

# Making them pay

*How big oil companies shortchange taxpayers on royalties*

BY JIM MORRIS

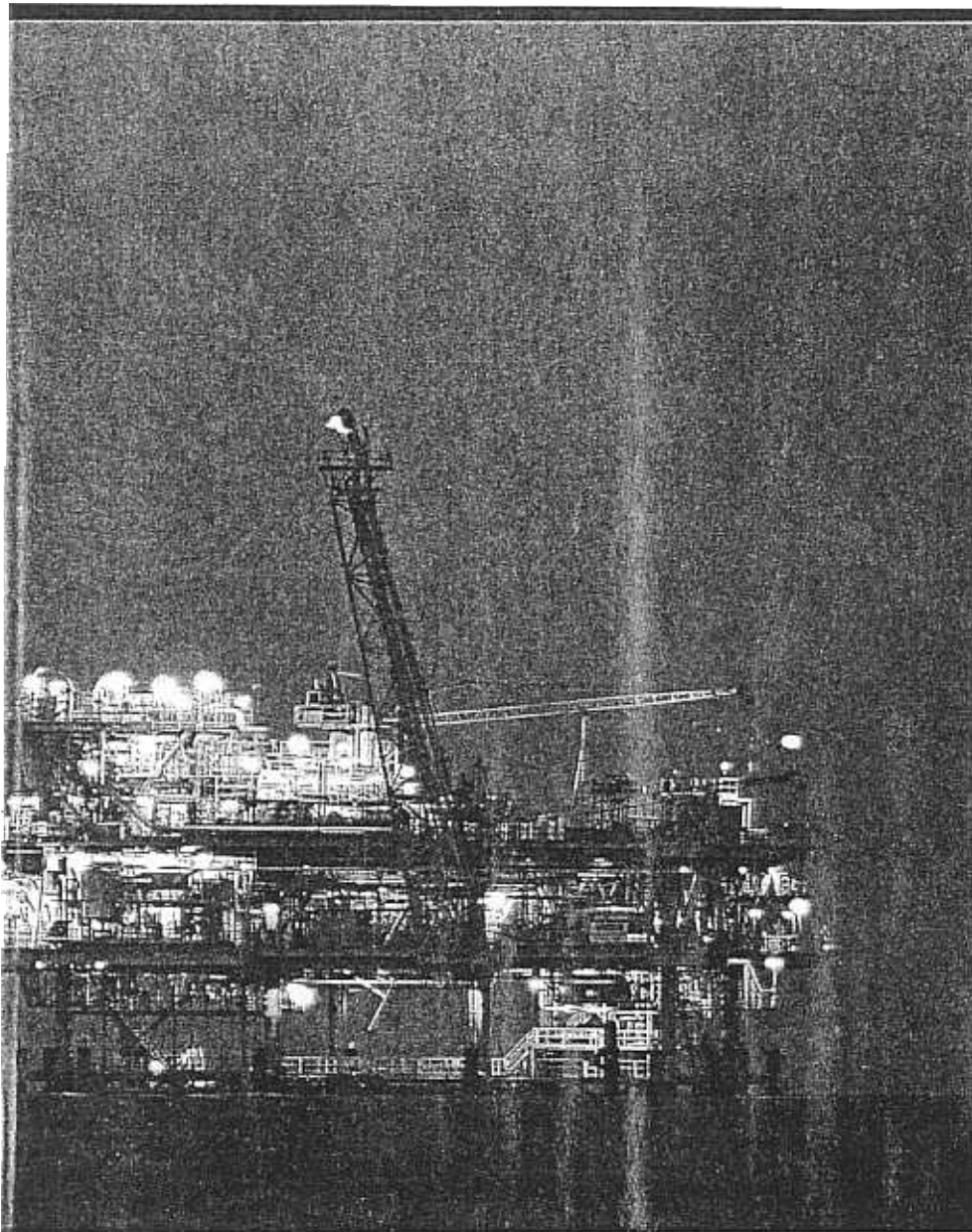
**I**n a frenzied three hours on March 28, the federal government meted out half a billion dollars' worth of oil and gas leases in the central Gulf of Mexico. The announcement of the winning bids, which took place in a packed New Orleans hotel ballroom, vividly demonstrated the appeal of public resources—in this case, 547 underwater tracts that could generate tremendous profits for an industry already enjoying a banner year.

By law, American taxpayers are due a cut of the action. Holders of offshore and

onshore leases must pay royalties—typically, one eighth to one sixth of their proceeds—to the Interior Department. Since 1982 these fees have put more than \$100 billion into the U.S. Treasury, some of which goes to federal parkland and habitat acquisition, and the rest to states for schools, libraries, and roads. Some states have their own royalty programs as well.

In theory, anyone who takes publicly owned minerals should share the wealth. In practice, evidence uncovered in recent litigation and government audits suggests, oil and gas companies have paid far less in royalties than they owe. For

decades, court documents show, producers have set artificially low prices and used other dubious means to underpay by billions of dollars, partly because regulators either weren't mindful or were disinclined to act. Now, amid what President Bush calls an energy crisis, oil companies want access to more federal, state, and tribal properties, even as they challenge new rules designed to ensure that the public gets its fair share of the bonanza. "They will underpay when they can," warns Bob Armstrong, assistant Interior secretary for land and minerals management from 1993 to 1999.



**ExxonMobil drilling rig near Mobile, Ala.**

● *"They were sending a message . . . : If you cheat you will be punished."*

reported gas volumes from 1993 through at least 1999, and improperly claimed deductions for such expenses as catering, maid service, and pagers. According to one internal document, the company believed that only one deduction—for fuel used to operate the offshore platforms—was clearly allowed under its lease with the state. In another document, under the heading, "Consequences of Underpayment," a company attorney states that "if we adopt anything beyond a 'safe' approach, we should anticipate a quick audit and subsequent litigation."

Long before ExxonMobil was called to

### Getting what's owed

Oil companies paid \$5.6 billion in royalties to the U.S. government last year. These figures show amounts collected between 1991 and 2000. Underpayments were collected after litigation and government audits.

	Total royalties	Underpayments
<b>Chevron</b>	\$3.6 bil.	\$106 mil.
<b>Shell</b>	\$3.2 bil.	\$55.7 mil.
<b>ExxonMobil*</b>	\$2.3 bil.	\$7.2 mil.
<b>Texaco</b>	\$2 bil.	\$91 mil.
<b>BP (Amoco)</b>	\$1.9 bil.	\$102 mil.

\*Includes only Exxon figures prior to 1999 merger with Mobil  
Source: U.S. Minerals Management Service

At the root of the controversy is the method of valuing the minerals on which royalties are paid. For years, oil companies have proved themselves adept at keeping those values as low as possible, stretching the definition of fair market price to make sales look less profitable. In a lawsuit filed by independent Texas oilman Harrold "Gene" Wright and joined by the U.S. Justice Department, 27 producers are charged with using a variety of techniques to defraud the federal government. Among them: Undermeasuring gas production volumes and paying royalties on those measurements, and taking improper deductions for "marketing" costs. The suit also alleges that, companies would store gas in the summer, when prices are depressed, and sell it in the winter, when prices are higher. They would then pay royalties on the lower summer prices.

Now the government is cracking down on such practices. Firms such as Chevron, Texaco and BP (formerly BP Amoco) have been forced to spend nearly \$8 billion to

settle underpayment lawsuits with the federal government and seven states, according to the Project on Government Oversight, an independent watchdog group. In December, a jury in Montgomery, Ala., found that ExxonMobil had shortchanged Alabama taxpayers by \$87.7 million from offshore gas leases. Jurors tacked on another \$3.4 billion in punitive damages—one fifth of ExxonMobil's 2000 profits. "They were sending a message . . . : If you cheat you will be punished," says plaintiff's attorney John Crowder Jr.

**Shaky ground.** ExxonMobil called the verdict—upheld Thursday by a state judge—a gross overreaction to a \$40 million contract dispute. And the industry as a whole maintains that it has done nothing wrong. "Honest people can differ" over what constitutes market value for oil and gas, says Red Cavaney, president and CEO of the American Petroleum Institute. But evidence introduced at the Alabama trial suggests that ExxonMobil knew it was on shaky legal ground. The company under-

account in Montgomery, other lawsuits alleged that oil producers underpaid by basing royalties not on the true market prices of the resource but on arbitrary "posted prices," which, regulators came to believe, were suspiciously low. "They would pay royalties on a posted price of, say, \$16 [per barrel], but sell to each other for \$1 to \$2 more," says Armstrong. Spencer Hosie, a San Francisco attorney who represents plaintiffs in royalty and tax litigation, offers this analogy: "It would be like reporting your income for four out of every five days you work and ignoring the fifth, and claiming deductions for two home offices when you had none."

To perpetuate the ploy, Hosie says, "all the defendants had to work together. If one oil company reported honestly, those reports would have made clear that all the other oil companies were reporting dishonestly." The industry scoffs at claims of collusion. Chevron, for one, says it merely had a "good-faith dispute" with the government, brought about by an oil

and gas valuation system "critically [in] need of clarification and simplification."

The Interior Department, it should be said, was slow to react to the royalty problem and may have forfeited billions as a result. Almost 70 years ago, then Interior Secretary Harold Ickes observed that posted prices for oil taken from the Kettleman Hills field in California were lower than the actual market values. And in 1983, the New York Mercantile Exchange began trading crude oil futures, making market prices publicly available. But it wasn't until the early 1990s that the Interior Department began to aggressively pursue the lost revenue. Officials say the issue began to surface during the Reagan administration, which was loath to antagonize the oil industry.

The department's Minerals Management Service has picked up the pace considerably over the past decade, perform-

ing some 15,000 royalty audits and collecting more than \$1.8 billion in underpayments. Although the MMS maintains that its original rules were perfectly clear, it rewrote them to eliminate even a shade of doubt that royalties are to be based on *market* price. The industry responded by suing, claiming the rules are still vague and subjective.

**"Royalty in kind."** Now, some worry that the rules will be overturned in court or watered down under pressure from another oil-friendly administration. The current system could also be replaced by an industry-backed "royalty in kind" program, under which the government would accept the producers' oil or gas itself rather than money. Although studies have shown that such programs work in some instances—when the government has easy access to a pipeline, for example—they can be a big liability for taxpayers in others.

Who is hurt by underpayments? Everyone, to some extent, but especially the poor. A series of audits convinced Perr Shirley, assistant director of the Navajo Nation's Minerals Department, that the tribe is owed millions by producers who have been pumping from its Aneth oil field in Utah since the 1950s. That money Shirley says, "would have gone into essential services. Many homes still lack electricity and plumbing." Louisiana has had to make deep budget cuts—notably within an agency that operates clinics for low-income residents. While royalty payments are not specifically earmarked for the agency, Attorney General Richard Ieyoub says that the energy companies are partly to blame. "We rely heavily on monies we receive from the oil and gas industry," says Ieyoub. "If we're not paid the right amount, the taxpayers are the one who suffer." ●