal Government and the appropriate State. When MMS made the assertion that the regulations be revenue neutral, it did so, as I said, because it increased—it understood that there would be an increase in offshore royalties.

Mr. HORN. The higher proportion?

Mr. TARADASH. Yes. The Indian royalty terms which require highest price paid or offered as the basis of the major portion price, which is one of the indicia of royalty determinants, were going to be decreased because the methodology in the regulations is a median pricing methodology.

But Indian tribes do not get any share in offshore royalties. To say that these would be revenue neutral is dishonest because Indian tribes don't get offshore royalties; and yet there was a known decrease to the Indian tribes and their royalties.

Mr. HORN. I'm going to ask Mr. Turner if you have participated yet in this round. So the gentleman from Texas.

Mr. TURNER. Thank you, Mr. Chairman. Mr. Deal, maybe you are the right one to ask at least your initial opinion on this. Shouldn't there be some procedure in all of these regulations where at some point the MMS tells the oil companies that we agree or disagree with the value that you set and actually advise the oil company as to what they do owe?

Isn't there some way, some circumstance ending up with some regulations that kind of boxes in the issues a little bit, rather than leave it just wide open that you pay your tax and then somebody somewhere wants to challenge the amount that is paid, they can go do that.

I have practiced a little law in my lifetime. That's a pretty nice lawsuit to pursue. Big oil company issues opinion, expert testimony on valuation. I could make something out of that. It seems to me that as long as we have the system that gives so much flexibility to the process and has no end point to it, at least at the administrative level, we are always going to have these disputes.

I haven't seen anybody produce any numbers on how much litigation costs everybody here, but it's bound to be rather expensive. Of course, I know the royalties involved are billions of dollars over the years, and they are worth litigation costs. But there seems to me there is something missing here in terms of the basic procedure.

That's aside from the fact that we have all searched together for some common rules of valuation which we need, but the procedures seem to be a little bit fraught with potential problems.

Mr. DEAL. I certainly agree 100 percent. One of our suggestions is that the MMS adopt regulations where it would commit to issuing what we call binding determinations. Really, the better adjective is reliable determinations.

Industries—like you, Mr. Turner—think knowing early on what the obligation is is just as important for everyone involved. The regulations by any measure are very complicated. They are hard to figure out in some places. We would say, "Who better than the MMS itself can offer answers to difficult questions?"

Hence, we have suggested a process not unlike IRS revenue rulings whereby a lessee could present facts and ask for a determination. The determination would be limited to those facts, it would have no Presidential value, it would be limited to those facts.

To the extent that the MMS at some later point in time found it necessary to alter its opinion, they could certainly do that. But it would have no retroactive effect. We think that it makes sense. As to the points that you made about litigation, I have never seen a number which aggregates the dollars spent for litigation. I think we all know it is huge. One of the very objectives of the MMS rule-making is to arrive at certainty and decrease administration costs and litigation costs.

Mr. MCCABE. I might respond briefly to the Congressman as to litigation. We have initiated litigation and been very successful with this, acquired something like \$320 million for the school system of California. There has been other large litigation in this country. None of that litigation has arisen out of the regulations.

This is all litigation that arises as to private parties; in our case, Long Beach and others who want greater value out of their oil. That has been successful. None of that litigation, to my knowledge, arises out of the regulations or as to a difference of opinion as to what the regulations mean.

Mr. DEAL. Well, there are audits going on right now which have raised serious questions about past payments and, they are based on whether or not the companies complied or didn't comply with the existing regulations. So I guess all I can say is for API's members, at least the experience that I have seen, isn't the same as yours, Jim.

We have people who scratch their heads, try to comply with the regs and sometimes there are disagreements. We would just like to say up front that we are committed to paying every penny of royalty that we owe. What would really help the process is to know up front how many pennies there are involved.

To the extent that we can avoid audits maybe several years later where the facts have become a little dusty and maybe even the individuals involved in making policy decisions are long gone, if we could avoid that, everybody would be better off.

Mr. TURNER. Thank you, Mr. Chairman.

Mr. HORN. The gentlewoman from New York.

Mrs. MALONEY. I thought that we were called for another vote.

Mr. HORN. This will be it for this panel.

Mrs. MALONEY. Just following up on what you said, if you want certainty, what is wrong with paying the government what the oil companies pay each other when they sell their oil? Why not just go to market price? That would be certainty. That would be no litigation. It's very clear. It's on the exchanges. That seems to me a simple straightforward solution.

I have read the internal documents. When oil companies buy and sell their oil, they use market prices. I have read them where on California they use ANS. On the East Coast they use NYMEX. Why don't we just do that for the school children, the same standard, market price?

Mr. DEAL. Well, there are two observations. One, I think some of the examples you may be using have alluded to—posted prices are often alluded to. In the rulemaking we are talking about early on posted price—

Mrs. MALONEY. I am not talking about the rule—my question was why not just use market prices?

Mr. DEAL. I'm leading right up to that, ma'am. In the rulemaking early on, industry acceded to taking posted prices off the screen. What we looked at instead was the MMS proposal which originally was the NYMEX futures price. It was later changed to a somewhat different index, market centers.

Our observation is that it has a certain allure to it. It looks simple. But as we have dug into it, we think that it's simplistic. The reason that we think it is simplistic is when you use indices, they are by definition averages. We don't think it renders individual justice to individual lessees.

Plus, when you use an index, you have to adjust back to the value at the lease which the MMS itself accedes to is the end point or should be the end point.

As we have looked at even the use of market centers, when you add to the market center spot prices, the adjustments that the MMS contemplates, we are finding ourselves still falling short of getting all of the way back.

Hence, we have emphasized that before one uses an index—and in some cases you might have to use an index—but before you use an index, before you get on that slope, our strong suggestion is to look around to see what is at the top of the hill already.

We think there is an active market at the lease, often. We think if the lessee himself or herself hasn't engaged in an arm's-length transaction, there are often comparable sales. Those ought to be exploited fully. That is at the least a market price.

Mrs. MALONEY. Then why do the oil companies use the market price when they sell and buy their oil? I just like to back variety. I have been called to a vote, and I wanted to ask Mr. Dillon something. How many companies in the IPAA—

Mr. HORN. Let me just briefly say that I am going to go and vote and get back here. Mrs. Maloney can continue questioning.

Mrs. MALONEY. How many companies are members of the IPAA? How many companies are members of your independent IPAA?

Mr. DILLON. How many companies just in the industry in general? We have some 8,000 members.

Mrs. MALONEY. How many of them own pipelines?

Mr. DILLON. I would have to guess that it's probably somewhere in the area of 10 to 15 percent of those companies.

Mrs. MALONEY. How many of them own refineries?

Mr. DILLON. Less than probably 1 percent to 2 percent.

Mrs. MALONEY. You stated that your organization supports the industry proposal in its entirety; is that correct?

Mr. DILLON. That's correct.

Mrs. MALONEY. So I take it that it's your opinion that your companies have an interest in every specific provision that industry has put forward in its proposal?

Mr. DILLON. We find that, as we look at the work and develop the industry proposal, that in each of the issue areas, independence in one form or another are affected. So to answer your with one word, the answer is yes.

Mrs. MALONEY. I really feel that most Members of Congress agree with me that we don't want to do anything that hurts struggling producers, the real mom and pops. Some of my colleagues tell me that people have oil rigs in their backyard, that this is a way of life in some areas of the country. We just don't want to hurt those types of folks.

So I would like to ask you, what in this rule will harm these producers? I'm not talking about the entire membership, just the small producers. What in this proposed rule will harm them?

Mr. DILLON. I like to sometimes call them, Congresswoman, the "well head seller." The well head seller doesn't own the pipe and doesn't go downstream. They sell the production at the well. I think that is where Congressman Turner is. There are some issues which I did articulate in my oral statement that goes specifically to that type of producer. It is a subset of the issues discussed in the industry proposal.

Mrs. MALONEY. I have to go vote. May I ask, because I really am supportive to the small producers, if my counsel could continue down my line of questions with you? Is that all right? Not appropriate they are saying? Can I read my questions and ask Mr. McCabe to ask them for me? I have got to go vote.

Mr. DILLON. Might I suggest that you just submit them, and we will respond to them in writing.

Mrs. MALONEY. I'm not going to submit them for the record because I never get the answers back. I am going to give them to Mr. McCabe. If he could ask them, then I will get them on the way back.

I can't. I have got to go vote.

Mr. DILLON. I don't think the committee is in session with no Members. If I may ask for a point of order.

Mr. KAPLAN. We will need to recess until the Members return.

Mr. DILLON. There is no one here from the committee.

Mrs. MALONEY. Here is the questions, if you could ask them. On the duty to market issue, are any of your members private royalty owners? To the best of your knowledge, do they insist on a duty to market? Can you name a specific instance when MMS has second-guessed a bona fide arm-length sale that one of your companies en-

gaged in simply because another producer obtained a higher price and how often has this occurred?

Then I have another series of questions that I wanted to ask Mr. Deal because I certainly support free enterprise. I know that you are interested in an honest and fair system. I just wanted to ask you a series, too, but I have got to go vote. I will be right back. I don't see why we can't have someone else ask them while we are gone.

Counsel has stated that on the record while we are gone that you can answer these questions that I just gave. Thank you. I'm sorry.

Mr. DILLON. Counsel, I would like to suggest that we will commit to respond in writing. I don't see the purpose of proceeding since no members of the committee are here. But I certainly give you my word and promise to the committee that we will respond in a very timely fashion.

I barely was able to write down her questions. If that's acceptable, we will work with your staff, and we will have you a response in the very near future. We won't delay.

Mr. MCCABE. I will respond very briefly for the record. I would like to submit to the committee a list of authority. I think this issue is a side show where the States uniformly accept a duty to mark up on the lessee. And I will leave it at that.

Mr. DILLON. Before we close, I would like to submit a letter for the record that I just received that I do think the chairman and the Members of Congress will be interested in. It is a letter that Chairman Frank Murkowski, Senators Domenici and Nickles sent to the Department of Interior Secretary, Bruce Babbitt, today inquiring into the allegations about Bob Berman and the relationships of POGO. So I just thought the committee might find that instructive and of some use.

Mr. MCCABE. I will also submit a letter from the State of New Mexico from Commissioner Powell in support of MMS.

Mr. KAPLAN. I think technically what we will have to do is when the Members return request that the chairman insert the letters into the record.

Mr. DILLON. In fact, I withdraw my request because the point of order is plain. Given that the chairman is not present, I withdraw the letter because he would have to acknowledge the submission of it. I think Jim would have to respectfully do the same.

Mr. MCCABE. I wouldn't respectfully do anything at this point.

Mr. DILLON. We will be glad, in a serious note, to respond to the questions from Congresswoman Maloney.

[Recess.]

Mr. HORN. Mrs. Maloney has some questions that she will write you about. If you would, do the answer if you could in 30 days. We would appreciate it. We would like to put it in the record at this point. So we thank you all for coming and we will now swear in the second panel. I know that we have a logistics problem there.

These are documents that we will put into the record without objection: one is to Secretary Babbitt, signed by three U.S. Senators, Pete Domenici, Don Nickles, Frank Murkowski.

Another one is "Sampling Of Duty to Market Cases Under State and Federal Law," citing Oklahoma, New Mexico, Texas, Louisiana, and Federal law generally.

And a letter here from the State of New Mexico commissioner of public lands, who is Ray Powell. That's to the Honorable Don Nickles, chairman, Energy Research, Development, Production and Regulation Subcommittee of Senate Energy and Natural Resources Committee. That will go into the record also.

[The information referred to follows:]

FRANK H. MURKOWSKI, Alaska, Chairman

PETE V. DOMERICK, New Mexico	JEFF BINGAMAN, New Mexico
DONNICK PETER DIAMONTE	DANIEL K. AKAKA, Hawaii
LARRY E. CRAIG, Idaho	BYRON L. DORGAN, North Dakota
BEN RICHTHOFER, CAMPBELL, Colorado	BOB GRAHAM, Florida
CLAUDE TOULON, Wyoming	RON WYDEN, Oregon
GORDON SMITH, Oregon	TIM JOHNSON, South Dakota
T. BURNING, Kentucky	JARRI L. LANDRIEU, Louisiana
ERIC O. FITZGERALD, Illinois	EVAN BAYH, Indiana
GLENN L. GORTON, Washington	BLANCHE L. LINCOLN, Arkansas
CONRAD BURNS, Missouri	

ANDREW D. LUNDQVIST, STAFF DIRECTOR
 DAVID S. OYE, CHIEF COUNSEL
 JAMES P. BERNE, DEPUTY CHIEF COUNSEL
 ROBERT M. SIMON, DEMOCRATIC STAFF DIRECTOR
 SAM E. POWLER, DEMOCRATIC CHIEF COUNSEL

United States Senate

COMMITTEE ON
 ENERGY AND NATURAL RESOURCES
 WASHINGTON, DC 20510-6150

WWW.SENATE.GOV/ENERGY
 May 19, 1999

The Honorable Bruce Babbitt
 Secretary
 Department of the Interior
 1849 C St. N.W.
 Washington, D.C. 20240

Dear Mr. Secretary:

The Department of the Interior (DOI) is undertaking a rulemaking to alter the method for calculating the royalty owed to the United States for oil produced on Federal lands. We write to ask that you suspend the oil valuation rulemaking until issues surrounding its propriety are resolved.

Ms. Danielle Brian, Executive Director of the Project on Government Oversight (POGO), recently disclosed that she rewarded \$350,000 to each of two persons who, as federal employees, were deeply involved in the adoption of valuation policies by the Departments of Interior and Energy which led to the proposed rule change. One of the employees, now retired from the Department of Energy, was a member of former Assistant Secretary Bob Armstrong's Interagency Task Force investigating allegations of underpayments on federal leases in California. It was the findings of this Task Force which led to the current rulemaking. The other person to receive a \$350,000 payment from POGO is a current DOI employee in the Office of Policy Analysis, Robert Berman. Over the last decade, Mr. Berman has been heavily involved in a variety of issues involving oil and gas development on public lands and has played an integral role in new oil valuation policy.

The concept that oil be valued for royalty purposes further and further downstream from the wellhead has been controversial. Indeed, Congress has acted repeatedly to stop the implementation of the rule based on our concern that the proposed rule imposes a backdoor tax increase on domestic energy producers. Such cost increases heighten our dependence on imported oil which threatens our national security. To now discover that two Federal employees integrally involved in the policies leading to the rule change have financially benefitted from their advocacy is a scandal which strikes at the heart of the Department's rule and calls into question the propriety of the Department's administrative process.

Secretary Babbitt
May 19, 1999
page 2

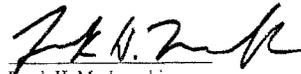
We recognize that the act of offering and the acceptance of these payments raises a number of complex fact-specific legal issues as to whether or not such a payment is allowed under the False Claims Act. Ms. Brian acknowledges that payments were made to the two employees "who had already been trying to fix this problem within the bureaucracy for years previously". These questions are being examined in ongoing, related litigation between DOI and a number of oil companies. In addition, it is my understanding that both the DOI Office of Inspector General and the Department of Justice's Office of Public Integrity are investigating the conduct of the Federal employees, including Mr. Berman, and POGO in this matter.

In light of these investigations, the legitimacy of the oil valuation rulemaking is tainted. It is unclear whether or not Mr. Berman, and in turn, the entire rulemaking process were influenced by Mr. Berman's acceptance of money from POGO or whether earlier actions which led to the rulemaking may have been influenced by the expectation of such remuneration. Accordingly, I respectfully request that you suspend the oil valuation rulemaking until the current investigations are completed. To fail to do so, will forever tarnish the final rule and will only lend further credence to those who believe that the entire rulemaking was designed to further the agenda of special interests.

Sincerely,


Pete V. Domenici


Don Nickles


Frank H. Murkowski



State of New Mexico
 Commissioner of Public Lands

RAY POWELL, M.S., D.V.M.
 COMMISSIONER

310 OLD SANTA FE TRAIL P.O. BOX 1148
 SANTA FE, NEW MEXICO 87504-1148

(505) 827-2760
 FAX (505) 827-2766

May 17, 1999

VIA TELEFAX
AND U.S. MAIL

The Honorable Don Nickles, Chairman
 Energy Research, Development, Production and Regulation Subcommittee
 Senate Energy and Natural Resources Committee
 SD-308 Dirksen Senate Office Building
 Washington, DC 20510-6152

RE: S 924 - The Federal Royalty Certainty Act

Dear Senator Nickles:

It is my understanding that your subcommittee will be holding hearings on the referenced legislation on May 18, 1999. I request that the comments contained in this letter be considered by the subcommittee as it deliberates action on the bill and that this letter be entered into the subcommittee's record.

As the New Mexico Commissioner of Public Lands, I am the elected official responsible for the management and care of over thirteen million mineral acres of state land. A major element of my duties concerns the leasing of those lands for oil and gas development and the collection of oil and gas royalties due under the leases. Actions by the federal government concerning federal royalties have historically had a direct impact upon the management of, and the collection of, royalties from state lands. Also, New Mexico is a major recipient of federal royalties and relies on its share of those royalties to benefit its public schools. For these reasons, we have a profound interest in any federal legislation that may affect the calculation and payment of federal royalties.

I am acutely aware of the current problems facing the oil and gas industry. With oil prices falling close to an all-time low in 1998 and gas prices remaining stagnant for a number of years, we have seen a large decrease in leasing and drilling activity and consequent production. Also, as a royalty owner of production from state lands and the recipient of federal royalties, the State of New Mexico has proportionately suffered with the industry. However, S 924 does nothing to stimulate prices or demand for oil or gas; rather, it proposes to help the industry by disproportionately shifting the burden of low revenues from the oil and gas industry to the citizens and royalty-share states. Moreover, the principal industry beneficiaries of S 924 would not be the ones that most need the help, the independent producers who sell arm's-length at the

The Honorable Don Nickles, Chairman
 Energy Research, Development, Production and Regulation Subcommittee
 Senate Energy and Natural Resources Committee
 May 17, 1999
 Page 2

wellhead. Instead, the bill will primarily benefit the integrated oil and gas companies who, because of refining margins and other downstream activities, are already suffering much less than independent producers and royalty owners. For these reasons, I oppose S 924.

In the guise of providing "certainty" for the calculation of royalties, S 924 proposes to reverse long established principals that have been developed over the years by the courts and the federal government to ensure that royalty owners are fairly compensated for providing producers the right to develop federal oil and gas. In addition, the bill would establish, in statute, a specific mandate for calculating royalties, thereby stripping the Minerals Management Service (MMS) of the ability to react administratively to changes in the oil and gas industry and the marketing of production. The following are a few of the more obvious deficiencies in the bill:

- The bill would require that the federal government be charged for costs to the industry of "marketing ... and other services". Courts and the federal government have long held that oil and gas leases contain an implied covenant to market the production at no cost to the lessor. By overturning this precedent, the provision would cost the federal government, the royalty-share states, and their citizens millions of dollars. In addition, the terms "marketing" and "other services" are not defined in the bill and could be interpreted by industry to include a wide range of costs that are not now being contemplated. (For example, will the government and its citizens be charged for a portion of the advertising expenditures made by oil companies?) The inclusion of ambiguous terms such as "other services", the meaning of which will no doubt be litigated for the indefinite future, surely flies in the face of the stated purpose of the legislation (to provide "simple, clear and certain guidelines").
- The bill would allow royalties to be paid on production at the lease as long as it is in a "marketable condition". Again, this contradicts long standing oil and gas principles that allow the royalty owner to share in enhancements to value performed by the oil and gas lessee. For example, under current law, if a producer decides to process natural gas in order to remove and separately market valuable natural gas liquids, royalty is paid on the value of both the residual natural gas and the natural gas liquids (less actual and reasonable costs of processing). This has been the law for decades. This bill would remove that requirement and allow royalties to be paid on the value of the natural gas before processing. This provision would also cost the government and its citizens millions of dollars.

The Honorable Don Nickles, Chairman
 Energy Research, Development, Production and Regulation Subcommittee
 Senate Energy and Natural Resources Committee
 May 17, 1999
 Page 3

- In the case of non-arm's-length contracts, the bill would require costs to be calculated based on "a contract for similar services in the same area between parties with opposing economic interests". This also reverses a long-standing concept in the oil and gas industry that only actual costs should be charged to the royalty owner. From a revenue standpoint, this provision provides a direct benefit to those large, integrated oil and gas companies that process, refine, transport or otherwise perform downstream activities themselves rather than under arm's-length contracts because contract rates to third parties are always higher than actual costs.
- Oddly enough, for a bill intended to "simplify and eliminate regulatory obstacles", the bill also adds yet another federal agency into the mix for the purpose of resolving disputes between the MMS and producers over costs incurred by affiliated transporters. The bill provides that the Federal Energy Regulatory Commission (FERC) will decide the just and reasonable rates that may be charged to the federal government. The bill is unclear how this provision relates to the current resolution process through the Interior Board of Land Appeals (IBLA) or why resolution by the FERC will provide more "certainty". (I presume that industry believes that the FERC is more industry friendly than the IBLA.)

In summary, as stated above, the bill does nothing to help the entities that are most hurt by the present oil and gas economy; i.e., those independents that sell their production arm's-length at the wellhead to large oil or gas companies. Under past and proposed regulations and any interpretation of this bill, they will continue to pay royalties on the proceeds received from the sales. The bill only provides relief by taking money that would otherwise belong to the state and federal governments and their citizens and transferring it to oil and gas companies that do not sell oil and gas at the wellhead.

In considering the bill, there is one additional point that the subcommittee should remember. As the prime sponsor of the bill has pointed out, the current "uncertainty" concerning the payment of federal royalties began when MMS issued a Notice of Proposed Rule-making (NOPR) for a new oil valuation rule in January of 1997. The NOPR, in turn, was necessitated by the realization by royalty owners throughout the country that posted prices were no longer representative of actual value and that royalties were being consistently undervalued at the expense of royalty owners. Oil companies, that needed oil for their downstream refineries, were paying premiums above the posted price when purchasing oil in arm's-length transactions but, when calculating royalties on their own production, those companies used the lower posted price. Therefore, through the

The Honorable Don Nickles, Chairman
Energy Research, Development, Production and Regulation Subcommittee
Senate Energy and Natural Resources Committee
May 17, 1999
Page 4

practice of the oil and gas industry, the "certainty" associated with posted prices was no longer valid and new regulations became necessary that more accurately reflect the actual value of the oil.

Thank you in advance for your consideration of these comments.

Sincerely,



Ray Powell, M.S., D.V.M.
New Mexico Commissioner of Public Lands

RP:pls

pc: The Honorable Bob Graham, Ranking Minority Member
Energy Research, Development, Production and Regulation Subcommittee
Senate Energy and Natural Resources Committee
SD-308 Dirksen Senate Office Building
Washington, DC 20510-6152

SAMPLING OF DUTY TO MARKET CASES UNDER STATE AND FEDERAL LAW**OKLAHOMA**

Mittlestaedt v. Santa Fe Minerals, (Okla 1998). Gas Case/deductibility of dehydration, blending, compression gathering when activities conducted off lease and not necessary to make product marketable. Followed and adopted *Garman v. Conoco, Inc.* (Colo. 1994).

Where activities are necessary to make the product marketable, they are not deductible against royalty even if conducted off lease. However where the product is already marketable, costs (e.g., additional downstream compression) "may" be deducted, but only when: (1) the costs are reasonable, (2) actual royalty revenues increase in proportion to the costs assessed against the royalty interest, (3) the costs are associated with transforming a marketable produce into an enhanced product, and (4) the lessee meets the burden of establishing all the above facts. [Lexsee at p. 21]

TXO Production v. Commissioners of the Land Office, (Okla. 1994). Gas case/deductibility of compression, gathering and dehydration. Held, not deductible, following *Wood v. TXO* (below).

"If the processes of dehydration and gathering are necessary to prepare the product for market, then the costs of these processes may not be deducted under the royalty provision of the lease." [Lexsee p. 6]

Wood v. TXO Production Corp. (Okla. 1982). Gas case/deductibility of costs of compression. Held, not deductible because of duty to market.

"We interpret the lessee's duty to market to include the cost of preparing the gas for market. The lessor, who generally owns the minerals, grants an oil and gas lease, retaining a smaller interest, in exchange for the risk-bearing working interest receiving the larger share of proceeds for developing the minerals and bearing the costs thereof." [Lexsee p. 81]

NEW MEXICO

Darr v. Eldridge (New Mexico Supreme Court, 1959). Mineral water well.

"Obviously production without disposition of the product is futile. Thus the courts have developed the implied covenant 'to make diligent efforts to market the production in order that the lessor may realize his royalty interest.

"The same logic and equitable principles being applicable, the courts have implied the four basic oil and gas lease covenants, including the covenant to exercise reasonable diligence to market, to mill leases, farming leases and so-called solid mineral leases, as well as to a covenant granting a right to sell mineral water from the land of another." [Lexsee p. 38]

"As heretofore pointed out, the lease in question should be governed by the principles applicable to oil and gas leases including the doctrine that such a lease will be cancelled for failure to exercise reasonable diligence in marketing the product." [Lexsee p. 39]

TEXAS

Amoco Production Co. v. First Baptist Church of Pyote (Texas Supreme Court 1980)[Refusing writ of error, confirming lower court decision]

"It is implicit in the [lower] court's reasoning that there was evidence of a breach of the covenant to market in good faith in Amoco's marketing of the lessors' gas at a rate substantially lower than market value, where by doing so Amoco was able to obtain for itself the collateral benefit of increasing the price for gas from its other previously dedicated leases from third parties. [citation omitted] We agree." [Lexsee p. 72]

Texas Oil & Gas Corp. v. Hagen (Tex. App. 1984). Gas case. Sale to affiliated company for resale at a higher price. Held: lessor entitled to royalties based on resale price less transportation/processing.

"[T]he purported sale of the gas to Delhi was a sham, and ... TXO used that arrangement and its relationship with its wholly owned subsidiary to create an unfair device to deprive plaintiffs of their rightful royalties" [Lexsee p. 36]

"Market value at the well is the market value of the gas where sold, less reasonable cost of transporting the gas to the market and ... processing...." [Lexsee p. 36]

Exemplary damages awarded for breach of duty to market:

"An oil and gas lessee owes its lessors a higher than ordinary duty to market the production from the leases in a manner which will obtain the best and highest price reasonably obtainable." [Lexsee p. 37]

LOUISIANA

Frey v. Amoco Production Co., (La. Supreme Court 1992). Duty to market as part of Civil Code of Louisiana, LA. REV. STAT. 31:122, Art. 122, Mineral Code.

"Relevant for our purposes is the implied obligation to market diligently the minerals discovered and capable of production in paying quantities in the manner of a reasonable, prudent operator...Encompassed within the lessee's duty to market diligently is the obligation to obtain the best price reasonably possible." [Lexsee p. 114]

If a lessor is denied "a share" of greater receipts "on the basis he shares none of the costs and risks of development and marketing, one may assume all royalties are unfair." [Lexsee p. 118].

[Note: Louisiana's State Mineral Board and Department of Natural Resources appeared amicus curiae in support of the lessor/royalty owner.]

Shell Offshore, Inc. v. FMP Operating Co., (E.D. La. 1988). Where Shell reserved an overriding royalty interest -- a "non-cost bearing interest", it was error for company operating lease to calculate royalties by deducting all of the costs that would be deducted from a working interest. Operating lessee had a duty to market the production attributable to the overriding royalty interest, when Shell notified operator that it wanted to take its royalty in value. Fact that Shell voluntarily agreed in

writing to assume certain specified costs does not transform the nature of its interest, make it liable for other costs, or reduce the operator's duty to market.

"It is well recognized ... that working interest owners have a duty to market an overriding royalty owner's share of production once production has been achieved." [Lexis p. 103]

"It may be that Shell does not 'need' the protection of an implied duty to market, but the lack of need is not sufficient reason to eliminate the duty ..." [Lexis p. 103].

Wegman v. Central Transmission, (La. App. 1986). Gas case. Sale to an affiliated limited partnership for resale at a higher price. Held: lessee failed to act in good faith. Market value is resale price less transportation. No deduction for affiliate limited partnership's cost of transporting from lease to major transportation line. [Lexsee p. 26]

Hall v. Arkansas-Louisiana Gas Company, (La. App. 1978). Independent gas producer gains higher sales price from purchaser, a "large integrated gas utility company," through evidence that royalty payments made to the U.S. were made at a higher sales value.

FEDERAL

Mesa Operating Limited Partnership, (5th Cir. 1991). Federal Marketable Condition Rule supports inclusion of production-related expenses as part of royalty owed, even though expenses were not included in ceiling price for delivered gas.

California Co. v. Udall, (D.C.Cir. 1961). Upholding Secretary of the Interior's determination that:

[S]ince the lessee was obliged to market the product, he was obligated to put it in marketable condition; and that the "production" was the product in a marketable condition."

Winlock Veneer Co. v. Acting Juneau Area Director, (IBLA 1991). Timber contract. Based on general contractual principles, leases contain an implied requirement that they be carried out in good faith and in accordance with standards of commercial reasonableness.

The Texas Company, (IBLA 1957). Applying duty to market, as set out in Interior regulations. Denying deduction for gathering and transport to point of delivery, compression.

"In fulfillment of its express duty to market its gas, the appellant made a contract for the sale thereof. It agreed to deliver the gas a given pressure presumably in order to sell the gas. It cannot reasonably expect the lessor to assume the cost of meeting the lessee's obligation in this respect." [Lexis p. 26]

"Whether the facilities used by the lessee in this case are termed sales facilities or producing facilities is immaterial to the question whether deductions for the use of such facilities should be allowed in determining the lessee's royalty obligation to the United States under its lease." [Lexis p. 27]

Mr. HORN. Now, if we have everybody here.

Mrs. MALONEY. Before we left I had a series of questions that I asked. I understand that they didn't even answer those while I was gone. I feel very frustrated because not one single question that I asked was ever answered because I also had to go vote.

Mr. HORN. Let's get it in writing and see what we got. We can always have another hearing.

You, I think, might have heard the ground rules for panel one, but essentially as an investigatory subcommittee of Government Reform, we swear in all witnesses. The minute we call on you, your statement automatically goes into the record at that point.

The staff and the Members have had an opportunity to read them unless we didn't get them until now or something which sometimes happens with the administration, but I would hope that it would not happen with this panel.

We will then, if you would, rise, raise your right hands, and I will swear you in. If anybody, I might add for the administration, or even the private counsels, if anybody behind you is going to talk, get them to stand up, too, so I don't have to do five baptisms, which is what I do at the Pentagon unless I get them all up.

[Witnesses sworn.]

Mr. HORN. I see one, two, three, four, five, six, seven, eight, nine witnesses potentially. We thank you.

We will now start with Susan and I'm not sure of the pronunciation is it Kladiva? Say it real fast.

Ms. KLADIVA. Kladiva.

Mr. HORN. Susan Kladiva is the associate director, Energy, Resources, and Science Issues, Recourses, Community, and Economic Development Division of the U.S. General Accounting Office. For those that aren't familiar with the General Accounting Office, they are an arm of the legislative branch and conduct wonderful program and financial audits for the Congress. We are glad to have you here. Usually we start off the whole hearing with a GAO person. We are doing it a little backward today.

STATEMENTS OF SUSAN KLADIVA, ASSOCIATE DIRECTOR, ENERGY, RESOURCES, AND SCIENCE ISSUES, RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE; SYLVIA BACA, ACTING ASSISTANT SECRETARY FOR LAND AND MINERALS MANAGEMENT, U.S. DEPARTMENT OF THE INTERIOR; LUCY QUERQUES DENETT, ASSOCIATE DIRECTOR, ROYALTY MANAGEMENT PROGRAM; ROBERT WILLIAMS, ACTING INSPECTOR GENERAL, U.S. DEPARTMENT OF THE INTERIOR; AND JOHN SINCLAIR, ASSISTANT INSPECTOR GENERAL, U.S. DEPARTMENT OF THE INTERIOR

Ms. KLADIVA. Thank you, Mr. Chairman. Mr. Chairman, members of the subcommittee, we are here today to testify on the valuation of Federal oil. My statement will summarize the results of a report that we issued in August 1998 and events that have happened since then.

Specifically, we will discuss the information MMS used to justify revising its oil valuation regulations, how MMS addressed concerns

expressed during the development of these regulations, and the feasibility of the government taking its oil and gas royalties in-kind.

Current regulations define oil sold at arm's length as oil that is bought and sold by parties with competing economic interest. The price paid in an arm's-length sale established the market value for the oil. For the most part, current and proposed regulations value oil sold at arm's length in a similar fashion.

However, about two-thirds of the oil from Federal leases is not sold at arm's length. It is exchanged between parties that do not have competing economic interest under terms that do not establish a price or market value. According to the current regulations, the price of oil sold in these transactions is based predominantly on posted prices.

Posted prices, however, are simply offers by purchasers to buy oil from a specific area. Recent evidence indicates that oil is now often sold for more than posted prices, suggesting that the value of oil from Federal leases and the amount of Federal royalties should both be higher.

Under the proposed regulations, the price of much of the oil that is not sold at arm's length will be based primarily on spot prices. MMS estimates that this will increase Federal royalty collections by about \$66 million annually.

MMS's decision to revise the oil valuation regulations relied heavily on the findings of an interagency task force consisting of representatives from MMS, Interior's Office of the Solicitor, the Departments of Commerce and Energy, and the Department of Justice's antitrust division.

The task force recognized that the city of Long Beach reached agreement with six major oil companies to accept \$345 million to settle a lengthy lawsuit. One of the major issues in this suit was whether the companies' use of the posted prices represented the market value of oil.

The task force noted that seven major oil companies dominated the oil market in California by controlling most of the facilities that produce, refine, and transport oil in the State, and that this domination, in turn, suppressed posted prices.

The task force concluded that the major oil companies in California inappropriately calculated Federal royalties on the basis of posted prices, rather than include the premiums over posted prices that they paid or received.

The task force estimated from 1978 to 1993 the companies should have paid between \$31 million and \$856 million in additional royalties to the Federal Government.

MMS also contracted for studies that examined oil pricing in other areas of the country to determine how oil is exchanged, marketed, and sold. The studies concluded that posted prices do not represent the market value of oil, citing situations in which oil is bought and sold at premiums above posted prices throughout the country.

As additional evidence the posted prices are less than market value, the studies cited the common practice of oil traders and purchasers quoting a posted plus a premium which is known as the P-plus market.

In addition, varying States supplied MMS with information on legal settlements they reached with major oil companies concerning the undervaluation of oil from State leases. In general, the States disputed the oil companies' use of posted prices as the basis for determining royalties.

Settlements resulted in Alaska, Texas, New Mexico, Louisiana collecting over \$1 billion. MMS began soliciting input to its proposed regulations over 3½ years ago starting in December 1995.

Since then, MMS solicited public comments on proposed valuation changes in seven Federal register notices and in 17 public meetings throughout the country. Comments submitted by States were often at odds with those by the oil industry.

States generally support the proposed regulations because MMS anticipates that the royalty revenues which it shares with the States will increase. The oil industry generally opposes the proposed regulations because they would increase the oil companies' royalty payments and administrative burden.

MMS has revised the proposed regulation five times in response to comments received from both the oil industry and the States. The recently opened comment period closed on April 27. As an alternative to accepting royalties in cash, some lessors in the United States and Canada accept royalties in-kind under certain conditions.

These conditions, however, do not exist for most Federal leases. More specifically, the Federal Government does not currently have a statutory or regulatory authority over pipelines that would ensure relative ease of access for transporting oil and gas from Federal leases.

In addition, some pipelines are privately owned and the owners are free to set their own transportation fees. These fees can be substantial when just a single pipeline is available.

To be cost effective, royalty in-kind programs must also have large enough volumes of oil and gas so that sales revenues exceed the program's administrative costs. The majority of oil and gas leases on Federal lands, however, produce relatively small volumes and are geographically scattered, particularly in the western States.

In addition, many Federal leases produce small volumes of gas that need to be processed. In certain locations there is only a single gas processing plant, and the lack of competition might allow these plants to charge high fees.

Finally, the Federal Government has limited experience in marketing oil and gas, and marketing experience is a key ingredient in non-Federal royalty in-kind programs.

Mr. Chairman, this concludes my prepared statement, and I would be pleased to answer questions.

Mr. HORN. Thank you very much. We will wait until all of the panelists have had their say.

[The prepared statement of Ms. Kladiva follows:]

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Government Management,
Information, and Technology, Committee on Government
Reform, House of Representatives

For Release
on Delivery
Expected at
2 p.m. EDT
Wednesday
May 19, 1999

FEDERAL OIL VALUATION

**Efforts to Revise
Regulations and an Analysis
of Royalties in Kind**

Statement of Susan D. Kladiva,
Associate Director, Energy,
Resources, and Science Issues,
Resources, Community, and Economic
Development Division



Mr. Chairman and Members of the Subcommittee:

We are here today to testify on the valuation of federal oil. In fiscal year 1998, the Department of Interior's Minerals Management Service (MMS) collected \$3.6 billion in royalties from oil and gas leases on federal lands. States in which federal leases are located received a share of the royalties collected. The value of these royalties depended upon the price of oil. As an alternative to accepting cash royalty payments, the federal government could have taken a percentage of the actual oil and gas produced and then arranged for its sale, taking what are known as royalties in kind.

Historically, the value of much of the oil from federal leases has been based on posted prices which are offers by purchasers to buy oil from a specific area. However, recent evidence indicates that oil is now often sold for more than the posted prices, suggesting that the value of the oil from federal leases and the amount of federal royalties should both be higher. On the basis of this evidence, in 1995 MMS began revising its oil valuation regulations so that they rely less on posted prices and more on other, and oftentimes, higher prices. These revised regulations are still pending.

Most of my statement will summarize the results of a report that we issued in August 1998 on the Department of Interior's attempts to revise the federal oil valuation regulations and the feasibility of the government's taking its oil and gas royalties in kind.¹ Specifically, I will discuss three issues: (1) the information MMS used to justify the need for revising its regulations; (2) how MMS addressed concerns expressed by the oil industry and the states in developing these regulations; and (3) the feasibility of the government's taking its oil and gas royalties in kind, instead of in cash.

In summary, Mr. Chairman, MMS relied heavily on the findings of an interagency task force to revise its oil valuation regulations. This task force concluded that the major oil companies' use of posted prices in California to calculate federal royalties was inappropriate and recommended that the federal oil valuation regulations be revised. MMS also relied on contracted studies of oil markets and on valuation disputes between the states and oil companies that the oil companies agreed to settle for more than \$1 billion. To address concerns of the oil industry and the states, MMS solicited public comments on the proposed regulations in seven Federal Register notices, held 17 public meetings, and revised its regulations five times. Proposed changes to the regulations are still

¹Federal Oil Valuation: Efforts to Revise Regulations and an Analysis of Royalties in Kind (GAO/RCED-98-242, Aug. 19, 1998).

pending. Concerning the government's taking of its royalties in kind, we concluded that this would not be feasible except under certain conditions. These conditions include having easy access to pipelines, leases that produce large volumes of oil and gas, competitive arrangements for processing gas, and expertise in marketing oil and gas. However, these conditions are currently lacking for the federal government and for most federal leases.

Background

In fiscal year 1998, MMS collected about \$2.4 billion in royalties for gas sold from leases on federal lands and about \$1.2 billion in royalties for oil sold from leases on federal lands. Oil and gas royalties are calculated as a percentage (usually 12-1/2 percent for onshore federal leases and 16-2/3 percent for offshore federal leases) of the value of production less certain allowable adjustments (such as the cost of transporting oil to markets). The value of production is determined by multiplying the volume produced (which is measured in barrels of oil and in cubic feet of gas) by the sales price.

MMS promulgated the oil valuation regulations that are currently in effect in 1988. These regulations differentiate between oil sold "at arm's length" and oil that is not sold at arm's length. "At arm's length" refers to oil that is bought and sold by parties with competing economic interests, and the price paid establishes a market value for the oil. However, roughly two-thirds of the oil from federal leases is not sold at arm's length; it is exchanged between parties that do not have competing economic interests under terms that do not establish a price or market value. For example, oil companies that both produce and refine oil may transport the oil they produce to their own refineries. These oil companies may also exchange similar quantities of oil with other oil companies to physically place oil closer to their refineries and thereby reduce their costs of transporting it.

The 1988 regulations define the price of oil sold in arm's-length transactions, for the purpose of determining federal royalties, as all financial compensation accruing to the seller. This compensation, known as gross proceeds, includes the quoted sales price and any premiums the buyer receives. For other transactions (i.e., those not at arm's length), the price of the oil is defined as the higher of either the gross proceeds or the amount arrived at by the first applicable valuation method from the following list of five alternatives: (1) the lessee's posted or contract prices, (2) others' posted prices, (3) others' arm's-length contract prices,

(4) arm's-length spot sales² or other relevant matters, and (5) a netback³ or any other reasonable method. The first two alternatives, and to a lesser extent the third, can rely on posted prices in establishing value.

Under the revised oil valuation regulations that are currently proposed, MMS would continue to require, for federal royalty purposes, that gross proceeds be used to establish the price of oil sold in arm's-length transactions, except in certain circumstances involving multiple exchanges or sales. For transactions that are not at arm's length, however, the proposed regulations substantially change the means for determining the price of the oil, no longer relying on the use of posted prices and instead relying on spot prices.

To determine federal royalties, the proposed regulations define the price of oil not sold in arm's-length transactions differently in each of three domestic oil markets: (1) Alaska and California (including leases off the shore of California); (2) the six Rocky Mountain states of Colorado, Montana, North Dakota, South Dakota, Utah, and Wyoming; and (3) the rest of the country, including the Gulf of Mexico.

In Alaska and California, the price of oil not sold in arm's-length transactions is defined in the proposed regulations as the Alaska North Slope spot price, adjusted for the location of the lease and the quality of the oil. In the six Rocky Mountain states, this price is proposed to be the first applicable valuation method from the following list of four alternatives: (1) the highest bid in an MMS-approved tendering program (akin to an auction) conducted by the lessee; (2) the weighted average of the lessee's arm's-length purchases and sales from the same oil field, when they exceed 50 percent of the lessee's purchases and sales in that specific oil field; (3) the spot price for West Texas Intermediate crude oil at Cushing, Oklahoma, (where several major oil pipelines intersect and storage facilities exist) adjusted for the location of the lease and the quality of the oil; or (4) a method established by the MMS Director. For the rest of the country, the price of oil is defined by local spot prices, adjusted for the location of the lease and the quality of the oil.

While oil and gas royalties are most often paid in cash, they may instead be paid with a portion of the actual oil and gas that is produced—referred to

²Under spot sales, the buyer and seller agree to the delivery of a specific quantity of oil in the following month.

³A "netback" involves adjusting a price that is established for a sale occurring away from the lease site to approximate a sales price that would have been paid at the lease, by taking deductions reflecting the transportation costs and the quality of the oil sold.

as paying royalties in kind. Paying royalties in kind rather than in cash eliminates the need to determine the sales price of the production because royalties in kind are calculated only on the basis of the volume of oil or gas that is produced.

Information Used by MMS to Justify Revised Regulations

MMS' decision to revise the oil valuation regulations relied on the findings of an interagency task force that examined whether the use of posted prices for the purpose of determining federal royalties in California was appropriate. By 1991, the City of Long Beach, California, reached agreement with six of seven major oil companies to accept \$345 million to settle a lawsuit it had filed years earlier. Although the lawsuit and settlement included issues other than the valuation of oil, one of the major issues was whether the companies' use of posted prices represented the market value of oil produced from leases owned by the city and the state. After conducting a preliminary assessment of the implication of the settlement for federal oil leases in California and consulting with state officials, in June 1994 Interior assembled an interagency task force with representatives from MMS, Interior's Office of the Solicitor, the departments of Commerce and Energy, and the Department of Justice's Antitrust Division. The purpose of the task force was to examine whether the use of posted prices was appropriate for the purpose of determining federal royalties in California. MMS also initiated audits of two of the seven major oil companies that produced oil from federal leases in California.

The task force examined documents submitted by the companies in the lawsuit, reviewed the results of MMS' audits, and employed consultants to analyze the market for oil in California. The market studies noted that the seven major oil companies dominated the oil market in California by controlling most of the facilities that produce, refine, and transport oil in the state—that is, most of these transactions were not at arm's length—and that this domination in turn suppressed posted prices. According to one of the studies, transactions involving Alaska North Slope crude, an oil that is transported into the state by a company that does not own any California refineries and that is actively traded at arm's length, commanded substantial premiums over California oil that was comparable in quality. The task force concluded that the major oil companies in California inappropriately calculated federal royalties on the basis of posted prices, rather than include the premiums over posted prices that they paid or received. The task force estimated that the companies should have paid between \$31 million and \$856 million in additional royalties (the wide range reflects the use of different methodologies and different

treatments of accrued interest) to the federal government for the period 1978 through 1993. In its final report issued in 1996, the task force recommended that MMS revise its oil valuation regulations to reduce reliance on the use of posted prices for valuing oil for royalty purposes.

MMS also relied on additional studies, for which it had contracted, that examined oil pricing in other areas of the country. These studies provided MMS with information on how oil is exchanged, marketed, and sold, as well as information on the relevance of posted prices, spot markets, and NYMEX (New York Mercantile Exchange)⁴ futures prices in oil markets. The studies concluded that posted prices do not represent the market value of oil, citing situations in which oil is bought and sold at premiums above posted prices throughout the country. The studies cited the common practice of oil traders' and purchasers' quoting a posted price plus a premium, in what is known as the P-plus market, as additional evidence that posted prices are less than market value.

In addition, various states supplied MMS with information on legal settlements they had reached with major oil companies concerning the undervaluation of oil from leases on state lands. In general, the states disputed the oil companies' use of posted prices as the basis for determining royalties paid to the states. For example:

- Alaska reported settling a lawsuit filed against three major oil companies for about \$1 billion. These companies produced oil and transported it directly to their refineries, paying state royalties based on prices the companies had themselves calculated. The state contended that these transactions from 1977 through 1990 were not at arm's length and that the calculated prices were less than the market value of the oil.
- A major oil company agreed to pay Texas \$17.5 million to settle allegations that from 1986 through 1995 it had paid royalties on prices for oil from state leases that were less than market value.
- Louisiana reported it settled 10 disputes involving oil companies that owned their own refineries and paid state royalties on posted prices from 1987 through 1998. These companies agreed to collectively pay about \$6 million to settle these claims and to make future royalty payments based on average spot prices in the Louisiana oil market.
- New Mexico reported two settlements with a major oil company that used its own posted prices as a basis for state royalties from 1985 through 1995. The company paid the state about \$2 million.

⁴Each NYMEX futures contract establishes a price for the future delivery of 1,000 barrels of sweet crude oil (similar in quality to West Texas Intermediate) at Cushing, Oklahoma.

How MMS Has Addressed Industry's and States' Concerns

From December 1995 through April 1999, MMS solicited public comments on its proposal to change the way oil from federal leases is valued for royalty purposes in seven *Federal Register* notices and in 17 public meetings throughout the country, and it has revised the proposed regulations five times in response to the comments received. Comments submitted by states were often at odds with comments provided by the oil industry. States generally support the proposed regulations because MMS anticipates that royalty revenues—which are shared with the states—will increase. MMS estimates that its proposed regulations will increase federal royalties by \$66 million annually. The oil industry generally opposes the proposed regulations because they would increase oil companies' royalty payments and administrative burden.

In its first *Federal Register* notice, published in December 1995, MMS announced that it was considering revising its oil valuation regulations because it had acquired evidence indicating that posted prices no longer represented market value. In response, representatives of the oil industry generally commented that they opposed any changes to the current regulations but that pending litigation prevented them from offering specific comments on the issues identified by MMS. Several states commented that they believed that posted prices no longer reflected market value, provided evidence supporting their position, and recommended that MMS adopt spot prices or NYMEX futures prices for valuing oil from federal leases that was not sold at arm's length.

MMS' second *Federal Register* notice, published in January 1997, proposed retaining the use of gross proceeds for valuing federal oil sold at arm's length but reduced the number of oil companies that could use this method by restricting its applicability to those companies that had not sold oil in the past 2 years. It also eliminated the use of posted prices for oil not sold at arm's length. For these sales, MMS proposed that the value of oil from federal leases in Alaska and California would be based on Alaska North Slope spot prices and that the value of oil from other federal leases would be based on NYMEX futures prices. Both the Alaska North Slope and NYMEX prices would be adjusted for differences in the location of the leases and the quality of the oil.

In its third through seventh *Federal Register* notices, published from July 1997 through March 1999, MMS responded to comments and modified its regulations in response to these comments. For example, in response primarily to the oil industry's comments, MMS eliminated the use of NYMEX for establishing the value of oil not sold at arm's length, proposed a

separate system for valuing oil not sold at arm's length in the Rocky Mountain states, and modified the definition of "affiliate." In response primarily to the states' comments, MMS proposed the use of spot prices in valuing oil not sold at arms' length and proposed certain price adjustments for location and quality. As suggested by the oil industry and the states, MMS also deleted a proposed 2-year limitation on the use of a valuation methodology relying on gross proceeds. When MMS disagreed with a comment received, the agency provided reasons for not revising the proposed regulations as suggested. For example, MMS disagreed with and dismissed the oil industry's suggestion to initiate a royalty-in-kind program as an alternative to the proposed regulations, stating that the agency would seek input on this issue through other avenues.

Feasibility of a Royalty-In-Kind Program

Although most oil and gas lessors take their royalties in cash, several limited programs exist in the United States and Canada under which lessors accept their royalties in kind. Oil royalty-in-kind programs are currently operated by MMS,⁹ the Canadian Province of Alberta, the City of Long Beach, the University of Texas, and the states of Alaska, California, and Texas. Gas royalty-in-kind programs are also currently operated by Texas and the University of Texas. According to information from studies and the programs themselves, royalty-in-kind programs are feasible if certain conditions are present. In particular, the programs are workable if the lessors have (1) relatively easy access to pipelines to transport the oil or gas to market centers or refineries, (2) leases that produce relatively large volumes of oil or gas, (3) competitive arrangements for processing gas, and (4) expertise in marketing oil or gas. However, these conditions do not exist for the federal government or for most federal leases.

Several of the entities operating royalty-in-kind programs told us that having relative ease of access to pipelines is a key component of their programs because it assures them that they can transport oil and gas to where they need it at a relatively low cost. However, the federal government does not currently have the statutory or regulatory authority over pipelines that would ensure relative ease of access for transporting oil and gas from federal leases. In addition, some pipelines are privately owned and the owners are free to set their own transportation fees. In some areas of the country, oil from federal leases can be transported on just a single pipeline, and the owner of that pipeline may charge substantial fees. Oil and gas marketers we contacted confirmed that the

⁹The purpose of MMS' royalty-in-kind program is to supply oil to small refineries that may otherwise not be able to obtain oil at competitive prices.

federal government would need to transport any royalty-in-kind production it received to market centers or refineries in order to increase its revenues.

To be cost-effective, royalty-in-kind programs must have volumes of oil and gas that are high enough for the revenues made from selling these volumes to exceed the programs' administrative costs. The majority of oil and gas leases on federal lands, however, produce relatively small volumes and are geographically scattered—particularly federal leases located in the western states. For example, MMS estimates that about 65 percent of the wells on federal oil leases in Wyoming produce less than 6 barrels of oil daily, which would result in less than 1 barrel per day in oil royalties in kind. Most federal leases in the San Juan Basin of New Mexico also produce low volumes.

Because natural gas may need to be processed before it can be sold, arranging for processing is a critical consideration in operating a gas royalty-in-kind program. Many federal leases produce small volumes of gas that need to be processed. In certain areas, there is only a single plant to process the gas from many of these leases. In these circumstances, the lack of competition might allow the plants to charge high fees. For example, MMS estimates that the federal government could lose up to \$4.3 million annually if the agency accepted royalties in kind from federal leases in Wyoming for which there is access to only a single gas-processing plant.

Lessors who accept royalties in kind must sell the oil or gas to realize revenues, and they are likely to receive higher prices if they move it away from the lease and closer to marketing centers or refineries. Storing, transporting, marketing, and selling oil or gas can be complicated processes. Profit margins are often thin, and there may be little room for error. The nonfederal royalty-in-kind programs have generally been in existence for years, and the entities running these programs have gained both experience and expertise. In contrast, the federal government has limited experience in marketing oil or gas royalties in kind.

Mr. Chairman, this concludes our prepared statement. We will be pleased to respond to any questions that you or Members of the Subcommittee may have.

Mr. HORN. I might say to the others, which I didn't say before, is that don't read us your statement, just summarize it. I would hope that you could do it within 8 to 10 minutes because your statements have been read.

We now have Sylvia Baca, the Acting Assistant Secretary for Land and Minerals Management, U.S. Department of the Interior. Secretary Baca.

Ms. BACA. Mr. Chairman and members of the subcommittee, thank you. I appreciate the opportunity to be here today to provide this subcommittee with an update on the major royalty management issues on which the Department of Interior and its Minerals Management Service have been working since we last testified before you in June 1996.

Much has happened since then, and I would like to briefly describe the progress that we have made from our Federal oil valuation efforts to our royalty in-kind initiatives to re-engineering MMS's entire royalty management program.

My written testimony goes into more detail, and we ask that this be submitted for the record. As you know, in May 1996 the inter-agency task force we created to examine the value of California crude oil reported that it found significant evidence that in California posted prices were inaccurate measures of market value.

In July 1996 the Department announced that it would begin special reviews of oil valuation in California to determine the amount of royalty underpayments. The Department targeted the 20 largest royalty payers that accounted for 97 percent of the State's Federal crude oil production.

As a result of those reviews, the MMS billed companies for underpayments totaling \$277 million for the period of 1980 through 1995. These bills have been appealed and several have gone into litigation. In two decisions the district for northern Oklahoma ruled that the statute of limitations barred the MMS from enforcing the orders and disputes covering the time period from January 1980 to February 1988. Those decisions are currently under appeal.

It has been well documented over the past several years that posted prices no longer reflect market value of crude oil, not only in California, but in other areas as well. This is not only the view of the Federal Government. Many private royalty owners and State governments have brought suit against the oil industry for underpayment of royalties primarily based on posted prices. You have been given the amounts and the States.

Chevron has settled for \$17.5 million in Texas. The State of Alaska settled for \$2.5 million. Recently it was reported that several of the largest oil companies settled claims from private royalty interests across the United States for \$193 million.

Further, as many of you know, the Department of Justice has intervened in qui tam suits involving underpayment of royalties for oil produced from Federal lands.

One company, Mobil Oil, recently settled with the government for \$45 million. That included California production. The Department has also taken an active role outside of California.

In June 1996, MMS issued new guidance for valuing crude oil production nationwide because of the growing prevalence of companies paying premium above posted prices to purchase to crude oil.

In August 1996, MMS developed a national crude oil audit strategy for other States and Federal production in the Gulf of Mexico's outer continental shelf.

The national strategy targeted 125 companies which produce about 86 percent of Federal crude. These audits are ongoing. Since December 1995, we have engaged in a thorough process to revise our Federal oil valuation regulations.

The current regulations, which rely heavily on posted prices in valuing oil not sold at arm's length were published in 1998 and have remained in effect until today. Our proposed rule would move away from posted prices for the so-called "non-arm's-length" transactions in those parts of the country and would instead use published spot prices established at major market trading centers.

The spot prices would then be adjusted for transportation, for location, and for quality to arrive at a fair value. In the Rocky Mountain region where there is no established spot market prices, we would use a series of bench marks.

While industry opposes certain aspects of the proposed rule, it generally agrees that the new rule would not rely on posted prices to determine value for nonarm's-length transactions. Over the last 3 years, we have modified the proposal several times to address the concerns expressed by many with a direct interest in the rule. We have made particular efforts to try to resolve industry's concerns.

However, Mr. Chairman, we must hold firm on our basic principle and our statutory responsibilities to our most important constituent, the American taxpayer. We want a rule that is administratively simple, certain, efficient, adaptable to market conditions and, most importantly, reflective of today's crude oil market.

It is important to understand that this royalty is not a tax. It is what is owed to the taxpayers for the minerals produced from public lands. We owe it to the taxpayers to have a rule in place that accomplishes these objectives.

Secretary Babbitt has been keenly interested in this process and recently reopened the comment period for all interested parties to submit new ideas that would move us forward toward publication of a final rule. He has also announced additional workshops so that industry, so that government, public interest groups, and the States could discuss ideas informally in an open setting.

Now that the comment period has closed and the workshops are completed, we are in the process of reviewing the written comments and deciding on a future course of action. I can promise you this, however, that we are committed to publishing a rule that assures the public fair return for the minerals produced from its land.

Mr. Chairman and the members of the subcommittee, I would like to take this opportunity to clear up what I think is a misperception about this issue. The oil rule has nothing to do with recent low prices that have plagued the industry. In other words, the royalty is not a tax.

While we are sympathetic with what the industry is experiencing, we do not believe that compromising the oil valuation rule is the proper way to address the industry's concerns. The purpose of these regulations is to fulfill our statutory responsibility to capture market value for the public's resources.

When the market goes up, our royalties go up. And when the markets go down, we suffer in tandem with the industry. However, regardless of market conditions, we do not think that compromising the oil valuation rule is the proper way to alleviate market pressures on industry.

There are two other areas that we are changing how we do our business and that is in our royalty in-kind programs and our re-engineering efforts.

Let me say briefly that royalty in-kind test programs have been quite successful. Our RIK pilot for crude oil in Wyoming has shown us how to maximize revenues under certain conditions. And our offshore Texas program has proven that we can take the royalty portion of natural gas from public land and deliver it to public facilities for less cost.

In concert with the Department of Energy, we are also beginning to deliver royalty in-kind production from leases in the Gulf of Mexico to the strategic petroleum reserve.

Finally, the efforts that we now have under way to re-engineer the entire royalty management program have been going smoothly. Under re-engineering design, royalty management functions will be organized around two core business processes: financial management and compliance and asset management.

The benefits of re-engineering will be significant for industry, States, and tribes alike, including reducing the time to distribute mineral revenues to recipients from 30 days to 24 hours and cutting the business cycle from 6 years to 3 years and streamlining required reported data by up to 40 percent. We hope for a one-stop shopping for better overall customer service.

That concludes my prepared remarks. I would be happy to answer any questions.

Mr. HORN. Thank you very much. We will hold questions until Mr. Williams, the Acting Inspector General, finishes his testimony.

[The prepared statement of Ms. Baca follows:]

TESTIMONY OF

**Sylvia Baca, Acting Assistant Secretary
for
Land and Minerals Management
U.S. Department of the Interior**

Before the

**Subcommittee on Government Management, Information and Technology
House Committee on Government Reform**

House of Representatives

May 19, 1999

Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to appear before you today to provide an overview of the Minerals Management Service's (MMS) Royalty Management Program and a status report on the Department of the Interior's efforts to revise its regulations for valuing crude oil. It has been almost three years since MMS last testified before this Subcommittee on the issue. During that time, I believe we have made great strides in our attempt to publish a final rulemaking, but our efforts are not yet finished. My intent today is to highlight the Department's progress and efforts thus far and to discuss where we go from here. However, prior to discussing further details of the Department's efforts to revise the crude oil regulations, let me begin with a brief overview of current efforts of the MMS.

Background

The Department's MMS was created 17 years ago: (1) to manage the Nation's Outer Continental Shelf (OCS) mineral resources in an environmentally sound and safe manner; and (2) to collect, verify and distribute mineral revenues from Federal (both onshore and offshore) and Indian lands. In that role, the agency collects, accounts for, and disburses over \$4 billion in revenues each year from Federal offshore mineral leases and from onshore leases on Federal and Indian lands. These revenues are distributed and disbursed to 38 States, 41 Indian Tribes, 20,000 Indian mineral royalty owners, and to U.S. Treasury accounts. Of the \$4 billion, about \$1.6 billion annually is collected in oil royalties.

The Federal government has been systematically collecting revenues associated with mineral production on Federal onshore lands since 1920 and from offshore lands since 1953. However, it was not until 1982, with the establishment of MMS and the enactment of the Federal Oil and Gas Royalty Management Act (FOGRMA), that a comprehensive system was put into place for properly collecting, accounting for, distributing, and valuing these revenues. Since 1982, MMS has worked to develop systems, policies, and procedures to respond to the mandates of FOGRMA as well as the expectations of its constituencies and numerous oversight

organizations. In 1996, FOGRMA was substantively amended by the Federal Oil and Gas Royalty Simplification and Fairness Act (RSFA). The proper implementation of these two Acts forms the core of the RMP mission. In particular, RSFA significantly changed many historical RMP operating assumptions and revenue processing methods.

From an economic standpoint, in FY 2000, MMS will account for an estimated \$4.0 billion in Federal receipts, including \$2.8 billion from OCS receipts and \$1.2 billion from onshore receipts. From a taxpayer's perspective, this will convert to:

- \$1.9 billion deposited to the General Fund of the treasury to help pay for Federal programs and reduce the Federal debt;
- \$611 million in mineral revenue payments made to onshore States;
- \$106 million in shared natural gas and oil receipts with coastal States;
- \$150 million to Indian Tribes and individual Indian mineral owners;
- \$897 million transferred to the Land Water Conservation Fund; and
- \$497 million credited to the Reclamation Fund.

For most producing Indian mineral leases, MMS collects rents and monthly royalties due under the terms of the leases and notifies the Office of Trust Funds Management (OTFM - part of the Office of the Special Trustee) daily of the total amounts collected for tribal and allotted leases. Tribal amounts are identified separately, while individual amounts are provided initially in lump sum. (In addition, some rents and royalties from coal leases are paid directly to tribes by the lessee.) It is OTFM's responsibility to invest the totals passed on by MMS into interest-bearing accounts. Twice each month, MMS sends the Bureau of Indian Affairs a data file that breaks the amounts collected for individuals down by lease numbers. The MMS system is based on lease numbers and therefore we have no information relating to tribal or allotted accounts. These accounts are managed collaboratively by OTFM and BIA who make the actual disbursements to the account holders.

As a steward of public and Indian lands, MMS ensures that revenues collected are disbursed and shared by several entities. In order to share these revenues, we must first make sure we are properly organized and are using the most appropriate methodologies to collect revenues from oil and gas produced on Federal lands. Revising our crude oil regulations is crucial to our efforts to properly collect royalties for distribution to the appropriate Federal accounts and to the States.

California Federal Crude Oil Underpayments

A lot has happened in our Federal oil valuation rulemaking initiative since we last met with you in June 1996. In September 1996, the Committee issued a report recommending that, among other recommendations, DOI begin expanded efforts to collect royalty underpayments in California. But before delving into that let me give you a brief recap of the Department's efforts on oil valuation.

As we reported to you in June 1996, MMS began studying the California crude oil market in 1986 in an effort to determine whether royalties from Federal leases had been properly valued. Based on information available at that time, MMS concluded that posted prices fairly represented crude oil values for royalty payment purposes, and the issue was not pursued further.

By 1991 however, following the Ninth Circuit's reversal of the District Court's summary judgment order, six of the companies involved in the Long Beach litigation (ARCO, Shell, Chevron, Mobil, Texaco, and Unocal) reached settlements to end court actions alleging undervaluation on State and City leases as well as other issues relating to pipelines. A seventh defendant, Exxon, went to trial. On January 31, 1995, the Ninth Circuit upheld the U.S. District Court for the Central District of California ruling in favor of Exxon in a law suit covering 1971 to 1977. Another appeal covering a later time period is still pending.

Because of the settlements completed in 1991 between the State of California, the City of Long Beach, and the six companies (ARCO, Shell, Chevron, Mobil, Texaco, and Unocal), the Department began reassessing its 1986 findings and decided further analysis was warranted. In June 1994, MMS formed an interagency task force with the State of California and some of the agencies that had reviewed the matter previously -- Department of Energy, Department of Justice (DOJ), and the Department of Commerce -- to gain information for determining whether the major oil companies wrongfully undervalued crude oil from Federal leases. After a failed attempt to obtain records from the Internal Revenue Service, MMS requested help from California in obtaining access to the documents in the second Long Beach case. While these documents were not initially available to MMS, as they were sealed by the court, the team was able to gain access to the materials by signing a confidentiality agreement with the companies involved in that litigation.

Those documents, which reflected activities that occurred between 1980 and 1989, showed that California crude oil pricing practices required closer scrutiny. The task force recommended that a special audit be performed to determine if Federal lessees in California received revenues above posted prices that should be subject to royalties. This proposed special audit would differ from conventional audits because it would look beyond intracompany transactions that occurred at posted prices to determine whether any additional revenues may have been received by an affiliate in a later transaction. In May 1996, the interagency team reported that:

The team concludes that companies often receive gross proceeds higher than oil company posted prices for crude oil produced in California. Since the team was informed by MMS and California auditors that most Federal royalty payments were based on postings, it follows that royalties have been underpaid.

Further, all of the taskforce members unanimously recommended that:

The oil companies undervalued crude oil produced from Federal leases onshore and offshore in California; MMS should concentrate collection efforts on those ten companies producing at least 90 percent of Federal crude oil in California; MMS should compute royalties owed based on premiums paid on arm's-length contracts for oil produced from the same field or area for periods starting with the effective date of MMS's most recent valuation regulations, March 1, 1988; and MMS should modify its oil royalty valuation regulations to place less emphasis on posted prices.

On July 18, 1996, MMS announced its plan of action to pursue and collect underpayments of royalties on Federal crude oil produced in and offshore California from 1980 forward. MMS stated that it would focus its efforts on the 20 largest payors who together accounted for nearly 97 percent of California's Federal production, and that it would issue its first orders and bills within a few months and conclude its reviews and billing efforts within a year after all data were received. Simultaneously, MMS issued letters to the 20 companies. To date, MMS has also issued subpoenas to companies that have not responded to MMS's requests for data necessary to complete the reviews.

The first order and bill was issued on September 5, 1996, for post-1988 production. On October 18, 1996, MMS issued additional orders and bills to 10 of the 20 companies that refine the crude oil they produce. The orders and bills issued to these integrated companies pertain to underpayments for the period October 1983 through February 1988. Detailed audits of integrated company records for that period were not required because the royalty value of the oil would be based on Alaska North Slope (ANS) prices which are readily available, not on individual sales contracts. On December 20, 1996, MMS issued bills to these same companies for the period January 1980 through August 1983, using ANS prices as the valuation basis.

As a result of the efforts in California, bills have been issued for a total royalty underpayment of \$277 million. All bills have been appealed and two complaints have been filed in the Northern District of Oklahoma. The court has ruled that a six year Statute of Limitations bars MMS from enforcing the orders for periods prior to 1988. MMS appealed the decision.

Also as a result of findings of the interagency task force, in June 1996, MMS issued valuation guidance for auditing crude oil production nationwide. These guidelines explicitly provided that premiums received by lessees represent proceeds subject to royalty. The guidelines were

provided to all MMS audit offices and States and Tribes with MMS delegated audit authority. Audit personnel were instructed to hold open all audit periods to ensure access to those records necessary to determine whether lessees paid royalties on less than arm's-length gross proceeds.

In addition to California, MMS developed a National Crude Oil Strategy and began pursuing similar oil valuation issues in other States and the Gulf of Mexico. In August 1996, MMS began auditing the other States and the Gulf of Mexico producing regions. The National Strategy targeted about 125 companies, which produce about 86% of the crude from Federal lands. However, unlike the California effort, it focuses on the more current periods but is not necessarily limited to only the most recent 6-year period.

Based on further recommendations of the task force and the Committee, MMS agreed that a revision of its regulations was necessary. These regulations, which were drafted in the mid-1980's and published in 1988, rely heavily on posted prices. These regulations remain in effect today and are used by the industry to calculate royalty payments on Federal production.

In addressing this matter, it is important to understand the nature of posted prices and the problems posed by using this measure to ascertain market value for Federal oil and gas. Posted prices are set by the marketing or refining arms of oil companies as a price at which they generally will be willing to buy crude oil. Posted prices are not an obligation to buy, but merely serve as a reference point or starting point for negotiating a market price on the open market. Frequently, premiums are paid above posted prices in non-affiliated transactions. Based on our analyses of company transactions, we know that these premiums can range from \$0.25 per barrel to \$2.00 per barrel. However, when the producing arms of large integrated oil companies (the lessee) transfers oil in house to their marketing or refining arms, they typically pay royalties on their posted price. In other words, some oil companies have been selling oil at one price and paying royalties on a lower price. This is unfair to the American taxpayer, and it violates the basic principle of our regulations that royalty must be paid on no less than gross proceeds received from the sale of production.

Investigations by an assortment of concerned parties have confirmed the inadequacy of posted prices as a basis for valuing production for royalty purposes. A number of States (i.e. Alaska, California, New Mexico, Texas, and Louisiana) have brought suit against several major oil companies primarily for basing royalties, severance taxes, and other payments on posted prices that are below market value, and have received settlements ranging from tens of millions to billions of dollars. Some of these settlements included agreements by the companies to pay future royalties and taxes based on index prices. At least seven class actions against the industry have been filed on behalf of private landowners over the past two years. One of these was settled for several million dollars. In addition, these problems with posted prices have been confirmed in many arenas through audit findings.

In February 1998, the DOJ announced it would intervene in qui tam suits against four major oil companies accused of undervaluing oil production from Federal leases. To date, DOJ has intervened against seven large oil companies. Recently, the DOJ with MMS negotiated a settlement with Mobil for crude oil underpayments. Of the \$45 million collected, \$6 million applied to California production for 1980-1997. The State received \$1.8 million.

Federal Crude Oil Rulemaking Process

As you know, in December 1995, MMS began an extensive effort to revise its regulations on valuing oil produced from onshore and offshore leases at the recommendation of the interagency taskforce. Since 1995, the agency has gone to great lengths to work with our constituencies in this rulemaking process. MMS published in 1995 an Advanced Notice of Proposed Rulemaking and asked whether MMS's regulations needed to move from reliance on posted prices and be more market oriented. We also requested ideas on alternative valuation methods. Finally, we asked for comments on how the rulemaking process should be conducted, such as using a negotiated rulemaking process.

MMS received comments from States indicating that postings no longer reflected market value and that some form of index pricing would be appropriate. The States recommended in their comments that MMS move quickly to publish an interim final rule based on index pricing. On the other hand, industry generally supported retention of posted prices and declined to participate in a negotiated rulemaking process because of their involvement in ongoing litigation with State and private royalty owners over similar issues. At the same time, the Department decided to proceed with its rulemaking process.

In 1997, the Department published two proposals, and each time, extended the comment period to accommodate industry's requests. We also held 9 public workshops and meetings. In 1998, the Department published two more proposals and held 5 more public workshops and meetings. During the summer of 1998, Members of Congress requested that the Department meet with them and industry representatives to discuss the rule. During these open comment periods the Department received over 4,000 pages of comments from interested parties. Industry opposed many aspects of the proposed rule but no longer supported reliance directly on posted prices as a basis for valuing non-arm's-length transactions.

As we have attempted to finalize the crude oil rulemaking, we have been halted twice by Congress through riders attached to appropriation bills. Just prior to publishing a final Federal oil rulemaking, a prohibition was added to a FY 1998 Emergency Supplemental Appropriations Act (P.L. 105-174) that barred MMS from implementing crude oil rulemaking until the end of FY 1998. This prohibition was extended by the FY 1999 Omnibus Appropriations Act (P.L. 105-277) until June 1, 1999, or until a negotiated agreement is reached. However, that date may be extended since the Appropriations Conferees have agreed to include a prohibition until October 1, 1999, in the FY 1999 Emergency Supplemental Appropriations bill.

Four years after we began the process, we are continuing to seek comments on the rulemaking. On March 12 of this year, in response to requests from many Members of Congress and parties interested in moving the process forward to publish a final rule, the Department reopened the comment period on the Federal oil rulemaking for 30 days to seek new, not previously considered ideas. During the comment period, the Department held three workshops in Houston, Texas; Albuquerque, New Mexico; and Washington, D.C.

During these workshops, MMS informed all interested parties on its current views of the proposed Federal rule. We also provided details and rationale on the draft final rule in a letter to Senator Breaux and other Members of Congress in August 1998 which explained the direction of the Department's final Federal oil valuation rulemaking. The following four key issues dominated the three workshops: (1) valuation for non-arm's-length transactions; (2) valuation for arm's-length transactions; (3) advance determinations of valuation methods; and (4) transportation allowances. As a result of the workshops, all parties had an opportunity for further dialogue, and we believe that all parties have a better understanding of the issues and the Federal rulemaking effort. The minutes of the workshops are posted on MMS's Internet website-- <http://www.mms.rmp.gov>. In response to industry requests, MMS extended the comment period two weeks until April 27, to allow commenters time to submit comments following the recent workshops.

We have exerted an extraordinary effort to include our constituents in developing a crude oil valuation rulemaking. Throughout the process we have been guided by several basic principles-- (1) provide certainty to all involved; (2) simplify royalty valuation; (3) reduce the need for audit; (4) minimize royalty disputes; and (5) provide maximum flexibility to adapt to changing market conditions; and (6) assure that the taxpayers of this nation get a fair return for their oil and gas resources.

In this effort, we have acted within our full authority under applicable statutes and lease terms to develop and issue proposed regulations for valuing Federal and Indian oil. Section 32 of the Mineral Leasing Act of 1920 (MLA), 30 U.S.C. 189, authorizes the Secretary to prescribe rules and regulations that are necessary to carry out the requirements of the MLA relating to leasing of onshore Federal lands, including the provision that royalties be not less than 12 ½ per centum in amount or value of the production removed or sold from the lease. The Outer Continental Shelf Lands Act of August 7, 1953, has similar provisions relating to the OCS at 43 U.S.C. 1334. Finally, most Federal oil leases provide that the Secretary shall establish the value of production.

As you are aware, the oil industry is opposed to our Federal proposed rulemaking. However, we continue to believe that the rule would not affect the independent companies that sell oil at arm's length. This group makes up about 95 percent of the producers who pay Federal royalties.

Because about two-thirds of Federal oil is produced and refined by large, integrated companies, these companies would be primarily affected by the revised regulations. We estimate that the large, integrated companies would owe an additional \$66 million dollars in Federal royalties each year.

The States, on the other hand, support the use of index pricing and our proposed Federal rule. In fact, the States of New Mexico, Wyoming, Alaska and Louisiana specifically commended our efforts to develop Federal oil regulations that are fair to all parties in a difficult and litigious environment.

Our goal continues to be issuing a new oil valuation rule that brings "value" certainty to the oil industry. More importantly, it is the right thing to do for the millions of Americans who own the Federal lands and associated oil resources. They are entitled to a fair return on their resources, and our ability to finalize this rule quickly will guarantee that.

I have attached a copy of our Federal oil valuation chronology to illustrate the origin and efforts exerted by MMS on this rule. In addition to finalizing our crude oil regulations, we have also been involved in other efforts that are complementary of the oil rules, and I will address these issues later in my testimony.

Next Steps

As a result of MMS opening the comment period and holding three recent workshops, the Department decided to extend the comment period to April 27, 1999. Now that the comment period has closed, the Department will thoroughly consider all ideas discussed at the workshops and all comments it received. MMS held constructive dialogue at the workshops with all parties. Suggestions were made by industry, as well as States and public interests groups. This allowed all parties to better understand each other's positions on our rulemaking efforts. We had the opportunity to ask questions and discuss some concerns all had with certain portions of the proposals offered. MMS will consider all of the ideas presented carefully.

Indian Crude Oil Rulemaking

MMS is also in the process of developing separate oil valuation regulations for Indian leases. MMS published a proposed rule for Indian oil on February 12, 1998. MMS is preparing a supplementary proposed rule to improve some elements based on changes to the similar Federal crude oil rule proposal. The supplementary proposed rule should be published soon with a 30-day comment period. There is a moratorium on publishing a final rule before June 1, 1999, and as part of the Supplemental Appropriations process, the Appropriations Conferees have agreed to include a provision to extend the moratorium until October 1, 1999.

Reengineering Efforts

In addition to updating our oil regulations, we have also been working on changing the way we do our business as this Committee recognized and recommended in 1996. We realize that an outward focus on dynamic market conditions is needed in today's RMP processes, priorities, and systems. MMS is currently shifting to a market-focused business environment by reengineering the Royalty Management Program. Royalty management reengineering is MMS's number one priority for the new millennium. In the early stages of the RMP reengineering initiative, MMS established a reengineering team to fully examine and review the program's current business practices. The team issued a report, in November 1998, "*Road Map to the 21st Century*," outlining the path MMS should take to replace its current business practices. The report revealed that a comprehensive overhaul is necessary because of new legislative mandates, changing energy markets, the need for more cost-effective operations, and outdated computer systems. The future RMP will be process centered, focused on outcomes, less costly, and, hopefully, viewed as the best by others in the 21st century. The implementation of this effort is largely internal and currently underway. It is expected to be fully implemented and operational by the year 2003.

Two goals have been established to "stretch" MMS to achieve results that are impossible under current operating processes. These stretch goals are:

- To ensure that royalty recipients will have access to their revenues within 24 hours of the time MMS receives it. Today, it generally takes 30 days to make revenues available; and
- To ensure royalty compliance within three years as opposed to six years.

To test the latter process, MMS established teams to conduct three operational models-- oil and gas leases in the Gulf of Mexico, oil and gas leases in the Uintah Basin of Utah/Colorado, and solid mineral leases in Utah, Wyoming, Colorado, and Montana. A sub-group within the solids team will focus on geothermal issues. These pilots have been operational beginning with the offshore model since early February of this year.

As part of furthering the reengineering initiative, MMS has put into place several partnerships with our customers in order to actively involve them in defining future business processes, refining reporting requirements, and developing the best information technology solutions for the future. Amoco, Texaco, Coastal, Devon, and Chevron are participating in the operational models for fluid minerals; the States of Utah, Colorado, and the Ute Tribe will participate in the similar onshore model; industry representatives on the solids operational model team are BHP, Cyprus-Amox, Kennecott Energy Company, PacifiCorp, Peabody Group, and Westmoreland Resources Inc. They join Colorado, Montana, Utah, Wyoming and the Navajo Nation and Crow Tribe.

Our second stretch goal is to complete lease royalty compliance within three years or less. Therefore, beginning in Fiscal Year 1999, MMS will utilize a new audit strategy that will concentrate on a property rather than company basis. This strategy will emphasize the use of special teams to audit specific producing properties and other targets such as collection and distribution terminals, gas plants, and crude oil refineries. Future audits will be highly integrated, with the compliance processes being tested and developed by the reengineering operational model teams. The new strategy provides for full audit coverage of OCS royalties on a property basis, 80 percent coverage of onshore and tribal royalties, and reserves significant resources for a continued high level of coverage of individual Indian mineral revenues. These audit goals will be integrated into the reengineering environment by the year 2003.

Royalty In-Kind (RIK)

An important complement to reengineering, MMS is continuing to pilot programs to test taking Federal royalties in kind (RIK). MMS has long been a supporter and developer of novel approaches to royalty management, such as exercising its right to take the Federal Government's royalty share in kind. In fact, MMS conducted an RIK gas pilot in 1995 and completed an RIK Feasibility Study in 1997. Although the results of 1995 were mixed, our interest in pursuing RIK continues. The 1997 RIK Feasibility Study concluded that, if implemented correctly, RIK in some areas could be workable, revenue positive, and administratively more efficient for all parties.

MMS has established a task force to implement three new RIK pilot programs. These pilots are: (1) oil production in Wyoming; (2) 8(g) natural gas production offshore Texas; and (3) natural gas production in the Gulf of Mexico. By using pilots, MMS can test and develop RIK programs without placing over \$4 billion in royalty collections at significant risk. While we are enthusiastic about the prospects of these programs to provide administrative relief, given our past results, we believe a cautious approach is merited to develop a program that is workable for the Federal government without jeopardizing revenues.

The preliminary results from the pilot in Wyoming through two bidding cycles, suggest that we have been successful in increasing our royalty revenue. It has also shown that RIK cannot work everywhere. RIK will not work for small stripper well properties where oil is trucked to market.

The natural gas pilot in the 8(g) zone offshore so far has demonstrated it is feasible to move Federal production to Federal agencies for direct use by the government. This can help lower Federal energy costs. But again, this is sensitive to specific conditions, and we cannot presume it will work in all places.

The natural gas pilot in the Gulf of Mexico is still under development, and is slated for start-up in the Fall of this year. The pilot will move RIK natural gas on a grand scale with as much as 800 million cubic feet a day.

Though not part of the RIK pilots, MMS is also working with the Department of Energy to transfer 28 million barrels of royalty oil in the Gulf of Mexico to the Strategic Petroleum Reserve. This project is off to a good start -- we've reached agreements with four companies to deliver about 40,000 barrels per day into the Strategic Petroleum Reserve (SPR) facilities over the next three months. This summer, we will start a competitive process to exchange royalty oil for oil delivered to the SPR, increasing the program to up to 100,000 barrels per day.

Finally, MMS has renegotiated the existing contracts with the companies purchasing crude oil under the small refiner program. Instead of billing on the basis of the posted prices reported by lessees of Federal lands, the prices that MMS uses to sell are now based on the spot market prices adjusted for the quality of the crude oil at the lease. Through the use of market based pricing, MMS has significantly increased its revenues, compared with the use of posted prices.

Conclusion

Mr. Chairman, I hope I have captured the extensive progress and activity MMS has been involved with over the past four years to ensure implementation of a final oil regulation as well as other activities to make sure that royalties are properly accounted for. The American public is entitled to a fair return on the production of the resources extracted from Federal land. We do not believe that further moratoria on publication of the rule are conducive to a satisfactory result on this issue but rather think the Congress should allow the rulemaking process to proceed. Again, we commit that we will carefully consider all of the comments we have received on the rule before publishing a final rule and will seek the best result for the Nation, considering our statutory mandates and the goal of receiving a fair return for the public. This concludes my written testimony. However, I will be pleased to answer any questions you or Members may have regarding MMS's proposed Federal oil valuation rule or any other issues that I raised during my testimony.

Federal Oil Valuation Chronology

<u>Date</u>	<u>Event</u>
Mid 1980's	City of Long Beach/California sue six major oil companies for underpaying royalties.
Early 1990's	City and State settle with five of the companies for about \$350 million total.
June 1994	MMS formed interagency task force to investigate allegations of Federal oil undervaluation in California.
December 1995	Task force presents interim report to the Department. MMS issues Advance Notice of Proposed Rulemaking for Federal oil
May 1996	Task force presents final report to the Department.
June 1996	MMS forms team to develop new proposed oil valuation regulations and issues new valuation guidance to auditors.
July 1996	MMS issues engagement letters to the 20 major companies producing Federal oil in California.
August 1996	MMS begins National Crude Oil Strategy audits.
Fall 1996	MMS begins issuing bills to the companies in California. Total billing assessments by February 1998 amount to \$257 million.
January 24, 1997	MMS proposes new Federal oil valuation rule (NYMEX and ANS).
April 1997	MMS holds two public meetings on proposed rule.
July 3, 1997	In response to public comments, MMS publishes supplementary proposed Federal oil valuation rule (expanded use of arm's-length contracts).
September 1997	Again in response to public comments, MMS reopens comment period and lists additional alternatives for consideration.
October 1997	MMS holds 7 public workshops on alternatives valuation methods.

February 6, 1998	After receiving 2,600 pages of comments and input at the workshops, MMS publishes second supplemental proposed rule (ANS for CA, benchmarks for Rockies, and spot elsewhere).
February - March 1998	Five public hearings held to get comments on latest proposal.
March 24, 1998	MMS extended the comment period to April 7, 1998.
May 1, 1998	President signed the FY 1998 Supplemental Appropriations Act (P.L. 105-174) that includes language bill to delaying publication of the final oil valuation rule until October 1, 1998.
June 3, 1998	MMS sends report to Congress on status of the rulemaking.
June 11, 1998	Senate Subcommittee on Energy and Natural Resources held a hearing with the Department, the public, and representatives of the industry to hear concerns about publishing the oil rule.
Late June	Senate Committee on Appropriations approved language that would extend the delay of publishing a final rule until October 1, 1999.
July 8, 1998	MMS reopened the comment period from July 9, 1998, to July 31, 1998.
July 9 & 22, 1998	Senate Energy Subcommittee holds meetings with industry and DOI to discuss further industry concerns.
July 16, 1998	MMS publishes another supplemental proposed rule to address industry concerns.
July 21, 1998	Maloney and Miller hold meeting to involve other interest groups.
July 28, 1998	Senate staffers meet with DOI to discuss rule changes that would address industry concerns.
August 11, 1998	Assistant Secretary sends first letter to key Senators regarding direction of final rule.
August 31, 1998	Assistant Secretary sends second letter to key Senators containing outline of final rule direction.
September 1, 1998	MMS sends second report to Congress on status of rulemaking.

October 8, 1998	President signs FY 1999 Omnibus Appropriations Act (P.L. 105-277) extending moratorium on rule until June 1, 1999.
March 12, 1999	Secretary Babbitt announces another reopening of comment period for 30 days, until April 12. In addition, three workshops scheduled during this time.
March 23, 1999	Senate approved FY 1999 Emergency Supplemental Appropriations bill with a rider attached that would prohibit MMS from publishing a final rule October 1, 1999.
March 24 - April 7, 1999	Workshops held in Houston, Texas, Albuquerque, New Mexico and Washington, D.C.
April 12, 1999	MMS extends comment period until April 27, 1999.
May 19, 1999	Subcommittee on Government Management, Information and Technology holds hearing on oil rule with Department.

Mr. HORN. Robert Williams is Acting Inspector General, U.S. Department of the Interior. Mr. Williams.

Mr. WILLIAMS. Thank you, Mr. Chairman, members of the subcommittee. I am pleased to be here today to provide testimony on our reviews of the Department of the Interior's royalty management system.

Over the past 5 years my office has issued 24 royalty related reports, which identified monetary impacts of about \$309 million, and made 63 recommendations, of which 43 have been implemented, 18 are to be implemented, and 2 are unresolved.

Our Office of Investigations has initiated 30 cases that have resulted in civil settlements of about \$47 million to date. The results of these reviews generally found that the Department was making progress in improving the royalty management system. However, improvements were needed to ensure that all royalties due the Government were collected and accounted for.

I will briefly discuss some of the more significant audits and investigations by issue area.

In regard to royalty determination collection, and distribution, we noted that the royalty in-kind pilots in the Gulf of Mexico to test gas and in Wyoming to test oil will provide the Minerals Management Service with the knowledge and experience to implement a permanent royalty in-kind system for those particular regions and products. However, we concluded that the pilot program will not provide a conclusive assessment for all Federal oil and gas production.

The negotiated royalty settlements were not always conducted in accordance with the Service's settlement negotiation procedures. For 9 of the 10 settlements that we reviewed, the Service did not adequately document the reduction of values from \$312 million to \$94 million for negotiated issues.

Royalty payors had deducted transportation and gas processing allowances that exceeded either the actual cost, the maximum percentages allowed without the approval of the Service, or 100 percent of the value of the product. We estimated about \$27 million in additional payments was owed the Federal Government because of excess allowance deductions.

In the area of the Service's operations, we found that cost-sharing deductions were computed efficiently and deducted from the States' mineral leasing receipts in a timely manner. However, inconsistencies in the methods used to compute the deductions resulted in excess distributions from some States' receipts. The Service is in the process of returning, in part, the excess cost deductions to the respective States. The Service did not accurately identify the additional royalties that were allegedly owed the Federal Government for undervalued California crude oil. As a result, 19 bills for collection were misstated by at least \$185.6 million. Although the Service took prompt actions to correct the errors and issued revised bills, we concluded that the revised bills were still overstated.

Regarding onshore oil and gas operations, we found that the Bureau of Land Management's Inspection and Enforcement Program did not adequately ensure production accountability for oil and gas or regulatory compliance for well drilling and well plugging operations on Federal and Indian leases. As a result, the Government

has plugged 131 orphan wells, at a cost of about \$1.6 million, since 1991 and is presently liable for plugging more than 300 additional orphan wells, at a cost estimated by the Bureau to exceed \$3 million.

In regard to automated systems, we found that the Minerals Management Service had established general controls over its automated information systems but that these controls were inadequate in certain areas, such as risk assessment, security, logical access controls, and disaster recovery plans. These weaknesses increased the risk of unauthorized access to, modification to, and disclosure of program data; theft or destruction of software and sensitive information; and potential loss of system capability in the event of a disaster or system failure.

The Service was using outdated and inefficient data structures that were difficult to change and improve, it did not sufficiently test its application software programs to ensure their operational effectiveness, and it did not adequately document the program's automated systems. As a result of these deficiencies, the program unnecessarily incurred \$3.2 million annually for contractor support and for additional work to detect and correct errors and deficiencies in the application process.

For offshore operations, we found that the Service had implemented our recommendation to evaluate the adequacy of minimum bonus bids and annual rental fees before lease resale. As a result, we estimated that leases issued between September 1993 and August 1997 had increased revenues by \$141 million and will generate another \$194 million in added revenues through 2001.

This concludes my oral statement. I will be pleased to answer any questions the subcommittee may have at this time.

[The prepared statement of Mr. Williams follows:]

**Testimony of
Robert J. Williams
Acting Inspector General
U.S. Department of the Interior
on
The Royalty Management System**

Mr. Chairman and members of the House of Representatives Subcommittee on Government Management, Information and Technology, I am pleased to be here today to provide testimony on our reviews of the Department of the Interior's Royalty Management System. In this testimony, I will provide brief background information on the Royalty Management System and a summary of the significant audits and investigations relating to royalty issues accomplished over the past 5 fiscal years, through March 1999.

The Royalty Management System was established by the Secretary of the Interior under the Federal Oil and Gas Royalty Management Act of 1982 to ensure that oil, gas, and other mineral royalties; interest; fines; penalties; fees; deposits; and other payments owed are accurately determined and that these revenues are collected and distributed in a timely manner. The System is a comprehensive one, with components for inspection, fiscal and production accounting, collection and distribution, and auditing. The Secretary assigned the responsibility for accomplishing the objectives of the System to the Minerals Management Service, the Bureau of Land Management, and the Bureau of Indian Affairs.

The Minerals Management Service operates two specialized programs: the Royalty Management Program and the Offshore Minerals Management Program. The Service has centralized all its mineral revenue functions under the Royalty Management Program to ensure that the bonuses, rents, and royalties from Federal and Indian lands are determined, collected, and distributed in a manner that maximizes the efficient management, production, and use of oil, gas, coal, and other mineral resources, consistent with public health and safety, environmental, and public land use requirements. Under its Offshore Minerals Management Program, the Service conducts leasing activities for and provides oversight of mineral operations on the Nation's Outer Continental Shelf.

The Bureau of Land Management is responsible for monitoring oil and gas production from onshore Federal and Indian leases.

The Bureau of Indian Affairs distributes mineral revenues to individual Indians and tribes.

The policies and procedures for the Department's Royalty Management System are delineated in public laws and Departmental regulations, including the Allotted Indian Land

Leasing Act of 1909, as amended; the Mineral Leasing Act of 1920, as amended; the Indian Mineral Leasing Act of 1938; the Minerals Leasing Act for Acquired Lands of 1947, as amended; the Outer Continental Shelf Lands Act of 1953, as amended; the Geothermal Steam Act of 1970; the Combined Hydrocarbon Leasing Act of 1981; the Indian Mineral Development Act of 1982; the Federal Oil and Gas Royalty Management Act of 1982; the Federal Oil and Gas Leasing Reform Act of 1987; and the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996.

The Inspector General Act of 1978, as amended, requires my office to conduct independent and objective audits and investigations relating to programs and operations of the Department of the Interior. In addition, the Federal Oil and Gas Royalty Management Act of 1982, Section 302(b), requires my office to perform a biennial audit of the Federal Royalty Management System and submit the results to the Congress and the Secretary. To accomplish the biennial audit, we performed individual audits of key components of the Royalty Management System and reported on the results. At the end of the biennial period, we provided a report summarizing the results of audits performed for that 2-year period. Since 1982, we have issued seven biennial reports. This reporting requirement was eliminated by the Federal Reports Elimination Act of 1998, enacted November 10, 1998, but we will continue to perform audits of these activities.

For the past 5 years (fiscal years 1994 through March 1999), my office has issued 24 reports, which identified potential monetary impact to the Government of about \$309 million and made 63 recommendations of which 43 have been implemented, 18 have not been implemented, and 2 are unresolved. Also, during this period, the Office initiated 30 investigations, that have resulted in civil settlements of about \$47 million. The results of the reviews generally found that the Department was making progress in improving its Royalty Management System, but that additional improvements were needed to ensure all royalties due the Government were collected and accounted for.

Audits and Investigations Relating to Royalty Determination, Collection, and Distribution

"Royalty-in-Kind Demonstration Pilots, Minerals Management Service" (No. 99-I-371), dated March 1999. The report stated that the pilot program in the Gulf of Mexico to test gas and in Wyoming to test oil would provide the Service with the knowledge and practical experience to implement a permanent royalty-in-kind system for those particular regions and products. However, because the United States' oil and gas industry operates in distinct regions, we concluded that the limited geographic coverage and products included under the pilot program would not provide a conclusive royalty-in-kind feasibility assessment for all Federal oil and gas production. The report did not contain any recommendations.

"Royalty Gas Marketing Pilot, Minerals Management Service" (No. 96-I-786), dated May 1996. The report stated that the Service had demonstrated the feasibility of taking natural gas royalties in kind as an alternative to the royalty-in-value system. However, we found weaknesses in pilot design, revenue collection, marketing strategies, and

administrative controls that the Service should consider in studying the royalty-in-kind concept. At the time of our review, the Service was conducting its own evaluation of the pilot, including determining whether savings could be realized in reducing administrative costs and audit efforts and in avoiding royalty appeals and litigation. Although the final results of these analyses were not available at the time of our review, Service officials said that they did not expect to realize significant benefits unless they implemented the gas royalty-in-kind program on a large scale, such as for all of the leases in the Gulf of Mexico. The report did not contain any recommendations.

"Negotiated Royalty Settlements, Minerals Management Service" (No. 96-I-1264), dated September 1996. The report stated that negotiated royalty settlements were not always conducted in accordance with the Service's settlement negotiation procedures. Specifically, 9 of the 10 settlements reviewed did not have documentation for the estimated values of the underpayment of royalties issues to be negotiated, the arguments for reducing the values of issues, and/or the reasons why the values of issues were reduced as a result of the negotiations. For these settlements, the Service did not adequately explain the reduction of its values from \$312 million to \$94 million. Further, in one settlement, Indian tribes were not given the opportunity to exclude Indian issues and were not included in negotiations applicable to their leases. The Service agreed with the report's three recommendations, which we considered resolved and implemented.

Mobil Oil (DOI/OIG Case File No. 96VI-453). An investigation conducted by the Office of Inspector General, in conjunction with the U.S. Department of Justice, Civil Division, and the U.S. Attorney's Office, Eastern District of Texas, resulted in a settlement agreement whereby Mobil agreed to pay \$45 million to resolve claims that it underpaid royalties owed to the Government for oil produced on Federal and Indian lands in California, the Rocky Mountains area, and the Gulf of Mexico. Specifically, Mobil was alleged to have systematically underreported the value of oil it produced from Federal and Indian lands during January 1980 through December 1997.

Oryx Energy Company (DOI/OIG Case File No. 96VI-501). An investigation conducted by the Office of Inspector General, with the assistance of Bureau of Land Management and Minerals Management Service personnel, resulted in a civil settlement in which Oryx agreed to pay \$200,000 for allegedly defrauding the Service with respect to royalty payments. The investigation was initiated based on information alleging that Oryx falsely reported its production of condensate to the Service on land leased from the Bureau in southeastern New Mexico, thereby avoiding payment of royalties to the Service, which are based on production figures. As part of the settlement, Oryx also agreed to file amended production reports with the Service.

"Transportation and Processing Allowance Deductions, Minerals Management Service" (No. 94-I-1110), dated August 1994. The report stated that royalty payors had deducted excess oil and gas transportation and gas processing allowances. Specifically, payors deducted allowances that exceeded actual costs, the maximum allowed percentages without the approval of the Service, and 100 percent of the value of the product. In our

report, we estimated that about \$27.2 million in additional payments may be owed the Government because of excess allowance deductions. This amount included \$783,000 of additional royalty payments made to the Service as a result of excess allowance deductions identified during our audit. The Service agreed with the report's three recommendations, which we considered resolved and implemented.

"Status of Recommendations From the Task Force on Royalty Compliance" (No. 95-I-545), dated February 1995. This report stated that the Minerals Management Service had made significant progress in implementing the 26 Task Force recommendations. The recommendations were designed to encourage voluntary payor/producer compliance by clarifying existing laws and regulations, fully integrating Royalty Management Program compliance activities, increasing the use of automated systems to determine royalty compliance, and developing measures for overall royalty compliance. The Service developed an action plan that included six areas of emphasis: management and policy, a pilot program to identify and resolve royalty reporting irregularities, enforcement, audit, regulations, and automated systems. The Service also identified 112 steps to implement the recommendations. We believe that the steps completed and planned to be completed by the Service will satisfactorily address all 26 Task Force recommendations. As such, the report did not contain any recommendations.

Genwal Coal (DOI/OIG Case File No. 93VI-434). An investigation by our office, into allegations that Genwal Coal corporate officers conspired to create a scheme to diminish royalties received by the Government for coal production on a Federal lease, resulted in a \$205,000 civil settlement. Specifically, coal mined by an affiliate company was sold to another affiliate company and was therefore not an arms-length transaction. This fact was not disclosed to the Minerals Management Service, which allowed the affiliate to reduce the amount of royalties owed the Government. The settlement was reached after the Civil Division of the U.S. Department of Justice filed a complaint alleging violations of the Civil False Claims Act, breach of contract, unjust enrichment, and negligent misrepresentation.

Audits Relating to Audit Operations

"Costs Recovered Through Net Receipts Sharing Deductions, Minerals Management Service and Bureau of Land Management" (No. 98-I-79), dated October 1997. The report stated that the cost-sharing deductions were computed efficiently and deducted from the states' mineral leasing receipts on a timely basis. However, we noted inconsistencies in the methods used to compute cost-sharing deductions, which resulted in the inequitable distribution of mineral leasing program costs. We recommended that the Service and the Bureau establish consistent policies and procedures to guide the net receipts process and to improve communication with the states. We further recommended that the Bureau obtain a Solicitor's opinion on whether preleasing costs were allocable deductions to the states. The Service and the Bureau agreed with the report's recommendations, which we considered resolved and implemented. Subsequently, the Service has also been in the process of returning the excessive cost deductions to the respective states.

"Minerals Management Service Work Regarding Underpricing of California Crude Oil" (No. 98-I-484), dated June 1998. The report stated that the Service did not accurately identify additional royalties that were allegedly owed the Federal Government for undervalued California crude oil, which has adversely affected the Service's ability to collect the royalties. Specifically, for integrated company transactions from January 1980 through February 1988, the Service did not always adequately plan its work, accurately prepare supporting evidence, exercise due professional care in performing analyses, or have adequate quality control procedures to ensure the accuracy of its conclusions. As a result, 19 bills for collection were misstated by at least \$185.6 million. Although the Service took prompt action to correct the errors and issued revised bills, we concluded that the bills were still overstated, which will impede collection. The Service disagreed with the report's two recommendations.

"External Quality Control Review of the Audit Divisions, Minerals Management Service" (98-I-398), dated April 1998. The report concluded that Service audits generally complied with the Service's Audit Procedures Manual and with the "Government Auditing Standards," issued by the Comptroller General of the United States. Further, we found that the audits were conducted professionally, audit conclusions were adequately supported, and auditors were usually current in their continuing education requirements. Although we found minor deficiencies in the areas of audit management, we did not find that these weaknesses adversely affected the Service's audit findings. The report did not contain any recommendations.

Audits Relating to Financial Statements and Automated Systems

"General Controls Over the Automated Information System, Royalty Management Program, Minerals Management Service" (No. 98-I-336), dated March 1998. This report stated that the Service had established general controls over its automated information systems, but that these controls were inadequate in the areas of risk assessment; security policies, procedures, and awareness; logical access controls; software change control practices; separation of duties; use of available mainframe security software; and inclusion of appropriate hardware and software systems in the Royalty Management Program's disaster recovery plans. These weaknesses increased the risk of unauthorized access, modification, and disclosure of Program data; theft and destruction of software and sensitive information; and potential loss of Program system and function capability in the event of a disaster or system failure. The Service agreed with the report's 23 recommendations to improve the controls over the Program's automated information systems, which we considered resolved and implemented.

"Royalty Management Program's Automated Information Systems, Minerals Management Service" (No. 97-I-1042), dated July 1997. The report stated that the Service was using outdated and inefficient data structures, which were difficult to change and improve. Additionally, the Service did not test its application software programs sufficiently to ensure the operational effectiveness of the software programs. We also found that the Royalty Management Program's automated systems were not adequately documented in

accordance with established standards. As a result of these deficiencies, the Program unnecessarily incurred about \$3.2 million annually for contractor support of the automated systems and for additional work to detect and correct errors and deficiencies in application processing. The Service agreed with the report's seven recommendations, which we considered resolved and implemented.

"Minerals Management Service Financial Statements for Fiscal Years 1995 and 1996" (No. 97-I-445), dated February 1997, and "Minerals Management Service Financial Statements for Fiscal Years 1996 and 1997" (No. 98-I-382), dated March 1998. The reports presented an unqualified opinion regarding the financial operations of the Service. The audits found that the internal control structure in effect at year-end, except for certain matters involving general controls over the Service's Royalty Management Program's automated information system, was sufficient to safeguard assets against loss from unauthorized use or disposition; ensure that transactions were executed in compliance with laws and regulations; ensure that transactions were properly recorded, processed, and summarized; and provide reasonable assurance that any losses, noncompliance, or misstatements that were material to the financial statements would be detected. The reports did not contain any recommendations.

Audits Relating to Onshore Operations

"Drainage Protection Program, Bureau of Land Management" (No. 99-I-358), dated March 1999. The report stated that the Bureau generally managed its Drainage Protection Program effectively. However, the Bureau did not apply sufficient resources to handle the increased work load resulting from an increase in coal bed methane drilling activity. Consequently, the Bureau had to use negotiated settlements to accelerate the royalty collection process and prevent the complete loss of royalties attributable to the 6-year record retention limitation. While these settlements did result in the collection of royalties and interest, royalty revenues of \$24,530 were not collected because of the 6-year statute of limitations on record retention. Furthermore, interest of \$83,000 was not collected. The Bureau agreed with the report's four recommendations, which we considered resolved.

"Inspection and Enforcement Program and Related Activities, Bureau of Land Management" (No. 96-I-1267), dated September 1996. The report stated that improvements were needed in the Bureau's Inspection and Enforcement Program to improve production, drilling, and plugging inspections and to ensure that wells were not left unplugged after production activities had ceased. Specifically, we found that the Bureau inspected leases that had minimal or no production, that over one-half of the production inspections reviewed were deficient in depth of coverage and quality of documentation, and that many of the high priority well-drilling and well-plugging inspections were not conducted. As a result, the Program did not adequately ensure production accountability for oil and gas or regulatory compliance for well-drilling and well-plugging operations on Federal and Indian leases. The report also noted that none of the seven field offices reviewed had properly classified wells as shut-in or temporarily abandoned in their Automated Inspection Records Systems. Accordingly, some operators had gone out of business, and the

Government was responsible for plugging the wells. Since 1991, the Government has plugged 131 orphan wells, at a cost of over \$1.6 million, and is presently liable for plugging more than 300 additional orphan wells, at a cost estimated by the Bureau to exceed \$3 million. In addition, the Government may be responsible for the cost of cleaning up contaminated groundwater and other damage to the natural resources caused by these unplugged wells. The Bureau agreed with the report's 11 recommendations, which we considered resolved and implemented.

"Followup Review of Enforcement of Common Carrier Statutes for Pipelines Crossing Federal Lands in California" (No. 95-I-728), dated March 1995. Our February 1991 audit report on the enforcement of common carrier statutes for pipelines crossing Federal lands in California (Report No. 91-I-503) stated that six intrastate pipelines crossing Federal lands functioned as private carriers, which was in violation of their right-of-way easements. The report recommended that the Bureau of Land Management ensure that regulations and requirements pertaining to common carrier pipelines were communicated to all oil companies with operations in California. Our followup review of the enforcement of common carrier statutes for pipelines crossing Federal lands in California found that the Bureau had notified all oil companies with operations in California of the common carrier requirements of the Mineral Leasing Act, but that at least three of the major pipelines were not operated as common carriers, even though they crossed Federal lands. The Bureau said that it would conduct inquiries into any complaints alleging that a right-of-way holder was not complying with the common carrier requirements. Since no independent oil producer had formally complained to the Bureau concerning the lack of pipeline access, the Bureau said that it had no authority to enforce common carrier requirements. We recommended that the Bureau obtain a Solicitor's opinion regarding the Bureau's authority and responsibility concerning the regulation of pipelines that cross Federal lands. The Bureau agreed with our recommendation. The April 3, 1995, opinion from the Associate Solicitor for Energy and Resources stated that common carrier provisions apply to activities outside the boundary of the rights-of-way unless otherwise exempted and that the Department can "condition" the approval of a right-of-way grant on a pipeline company's submission of rate or tariff schedules to the appropriate agency, initiate proceedings to suspend or terminate right-of-way grants, or request the U.S. Attorney to prosecute violations of the Mineral Leasing Act. We considered the report's one recommendation resolved and implemented.

"Onshore Oil and Gas Leasing Activities, Bureau of Land Management" (No. 95-I-638), dated in March 1995. The report stated that changes in the Federal Oil and Gas Leasing Reform Act of 1987 could increase competition and revenues to the Bureau's oil and gas leasing program. Accordingly, the Bureau could have generated additional revenues of \$4.2 million annually if it had the authority to charge noncompetitive leases a fee equivalent to the minimum bonus bid of \$2 an acre, the fee applicable to competitive leases. The Bureau agreed with the report's two recommendations, which we considered resolved and implemented.

"Onshore Oil and Gas Rental Reduction, Bureau of Land Management" (No. 94-I-595), dated May 1994. The report recommended that the Bureau reevaluate the 1992 Oil

and Gas Reduction Review for determining whether the rental rate reduction for leases issued before 1987 should be continued. The Bureau concurred with our recommendation; the reevaluation was completed; and the rental rate reduction was allowed to expire on February 29, 1996. We estimated the potential additional revenues for fiscal years 1994 through 1997 to be about \$26 million.

Audits Relating to Offshore Operations

"Followup of Offshore Minerals Leasing Activity" (No. 98-I-385), dated April 1998. The report presented the results of a followup review of recommendations contained in our audit report "Offshore Minerals Leasing Activities, Minerals Management Service" (No. 94-I-179), issued in December 1993. In our followup review, we found that the Service had acted expeditiously to implement the prior report's recommendation to evaluate the adequacy of minimum bonus bids and annual rental fees before each lease sale to ensure that the Federal Government received optimum value for offshore oil and gas leases. As a result, we estimated that the rate increase generated additional revenues of \$141 million for leases issued between September 1993 and August 1997 and will generate an estimated \$194 million in increased lease revenues during 1998 through 2001. The followup report did not contain any new recommendations.

"Opportunity To Increase Offshore Oil and Gas Rental Revenues, Minerals Management Service" (No. 99-I-387), dated March 1999. The report stated that the Service has an opportunity to increase rental fee revenues. Specifically, the Deep Water Royalty Act allows for royalty payments to be suspended for up to 87.5 million barrels of oil equivalent produced under offshore leases in deep water (considered by the Royalty Relief Act to be water depths of 200 meters or more), primarily in the central and western portions of the Gulf of Mexico. During the period when royalty payments are suspended, the Service's offshore oil and gas leases terminate rental fees. Accordingly, the Department of the Interior does not receive any revenues during this period. In contrast, the terms of onshore leases require payments to be equal to rental fees or royalties (whichever is higher) throughout the time period of the lease. The Service has an opportunity to increase rental revenues by an estimated \$2.4 million to \$26 million for leases that will be issued between April 1999 and December 2000 by changing the terms of the offshore leases before they are sold to require rental payments during periods of royalty relief. The Service has been asked to provide additional information on the report's two recommendations.

Mr. HORN. Thank you very much. The gentleman from Virginia, Mr. Davis.

Mr. DAVIS. Thank you very much. Ms. Baca, let me ask, you are not implying that because someone settled, that it's an admission of guilt on the part of any company, are you?

Ms. BACA. I'm sorry?

Mr. DAVIS. Because someone may have reached a settlement with you and paid a sum of money is not an admission that they necessarily owed money or were guilty in any way of paying additional money, is it?

Ms. BACA. We are not implying that.

Mr. DAVIS. I just wanted to get that on the record. Let me ask if I can, Mr. Williams, when did you first hear about the \$700,000 in payments at the Project on Government Oversight made to Bob Berman of DOI and Mr. Speer of DOE from the Mobil settlement proceeds?

Mr. WILLIAMS. If I can, I have with me John Sinclair, my Assistant Inspector General for Investigations.

Mr. DAVIS. That would be great. Is he sworn?

Mr. SINCLAIR. Yes, I am. I will try to answer that question for you. The issue regarding the sharing of the relator's payment that came in, we were first notified of that in the first week of April by the Department of Justice Public Integrity Section.

Mr. KLEIN. And we have been actively looking into that issue with the Department since that time. I can't give you any specifics. It's an ongoing criminal investigation.

Mr. DAVIS. But your office is currently investigating the propriety of the payments?

Mr. SINCLAIR. Yes, yes, we are.

Mr. DAVIS. Do you know who's handling the investigation?

Mr. SINCLAIR. The particular attorney? Yes, I do.

Mr. DAVIS. OK. Is that a secret?

Mr. SINCLAIR. Well, I contacted Public Integrity today, and they asked me to refer everything through their public affairs office.

Mr. DAVIS. How long have they known about it?

Mr. SINCLAIR. They referred it to us the first week of April.

Mr. DAVIS. How long have they known about it?

Mr. SINCLAIR. How long has the Justice Department?

Mr. DAVIS. Right.

Mr. SINCLAIR. I can't answer that question.

Mr. DAVIS. Any idea at all; 2 weeks, 4 months?

Mr. SINCLAIR. I believe that the allegation and the information came out of the ongoing qui tam cases, so I would assume that the information which came from another source than Public Integrity probably was available and the Justice Department—

Mr. DAVIS. But who was handling that decision? You feel this committee shouldn't know that? Is that your position?

Mr. SINCLAIR. No. Do you want the name of the attorney?

Mr. DAVIS. Yeah.

Mr. SINCLAIR. OK. It's Brenda Morris.

Mr. DAVIS. OK. Thank you. And normally would you expect government employees who are offered \$350,000 payments from private plaintiffs in litigation related to their job, wouldn't you expect them to seek guidance from their ethics offices?

Mr. SINCLAIR. Well, I would, yes.

Mr. DAVIS. OK. Have you ever heard of a situation like this where large cash payments to government officials were proper?

Mr. SINCLAIR. I think that's the reason the Justice Department and we are looking into this right now.

Mr. DAVIS. And you don't know how long the Department of Justice sat on these payments? My understanding, it was 7 months, but you don't have any—

Mr. SINCLAIR. I have not heard that number. I couldn't even speculate as to whether it would have been known that long.

Mr. DAVIS. OK. Are you investigating the Department of Justice's nondisclosure of the payments as well?

Mr. SINCLAIR. No, that's not something that's within our jurisdiction to look at.

Mr. DAVIS. And whose jurisdiction would that be in?

Mr. SINCLAIR. I don't know. It's internal to the Justice Department. If they have some—

Mr. DAVIS. To overlook the Department of Public Integrity.

Mr. SINCLAIR. It would probably go to the Office of Special, or Office of Professional Responsibility, one of the internal mechanisms within Justice.

Mr. DAVIS. In your June 1998—going back to Mr. Williams, in your June 1998 report that was entitled Mineral Management Service's Work Regarding Unpricing of California Crude Oil, you know what I'm talking about?

Mr. WILLIAMS. Yes.

Mr. DAVIS. OK. Your office reported that the Minerals Management Service failed to accurately identify additional royalties owed to the Federal Government for undervalued California crude oil.

You report that the Service did not adequately plan its work, accurately prepare supporting evidence, exercise due professional care in performing analyses or have adequate quality control procedures to ensure the accuracy of its conclusions. As a result, 19 bills sent to oil companies were overstated by at least \$185.6 million; that correct?

Mr. WILLIAMS. Correct.

Mr. DAVIS. In responding to your report in a letter to this subcommittee, Service officials stated that due to the nature of this project, generally accepted government auditing standards did not apply. Do you agree with the Service's position, that professional auditing standards would not have applied in this situation?

Mr. WILLIAMS. We responded in the report, and they are responding back to us as a result of the final report and final position. But what we stated in the report was that given the sensitivity and the interest in that particular activity, we felt that some of the professional standards should have applied.

Mr. DAVIS. Let me ask Ms. Baca, what are you—what is the Department's position on this? Why professional standards shouldn't have applied?

Ms. BACA. Congressman Davis, I believe that we were up against a statute of limitations on this particular issue, and we did not conduct a full-blown audit. We felt that a special process was warranted.

I think it has been found both by the IG and GAO and has been affirmed by the Oklahoma decisions that if we had not acted within the time that we did the statute of limitations would have run out and the government would not have been able to make their case.

Mr. DAVIS. So you just throw it in—I mean, 19 bills sent to oil companies were overstated. You overstate the case and move something forward so you didn't lose the statute and then argue about it later?

Ms. BACA. The bills were sent out based on the best data that we had, and I believe that what we said is that the companies could come in at anytime and provide us with information and we would make adjustments. And we did make those adjustments.

Mr. DAVIS. Mr. Williams, I understand the large percentage of the errors that were found in the billings were due to computational errors in spreadsheets prepared by the Minerals Management Service's staff. The IG's report stated that one reason for this was that the working papers did not show evidence of any supervisory review. Is there a review of an auditor's work required by auditing standards?

Mr. WILLIAMS. Supervisory reviews? Yes, there is.

Mr. DAVIS. And I guess it's—my red light's on, so it's my last question, and Ms. Baca, your position is because you were up against a time crunch. You just didn't have time to move supervisory review of these?

Ms. BACA. Well, that was clearly a violation of our own internal procedures.

Mr. DAVIS. OK. My time is up, Mr. Chairman.

Mr. HORN. If you would like your own time, I'll yield to Mrs. Maloney. I, in essence, gave you my time.

Mr. DAVIS. Oh, all right. Let me just take a couple of more minutes. I take my time back.

Mr. TURNER. Mr. Davis, do you want—

Mr. DAVIS. Just for a couple more questions. Then you would agree, Ms. Baca, that it's—we understand what happened in this situation, but the good business is to adequately plan, review your work and complete it with professional care, and we won't see this kind of thing again.

Ms. BACA. No, sir, you will not.

Mr. DAVIS. OK. I'll stop there. Thank you.

Mr. HORN. OK. Gentleman from Texas, Mr. Turner, the ranking member.

Mr. TURNER. Thank you, Mr. Chairman.

Ms. Baca, I think I heard you correctly. You have several royalty-in-kind programs that you said were very successful; is that correct?

Ms. BACA. Under certain circumstances, yes.

Mr. TURNER. I guess I noted a little bit of criticism from the General Accounting Office about the royalty-in-kind programs in the report that I read. Does it really come down to the fact that in some cases royalty-in-kind is real good for the government, and other cases it just doesn't work?

Ms. KLADIVA. That's correct, sir.

Mr. TURNER. And that's what this really—

Ms. KLADIVA. That's correct, sir. In certain circumstances, they can be very successful.

Mr. TURNER. Ms. Baca, in terms of what the government should get in royalty for its, for its appropriate or portion of the royalty, is it fair to evaluate the issue based on what the government would get if it actually took all of its royalty-in-kind?

Ms. BACA. Well, I think that the pilots that we have looked at again certainly have found that there are certain circumstances where it works and it is beneficial, but I'll cite you an example. In Wyoming—we went in and we did a pilot with the State of Wyoming, and we found that under circumstances it worked, but in an area where it involved small stripper wells where they were transporting the oil by truck, that was not beneficial to the government. And we maintained that we will look at royalty-in-kind where it makes sense and where it's going to benefit the government, but we would like, and we very much promote, that this is done on a basis that benefits the government.

Mr. TURNER. So, under law, you currently have the authority to take your royalty-in-kind?

Ms. BACA. Yes, right now, it is voluntary, and that is certainly the position that we are promoting.

Mr. TURNER. In these other instances, where it's really not in the government's interest, it seems to me that there are some factors involved there that clearly affect the market value of that royalty. Are those factors taken into account under your proposed regulations?

Ms. BACA. I will have to ask Lucy Querques to answer that question, if that would be all right.

Mr. HORN. Would you identify yourself and your title.

Ms. QUERQUES DENETT. Yes. My name is Lucy Querques Denett. I'm the associate director for the Royalty Management Program. In the last version of the proposed rule, in fact, normally a lot of these wells—Ms. Baca referred to a stripperwell and the production that would come from them.

A lot of those are owned by small, independent companies. They normally sell arm's length, and we would accept the price that they would receive if it's a third party arm's-length contract. So, yes, I think we have taken that into consideration.

Mr. TURNER. There seems to be a lot of progress that has been made in arriving at some new regulations, and I think it's important for us to separate the disputes that are in the past and the litigation that's pending from where we are currently and where we need to go. But it does seem to be possible, based on what I'm hearing—I think there was some testimony that maybe you offered before the Senate yesterday that indicated maybe the, the agency was going to open up the matter once again and allow some additional comments before you come to a final proposal on these rules. Is that where we are right now?

Ms. BACA. I don't know if that was included in any testimony yesterday, but we just recently opened up the comment period.

We opened it up March 17th, and we went out and we held three additional workshops. Where we are in the process right now is in the process of reviewing those comments, and based on what those comments reveal, we will make a determination of whether or not

we'll have a final rule or whether or not the comments change the rule, and therefore, we would have to go out for a new rule.

So we're in this review stage right now.

Mr. TURNER. I guess what I'm looking for here is some sense of whether, what you're now going through is going to result in some changes in the current proposal or are you just not able to commit one way or the other?

Ms. BACA. I'm not able to tell you. The APA doesn't allow us to go into that right now because we're reviewing the comments. The comments period just closed and staff is going through them, and I believe by mid-June we'll have a better sense of, you know, what sort of changes, if there are any changes that would be made.

Mr. TURNER. Thank you.

Mr. HORN. Has the gentleman completed his questioning?

Mr. TURNER. The light went on so I'll wait my next turn.

Mr. HORN. Forget the night, I mean light. No, you want to finish a few questions?

Mr. TURNER. Well, I might ask if you expect to be able to evaluate all the comments by June, then what's the timetable for actually coming up with a revised proposal, if, in fact, it is revised?

Ms. BACA. Well, I think soon after the middle of June we'll have a good sense of where we're going with this rule. You know, if we were going to change the rule drastically we would have to go out for a new rule, a new proposed rule, but if the comments are not—if they don't warrant us changing the rules substantially, we would be able to have a final rule which would be, you know, sometime this summer.

If we go to a new proposed rule, I'm told that we could probably have a final rule somewhere at the end of the year or the very beginning of 2000.

Mr. TURNER. What's the Department's position on this suggestion that there be some procedure for some advance ruling where a set of facts could be presented and the agency would then acknowledge that that's the appropriate valuation method, and therefore, the royalty could be paid based on that advanced ruling?

Ms. BACA. Are you talking about a negotiated rule?

Mr. TURNER. No. The earlier testimony—in earlier testimony we had some reference to the possibility of having some advance ruling that could be issued by the agency so that the royalty could then be paid based on those facts, if in fact, it turned out the factual basis for the Department's ruling was not what really happened, then, of course, the Department would always have the right to go back and collect the additional royalty.

Ms. BACA. The issue of binding determination has come up at the workshops, and the position that we have held, and we held in our last rule which is out there and circulating, is that we don't feel that binding determination should be just sort of blanket-given to the industry out there.

We feel that there may be an opportunity to look at this on a case-by-case level, but we certainly did not support in our July 1998 rule that we would be open to just blanket binding determination. If, in fact, we find there are a set of circumstances out there where we need to consider those factors, we would do that on a case by case.

The other thing that was proposed was that if we did not act on those in 180 days that it would be in favor of the industry. We certainly can't support anything like that.

Mr. TURNER. What's your reluctance to provide some advance binding determination on what the valuation method should be under this particular set of facts?

Ms. BACA. Well, we feel that if we got to index prices, you aren't going to have very many circumstances where binding determination is going to be needed. If you get to index or spot pricing here, that is a pretty certain set of circumstances out there for determining the value of the crude oil. So having the binding determination isn't, I don't believe, something that, you know, is going to be warranted.

It may be warranted on a case-by-case basis, and we have always said that we would be open to case by case.

Mr. TURNER. Do you feel that the agency should have the authority to make the final determination rather than other third parties who may also be beneficiaries of the valuation that's set?

Ms. BACA. Well, I think that we have listened to all of the third parties through these 17 workshops that we've held throughout the country, and it's up to the Secretary to set—the law certainly gives the Secretary the authority to set the royalty values and the regulations for getting there.

Mr. TURNER. Do you agree with me that the situation that we find ourselves in with all the litigation that has occurred that we'd like to get to a point where these matters are not continually disputed and in court constantly?

Ms. BACA. Well, litigation certainly is not in the best interest of anybody here. We would rather that we could all come to agreement on what a fair value is for the taxpayer and that we could all get there and not have to be caught up in litigation.

Mr. TURNER. But it also seems to me true that when you're talking about valuation, you know, experts can always differ with regard to what that value is, and therefore, the issue is always going to be unless you put some strict restrictions in place that will allow you to make a clear determination, it's always going to be subject to litigation.

And it would seem to me to be preferable to have a set of regulations that had some certainty to them and that had some period there within which everybody involved would know if you want to dispute it, you dispute it now but not later. Because it seems like if you don't do that, you're going to have continued lawsuits because the plaintiffs are too high profile, the number of parties who benefit from the royalties are too numerous, and it's too politically charged not to expect there wouldn't be litigation if there's an opportunity to have it.

And I just want to be sure that the Department is sensitive to those kinds of concerns, and that you try to draw regulations that will avoid that because it's an area that just seems to me too easy to have lawsuits.

Ms. BACA. Well, you know, we agree. We prefer not to go down the litigation course ourselves.

That's why we've had 17 workshops and why we have opened the rule numerous times trying to accommodate a lot of the concerns

that are out there and to come to a rule that, you know, hopefully will be fair to all parties interested.

Mr. TURNER. Thank you.

Mr. HORN. Thank you. And now we have a problem here. I'm conscious the Secretary has to be somewhere else, I believe. Mrs. Maloney has to be somewhere else so we'll start with her with 5 minutes, and then I want to get in one question, then I'll be glad to give Mrs. Maloney more time, but right now, it's 5 minutes.

Mrs. MALONEY. I'd like to ask Ms. Baca, industry has argued and—actually Mr. Davis was asking the same types of questions, that these lawsuits are caused by the fact that MMS' rules are simply unclear and that there is no deception involved. Is this accurate?

Ms. BACA. I'm sorry, could you repeat the question?

Mrs. MALONEY. Well, along Mr. Davis' question and industry argues that all these settlements and lawsuits are because MMS' rules are simply unclear and that there is no deception involved. Now, is that accurate?

Ms. BACA. The lawsuits have not been on this regulation. There is no litigation regarding our regulation right now.

That is not—the lawsuits are based on the States going out there through the qui tam cases, looking at the royalties that were paid, and these were settlements that were made out there. It has nothing to do with rule. Our rule has not been litigated yet.

Mrs. MALONEY. It's based on the theory or the fact that the oil companies were undervaluing their oil, their payments, their royalties to the government, which then is the rule that you're putting forward.

They're saying that the rules are unclear and that's why they were, "making this huge mistake." But I guess basically what I'm asking is, are companies paying millions in settlements, and in one case billions, simply because the rules are unclear?

Why do you think they're paying millions and billions in settlements if they weren't, in fact, doing what the cases from the States are saying, undervaluing their law—their payments, stealing from the school children of this Nation?

Ms. BACA. Well, there have been settlements, and it has been—the States and the other interested parties went after them for undervaluation, and that is a reasonable conclusion.

Mrs. MALONEY. But you just testified to Mr. Davis that there was no deception involved. Undervaluation is deception; is it not?

Ms. BACA. It is a deception.

Mrs. MALONEY. OK. Now, I have a series of questions. I'm going to put them in writing, but I just want to say one thing.

I opened with this letter that talked about a meeting between the big oil companies and they were going to get the independents to front for them, and it goes through it. And everything they said in this letter has come to pass, that they would attach riders, that they would go to court, that they would do everything to stall, and you've bent over backward. You've opened it up for six times for comments. You have been detained, delay, delay, delay, delay.

This memo, this letter, I'm going to give it to you and send a copy to all of you.

It just says delay, delay, delay, and then it ends by saying, if they finally do get a rule, then we will tie them up in court so that the rule will never be implemented.

So no matter what you do, and I compliment you and your predecessor and everybody over there who is trying to get a just payment for the children, according to their own internal game plan that was put forward 2 years ago, they've done everything in it, the rider, the this, the that. We won't pay what we have to, we're going to stop it, and then it says, if by some chance there is a rule, we will just sue, sue, sue, it will never be implemented.

So my point is—and I really am pleading with my colleague, Mr. Horn, in a bipartisan way, I truly and honestly believe that no rule will ever be implemented, that we will have to legislate it. That is the only way it will happen, and again, I want to ask each and every one of you, we have the internal documents, that they pay spot prices, market prices when they sell it to each other.

Why don't we just go back to that? Legislate it? Would that not take care of the problem? Because I honestly believe that they will implement their plan. They've been successful for 2 years. They've certainly got more money than anybody else, and you know, they've already paid \$2.9 billion so far in settlements. It's never going to be implemented.

The only way it will ever happen is through legislation, I really believe that, and I just wanted to comment. And again, I'm going to be asking GAO to do a report on how much it's going to cost the Federal Government to go to an in-kind payment.

I mean, I find this almost humorous. The Soviet Union, the former Soviet Union, used in-kind settlements. Government controls everything, no dollar exchange, no free market, no market price, in kind, and now what we—you know, we conquer with this free enterprise system the Soviet Union with our strong economy and then I hear union—I mean private sector officials arguing to go to the in-kind payment system.

I mean, I find it almost unbelievable to a system that has been, in the history of other countries, burdensome, creates more Federal bureaucracy, more paperwork, more internal problems, and I just, I just find the whole thing very frustrating, and I feel that—I just feel that there's been a lot of manipulation and deception, not only to the school children but to this Congress, to the MMS, to the rule, to anyone who's trying to get a fair payment on this system.

So I just want to ask you—I want to ask the—well, I don't know. I'm going to just put it in writing, but I just don't think you'll ever see a rule. If you see a rule, they're just going to sue, they're going to tie you up in knots. If it ever comes they got to pay free market, they're then going to go to in-kind, manipulate that ruling more and you'll just never see the dollars that are owed to the school children.

So I just think that we have a real challenge, Mr. Horn, to attempt to legislate it so you get the fair market value to the taxpayers that the industry is getting for themselves, and that's what these settlements are about, and that's what all the lawsuits have been about, and that's really what's going on here, and anyway—

Mr. HORN. Let me ask you, Madam Secretary, as I remember, the March 9, 1999, New York Times had an article entitled Poor

Indians on Rich Land Fight a U.S. Maze, the Federal Government is failing in its responsibility as trust manager for mineral leases on tribal lands.

As you know, the trust requires the Department of the Interior as trust manager to value, collect and disburse royalties from leases on tribal lands, which is what this hearing is about in part. The article suggests that fees are collected, but many checks are not sent out because the government cannot find the beneficiaries.

The article goes on to say that currently there is no system to track how much money is coming in and how much is going out. Hundreds of thousands of records are lost, missing or unaccounted for. According to the article, records, some covered with rat excrement, have crumbled in riverside warehouses, been lost to fire, washed away by floods or buried in salt mines. By some estimates tribes are owed as much as \$10 billion.

What are we doing to address that problem?

Ms. BACA. Chairman Horn, the article that you're alluding to is a problem that the Office of Special Trust within the Interior Department is addressing. It's a separate entity from us.

The only involvement that we have in the Indian Federal leases is that we are responsible at MMS and BLM for making sure that we provide the Office of Special Trust and the BIA with accurate information on the amount of oil that is taken from those leases. We provide that to them. They then take that information and they post it to the accounts, and they are responsible for making sure that it reaches the individual tribesmen.

Mr. HORN. So you deal with the tribes, too, though, don't you?

Ms. BACA. Yes, we do, and what we do is we make sure that whatever oil or gas that is coming from their properties is reported to the BIA and to the Office of Special Trust. They are the ones who are responsible for posting it to the accounts and making sure that it goes to the proper allottees and beneficiaries.

Mr. HORN. Now, in other words, you don't check, and let's get the Inspector General in GAO in on this one, you don't check whether the tribe has the check because you're sending it to what, the Bureau of Indian Affairs?

Ms. BACA. Yeah. We just send the information on how much oil, how much gas, how much mineral production was taken off of those leases. They then are responsible for posting it and making sure that it is disbursed.

Mr. HORN. Well, let's hold a hearing then on the other group. What's the name of that group within Interior?

Ms. BACA. We collect the royalties is what I'm told and we pass it on, and it is the office of special trust.

Mr. HORN. Office of special trust or trusts?

Ms. BACA. Indian trusts.

Mr. HORN. There's not an S on there or is there?

Mr. WILLIAMS. Office of the Special Trustee.

Mr. HORN. Special Trustee?

Mr. WILLIAMS. Right.

Mr. HORN. OK. Has the Inspector General ever reviewed what they're doing? Did they see this article in the New York Times?

Mr. WILLIAMS. To the best of my knowledge, the Department has a massive effort—the High Level Implementation Plan—I believe is addressing—

Mr. HORN. Could you get that microphone a little closer.

Mr. WILLIAMS. Sure. I think the GAO is providing oversight of this as well, and we are like a technical advisor in terms of the High Level Implementation Plan that is addressing what is considered the major problems with royalties going to the individual Indians and the tribes.

Mr. HORN. So you're looking at that now or do you have a study already?

Mr. WILLIAMS. No, we are in the process of participation in sort of roundtable discussions. We are looking at aspects of it, but more so, GAO has been there from the beginning, so we've coordinated our efforts. Where GAO may be looking at the implementation of an automated system or a particular program, we would back off and allow GAO to review it, and if there was something that we would do jointly, we would go in and do that.

Mr. HORN. Well, is the General Accounting Office going to move in on that situation?

Ms. KLADIVA. I'm specifically aware of the work that we may be doing on an automated system, probably from our accounting and information management division, but I will be pleased to provide, for the record, information on what GAO has underway.

[The information referred to follows:]

Since the beginning of 1994, GAO's Accounting and Information Management Division has issued 15 reports and testified 7 times on the Department of Interior's management of the Indian Trust Funds, reporting most recently in April 1999. That report, INDIAN TRUST FUNDS: Interior Lacks Assurance That the Trust Improvement Plan Will Be Effective (GAO/AIMD-99-53, April 28, 1999) examined whether the Interior's High-Level Plan for improving Indian trust operations provides an effective solution for addressing its long-standing management weakness and whether its acquisition of a new asset and land records management service will cost effectively satisfy trust management needs. This report is available on GAO's homepage at www.gao.gov.

Ms. KLADIVA. Within our group, the energy resources and sciences group, we have looked at management of the Indian trust and have found it to be problematic. I could also provide information on that.

[The information referred to follows:]

In our report entitled MAJOR MANAGEMENT CHALLENGES AND PROGRAM RISKS: Department of Interior (GAO/OGC-99-9, pp. 23-29, January, 1999) we noted that management of the \$3 billion Indian trust fund has long been characterized by inadequate accounting and information systems, untrained and inexperienced staff, poor recordkeeping and internal controls, and inadequate written policies and procedures.

Mr. HORN. What does the word "problematic" mean, mean not stealing or disposing it or what?

Ms. KLADIVA. Their interests are not being well served by the individuals within the government who are responsible for seeing that they are well served.

Mr. HORN. OK. Now, are you the right division of GAO to go investigate that?

Ms. KLADIVA. Yes, sir, we are the right division.

Mr. HORN. OK. You are going to investigate it?

Ms. KLADIVA. I will pass this back to the correct person within our division.

Mr. HORN. Our staff director, Mr. George, will be in touch with you, and I would assume you'd both work together on that because we ought to really look at that one.

I don't know if it's the Indian tribes doing it or Interior doing it. But if this article is correct and tribes are owed, now whether they're just generalizing from all tribes across the country or they're dealing with the one or two that they discussed, but it just seems to me we ought to get to that very rapidly.

And I guess I would ask is, what accounting system is being used to track the royalties collected from Indian leases to ensure that they collect it and disburse it in a timely and efficient manner? Is that your shop when the accounting system—

Ms. KLADIVA. It's within our office, sir. I'll pass the information on.

Mr. HORN. No, I'm thinking of Interior. In whose shop is the accounting system problem on tracking royalties? Who knows?

Mr. WILLIAMS. It would be in the Bureau of Indian Affairs.

Mr. HORN. OK. So—and yet I thought you found out what the royalties should be, you sent the check to the Indian Affairs to send to the tribe. Maybe we ought to knock the middleman out of that, just send it to the tribe and audit them.

Ms. QUERQUES DENETT. Did you want an answer on that?

Mr. HORN. Yes, right.

Ms. QUERQUES DENETT. The MMS, the royalty management program does collect the royalties from the production on Indian land.

Mr. HORN. Right.

Ms. QUERQUES DENETT. And we account for it, and then we disburse it out to the BIA and the Office of Special Trustee, who then in turn provides it to the special accounts, the allottees or the tribes, but we collect it and account for it and audit the leases to make sure the proper payment has been received.

Mr. HORN. And you don't send it to the tribe directly?

Ms. QUERQUES DENETT. Correct.

Mr. HORN. You send it to, what, let's go over it again, the Bureau of Indian Affairs and they send it to the special trustee, is that—

Ms. QUERQUES DENETT. The accounting, it's the Office of the Special Trustee that receives the—I believe the money. They have what are called IIM accounts, individual—all the money goes to them, they account for it, and they in turn cut the checks to the Indian allottees.

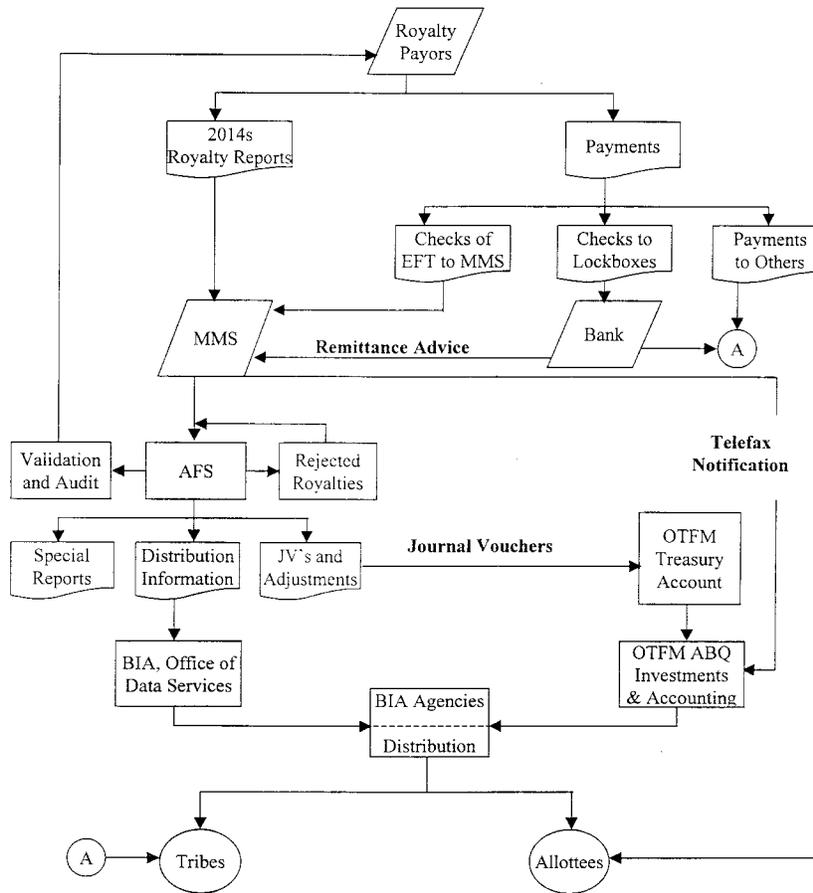
Mr. HORN. OK. Now, that would be the Indian individual beneficiaries, or are you saying those are the tribes?

Ms. QUERQUES DENETT. I believe both.

Mr. HORN. Both. Well, what I would like is for you all to get together in Interior and send us a nice chart and an explanation, and it will go without objection into the record at this point of the hearing.

[The information referred to follows:]

**Flow of Royalty Data and Payments
Between The Minerals Management Service
and the Bureau of Indian Affairs**



**U.S. Department of the Interior
Minerals Management Service
Royalty Management Program**

**Flow of Royalty Data and Payments
Through the Minerals Management Service
to the Bureau of Indian Affairs**

Background

MMS receives, accounts for, and disburses Indian mineral revenues to the Bureau of Indian Affairs (BIA). These revenues include rents and royalties from producing leases, and rents from non-producing leases tied to production. The accuracy of the amounts paid through MMS is verified through validation software and audit after the monies are disbursed to BIA's Office of Trust Funds Management (OTFM). Payors send directly to BIA, tribes, or the Cook Inlet Region, Inc (CIRI) royalties and rents due on solid mineral leases, rents due on non-producing leases not tied to production, and all amounts due CIRI.

Royalty payors send the MMS two documents each month, a Report of Sales and Royalty Remittance (Form MMS-2014) and a payment. Indian royalties are required to be reported separately from Federal royalties. A discussion of the processing of Indian payments and reports follows.

Payments

Payors remit Indian royalty payments in various forms: checks and Electronic Funds Transfers (EFT) to MMS, checks to tribal lockboxes, and Payments to Others.

Checks and EFT: When checks are received by MMS they are grouped into Deposit Ticket "batches." A data input document, Payment Processing Worksheet (PPW), is prepared representing each payment and assigned a Document Control Number (DCN). A special Fund Code is transcribed onto each PPW which identifies the appropriate tribe or group of allottees by BIA office to which the payment should go based on information from the payor. The PPWs are sent to data entry for keypunching and processing into the Auditing and Financial System (AFS). EFTs and Lockbox Payments are similarly processed.

One business day following receipt, MMS sends a telefax notification to OTFM summarizing daily receipts by total tribal amount and total allotted amount by deposit ticket number. OTFM uses this information to invest the revenues into appropriate interest-bearing accounts.

Usually within 2 business days following receipt, the AFS generates two reports which detail the aggregate receipts by fund codes previously transcribed onto the PPWs. MMS uses the Check Register to reconcile system cash to Treasury cash deposited via the previously prepared Deposit Ticket. MMS sends journal vouchers, Schedules of Withdrawals and Credits (SF 1081), to OTFM who uses them to further control the investment of deposits between specific interest-bearing accounts. All transfers are summarized in MMS's month-end Statement of Transactions (SF 224).

Tribal Lockboxes: The Navajo Nation, Southern Ute, Blackfeet, and Jicarilla-Apache Tribes currently have lockbox arrangements which they have negotiated with commercial banks for receiving their payments. Under these arrangements, payors remit payments to a post office box which the bank administers. A tribe's bank collects payments and other documents from the box at least daily and deposits the payments directly into the tribe's account. Each bank is required to send MMS a remittance advice for each payment. These remittance advices are then processed into the AFS in the same manner as checks and EFTs. In Fiscal Year 1998, MMS collected and accounted for \$108 million through actual receipts and lockbox payments.

Payment to Others: These payments go directly from payors to individual allottees and tribes and are not recorded as "actual payments" in the AFS. Tribes receive these payments for solid minerals royalties. The primary group of allottees receiving direct payments are from the Muskogee Area Office, Oklahoma. In the late 1970's, the volume of payments to allottees from this BIA Area Office was so great that BIA could not maintain the workload. They instituted the Direct Pay option whereby selected allottees received their payments directly from payors, bypassing receipting by the Federal Government. Today, although MMS does not actually receive the funds, payors are still required to submit a 2014. The 2014s are processed into the AFS and direct payment detail reports are generated and forwarded to appropriate tribes and BIA offices for comparison to other information as necessary. In Fiscal Year 1998, \$86.9 million was reported to MMS as having been paid directly to Indians from payors. It is important to note that MMS has no way of knowing whether amounts reported as direct pay are actually received by the appropriate tribes and allottees.

2014s

Each payment received by MMS requires a 2014 to direct the flow of money to the proper lessors. Information on the 2014, not information on the payment document, establishes the only proper credit to a lease. A 2014 report can contain only one line item of data for one lease, or it may contain several thousand line items of data for a like number of leases. 2014s are sent to MMS in several formats: magnetic tape, floppy diskettes, hand-printed paper forms, and computer-generated paper forms. When entered into the AFS, either directly from magnetic medium or after keypunching, each 2014 line item is subjected to many edits which cause some lines to reject. Rejected line items are reported back to an MMS branch for correction after consultation with the payor as necessary.

Accepted line items appear on special internal reports and are used for review prior to running a "Distribution Cycle." This cycle causes royalty lines matched with payments to "distribute" to BIA. This information is electronically transmitted to the BIA Office of Data Services (ODS) in Albuquerque, New Mexico. ODS then splits the data by BIA field office and electronically transmits it to these offices for final disbursement to allottees. Tribes may receive their money from BIA upon deposit to their Tribal Trust Fund Account.

Once received by BIA, the distribution data confirms that the monies representing the reported amounts were received by MMS and transferred to BIA and are then ready for further disbursement to allottees. BIA places all oil and gas revenues into allottees' accounts. However, by far, the biggest majority of such revenues are disbursed immediately out of allottees' Individual Indian Moneys accounts to allottees via checks. The accounting transactions are essentially simultaneous and BIA, therefore, makes the "final disbursement" immediately.

When making payment to allottees, BIA field offices generate an Explanation of Payments report for each allottee. Tribes, on the other hand, receive such an explanation directly from MMS by a copy of the distribution report sent to the BIA.

Mr. HORN. One last question, Ms. Secretary, and you can then leave. I guess what bothers me a little bit is when I hear about the accusations of individuals who, in essence, were blowing the whistle, and I guess I'd be bothered by that. I know Mr. Davis went over some of this on the \$45 million settlement and so forth and so on. And, then the Project on Government Oversight received \$1.2 million, and according to April 30, POGO released—Project On Government Oversight—two Federal Government employees were each paid \$350,000. How did those payments to those two people, who I believe were on the Interagency Task Force Report, weren't they?

Ms. BACA. Sir, no.

The individual from the Department of Energy was on the task force, but the individual who works for the Department of Interior was not on the task force.

Mr. HORN. OK. So it wouldn't affect the reliability of the Interagency Task Force report then, right?

Ms. BACA. No, we don't believe that at all. This person was not in any way involved in the writing of this regulation. He—

Mr. HORN. OK. Well, that's what I'm saying, the individual is clear of any conflict of interest with the regulation.

Ms. BACA. The individual did not work with the MMS to put this regulation together, and he did not serve on the interagency task force.

Mr. HORN. OK. So you would agree then that he has had no impact on the reliability of the Interagency Task Force?

Ms. BACA. We don't believe he's an impact in the Department, no.

Mr. HORN. Right, OK.

That's what I wanted to hear. It's either one way or the other. So it isn't because of the alleged conflict of interest. It's—the fact was he had no interest in it.

Ms. BACA. The IG and the Department of Justice are looking into it, but we feel that because he did not serve on the Interagency Task Force and he was not involved in the writing of the regulation that there's not a conflict of interest.

Mr. HORN. Thank you. I wanted to get that in the record because I don't think people should be implying things about other people unless we know what the facts are.

So, I don't have any other questions, but I'll say this to the three participants here. If you have any question you want to raise or a point you want to raise about each other's testimony, I'd be glad to put it in the record at this point. Do you have any thoughts, Inspector General?

Mr. WILLIAMS. No.

Mr. HORN. You're happy, OK. Madam Secretary, you got any thoughts?

Ms. BACA. Mr. Chairman, we are just very anxious to get our rule out. We have, you know, labored on this for many years.

We have opened the comment period several times to accommodate numerous requests. We have come a long way. We've been criticized by all sides on this issue, and all we're trying to do is get a regulation out there that's going to protect the taxpayers and get a fair value. The congressional moratorium has really hurt us, and

we would really hope that the congressional riders would not be extended and that we would be able to move forward and have our rule out on the street.

Mr. HORN. General Accounting Office have any thoughts on this?

Ms. KLADIVA. Well, just to say, sir, that, you know, that the General Accounting Office is not too prone to be complimentary of agencies when we do work, but I do want to say that in—specifically in looking at the process that MMS has followed in working toward the regs to this point that we believe that they've been deliberate and that they have taken all due care to include the positions and to respond to the positions that have been put forth by the State, as well as the industry.

It's taken a long time because they have been that thoughtful in approaching it, a year to do the studies about how the oil marketing process works so that they could understand the industry they were regulating; a year and a half to solicit and to deal with public comments; and then the last year has been specifically at the behest of a Congress to continue to work with the industry and try to negotiate the regs.

So it appears to be a long time, but we believe that it has been thoughtfully approached.

Mr. HORN. Well, that's a good recommendation. I just want to tell you where I'm coming from.

I'm coming from the fact that if you have to auction it or whatever, get the highest competitive price and base your royalties on that in some way—because I agree, the taxpayers have something and all of the local units of government also have something depending on the law and the relationship. So, we would welcome any comments any panel member has of the first panel or second panel. We'll put them in the record at this point so we get it spread out completely and with that we adjourn this hearing.

I would like to thank the following people: J. Russell George, staff director and chief counsel; Randy Kaplan, counsel; Bonnie Heald, director of communications; Mason Alinger, clerk; Faith Weiss, minority counsel; Early Green, minority staff assistant; and Melinda Walker and Randy Sandefer, court reporters.

[Whereupon, at 6 p.m., the subcommittee was adjourned.]

