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CRUDE OIL UNDERVALUATION: THE INEFFECTIVE RESPONSE OF THE MINERALS MANAGEMENT SERVICE

SEVENTEENTH REPORT

BY THE

COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT

SEPTEMBER 27, 1996.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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LETTER OF TRANSMITTAL

HOUSE OF REPRESENTATIVES,
Washington, DC, September 27, 1996.

Hon. NEWT GINGRICH,
Speaker of the House of Representatives,
Washington, DC.

DEAR MR. SPEAKER: By direction of the Committee on Government Reform and Oversight, I submit herewith the committee's seventeenth report to the 104th Congress.

WILLIAM F. CLINGER, Jr., *Chairman.*

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104TH CONGRESS 2nd Session } HOUSE OF REPRESENTATIVES { REPORT 104–858

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SEPTEMBER 27, 1996.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. CLINGER, from the Committee on Government Reform and Oversight, submitted the following

SEVENTEENTH REPORT

On September 24, 1996, the Committee on Government Reform and Oversight approved and adopted a report entitled "Crude Oil Undervaluation: The Ineffective Response of the Minerals Management Service." The chairman was directed to transmit a copy to the Speaker of the House.

I. SUMMARY OF OVERSIGHT FINDINGS AND RECOMMENDATIONS

A. INTRODUCTION

The Committee on Government Reform and Oversight ("the committee") has primary legislative and oversight jurisdiction with respect to the "overall economy, efficiency and management of Government operations and activities, including Federal procurement." It also has primary oversight responsibility to "review and study, on a continuing basis, the operation of Government activities at all levels with a view to determining their economy and efficiency."[1] In addition to its other oversight responsibilities:

> [T]he Committee on Government Reform and Oversight may at any time conduct investigations of any matter without regard to the provisions . . . conferring jurisdiction over such matter upon another standing committee. The committee's findings and recommendations in any such investigation shall be made available to the other

[1] Rules of the House of Representatives, 104th Congress, X, 1(g)(6) and (12) and X, 2(b)(2).

standing committee or committees having jurisdiction over the matter involved. . . .[2]

Pursuant to this authority, Subcommittee on Government Management, Information, and Technology of the Committee on Government Reform and Oversight convened an oversight hearing on June 17, 1996 to examine whether companies under agreements to extract oil from Federal lands in California undervalued the oil and as a result, underpaid royalties to the Federal Government. The subcommittee also reviewed the management of this program by the Minerals Management Service of the Department of the Interior.

B. SUMMARY OF FINDINGS AND RECOMMENDATIONS

Between 1978 and 1993, oil companies did not pay sufficient royalty on crude oil drilled on Federal lands in California and elsewhere. These amounts may reach as high as $2 billion nationwide. This is a serious problem that the Department of the Interior's Minerals Management Service has failed to seriously address.

FINDINGS IN BRIEF

1. There is an undervaluation problem, where crude oil royalties received by the Federal Government have been below fair market value.
2. The Minerals Management Service has delayed collecting crude oil royalty revenues due to these undervaluations.
3. Global settlements between the Federal Government and major oil companies have not protected the financial interests of the U.S. Government and its taxpayers.
4. The crude oil undervaluation problem is not limited to California; it exists in other oil-producing States.
5. Royalty-in-kind transactions may have left Federal financial interests unprotected.
6. Pipelines which cross Federal lands harm Federal interests by depressing oil royalty revenues and preventing an efficient oil market through the monopolistic distortion caused by proprietary pipelines.

RECOMMENDATIONS IN BRIEF

1. The Minerals Management Service must prepare a timetable for collecting royalty underpayments.
2. The Minerals Management Service needs to consider outside audit assistance to supplement its existing audit staff.
3. The Minerals Management Service, together with the Department of Justice, should review existing global settlements to determine whether Federal financial interests can be salvaged and prevent future problems with global settlements which reduce the potential for royalty collections by the Federal Government.
4. The Department of the Interior should immediately proceed to examine whether other underpayments have occurred in States other than California.

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[2] Rules of the House of Representatives, 104th Congress, X, 4(c)(2).

5. The Department of the Interior should examine royalty-in-kind payments to determine whether these amounts also suffered from undervaluation, and whether the royalties can be recovered.

6. The Department of the Interior should enforce the administration's stated policy on oil pipelines, and discuss the issue with officials in the State of California to ensure that all pipelines in California promote an efficient oil market and protect Federal financial interests.

C. BACKGROUND

California is the fourth largest oil-producing State in the United States.[3] During 1994, California's crude-oil production totaled about 345 million barrels of oil, or just under 1 million barrels a day.[4] This includes a large amount of oil produced on Federal lands in California. In 1975, the State of California and the city of Long Beach initiated litigation against seven major oil companies operating in California alleging that the companies conspired to keep posted oil prices low.[5] The city and State claimed they had been damaged because their oil revenues depended on posted prices and the royalty thereon.[6] If the posted price is below fair market value, the Federal Government loses royalty revenue.

In 1986, the Minerals Management Service (MMS) of the Department of the Interior contacted State officials in California to assess the appropriateness of posted prices as the royalty value basis.[7] MMS concluded that the system of posted prices existing at the time fairly represented market value. Weighing heavily in the MMS decision was the fact that the State of California and the city of Long Beach had been unsuccessful with their antitrust claims in court.[8] The Department of Justice looked into the issue and chose not to pursue an investigation.[9]

In 1991, six of the companies involved (ARCO, Shell, Chevron, Mobil, Texaco, and Unocal) reached settlements totaling $345 million to end the court actions by the State and city alleging undervaluation.[10] A seventh defendant, Exxon, went to trial and was exonerated on the antitrust charges relating to State oil leases. That decision was appealed, and Exxon won the appeal in January

[3] California Department of Conservation homepage, Internet address http://www.consrv.ca.gov/dog/facts.html.

[4] *Ibid.*

[5] U.S. Department of the Interior, *History of the California Pricing Issue*, undated document released with the *Final Interagency Report on the Valuation of Oil Produced from Federal Leases in California*, May 16, 1996. The oil companies involved in the suit included ARCO, Shell, Chevron, Mobil, Texaco, Unocal, and Exxon.

[6] *Ibid.* Posted prices are the announced prices at which crude oil purchasers, generally major refiners, will purchase crude oil from producers at the wellhead.

[7] *Ibid*.

[8] *Ibid.* The State of California and the city of Long Beach had attempted to show collusion between the oil companies to keep posted prices low. The State and city's demonstration of underpricing of crude oil have been more convincing than the charge of collusion, as the collusion/antitrust claim is more difficult to prove.

[9] *Ibid*. In the mid-1980's, MMS, the General Accounting Office and the Internal Revenue Service independently analyzed the issue, but the information available to them at the time was inconclusive in proving that Federal oil was undervalued at posted prices. For example, see U.S. General Accounting Office, *California Crude Oil: An Analysis of Posted Prices and Fair Market Value*, GAO/GGD 88–114, September 8, 1988.

[10] U.S. Department of the Interior, *Final Interagency Report on the Valuation of Oil Produced from Federal Leases in California*, May 16, 1996, page 1 of the Executive Summary.

1995.[11] A separate appeal covering a different time period is still pending.

In light of the 1991 settlement relating to undervaluation of State crude oil leases, MMS performed a scoping exercise to estimate the size of any potential royalty underpayments relating to Federal lands.[12] However, since the MMS scoping exercise lacked crucial information relating to the Long Beach cases such as internal oil company records, the State of California urged the Department of the Interior to begin a more formal investigation.[13] MMS responded by creating an interagency task force in 1994.[14] The task force consisted of representatives from MMS, the Office of the Solicitor in the Department of the Interior, the Department of Commerce, the Department of Energy and the Department of Justice.

The State of California assisted the Federal team in obtaining court records from the earlier litigation. These documents were instrumental in demonstrating the undervaluation of crude oil to the Federal interagency team. In May of 1996, the Federal interagency team released its report, which concluded that companies often received gross proceeds higher than their posted prices.[15] The bulk of crude oil in California was not sold in competitive markets with competing economic interests. Rather, it was moved through intracompany transfers; straight exchanges (where one oil company trades oil at one location with another company which has oil at another location; this allows both to avoid or reduce transportation costs); and buy/sell contracts (which include other costs in addition to the value of the crude oil, including transportation costs or other considerations).[16] In the absence of vigorous competition amongst competing economic interests, it is difficult to determine a proxy for the market value of oil. Correspondingly, it is easy for oil companies to hide the true value of the crude oil in complicated contracts with separate charges for transportation.[17]

The interagency report estimates that Federal revenues from oil royalties on California leases alone are between zero and $856 million for the period between 1978 and 1993. The report recommended:

- that MMS focus collection efforts on those companies (about 10) that produce 90 percent of Federal crude oil in California;
- that for the period beginning March 1, 1988, Federal royalties be computed by the premium paid on competitive arm's-length contracts for oil produced from the same field or area;
- that the Assistant Secretary of the Interior issue a royalty payor letter ordering targeted oil companies to submit all arm's-length contract records for the periods in question so as to minimize audit expenses;

[11] *Ibid*.
[12] *Ibid*, page 15.
[13] *Ibid*, page 15.
[14] *Ibid*, page 2. The Department of Justice subsequently resigned from the team, citing the move away from the interagency team from investigating antitrust violations and more focus on undervaluation of royalty payments.
[15] *Ibid*, page 44.
[16] *Ibid*, page 50.
[17] Summit Resource Management, Inc., *Crude Oil Royalty Payment Analysis*, February 21, 1995, page 5. The Summit report compares lease pricing methods with trade pricing methods and concludes that the "sales price at the lease has absolutely no bearing on the actual price received for the sale of the oil."

• that the Federal Government submit a bill for 1989 and 1993 to Texaco, since MMS audited those records;

• that MMS's oil royalty valuation regulations be revised to consider alternatives to reliance on posted prices and improve clarity; and

• that a method be chosen to determine royalties owed. The team was split on which approach to take for the period before March 1, 1988. The team was split as follows:

(1) the Commerce and Energy Departments recommended using Alaska North Slope oil market prices as the basis for valuing Federal crude oil in California for purposes of determining royalties (this is less audit intensive, but potentially open to legal challenges) and that MMS pursue underpayments from 1980 forward; while

(2) the MMS/Solicitor's office recommended using the same procedures before 1988 as after 1988 (these procedures require labor-intensive audits, but closely conform to established precedent), and that MMS and the Solicitor's office determine how far back to pursue royalty underpayments.[18]

Subsequently, MMS announced that it would accept part of the task force's recommendations and attempt to collect approximately $440 million.[19] The $856 million figure was reduced due to global settlements between the oil companies and the Department of the Interior, payments-in-kind of the royalty, and other factors. However, this does not include potential underpayments from States other than California. It is limited solely to Federal crude oil coming from lands in California.[20]

In August of 1996, a draft report of the inspector general of the Department of the Interior was obtained by various press sources.[21] The draft report criticized the Department for improper procedures during negotiations with oil companies. During these negotiations, the Department reduced the estimated value of items to be negotiated by more than $350 million—without documentation.[22] The draft report is dated November 1995; it has not yet been released, having been delayed for nearly 1 year.

D. PROCEEDINGS OF THE SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION, AND TECHNOLOGY

On June 17, 1996, the subcommittee convened a hearing examining whether the Federal Government was receiving the oil royalties that are due it. Subcommittee Chairman Horn opened the hearing noting that the recently enacted Debt Collection Improvement Act provided to agencies the tools they need to collect delinquent debts owed to the Federal Government, and the great interest of Congress in general, and the Committee on Government Reform and

[18] U.S. Department of the Interior, *Final Interagency Report on the Valuation of Oil Produced from Federal Leases in California*, May 16, 1996, pages 54–87.

[19] Press Release, U.S. Department of the Interior, *MMS Pursues California Undervaluation Royalties*, July 18, 1996.

[20] *Ibid.*

[21] Wall Street Journal, U.S. May Have Lost Out on Vast Oil Royalties, August 15, 1996, section A, page 3.

[22] U.S. Department of the Interior, Office of Inspector General, Draft Audit Report, *Negotiated Royalty Settlements*, November 1995, pages 5–6.

Oversight in particular, in collecting these amounts.[23] Ranking member Representative Carolyn Maloney noted her interest in seeing that oil royalties are collected. Mrs. Maloney advocated using the market price of Alaska North Slope crude as a proxy for fair market value of California crude oil rather than auditing each Federal mineral lease contract.[24]

Representative Ken Calvert, chairman of the Subcommittee on Energy and Mineral Resources of the Committee on Resources, reviewed his committee's activities regarding the royalty management program: "The Federal Government runs an inefficient, complicated, and burdensome system for royalty collection and accounting which has resulted in enormous amounts of litigation over the years."[25] Mr. Calvert advocated the passage of H.R. 1975, the Federal Oil and Gas Royalty Simplification and Fairness Act, to help solve the problem.[26] The cornerstone of the bill is expanded authority for State governments to manage the royalties from Federal lands located in the State. Mr. Calvert noted that half of the revenues from onshore crude oil production go to the State from which they are derived. The legislation will assist in solving the royalty underpayment problem in the future, but will not give any directions on how the Minerals Management Service should pursue past underpayments.[27]

Director of the Minerals Management Service Cynthia Quarterman testified that in 1993, the Office of Policy Analysis at the Department of the Interior asked MMS to review the undervaluation issue in light of the 1991 settlement in the Long Beach litigation.[28] Director Quarterman described the timing of events surrounding the crude oil undervaluation issue. A scoping exercise in 1993 and 1994 confirmed that the underpayment issue should be pursued using an interagency task force employing representatives from MMS and the Solicitor's office in the Department of the Interior, and the Departments of Commerce, Energy and Justice. The Federal employees were supplemented by consultants.[29] Abraham E. Haspel, Chief Economist at the Department of Energy, described the role of the Department of Energy in the interagency

[23] Opening statement of Subcommittee Chairman Stephen Horn before a hearing of the Subcommittee on Government Management, Information, and Technology, House Committee on Government Reform and Oversight, *Valuation of Federal Oil—Is the U.S. Getting the Royalties it is Owed?* June 17, 1996.

[24] Opening statement of Representative Carolyn Maloney before a hearing of the Subcommittee on Government Management, Information, and Technology, House Committee on Government Reform and Oversight, *Valuation of Federal Oil—Is the U.S. Getting the Royalties it is Owed?* June 17, 1996.

[25] Statement of Representative Ken Calvert before a hearing of the Subcommittee on Government Management, Information, and Technology, House Committee on Government Reform and Oversight, *Valuation of Federal Oil—Is the U.S. Getting the Royalties it is Owed?* June 17, 1996.

[26] H.R. 1975 passed the House of Representatives on July 16, 1996 under suspension of the rules and passed the Senate on August 2, 1996. President Clinton subsequently signed the Federal Oil and Gas Royalty Simplification and Fairness Act on August 13, 1996. It became Public Law No. 104–185.

[27] Statement of Representative Ken Calvert, during debate on H.R. 1975, the Federal Oil and Gas Royalty Simplification and Fairness Act, Congressional Record, page H7606.

[28] Oral testimony of Director Cynthia Quarterman, Director, Minerals Management Service, U.S. Department of the Interior before a hearing of the Subcommittee on Government Management, Information, and Technology, House Committee on Government Reform and Oversight, *Valuation of Federal Oil—Is the U.S. Getting the Royalties it is Owed?* June 17, 1996.

[29] U.S. Department of the Interior, *Final Interagency Report on the Valuation of Oil Produced from Federal Leases in California*, page 29. The contract was with Innovation and Information Consultants, Inc., which had assisted the State of California in analyzing oil sales contracts for the Long Beach litigation.

task force and summarized some of the conclusions which the task force generated.

In the question period, Subcommittee Chairman Horn quoted a 1993 memorandum in which Robert Berman, an economist in Interior's Office of Policy Analysis, suggested that the Department should "[p]roceed immediately to ascertain the amount of additional royalties due and initiate collection procedures."[30] Adding that this was the same conclusion reached by the interagency team after a 3-year delay, Subcommittee Chairman Horn placed in the record a 1994 electronic mail message from the interagency team leader David Hubbard, expressing his concern about the timetable for completing the interagency report and his feeling that he has "stalled on this issue long enough."[31] In the hearing, Director Quarterman responded that the agency was not engaging in a pattern of delay and stressed that auditing oil company records was a time-consuming process.[32]

Mrs. Maloney noted her belief that MMS should attempt to collect underpayments which occurred during the period 1980–85, since nearly three-fourths of all underpayments occurred in that time period. Director Quarterman declined to commit to that request, noting that there were other factors at work, including competing demands for time and staff which might involve greater dollar figures. Mrs. Maloney repeated her wish that the prices for crude oil from the Alaska North Slope (ANS) be used as a proxy for market value in California. Again, Director Quarterman would not commit MMS to this course of action, despite the use of ANS prices as market value in California by the task force and by major oil companies.[33]

Subcommittee Chairman Horn asked what would be an appropriate gauge of market value of crude oil. Mr. Berman indicated that a market price, such as the price of crude oil on the New York Mercantile Exchange, or, on the west coast, ANS prices, provide the best benchmark for economic value. Subcommittee Chairman Horn inquired whether adjustments needed to be made for transportation costs. Mr. Berman believed that could be easily done by using the spot market for a given commodity in a given location. He added that it is easy for the owner of a pipeline to disguise a premium on crude oil.[34]

Director Quarterman described the changing resource levels devoted to the royalty management program, and the recent addition of $4 million above the President's request by the House Committee on Appropriations for the audit division.[35]

Mrs. Maloney reviewed the chronology of MMS's actions with respect to crude oil undervaluation. She pointed out that MMS entered into a global settlement with Exxon and Chevron after an in-

[30] U.S. Department of the Interior, memorandum from Bob Berman to Brooks Yeager, *California Common Carrier and Crude Valuation*, August 6, 1993.

[31] U.S. Department of the Interior, electronic mail message from David Hubbard, MMS Denver, CO, to James W. Shaw, MMS Denver, CO.

[32] Testimony of Director Quarterman, June 17, 1996.

[33] *Ibid*.

[34] Oral testimony of Robert Berman, Office of Policy Analysis, U.S. Department of the Interior before a hearing of the Subcommittee on Government Management, Information, and Technology, House Committee on Government Reform and Oversight, *Valuation of Federal Oil—Is the U.S. Getting the Royalties it is Owed?* June 17, 1996.

[35] Testimony of Director Quarterman, June 17, 1996.

ternal memorandum noted that perhaps $422 million was owed in underpayments.[36] Director Quarterman replied that the Exxon agreement included a provision that would allow MMS to collect in the case of fraud, malfeasance, concealment or misrepresentation of fact. Director Quarterman agreed not to proceed with additional global settlements without an exclusion relating to crude oil valuation.[37]

Mrs. Maloney quoted the task force conclusion that pipelines owned by a vertically integrated oil company—through which oil may be required to go—contribute to the undervaluation problem. Director Quarterman asserted that the Department of the Interior did not have jurisdiction over the pipelines in California since they do not traverse Federal land or raise interstate commerce issues by going through another State.[38]

Subcommittee Chairman Horn noted the task force recommendation that bills be sent immediately to oil companies which were subjected to audits by the task force. Director Quarterman testified that she did not anticipate sending bills, to avoid a piecemeal approach to collecting underpayments.[39]

Mrs. Maloney asked whether Mr. Berman had sent a memorandum warning MMS of the potential loss of Federal revenue if the undervaluation issue was included as a part of the global settlements being negotiated with certain oil companies. Mr. Berman said that he had sent this memorandum to Brooks Yeager, the Director of the Office of Policy Analysis, and discussed the matter with Yeager and Ted Heintz, Berman's immediate supervisor.

Mr. Berman testified that he had initiated an investigation to determine whether posted prices reflect market value outside of California. According to Mr. Berman, the initial investigations indicate that posted prices are below market value outside of California. Subcommittee Chairman Horn asked the amount by which posted prices understated value. Mr. Berman replied that posted prices might have been between 3 and 10 percent below the market value of the crude oil.[40]

Assistant Secretary of the Interior for Land and Minerals Management Robert Armstrong was asked by Subcommittee Chairman Horn for a timetable of when bills would be sent to Texaco, which was the subject of an audit during the task force deliberation. Mr. Armstrong responded that in 4 to 6 weeks, a bill would be sent.[41]

Subcommittee Chairman Horn asked Mr. Berman whether the appropriate market gauge for fair market value for crude oil is the ANS price. Mr. Berman noted that a common benchmark should be used. In California, this benchmark is the ANS price, while outside of California there are other, more useful market benchmarks such as the price on the New York Mercantile Exchange, Cushing, and

[36] Statement of Representative Carolyn Maloney, June 17, 1996.
[37] Testimony of Director Quarterman, June 17, 1996.
[38] *Ibid.*
[39] *Ibid.*
[40] Testimony of Mr. Berman, June 17, 1996.
[41] Oral testimony of Assistant Secretary for Land and Minerals Management, U.S. Department of the Interior, Robert Armstrong, before a hearing of the Subcommittee on Government Management, Information, and Technology, House Committee on Government Reform and Oversight, *Valuation of Federal Oil—Is the U.S. Getting the Royalties it is Owed?* June 17, 1996. Mr. Armstrong's testimony contradicted that of Director Quarterman, who indicated that bills for these audits would not be sent out in a "piecemeal fashion." A bill has not yet been sent.

St. James. Mr. Horn urged that a market price be used in determining fair market value.

Mrs. Maloney asked Robert Speir, an economist at the Department of Energy and a member of the interagency task force, why the task force opinion diverged on whether to use ANS crude oil prices as a proxy for market value. Mr. Speir indicated that the divergence resulted from different opinions on how to value crude oil accurately.[42] Mr. Speir explained that since ANS represents fair market value, that was the determinant in his belief in the appropriateness of using an ANS benchmark. Mr. Speir also noted that oil companies used an ANS benchmark to determine value and that he had reviewed oil company documents that indicated that posted prices did not represent fair market value.[43]

Mrs. Maloney asked Mr. Armstrong, Mr. Haspel, Mr. Berman and Mr. Speir the number of heated oil pipelines which crossed Federal lands in California. There was agreement that there was only one pipeline, Mobil's M–70, that crossed Federal land. Mr. Haspel noted that it is the policy of the Department of Energy that pipelines operate as common carriers.[44]

Brian McMahon, an attorney with Hoecker and McMahon, represented the city of Long Beach and the State of California in litigation regarding crude oil undervaluation. Mr. McMahon testified that periodic oil selloffs by the Federal Government at Elk Hills in California, or by the State of California or the city of Long Beach would typically yield premia over posted prices.[45] McMahon also noted Texaco's assertion, in an official document to the Federal Trade Commission, that posted prices were lower than market value.[46] Mr. McMahon noted that there was a problem with the pipelines in California and their continuing usage of posted prices:

> To my knowledge, there is only one heated pipeline coming out of the San Joaquin Valley to Los Angeles, and that is the pipeline identified as the M–70 of Mobil. That goes through the Angeles National Forest, and we know that the Mobil Co. received an MLA permit, it is called, a Mineral Leasing Act permit, in order to pass through Federal lands. That permit required Mobil to dedicate its pipeline as a common carrier. In fact Mobil does not dedicate its pipeline as a common carrier, and crude oil producers in the San Joaquin Valley must sell their crude at the price

[42] Mr. Speir indicates that he and the Department of Commerce representative prefer a market-based valuation for fair market value, while the Department of Interior personnel from MMS and the Solicitor's office appear to be more interested in consistency and performing the task of valuation as it has always been done.

[43] Oral testimony of Robert Speir, U.S. Department of Energy before a hearing of the Subcommittee on Government Management, Information, and Technology, House Committee on Government Reform and Oversight, *Valuation of Federal Oil—Is the U.S. Getting the Royalties it is Owed?* June 17, 1996.

[44] Oral testimony of Brian McMahon, Hoecker and McMahon, before a hearing of the Subcommittee on Government Management, Information, and Technology, House Committee on Government Reform and Oversight, *Valuation of Federal Oil—Is the U.S. Getting the Royalties it is Owed?* June 17, 1996. Mr. McMahon refers to a letter from William Weitzel of Texaco, Inc. to the Federal Trade Commission referring to Texaco's acquisition of Getty Oil. The letter refers to a Consent Order requiring Texaco to sell oil at posted price and characterizes this action as "inappropriate and unfair" since "posted prices are currently lower than market." Page 9.

[45] *Ibid*. The premia is present where the price obtained through a market sale was higher than a price obtained through the use of a posted price, with the premium being the difference between the two prices, and premia being the plural of premium.

[46] Testimony of Mr. Speir, June 17, 1996.

> Mobil sets for its crude oil, and that price is the posted price.[47]

Mr. McMahon described an instance where the production unit of Union Oil Co. was faced with a situation where the posted price was lower than the price of production.[48] The company affirmed that the posted price did not represent market value.[49] In response to this situation, the production arm suggested that it should share in the value of the refined value of the crude oil, much like what the State of California has suggested that the oil companies should do in correcting undervaluation of crude oil.

In response to questioning by Mrs. Maloney, Mr. McMahon indicated that the documents relating to the Long Beach undervaluation cases contain very sensitive information evidencing underpricing.[50] Robert Shannon, assistant city attorney for the city of Long Beach, testified that the competitors of the oil companies had seen the documents, and that this mooted the question of commercial sensitivity.[51]

Mr. McMahon also described the difficulty of determining what is an arm's-length transaction. For example, Mr. McMahon characterized shadow transactions which had the effect of disguising market value:

> Suppose that I am tired of [California] earthquakes and my friend in Hartford, CT, is tired of snow, so we decide I am going to move to Hartford and he is going to move to California. And we both have a Ford Taurus, and he has a car that is 1 year younger than mine, and it is worth $2,000 more. We say why should we drive both cars cross country. Let's just sell it to each other. Then I say that I will price yours at $22,000 and you price mine at $20,000, and we will write checks for that amount. So he says, "Wait a minute! If we do that, we are going to have to pay a lot of tax on this. Let's price my car at $3,000 and your car at $1,000." This preserves the $2,000 real difference in price, but we paid much less in taxes. And that is what the oil companies are doing with the posted prices.[52]

Mr. McMahon further elaborated on the issue, comparing the pipeline distribution system to other transportation bottlenecks, such as the railroads in the 19th century.[53]

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[47] Testimony of Mr. McMahon, June 17, 1996.

[48] Often, oil companies are vertically integrated, with the same firm owning or controlling the drilling, transportation, refining and marketing of petroleum products. These various units are sometimes made into a subsidiary corporation for favorable legal purposes.

[49] *Ibid*.

[50] *Ibid*.

[51] Oral testimony of Robert Shannon, assistant city attorney, city of Long Beach, CA, before a hearing of the Subcommittee on Government Management, Information, and Technology, House Committee on Government Reform and Oversight, *Valuation of Federal Oil—Is the U.S. Getting the Royalties it is Owed?* June 17, 1996.

[52] Testimony of Mr. McMahon, June 17, 1996.

[53] *Ibid*. The bottleneck theory of antitrust holds that monopolies can flow from dominating either production, distribution or transportation hubs through which a particular product must pass. In the 19th century, railroads were a necessity to get many products to market. The differential prices which railroads charged different customers allowed trusts, such as the Standard Oil Trust, to dominate the market.

E. FINDINGS

The committee finds the following:

The Minerals Management Service has delayed collecting royalty undervaluations

In the hearing held by the committee on June 17, 1996, members expressed concern over delays in collecting underpayments. MMS has engaged in tactics to delay the release of the interagency report, as evidenced by an electronic message to his supervisor in 1994, David Hubbard, the interagency task force leader, in requesting additional audit resources, stated that he has "stalled long enough."

Once MMS disclosed that it would attempt to collect $440 million, it did not include a timetable for the completion of this task. MMS will not simply send the oil companies a bill using Alaska North Slope crude prices as a proxy for the market price of oil. Instead, MMS will audit each and every contract. Given that MMS will have to use scarce audit resources, it will likely take many years to complete this task. This is especially true because the MMS audit division is not committed to collecting these revenues. Unpublished Department of the Interior notes quote the head of the MMS audit division dismissing the interagency task force report in November 1995 as "a piece of [expletive deleted]." Giving control of the audit process to staff who vehemently disagree with the results provides MMS management with further opportunities to delay implementation of sensible policies.

The MMS announcement does not outline any interim steps the agency will take. The interagency task force audited Shell's contracts in California for 1984 and Texaco for 1989 and 1993.[54] As recommended in the report, bills should immediately be sent to those companies for those years. During the June 17 hearing on this issue, Assistant Secretary of the Interior for Land and Minerals Management Robert Armstrong stated that bills would be sent out within 4 to 6 weeks. As of the date of this report, 9 weeks have passed since the date of the hearing, and no action has occurred.

Global settlements may not have protected U.S. financial interests

MMS engaged in global settlements (i.e., a settlement agreement between the Federal Government and an oil company which covers a number of issues and claims in one fell swoop) which allowed two oil companies with large underpayments to avoid payment with the full knowledge that there were substantial problems with underpayments in California in this program. These agreements may have extinguished the claim of the Federal Government to collect the amounts owed. Apparently, the inspector general also recognized that these agreements did not demonstrate that the best interests of the United States were protected.[55] In a draft report, the inspector general noted that the royalty settlements were not con-

[54] U.S. Department of the Interior, *Final Interagency Report on the Valuation of Oil Produced from Federal Leases in California*, pages 63–64.

[55] U.S. Department of the Interior, Office of Inspector General, Draft Audit Report, *Negotiated Royalty Settlements*, November 1995, page 1.

ducted in accordance with "Minerals Management Service Settlement Negotiation Procedures." The report faults MMS for including "no documentation for the estimated values of the issues concerning the underpayment of royalties to be negotiated. . . ." [56] In addition, the report faults MMS for writing down amounts owed for no apparent reason:

> Prior to negotiations, one of the Service's Royalty Management Program divisions estimated the value of a particular issue to be negotiated in a global settlement to be about $439 million. However, the list of issues and values prepared by the negotiation team prior to negotiations estimated that the same issue was valued at $78 million. Documentation in the settlement file was insufficient to explain the $360.4 million difference in the estimated values of this issue.[57]

These are serious charges. It would be helpful for MMS to realize that the problem that we have with the Federal budget deficit means that we must protect the taxpayers of this country through better financial management. MMS's poor management and slow response reflect poorly on the administration's record. During testimony in a hearing on this topic on June 17, Robert Berman, an economist in the Office of Policy Analysis of the Department of the Interior testified that he issued a memorandum expressing his concern that MMS was entering into global settlements with no consideration given to the underpayment issue.[58] This memorandum was issued prior to the global settlements, but apparently went unheeded.

The California undervaluation problem exists in other States

During the June 17 committee hearing, Robert Berman also testified that the amount of the undervaluation of oil extracted from Federal lands may amount to between 3 and 10 percent for States other than California. This may amount to more than $1.3 billion if the higher range is used.[59]

Royalty-in-kind transactions may have left U.S. financial interests unprotected

The May 1996 interagency task force report acknowledged that the team had not "investigated recoupment of additional revenues on royalty-in-kind crude oil that might have been undervalued." The report recommends that the "Department [of the Interior] should consider the effects of RIK [royalty-in-kind] volumes in its decisionmaking, including potential collections where these volumes were undervalued." [60]

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[56] *Ibid*, page 4.
[57] *Ibid*, pages 5–6.
[58] Testimony of Mr. Berman, June 17, 1996.
[59] Testimony of Mr. Berman, June 17, 1996 and press release by the Project on Government Oversight, August 5, 1996. Berman testified that the undervaluation of crude oil was probably between 3 and 10 percent. Using this information, the Project on Government Oversight estimated that applying this percentage to crude oil royalties outside of California would yield $1.3 billion.
[60] U.S. Department of the Interior, *Final Interagency Report on the Valuation of Oil Produced from Federal Leases in California*, page 40, footnote 16.

In concept, royalty-in-kind oil is taken by the Department of the Interior and sold directly to a refiner. In practice, the Department relied on the Federal leaseholder and the refiner-purchaser to arrange the terms of sale and transfer to the refiner's facility. The Federal Government then received payment from the refiner. Typically, this was the posted price, which has been determined to be undervalued. It is possible that royalty-in-kind purchasers were effectively forced to pay, through excessive transportation charges, more for their Federal crude oil than the Federal Government received (i.e., the Federal Government may not have received all of the fair market value of the crude oil which it was due since some of the value may have been retained by the leaseholder through excessive transportation charges).[61]

To the extent that royalty-in-kind purchasers were forced to exchange their royalty-in-kind crude oil with the Federal leaseholder because the purchaser could not gain access to proprietary pipelines, the purchasers may have had to pay a premium due to lack of access to transportation assets.

Pipelines which cross Federal lands harm Federal interests by depressing royalty revenues and preventing an efficient oil market

The problem of proprietary pipelines was well understood by the task force. As the task force notes:

> The market restrictions imposed by proprietary pipelines operated by the major oil refiners had two critical effects. First, it greatly restricted open-market trading in California crude oil; second, it segregated the crude oil markets of the San Joaquin Valley and Ventura Basin from the refining centers in San Francisco and Los Angeles. The reports [of two consultants employed by the task force] concluded that the pipeline situation contributed to postings substantially understating California crude oil values.[62]

The Department of Energy also recognizes this problem. The Department of Energy has indicated that the administration's Domestic Natural Gas and Oil Initiative included a pipeline reform plank.[63] The Department of Energy requested that the Department of the Interior require pipelines that cross Federal lands operate as common carriers. The Department of the Interior has not taken any action on the issue, allowing a continued distortion of the California oil market.

F. RECOMMENDATIONS

The committee urges that the Secretary of the Interior: (1) begin collecting amounts relating to royalty underpayments in California which are well established; (2) begin assessing and collecting amounts relating to royalty underpayments in other States; and (3) ensure that any global settlement sensibly values the possibility of these collections. There is an unwillingness to address issues relat-

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[61] See note 17.

[62] U.S. Department of the Interior, *Final Interagency Report on the Valuation of Oil Produced from Federal Leases in California*, page 47.

[63] Letter from Deputy Secretary of Energy Bill White to Secretary of the Interior Bruce Babbitt, dated March 29, 1994.

ing to the undervaluation of crude oil at the Minerals Management Service. Leadership is required to address these problems.

With these goals in mind, the committee urges action in the following areas:

Timetable for collections

The MMS and the Department of the Interior should develop a timetable to collect these amounts, including specific dates by which to achieve specific goals. This would assist Congress in providing oversight of this essential task, and commit the administration to a realistic schedule of collecting these debts.

Audit resources

There is some question as to whether MMS's audit staff can perform the task of implementing the interagency task force report without prejudice. If the audit staff is unwilling to support program goals determined by the Administration, then MMS should contract with a professional firm of certified public accountants. In depending on a private law firm, the State of California took a similar approach, which resulted in a $345 million settlement. California now contracts with a professional firm of certified public accountants to manage its oil sales.[64] If MMS is experiencing internal resistance in key functions to collecting these underpayments, then MMS should seek outside assistance to expedite collections.

Review global settlements

The question of whether the global settlements will prevent recoveries of underpayments needs to be addressed. The Department of the Interior should request that the Department of Justice prepare an opinion certifying that these amounts have been negotiated away by MMS.

Also, the Department of the Interior needs to review its compromise procedures, which are more sweeping than almost any other Federal agency. Agencies which compromise debts are limited in their authority to do so. Under existing Federal law, Federal agencies may:

> Compromise a claim of the Government of not more than $100,000 (excluding interest) or such higher amount as the Attorney General may from time to time prescribe that has not been referred to another executive or legislative agency for further collection action.[65]

The Department of the Interior, in connection with the Office of Management and Budget and the Department of Justice, should examine whether the persistent mismanagement at MMS requires a threshold for global settlements which would trigger the involvement of the Department of Justice.

Collecting underpayments in States other than California

The Department of the Interior should develop a strategy to address this issue and advise the committee of its plan. If there is an

[64] Staff conversation with Brian McMahon.
[65] Title 31, United States Code, Section 3711(a)(2).

underpayment problem in California, it is highly likely that the same problem exists elsewhere.

Royalty-in-kind transactions

The May 1996 interagency task force report recommends that the Department of the Interior should consider potential collections where crude oil royalties which were taken in-kind were undervalued. This should be done.

Common carrier pipelines

The Department of the Interior should alter its policy to comport with the administration's recommendations regarding the Domestic Natural Gas and Oil Initiative. In addition, the Department should contact officials from the State of California and demonstrate the problem of proprietary pipelines, and the harm which unregulated pipelines can bring to consumers, crude producers and royalty owners such as the State of California and the Federal Government.

G. CONCLUSION

The Minerals Management Service needs to review its operations to ensure that the amounts which are owed to the Federal Government are collected in a timely fashion. For years, oil companies were able to use complex transactions to disguise premia on crude oil from Federal regulators. Now that the Federal Government has determined that there are hundreds of millions of dollars of additional payments owed, MMS must aggressively pursue this problem to protect Federal financial interests. MMS has failed to do so. There is still time to accomplish this task. Until that happens, the crude oil undervaluation issue is a serious hole in the Federal budget deficit that amounts to perhaps $2 billion nationwide for crude oil leasing. This is a problem that is preventable, and requires the attention of senior management in the administration.