S. HRG. 110–7

OIL AND GAS ROYALTY MANAGEMENT AT DOI

HEARING

BEFORE THE

COMMITTEE ON ENERGY AND NATURAL RESOURCES UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

ON

ISSUES RELATING TO OIL AND GAS ROYALTY MANAGEMENT AT THE DEPARTMENT OF THE INTERIOR

JANUARY 18, 2007

Printed for the use of the
Committee on Energy and Natural Resources

U.S. GOVERNMENT PRINTING OFFICE

33–870 PDF WASHINGTON : 2007

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

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OIL AND GAS ROYALTY MANAGEMENT AT DOI

THURSDAY, JANUARY 18, 2007

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, DC.

The committee met, pursuant to notice, at 9:32 a.m., in room SD–G50, Dirksen Senate Office Building, Hon. Jeff Bingaman, chairman, presiding.

OPENING STATEMENT OF HON. JEFF BINGAMAN, U.S. SENATOR FROM NEW MEXICO

The CHAIRMAN. Why don't we call the hearing to order? I thank everybody for coming today. We thank our witnesses for being here. Today the committee will hear from witnesses on the topic of oil and gas royalty management in the Department of the Interior. Problems in this program have been the subject of work both by the Department, the Department's Inspector General, Mr. Devaney, who is here today and also by the Government Accountability Office. Mr. Gaffigan is here today representing that office.

I've had a chance to briefly review the IG's report that is being released today and it's obvious there is a lot of blame to spread around on this issue. Almost a year ago, we became aware that Outer Continental Shelf oil and gas leases issued in 1998 and 1999 in the Gulf of Mexico did not contain so-called price thresholds, therefore allowing a certain volume of royalty-free production under the Deep Water Royalty Relief Act of 1995.

At that time, I was joined on a bipartisan basis by 21 members of the Senate and some members from the House in requesting the General Accountability Office to look into the matter. The problem may result, I'm informed, in losses to the Treasury of $10 billion over 25 years.

While this error initially occurred in the Clinton administration, I think it is clear that it was an error that was accomplished by civil servants working in the Department. Lease terms were changed without the Solicitor's Office being asked to review the modifications. Communications were confused when the error was discovered. Mid-level managers did not raise the issue with departmental officials higher up in the Department.

Subsequently, when the problem became known in the Bush administration to some of their officials, there was not much done initially, but efforts in the last year have resulted in settlement agreements with, I believe, six different companies. There are still many companies that have leases that have not agreed to settle.

From my vantage point, the entire matter raises serious questions about management and organization at the Department, and the adequacy of resources committed to this activity, particularly in the Solicitor's Office. I hope the testimony today can lead to some concrete, constructive steps, such as increasing resources that are needed, any changes in management, management reforms, and legislative solutions, if those are required.

I'm also deeply concerned about pending litigation that has been brought by the Kerr McGee Corporation. They have recently been acquired by Anadarko Petroleum. That litigation relates to the same Deep Water Royalty Relief Program. The lawsuit challenges the authority of the Secretary of the Interior to impose price thresholds for any leases issued from 1996 through 2000. I believe Congress intended that price thresholds apply but if the industry were to prevail in that litigation, the exposure to the Treasury and the windfall to the industry could be very large. I'm told it could be in the range of $60 billion over 25 years.

Unfortunately, the royalty management problems don't end with those items that I've mentioned. Last month, the IG issued a report related to the audit and compliance review process for both onshore and offshore royalties. That report indicates MMS has reduced the number of auditor positions by over 20 percent since 2000. The number of audits has been reduced by 22 percent over the period from 2000 to 2004. Ensuring the MMS collects the proper amount of royalties has implications not only for the Federal Treasury, it also has implications for the States that share in the royalty proceeds and for Indian tribes, with Indian oil and gas resources involved and they are in some of what we're talking about.

I've been concerned also that for-government auditors who have monitored leases for oil and gas on Federal lands have now alleged that the Interior Department suppressed their efforts to recover millions of dollars from leasees. These individuals have filed *qui tam* cases under the Federal Government Civil False Claims Act, seeking to recover these amounts on behalf of the Government. I believe the IG is looking into this matter. I don't know if he will be able to testify on any aspect of it today.

Finally, last June, Chairman Rahall and I requested GAO to review whether the royalty rates for oil and gas leases are commensurate with royalties received by States and by private interests on their lands. I note with interest that this last week, the administration announced an increase in royalty rates for OCS leases in the deep waters of the Gulf of Mexico. I hope the GAO will be able to give us some initial findings in that regard.

The final point I would mention is that Mr. Devaney, in your testimony last fall, I believe on the House side, you made a statement that I thought was fairly striking. You said short of a crime, anything goes at the highest levels of the Department of the Interior. Congress needs to take its oversight responsibilities seriously. Obviously that's the kind of statement that needs to get our attention. We're anxious to hear any comments you have on that issue today.

Let me defer to Senator Domenici for any statement he has and then we'll go to the witnesses.

[The prepared statements of Senators Sanders and Wyden follow:]

PREPARED STATEMENT OF HON. BERNARD SANDERS, U.S. SENATOR FROM VERMONT

Mr. Chairman, Mr. Ranking Member, thank you for holding this hearing today. The mismanagement of the royalty program at the Department of the Interior is something that this Committee rightly must thoroughly oversee. And, it isn't only the mismanagement that needs oversight—although clearly, with a billion dollars already lost and billions more at risk, we must get a grip on what is happening. We need to thoughtfully assess the underlying idea of royalty relief, which is nothing more than an embarrassing giveaway of taxpayer dollars. At this point in time, when we should be encouraging movement away from fossil fuels that cause global warming and moving toward clean, renewable sources of energy, why would the federal government give oil and gas companies—while they are making record profits and consumers feel the pain—free money for the resources they take from public lands? If I didn't know better, I would laugh if someone tried to tell me about the situation.

Unfortunately, it is no joke.

Along with many of my colleagues, I am glad that the *New York Times* exposed the mismanagement issues last year and I look forward to helping ensure that the Department of the Interior changes its tune. I appreciate the work done by the Interior Department's Inspector General and the GAO, and I thank them for appearing here this morning. I also appreciate the Assistant Secretary for Lands and Minerals Management spending time with the Committee today.

PREPARED STATEMENT OF HON. RON WYDEN, U.S. SENATOR FROM OREGON

Thank you, Chairman Bingaman and Senator Domenici, for scheduling a hearing on this important subject—how American taxpayers are getting fleeced for billions of dollars by oil and gas companies drilling on public land and on the Outer Continental Shelf. Drilling in these places isn't a right, it's a privilege, and I am deeply concerned about the on-going taxpayer ripoffs in this program uncovered over the last year.

In December, the Inspector General issued a report documenting numerous problems in how the Mineral Management Service is failing to make sure that companies pay what they owe. Not surprisingly, the amount of money collected through MMS enforcement actions in 2005 was about one-fourth what it had been a few years earlier.

Things are apparently so bad in the audit program that four MMS auditors have filed their own lawsuits under the Federal False Claims Act on behalf of the government to collect tens of millions of dollars in unpaid royalties. The auditors—agency veterans—say their superiors at MMS ordered them not to pursue these cases on the job, so they are doing it on their own. And how did the Interior Department respond? One of the auditors claims he was forced out of his job and the other three have been reassigned to other jobs and are the subject of internal Department investigations.

Today, the IG has released another report, this one on why hundreds of leases in the Gulf of Mexico were signed without price thresholds, a failure that will cost the taxpayers billions of dollars in lost royalties while oil companies report record profits. Despite the IG's best efforts, it's still not clear exactly how this happened—we hear that nobody read the leases, that it was bureaucratic bumbling at its worst, that current MMS officials have known about the problem for years but did nothing—and this is all a damning indictment of the way the Department handles billions of dollars worth of oil and natural gas leases.

Mr. Chairman, the problems with the mineral leasing programs don't end here. The program is also the subject of multiple criminal investigations, at least one involving the Royalty-In-Kind program—a program that started with serious problems, as documented by the GAO in 2003 and 2004, and which appears to have gotten worse. States and Indian tribes that carry out royalty audits under agreement with MMS say they are being reined in so they can't properly do their job or challenge the agency's decisions. I could go on.

The bottom line, Mr. Chairman, is that today's hearing is a good first step, but there is much more to do. And I want to work with you and our colleagues on the Committee on both sides of the aisle, and especially on the Public Lands Subcommittee, to understand this mess and fix it. The way things are being handled at the Interior Department and MMS is simply unacceptable.

STATEMENT OF HON. PETE V. DOMENICI, U.S. SENATOR FROM NEW MEXICO

Senator DOMENICI. Senator Bingaman, first, thank you for your statement. Thank you for calling the hearing and thank you for your demeanor. As usual, you have, in my opinion, laid this issue properly before the Congress. Thank you.

First, let me make sure we understand that thresholds are missing from 1998 and 1999 leases and that equals 1,032 leases in that time period that we did not have thresholds. It's not leases before that and it's not leases after that. It's leases during that period of time. Now, just so we straighten out who was in office and running the show, not by way of laying blame because right now, I don't think we lay blame on anybody. But those were Clinton years, followed by Bush years. Somehow or another, for those 2 years, leases that were issued—they were issued under this new act, which was supposed to sensitize that part of the gulf to more activity. Senator Craig, the act was supposed to be something that would excite the leasees to go out and bid and in spite of us being here today, worrying about what happened, the truth of the matter is, the act did work. A lot more people bid to get a leasehold going because of the act that we're speaking of that invited more activity.

So, we are able to determine how much occurred during those 2 years and already, the action has cost the Treasury and I think all of you sitting in front of me will confirm this—if not all of you, at least some of you, will confirm that $900 million was lost during that time period because of the price of oil and we are assuming, a lack of a threshold. A threshold wasn't there. We should have been gaining money and the estimate is $900 million. We hear another term, $10 billion. Well, that is projected further out by GAO to cost $10 billion and that's a GAO estimate. If you go all the way out, that's what it would cost for the leases that are missing thresholds during the 2 years that I've talked about.

Now, obviously, we all know enough now, Senator Salazar. Nobody contemplates putting these leases on without thresholds, at least I hope so. With these hearings, it ought to make anybody thinking about doing that rather uncomfortable, it would seem to me.

Now having said that, again, I want to thank the chairman and I want to thank the witnesses. I have not had a chance to talk to all of you but I did get a chance to talk to you, Mr. Secretary, yesterday for just a few moments. You have a difficult job and I thank you for coming here and being very forthright and I urge that you continue to do so. There are some unanswered questions that still, as of this morning, if you read the GAO and your report, you still don't get the answers to all the questions. There are some unanswered questions about what happened to whom, who was there to take telephone calls, who died and who has dementia among those people that are part of this overall activity.

What I want you to know is that the issue is of enormous significance to the American people and to our Nation's fiscal well being. According to the Interior Department, I've already told you that the MMS collected $9.9 billion in royalties from approximately 27,800 producing leases. So the stakes of getting this right are terrifically important. In 1998 and 1999, the Department of the Interior failed to include so-called price thresholds in deep-water oil and gas leases. From all accounts, from this time, it appears that the omissions of these thresholds were the result of negligence and not a nefarious action.

Nevertheless, according to an initial estimate from the GAO, this failure during the Clinton administration Interior Department, it could have cost the taxpayers $10 billion over 25 years.

Last summer, I sponsored an amendment that passed the Interior Committee that among other things, encouraged, Mr. Chairman, the negotiation of 1998 and 1999 leases and provided the Secretary of the Interior with the clear authority to negotiate these leases to include price thresholds. Though the Interior Appropriations bill was never brought up on the Senate floor, I suspect that the committee vote sent the proper signal to the companies and the Department.

In December, six companies negotiated, as I understand it, with you, Mr. Secretary. You're the one doing that work. Six companies negotiated the terms of the agreements to include price thresholds. The Department of the Interior believes that this will bring an estimated 20 percent of the outstanding lost royalties as a result of the error in the 1998 and 1999 leases.

I continue to encourage all companies to come forward and renegotiate with the Department of the Interior. It is important for our Nation's fiscal stability. It's important that we know what these leaseholds will yield. That's a very important fact for us to know. It is significant. It is important to get this issue resolved so that the Department and these companies, these holders can get back to doing what they do best—that is, produce American oil and gas supplies to help reduce our energy dependence.

As we heard at last week's global oil hearing, this is an economic security issue. It is a foreign policy issue and a national security issue and we should keep our focus on that fact. Additionally, I want to make it clear that the Deep Water Royalty Relief Act of 1995 was a good thing. We should not confuse the failure of the Clinton administration's implementation for 2 years with its substantive policy advance and achievement made as a result of this act. Since President Clinton signed the act into law, our domestic oil and gas in deep water has increased dramatically. In 2005, oil production was over 400 percent greater than 1995 and natural gas was 340 percent greater than 1995 and as we begin to make our judgments on how to resolve this issue of the 1998 and 1999 leases, I trust that we will examine the important and difficult legal issues, contractual and property and constitutional issues, that this situation presents for all of us.

I hope this Congress will resist the temptation of the headlines and will act in a thoughtful, practical way. We should know that the eyes of the world and Mr. Chavez and Mr. Putin are watching how we treat shareholders of property and contract rights on our Federal lands.

I thank the chairman for holding this important hearing and look forward to hearing my colleagues ask questions. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. Why don't we just go through each of the witnesses, if they would each take 10 minutes or so and give us the substance of their testimony. Obviously, your written testimony will be included in the record but if you have significant points you want us to focus on, we'd be anxious to have you explain what those are. Why don't we start with you, Mr. Devaney and we'll just go right across the row that way.

STATEMENT OF EARL E. DEVANEY, INSPECTOR GENERAL, DEPARTMENT OF THE INTERIOR

Mr. DEVANEY. Thank you Mr. Chairman and members of the committee. I want to thank you for the opportunity to address the committee this morning about the various oversight activities being conducted by my office regarding the Minerals Management Services Royalty Program.

Specifically, I'm here today to discuss the results of our audit of MMS's compliance review process, which was released publicly in December 2006 and the results of our investigation into the circumstances surrounding MMS's failure to include price thresholds in deep water leases entered into during 1998 and 1999, which is being released this morning.

Our audit of the compliance review process was initiated in response to requests from this committee and other members of Congress. This is not our first audit of MMS's Compliance and Asset Management Program. For instance, in 2003, we conducted an audit of MMS's audit function in which we concluded that MMS's internal quality control system could not ensure that the audits were being conducted in accordance with government auditing standards. We also found incredibly, that MMS auditors had recreated and backdated working papers prior to that audit.

Since that time, however, MMS audit offices have undergone and passed two external peer reviews, an indication that MMS has corrected the problems we identified in 2003.

From our most recent audit of the compliance review process, we found that compliance reviews can provide a broader coverage of royalties using fewer resources than traditional audits. They do not, however, provide the same level of detail or assurance that a traditional audit provides. As a result, we concluded that compliance reviews should only be used in conjunction with audits and in the context of a well-defined risk based compliance strategy. We discovered two principle weaknesses that are preventing MMS from maximizing the benefits of compliance reviews.

First, we discovered that very few full audits were ever triggered by anomalies discovered during those compliance reviews. We also learned that because the program's performance measures were tied to dollar figures, only the big companies and leases were being reviewed, leaving hundreds of smaller companies that MMS never looks at. With few exceptions, MMS agreed with our recommendations and as promised, they have provided us with an action plan for implementing these changes.

We've just finished our investigation into the failure of MMS to include price thresholds in the terms of deep-water leases issued in 1998 and 1999. We conducted our investigation with two primary purposes in mind: how and why price thresholds were omitted from the leases and what happened once the omissions were discovered. During the course of our investigation, we conducted 44 interviews and reviewed approximately 19,000 e-mails and 20,000 pages of documents. We determined that MMS intended to include price thresholds in leases issued pursuant to the Deep Water Royalty Relief Act, as evidenced in the first leases issued in 1996 and 1997, as well as in 2000. But while MMS was developing new regulations relating to the Deep Water Royalty Relief Act, there was significant confusion among the MMS's operational components and the Office of the Solicitor as to whether or not the regulations would address price thresholds. In the end, the regulations did not and the price thresholds were left out of the leases.

The person responsible for directing the preparation of the leases said he was told by persons in MMS's Economic and Leasing Divisions to take the price threshold out of the leases. He successfully passed a polygraph exam. The people in the Economics and Leasing Divisions denied telling him to take the language out and the one person involved in both the regulation development and the notice of sale review process, a solicitor's attorney, conceded that he should have spotted the omission but did not. The official who signed the leases on behalf of MMS told us he relied on that same solicitor attorney and his own staff before signing.

When the omission was discovered by MMS staff in 2000, it was unexplainably not conveyed up the chain of command to the MMS Director. Unfortunately, the official who made this particular decision is now deceased. We interviewed the former MMS Directors who were in place at the time of the omission and the time of its discovery as well as the present Director. Each told us that they only became aware of the omission when the first *New York Times* article came out last fall.

Near the end of the investigation, however, we found a series of e-mails, which suggested that the present Director had been advised of the price threshold omission as early as 2004. We went back to her with this information and when she read the e-mails, she appeared genuinely surprised but conceded that the e-mails indicated that she probably had been told of the omission in 2004. She still had no independent recollection but speculated that she was probably told of the mistake in conjunction with being informed that the Solicitor's Office had opined that nothing could be legally done to remedy the situation.

Mr. Chairman, this, at a minimum, is a shockingly cavalier management approach to an issue with profound financial ramifications, a jaw-dropping example of bureaucratic bungling and a total reliance on surname process, which diluted responsibility and accountability. Although we found massive finger pointing and blame enough to go around, we do not have a smoking gun or any evidence that this omission was deliberate. We do, however, have a very costly bureaucratic mistake.

I'd like to tell you that this concludes the summary of oversight activities my office is conducting relative to MMS's royalty program. Unfortunately, it does not. We have several other investigations ongoing, some of which are criminal in nature. As a result, I'm not at liberty to discuss them with you here today. However, we have coordinated closely with the Department in order to provide Assistant Secretary Allred with enough general information so that he could take some interim preventative measures. In fact, I'd like to publicly thank both Secretary Kempthorne and Assistant Secretary Allred for being very receptive to our findings and recommendations of these matters. I'm encouraged that they both share my belief that beyond any actual impropriety, appearances do matter.

This concludes my formal testimony. Thank you for the opportunity to appear before the committee today. I'll be glad to answer any questions any of you might have.

[The prepared statement of Mr. Devaney follows:]

PREPARED STATEMENT OF EARL E. DEVANEY, INSPECTOR GENERAL, DEPARTMENT OF THE INTERIOR

Mr. Chairman and members of the Committee, I want to thank you for the opportunity to address the Committee this morning about various oversight activities being conducted by the Office of Inspector General (OIG) for the Department of the Interior (DOI) concerning multiple issues involving the Minerals Management Service (MMS). Specifically, I am here today to discuss the results of our audit of MMS' Compliance Review Process, which was released publicly in December 2006, and the results of our investigation into the circumstances surrounding MMS' failure to include price thresholds in deepwater leases entered into during 1998 and 1999, which is being released publicly this morning.

Our audit of the compliance review process—one of several tools utilized by MMS' Compliance Asset Management (CAM) Program—was initiated in response to a request from this Committee and other members of Congress to assess the effectiveness of these compliance reviews. This audit was timely—not only because it followed the first of several *New York Times* articles on MMS and its royalty program, but also because the compliance review process, which was launched in 2000, was ripe for an audit in 2006.

This is not our first audit of MMS' Compliance Asset Management Program. In 2003, we conducted an audit of MMS' audit function in which we concluded that MMS' internal quality control system could not ensure that its audits were being conducted in accordance with policies, procedures and Government Auditing Standards. We also found an instance of MMS auditors recreating and back-dating working papers. Since that time, however, the MMS audit offices have undergone and "passed" two external peer reviews, an indication that MMS has corrected the problems we identified in 2003.

From our audit of the compliance review process, we found that compliance reviews play a useful role in MMS' greater Compliance and Asset Management Program. Compliance reviews can provide a broader coverage of royalties, using fewer resources than traditional audits. They do not, however, provide the same level of detail or assurance that a traditional audit provides. As a result, we concluded that compliance reviews should only be used in conjunction with audits, in the context of a well-designed, risk-based compliance strategy. We also discovered two principal weaknesses that are preventing MMS from maximizing the benefits of compliance reviews. First, we discovered that very few full audits were ever triggered by anomalies discovered in the compliance review process. We also learned that because the program's performance measures were tied to dollar figures, only the big companies and leases were being reviewed, leaving hundreds of smaller companies that MMS never looked at.

In addition, we made several recommendations to improve CAM's management data, and to strengthen the compliance review process overall. With few exceptions, MMS agreed with our recommendations; most notably, MMS agreed to revise its performance measures and to develop and pilot a risk-based compliance strategy for its compliance review process; and, as promised, MMS has now provided us with an Action Plan for implementing these changes.

Contemporaneous with our audit of the compliance review process, we conducted an investigation into the failure of MMS to include price thresholds in the terms of deepwater leases issued in 1998 and 1999. We conducted our investigation with two primary questions in mind: How and why were price thresholds omitted from the leases; and what happened once the omission was discovered. During the course of our investigation, we conducted 44 interviews and reviewed approximately 19,000 e-mails and 20,000 pages of documents. We have determined that MMS intended to include price thresholds in leases issued pursuant to the Deepwater Royalty Relief Act, as evidenced in the first leases issued in 1996 and 1997, as well as in 2000; but while MMS was developing new regulations relating to the Deepwater Royalty

Relief Act, there was significant confusion among MMS operational components and the Office of Solicitor (SOL) as to whether or not the regulations would address price thresholds. In the end, the regulations did not, and the price thresholds were left out of the leases.

The person responsible for directing the preparation of the leases said he was told by persons in MMS' Economics and Leasing Divisions to take the price threshold language out of the leases. The people in the Economics and Leasing Divisions denied doing so. The one person involved in both the regulation development and lease review process, a SOL attorney, conceded that he should have spotted the omission, but did not. The official who signed the leases on behalf of MMS told us he relied on the SOL attorney and his own staff.

When the omission was discovered by MMS staff in 2000, it was not conveyed up the chain of command to the MMS Directorate. Unfortunately, the official who made this particular decision is deceased. We interviewed the former MMS Directors who were in place at the time of the omission and the time of its discovery, as well as the present Director. Each told us that they only became aware of the omission when the first *New York Times* article came out last fall.

Near the end of our investigation, however, we found a series of e-mails that suggested that the present Director had been advised of the price threshold omission as early as 2004. We went back to her with this information and conducted a follow-up interview. When she read the e-mails, she appeared genuinely surprised, but conceded that the e-mails indicated that she had probably been told of the omission in 2004. She still had no independent recollection, but speculated that she was probably told of the mistake in conjunction with being informed that the Solicitor's Office had opined that nothing could be legally done to remedy the issue.

Mr. Chairman, this, at a minimum was a shockingly cavalier management approach to an issue with such profound financial ramifications, a jaw-dropping example of bureaucratic bungling, and a reliance on a surname-process which dilutes responsibility and accountability. Although we found massive finger-pointing and blame enough to go around, we do not have a "smoking gun" or any evidence that this omission was deliberate; we do, however, have a very costly mistake which might never have been aired publicly absent the *New York Times,* the interest of this Committee, the House Subcommittee on Energy and Resources and that of several other interested members of Congress.

I would like to say that this concludes the summary of the oversight activities my office is conducting relative to MMS; unfortunately, it does not. We have several other investigations ongoing, some of which are criminal in nature. As a result, I am not presently at liberty to discuss them. With regard to these matters, however, we have coordinated closely with the Department in order to provide Assistant Secretary Allred with enough general information so he could take some interim preventive measures. In fact, I would like to publicly thank both Secretary Kempthorne and Assistant Secretary Allred for being receptive to our findings and recommendations. I am encouraged that they both share my belief that beyond actual improprieties, appearances do matter.

This concludes my formal testimony. Thank you for the opportunity to appear here before the Committee today. I will be happy to answer any questions you may have.

The CHAIRMAN. Thank you very much for your testimony, Mr. Devaney. Next is Mark Gaffigan, who is the Acting Director of the Natural Resources and Environment section in the Government Accountability Office. I appreciate you being here.

STATEMENT OF MARK E. GAFFIGAN, ACTING DIRECTOR, NATURAL RESOURCES AND ENVIRONMENT, GOVERNMENT ACCOUNTABILITY OFFICE

Mr. GAFFIGAN. Thank you, Mr. Chairman, ranking member Domenici, members of the committee. Good morning. I'm pleased to be here to assist you in your oversight of royalties obtained from the sale of oil and natural gas produced from Federal lands and waters.

MMS recently reported collecting about $10 billion in annual oil and gas royalty revenue from Federal production that supplies about one-third of all the oil and one-quarter of all the natural gas produced in the United States. Obviously, such a large and financially significant resource must be carefully managed and developed to strike a balance between meeting our Nation's significant energy needs while also ensuring a fair return to the American people, especially in light of the current and long range fiscal challenges facing the Nation.

As part of this balance, the Federal Government has provided royalty relief, which is the waiver or reduction of royalties in order to encourage the development of oil and gas. However, to maintain balance and ensure a fair return, royalty relief also typically includes volume limitations or price thresholds that limit relief and restore royalties once a certain amount of oil or gas has been produced or once market prices reach certain levels.

In 1995, in a period of lower prices and declining production, a significant royalty relief act, the Deep Water Royalty Relief Act of 1995, mandated relief for oil and gas leases issued in the deep waters of the Gulf of Mexico. Sadly, the establishment of limitations on the royalty relief provided by this act has been fraught with problems, likely costing billions of dollars in foregone royalty revenues and placing into question whether a fair return has been achieved.

Based on our ongoing work reviewing the fiscal impact of royalty relief, I would like to emphasize three points. First, a series of mistakes and legal challenges in implementing relief under the 1995 Act will likely add billions in unanticipated costs. For example, Interior lost a 2004 court case on MMS's establishment of volume units for royalty relief, resulting in higher volume limits being applied and thus, more relief. MMS has estimated that this decision could cost up to $10 billion in foregone revenue.

Another problem that has been widely reported has been the price thresholds left off the 1998 and 1999 leases. MMS has estimated that this could cost another $10 billion, a billion of which has already been foregone.

Finally, Kerr McGee, in a current lawsuit, is questioning whether MMS even has the authority to establish price thresholds for any of the leases issued under the 1995 Act, thus bringing into question another 2,300 leases issued in 1996, 1997 and 2000. If this case is lost, again MMS has preliminarily estimated that this could add up to another $60 billion.

My second point—while we are reviewing these cost estimates, even without the uncertainty stemming from this litany of problems that has resulted in these potential, unanticipated costs, determining the fiscal impact of royalty relief is inherently difficult. It is difficult because of uncertainty about the amount and timing of future oil and gas production and future prices. In addition, potential benefits that may offset costs should also be considered. For example, benefits might include increased production or higher amounts companies are willing to pay for leases.

My third point—although leases are no longer issued under the 1995 Act, royalty relief can still be granted today under two basic existing authorities. First, MMS currently offers several royalty relief programs under the discretionary authority granted to the Secretary of the Interior. In addition, the Energy Policy Act of 2005 also contains several royalty relief provisions. Relief under these discretionary programs and legislation may further impact future royalty revenues.

Royalty policy can be an important tool in striking a balance between encouraging production and ensuring a fair return. However, this balance must be struck in careful consideration of both the costs and benefits of all royalty relief provisions. Unfortunately, the Federal Government has not consistently given this careful attention, resulting in unforeseen costs and many questions about the ultimate impact of royalty relief.

As we continue our work, GAO looks forward to assisting the Congress and MMS in the future, through its reviews of these issues. This concludes my opening remarks. I have submitted a written statement for the record and I welcome any questions you might have. Thank you.

[The prepared statement of Mr. Gaffigan follows:]

Prepared Statement of Mark E. Gaffigan, Acting Director, Natural Resources and Environment, Government Accountability Office

WHY GAO DID THIS STUDY

Oil and gas production from federal lands and waters is vital to meeting the nation's energy needs. As such, oil and gas companies lease federal lands and waters and pay royalties to the federal government based on a percentage of the oil and gas that they produce. The Minerals Management Service (MMS), an agency in the Department of the Interior, is responsible for collecting royalties from these leases. In order to promote oil and gas production, the federal government at times and in specific cases has provided "royalty relief," waiving or reducing the royalties that companies must pay. However, as production from these leases grows and oil and gas prices have risen since a major 1995 royalty relief act, questions have emerged about the financial impacts of royalty relief.

Based on our work to date, GAO's statement addresses (1) the likely fiscal impacts of royalty relief on leases issued under the Outer Continental Shelf Deep Water Royalty Relief Act of 1995 and (2) other authority for granting royalty relief that could further impact future royalty revenue.

To address these issues our ongoing work has included, among other things, analyses of key production data maintained by MMS; and reviews of appropriate portions of the Outer Continental Shelf Deep Water Royalty Relief Act of 1995, the Energy Policy Act of 2005, and Interior's regulations on royalty relief.

OIL AND GAS ROYALTIES

Royalty Relief Will Likely Cost the Government Billions, but the Final Costs Have Yet to Be Determined

WHAT GAO FOUND

While precise estimates remain elusive at this time, our work to date shows that royalty relief under the Outer Continental Shelf Deep Water Royalty . Relief Act of 1995 will likely cost billions of dollars in forgone royalty revenue—at least $1 billion of which has already-been lost. In October 2004, MMS estimated that forgone royalties on deep water leases issued under the act from 1996 through 2000 could be as high as $80 billion. However, there is much uncertainty in these estimates. This uncertainty stems from ongoing legal challenges and other factors that make it unclear how many leases will ultimately receive royalty relief and the inherent complexity in forecasting future royalties. We are currently assessing MMS's estimate in light of changing oil and gas prices, revised estimates of future oil and gas production, and other factors.

Additional royalty relief that can further impact future royalty revenues is currently provided under the Secretary of the Interior's discretionary authority and the Energy Policy Act of 2005. Discretionary programs include royalty relief for certain deep water leases issued after 2000, certain deep gas wells drilled in shallow waters, and wells nearing the end of their productive lives. The Energy Policy Act of 2005 mandates relief for leases issued in the Gulf of Mexico during the five years following the act's passage, provides relief for some gas wells that would not have previously qualified for royalty relief, and addresses relief in certain areas of Alaska.

Mr. Chairman and Members of the Committee:

We appreciate the opportunity to participate in the Committee's hearing on federal royalties obtained from the sale of oil and natural gas produced from federal lands and waters. Oil and gas production from federal lands and waters is vital to meeting the nation's energy needs, supplying about 35 percent of all the oil and about 25 percent of all the natural gas produced in the United States in fiscal year 2005. Oil and gas companies that lease federal lands and waters agree to pay the federal government royalties on the resources extracted and produced from the lease. In fiscal year 2006, oil and gas companies received over $77 billion from the sale of oil and gas produced from federal lands and waters, and the Minerals Management Service (MMS), the Department of the Interior's (Interior) agency responsible for collecting royalties, reported that these companies paid the federal government about $10 billion in oil and gas royalties. Clearly, such large and financially significant resources must be carefully developed and managed so that our nation's rising energy needs are met while at the same time the American people are ensured of receiving a fair rate of return on publicly owned resources, especially in light of the nation's current and long-range fiscal challenges.

In order to promote oil and gas production, the federal government has at times and in specific cases provided "royalty relief"—the waiver or reduction of royalties that companies would otherwise be obligated to pay. When the government grants royalty relief, it typically specifies the amounts of oil and gas production that will be exempt from royalties and may also specify that royalty relief is applicable only if oil and gas prices remain below certain levels, known as "price thresholds." For example, the Outer Continental Shelf Deep Water Royalty Relief Act of 1995, also known as the Deep Water Royalty Relief Act (DWRRA), mandated royalty relief for oil and gas leases issued in the deep waters of the Gulf of Mexico from 1996 to 2000. These deep water regions are particularly costly to explore and develop. However, as production from these leases has grown, and as oil and gas prices have risen far above 1995 levels, serious questions have been raised about the extent to which taxpayer interests have been protected. These concerns were brought into stark relief when it was learned that MMS issued leases in 1998 and 1999 that failed to include in the lease contracts the price thresholds above which royalty relief would no longer be applicable, making large volumes of oil and natural gas exempt from royalties and significantly affecting the amount of royalty revenues collected by the federal government. Although leases are no longer issued under DWRRA, further royalty relief is currently available under other legislation and programs, raising the prospect that the federal government may be forgoing additional royalty revenues.

Recently, congressional committees, the Department of the Interior's Office of the Inspector General,[1] public interest groups, and the press have questioned whether our nation's oil and gas royalties are being properly managed. Many of these entities have also amplified questions about whether the oil and gas industry is paying its fair share of royalties, especially in light of rapidly rising oil and gas prices, record industry profits, and a highly constrained federal budgetary environment. GAO has expressed similar concerns, and the U.S. Comptroller General has highlighted royalty relief as an area needing additional oversight by the 110th Congress.[2]

You asked us today to address royalty relief issues based on our ongoing work for this Committee. Specifically, my testimony (1) discusses the likely fiscal impacts of royalty relief for leases issued under the Deep Water Royalty Relief Act of 1995 and (2) describes other authorities for granting royalty relief that could further impact future royalty collections. To address these issues, our ongoing work has included interviews of MMS personnel in the Economics Division in Herndon, Virginia and the Gulf of Mexico OCS Region in New Orleans, Louisiana. We have collected and are analyzing key production data maintained by MMS and are examining numerous documents and studies. We are also reviewing appropriate portions of the Deep Water Royalty Relief Act of 1995, the Energy Policy Act of 2005, and Interior's royalty relief regulations. Our work follows the issuance of our report last year explaining why oil and gas royalties have not risen at the same pace as rising oil and

[1] *Minerals Management Service's Compliance Review Process,* Department of the Interior Office of the Inspector General, Report No. C-IN-MMS-0006-2006 (Washington, D.C.: December, 2006).

[2] *Suggested Areas for Oversight for the 110th Congress,* GAO-07-235R (Washington, D.C.: November 17, 2006).

gas prices.[3] In addition, we are conducting other work for your Committee on federal oil and gas royalty rates and the diligent development of federal oil and gas resources. Our work is being done in accordance with generally accepted government auditing standards.

In summary, we have found the following:

- Our work to date shows that the likely fiscal impact of leases issued under the Deep Water Royalty Relief Act of 1995 is in the billions of dollars in lost royalty revenues, but precise estimates of the costs are not possible at this time for several reasons. First, MMS's failure to include price thresholds for leases issued in 1998 and 1999 along with current attempts to renegotiate these leases have created uncertainty about which leases will ultimately receive relief. MMS estimates that the failure to include these price thresholds during a period of higher oil and gas prices could cost up to $10 billion in forgone royalty revenue. To date, about $1 billion has already been lost. In addition, a recent lawsuit questions whether MMS has the authority to set price thresholds for the leases issued from 1996 through 2000. Depending on the outcome of this litigation, MMS preliminary estimates indicate that this could result in up to $60 billion in additional forgone royalty revenue. Beyond the problematic implementation of the royalty relief provisions, assessing the ultimate fiscal impact of royalty relief is a complex task, involving inherent uncertainty about future production and prices. We are currently assessing MMS's estimates of royalty relief costs in light of two years worth of additional production data and several other variables, including changing oil and gas prices, revised estimates of the amount of oil and gas that these leases are expected to produce, the availability of deep water rigs to drill untested leases, and the present value of these royalty payments. In addition, any loss in royalty revenues may be partially mitigated by the potential benefits of royalty relief, such as increased production or increased fees that companies are willing to pay the federal government to acquire these leases.
- Additional royalty relief, potentially affecting future federal royalty collection, is offered under other programs and legislation. More specifically, royalty relief can be provided under two existing authorities: (1) the Secretary of the Interior's discretionary authority and (2) the Energy Policy Act of 2005. MMS currently administers several royalty relief programs in the Gulf of Mexico under discretionary authority provided by the 1978 amendments to the Outer Continental Shelf Lands Act of 1953. These programs largely address royalty relief for certain leases issued in deep waters after 2000, certain deep gas wells drilled in shallow waters, and wells nearing the end of their productive lives. In addition, the Congress authorized additional royalty relief under provisions of the Energy Policy Act of 2005. Certain provisions in the Energy Policy Act of 2005 are similar to those in DWRRA in that they mandate royalty relief for leases issued in the Gulf of Mexico during the five years following the act's passage. The Energy Policy Act of 2005 also extends royalty relief to gas produced in the Gulf of Mexico from certain new wells that previously would not have qualified for royalty relief. Other provisions in the act address royalty relief in areas of Alaska where there currently is little or no production.

BACKGROUND

The Department of the Interior (Interior), created by the Congress in 1849, oversees and manages the nation's publicly owned natural resources, including parks, wildlife habitat, and crude oil and natural gas resources on over 500 million acres onshore and in the waters of the Outer Continental Shelf. In this capacity, Interior is authorized to lease federal oil and gas resources and to collect the royalties associated with their production. Onshore, Interior's Bureau of Land Management is responsible for leasing federal oil and natural gas resources, whereas offshore, MMS has leasing authority. To lease lands or waters for oil and gas exploration, companies generally must first pay the federal government a sum of money that is determined through a competitive auction. This money is called a bonus bid. After the lease is awarded and production begins, the companies must also pay royalties to MMS based on a percentage of the cash value of the oil and natural gas produced

[3] *Royalty Revenues: Total Revenues Have Not Increased at the Same Pace as Rising Natural Gas Prices due to Decreasing Production Sold,* GAO-06-786BR (Washington, D.C.: June 21, 2006).

and sold.[4] Royalty rates for onshore leases are generally 12 and a half percent whereas offshore, they range from 12 and a half percent for water depths greater than 400 meters to 16 and two-thirds percent for water depths less than 400 meters. However, the Secretary of the Interior recently announced plans to raise the royalty rate to 16 and two-thirds percent for most future leases issued in waters deeper than 400 meters. MMS also has the option of taking a percentage of the actual oil and natural gas produced, referred to as "taking royalties in kind," and selling it themselves or using it for other purposes, such as filling the nation's Strategic Petroleum Reserve.

THE DEEP WATER ROYALTY RELIEF ACT WILL LIKELY COST THE FEDERAL GOVERNMENT BILLIONS OF DOLLARS IN FORGONE ROYALTY REVENUES, BUT PRECISE ESTIMATES REMAIN ELUSIVE

Based on our work to date, the Deep Water Royalty Relief Act (DWRRA) will likely cost the federal government billions of dollars in forgone royalties, but precise estimates of the costs are not possible at this time for several reasons. First, the failure of MMS to include price thresholds in the 1998 and 1999 leases and current attempts to renegotiate these leases has created uncertainty about which leases will ultimately receive relief. Second, a recent lawsuit is questioning whether MMS has the authority to set price thresholds for the leases issue from 1996 through 2000. The outcome of this litigation could dramatically affect the amount of forgone revenues. Finally, assessing the ultimate fiscal impact of royalty relief is an inherently complex task, involving uncertainty about future production and prices. In October 2004, MMS preliminarily estimated that the total costs of royalty relief for deep water leases issued under the act could be as high as $80 billion, depending on which leases ultimately received relief. MMS made assumptions about several conditions when generating this estimate and these assumptions need to be updated in 2007 to more accurately portray potential losses. In addition, the costs of forgone royalties need to be measured against any potential benefits of royalty relief, including accelerated drilling and production of oil and gas resources, increased oil and gas production, and increased fees that companies are willing to pay through bonus bids for these leases.

Implementing Royalty Relief Has Been Problematic and Resulted in Unanticipated Costs

The Congress passed DWRRA in 1995, when oil and gas prices were low and production was declining both onshore and in the shallow waters of the Gulf of Mexico. The act contains provisions to encourage the exploration and development of oil and gas resources in waters deeper than 200 meters lying largely in the western and central planning areas of the Gulf of Mexico. The act mandates that royalty relief apply to leases issued in these waters during the five years following the act's passage—from November 28, 1995 through November 28, 2000.

As a safeguard against giving away all royalties, two mechanisms are commonly used to ensure that royalty relief is limited and available only under certain conditions. The first mechanism limits royalty relief to specified volumes of oil and gas production called "royalty suspension volumes," which are dependent upon water depth. Royalty suspension volumes establish production thresholds above which royalty relief no longer applies. That is, once total production for a lease reaches the suspension volume, the lessee must begin paying royalties. Royalty suspension volumes are expressed in barrels of oil equivalent, which is a term that allows oil and gas companies to combine oil and gas volumes into a single measure, based on the relative amounts of energy they contain.[5] The royalty suspension volumes applicable under DWRRA are as follows: (1) not less than 17.5 million barrels of oil equivalent for leases in waters of 200 to 400 meters, (2) not less than 52.5 million barrels of oil equivalent for leases in waters of 400 to 800 meters, and (3) not less than 87.5 million barrels of oil equivalent for leases in waters greater than 800 meters. Hence, there are incentives to drill in increasingly deeper waters. Before 1994, companies drilled few wells in waters deeper than 500 meters. MMS attributes additional leasing and drilling in deep waters to the passage of these incentives but also cites other factors for increased activity, including improved three-dimensional seismic surveys,

[4] Specifically, royalties are computed as a percentage of the monies received from the sale of oil and gas, with the total federal royalty revenue equal to the volume sold multiplied by the sales price multiplied by the royalty rate.

[5] One barrel of oil equals one barrel of oil equivalent. One thousand cubic feet of gas (mcf) is converted to barrels of oil equivalent by dividing it by 5.62.

some key deep water discoveries, high deep water production rates, and the evolution of deep water development technology.

After the passage of DWRRA, uncertainty existed as to how royalty suspension volumes would apply. Interior officials employed with the department when DWRRA was passed said that they recommended to the Congress that the act should state that royalty suspension volumes apply to the production volume from an entire field. However, oil and gas companies paying royalties under the act interpreted the royalty suspension volumes as applying to individual leases within a field. This is important because an oil and gas field commonly consists of more than one lease, meaning that if royalty suspension volumes are set for each lease within a field rather than for the entire field, companies are likely to owe fewer royalties. For example, if a royalty suspension volume is based on an entire field composed of three leases, a company producing oil and gas from a 210 million barrel-oil field where the royalty suspension volume is set at 100 million would be obligated to pay royalties on 110 million barrels (210 minus 100). However, if the same 210-million barrel field had the same suspension volume of 100 million barrels applied to each of the three leases, and 70 million barrels were produced from each of the three leases, no royalties would be due because no lease would have exceeded its royalty suspension volume. After passage of the act, MMS implemented royalty relief on a field-basis and was sued by the industry. Interior lost the case in the Fifth Circuit Court of Appeals.[6] In October 2004, MMS estimated that this decision will cost the federal government up to $10 billion in forgone future royalty revenues.

A second mechanism that can be used to limit royalty relief and safeguard against giving away all royalties is the price threshold. A price threshold is the price of oil or gas above which royalty relief no longer applies. Hence, royalty relief is allowed only so long as oil and gas prices remain below a certain specified price. At the time of the passage of DWRRA, oil and gas prices were low—West Texas Intermediate, a key benchmark for domestic oil, was about $18 per barrel, and the average U.S. wellhead price for natural gas was about $1.60 per million British thermal units. In an attempt to balance the desire to encourage production and ensure a fair return to the American people, MMS relied on a provision in the act which states that royalties may be suspended based on the price of production from the lease. MMS then established price thresholds of $28 per barrel for oil and $3.50 per million British thermal units for gas, with adjustments each year since 1994 for inflation, that were to be applied to leases issued under DWRRA.

As with the application of royalty suspension volumes, problems arose with the application of these price thresholds. From 1996 through 2000—the five years after passage of DWRRA—MMS issued 3,401 leases under authority of the act. MMS included price thresholds in 2,370 leases issued in 1996, 1997, and 2000 but did not include price thresholds in 1,031 leases issued in 1998 and 1999. This failure to include price thresholds has been the subject of congressional hearings and investigations by Interior's Office of the Inspector General. In October 2004, MMS estimated that the cost of not including price thresholds on the 1998 and 1999 leases could be as high as $10 billion. MMS also estimated that through 2006, about $1 billion had already been lost. To stem further losses, MMS is currently attempting to renegotiate the leases issued in 1998 and 1999 with the oil and gas companies that hold them. To date, MMS has announced successful negotiations with five of the companies holding these leases and has either not negotiated or not successfully negotiated with 50 other companies.

In addition to forgone royalty revenues from leases issued in 1998 and 1999, leases issued under DWRRA in the other three years—1996, 1997, and 2000—are subject to losing royalty revenues due to legal challenges regarding price thresholds. In 2006, Kerr McGee Corporation sued MMS over the application of price thresholds to leases issued between November 28, 1995 and November 28, 2000, claiming that the act did not authorize Interior to apply price thresholds to those leases.[7] MMS estimated in October 2004 that if price thresholds are disallowed for the leases it issued in 1996, 1997, and 2000, an additional $60 billion in royalty revenue could be lost.

Assessing the Fiscal Impact of Royalty Relief Is Inherently Complex

Trying to predict the fiscal impacts of royalty relief is a complex and time-consuming task involving considerable uncertainty. We reviewed MMS's 2004 estimates and concluded that they had followed standard engineering and financial practices and had generated the estimates in good faith. However, any analysis of forgone royalties involves estimating how much oil and gas will be produced in the future,

[6] *Santa Fe Snyder Corp.* v. *Norton,* 385 F.3d 884 (5th Cir. 2004).

[7] Kerr-McGee (Andarko) suit 3/17/06, W.Dist. LA, CV06-0439LC.

when it will be produced, and at what prices. While there are standard engineering techniques for predicting oil and gas volumes that will eventually be recovered from a lease that is already producing, there is always some level of uncertainty involved. Predicting how much oil and gas will be recovered from leases that are capable of producing but not yet connected to production infrastructure is more challenging but certainly possible. Predicting production from leases not yet drilled is the most challenging aspect of such an analysis, but there are standard geological, engineering, and statistical methods that can shed light on what reasonably could be expected from the inventory of 1996 through 2000 leases. Overall, the volume of oil and gas that will ultimately be produced is highly dependent upon price and technology, with higher prices and better technology inducing greater exploration, and ultimately production, from the remaining leases. Future oil prices, however, are highly uncertain, as witnessed by the rapidly increasing oil and gas prices over the past several years. It is therefore prudent to assess anticipated royalty losses using a range of oil and gas prices rather than a single assumed price, as was used in the MMS estimate.

Given the degree of uncertainty in predicting future royalty revenues from deepwater oil and gas leases, we are using current data to carefully examine MMS's 2004 estimate that up to $80 billion in future royalty revenues could be lost. There are now two additional years of production data for these leases, which will greatly improve the accuracy of estimating future production and its timing. We are also examining the impact of several variables, including changing oil and gas prices, revised estimates of the amount of oil and gas that these leases were originally expected to produce, the availability of deep water rigs to drill untested leases, and the present value of royalty payments.

To fully evaluate the impacts of royalty relief, one must consider the potential benefits in addition to the costs of lost royalty revenue. For example, a potential benefit of royalty relief is that it may encourage oil and gas exploration that might not otherwise occur. Successful exploration could result in the production of additional oil and gas, which would benefit the country by increasing domestic supplies and creating employment. While GAO has not assessed the potential benefits of royalty relief, others have, including the Congressional Budget Office (CBO) in 1994, and consultants under contract with MMS in 2004.[8] The CBO analysis was theoretical and forward-looking and concluded that the likely impact of royalty relief on new production would be very small and that the overall impact on federal royalty revenues was also likely to be small. However, CBO cautioned that the government could experience significant net losses if royalty relief was granted on leases that would have produced without the relief. The consultant's 2004 study stated that potential benefits could include increases in the number of leases sold, increases in the number of wells drilled and fields discovered, and increases in bonus bids the amount of money that companies are willing to pay the federal government for acquiring leases. However, questions remain about the extent to which such benefits would offset the cost of lost royalty revenues.

ADDITIONAL PROGRAMS AND LEGISLATION AUTHORIZE ROYALTY RELIEF, POTENTIALLY AFFECTING FUTURE FEDERAL ROYALTY COLLECTION

Although leases are no longer issued under the Deep Water Royalty Relief Act of 1995, royalty relief can be provided under two existing authorities: (1) the Secretary of the Interior's discretionary authority and (2) the Energy Policy Act of 2005. The Outer Continental Shelf Lands Act of 1953, as amended, granted the Secretary of the Interior the discretionary authority to reduce or eliminate royalties for leases issued in the Gulf of Mexico in order to promote increased production. The Secretary's exercising of this authority can effectively relieve the oil and gas producer from paying royalties. MMS administers several royalty relief programs in the Gulf of Mexico under this discretionary authority. MMS intends for these discretionary programs to provide royalty relief for leases in deep waters that were issued after 2000, deep gas wells located in shallow waters, wells nearing the end of their productive lives, and special cases not covered by other programs. The Congress also authorized additional royalty relief under the Energy Policy Act of 2005, which mandates relief for leases issued in the Gulf of Mexico during the five years following the act's passage, provides relief for some wells that would not have previously qualified for royalty relief, and addresses relief in certain areas of Alaska.

[8] *Waiving Royalties for Producers of Oil and Gas from Deep Waters,* Congressional Budget Office, May 1994. Effects of Royalty Incentives for Gulf of Mexico Oil and Gas Leases, P.K. Ashton, L.O. Upton III, and M.H. Rothkopf, under Contract No. 0103CT71722, U.S. Department of the Interior, Minerals Management Service, Economics Division, Herndon, VA, OCS Study 2004-077.

MMS Currently Administers Royalty Relief Using Discretionary Authority

Under discretionary authority, MMS administers a deep-water royalty relief program for leases that it issued after 2000. This program is similar to the program that DWRRA mandated for leases issued during the five years following its passage (1996 through 2000) in that royalty relief is dependent upon water depth and applicable royalty suspension volumes. However, this current program is implemented solely under the discretion of MMS on a sale-by-sale basis. Unlike under DWRRA, the price thresholds and the water depths to which royalty relief applies vary somewhat by lease sale. For example, price thresholds for leases issued in 2001 were $28 per barrel for oil and $3.50 per million British thermal units for natural gas, with adjustments for inflation since 2000. As of March 2006, MMS reported that it issued 1,897 leases with royalty relief under this discretionary authority, but only 9 of these leases were producing.

To encourage the drilling of deep gas wells in the shallow waters of the Gulf of Mexico, MMS implements another program, the "deep gas in shallow water" program, under final regulations it promulgated in January 2004. MMS initiated this program to encourage additional production after noting that gas production had been steadily declining since 1997. To qualify for royalty relief, wells must be drilled in less than 200 meters of water and must produce gas from intervals below 15,000 feet. The program exempts from royalties from 15 to 25 billion cubic feet of gas per well. According to MMS's analysis, these gas volumes approximate the smallest reservoirs that could be economically developed without the benefit of an existing platform and under full royalty rates. In 2001, MMS reported that the average size of 95 percent of the gas reservoirs below 15,000 feet was 15.7 billion cubic feet, effectively making nearly all of this production exempt from royalties had it been eligible for royalty relief at that time.[9] This program also specifies a price threshold for natural gas of $9.91 per million British thermal units in 2006, substantially exceeding the average NYMEX futures price of $6.98 for 2006, and ensuring that all gas production is exempt from royalties in 2006.

Finally, MMS administers two additional royalty relief programs in the Gulf of Mexico under its discretionary authority. One program applies to leases nearing the end of their productive lives. MMS intends that its provisions will encourage the production of low volumes of oil and gas that would not be economical without royalty relief. Lessees must apply for this program under existing regulations. MMS administers another program for special situations not covered by the other programs. Lessees who believe that other more formal programs do not provide adequate encouragement to increase production or development can request royalty relief by making their case and submitting the appropriate data. As of March 2006, no leases were receiving royalty relief under the "end of productive life," and only three leases were receiving royalty relief under the "special situations" programs.

The Energy Policy Act of 2005 Authorizes Additional Royalty Relief

The Congress authorized additional royalty relief under the Energy Policy Act of 2005. Royalty relief provisions are contained in three specific sections of the act, which in effect: (1) mandate royalty relief for deep water leases sold in the Gulf of Mexico during the five years following passage of the act, (2) extend royalty relief in the Gulf of Mexico to deep gas produced in waters of more than 200 meters and less than 400 meters, and (3) specify that royalty relief also applies to certain areas off the shore of Alaska. In the first two situations, the act specifies the amount of oil and/or gas production that would qualify for royalty relief and provides that the Secretary may make royalty relief dependent upon market prices.

Section 345 of the Energy Policy Act of 2005 mandates royalty relief for leases located in deep waters in the central and western Gulf of Mexico sold during the five years after the act's passage. Similar to provisions in DWRRA, specific amounts of oil and gas are exempt from royalties due to royalty suspension volumes corresponding to the depth of water in which the leases are located. However, production volumes are smaller than those authorized under DWRRA, and this specific section of the Energy Policy Act clearly states that the Secretary may place limitations on royalty relief based on market prices. For the three sales that MMS conducted since the passage of the act, MMS included prices thresholds establishing the prices above which royalty relief would no longer apply. These price thresholds were $39 per barrel for oil and $6.50 per million British thermal units for gas, adjusted upward for inflation that has occurred since 2004. The royalty-free amounts, referred to as royalty suspension volumes, are as follows: 5 million barrels of oil equivalent per lease between 400 and 800 meters; 9 million barrels of oil equivalent per

[9] The average of the other 5 percent was 105 billion cubic feet, and these reservoirs are within the highly productive Norphlet Trend.

lease between 800 and 1,600 meters; 12 million barrels of oil equivalent per lease between 1,600 and 2,000 meters; and 16 million barrels of oil equivalent per lease in water greater than 2,000 meters. MMS has already issued 1,105 leases under this section of the act.

Section 344 of the Energy Policy Act of 2005 contains provisions that authorize royalty relief for deep gas wells in additional waters of the Gulf of Mexico that effectively expands the existing royalty-relief program for "deep gas in shallow water" that MMS administers under pre-existing regulations. The existing program has now expanded from waters less than 200 meters to waters less than 400 meters. A provision within the act exempts from royalties gas that is produced from intervals in a well below 15,000 feet so long as the well is located in waters of the specified depth. Although the act does not specifically cite the amount of gas to be exempt from royalties, it provides that this amount should not be less than the existing program, which currently ranges from 15 to 25 billion cubic feet. The act also contains an additional incentive that could encourage deeper drilling—royalty relief is authorized on not less than 35 billion cubic feet of gas produced from intervals in wells greater than 20,000 feet deep. The act also states that the Secretary may place limitations on royalty relief based on market prices.

Finally, the Energy Policy Act of 2005 contains provisions addressing royalty relief in Alaska that MMS is already providing. Section 346 of the act amends the Outer Continental Shelf Lands Act of 1953 by authorizing royalty relief for oil and gas produced off the shore of Alaska. MMS has previously included royalty relief provisions within notices for sales in the Beaufort Sea of Alaska in 2003 and 2005. All of these sales offered royalty relief for anywhere from 10 million to 45 million barrels of oil, depending on the size of the lease and the depth of water. Whether leases will be eligible for royalty relief and the amount of this royalty relief is also dependent on the price of oil. There currently is no production in the Beaufort Sea. Although there have been no sales to date under this provision of the act, MMS is proposing royalty relief for a sale in the Beaufort Sea in 2007. Section 347 of the Energy Policy Act also states that the Secretary may reduce the royalty on leases within the Naval Petroleum Reserve of Alaska in order to encourage the greatest ultimate recovery of oil or gas or in the interest of conservation. Although this authority already exists under the Naval Petroleum Reserves Production Act of 1976, as amended, the Secretary must now consult with the State of Alaska, the North Slope Borough, and any Regional Corporation whose lands may be affected.

CONCLUSIONS

In order to meet U.S. energy demands, environmentally responsible development of our nation's oil and gas resources should be part of any national energy plan. Development, however, should not mean that the American people forgo a reasonable rate of return for the extraction and sale of these resources, especially in light of the current and long-range fiscal challenges facing our nation, high oil and gas prices, and record industry profits. Striking a balance between encouraging domestic production in order to meet the nation's increasing energy needs and ensuring a fair rate of return for the American people will be challenging. Given the record of legal challenges and mistakes made in implementing royalty relief to date, we believe this balance must be struck in careful consideration of both the costs and benefits of all royalty relief. As the Congress continues its oversight of these important issues, GAO looks forward to supporting its efforts with additional information and analysis on royalty relief and related issues.

Mr. Chairman, this concludes my prepared statement. I would be pleased to respond to any questions that you or other Members of the Committee may have at this time.

The CHAIRMAN. Thank you very much. Our third and final witness today is the Honorable C. Stephen Allred, who is the Assistant Secretary for Land and Minerals Management at the Department of the Interior. We appreciate you being here very much.

STATEMENT OF C. STEPHEN ALLRED, ASSISTANT SECRETARY, LAND AND MINERALS MANAGEMENT, DEPARTMENT OF THE INTERIOR

Mr. ALLRED. Thank you very much, Mr. Chairman, Senator Domenici and members of the committee. I appreciate the opportunity to visit with you today about these issues. I believe that our government institution employees must always act to protect the public interest of the United States and as well, must be perceived that we are doing so. The controversies that we are discussing here today, whether in fact or perception, damage that image to the detriment of all of us.

You have the report of the Inspector General in front of you and that information will be interpreted by different individuals in different ways. However, what I want to do in the next couple of minutes, to allow you the maximum time for questions, is to tell you what the Secretary and I are doing to deal with these issues that are the subject of this hearing.

After the Senate confirmed me as Assistant Secretary some 3½ months ago, which sometimes seems like a lifetime, Secretary Kempthorne asked me to review the issues involving the Minerals Management Service. As you know, he places great importance on the Department, its agencies and its employees acting in a highly ethical manner, again both in fact and perception.

With regard to the first issue that Mr. Devaney discussed, as to whether or not MMS is collecting the full amount of oil and gas revenues, which are due the United States, the States and the Tribes, I have reviewed the Inspector General's report. I have traveled to the Minerals Management Service's Denver Operation Center where these activities take place and have been thoroughly briefed on their royalty collection processes.

We are forming a high-level review panel to look at those processes and procedures. We hope to announce that very quickly. Based on my review, however, I believe that we are collecting the revenues that are due to the United States, the States and the Tribes. As with any large organization with complex operations, there are many opportunities to improve those operations. The Inspector General's recommendations and those of the review panel will give us the opportunity to continue to do so.

Regarding the price threshold issue in the 1998 and 1999 leases, we have just started to review the voluminous report that the Inspector General has provided to us. As we begin to understand and review the information contained in the report, we will take further steps regarding this issue. It is important, as many of you have said, to understand that this issue occurred in 1998 and 1999. Since 2001, this administration has made sure that price thresholds have been included as part of any royalty relief granted under the Deep Water Royalty Relief Act that you have passed.

I have discussed this issue with the companies who hold these leases and in those discussions, I have three guiding principles. The first, there is a valid contract between the United States and the companies. Second, my goal has been to focus on the greatest amount of royalties available, those which will be derived from future production and third, I have sought to minimize to the extent possible, the opportunities for legal challenges to the processes that we will follow.

As you are aware, we have been successful in negotiating for future royalties with six companies. We are continuing discussions with the companies but I believe that we will not make further progress until Congress has defined the role that it chooses to play in this issue.

The Inspector General has discussed ongoing investigations regarding employees in the Denver office. I want to very briefly address this issue. The Director of the Minerals Management Service asked the Inspector General to investigate this matter. The Director, with my concurrence, removed those subject employees from positions that they held and placed them in less sensitive positions for the duration of the investigation. I have looked at this issue and subject to forthcoming information from the Inspector General, I do not believe that these issues involve the royalty program itself.

The Director of MMS has also recently taken action in a separate incident at another location, to terminate an employee who failed to follow the agency's ethics rules.

I assure you that the Secretary and I take these issues very seriously. We will demand that our employees conduct themselves according to the highest ethical standards and we will hold individuals accountable when they fail to do so. I also believe, based on my experience in the Interior so far, that our agencies and employees are serving the public well. I intend to make sure that we continue to do so and improve upon that.

Mr. Chairman, we've submitted testimony for the record and I'd be most happy to answer questions from the panel.

[The prepared statement of Mr. Allred follows:]

PREPARED STATEMENT OF C. STEPHEN ALLRED, ASSISTANT SECRETARY, LAND AND MINERALS MANAGEMENT, DEPARTMENT OF THE INTERIOR

Mr. Chairman, thank you for the opportunity to appear here today to discuss with you the Department of the Interior's role in managing energy production on the Outer Continental Shelf and revenue from all Federal and Indian mineral leases. I know this Committee has been instrumental in shaping our domestic energy program, particularly with regard to encouraging environmentally sound development of our domestic oil and gas resources on the Outer Continental Shelf.

The Department and its agencies, including the Minerals Management Service (MMS), serve the public through careful stewardship of our nation's natural resources. The Department also plays an important role in domestic energy development. One third of all energy produced in the United States comes from resources managed by the Interior Department.

As energy demand continues to increase, these resources are all the more important to our national security and to our economy. The Energy Information Administration estimates that, despite increased efficiencies and conservation, over the next 20 years energy consumption is expected to grow more than 25 percent. Even with more renewable energy production expected, oil and natural gas will continue to account for a majority of energy use through 2030. Interior's domestic energy programs, particularly offshore oil and gas production, will remain vital to our national energy portfolio for some time to come, as evidenced in Figure A attached at the end of my statement.*

Since assuming the duties of Assistant Secretary of Land and Minerals Management three months ago, I have developed a deeper appreciation for the complexities involved in managing federal energy production. I also am committed to ensuring we provide an accurate and transparent accounting of the revenue this production generates for the American people.

At the direction of Secretary Kempthorne, two important topics have been my major focus over the past three months—the deep water leases issued without price thresholds for royalty relief in 1998 and 1999, and the management of royalty revenues.

I would like to begin by providing some background on MMS's role in Federal energy production and revenue collection. I then will discuss in greater detail the two primary issues I am focusing on with MMS.

* Figures A-D have been retained in committee files.

MMS BACKGROUND

The MMS has two significant missions: managing access to offshore federal energy resources and managing revenues generated by federal and Indian mineral leases, on and offshore. Both of these functions are important to the nation's economic health and are key to meeting the nation's energy needs.

The Federal Outer Continental Shelf (OCS) covers 1.76 billion acres and is a major source of crude oil and natural gas for the domestic market. In fact, according to the Energy Information Administration, if the Federal OCS were treated as a separate country, it would rank among the top five nations in the world in terms of the amount of crude oil and second in natural gas it supplies for annual U.S. consumption.[1]

Since 1982, MMS has overseen OCS production of 9.6 billion barrels of oil and more than 109 trillion cubic feet of natural gas.

During that time, OCS leasing increased by 200 percent and since 1994, OCS oil production has increased by 63 percent. According to MMS's calculations, within the next 5 years, offshore production will likely account for more than 40 percent of oil and 20 percent of U.S. natural gas production, primarily due to deep water discoveries in the Gulf of Mexico.

Attached Figure B shows the Energy Information Administration's 2007 forecast for total domestic oil and gas production and illustrates what the significance of the OCS contribution is to the Nation's energy security.

To support increased production offshore, MMS's Proposed 5-Year OCS Oil and Gas Leasing Program for 2007-2012 calls for a total of 21 lease sales.

We are closer to achieving the goals of this proposed program since the President last week modified a Presidential withdrawal in order to allow leasing in two areas previously closed—the North Aleutian Basin in Alaska and an area in the central Gulf of Mexico. The President modified the leasing status of these two areas in response to congressional action and the request of Alaska State leaders. In addition, this Administration has increased the royalty rate from 12.5 percent to 16.7 percent for any new deep water leases offered in the Gulf of Mexico.

In implementing the mandates of the Gulf of Mexico Energy Security Act, MMS will offer deep-water acreage in the "181 South" area and in a portion of the Sale 181 area remaining in the Eastern Gulf of Mexico.

Our analysis indicates that implementing the new program would result in a mean estimate of an additional 10 billion barrels of oil, 45 trillion cubic feet of gas, and $170 billion in net benefits for the nation over a 40-year time span.

In addition to providing and managing access to the OCS, MMS administers and enforces the financial terms for all Federal mineral leases, both onshore and offshore and on Indian lands.

These activities have generated an average of more than $8 billion in revenue per year over the past five years, representing one of the largest sources of non-tax revenue to the Federal Government. (In FY 2006, $12.6 billion was collected, and 60 percent of that was from offshore activities).

Since 1982, the MMS has distributed approximately $164.9 billion to Federal, State, and Indian accounts and special funds, including approximately:

- $101.1 billion to the General Fund of the U.S. Treasury;
- $20.4 billion to 38 states;
- $5.2 billion to the Department's Office of Trust Funds Management on behalf of 41 Indian tribes and 30,000 individual Indian mineral owners; and
- $38.2 billion to the Land and Water Conservation Fund, the National Historic Preservation Fund, and the Reclamation Fund.

MMS carries out these responsibilities under statutory mandates and ongoing oversight by Congress, the Government Accountability Office (GAO) and the Department's Office of Inspector General.

I am happy to point out that for the past five years, as part of its annual CFO audit, MMS consistently has received clean audit opinions from the Office of the Inspector General and its delegated independent auditing firm.

1998-1999 OCS LEASES WITHOUT PRICE THRESHOLDS FOR ROYALTY RELIEF

Earlier today, the Department's Office of Inspector General presented its findings on the 1998-1999 deep water leases issued without price thresholds. The MMS requested this independent review last year. We appreciate the Inspector General's work and look forward to further reviewing the report.

[1] EIA U.S. Imports by Country of Origin, 12-21-2006.

The Department of the Interior shares Congress's frustration that during the previous Administration price thresholds were not included in the 1998-1999 deep water leases. This Administration has included price thresholds in all deep water leases it has issued with royalty relief. The American people own these resources and are entitled to receive a fair return.

The Deep Water Royalty Relief Act of 1995 required deep water leases issued from 1996-2000 to include a royalty incentive to allow companies to produce a set volume of oil and gas before they began paying royalties. Since enactment, the deep waters of the Gulf of Mexico have become one of the Nation's most important sources of oil and natural gas. Price thresholds limit royalty relief when oil and gas prices are high. Price thresholds were included in leases before 1998 and after 1999. They were not included in the 1998-1999 leases.

This matter has been a focus of mine since I assumed this position last fall. In an attempt to address the missing price thresholds, we are now negotiating with companies to obtain agreements to apply price thresholds to the deep water leases issued in 1998-1999. We are focusing our negotiations on obtaining the much larger royalty amounts to be realized from future production, estimated to exceed $9 billion.

To date our progress has included agreements reached in December 2006 with six companies. This is a significant but first step; there is still much more work to do in reaching agreements with additional companies.

I have adopted three basic principles to guide my actions in seeking to resolve this matter. First, our focus will be to negotiate price thresholds in leases prospectively; second, we will not give economic advantage to one company over another; and finally, we will strive to amend these agreements in a way that will minimize litigation risk.

To achieve these principles, the Administration and the Congress must work together. We cannot do this alone.

We know that Congress will consider addressing this issue legislatively. We appreciate Congress's efforts to encourage companies to come to the negotiating table. However, we must be mindful of potential unintended consequences. For example, potential new legislation could conceivably result in litigation. If legislation addressed future lease sales, and if a judge were to enjoin future lease issuance for a period of time, the resulting impacts would be significant. Litigation could take years to resolve. The MMS has attempted to project what the potential loss of production, revenue and royalties if lease sales were delayed for a three-year period could look like.

Attached Figure C shows for example, for a 3-year delay, production over 10 years would be reduced 1.6 billion barrels of oil equivalent (boe).

Attached Figure D shows for example, the expected cumulative revenue decline over a 10 year period of $13 billion for a 3-year delay.

We all can agree this would not be in the Nation's best interest. The OCS is a significant supplier of oil and gas. We cannot afford major delays in offshore energy production due to unintended consequences.

We look forward to working with Congress on resolving this issue of national interest.

MANAGEMENT OF ROYALTY REVENUE

My second focus is the management of royalty revenue collected from Federal and Indian mineral leases. In FY 2006, about 2,600 companies reported and paid royalties totaling $12.6 billion from approximately 27,800 producing Federal and Indian leases.

MMS's mineral revenue processes and procedures are complex and involve implementing myriad statutory authorities and regulations, as well as a complex set of case law from over 50 years of administrative and judicial decisions on Federal royalty matters.

The process begins when companies calculate their payments for royalties owed the Federal government. Royalties are calculated based upon four components: the volume of oil and gas produced from the lease, which is verified by BLM or MMS officials during regular on-site inspections; the royalty rate, which is specified in the lease document; the value of the oil and gas as determined by regulations; and any deductions for the the costs of transporting and/or processing the oil and gas production, which are also determined by regulations. Companies are required to report this information and submit their royalty payments to MMS on a monthly basis.

MMS receives reports and payments from payors and accepts them into the accounting system, similar to filings with the Internal Revenue Service. Fundamental accounting processes identify revenue sources, and funds are distributed to recipients as prescribed by law. Interest is assessed on late and/or under payments.

MMS's audit and compliance program assesses whether royalty payments are correct. The types of questions that arise during compliance activities include whether the company reported and paid its royalty on the right volume, royalty rate, and value and whether the company correctly calculated allowable transportation and processing costs. Findings of underpayments are followed by collection of the payment plus interest. Enforcement proceedings range from alternative dispute resolution to orders to pay and penalty actions.

The current compliance strategy uses a combination of targeted and random audits, compliance reviews, and royalty-in-kind property reconciliations. The strategy calls for completion of the compliance cycle within 3 years of the royalty due date. In fiscal year 2006, this strategy resulted in compliance reviews on $5.8 billion in Federal and Indian mineral lease revenues, 72.5 percent of total mineral revenues paid for calendar year 2003.

In recent years, MMS has completed an increased number of audits, doubling the number of audits in the most recent three-year period over the previous three years. From 1998-2001, MMS, State, and Tribal auditors completed 784 audits compared to the 1,572 audits completed from 2002-2005. This increase is partially the result of the effort in 2005 on the part of MMS to close a significant number of old audits as a result of a recommendation from an external peer review of our audit activities. Collections based on audit work fluctuate from year to year. The apparent reductions in collections resulting from compliance efforts from 2001 through 2004 stand in contrast with very large collections in the 1998-2001 period. This anomaly is due to resolution of numerous lawsuits on undervaluation of crude oil and natural gas during the 1998-2001 period. The result of the resolution of these issues was large payments of additional royalties. Because these issues were resolved, no additional large payments were owed in 2002-2005.

The MMS compliance and enforcement program has generated an annual average of more than $125 million for each of the last 24 years. In other words, MMS has collected a total of more than $3 billion dollars in additional mineral revenues since program inception in 1982.

From FY 2003 through FY 2005, for every dollar spent on compliance reviews, MMS has collected $3.27. For every dollar spent on audits, MMS has collected $2.06.

MMS aggressively pursues interest owed on late payments as required by law. In Fiscal Year 2006, MMS issued over 3,800 late payment interest bills and collected a net amount of $7 million.

MMS has authority to use civil penalties in situations where routine compliance efforts have been unsuccessful. During the last 5 years MMS has collected over $23 million in civil penalties resulting from MRM enforcement actions. So far in FY 2007 MMS has issued over $2 million in civil penalty notices that are now in the administrative process. When combined with other MMS enforcement actions during the same time frame, MMS collected a total of 52.4 million.

Last year, the MMS while performing reconciliation of volume imbalances, promptly identified that the Kerr McGee Oil and Gas Corporation had underdelivered royalty gas volumes to MMS's Royalty-In-Kind (RIK) program—at a time of very high gas prices. MMS pursued the issue and collected $8.1 million—based on these high price periods—to resolve the issue.

In December, MMS announced that a bill for over $32 million had been issued to BP America Production Company for additional royalties and interest due identified through audit work of BP's coalbed methane production that occurred in the state of New Mexico.

These day-to-day efforts are just part of MMS's normal course of business. These efforts are not only effective at ensuring compliance, but also beneficial in bringing the appropriate revenues to the states, Indians, and the American public.

I would like to emphasize, however, that although this work is important, our focus is not on numbers of audits or amounts obtained in collections. The real goal is to increase upfront compliance. We measure success in having higher levels of upfront compliance so that companies are making correct payments the first time. Audits act as a deterrent, but we hope that audits will reveal fewer problems as companies increase voluntary compliance.

MMS has taken steps to improve compliance rates in order to achieve this goal. They include the following:

- Clearer regulations—MMS has made significant progress in developing and implementing clearer regulations, eliminating much uncertainty and ambiguity that previously resulted in major findings.

- RIK—MMS is receiving an increasing percentage of revenues through its RIK program and has eliminated many valuation issues for the RIK volumes. During FY2005, for example, MMS received about one-third of its revenues through RIK.
- More effective compliance strategies—Compliance reviews have allowed MMS to cover more properties than were possible using audits alone, thereby increasing the deterrent effect. This increased presence encourages companies to be more vigilant about proper reporting and payment.

We appreciate the recent report of the Office of Inspector General concerning the audit and compliance program. The results are similar in substance to audits I have reviewed in State government or in the private sector. My experience is that in any organization with such large and complex operations, I would expect any performance audit to find opportunities for improvement. MMS has embraced virtually all of the findings, and has an action plan to address them.

We note the Inspector General's major conclusion that compliance reviews are a useful tool in our program, and we look forward to implementing recommendations to further improve our application of compliance reviews. We submit for the Committee's attention our "Action Plan to Strengthen Minerals Management Service's Compliance Program Operations" which documents improvement actions taken and planned in this area.

MMS does not work alone in its efforts to ensure the proper collection of royalties; MMS collaborates with the States and tribes on our compliance and audit activities. In addition, every three years, the federal audit function of MMS is peer-reviewed by an outside independent certified public accounting firm. Most recently, in 2005, the MMS audit program was found to meet all applicable government auditing standards. I am also happy to point out that for the past five years, as part of its annual Chief Financial Officer audit, MMS consistently has received clean audit opinions from the Office of the Inspector General and its delegated independent auditing firm.

Having said that, it is also true that MMS continues to look for ways to improve its programs, practices and performance. We welcome input from this Committee, the full Congress, the Office of the Inspector General, GAO and the public.

In response to the recent interest regarding the accuracy and effectiveness of the MMS's royalty management program, Secretary Kempthorne and I determined that an independent panel should be convened to review the procedures and processes surrounding MMS's management of mineral revenue. We are committed to ensuring our processes are effective and transparent, and we welcome advice and counsel.

The new panel will operate as a Subcommittee under the auspices of the Royalty Policy Committee, an independent advisory board appointed by the Interior Secretary to advise on royalty management issues and other mineral-related policies.

The Subcommittee on Royalty Management has been asked to review prospectively:

- The extent to which existing procedures and processes for reporting and accounting for federal and Indian mineral revenues are sufficient to ensure that the MMS receives the correct amount.
- The audit, compliance and enforcement procedures and processes of the MMS to determine if they are adequate to ensure that mineral companies are complying with existing statutes, lease terms, and regulations as they pertain to payment of royalties.
- The operations of the Royalty-in-Kind program to ensure that adequate policies, procedures and controls are in place to ensure that decisions to take federal oil and gas royalties in kind result in net benefits to the American people.

The Subcommittee will conduct its review over a six-month period and then provide its final findings and recommendations to the full Royalty Policy Committee and the Secretary of the Interior. We will be happy to share the recommendations with you when they are available.

Members of the Subcommittee will be announced in the near future.

CONCLUSION

In the three months since I was confirmed to this position, I have been working closely with the MMS to understand the complex processes associated with accounting for the revenues generated from oil and gas development on Federal lands, including the Outer Continental Shelf. In an effort to gain a greater understanding of this work, earlier this month I traveled to MMS's Denver office where I reviewed the procedures and controls used to ensure that minerals revenues are properly reported and accounted for. I also visited offices and reviewed operations in the Gulf of Mexico Regional Office.

This work is very important and must be undertaken carefully. Equally important, and very important to Secretary Kempthorne and me, is that we conduct business with the highest standards of ethics possible. Making sure we can live up to that standard has been a high priority of mine. I have stressed, and will continue to stress, our obligation to conduct ourselves in accordance with the highest ethical standards and to be accountable for our actions. Moreover, our conduct must be ethical both in fact as well as in perception.

To summarize my remarks today, I want to reiterate I will continue to focus on several key areas as I provide oversight to the Minerals Management Service.

We will issue our 5-year proposed OCS leasing program on time. This is an important plan that addresses national energy security and facilitates the development of critical energy resources now and in the future.

I will continue to seek prospective royalty agreements with the companies that entered into leases issued in 1998 and 1999 that lack price thresholds in order to capture the majority of the revenues the government would have received.

I am pleased at the results of our efforts thus far, but recognize that there is much more work to be done. I look forward to continuing to work with you, the members of Congress, to address this important issue.

In addition, I will continue to work with MMS to review and improve our royalty management programs. I have every confidence that MMS will successfully implement appropriate Inspector General's recommendations and that the review by the soon-to-be finalized royalty policy subcommittee will provide a fresh perspective on royalty management issues and challenges.

I welcome your input on all of these initiatives, and I look forward to working with you.

Mr. Chairman, this concludes my remarks. I would be happy to answer any questions you have.

The CHAIRMAN. Thank you very much. Let me ask a few questions and then we'll do 7-minute rounds here.

Mr. Devaney, let me first just ask by clarification, you make reference to a—I think it's a surname process. I think your testimony says a surname process, which dilutes responsibility and accountability. This is in connection with the way that these leases were entered into or managed or drafted. Could you explain that somewhat? I'm not clear what you mean by a surname process there.

Mr. DEVANEY. Mr. Chairman, that's the process by which MMS sends the documents forward and gets signed off from various officials within the Department. It tends to be very stove piped and comes up different stovepipes of MMS and Assistant Secretary Allred and I have briefly discussed this issue. We're both concerned, I think, that too many people are involved. Nobody is being—I'll let Assistant Secretary Allred speak for himself but my concern is that nobody is actually held responsible and accountable for the final product that comes out of Interior, that people are just getting these voluminous documents, putting their initials on top and passing it on to the next person and in the case of when it went over, at least in one case, when it went over to the Solicitor's Office, it wasn't reviewed as thoroughly as we all might have hoped. So it's a process that needs fixing. It's some lessons learned here and I think it can be fixed but it's broken right now.

The CHAIRMAN. Does this management plan that you referred to that is the action plan for correcting the problems, does it do the job in your view, the MMS Action Plan?

Mr. DEVANEY. I was pleased with two things. First, I was pleased with the reception that our recommendations actually got from Secretary Kempthorne and Assistant Secretary Allred and I was also pleased that I got so quickly an action plan to implement those changes. So I am, at this point, very pleased.

The CHAIRMAN. To try to just understand, obviously the mistakes in the drafting of these leases were made in 1998 and 1999. My impression is that in addition to that mistake, it was a mistake not to go ahead and confront the issue and try to correct the problem more quickly once it did come to light. Am I understanding that right? It would seem to me that trying to get these leases re-negotiated or trying to deal with this issue has become more and more difficult as time has gone on. Is that your view of things, Mr. Devaney?

Mr. DEVANEY. Well, it's extraordinarily difficult to predict what would have happened had it been confronted head on. Suffice to say, in hindsight, with the benefit of hindsight, I would have hoped that the issue would have been thought about in a much more robust way than it was. I mean, when it was first identified in 2000 by an analyst down in the gulf and for some unexplained reason, it never reached the higher levels of MMS for full discussion. Then in 2004, similarly, there appeared to be just a casual conversation that was held that suggested that well, the Solicitor's Office has already made a decision on this so there is no use talking about it.

I think, in hindsight, a more—a fuller discussion should have occurred. I would hope that that would happen today if it happened again but I have no way of knowing whether that would have actually resulted in any additional revenues being collected.

Senator DOMENICI. Mr. Chairman, could I ask a question?

The CHAIRMAN. Sure.

Senator DOMENICI. You just asked Mr. Devaney when "it"—what is the "it?" What we are talking about?

Mr. DEVANEY. I'm sorry, Senator?

Senator DOMENICI. It—I T. You said—you referred to the "it"—what is the "it?" What is it that is being considered?

The CHAIRMAN. I think it was a mistake——

Mr. DEVANEY. Oh, that the—excuse me, Senator. I think what I meant to say was, if that kind of an issue was brought to management's attention today, I would hope that they would call the Solicitor himself in, perhaps DOJ in and have a discussion. Now, the answer might be, we can't do anything about it. But that is the going back, retrospectively and asking the oil companies to pay back royalties.

Senator DOMENICI. Thank you very much.

Mr. DEVANEY. Sure.

The CHAIRMAN. Mr. Gaffigan, you cited the various problems that you've identified looking forward as far as ability to collect appropriate royalties and I think I heard you say that one of the problems is, is that there is no requirement in the law now for the Secretary to charge a royalty or to impose a royalty above any threshold—that that's purely discretionary. Is that what I heard you say?

Mr. GAFFIGAN. Well, the discretionary authority I was referring to is that the Secretary does have the discretionary authority to offer royalty relief, under different programs and he or she has done so over time, through the MMS and MMS has administered several different discretionary programs. I think the major one that they've looked at has sort of extended the relief in the deep water of the gulf and I think there were about 1,800 leases potentially, to date, that have had that kind of relief put on there. And of course, they have put in thresholds and volume limits using their discretion.

The CHAIRMAN. But am I correct in understanding, for example, in last year's bill, we put a provision in saying that the Secretary may place limits on royalty relief, not that the Secretary has to. The Secretary may.

Mr. GAFFIGAN. Right.

The CHAIRMAN. Do you see that as problematic?

Mr. GAFFIGAN. It just depends in terms of the implementation. Given our track record of the legal challenges and such that have come up, I would look closely at how we're implementing that act. Again, we have not done that. We're not aware that there are any problems and we do know that in the implementation of the EPAct, the MMS has put in both price thresholds and volume limits.

The CHAIRMAN. OK. Mr. Allred, let me ask you. What is your opinion as to the best way forward to try to obtain for the U.S. taxpayer, a reasonable royalty on the resources that have been and are continuing to be produced in this outer continental shelf?

Mr. ALLRED. Mr. Chairman, members of the committee, I still think that negotiations between the Government and the companies is what has to happen. I'm afraid that if there are other measures taken which would abrogate those contracts, we will end up with substantial problems going forward in leasing and developing new oil resources and in the full testimony, there are some numbers in there in what I call the "unintended consequences" that could involve both drastic reductions in production and significant loss of revenues to both the U.S. Government and the States. Now, how do you obtain agreement to modify those contracts that we currently have? First of all, I want to point out that six have and these are six—the majority of them are large companies that we know on an everyday basis. I believe that we could bring more in and perhaps also solve a problem by offering some additional incentives that do not result in monetary losses to the U.S. Government and I would be glad to work with this committee on some of those ideas.

But I believe that given the right set of circumstances and the right actions designed to accomplish that by Congress, we can renegotiate those agreements and obtain what we need to do.

The CHAIRMAN. My time is up.

Senator Domenici.

Senator DOMENICI. Sir, the last statement that you made goes to the heart of the issue. If I heard you right, you said to the committee here that you thought the best way we could handle this would be to permit you to negotiate this matter out and to negotiate the best deal you could with the companies that have leases during that span and have no threshold on them, thus they are not paying any royalties. That's what we've been struggling with all along. What leads you to believe that they will do that? I tend to have a feeling much like you but it's just my opinion. Do you have something more than just your opinion, which would lead you to think that's the way to do it, that we could just start negotiating?

What would we have to do? Have a resolution saying we urge it? We already adopted a resolution in a Subcommittee of Interior Appropriations, which encouraged the negotiations, is that not correct? What else are you talking about us doing that would give you the latitude to go negotiate?

Mr. ALLRED. Mr. Chairman, what I'm suggesting is that Congress give us additional tools that we do not now have.

Senator DOMENICI. Like?

Mr. ALLRED. One, for example, would be to offer for those who would sign and those who would have had diligence on their leases, to offer them an extension on the deep water leases that they have. I think that would be of advantage to them and of advantage to the United States because as you well understand, these are very expensive, very difficult developments to undertake and the 5-year period * that we currently provide on the leases may not be sufficient to maximize the results of those leases.

Senator DOMENICI. First let me back up and commend you on the work you've done. You have not been there a long time. I have not heard anyone from the outside looking at your work that has been anything other than rather laudatory of the way you do it. I hear Mr. Devaney talking here. He's doing that. He's nodding affirmatively.

But I'm of the opinion that for those who say why don't we just go out and cancel the leases—that's kind of acting the way Hugo would act, the way the Russians would act and it would not be considering the sanctity of contracts—we'll just decide that we're going to go pick and choose and cancel these certain kinds. I believe that would be detrimental over the long run to the United States. What is your feeling and if you know the Department's feelings on that, could you tell us?

Mr. ALLRED. Senator Domenici, with your permission, if I could show you a couple of graphs that I have, I think perhaps it will illustrate it as to what we believe the impact would be, the unintended consequences of any law which could be challenged in the courts. The first one I'd like to show you is with regard to the loss of production.

This particular graph shows that with regard to—if we were to proceed with the next sales which will be this fall and if we were to be enjoined by a court from issuing leases, this graph demonstrates our estimate of what might be the foregone production in a 10-year period from a 3-year delay due to court action and as you can see here, with regard to production, it would equal about 1.6 billion barrels of oil equivalent from that 3-year delay. That is a significant amount of delay in the production of oil with regard to our energy security.

The second graph I would like to show you is the estimate of the decline in revenue, again during a 10-year period from a 3-year period of delay in issuing new leases and you will see there that that is a $13 billion decline during that 10-year period from what would be an unintended consequence.

* In the Gulf of Mexico, deep water leases have 5 year lease terms in water depths between 200 and 400 meters, 8 year terms in water depths between 400 and 800 meters, and 10 year lease terms for leases in water depths greater than 800 meters.

I'll only point this out from the standpoint that I think it is—I think there is an important role here for Congress to play in solving this. I cannot solve it or the Department cannot solve it by ourselves. But how we do it is extremely important, such that we do not get into a situation where the United States cannot issue new leases. So that's why I'm very concerned about—we need to do it but we need to be very concerned about how we do do it.

Senator DOMENICI. Thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Wyden.

Senator WYDEN. Thank you. Thank you very much, Mr. Chairman. Gentlemen, in my view, this oil royalty relief program has the stench of conflict of interest and incompetence all over it and every time you think you're at the bottom of the slump, you seem to come up with more muck.

Let me start with you, if I might, Mr. Allred. I'm looking at the press release you issued on November 14 of last year. This was many months after I went to the floor of the Senate and spent almost 5 hours in one spot, talking about problems with the program and you announced this new panel that you're talking about to review this particular program where so much has gone wrong. And the person named to head the program is a gentleman named David Deal. I went to his website to look at his background and let me just read to you from his own website with respect to his background. He said on his website that he was centrally involved in all Federal royalty management rulemaking since 1980. He was the principle author of all American Petroleum Institute written comments on Federal royalty rulemaking from 1986 to 2004. He was the principle author of all inner association oil industry comments from 1996 to 2004 and he was the regular industry spokesman at agency hearings and workshops. How does it send a message of independence to put at the head of your new watchdog group, somebody with that background?

Mr. ALLRED. Senator Wyden, first of all, I might clarify that he was not—we did not pick him. He was picked by the chairman of the Royalty Policy Group, which is a FACA outside group that advises the agency. He is the person off the Royalty Policy Group who will have a role in supporting another group, which is being created under that FACA Committee. I guess I would urge you to wait and see who the appointees are. I would hope that when you see those, you will feel very comfortable with the people who are the co-chairs on that group.

Senator WYDEN. I'm just looking at your press release and I will say, given the fact that this was so touted in November. Now this was long after we'd been in it that that would have been an opportunity to show it was a fresh day and it looked like once again, the foxes were going to be in charge of the henhouse.

Let me ask one other question of you, Mr. Allred, again dealing with today's circumstances. It has come to light recently that Ms. Burton was warned about the leases as early as 2004. She told a congressional committee she didn't know about that. Now you all are moving in areas that were interested in working with you on with respect to re-negotiating leases but why wasn't any action taken to this date to hold people accountable for what is now on the record? Wouldn't you have moved Ms. Burton to another position? Wouldn't something be done to show that when the people who are responsible for these mistakes face some consequences?

Mr. ALLRED. Senator Wyden, first, we have just received this information, as you have and while I have reviewed the summary, I have not had an opportunity to go through this in detail. I have talked with Mr. Devaney about what's in it. These mistakes that occurred did not occur under her management. My experience at this point in time with Director Burton is that I have found her to have the highest integrity and be a very competent person. I have not seen a reason yet to make a change in her status.

Senator WYDEN. But she knew about the problems as early as 2004 and she told a congressional committee she didn't know anything about it until 2006. I'm going to see if I can get one other question, if I might and one for you, Dr. Devaney. As I understand it, with respect to this audit process, essentially as of right now, the Government pretty much takes the oil companies' word for what's really going on. There are these compliance reviews and that's pretty much where we are as of today. After all that has come out on this program, we pretty much take the oil companies' word for what goes on. Is that correct?

Mr. DEVANEY. It's more or less of an honor system. There are checks and balances that take place during the compliance review process to ensure that the numbers being put forward are, relatively speaking, industry standards. There also are some audits being done. So there are audits although as the chairman pointed out earlier, there are fewer audits today than there used to be.

Senator WYDEN. My time has expired, I think, but my understanding is with respect to recoveries, the royalties are really coming in from all of you—the $568 million—you are the ones bringing in the royalties, isn't that correct?

Mr. DEVANEY. Well, it is true that in the context of *qui tam* investigations that we've done, we've raised that—we've brought in that kind of——

Senator WYDEN. That is the amount that the Department did not catch that you did. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Thomas is next.

Senator THOMAS. Thank you, Mr. Chairman. I'm glad we're having this hearing. It certainly is an issue that is very important to us. I think we ought to get right into the real issue and that is, why were these thresholds omitted and how were they omitted and more importantly, now what do we do about it? Now we seem to be pretty busy from time to time, blaming some of the current people that are there about it, which distresses me a little bit but in any event, we need to know why this took place, we need to know what we can do about it. We need to know how it can be done. We certainly don't want to be in the process of breaking contracts. I don't think we want to be in the process of the Government going back and doing Venezuelan kinds of things in terms of changing the contracts. I don't know why we're quite so involved in the personnel aspect of it, quite frankly but I think Mr. Devaney, it's your reports that have kind of caused that. You described Johnnie Burton's management as shockingly cavalier and her reaction to hearing the Clinton administration as a jaw-dropping example of bungling. But you refrain from similar language about the Clinton administration officials who did it in the first place. Now, the fact is, Johnnie in the meantime, has done something about it, has gotten six of them going and so how do you respond to that assessment of management style in this way?

Mr. DEVANEY. Senator, I was not attributing those remarks to Johnnie Burton herself. My remarks were not directed towards Johnnie Burton. My remarks were directed towards—after the mistake was made in 1998 and 1999. In 2000, the mistake was discovered by our low level employee down in the gulf and for some unexplained reason, that mistake was never brought to the attention of the two former Directors or anybody in Washington. In 2004, it appears through the e-mails we discovered and from talking to Johnnie Burton, there was a very brief discussion about the fact that the omissions had been raised again and the discussion was very brief and centered around the fact that the Solicitor's Office had opined that there was nothing that could be done about it and that was the end of the discussion. Our remarks were, quite frankly, to be fair in hindsight, I think, a much more robust discussion should have occurred in which the Solicitor himself as opposed to a line solicitor, perhaps the Department of Justice and others came together and discussed what, if anything, could be done. Now I have no reason to believe that anything would have changed but I am disappointed that that conversation did not occur.

Senator THOMAS. I guess I was a little interested too, why the *New York Times'* writing detailed accounts of your report before this committee and the American people were given a chance to review it.

Mr. DEVANEY. I have no idea how that happened. I was not happy myself. Quite frankly, the purported remarks did not reflect my true feelings or my testimony today.

Senator THOMAS. I see. In your testimony, you mentioned an attorney from the Solicitor's Office during the Clinton administration who admitted that he should have spotted the mistake but did not. Who was that?

Mr. DEVANEY. His name is Milo Mason.

Senator THOMAS. Do you believe it would have been productive for Mr. Mason to provide the committee with testimony?

Mr. DEVANEY. Mr. Mason did testify on the House side about this issue in the fall of last year and he probably is somebody that you might want to hear from.

Senator THOMAS. The leases from 1998 and 1999 did not contain the price threshold but leases issued in 2000 did. Apparently somebody discovered it and remedied the problem.

Mr. DEVANEY. Yes. They did. They took care of that.

Senator THOMAS. So why are we complaining about 2004 then, if we took care of the problem—we need to get down to the core of the problem but all the discussion seems to be about who was here, who heard what when and frankly, I think I've kind of observed and I have a little more involvement than most with Johnnie Burton but I think she's done a great job and she seems to be getting all the complaints about it when there is no evidence that that should be the case. At any rate, I hope we can move on to find some answers to the thing and I appreciate your interest.

The CHAIRMAN. Senator Dorgan.

Senator DORGAN. Mr. Chairman, thank you very much. I regret I had to go chair another hearing for a brief period and missed part of the presentation. I've had a chance to read through your presentations. Let me ask a question—maybe it's already been asked. What percent of the production that exists on these disputed leases, disputed contracts—what percent of the production comes from companies with whom you've now made an agreement on the price thresholds? Mr. Allred, could you answer that?

Mr. ALLRED. Senator Dorgan, it's about 20 percent of what we believe might be future production. These are estimates.

Senator DORGAN. So about 80 percent, at this point, is still outside the area that has been settled and would be producing under circumstances in which there is not a price threshold?

Mr. ALLRED. That is correct. There is about—there is 20 percent within these companies. There is another 20 percent held by one other company and then there is about another 20 percent that are held by what I'll call offshore foreign companies and then a smattering of others.

Senator DORGAN. Does that 20 percent mean that we are, with the estimate of $10 to $11 billion that 20 percent of that now will be recovered and there is a shortfall of perhaps about $8-plus billion to the American taxpayer? Is that a proper way to calculate that?

Mr. ALLRED. Senator, our numbers—about $1.5 billion would be produced by these new agreements with those six companies.

Senator DORGAN. You know, I don't understand this issue as well as I should. Some others perhaps do. But I come from a town of 300 people and if there are businesses on main street of my home town doing contracts with each other and one contract is done and there is a major omission by mistake and the person that is the beneficiary of that omission says, you know what? That's tough. You've signed it. Tough luck. You're out of luck. I'm not re-negotiating anything. You know what the first business would say? That's just fine. Don't come around here anymore then. Don't show up here if that's the way you're going to be. You understand it's a mistake. We understand it's a mistake. This is a windfall for you. If we both understand it's a mistake and we do and you're not willing to negotiate and you're not willing to correct this mistake, don't show up here anymore because you're not going to do business with me anymore. Why would you not take that position, Mr. Allred? Why would the Government, why would the Department not at this point, take that position? Say, you know what? Either you re-negotiate with us or sorry, Charlie. You're out of luck. We're not going to do business with you.

Mr. ALLRED. Senator Dorgan, obviously we have to enforce the laws that you pass and those laws don't allow us to do that. Before you were able to get here, we did talk a little bit about unintended consequences and I can go over that a little bit or I can brief you separately if you'd like.

Senator DORGAN. I'm sorry—you did, I believe, indicate that you would like some additional incentives or tools with which to go to these companies to say, you know what? We need to redo this because there was a mistake and you want some tools or incentives. I'm just saying that the best incentive is to say, you know what? Either you come clean on this. This was a mistake. We both understand that or don't show up the next time there is a bid. The next time there is a lease you want to bid on, don't show up around here. Now, if you don't have the capability to do that and you need some legal authority to do that, I'm perfectly happy and I know there will be great dispute about that, perhaps but I'm perfectly happy to give you that. But my sense is that the Department has not been as aggressive as I would prefer to have it. I mean, there is a legal doctrine called mutual mistake. I don't know whether you pursue that. Maybe it's a long shot, maybe not. It seems to me you would be very aggressive and pursue every opportunity you have to get what we should get here and what was omitted by mistake in those contracts. The fact is, this is not a perfect government. Mistakes are made. This one is—I'm sure everybody up here feels the same frustration. It's unbelievable that somebody would be involved in contracts like this and make a mistake that has the consequence of $10 or $11 billion over the long term but if that's where we find ourselves, then let's try to figure out how we deal with it and I say, deal with it aggressively. We've got about 80 percent of the potential ramification for the Government and therefore the taxpayer is still laying out there that may never be collected unless we become more aggressive. How can you become more aggressive? What tools do you need from us?

Mr. ALLRED. I have, in a previous discussion, identified one that I think would be very helpful and it has to do with creating a reason for companies to sign without giving them a benefit which would decrease royalties to the United States. There are probably some other things that we could do as well and as I have volunteered to the committee, I would very much like to work with your staffs to develop that suite of tools that I think could bring the companies to the table. I will say that I have been aggressive and I'm sure you've heard, probably, some complaints about how aggressive I've been. I clearly believe these are contracts that we cannot abrogate but I think there is a responsibility to re-negotiate them. We have looked at the mistakes theory and information that while we still have to look at in detail, based upon the information that Mr. Devaney has provided to us, it appears that these were conscious decisions to remove these in 1998 and 1999. I don't believe they were malicious but they were conscious. That would make it, as I understand it from our solicitor, very difficult to argue a mistakes theory.

Senator DORGAN. Mr. Allred, I understand about contracts sanctity and I understand the concerns others have expressed about abrogating a contract. On the other hand, this is a different situation than just abrogating a contract. It is a contract that was produced by error. Those who are the beneficiaries of that, I'm sure are smiling all the way to the bank and will for 10, 20 years. But I think it is our responsibility to decide that we're going to try to make this right on behalf of the American taxpayer. The American taxpayers, at this point, have a significant interest here and I'm not—boy, I don't think we need a lot of sugar here to lay out as sweeteners.

You need the tools from us. I think we should give you the tools to say to these companies, you want to keep bidding? Then own up on this issue to a mutual mistake. We made it, perhaps, in the agency but everyone understands it's an omission and a mistake. Own up to it and you're going to be a partner here and keep bidding. If not, go somewhere else because we don't need you if that's the way you're going deal with us. So I hope you will tell us what you need. I think you have plenty to proceed ahead but if you need more, I'm perfectly willing to work to get it there because I don't think we need sweeteners. You just need to say that we're open for business only for those folks who in good faith understand they're willing to join us in correcting a very serious mistake that disadvantages the American people to the tune of $10 or $11 billion.

Finally, my time is up but I do want to say, Mr. Devaney, I've read your work extensively and when I chaired the Interior Appropriations Subcommittee, I read the statements you made about the Interior Department. I am very concerned about that as the chairman indicated he was in his statement. All of us want good government and you keep being aggressive and keep pushing and keep giving us information we need with which to do our job as well. I want to thank all three witnesses for coming today, Mr. Chairman.

The CHAIRMAN. Thanks very much.

Senator Craig.

Senator CRAIG. Well, Mr. Chairman, thank you. I apologize like my colleague did, a few moments ago for not being here for your testimony. I was involved elsewhere but I have read a fair amount of it and I have focused on this issue quite a bit and Mr. Chairman, thank you for doing the oversight that is clearly important here, as we deal with, I think, this issue.

I find it interesting that in reading Mr. Devaney's report and listening to the Secretary that this was not an omission but a bad decision. Is that something that is a reasonable conclusion to draw? Either of you?

Mr. DEVANEY. Sir, I would say it was not a deliberate omission. It was a mistake.

Senator CRAIG. Mr. Secretary?

Mr. ALLRED. Well, I'm depending upon Mr. Devaney's information but it would appear there was a decision to remove them, whether that was good or bad. I don't believe it was done at the—it was not designed to be to the detriment of the United States but I think it was a decision that either was not fully understood or was not carried through as it should have been.

Senator CRAIG. Therein lies, I think, for any prosecutable effort a very real frustration if that is the reality of what we're dealing with here and there is a reality of contracts, our contracts and they have some degree of sanctity and they must have in our Nation of laws. At the same time, I am extremely frustrated that we don't get it corrected and do so in an appropriate way with the companies involved.

I find it interesting that you had a number of companies—Marathon, Conoco, Phillips, BP and Shell in December become very proactive in solving the problem. Then all of the sudden, it appears to have stopped. Mr. Secretary, is there any reason for that, from your knowledge and experience now in the position that might have caused that?

Mr. ALLRED. Senator Craig, I have an opinion. I don't know for sure but my opinion is that those companies that have not signed are waiting to see the role that Congress will play in this issue.

Senator CRAIG. That's an interesting opinion because there is a bit of street talk out there that suggests that that is exactly what's happening—that companies, more of them, would be forthcoming to solve this problem but with a new Congress, in some instances, they are being told, step back. We are going to legislate this so that we can score it for the budget or in fact, we will gain political points by muscling this issue around a bit. If that is happening out there, if that is what some of us are saying to these companies, shame on us. We ought to get this problem solved, first of all, voluntarily if we can and it appears that that was happening at a fairly rapid rate and a substantial amount of money has been saved as a result of that in royalties to come and some retrieved. And I would hope, more to come so I think I join with my ranking member in saying to the companies involved here, don't wait for the vicissitudes of Congress or the politics of this issue. Move forward now. I don't blame the Senator from North Dakota for saying what he says but there is goodwill and if contracts were negotiated in good faith—South Dakota, I'm sorry. It's so cold in those two States right now, I can't tell one from the other. But I don't blame him for that frustration.

But the major finds of oil in the next decade for our supply are going to come out of the gulf and there are a limited number of companies who have the capability to drill in deep water and bring that production to this country and into our system. We ought to be working to solve the problem, enhance the situation and move on. Let me conclude with these questions, then.

Mr. Secretary, do you believe the audits and compliance reviews relating to royalty payments should be undertaken by MMS or another entity?

Mr. ALLRED. Senator Craig, I think that operation is so integral into MMS's operations; it would be very difficult to do it. For example, we monitor the meters—there are MMS supervised meters on every offshore well on every offshore gas—both oil and gas that determines the amount of product that is being produced. We do the analysis of the material being produced. We collect information with regard to transportation costs and processing costs. My own personal viewpoint is that it would be very difficult to separate that sort of information from the operation of the audit program or the compliance program. Audit is only part of it. The compliance, I believe, as Mr. Devaney agrees, is an important tool that we need.

Senator CRAIG. Well, do you believe the IG should have a permanent role in overseeing MMS audit and compliance activities?

Mr. ALLRED. Senator Craig, that's not something I've really thought much about, but my own opinion would be that the reason to have an Inspector General is to have someone who is in an oversight role and who does not have a conflict of interest in reviewing the operations of the agency. My concern would be that—not specific to the Inspector General but to put any oversight role into an actual operating process would certainly lesson the independence of that review.

Senator CRAIG. OK. My last question, Mr. Chairman. Mr. Devaney, do you believe that the current budget for the compliance and assessment management program is adequate?

Mr. DEVANEY. Senator, we really didn't address that issue. My sense is they could always use more resources to do that job. As we've identified in our audit, we believe that it is the combination of audits and compliance reviews done in a strategic risk based compliance system that would ensure the greatest possibility of total oversight and they need the resources to do that.

Senator CRAIG. You've answered the question then, I guess and we will certainly take a look at that as we deal with your budgets in the coming months to make sure that these tools are right and that hopefully, mistakes and/or decisions of this kind are not made in the future. Obviously, it is important that this be a resource for our government; therefore for our citizens. At the same time, we want to maintain a solid working relationship with these companies that do have the capability to reach out into that deep water and supply us with these resources and that's only going to happen when those relationships are legal, stable, transparent, understandable, and predictable as it relates to production and certainly that will fit with the costs at hand in dealing with these kinds of production units. So we thank you very much, Mr. Chairman. Thank you for our role and responsibility and let me close by saying, I would hope that the companies who are still out there waiting, would come forward. If they are waiting for the politics of this issue to settle and for legislation to come about, they may wait a while longer. I hope we do act responsibly here and we don't cause companies to say, this is no place to do business. More importantly, our government is no partner in a business relationship. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Tester, you're next.

Senator TESTER. Thank you, Mr. Chairman, a couple of questions. Mr. Devaney, the audit was publicly released in 2006 and I will follow the other ones—excuse me if this has been covered and I haven't been here to hear it. But in 1998 and 1999, the offense was committed. When did you start your audit?

Mr. DEVANEY. We started our audit about a year ago.

Senator TESTER. And was that at the direction of this committee? Or why did you start that audit? Why was it initiated?

Mr. DEVANEY. It was a request not only by this committee but also of a dozen or so individual members of the committee—members of the Senate and House.

Senator TESTER. Is there a normal audit that would catch this situation? I mean, you talk about the compliance audit. Is that the only way?

Mr. DEVANEY. We did an audit in 2003 and looked at the program. We had some findings that I spoke about in my opening remarks that have been corrected now and they have gone through two peer reviews. We periodically drop in on this program. What I mean by that is, every 3 or 4 years.

Senator TESTER. Every 3 or 4 years?

Mr. DEVANEY. Right.

Senator TESTER. Okay, so that would have been 2003?

Mr. DEVANEY. That was 2003.

Senator TESTER. As some of my comrades on this committee have already stated, hopefully the situation from a business standpoint will be cleaned up. I can't help to think that if I was in the business of oil production that I would have known exactly what the rules were when I went into the contract and known exactly if I was going to get a good deal that actually subverted somewhat the rules. So I too, hope it's cleared up. In your testimony here, you said you don't have any evidence of a smoking gun or evidence that this omission was deliberate and then in the next paragraph, it talks about investigations are going on. Can you tell me how many people are being investigated?

Mr. DEVANEY. We're looking at the behavior of perhaps a dozen.

Senator TESTER. A dozen people? Can you tell me if that investigation includes personal financial benefits?

Mr. DEVANEY. I'm not prepared to say that today, Senator.

Senator TESTER. OK. As many steps as this went through the bureaucracy, this type of mistake is hard for me to think that it was a mistake. Now I know you said that it wasn't deliberate. It may be a question to revolve around. What makes you think it wasn't deliberate? I mean, I saw at least three steps here.

Mr. DEVANEY. We have taken a very close look at the people involved in this and heard them out and tried to understand the context in which they were making those decisions. The organizational components of MMS were in different parts of the country. There was clearly a communications breakdown. They were trying to understand themselves, the ramifications of the Royalty Relief Act. It appears to us at the end of the day that this was a mistake, a bureaucratic mistake and a very costly one.

Senator TESTER. Point well taken. Was there a reduction in audit staff force on this or has this been kind of the way business has been done for the last 10, 15 years as far as the frequency of the audit?

Mr. DEVANEY. We're talking about MMS's audit program, not our audit program in my office but MMS's audit program has had a slight reduction in auditors and a definite shift in thinking that they wanted to do more compliance reviews in the belief that that would allow them to cover a broader range of companies and leases. Those compliance reviews are not traditional audits and do not provide as good of coverage as a traditional audit would provide so they have had a shift in philosophy by trying to cover a broader range of companies and leases, to more or less go to this compliance review, which is sort of a checklist process. It is done from a desk in an office as opposed to knocking on the door and saying, let us see your books.

Senator TESTER. In your personal opinion, do you think that there would be a cost benefit ratio if we were able to bump up not the compliance audit but more of the regular audits like you are doing?

Mr. DEVANEY. As I tried to answer the earlier question, this is a place where investments might be wise because of the financial ramifications of what we're talking about.

Senator TESTER. Thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Sessions is next.

Senator SESSIONS. Thank you, Mr. Chairman. It's a very valuable hearing and important hearing. Mr. Devaney, you have suggested—said flatly that there was no one to take responsibility. I assume you mean that was a mindset that papers just got moved along. But Mr. Allred, somebody had responsibility when a lease is signed, any lease, particularly one that involves billions of dollars, who is it? Is it the Assistant Secretary? Is it the Secretary? Or who?

Mr. ALLRED. Senator, my belief is that the top management of the Department is always responsible for——

Senator SESSIONS. Well, top management. Is that you?

Mr. ALLRED. That is I and the Secretary.

Senator SESSIONS. Well, which one of you is ultimately responsible for signing the lease?

Mr. ALLRED. We are responsible for the activities of the agency. Neither I nor the Secretary were here when this happened.

Senator SESSIONS. I'm well aware of that. But today, if a lease is signed, who in this Department is the person responsible for final approval and authorization of the lease?

Mr. ALLRED. I and the Secretary.

Senator SESSIONS. Both of you?

Mr. ALLRED. Well, I first and then the Secretary.

Senator SESSIONS. You make a recommendation to the Secretary?

Mr. ALLRED. That's correct.

Senator SESSIONS. And he ultimately signs the lease?

Mr. ALLRED. The actual signature does not take place at that level but we are responsible for assuring that that is done in the manner in which we instruct people to do it.

Senator SESSIONS. Well, there we go. Now, does the Secretary himself or herself sign some document to say I approved the lease?

Mr. ALLRED. No.

Senator SESSIONS. Well, then I would say that the Secretary is not actually deeply involved if they don't make any signature. Whose signature is required on such a document?

Mr. ALLRED. The signature on the document itself is delegated to the Mineral Management Service. The agency—I and the Secretary—specify what they are to consider and how they are to do that.

Senator SESSIONS. Well, first let me just suggest to you, Mr. Allred, that the legal department doesn't seem to have functioned well in this. Is that department that reviews these leases—do they report to you? Are you responsible for their ultimate effectiveness?

Mr. ALLRED. The Solicitor's Office does not report to me but we utilize the services of the Solicitor's Office. There is a solicitor within the Department of the Interior. It is our responsibility to make sure that we ask the right questions and get adequate advice.

Senator SESSIONS. Mr. Gaffigan, I believe your comments troubled me. Along that very same line, you said there were a series of mistakes, vague language that may be as to what the threshold may be and maybe litigation over that. Of course, the issue we're confronting here, the thresholds that were not in that and even Kerr McGee's threat of a lawsuit. Would you say that in any major Federal agency, you need the best legal department you can get and when you're dealing with millions, even tens of billions of dollars, that these are—every word in these leases and documents must be given the most careful scrutiny and you need the best legal team available?

Mr. GAFFIGAN. Given the track record of the legal challenges in this area and this whole area of royalties has a whole history of litigation going back to litigation over the value of royalties and what the sales value is there. So I would say yes, it's very important that we look at both the regs and the laws.

Senator SESSIONS. And Mr. Allred, you say the Congress needs to help you. Senator Domenici asked exactly what, exactly how. Are you an attorney and an expert in the legal matters of leasing and so forth, yourself?

Mr. ALLRED. Senator, I am not. I am just an engineer.

Senator SESSIONS. Well, with regard to that then, I think it is incumbent upon you to get the Solicitor General and the Secretary of the Interior and when you ask us to do something, it needs to have been thought through from every possible angle. That's all I'm saying. We've got to have a higher degree of responsibility here to make this system work. We don't want to end up continuing to have lawsuits and vague language that leads to disagreements.

Mr. Devaney, I have to follow up on this a little bit. According to your report, the person responsible in 1998, I guess, for directing the preparation of leases, said he was told by persons in MMS's economic and leasing divisions, to take the price threshold language out of the leases. Now you keep saying that was a mistake. Somebody made a decision to take that out. Who did it? Was it negotiated with the oil companies? Did the legal staff review that? Who came up with this idea to take the language out?

Mr. DEVANEY. Well, we spent a considerable amount of time trying to identify the person that told him. He suggested to us that it was one of three people. We talked to all of those three people. All three denied that they had told him to take that out. I will say that my reference to the mistake was that it's—at the end of our investigation, we believe that the mistake was that there was an assumption that the Royalty Relief Act regulations would actually include the price threshold language when in fact it did not. When the Royalty Relief Act regulations finally came out, it did not have any threshold language in it. And up until that time——

Senator SESSIONS. I'm not arguing with you but your report here would indicate that this was as to whether this language was actually going to be incorporated by reference and to do it in a certain way?

Mr. DEVANEY. That's right.

Senator SESSIONS. Not to actually change the policy of previous leases and to eliminate the threshold.

Mr. DEVANEY. That's right.

Senator SESSIONS. And you never discovered any discussions about actually changing the threshold limit by any policy makers or lawyers?

Mr. DEVANEY. No.

Senator SESSIONS. And Mr. Allred, then therefore, I think you have a potential—the main thing, mutual mistake. It was never explicitly discussed, an intention to change it. I'm not sure that cause of action is gone.

Mr. ALLRED. Senator, we have not discarded that opportunity. Congress has asked the Attorney General to provide an opinion and we look forward to that opinion.

Senator SESSIONS. I would be curious and will issue some written questions, Mr. Allred, about the impact that this could have, for example, on the legislation we passed, the Security Act of 2005 and the way we have on my home State of Alabama and other States. I hope you would review that and give us some information. But I think you need to tell us what you need to fix this thing and we need to evaluate it and see if we can do it, consistent with principles of contract law and the constitution. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. I was eager to join with you in asking for the IG's report and I am appreciative of this hearing today. You know, as I listen to some of the statements, I'm reminded of the story of lawyers; when you have the law on your side, you argue the law. When you have the facts on your side, you argue the facts. And when you have neither the law nor the facts, you pound on the desk and you create a diversion. It seems to me that either under the guise of political intrigue or dire consequences based upon some calculation of the action of Congress, that we are moving to a diversion of the real issue here, which is the rip off of billions of dollars in taxpayers' money.

Now, Mr. Secretary, you were quoted by the *New York Times* last month as saying with regards to the royalty program, "while I think there is a lot of room for improvement, I have not been able to find anything that's drastically wrong." Do you stand by that assessment today?

Mr. ALLRED. Senator Menendez, that's correct.

Senator MENENDEZ. Well, I don't understand that. Now here is a process that has effectively cheated the American taxpayers, at this point, out of billions of dollars. It resulted in several criminal investigations, and has auditors filing their own suits under the Civil False Claims Act because they claim the Department won't pursue action against oil and gas companies. Sounds like we're ready for another "heck of a job" comment.

Mr. ALLRED. Senator, I've looked at all of those and I'd be glad to respond individually but I do not believe the conduct of the agency at this point in time is such that it puts the United States at risk. It can be improved. There is no question about it.

Senator MENENDEZ. Mr. Devaney, there is nothing drastically wrong here?

Mr. DEVANEY. Oh, I think that there is plenty of room for improvement here.

Senator MENENDEZ. I think that is very charitable. Now I want to join Senator Wyden in saying to you, Mr. Secretary, that I have a real concern that the panel to review complaints and problems with the royalty program is headed by the former General Counsel for API. There are a great deal of people in this country who expect the Department of the Interior to act as the American peoples' watchdogs on this issue and I am hopeful that you and the Secretary will be making the changes necessary to restore our trust in your mission. But I'm not sure that having an API lawyer head an independent royalty review panel is a step in the right direction in restoring that trust. So I want to echo Senator Wyden's concerns.

But the most pressing question, of course, is how are we going to fix the problem that the IG reported on today. The House has been debating several options and we will have some of our own ideas but what I want to know is, Director Burton testified before the House that MMS had met with about ten companies and I heard you say today, you've actually re-negotiated with about six of them. So there are four or so that you are still working with, is that correct?

Mr. ALLRED. Senator, there is more than that. I've talked to not all of the leaseholders but probably a majority of the leaseholders, including the offshore companies.

Senator MENENDEZ. I think she was talking about some of the major companies. Are there still four major companies that are outstanding?

Mr. ALLRED. Probably more than four if you count the offshore.

Senator MENENDEZ. Is ExxonMobile one of those?

Mr. ALLRED. Pardon?

Senator MENENDEZ. Is ExxonMobile one that is outstanding?

Mr. ALLRED. Yes, it is.

Senator MENENDEZ. Well, in the third quarter of 2006, ExxonMobile reported over $10 billion in profit—in one quarter. That's the second highest profit of all time, second to their own record from a year ago. And right now, they and many others have wildly profitable companies and are taking advantage of a mistake—a mistake made against the clear intent of Congress and the Department of the Interior and it seems to me that we're already contributing billions of dollars to ExxonMobile at the gas pump as American consumers. It is outrageous that they are unwilling to renegotiate. And that is what jumps at me about this whole issue, the huge disparity about how we treat the American taxpayer and the multi-national oil conglomerates.

Mr. Devaney, I believe you recently found that MMS doesn't have a good way to determine interest payments for companies that underpay royalties, is that true?

Mr. DEVANEY. That's an ongoing inquiry we're conducting. It appears to us that they are collecting interest but not in a way that we would all hope. It is very slow.

Senator MENENDEZ. Meaning they are not collecting as comprehensively as they should, as much as they should? What do you mean?

Mr. DEVANEY. Well, the collection of interest in the modern world is done by computer and their computer program is not up to speed and it's a very slow process to collect this interest.

Senator MENENDEZ. Well, it's interesting. If the average taxpayer has an amount due, the IRS has no problem in sending them a notice with penalty, the exact amount that they are owed, including interest to the very penny. Yet we can't do that with the oil industry. Ask the American taxpayer if they think that that's fair.

Now let me ask you with reference to the audits. I understand, Mr. Secretary, that MMS has cut the number of auditor positions by over 20 percent since the year 2000 and reduced the number of audits by roughly 22 percent, and I believe that the amount of money that the Department has collected through auditing and compliance has gone from an average of $115 million per year before 2002 to about $48 million since. Do those numbers sound right to you?

Mr. ALLRED. Mr. Chairman, I don't have those in front of me but I know that our opinion with regard to compliance is that we are seeing more people comply than we did previously. I think it is because of two reasons. First, the regulations and our activities are much clearer to people. They understand better. Second, there were a large number of settlements that had to do with when we were first implementing the act that came in the previous time period. We are covering a wider number both in our audits and in our compliance reviews.

Senator MENENDEZ. Something is going wrong because we have gone to nearly a third of collections of what we had before when we had a greater number of auditors.

Mr. ALLRED. Senator, I would hope that what we're seeing is people are doing a better job of paying their royalties up front.

Senator MENENDEZ. Well, I hope that's the case but to be very honest with you, audits are not the only ways to keep the companies honest, they are a revenue raiser to the people of this country, and with the economic situation we find ourselves in, with the struggle of middle class families in this country, I think they would find it totally intolerable that they can be told to a penny what they owe the government and we cannot get the oil companies to do what is right. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator Murkowski.

Senator MURKOWSKI. Thank you, Mr. Chairman. Very important hearing this morning and gentlemen, I had really hoped that I was going to be able to come in here this morning and gain truly a better sense about how we got to where we are today and we've heard the discussion around the dais here about it is a mistake, it is a decision—extremely costly decision for this country and I have to admit that after listening, I'm not quite sure whether it was a mistake, or an omission, it sounds like there was a decision that was made. And it was a very wrong decision. I come from a State where we negotiate with the oil companies on a relatively frequent basis and let me tell you, they have the best and the brightest going over every single word of every single contract and if we as a State aren't similarly matched, we know that we get into this ongoing, endless litigation over royalty and other terms related in that contract. So the fact that you could have, perhaps vague language in the Deep Water Royalty Relief Act that might have suggested that you didn't have to include the language is one thing but then to know that in the year 2000, just 2 years afterwards, we went ahead and we did include the provisions within the leases, if I understand the testimony correctly, leads me to believe that we caught our mistake in relatively short order then. We have just failed to do anything about it for quite some time, which I think is greatly distressing.

Mr. Gaffigan, I guess I'd pose a question to you. We had this vagueness, if you will, within the Deep Water Royalty Relief Act and hopefully, we're beyond that now. We know what it says and what it means and how we can interpret that. But we also have royalty relief provisions within the OCS Lands Act, within the Energy Policy Act of 2005. Is there any possibility that in these two acts, we might have similar problems that we've either discovered or may discover a few years down the road? Give me some assurance.

Mr. GAFFIGAN. I wish I could. The reason we raised the issue is that there is this relief out there under those two provisions. Again, we are not aware of any problems but who is to say, given the track record and how we have consistently lost cases in this matter that there might be other challenges out there that we are not aware of. So I would be taking a good, hard look at all these provisions and not only looking at the cost benefits of them but also making sure we're sound because as you say, everyone does take a good, hard look at these things from a litigation standpoint.

Senator MURKOWSKI. So we in the Congress need to be making sure that the laws that we are drafting are very, very clear but from the administration perspective and within the Department and within the agencies, they too, need to be making sure that there is no uncertainties.

Mr. GAFFIGAN. I think everyone shares in that responsibility.

Senator MURKOWSKI. Let me ask then, I've said that extremely costly mistake or decision that we are in today, facing potentially a $10 billion loss and we recognize, if I am to believe your charts, Secretary Allred here, that the decisions that we make going forward as a Congress could add even more loss revenue to this Nation if we do not figure out how to do it right. So it is not just pointing the finger at how we got here but we have got an obligation to move very carefully and make sure that we are acting responsibly as we figure out what we do next. You have mentioned one possible tool and that was in terms of additional incentives. You indicated that perhaps an extension on deep-water leases might be one way that we can get some of these companies to renegotiate. Has this been put in front of them? Have they been receptive? Do you think that this is going to be a useful tool for you as you try to re-negotiate some of these?

Mr. ALLRED. Senator Murkowski, in trying to figure out what tools we might use, I have had some very preliminary discussions, being careful not to commit to anything, with some of the companies and I believe that there are significant companies who would find that very attractive.

Senator MURKOWSKI. Can I ask you—and I'm going to ask you to speculate a little, Mr. Allred, on the likelihood of success on the Kerr McGee suit. I believe that I heard somebody mention that the potential liability to us on that was $60 billion. Am I correct in that? Mr. Allred?

Mr. ALLRED. Senator, I'm not sure about the total liability but I believe it's in that range. The argument in that case, as you probably know, is whether or not the law gave us the authority to impose price thresholds. Our solicitor tells me that they are confident in our position. I've been around long enough to know that you can never predict what a court will do but the arguments that the Solicitor has he believes are very sound.

Senator MURKOWSKI. So the potential for us could be $10 billion that we are seeing as a loss now and if Kerr McGee were to be successful in its litigation, an additional $60 billion on top of that. Is that correct?

Mr. ALLRED. Senator, I believe that those are inclusive, that if we are not able to impose price thresholds totally, the lost opportunity for income could be up to $60 billion. The $10 billion would be a portion of—if we are unable to recover the 1998 and 1999.

Senator MURKOWSKI. OK. And then one final question for you, Mr. Allred and this is how the Department sets the royalty rates and there has been some discussion about the discretion of the Secretary. Traditionally we've seen these royalty rates set at 12.5 percent with some of the more prospective leases at 16⅔ percent. It was, I guess, just a few weeks ago that the Administration recently raised the royalty to 16⅔ percent in most places with the exception of Alaska, where it remains at 12.5. I just wanted to ask kind of what the rationale was behind that decision.

Mr. ALLRED. Senator, when we were asked to evaluate whether or not that should be done or not, we looked at a number of items but specifically, in our consideration, as to whether or not the 12.5 was needed offshore, continentally offshore. Our conclusion was that as we looked at the competition that was available and the interest in the oil companies and the state of the technology and that's very important—the state of the technology with regard to deep water offshore development that we did not think that the reduction in royalty rate was no longer necessary. It certainly probably was when we started but the technology has been developed sufficiently and there is sufficient interest and competition that we felt that it was appropriate to bring it up to 16⅔ as it is in shallow water on the OCS.

Senator MURKOWSKI. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Cantwell.

Senator CANTWELL. Thank you, Mr. Chairman. Mr. Devaney, as you started your investigation, did you advise the agency on not deleting e-mails?

Mr. DEVANEY. Actually I didn't have to, Senator. Under the Cobell lawsuit, the agency retains their e-mails. It is a wonderful thing for IGs.

Senator CANTWELL. And in that process, did you review e-mails between—the personnel and any of these companies that are involved in this?

Mr. DEVANEY. We looked at some 19,000 e-mails so while I can't definitively say, my assumption is, we have done that, yes.

Senator CANTWELL. So it wasn't just internal communication, it was communication between those employees and these companies as well?

Mr. DEVANEY. I believe so.

Senator CANTWELL. Is that in the report that we're receiving today? Are those e-mails in that report?

Mr. DEVANEY. No. But it is much more common that the e-mails reflected conversations within the Department. It would be few and far between e-mails with the oil companies themselves.

Senator CANTWELL. So we do not know whether those were asked for?

Mr. DEVANEY. I don't know as I sit here right now. I'm assuming that because we looked at such a large volume that it included—if there were any e-mails, it would have included them.

Senator CANTWELL. But that is something that we could go back and look at as well, is that correct?

Mr. DEVANEY. We could go back and look at them but our investigators have looked at them to see if there was conversation in those e-mails that might relate to these issues.

Senator CANTWELL. Mr. Chairman, I'm assuming we're getting a copy of this report today, with these e-mails, that members can review, is that correct?

Mr. DEVANEY. My belief is you are not getting the 19,000 e-mails, no.

Senator CANTWELL. In this report?

Mr. DEVANEY. No. You're getting today the e-mails that are relevant to the discussions, which go to the issue of whether or not anyone at MMS knew about these issues in 2004. There are four or five e-mails. It's a brief string of e-mails.

Senator CANTWELL. OK. But we are getting those e-mails, is that correct?

Mr. DEVANEY. Yes.

Senator CANTWELL. The committee will have access to those?

Mr. DEVANEY. Yes.

Senator CANTWELL. And we can get a clarification about this issue of external e-mails between employees?

Mr. DEVANEY. I would be glad to work with you on that.

Senator CANTWELL. Thank you. Secretary Allred, do you know, since this is an ongoing investigation, do you know of any discussions, meetings, or verbal reports that aren't included in the information today that might be cover-up discussions within the organization about this issue and ways in which to take this information and package it differently for Congress?

Mr. ALLRED. Senator, I'm not aware of any discussion that would present this information any differently than what Mr. Devaney has supplied it to you with.

Senator CANTWELL. I know you haven't been on the job very long, along with the Secretary—but didn't you come onto the job and hear discussions between employees about well, this is the way we ought to present this or change what's happened or anything of that nature? You're not aware of any such e-mail? We're not going to show you an e-mail later and you're going to say, oh, I don't remember receiving that?

Mr. ALLRED. Senator, one of my problems is I can't type so you probably won't see any e-mails but no, in fact, I found just the opposite. When I came on board, I found a very high level of concern about how to fix the problem and of course, Director Burton and others were actively involved in trying to figure out how to solve this issue with the oil companies and we have discussed a lot of strategy with regard to that.

Senator CANTWELL. Help me then understand your comments that you just made here this morning about this decision in the change of these 1998, 1999 contracts being a conscious decision. Help me in understanding that.

Mr. ALLRED. Senator, in the information that Mr. Devaney has supplied to you and to us, there is indication there that there was direction to an individual who was drafting the leases that they were to remove the price threshold. So that was a definitive decision.

Senator CANTWELL. By whom?

Mr. ALLRED. That is a problem and that's probably where you need to follow up with Mr. Devaney. But my understanding is that it was one of three people. He has interviewed all three of those. I understand one of them is not capable of responding. So how that happened and for what reason, the report is not indicative of that.

Senator CANTWELL. I think that's not a $10 billion question, it's the $80 billion question this morning. So you're saying it was a conscious decision and you're saying some individual made this decision and communicated that.

Mr. ALLRED. That's my understanding.

Senator CANTWELL. And Mr. Devaney, I'm just reading your report, which Deputy Director Cruickshank is simply saying, well it was a screw up and internal miscommunication. So we're hearing from the Secretary that it was a conscious decision by an individual and we're also having a report that kind of contradicts that. To me, that's a very interesting development this morning, that your report says it was just an internal screw-up and we're having the Secretary testify here that it was a conscious decision.

Mr. DEVANEY. Let's see here if I can not add to the confusion but perhaps make something clear—clearer. When Assistant Secretary Allred states that someone deliberately told somebody to do something, that's true. But it was done in the belief that—see, the price threshold language was always contained in the previous leases in an addendum that was attached to the leases.

Senator CANTWELL. I'm very well aware that the final rule mysteriously does not refer to this and that the agency then tried to say that they were covering their bases by referring to that rule that is then absent of the price threshold language. What I want to know is who gave that direction and why did the agency continue to pretend like this wasn't costing the taxpayers $10 billion. Now, this is a very important issue for the U.S. Senate and I hope, Mr. Chairman, that we will exercise our oversight responsibilities in getting to the bottom of this. I applaud the IG and the GAO for their diligence thus far but we don't have the whole story. I appreciate Mr. Allred being honest this morning and saying that he thinks it was a conscious decision. We need to get the bottom of this and I know I'm going to run out of time, Mr. Chairman, but as somebody who has spent the last 5 years on contract sanctity as it related to Enron, I appreciate the committee's really good work and due diligence on this issue. When it came to the bottom line, we saw some regulatory capture within the Federal Energy Regulatory Commission and them interpreting the statute the way they wanted to interpret it at the benefit of those industries that they were supposed to be regulating. So I hope that's not the case here. I hope that's not the case here. But I hope that we will not be buffeted by the notion of contract sanctity and then somehow forget our responsibilities to the taxpayers of this country. We have to get to the bottom line here and we have to make sure that there is reform within this agency that it does its proper job in oversight responsibilities to the taxpayers.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Landrieu.

Senator LANDRIEU. Thank you, Mr. Chairman. I'd like to follow up by saying, as someone who's been very focused on this issue for any number of reasons for quite a long time, that obviously there is a need for reform, for revamping, for transparency to give taxpayers both in Louisiana and throughout the gulf coast that now benefit rather directly or will benefit rather directly by this royalty sharing provision as well as taxpayers everywhere that this agency can operate, it can collect the revenues that are due and support an industry that creates hundreds of thousands of jobs for this country.

And in my view, Mr. Chairman, there really is hardly an issue other than the global issue of energy and dependence and balance that is more central than this one for that purpose because when we talk about more production, it's important that we get that production done correctly, which is where to drill, how to drill and how the revenues will be divided between either the State where the drilling is or the taxpayers generally and to move forward without this being corrected and addressed is going to be very difficult.

So I, for one, am willing to spend as much time as it takes to get to the bottom of exactly what happened. Senator Cantwell is very correct and as usual, has done a very good job. It is extremely important, Mr. Chairman, for this committee, whether through an oversight function or otherwise, to get to the bottom of whether this was a decision or a mistake because that will govern which direction we can move forward.

No. 2, I understand that the three people most responsible for this—whatever it was—a mistake or a decision, was Bruce Babbitt, who was the Secretary of the Interior during this time, Bob Armstrong, who was the Assistant Secretary for Land and Minerals Management, who was responsible for overseeing that, who is now in a health condition that he is unable to testify, correct? Mr. Devaney?

Mr. DEVANEY. No, that's not a name I'm familiar with.

Senator LANDRIEU. That is not correct so he can testify?

Mr. DEVANEY. I believe he could. I don't know the man.

Senator LANDRIEU. Well, I'd like—does anybody know at this table if he can or can't testify?

[Answer inaudible.]

Senator LANDRIEU. OK. Carolita Kallaur? K A L L A U R, who was Associate Director from 1998. She is deceased.

Mr. DEVANEY. Yes.

Senator LANDRIEU. OK, so she is obviously unable to testify. Those are the three people most responsible for whatever this was, an error or a decision. Is there anyone else that is a principal that we should know about?

Mr. DEVANEY. Those are—leaving aside the individuals that are deceased. We focused our attention on three employees of the Minerals Management Service.

Senator LANDRIEU. Could you, for the record, state their names?

Mr. DEVANEY. The names are Mr. Rodi, who was the person who actually changed the language. When we asked him why he did it, he said he was told to do it by one of three people.

Senator LANDRIEU. Who were those three people?

Mr. DEVANEY. We asked him to take a polygraph exam and he passed that polygraph exam.

Senator LANDRIEU. Who were the three people though?

Mr. DEVANEY. One person by the name of Rose. If you just give a second, I'll——

Senator LANDRIEU. You can take a minute. While you're looking at that, I think it is important for the record to reflect that, Mr. Chairman. But let me step back for a minute and take a second for this committee to recognize that the revenue increases from offshore oil and gas revenues have grown in a tremendous way over time and we don't want to do anything on this committee to reverse that positive trend. It's positive for the Treasury. It's positive for domestic job creation and now because of the good work of this committee, it's a very positive development to protecting and supporting America's energy coast and just for the record, Mr. Chairman, I'm going to submit what the actual numbers are projected to be between 2006 and 2016 but I'm also going to go back to the 1950's when this program started, in 1954, when the first offshore lease sale was done, I believe, in the mid-fifties and show to the country that this is a substantial increase.

ESTIMATED YEARLY RECEIPTS FROM THE OUTER CONTINENTAL SHELF

2006: $7.575 billion	2012: $9.425 billion
2007: $8.875 billion	2013: $10.975 billion
2008: $10.125 billion	2014: $10.825 billion
2009: $9.775 billion	2015: $10.850 billion
2010: $9.975 billion	2016: $11.175 billion
2011: $10.075 billion	

Source: Congressional Budget Office 1/30/06.

Senator LANDRIEU. No. 2, the 1995 Act that Senator Bennett Johnson, Chairman of this committee and our predecessor passed—one of its purposes—the Senator from Oregon should know and the Senator from Washington wasn't to diminish revenues to the Treasury but to increase revenues to the Treasury. That 1995 Deep Water Relief Act was drafted specifically to increase economic production and to generate more royalties, not less.

So I know for a fact that the principle author of this legislation had it as his intention and I'm sure if he would have been asked to testify, would tell you the same thing I'm testifying to you. It wasn't to get less revenues for the Treasury but more. And if it operates correctly, Mr. Chairman, that's exactly what will happen, which is going to be a great benefit for everyone.

Oil companies and gas companies drill more, the public gets more money so we can lower taxes if we wish or invest in education or highways and now because of the act that this committee took, the gulf coast, the energy coast that produces 100 percent of these revenues—they are not produced off the western coast, Mr. Chairman, and they are not produced off the eastern coast, Mr. Chairman and they're not produced in the Interior. They are produced in the Gulf of Mexico. So the gulf coast States have as much interest in getting this straight as anyone and I think this committee should hold as many hearings as possible until we determine, was it a mistake or was it a decision because then we can move forward so we don't get caught up in court for the next 10 years, recover the money that is owed, reform an agency, produce transparency, and allow an industry that can do good work and does good work, continue to do good work for America.

I hope—my final point is—as people are so anxious to wield these huge clubs, that we don't wield the club so huge that we hit our own self in the head by doing it and this is not that complicated, frankly, with the right information. So Mr. Chairman, I thank you for that and I will finally say one thing, if the committee will indulge me. I don't mind holding the people responsible accountable and I'd like to read again that it was the Secretary, former Secretary Bruce Babbitt, where this error occurred and his staff and whoever was in the Department. But for current people to be held liable for what happened in 1998—now they are, for not correcting it and we'll see, then fine. But please, let's direct our anger on the people responsible for when this occurred. Thank you.

The CHAIRMAN. Let me just clarify. I think there is a lot of confusion about the testimony we've had here. When a contract is entered into, it involves, presumably a meeting of the minds, an agreement between the two parties as to what is contained in the contract. From the Government's perspective, as I understand your testimony, Mr. Devaney, you say this was a bureaucratic mistake. You're saying that these lease thresholds or price thresholds were left out, consciously left out, based on a mistaken belief that the price thresholds were otherwise provided for in statute or regulation. Am I right?

Mr. DEVANEY. Yes.

The CHAIRMAN. So there was no decision by the Government to enter into a lease that did not contain price thresholds. They believed that the legal effect of the lease was to continue to have price thresholds?

Mr. DEVANEY. That is the conclusion we draw from our investigations.

The CHAIRMAN. So there was no conscious decision to enter into a lease that was very different from the previous leases or than was very different from the subsequent leases on the part of the Government?

Mr. DEVANEY. We found no evidence of that.

The CHAIRMAN. On the part of the companies, do we have any reason to believe that they understood that they were getting away with not having to pay any royalty ever, to the Government on the production from these leases? I assume that they were ignorant as well at the time these leases were signed. Do you have any reason to believe otherwise, Mr. Devaney?

Mr. DEVANEY. I think actually it was the companies themselves that brought the mistake to the attention of MMS in both 2000 and

2004. There were still companies that were involved in these leases that were expressing to MMS, could you clarify it for us? Did you really mean this? And those questions were being directed to folks in sort of the lower levels of MMS and the issue bubbled up, both in 2000 and 2004 because of those inquiries.

The CHAIRMAN. So the companies were coming forward and saying, you know, this has come to our attention here. It hadn't come to our attention before but it now has, that these leases are different than the ones that we previously entered into and maybe could you clarify what the deal is here. Is that basically what happened?

Mr. DEVANEY. Well, it's difficult to understand what their motivation for asking the question was, but it is true that during the course of our investigation, we found evidence that they were asking that question.

The CHAIRMAN. And in the bidding on these leases, as I understand the way this process works, when leases are let, companies come in and bid and give a bonus bid to get the lease. Is there any evidence that people were willing to bid more for these leases because these leases were written in such a way that companies were never going to have to pay any royalty and that was a great boom to them?

Mr. DEVANEY. That certainly was not uncovered during our investigation, no.

The CHAIRMAN. All right. Well, I guess at least from what I take from your statement, this was a mistake. It was a bureaucratic mistake. It was a mistake in what wound up in the language that was operative on the leases, and it seems to me that in light of that, we need to try to get it corrected. I mean, the companies didn't understand that they were getting away without having to pay royalties. The Government didn't understand that they were entering into leases that didn't require payment of royalty, regardless of the price of oil or gas and it seems to me, we ought to get it corrected and companies ought to be willing to come in and agree to re-negotiate these leases to get a reasonable royalty to the taxpayers of this country. I think that's the best result.

Now if that result isn't possible, then obviously we need to look at alternatives, legislative alternatives to get the problem fixed. But I would hope that we would have more companies willing to step up and be willing to recognize and acknowledge that a mistake was made here and that they should not take unfair advantage of that, as they have been taking for some period of time here.

Let me also just clarify, Mr. Devaney, I think you said that your investigation indicated that the decisions about this were made by the individuals involved and that there was no communication to higher officials in the Department about the issue, since there was no decision made not to include these price thresholds. Obviously, that wasn't communicated. But the fact of the mistake was not communicated either, to higher officials until 2000, is that what I'm informed?

Mr. DEVANEY. Even in 2000, the mistake, when it was uncovered by a lower level MMS employee, it was communicated to the individual mentioned earlier who is now deceased and we, of course, would have liked to have asked her why she decided, apparently, not to communicate that to the Assistant Secretary level.

The CHAIRMAN. She did not communicate that to Mr. Armstrong or to Mr. Babbitt or anybody else in the Department?

Mr. DEVANEY. No.

The CHAIRMAN. Let me just ask about this chart. Mr. Allred, I understand your good faith and your concern about potential downside risks to the Government of sort of forcing this issue or enacting something that would wind us up in court. But there is a very substantial financial incentive for these companies to want to see leasing continue in the gulf coast. I mean, we just had quite a debate last fall and there are a lot of people walking the halls up here, lobbying in favor of additional leasing in the gulf coast.

So as I understand it—I'll give you a chance to respond here, but I hope you're not saying that we should not insist on fairness for the taxpayer because to do so or to be too heavy-handed in it would run the risk that industry would go to court to prohibit additional leasing from occurring. It doesn't sound credible to me that it is in the interest of industry to prohibit additional leasing from occurring.

Mr. ALLRED. Mr. Chairman, my concern is not what we do. I believe we have to take action and I think Congress has a real role in that action. The only thing I'm urging is to think that through very carefully so that we minimize the possibility of being enjoined from doing leasing. I could—if you would like me to, I can lay out for you the scenario that has me concerned and that is, where a company would be prohibited from bidding and then because they were prohibited from bidding, it might be in their interest to delay the bidding process until they could have that resolved. And that is the action that I'm concerned about that could result in a significant delay in the development of the oil resources, an actual reduction in production and the delay of income to the U.S. Government.

I think there are many ways to do this and my concern in bringing this forward is just to illustrate that we have to make sure that we think through unintended consequences of an action and as I said before, I pledge to this committee to work with you and your staff to make sure that we consider what we do so that we avoid unintended consequences. I believe there is a real role for this committee to play.

The CHAIRMAN. Thank you very much.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. And Mr. Chairman, let me just say, as the incoming chair of the Subcommittee on Public Lands, it's my intent to work very closely with you to follow up on this and to work with all of our colleagues on a bipartisan basis because obviously we've got a number of outstanding issues.

I want to follow up on something also, to state in the clarification of business. We've had a lot of discussion back and forth about whether the central problem stemmed from a decision or a mistake. That is sort of how it was framed. I want to be very clear, Mr. Devaney. I want you to confirm something. This was not a one-time occurrence involving one lease. As far as I can tell, this involved hundreds of leases. Is that correct?

Mr. DEVANEY. I think there were over a thousand leases involved in this.

Senator WYDEN. All right, because we've now framed this as if we've got to get out and find one person who said—one instance that there was a mistake or a conscious decision but what we have, in my view, is an incredible pattern here, a pattern of incompetence and I believe, conflict of interest.

Let me, if I might, with you, Mr. Allred, go through something else that I find disquieting about what is happening right now. As you know, there have been a number of auditors with the agency, MMS, that have filed False Claim Act cases—at least two different courts of appeals, including the 10th Circuit where these auditors live and are pursing their cases, have held that the auditors—that the Federal employees have legal standing to file these claims under the False Claims Act. And other whistle-blower protection statutes may also come into play but let me tell you what I'm very troubled about this.

I've got a copy of an e-mail that was sent on January 9 of this year—this is an MMS e-mail asking for the sign-up sheets for any and all mandatory training courses taken by these three auditors in 2004, 2005 and 2006. Mr. Chairman, I ask your consent that this e-mail be made part of the record.

The CHAIRMAN. We'll include it in the record.

[The e-mail referred to follows:]

From: Sawicki, Michelle
Sent: Tuesday, January 09, 2007 2:06 PM
To: Ohadi, Pauline
Cc: Gilmore, Holly-Jean; Fields, Gary; Johnson, Ralph; Tyler, Paul
Subject: Documentation request
Importance: High

Debbie Gibbs Tschudy has asked for sign-in sheets for any and all mandatory courses (i.e. Ethics, FOIA, Privacy Act, Fraud, IT Security Awareness, Illegal Acts, etc.) taken by Randy Little, Joel Arnold and Lannis Morris during 2004, 2005 and 2006.

I am having Jeryl pull any sign-in sheets we may have for courses entered into the MRM Training Database. I will let you know if there are any we cannot find.

During the 03/04 CPE cycle each office had differing opinions on entering courses that did not carry CPE into the MRM Training DB. So, our dilemma is that many of the mandatory courses were not entered into the MRM Training DB. Therefore, we do not have record of those employees attending the mandatory training. We need for you to provide any sign-in sheets for those courses to Gary Fields no later than noon on Thursday January 11th.

Holly-Jean told me that the 05/06 training files are in Houston. If there are any sign-in sheets that we need during that time frame, we will have to have Holly-Jean get those for us.

Thanks for your cooperation on this in such a quick turn around time.

Paul, if you are not Pauline's supervisor, please forward to the appropriate person.

If you have any questions or need anything from me, please let me know.

Michelle

Senator WYDEN. My question, Mr. Allred, because I'm concerned about the climate of making sure that these whistle-blowers, who've told us an awful lot about what is actually going on there, that this climate does not degenerate further and that whistleblowers will come forward. So my question is, why are the managers at the Mineral Management Service checking the training records for just these three employees? It sure looks to me like this is not a kind of coincidence. If it's a program, you look at a lot of people, but what the e-mail shows is that it's just these three people. Do you find that troubling? Do you have any explanation? What message would you like to send today with respect to whistle blowing at the Department?

Mr. ALLRED. Senator, I'm not familiar with that e-mail but I can tell you, I will not allow any retribution against these people. I do not approve of what these people have done. It appears to me it's to their own benefit. But they still have that right and I will just not stand for reprisals against them. The responsible agency for investing what's going on is the Inspector General and that is where these sorts of questions and investigations should take place.

I can assure that—and now that I am aware of that, I will find out what's going on and I will not allow any retribution against these or any other people.

Senator WYDEN. Pretty hard, Mr. Allred, to see it as a coincidence, that nobody else's records get tracked except these three courageous public servants who watched, year after year, as the taxpayer got fleeced. These were the only three who have their records tracked. Wouldn't you say that's a little unusual?

Mr. ALLRED. Senator, again I don't know the circumstances. The first time I've heard about this is when you asked it. I would hope that you will reserve judgment on the claims that those people have made until the Inspector General has investigated it and reported it. I am aware, there are a number of circumstances that would raise questions about some of the statements they have made. But I will not allow any retribution against anybody like that.

Senator WYDEN. I understand the controversy that surrounds some of their claims, but we do know that a number of non-partisan officials, people who have no partisan bias on this, have been willing to step forward at considerable risk to their careers. Now they're the ones who are having their sign-up sheets pulled and apparently nobody else and that again, strikes me as hard to accept as coincidence.

Let me wrap up with you, Mr. Devaney and again, just commend you as my colleagues have, for your comments. It really strikes me that even today, at the heart of this, the Government is taking the oil companies' word with a program like this. Where it is clear we are going to be out several billions of dollars and it may even be $80 billion and I would tell my very good friend from Louisiana who I admire greatly, we all understand this program began when the price of oil was $19 a barrel.

When I was on the floor, trying to get a vote to make some changes, the price of oil was $72 a barrel. So we very much want the people of Louisiana to be productive and contributing to our energy security, but we have a program where it is now on the record that the taxpayers have been fleeced and it has not happened once. There hasn't been just one "mistake" or one "decision." It involved hundreds of leases and as we wrap up this morning, after Chairman Bingaman's thorough and commendable hearing, we are left with the fact that today, by Mr. Devaney's words, we've got an honor system.

I asked you about the oil companies, essentially being able to have the Government sign off on their figures. Your words were, we have an honor system. I just don't think that's good enough and Mr. Chairman, I want to say again that as chair of the Subcommittee on Public Lands, I'm going to work very closely with you and with Senator Domenici and all our colleagues as we follow up today.

The CHAIRMAN. Thank you very much.

Senator Cantwell, did you have additional questions?

Senator CANTWELL. I did, Mr. Chairman but I will be brief. I just wanted to ask of the Secretary about a report that they commissioned in 2003 that over a 40 year period, the current incentive program would lead to the discovery of only 1.1 percent more oil reserves than if there was no system of royalty relief at all. Are you familiar with that report?

Mr. ALLRED. I'm aware of the report but I have not had the opportunity to study it. Understand that again, I have not seen the thing, other than I am aware of some news reports of another study that was done like that.

Senator CANTWELL. But this, I think, was your own agency saying that it is—basically giving us a 1.1 percent return.

Mr. ALLRED. I just—I could not intelligently comment on that report. I would be glad to visit with you after I've had a chance to look at it.

Senator CANTWELL. And second, if we had not seen or if the *New York Times* had not run this article, would—and your testimony today is that it was a conscious decision—would anything have changed if we hadn't seen anything in the newspaper?

Mr. ALLRED. Senator, it's hard to speculate on what would have happened in the agency. When I came into the agency, management did know about it and so I don't know what might have happened in the previous times. I can tell you that the current management, the Secretary and I take this very seriously.

Senator CANTWELL. But in the context of you saying earlier there was a conscious decision and then they knew about it. If it hadn't been in the newspaper then maybe the policy would have continued beyond 1998.

Mr. ALLRED. Senator, obviously somebody discovered the discrepancy in 2000 because the leases after 2000 all contained the price thresholds.

Senator CANTWELL. But as Senator Wyden was talking about, within this time period, there were still thousands of leases that haven't been acted on. So I think we're getting maybe like 20 percent of the revenue that you might end up getting from these. I mean, we've only fixed 20 percent of the problem, is my point, as it relates to these thousand-plus leases. We still need to come back and fix that.

My last question—the President opposes the House legislation that is moving through as a proposed solution to this problem. Could you be specific about why the administration opposes that legislation?

Mr. ALLRED. I'm aware that there is a statement that the administration has drafted. I don't know that it has gone forward, and I would not be capable of intelligently briefing you on that.

Senator CANTWELL. Well, it too, is in the press, along with these other things so if we could get the Secretary to respond to whether the proposals being put forth by the House—my guess is, will probably pass overwhelmingly, what specific provisions of those changes the administration doesn't support. That would be very helpful. Thank you.

The CHAIRMAN. Senator Landrieu, did you have additional questions?

Senator LANDRIEU. Just to clarify a few things because I want to talk for a second and clarify this pattern issue and the quantity of the leases in question, because again, I think it is very important that we focus to find this solution and not run down rabbit holes.

Can somebody on the panel—maybe Mr. Allred, you would be the best one, explain how many leases are usually entered into in these 5-year trenches. Now this has been going on almost every 5 years since the 1950's and there is a big difference, Mr. Chairman, whether this is a pattern over time, from the 1950's to the present or whether it is an aberration or a terrible mistake or whatever, a change in that pattern starting in the lease sale that we're speaking about. Mr. Allred, could you add? How many leases are, on average, leased in a 5-year period?

Mr. ALLRED. Well, Senator in a typical——

Senator LANDRIEU. Or in a lease sale?

Mr. ALLRED. In a lease sale, there could be as many as 600 leases.

Senator LANDRIEU. Lease sales occur twice a year?

Mr. ALLRED. Yes. In the new 5-year program, for example, there would be 21 lease sales in that 5-year period. Perhaps just for some comparison purposes, we currently have some 20—almost 28,000 leases that we deal with—over 8,000 on the OCS—and of course, those rotate as they come back in and we put them out in new lease sales.

Senator LANDRIEU. But what you're saying is in the next 5 year lease sale, there are going to be 21 lease sales in 5 years so that's about 4 lease sales per year. And in each one of those lease sales, there are approximately how many?

Mr. ALLRED. Well, we haven't defined that yet. We do it at the time of the sale but typically you might look at 600 leases in a sale.

Senator LANDRIEU. Okay but out of those 600, like in this instance, how many were actually active in terms of actually producing out of those 600? In these leases in question, in this particular lot?

Mr. ALLRED. If we look at the 1998 and 1999, which is where I have some information, there originally were 1,032 leases. Five hundred and seventy of them are still in force, being actively developed by 45 companies. Of those, 19 are producing.

Senator LANDRIEU. So Mr. Chairman, it's important for the record that we understand that it's been 19 producing leases that we have to focus on in terms of contracts entered into where royalties are not being collected and what that revenue stream might be and then focus on the other several hundred that are "active," which I don't have time now but I'm going to get into some specifics about what that term actually means because prospectively, Mr. Chairman, if a lease is not being drilled and it is not active, it is released.

So in other words, we can correct prospectively this quite easily. It's the issue of the leases that are now producing under this faulty or bad decision contracts that if we could focus on, we could resolve this in a way that continues to produce money for the Treasury, relief to the gulf coast, and jobs for the taxpayers and that is what I'm hoping the bottom line here will be, instead of us either trying to whatever—beat up on oil companies or beat up on the Government or beat up—I mean, that can be done. I hope it's not done in a way that prevents us from actually solving the taxpayer problem right now. Thank you.

The CHAIRMAN. Thank you very much. Thank you to the witnesses for all of your time and good testimony. I think this has been helpful. In case there are members who came or who were not able to come who have questions, we'd ask that they provide those in writing by the end of business tomorrow and then we would ask sometime in the next couple of weeks, if you could respond to those in case there are written questions.

Thank you again and that will end the hearing.

[Whereupon, at 12:02 p.m., the hearing was adjourned.]

APPENDIX

Responses to Additional Questions

DEPARTMENT OF THE INTERIOR,
OFFICE OF INSPECTOR GENERAL,
Washington, DC, February 6, 2007.

Hon. JEFF BINGAMAN,
Chairman, U.S. Senate, Committee on Energy and Natural Resources, Washington, DC.

DEAR SENATOR BINGAMAN: With this letter, I am transmitting my written responses to questions submitted by you and members of the Committee following my testimony on January 18, 2007 on issues relating to oil and gas royalty management at the Department of the Interior.

I respectfully request that my written responses be included in the record. If you have any additional questions or concerns, please do not hesitate to contact me at (202) 208-5745, or your staff may contact Associate Inspector General for External Affairs, Kris Kolesnik, at (202) 513-0326.

Sincerely,

EARL E. DEVANEY,
Inspector General.

[Enclosure.]

Responses to Questions From Senator Bingaman

Question 1. Pending Work—Turning to the royalty management issues, could you please describe the additional work and related investigations that you have pending? When do you expect this work to be completed?

Answer. The additional investigations related to royalty management issues presently underway involve the outstanding *Qui Tam* cases, and several criminal investigations. My investigative staff is working hard to conclude each of these matters as expeditiously as possible. Given the recent verdict in the *Qui Tam* case against Kerr-McGee, however, we must evaluate the impact that the verdict might have on our *Qui Tam* investigation which will undoubtedly extend the time it takes for us to conclude the matter. As for the criminal investigations, I am hesitant to estimate when our work will be completed, as additional investigation is often requested by the Department of Justice in criminal matters.

Question 2. Management Issues—Your testimony makes reference to a "surname-process which dilutes responsibility and accountability." Could you please elaborate and explain how this may have played into the royalty price threshold problem?

Answer. The surname process that I referred to in my testimony is a review process that requires the reviewers to sign their surname on a form, indicating their approval or assent to forwarding the document in question to the next reviewer. We have found that in many instances, an excessive number of people are expected to review and surname a document. This, in my view, spreads responsibility for the accuracy and appropriateness of a document among too many people, leaving no one ultimately responsible. In the royalty price threshold matter, signatories to the surname process told us they signed off without thorough review, in reliance upon staff that reviewed and surnamed before them. This dilutes responsibility further, and undermines the very purpose of the surname process.

Question 3. Ongoing Price Threshold Issues—Your report on the OCS lease price threshold problem identifies e-mail from last year that indicates some ongoing confusion in the MMS with respect to implementation of price thresholds for royalty relief provisions enacted as part of the Energy Policy Act of 2005. Is this correct? What should be done to address this?

Answer. An e-mail from a lower level MMS employee was found seeking guidance regarding application of price thresholds in lease sales that were pending at the time. We feel that this e-mail is a symptom of a much bigger organizational issue regarding communication and policy documentation. To address this one issue, immediate policy must be developed and disseminated to all MMS and SOL individuals involved with the lease process. Once developed and disseminated, the policy must be memorialized for future reference.

Question 4. Audit and Compliance Action Plan—With respect to your report last month on the audit anti compliance review process (December 2006, "Minerals Management Service's Compliance Review Process," Report No. C-IN-MMS-0006-2006), I understand that MMS has committed to preparing an action plan to address your recommendations. How will you track MMS's implementation of this plan?

Answer. We will track the recommendations in accordance with Office of Management and Budget Circular No. A-50, *Audit Followup,* and the Department of the Interior's implementing regulations. In its response to the final audit report, MMS provided an action plan for implementing all of our recommendations. We have forwarded that action plan to the Department's Assistant Secretary for Policy, Management and Budget (PMB) for tracking of implementation. PMB maintains the inventory of open recommendations and is responsible for ensuring that recommendations are implemented before they are closed. After PMB notifies us that all of the recommendations from this audit report have been closed, we will conduct a verification review to ensure that the recommendations have actually been implemented.

Question 4a. In your view, what are the key reforms on which this Committee should focus to ensure substantial improvements are made in the agency's existing compliance review system?

Answer. Our report provides three recommendations for 1) improving data reliability, 2) improving the compliance review process, and 3) revising performance measures to better reflect program operations. We believe that these are the three key reforms on which the Committee should focus.

- Improving Data Reliability: MMS needs to develop and implement a plan to provide reliable data for managing and reporting on its compliance activities. Until this is accomplished, MMS cannot:
  - —effectively use existing systems for day-to-day management and reporting purposes;
  - —develop an effective strategy for deploying personnel and other resources between audits and compliance reviews;
  - —provide accurate information on program operations and results to stakeholders, including the Congress and state and tribal audit organizations; and
  - —determine the true costs and benefits of compliance reviews and audits.
- Improving the Compliance Review Process: Our report identifies numerous improvements that MMS can make to its compliance review process. Most importantly, MMS needs to develop risk-based criteria for selecting companies for audits and compliance reviews. MMS also needs to strengthen its procedures for verifying volumes and allowances reported by companies.
- Revising Performance Measures: We found that the performance measures used by MMS to manage and report on its operations were either unreliable or misleading. MMS needs to revise its performance measures to better reflect the program operations and allow stakeholders, including the Congress, to assess MMS' performance.

Question 5. Audits and Impacts on States and Tribes—Are the shortcomings that you have identified in the audit and compliance review process impacting revenues owing to states and tribes? If so, do you have estimates of the magnitude of the impacts? What recommendations do you make to avoid this?

Answer. The issues that we identified could be impacting royalty revenue to states and tribes because the issues prevent MMS from maximizing the outcome of its compliance program; however, we cannot estimate the magnitude of any potential impact. Because MMS lacks quality data, it cannot develop an effective strategy for deploying resources and cannot determine the true costs and benefits of compliance reviews and audits. Our report identifies improvements that, if implemented, could ultimately result in MMS identifying and collecting additional royalties. States and tribes would share in any additional collections resulting from improved compliance reviews. Additionally, the ability of states and tribes to conduct compliance reviews is hindered because they do not have full access to MMS' automated tools.

Unfortunately, there is no way to estimate additional royalties that might be collected as a result of more effective strategies and improved compliance reviews. MMS lacks the quality data needed to make such estimates. Ultimately, collection of any additional royalties would depend on 1) the amount of royalties underreported by companies and 2) MMS' ability to identify those additional royalties through its audit and compliance reviews.

Question 6. Incomplete Data—Regarding your finding that MMS' compliance review process relies on four separate databases, which in turn contain unreliable, incomplete and inconsistent information: what do you believe would be a reasonable timeline, enabling the MMS to correct its system's biggest flaws?

Answer. MMS' action plan indicates that it will complete implementation of our recommendation concerning data reliability by September 2007. This is an aggressive schedule, but reasonable if MMS focuses its attention and resources on the implementation of this recommendation.

Question 7. Compliance Review Actions Plan Implementation—flow will you track implementation of the MMS action plan for compliance with the recommendations of your December 2006 audit of the compliance review and audit process? In your view, what are the key reforms that this Committee should focus on, to ensure substantial improvements are made in the agency's existing compliance review system?

Answer. We will track the recommendations in accordance with Office of Management and Budget Circular No. A-50, *Audit Followup,* and the Department of the Interior's implementing regulations.

Our report provides three recommendations for 1) improving data reliability, 2) improving the compliance review process, and 3) revising performance measures to better reflect program operations. We believe that these are the three key reforms on which the Committee should focus. Once MMS addresses these issues, it will be able to better develop and implement effective strategies for ensuring company compliance with royalty regulations. MMS should periodically evaluate and monitor the effectiveness of its strategies and recalibrate them to improve its overall performance goals under the Government Performance and Results Act.

Question 8. Variance Thresholds—I was troubled by your conclusion in the December 2006 report that MMS cannot adequately explain its rationale or methodology for establishing acceptable "variance thresholds" between the revenues MMS expects to receive, and the royalty obligations a company reports to the agency.

What are your suggestions for how the agency might best revisit its methodology for establishing these thresholds, in a way that would provide more clarity and consistency?

Answer. We support MMS' use of thresholds in the compliance review process. Compliance review procedures calculate the expected royalties from a company based on available data and then compare the expected royalties to the royalties actually reported. These procedures are less precise than audit procedures; therefore, MMS needs to establish thresholds for when variances between the expected royalties and reported royalties are unreasonable and should be pursued in more depth. Where to set that threshold is a matter of professional judgment which should primarily be based on an analysis of costs and benefits of the additional procedures MMS would undertake to pursue the issue. If a threshold is too high, MMS risks loss of significant additional royalties. If a threshold is too low, MMS risks spending more resources pursuing the matter than it will ultimately collect in additional royalties.

While we agree with the use of thresholds, we were concerned that MMS had not documented its rationale or methodology for the thresholds that it had established. We found that the thresholds separately set by each of the program components differed significantly. For example, one component applied both a monthly and an annual limit, one component applied only an annual limit, and one component simply used "professional judgment" on an individual case basis. While we understand that thresholds may differ among the components, MMS should document how each was derived and why it is reasonable for them to differ. We also concluded that the threshold at one component was set so high that significant underpaid royalties may not be collected. No matter how the thresholds are derived, MMS should have the methodology clearly documented in writing to provide uniform guidance to all of the components.

In addition to costs and benefits, MMS should incorporate elements of risk into its establishment of thresholds. For example, if MMS has evidence that a company has underreported royalties in the past or has misreported information to other federal agencies, then MMS might lower the threshold for that company. A lower threshold might be warranted in this high risk situation because there is a greater likelihood of underreported royalties, a greater likelihood of additional collections, and the additional procedures could provide a deterrent for the company to underreport in the future.

MMS agreed with our conclusion and has indicated that it will revise its thresholds for pursuing underpayments. As part of this process, it will incorporate an analysis of costs and benefits to determine at what level it makes sense to pursue an underpayment. MMS' action plan indicated that this will be accomplished by December 2007. As MMS addresses its data reliability issues, it will have better data on the costs and benefits of audits and compliance reviews. This data should allow MMS to periodically reassess its thresholds and make changes in the future as necessary. Additionally, since states and tribes participate in compliance activities and are affected by their outcome, MMS should consult with them in establishing future thresholds.

Question 9. Qui Tam Cases—You noted in your audit that while MMS reported $699 million in collections from compliance activities from October 1999 to March 2006, about $134 million—or 19 percent of the total—actually resulted from *qui tam* royalty settlements, which were initiated when individual citizens file claims with the Department of Justice under the federal False Claims Act.

Please elaborate on your rational for recommending that collections resulting from *qui tam* cases be excluded from MMS' calculation of revenues claimed by its compliance review program.

Answer. Because collections resulting from *Qui Tam* cases do not originate from activity initiated by MMS' Compliance and Asset Management (CAM) Program, we believe that the inclusion of collections resulting from *Qui Tams* distorts the results of CAM's efforts.

Qui Tam collections are a result of lawsuits filed by individuals on behalf of the government to collect underpayments. These are generally cases where an underpayment has been identified and pursued by someone outside of MMS. Collections from these *Qui Tam* lawsuits do not result directly from MMS' audits and compliance reviews and should therefore not be considered as part of the benefits of the program.

MMS points out that, in some cases, it provides support for the *Qui Tam* lawsuits. While we agree and can support tracking of *Qui Tam* collections, we don't believe those collections should be included in the analysis of costs and benefits of the compliance program. Collections from *Qui Tam* lawsuits depend primarily on the number of *Qui Tams* that are filed and the time it takes for those lawsuits to be settled. Including those collections in the cost/benefit analysis skews the benefits of the program and makes it difficult to compare benefits of the program from one year to another. It also does not aid in developing strategies for conducting MMS' audits and compliance reviews.

I understand you are continuing to investigate allegations surrounding the most recent batch of *qui tam* cases, filed by a group of current or former MMS auditors, Please give the Committee an idea about the scope and timeline of this ongoing investigation.

Answer. The primary scope of our on-going investigation regarding the *Qui Tams* includes:

- Allegations raised by Relators,
- MMS response to allegations,
- Whether Relators followed DOI/MMS policy on disclosing allegations,
- Did MMS retaliate in any manner against Relators.

We have also received additional allegations from the Relators some of which will be incorporated into the current investigation; others may result in additional, separate investigations. The investigation is targeted to be complete by early spring.

Responses to Questions From Senator Domenici

Question 1. Attachment 56 of the Price Threshold Report of Investigation (the "Report") has a time line relating to 3/15/04, but the page 18 and 19 account of this event discussed within is far from definitive. Please provide the material that demonstrates the assertion made in the timeline.

Answer. The timeline contains a typographical error. The entry referring to 3/15/04 states the following: "*Director* of MMS makes formal decision that price thresholds will not apply to leases issued in 1998 & 1999." The entry should have stated, "*Directorate* of MMS makes formal decision that price thresholds will not apply to leases issued in 1998 & 1999." (emphasis added)

Question 2. Please clarify specifically who you are referring to in your testimony when you refer to a, "cavalier attitude" at MMS? Is this a reference to the current Director of MMS?

Answer. When I referred to the "cavalier attitude" associated with the price threshold omission, I did not intend to disparage Johnnie Burton herself by my comments. In my testimony, both written and spoken, I was referring to virtually everyone involved in this debacle, to include Ms. Burton, but particularly those who in 2000 knew of the price threshold omission and failed to bring it to the Director's attention, as well as those who raised the issue in 2004 through a series of e-mails and, apparently, through oral discourse which was referenced in the e-mails.

While Johnnie Burton has told us that she has no independent recollection of being told about the issue in 2004, she readily conceded that the e-mails we presented to her suggested otherwise. She went on to speculate what her thinking may have been nearly 3 years ago. Neither I nor my investigators found reason to question Ms. Burton's veracity about this issue.

I have known Johnnie Burton for nearly 5 years, and have found her to be forthright and responsible. She is one of the very few bureau directors in this Department who has made an effort to meet with me on a regular basis. She has also been, perhaps, the most responsive of the bureau directors to Office of Inspector General (OIG) findings and recommendations. I have never had a reason to question her integrity.

Question 3. Please provide any conclusive evidence that the current Director of the Minerals Management Service (MMS) knew of the price threshold omissions of 1998/1999 in 2004? Do you feel that you should clarify the record to reflect that e-mails between and among MMS employees regarding this issue in 2004 did not include messages sent directly to the current Director?

Answer. The only evidence we have to suggest that the current Director of MMS knew of the price threshold omissions in 2004 is the series of e-mails and personal recollections we identified in the report. None of these e-mails was sent directly to the current Director.

Question 4. Upon all evidence available as to when the current MMS Director knew of the missing price thresholds, what specific legal steps could the Director have taken to include price thresholds in the 1998 and 1999 leases?

Answer. Recognizing that I am armed with the benefit of hindsight, I believe that Ms. Burton should have conducted a much more thorough vetting, including a formal documented decision, for an issue of such enormous financial magnitude, although the end result may have been the same in 2004 as today. The informal and cavalier manner in which this matter was communicated by career staff from MMS and the Solicitor's office, however, did not serve Ms. Burton—or the previous MMS Directors—well.

Question 5. Please explain why the Report refers to certain individual Department of the Interior officials by name and position, while identifying other individuals by position only. Similarly, please explain why the Report does not identify by name political appointees serving at the Department of the Interior during the time of the issued leases which are the subject of the Report while identifying current political appointees by name.

Answer. Two versions of the Report of Investigation were provided to the Committee—an unredacted version which contained the names of all individuals interviewed, as well as all attachments, and a redacted version which was prepared for public dissemination which did not include attachments or the names of certain individuals, including the former Directors of MMS. The practice of my office is to issue a public version of high-profile reports which protects the personal privacy interests of those individuals whose identity warrants protection pursuant to the balancing of personal privacy interest against public disclosure, as required by the Freedom of Information and Privacy Acts. In this case, we concluded that the identities of the former Directors who have since left public service and who were not advised of the omission during their tenure, should be protected. They are, however, identified by name in the unredacted version of the report that was provided only to the Department and the Committee.

Question 6. In your testimony before the Committee, you stated that, "there is blame enough to go around." However, would you acknowledge that the Report fails to determine who is ultimately responsible for omitting price thresholds on the leases issued in 1998 and 1999 and who is responsible for the failure to address this issue when first discovered (as shown by the Report's evidence in 2000)?

Answer. While I continue to believe that there is blame enough to go around, I agree that our investigation and the resulting report fails to identify precisely who was ultimately responsible for omitting price thresholds on the leases issued in 1998 and 1999. I believe our report does, however, identify the individual responsible for the decision not to address the discovery in 2000. Unfortunately, that person is deceased.

Question 7. In your judgment, who told Mr. Rodi to omit price thresholds from the 1998 and 1999 leases in question? Why was Mr. Rodi given this directive?

Answer. While I have no reason to believe that Mr. Rodi changed the language in the lease documents unilaterally, our investigation was unable to definitively discern who gave Mr. Rodi this direction. Because we could not identify precisely who gave this direction, however, and we could not find a paper trail to support this decision, we are left to speculate as to why.

Question 8. In the Report, there are references to several interviews. Are these interviews transcribed? And, if so, is the record of these interviews made available? Are these interviews performed under oath?

Answer. The interviews we conducted were neither transcribed nor performed under oath. Investigative Activity Reports documenting the interviews were included in the unredacted Report of Investigation as Attachments. In the case of four witnesses, we asked that they prepare written statements that they then signed under oath. These are also included as Attachments to the unredacted Report.

Question 9. In as complete a manner as possible, please identify all employees of the Department of the Interior employed at any period of time between January 1993 and January 2007 who participated in any manner, (and specify the individual's title, office, role and level of participation) in the following:

- The drilling of the Deepwater Royalty Relief Act of 1995 (DWRRA).
- The consideration of the Statement of Administration Position of the DWRRA.
- The consideration and/or drafting of any rules and/or regulations implementing the DWRRA.
- The consideration, preparation and approval process of any oil and gas leases issued between the years 1995 and 2001. Please specify the leases and employees.
- The preparation for and participation in public meeting held in Louisiana on March 12 and March 13, 1996 referenced on page 5 of the Report.
- The phone conversation and subsequent discussions relating to the phone conversation involving Mr. John Rodi referenced on page 7 and page 8 of your report.
- The 1998 APPL Committee meeting referenced on page 14 in your report.
- The consideration and approval of all Proposed Notice of Sales Final Notice of Sales from January 1, 1997 to January 1, 2001, including those individuals participating in the surname process.
- The decision to exclude addenda incorporating royalty relief restrictions in the first instance on 1998 leases referenced on page 8 of the Report.
- The decision in the first instance to include an addendum on leases issued in 2000.

Answer. Much of the information requested here goes beyond the scope of our investigation. To the extent our investigation addressed these issues, they are contained in our report and the attachments. Most of this information could be best provided by MMS.

Question 10. To the best of your knowledge, please identify all communications between the Office of Inspector General and the *New York Times* between January 1, 2007 and January 7, 2007.

Answer. The Office of Inspector General had no communications with the *New York Times* between January 1, 2007 and January 7, 2007.

Question 11. Under the byline dated January 16, 2007 Edmund Andrews of the *New York Times* wrote the following, in reference to MMS Director Johnnie Burton, "A top official was told nearly three years ago about a legal blunder that allowed drilling companies to avoid billions of dollars in payments for oil and gas pumped from publicly owned waters, a report by the department's chief independent investigator has found." Is this statement accurate in its entirety? Is this statement an accurate reflection of your thoughts or the Report findings? If this statement is not accurate, please elaborate specifically on how it conflicts with the findings of the Report.

Answer. The statement in the January 16, 2007 *New York Times* article was more conclusory than our report was. In this regard, I reiterate a portion of my response to question #2, above: While Johnnie Burton has told us that she has no independent recollection of being told about the issue in 2004, she readily conceded that the e-mails we presented to her suggested otherwise. She went on to speculate what her thinking may have been nearly 3 years ago. Neither I nor my investigators found reason to question Ms. Burton's veracity about this issue.

Question 12. Please list the date that the Report was made available to the public?

Answer. The redacted version of our report was made available to the public via the Office of Inspector General website contemporaneously with my testimony on January 18, 2007.

Question 13. Please list all applicable federal statutes pertaining to the public availability of information in a Report of Investigation from the ice of Inspector General of the Department of the Interior.

Answer. The Freedom of Information and Privacy Acts are the primary federal statutes guiding public availability of a Report of Investigation issued by the Office of Inspector General for the Department of the Interior. Additional statutes governing grand jury secrecy, confidential business information, and other privileges may also apply to our determination of the content of reports made available to the public.

Question 14. Are you investigating how the *New York Times* reported on aspects of the content and substance of the Report prior to its receipt by the U.S. Senate Committee on Energy and Natural Resources and prior to its public release?

Answer. The *New York Times* has reported on several issues being investigated by my office. Various articles have contained information that had not been publicly released at the time of publication. In one instance, we had provided limited information to the Department about the investigation, but had also conducted a considerable number of interviews. In regard to the Report of Investigation which we released publicly on the date of my testimony, we had provided copies of the report to the Department and the Committee 2 days prior. I do not know how the *New York Times* obtained the information that was published in the articles, in either instance, but the article referred to "sources" that appear to have been disgruntled MMS employees. The OIG is not, however, conducting an investigation into these incidents.

Question 15. Are you concerned that with the approximately 40 stories published by the *New York Times* in just the past year on the issue of royalty relief, the release of privileged and confidential information prior to its public availability could prejudice the integrity of your investigations and the fairness of any potential civil or criminal litigation? What steps are you taking to avoid this? Could improvements be made with regard to this issue? If so, please specify.

Answer. While I am concerned about information being reported prematurely in a national publication, I do not believe that any potential civil or criminal litigation has been compromised by the articles. Because I am obligated by the Inspector General Act of 1978, as amended, to inform the Secretary and Congress of problems and deficiencies related to the programs and operations of the Department, I cannot necessarily control the further dissemination of such information. To the extent that information I provide to the Secretary or Congress is privileged or confidential, I will always identify it as such and request that it be treated accordingly.

Question 16. In Feb. 2001, the Associate Director of Offshore Minerals wrote, "For Notices of Sales held in 1998 and 1999 the price trigger language was left out of the Notices and lease document. This was within the discretion of MMS and the Secretary." The Associate Director does not note that this was a "mistake." Since your report does not determine who directed Mr. Rodi to modify these terms, in 1998, or why they were modified, please provide specific evidence that allows you to conclude that this change was a "mistake."

Answer. Several of the interviews included in the report identify statements of MMS employees indicating their belief that the omissions were the result of a mistake. Additionally, the e-mails included in the report indicate that the authors of the e-mails in 2000 (after discovery of the omissions) considered the omissions to be a mistake. Moreover, the action taken by MMS in 2000 after discovery of the omissions, to include the price thresholds in the leases for Sale 175, indicate that MMS was attempting to correct a mistake, rather than changing a conscious decision to not include them in 1998 and 1999.

Ultimately, a distinction must be made between the intentional act by Mr. Rodi to include reference to regulations in the leases and the mistaken result, which was the omission of price thresholds.

Question 17. Please reconcile seemingly conflicting findings on page 5 and 6 of the Report, which suggest that both thresholds on all deepwater leases issued between 1996 and 2000 was a Department of the Interior policy and that threshold language was affirmatively excluded from 30 CFR 260 because according to the Report, Mr. Cruickshank asserted that, "MMS wishes to remain flexible in deciding whether the thresholds would apply on a sale-by-sale basis."

Answer. According to MMS Deputy Director Cruickshank, it was the policy of MMS to include the price thresholds in all of the leases issued between 1996 and 2000. Cruickshank also stated that MMS decided not to include price thresholds in 30 CFR 260 because MMS wished to retain flexibility in deciding "whether the thresholds would apply on a sale-by-sale basis." These findings are not conflicting. MMS did in fact retain its flexibility in applying the thresholds because it theoretically could change its policy at any time not to include the price thresholds if they desired to do so, whereas, if the thresholds were placed in the regulation, MMS' flexibility in applying the thresholds would be greatly diminished since MMS could not readily change the regulation.

Question 18. Please provide all evidence to support the contention that the inclusion of price thresholds on deepwater leases issued from 1996 through 2000 was an Official policy of the Department of the Interior. Please specify in the evidence that you proffer, how one typically shows that a particular practice of the Department of the Interior is classified as Department policy.

Answer. All evidence was included in our report. MMS record keeping on policy development and retention was found to be deficient and a major obstruction to our investigation. We relied upon interviews and e-mail reviews to corroborate statements that asserted it was MMS policy to include thresholds.

Question 19. On page 5 of the Report, Mr. Cruickshank is reported to state that based upon Section 303 of the DWRRA, MMS made the policy decision in 1995 to apply price thresholds to all new leases issue under the Act. However, in February 1996, the MMS in its Advanced Notice of Proposed Rulemaking (as detailed on page 3-4 of the Report) asked for comments on whether price thresholds should apply to suspension volumes for new leases. How do you reconcile these inconsistencies?

Answer. The PowerPoint presentation that occurred on March 12-13, 1996, which is the only documentation we identified indicating MMS' intention to apply price thresholds to upcoming sales, occurred prior to MMS receiving responses to the ANPR. We can not explain the rational behind the ANPR question. This would be better answered by MMS.

Question 20. On page 6 of the Report, Mr. Mason is quoted as testifying on June 21, 2006 to the House Subcommittee that, "most of my legal advise is oral." Please provide evidence beyond this testimony that shows that it was the practice of the Office of the Solicitor during the time of the issuance of leases in question to render advice on matters of such significance as the applicability of price thresholds on oil and gas leases in oral rather than in written form, through memos or opinions.

Answer. The OIG has, through various audits and investigations, identified multiple instances in which the Office of the Solicitor renders legal advice in oral or summary check-list form, rather than in formal written form through memoranda or opinions. We have shared our concern about this practice with the Solicitor who has said he is taking corrective action.

Question 21. In your investigation, did you find any written advice or opinion from the Office of the Solicitor during the time of the issuance of the leases in question bearing on the question of whether to include price thresholds in either leases or by regulation? If so, please provide that information to the fullest extent possible and available.

Answer. We did not find any such written advice or opinion.

Question 22. Please comment specifically on the kind of flexibility pursuant to the DWRRA that the Secretary of the Interior is given in choosing to omit price thresholds from regulation and instead apply such thresholds on a lease-by-lease basis.

Answer. We did not analyze the authority of the Secretary under DWRRA as a part of our investigation. We relied on the information provided by witnesses as to MMS' interpretation of this authority.

Question 23. How many leases did the Department of the Interior issue in 1998 and 1999 pursuant to the DWRRA? Now many of the leases contained thresholds? How many of these leases are still active at present? Please explain with specificity the status of all of the leases that are not active.

Answer. According to information supplied to us by MMS, 1032 leases were issued in 1998 and 1999 and 570 remain active, and none of the leases contain thresholds. MMS would be better situated to explain the status of all of the leases that are not active.

Question 24. With respect to royalty collections, are their (sic) compliance review practices employed by the private sector and other federal agencies that you believe should be adopted by the MMS? If so, which?

Answer. We determined that MMS could benefit from adopting practices similar to the Internal Revenue Service (IRS). IRS has a similar mission to collect monies that are due to the federal government. In addition to audits, IRS extensively uses automated procedures to analyze tax returns and identify potential errors or irregularities. These procedures can identify discrepancies within the tax returns that are potential errors to be corrected. Additionally, the procedures can match information submitted by the taxpayer with related information submitted by other parties, such as the taxpayer's employer.

MMS would benefit by implementing similar automated procedures. These automated procedures could identify discrepancies in the information provided by companies reporting both production and royalty information. MMS could also match data provided by companies to other independent sources, such as the Bureau of Land Management's inspection data.

We also believe that MMS would benefit by adopting some of the performance measurement practices of the IRS. MMS should consider additional performance measures and goals to assess the efficiency of its operations. The IRS has multiple measures related to processing tax returns and resolving compliance issues, which help evaluate the efficiency of its operations. For example, in FY2005, one IRS efficiency measure was calculated by dividing the total number of examined tax returns by the number of employees. MMS could compute similar efficiency rates for its own audits and compliance reviews.

We did not identify any private sector practices that we recommend MMS adopt.

Question 25. Do you believe that the MMS should continue to undertake audits and compliance reviews? If not, which entity should be responsible for these activities?

Answer. Having the royalty audit function in MMS creates the potential for a conflict of interest, either in fact, or at minimum, in appearance. Audit organizations have a responsibility to maintain independence so that their opinions, conclusions, judgments and recommendations will be impartial and will be viewed as impartial by knowledgeable third parties. Royalty audits require auditors to independently assess the accuracy of royalty information reported by companies to MMS. Reasonable questions can arise about independence when the auditors are within MMS, the organization whose primary mission includes collecting, accounting for and distributing royalty revenues.

In addition to its fiduciary role over royalties, MMS also establishes and enforces applicable regulations and negotiates leases with the companies extracting minerals. It can be difficult for third parties to consider MMS auditors as independent when MMS is party to the leases under review. Whether or not the perception of "friendliness to industry" is accurate, the current positioning of the audit organization within MMS lends credence to the ability of MMS to use the audit function to push an agenda.

The Office of Inspector General (OIG) may be better suited to manage the royalty audit function because of its status as an independent audit and investigative organization. The Inspector General Act of 1978 establishes the independence of the Inspector General by removing the inherent conflict of interest that exists when audit and investigative functions are under the authority of the program being reviewed. This independence is brought about by the fact that the Inspector General, by law, reports to both the Secretary of the Department and the Congress. Moving the function from MMS to OIG would sever the relationship between audits and the programmatic functions of managing leases and collecting, accounting for, and distributing royalty revenues. The Department would be less prone to criticism concerning its compliance program, because audits would be conducted by the organization responsible for auditing the Department.

Question 26. Do you believe you should have a permanent role in overseeing MMS' audit and compliance activities?

Answer. I believe that the GIG already has a permanent role in overseeing MMS' audit and compliance review activities, as long as MMS is a part of the Department of the Interior.

Question 27. Do you believe that additional funding is required in order for MMS to adopt the recommendations contained in the Compliance Review Report? If yes, what do you believe would he an adequate amount?

Answer. This question would be better addressed by MMS, which could better assess the amount of resources it needs to implement its action plan. In our opinion, it is possible that MMS may need some additional resources on a temporary basis for initial implementation of our recommendations. Once the recommendations are implemented, however, we do not believe that there would be an ongoing need for additional resources to maintain the new processes. For example, addressing data reliability will require a significant one-time effort to evaluate and correct existing data in MMS' systems and to develop new procedures to ensure the reliability of future data entered into the systems. This one-time project may require significant resources or the redirecting of current resources from other activities such as current audits and compliance reviews. Once MMS implements new procedures for ensuring reliable data, the need for additional resources would diminish. MMS should make a determination of whether additional resources are necessary.

Question 28. If additional funding for MMS is required for proper royalty collection, for what purposes should it be appropriated? To hire additional employees? To improve information technology?

Answer. In our opinion any additional funding in the near future should be limited to those resources needed to implement the recommendations in our report. For example, implementing the recommendation designed to address data reliability issues may require additional IT resources and expertise. Or MMS may need additional resources to research and resolve the backlog of data needed to update the system. Additional resources may also be required to implement the recommendations aimed at strengthening the compliance review process by increasing data testing. MMS should determine whether it needs additional near term resources to meet the milestones set in its action plan to implement the recommendations.

Currently, MMS does not have the data that would be needed to develop a cost/benefit analysis to support a general increase in funding for compliance operations. In our opinion, MMS should first address the data reliability issues, improve its compliance review procedures, and develop performance measures that better reflect its operations, before expanding its program. Once those tasks are accomplished, then an evaluation could be performed to determine the optimal amount of funding that would ensure MMS effectively completes its mission.

Any additional funding that is provided should be specifically directed to the Compliance and Asset Management Program to ensure that the funds are solely used to improve the royalty compliance process. Additional funding could be used by MMS in the future to increase the number of companies subjected to compliance reviews and/or audits, perhaps increasing the identification of underreported royalties.

Question 29. It is my understanding that you are preparing a report on pending *Qui Tam* suits in which four government auditors allege that lessee companies failed to pay adequate royalties. When do you anticipate that this report will be completed?

Answer. My investigative staff is working diligently to conclude the investigation related to the *Qui Tam* suits as expeditiously as possible. Given the recent verdict in the *Qui Tam* case against Kerr-McGee, however, we must evaluate the impact that the verdict might have on our pending investigation which will undoubtedly extend the time it takes for us to conclude the matter. In addition, we have received additional allegations from the Relators, some of which will be incorporated into the current investigation; others may result in additional, separate investigations. The pending investigation is targeted to be complete by early spring.

Question 30. Can you assure this Committee that the privileged and confidential nature of the information of this investigation regarding the *Qui Tam* suits will be protected vigorously by the Office of Inspector General and that information related to this investigation will be provided to the public in a manner consistent with all applicable Federal laws?

Answer. Yes. The OIG takes seriously its obligation to protect any privileged and confidential information that becomes the subject of an investigation or audit. We also take seriously our obligation to inform the Secretary, the Congress and the public of the results of our audits and investigations, in keeping with applicable laws and regulations. In this regard, the general practice of the OIG is to provide a limited number of unredacted reports to the Secretary, and to the Congress, when we receive a written request from the Chair of a Committee or Subcommittee. The OIG must rely on the Secretary and Congress to assist in protecting such information when it is disclosed in such a limited way.

The OIG also goes to great lengths to issue a reader-friendly, public version of high-profile reports which protect privileged and confidential information as well as the personal privacy interests of those individuals whose identity warrants protection pursuant to the balancing of personal privacy interest against public disclosure, required by the Freedom of Information and Privacy Acts.

Question 31. Between 1998 and 2001, the Justice Department settled 16 *Qui Tam* lawsuits for nearly $440 million. The suits alleged that between 1980 and 1998, lessee companies underpaid on royalty obligations. What new regulations, if any, were promulgated by the Department of the Interior as a result of these lawsuits?

Answer. This was beyond the scope of our investigation. We believe that this question would be best answered by MMS.

Question 32. Please comment on the duties and responsibilities of the MMS as well as the duties and responsibilities of lessees to oil and gas leases on federal lands as it currently exists pursuant to the Federal Oil and Gas Royalty Management Act or 1982 and amendments to that Act, as well as all other relevant Federal law. And, do you think these duties and responsibilities ensure fairness and accuracy in the process of royalty valuation and collection?

Answer. The MMS is responsible for Outer Continental Shelf leasing and monitoring activities as well as for collecting, accounting for, and distributing royalties paid by companies that extract oil, gas, and other minerals from leased federal and Indian properties. Lessees are responsible for accurately reporting and paying royalties from leased federal and Indian properties. The applicable royalty and leasing laws include 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; the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996; and the Deep Water Royalty Relief Act.

The royalty monitoring process is complicated due to the large number of leases, differences in lease terms, and various valuation issues. Royalty valuation has been a contentious issue since at least the early 1980s. MMS has made efforts to improve valuation guidance and has issued revised guidance on both Federal Oil and Gas regulations as well as Indian Gas regulations. MMS has worked to keep those regulations up-to-date by amending them as appropriate.

Our December 2006 audit report concluded that compliance reviews can serve a useful role as part of MMS' Compliance and Asset Management Program. However, compliance reviews do not provide the same level of assurance as an audit and therefore should only be used in conjunction with audits in a coordinated compliance strategy. We believe that implementation of the report's recommendations should improve the accuracy of royalty collections.

RESPONSES TO QUESTIONS FROM SENATOR THOMAS

Question 1. Can you provide me with the following lists of Interior Department Officials? Please indicate their tenure at the Department of the Interior and whether or not they are still working for the federal government in any capacity? I would like to know:

Who at the Department of the Interior was involved in the issuance of offshore oil and gas leases in the 1998 to 1999 time frame.

Who at the Department of the Interior was involved in the drafting of the Deep Water Royalty Relief Act of 1995.

Who at the Department of the Interior was responsible for including price thresholds in leases issued during 1998 and 1999.

Answer. Our investigation focused on how and why price thresholds were not included in the 1998 and 1999 leases, and what the Department's response was once the omission was discovered. In our Report of Investigation, we have identified everyone that we were able to determine may have been involved in either of these two aspects. We did not endeavor to discern who, if anyone, at the Department was involved in the drafting of the Deep Water Royalty Relief Act of 1995.

Question 2. You have shared in testimony before the House and Senate your assessment of the way in which Johnnie Burton initially handled finding out about the omission of price thresholds in the 1998 and 1999 leases. Assuming the Solicitor's opinion that there was no legal option at Director Burton's disposal to recover lost revenues is accurate and would have remained so regardless of how public those deliberations were, do you care to elaborate on the way in which Director Burton has subsequently handled the effort to fix this problem?

Answer. I commend the efforts of Director Burton, Assistant Secretary Allred and the Office of the Solicitor to seek voluntary re-negotiation of the leases by the lessee oil companies. I believe that they are now exploring all possible avenues to ameliorate this problem.

GOVERNMENT ACCOUNTABILITY OFFICE,
NATURAL RESOURCES AND ENVIRONMENT,
Washington, DC, February 6, 2007.

Hon. JEFF BINGAMAN,
Chairman, Committee on Energy and Natural Resources, U.S. Senate.

Hon. PETE DOMENICI,
Ranking Minority Member, Committee on Energy and Natural Resources, U.S. Senate.

Hon. JEFF SESSIONS,
U.S. Senate.

This letter acknowledges the questions you submitted concerning our testimony on oil and gas royalty management before the Senate Committee on Energy and Natural Resources on January 18, 2007. Please see the enclosure for our responses.

MARK E. GAFFIGAN,
Acting Director.

[Enclosure.]

RESPONSES TO QUESTIONS FROM SENATOR BINGAMAN

Question 1. Royalty Rates—Chairman Rahall and I asked you to look at whether the royalty rates being charged for the production of oil and gas by the Department are commensurate with rates charged by states on state land and by private landowners on their lands. Can you share your findings to date with us?

Answer. We are currently in the process of evaluating and comparing the federal government's royalty rates to those of Alaska, Colorado, Louisiana, Montana, New Mexico, Texas, Utah, and Wyoming as well as private landowners, where possible. As part of this study for you and Representative Rahall, we are also considering other contract terms that may impact the royalty rates charged, including factors such as bonus bids and rental fees. We plan to share our preliminary findings with your offices in February 2007.

Question 2. Price Assumptions—Your testimony indicates that precise estimates of the revenues forgone to the Treasury remain elusive. However, MMS has indicated that the price threshold issue may result in up to $10 billion in forgone revenues over 25 years and that the Kerr McGee (Anadarko) litigation puts $60 billion at risk. What are the price assumptions underlying these estimates?

Answer. It is our understanding that MMS estimates assumed prices from January 2005 onwards of $45 per barrel of oil and $5.63 per million cubic feet of gas adjusted by an annual inflation rate of 2.1 percent.

Question 3. Ongoing Work—Can you please describe GAO's ongoing work with respect to oil and gas royalties and provide us with a timeline for completion of the work?

Answer. We currently have three engagements underway in response to congressional requests about oil and gas royalties. The first engagement is reviewing the laws and regulations for the offshore royalty relief program and estimating the fiscal impact of royalty relief on leases issued under the Outer Continental Shelf Deep Water Royalty Relief Act and other authorities. The second engagement currently focuses on two major blocks of work (1) comparing federal oil and natural gas royalty rates, as well as other contract terms, with state and private royalty rates and terms; and (2) describing statutory and regulatory "diligent development" requirements for federal lands. We plan to discuss the timeline for the completion of both of these assignments with your staff in February in order to attempt to best meet the needs of the Committee. The third engagement, which will be staffed in February, will analyze the accuracy of royalties collected on oil, condensate, and natural gas produced under leases of federal and Indian lands. A timeframe for this work has not yet been agreed upon with the requesting members' offices.

RESPONSES TO QUESTIONS FROM SENATOR DOMENICI

Question 1. In your testimony, you state that the failure to include thresholds in the 1998 and 1999 leases could cost up to $10 billion in forgone royalty revenue. How did you arrive at this estimate? How does this estimate change by the fact that six of the company lessees have come forward and renegotiated these leases?

Answer. The estimate of $10 billion in foregone royalty revenues, resulting from the failure to include price thresholds in the 1998 and 1999 leases, was developed by the Minerals Management Service (MMS). GAO has not yet completed an independent assessment of these foregone royalties. Further, the scope of our ongoing work does not include an assessment of how the ongoing negotiations between MMS and the six companies will affect estimates of foregone royalty revenues.

Question 2. How did you arrive at your estimate to the potential cost to the Federal Treasury with respect to the possibility of an unfavorable outcome for the United States in the Kerr McGee lawsuit, referenced in page 7 of your testimony as *Kerr-McGee (Anadarko) suit 3/17/06, W Dist. LA, CV06-0439LC?* Was this MMS estimate of $60 billion referenced on page 7 of your testimony ever published by MMS? Please state what the GAO estimate is at present?

Answer. MMS developed the $60 billion estimate in foregone royalty revenues should the Kerr-McGee (Anadarko) lawsuit result in an unfavorable outcome for the United States—whereby MMS could not enforce price thresholds on any of the leases issued under the Deep Water Royalty Relief Act of 1995 for the period 1996-2000. As noted above, GAO's assessment of MMS' estimates is ongoing. To our knowledge, this MMS estimate was not published.

Question 3. In the introductory page of your written testimony dated January 18, 2007, you state that, "*at least* (emphasis added) $1 billion [of which] has already been lost" because of the failure to include price thresholds on the 1998 and 1999 leases. On page 3 of your statement you state that, "*about* (emphasis added) $1 billion has already been lost. Can you provide a precise amount of royalty revenue that has been lost? Please comment on the accuracy of your estimate, describe how you arrived at this estimate and comment on whether this is consistent with the Department of the Interior's estimate of revenues lost thus far.

Answer. Because GAO's work is still ongoing, we do not have a precise estimate of the foregone royalty revenue resulting from the lack of price thresholds in 1998 and 1999 leases. Our reference of $1 billion refers to an analysis performed by MMS, which showed forgone royalty revenue of slightly greater than $1 billion.

Question 4. In the introductory page of your written testimony, you state that, "In October 2004, MMS estimated that foregone royalties on deep water leases issued under act from 1996 through 2000 could be as high as $80 billion." Please specify who at MMS made this estimate and whether this estimate was ever published in any form. Please also comment on whether the Director of MMS made or was aware of this estimate.

Answer. The Economics Division of MMS, located in Herndon, Virginia, prepared this estimate. The $80 billion estimate is the combination of potential foregone royalties from: (1) litigation that overturned MMS's application of royalty suspension volumes on a field basis ($10 billion); (2) MMS's failure to include price thresholds in the 1998 and 1999 leases ($10 billion); and (3) MMS potentially losing Kerr McGee's (Anadarko's) legal challenge to the application of price thresholds for 1996, 1997, and 2000 leases ($60 billion). We are not aware of whether this estimate was published, nor do we know whether the Director of MMS was made aware of this estimate.

Question 5. You state on page 2 of your testimony that the GAO is reviewing appropriate portions of the Energy Policy Act of 2005 (EPAct). Can you please specifically identify the sections that contain oil and gas royalty relief provisions and of those sections, please identify those that do not allow for the application of price thresholds. Additionally, please identify those sections in which leases issued pursuant contain price thresholds and those which do not.

Answer. As stated in our testimony, the sections of the Energy Policy Act of 2005 that contain oil and gas royalty relief provisions include Sections 344, 345, 346, and 347. For these sections, the Act provides the authority to the Secretary of Interior to place limitations on royalty relief based on market prices.

Question 6. On page 6 of your testimony, you state that the *Santa Fe Snyder* decision cost the federal government up to $10 billion in foregone future royalty revenue. Would it be more accurate, in fact, to state that the Fifth Circuit Court of Appeals affirmed Federal District Court's holding that the Department of the Interior was in fact implementing royalty relief in a manner contrary to the intent of the Deepwater Royalty Relief Act? Would it be more accurate to state that the Department of the Interior's decision in the 1990's to apply this royalty relief on a field basis was contrary to the law?

Answer. GAO's work examines the fiscal impacts of royalty relief on leases issued under the Outer Continental Shelf Deep Water Royalty Relief Act of 1995. Specifically, GAO is reviewing the revenue that the government would have collected but for the Act, which in our testimony, we referred to as "forgone" or "lost" revenue. The Court's interpretation of the Act in the *Santa Fe Snyder* decision, that the royalty relief in question must be implemented on a lease basis, resulted in an increase in the dollar amount of forgone revenue under the Act, as compared to the dollar amount based on MMS's field basis interpretation. As we noted in our testimony, MMS estimates that the decision increased future forgone royalty revenues under the Act by up to $10 billion. Whether MMS's initial determination to apply the relief on a field basis was contrary to law, was not relevant to our estimate of revenue forgone under the Act.

Question 7. How many leases did the Department of the Interior issue in 1998 and 1999 pursuant to the Deepwater Relief Act? How many of the leases contained thresholds? How many of these leases are still active at present? Please explain with specificity the status of all of the leases that are not active.

Answer. According to data provided by MMS, 1,032 leases were issued in the Gulf of Mexico in 1998 and 1999, none of which included price thresholds. As of December 31, 2006, 574 of the 1998 and 1999 leases were still active. GAO does not have detailed information on the remaining 458 leases.

Question 8. On page 8 of your written testimony, you state that, "to fully evaluate the impacts of royalty relief one must consider the potential benefits in addition to the costs of lost royalty revenue." Why was such an evaluation and assessment not made?

Answer. A number of Congressional members asked GAO to examine the costs of royalty relief—in light of rapidly rising oil and gas prices and press reports and questions by other interested parties as to whether the oil and gas industry was paying its fair share of royalties—not the benefits. However, as GAO indicated in its testimony, benefits are an important part of an overall assessment of royalty relief. These benefits may include increased bonus bids, greater production, and increased oil and gas exploration, among other things. We are in the process of identifying studies that attempt to analyze the benefits of royalty relief.

Question 9. Please elaborate more fully on your statement on page 9 of your written testimony, "However questions remain about the extent to which such benefits would offset the cost of lost royalty revenues." Should such "benefits" factor into estimates of lost revenue?

Answer. The potential benefits of royalty relief should be netted out of the foregone revenue associated with royalty relief to get a full accounting of the costs and benefits of the relief. These benefits include potentially higher bonus bids on leases as well as any associated benefits that accrue as a result of an increase in oil production that would otherwise not have occurred.

Question 10. The estimates from GAO fail to take into account potential increased production (and thus increased royalties) as a result of providing royalty relief. Does the GAO similarly fail to estimate the economic impact that increased domestic production has on a reduction in our nation's trade deficit in providing economic analysis of the impacts of royalty relief?

Answer. To our knowledge, no full cost-benefit study of the Outer Continental Shelf Deep Water Royalty Relief Act of 1995 has been conducted. Such a complete study would be very difficult to achieve with any assurance of accuracy because (1) the final costs depend on future oil production and future oil prices and these are difficult to predict, and (2) estimating the benefits depend on determining how much of the oil production that will occur is the result of, rather than simply coincident with, royalty relief. Because oil prices are much higher now than in 1995, when the royalty relief act was passed, the expected costs of the relief have gone up considerably. In addition, such higher oil prices would likely have led to greater oil exploration and development in the deep water regions of the Gulf of Mexico, even in the absence of royalty relief. These changing conditions are indicative of the difficulty in estimating the full costs and benefits of royalty relief.

RESPONSES TO QUESTIONS FROM SENATOR SESSIONS

Question 4. Based on your understanding of the Energy Security Act of 2005 ("Act") (Public Law No. 109432), and assuming that no further negotiations are successful in including price thresholds in existing leases, what is the actual impact, in dollar terms, of the exclusion of price thresholds in the leases in question on the amount of royalty revenue that is shared with producing states under the revenue-sharing provisions of the Act during the next ten years? What is your estimate of the impact on the revenue shared with the state of Alabama, specifically?

Answer. The scope of GAO's work to date has not included the estimated fiscal impacts of the revenue-sharing portions of Gulf of Mexico Energy Security Act of 2006 on producing states. We are unaware of any estimate having been completed on this issue.

Question 5. Based on your understanding of the Energy Security Act of 2005 ("Act") (Public Law No. 109-432), and assuming that no further negotiations are successful in including price thresholds in existing leases, what is the actual impact, in dollar terms, of the exclusion of price thresholds in the leases in question on the amount of royalty revenue that is shared with producing states under the revenue-sharing provision of the Act in the years between 2017 and the expiration of any then existing leases? What is your estimate of the impact on the revenue. shared with the state of Alabama, specifically?

Answer. The scope of GAO's work to date has not included the estimated fiscal impacts of the revenue-sharing portions of Gulf of Mexico Energy Security Act of 2006 on producing states. We are unaware of any estimate having been completed on this issue.

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