

Project On Government Oversight

Drilling the Taxpayer:

Department of Interior's Royalty-In-Kind Program

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FOREWORD

Drilling the Taxpayer: Department of Interior's Royalty-In-Kind Program is the fifth report by the Project On Government Oversight regarding the underpayment of royalties to the federal government by the major oil and gas companies. The previous four reports are:

Drilling For the Truth: More Information Surfaces On Unpaid Oil Royalties. 1997

Wait! There Is More Money to Collect...Unpaid Oil Royalties Across the Nation. 1996

With A Wink And A Nod: How the Oil Industry and the Department of Interior Are Cheating the American Public and California School Children. 1996

Department of Interior Looks the Other Way: The Government's Slick Deal for the Oil Industry. 1995

EXECUTIVE SUMMARY

Oil and gas royalties collected from drilling on federal lands and waters is the second largest source of revenue for the federal government other than taxes. Royalties used to be collected primarily in cash, also known as royalty-in-value. This changed in 1997, when Minerals Management Service (MMS) began a pilot program called Royalty-In-Kind (RIK). This program accepts royalty payments in the form of product rather than cash, and is one of the Department of Interior's primary methods of collecting those royalties.

There are extensive inappropriate relationships between MMS employees and the oil and gas industry, insufficient auditing of royalty payments, serious mismanagement of the RIK program, and a debilitating lack of transparency in the program. Despite these problems, the Department of Interior (DOI) intends to significantly increase the size of the RIK program by 2009.

MMS initially resisted the push from industry and some Members of Congress for the RIK alternative, and numerous oversight agencies and outside organizations voiced concerns about the proposal. Regardless of the concerns, a pilot RIK program was established and, a couple of years into the program, independent reviews revealed that the early concerns were warranted. But in the last few years, MMS has clearly changed its position and has embraced the idea of RIK.

Industry influence on the RIK program is traceable from the program's conception, through its expansion, to the full-blown program that exists today. Industry also has had significant influence over MMS and the RIK program through the revolving door. A number of the individuals who went through the revolving door have actually been sentenced to prison for violations of conflict-of-interest laws or obstruction of justice.

The DOI Inspector General recently found that "between 2002 and 2006, nearly 1/3 of the entire RIK staff socialized with, and received a wide array of gifts and gratuities from, oil and gas companies with whom RIK was conducting official business." The IG also described a culture of "ethical failure" and "substance abuse and promiscuity" in the RIK office.¹

The GAO found that in 2003, 2004, 2007, and 2008, MMS could not accurately account for the RIK program's costs and benefits. Despite unverifiable statistics about the program's success, and evidence that the RIK program was found at times to *lose* money, MMS continued to expand the RIK program.

Essentially, the RIK program asks taxpayers to trust that industry delivers the correct amount of oil or gas to the government in lieu of cash, but has reduced oversight to such a degree that the GAO labeled RIK's management "an honor system." However, numerous instances of royalty underpayments by the oil and gas industry have demonstrated the need to hold industry accountable to the taxpayers.

¹ Department of Interior, Office of Inspector General. "Memorandum on OIG Investigations of MMS Employees." September 9, 2008. pp. 1-2.
http://www.doiig.gov/upload/Smith%20REDACTED%20FINAL_080708%20Final%20with%20transmittal%209_10%20date.pdf (Downloaded September 15, 2008)

Even though the operations of the program remain largely opaque, the information available strongly indicates that RIK exists to benefit the oil and gas industry, to the detriment of the public.

The most fundamental reform necessary to make this program functional is a dramatic increase in auditing capacity, yet this fix would wholly undermine MMS's original justification for the program—that the reduced need for auditing would decrease oversight costs. This alone should be reason enough to cancel the failed program. However, the legitimacy of this program is called into further question given the recent findings that MMS employees consider themselves exempt from standard ethical provisions that protect the public's interest. MMS's close relationship with industry has further prevented the public from getting what is owed to them for industry's use of public resources. The extensive corruption and collusion in the RIK program, given that it is charged with managing billions of dollars of federal revenue, should be the final nail in the program's coffin.

Recommendations

- The Secretary of Interior should immediately begin phasing out the RIK program, and should return to relying on a market price-based RIV program instead.
 - RIK should only be used for the purposes of filling the Strategic Petroleum Reserve when prices are low.
- Congress should remove the auditing functions from MMS, and move these tasks to a separate and independent agency.
- MMS should establish strict guidelines and restrictions on what outside work MMS employees can perform while working for the agency.

If the RIK program is not canceled, there must be more institutional checks and increased oversight of this program:

- Congress should prohibit MMS's proposed expansion of the RIK program.
- Until auditing functions are removed from MMS, the Department of Interior should institute regular auditing of the RIK program to improve oversight and management, and only use compliance reviews as a tool to identify leases that need auditing rather than as a replacement for audits.
- The Department of Interior should disclose detailed bi-annual reports concerning the profitability and performance of the RIK program to the Congress.

INTRODUCTION

Oil and gas royalties collected from drilling on federal lands and waters is the second largest source of revenue for the federal government other than taxes,² with the government collecting the equivalent of over \$9 billion in oil and gas royalties in fiscal year 2007 alone.³ In 2006, approximately 40 percent of all royalty collections were made through the Royalty-In-Kind (RIK) program.⁴ In the Gulf of Mexico, the core source area of RIK revenues, approximately 72 percent of crude oil royalties and 45 percent of gas royalties were collected through the RIK program.⁵

RIK is a program where approximately 50 people in the Minerals Management Service (MMS) actually act as oil and gas marketers,⁶ accepting royalty payments in the form of product—crude oil or natural gas—rather than cash (royalty-in-value). To do this, the RIK program collects the product from the lease-holding companies, sells it in the marketplace, and returns the proceeds to the Treasury.⁷

The mission of MMS is “to manage the energy and mineral resources...to enhance public and trust benefits, promote responsible use, and realize fair value.”⁸ This mission includes determining which properties will be converted from in-value to in-kind, negotiating transportation contracts to move the royalty oil and gas, negotiating contracts for selling the oil and gas (often back to the same companies), and performing these tasks to the benefit of the Treasury and taxpayers.

² Department of Interior, Minerals Management Service. *Interim Report on the History of the Offshore Oil and Gas Industry in Southern Louisiana*. July 2004. p. 30.

<http://www.gomr.mms.gov/homepg/regulate/envIRON/studies/2004/2004-049.pdf> (Downloaded September 15, 2008)

³ Government Accountability Office. *Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk* (GAO-08-893R). September 12, 2008, <http://www.gao.gov/new.items/d08893r.pdf> (Downloaded September 15, 2008)

⁴ POGO derived the 40 percent figure by dividing the \$4 billion in RIK revenue by the \$10 billion in total royalty revenues collected in FY 2006. The Subcommittee on Royalty Management. “Report to the Royalty Policy Committee, Mineral Revenue Collection from Federal and Indian Lands and Outer Continental Shelf.” December 17, 2007. p. 95. http://www.mrm.mms.gov/Laws_R_D/RoyPC/PDFDocs/RPCRMS1207.pdf (Downloaded September 16, 2008); Government Accountability Office. *Testimony Before Committee on Natural Resources, U.S. House of Representatives on Royalties Collection: Ongoing Problems with Interior’s Efforts to Ensure A Fair Return for Taxpayers Require Attention* (GAO-07-682T). March 28, 2007. p. 1. <http://www.gao.gov/new.items/d07682t.pdf> (Downloaded September 15, 2008)

⁵ Department of Interior, Minerals Management Service. *Report to Congress: Minerals Management Service Royalty In Kind Operation for Fiscal Year 2006*. April 2007. p. i. <http://www.mrm.mms.gov/RIKweb/PDFDocs/RIKPRPFY2006.pdf> (Downloaded September 16, 2008)

⁶ Department of Interior, Minerals Management Service. *Budget Justifications and Performance Information*. Fiscal Year 2009. p. 139. http://www.doi.gov/budget/2009/data/greenbook/FY2009_MMS_Greenbook.pdf (Downloaded September 15, 2008)

⁷ Minerals Management Service. “The Royalty-In-Kind Program.” February 2007. <http://www.mms.gov/ooc/PDFs/TheMMSRoyalty-in-KindProgram.pdf> (Downloaded September 15, 2008)

⁸ Department of Interior, Minerals Management Service. *Budget Justifications and Performance Information*. Fiscal Year 2009. p. 2.

An examination of the RIK program's history reveals that it was proposed by industry as an alternative to royalty-in-value (RIV) at a time when RIV regulations were becoming less favorable to the oil industry.⁹ (Appendix B)

Recent Department of Interior Inspector General (DOI IG) reports¹⁰ as well as Project On Government Oversight (POGO) sources reveal that there are extensive inappropriate relationships between MMS (particularly RIK) employees and the oil and gas industry, insufficient auditing of royalty payments, serious mismanagement of the RIK program, and a debilitating lack of transparency in the program. Furthermore, the Government Accountability Office (GAO) has repeatedly found that the RIK program cannot ensure taxpayers are receiving full compensation for oil and gas produced on federal lands and waters, "raising significant questions about the reported financial benefits of the in-kind program."¹¹

Yet, the DOI hopes to significantly increase the size of the RIK program by 2009.¹² This is not a course of action POGO can condone. Over the past decade, POGO has raised concerns about the implementation of RIK, without opposing RIK in principle. However, in light of the proposed plan to expand the program yet again, and given the numerous damning reports about the RIK program and MMS's inability to prove that it is beneficial to the taxpayers—even ten years after its first pilot program—enough is enough. The RIK program should be terminated, and the system should revert to collecting royalties through the royalty-in-value system.

BACKGROUND

In 1997, in light of evidence that industry was getting around royalty regulations and underpaying royalties to the tune of billions of dollars, MMS proposed a more stringent royalty-in-value rule. In response to that rulemaking, industry proposed an alternative—royalty-in-kind. Some Members of Congress cried foul. In 2000, Senator Barbara Boxer (D-CA) described the RIK proposal as resistance to paying royalties based on fair-market value:

⁹ Deal Consulting & Dispute Resolution, LLC. "Federal Oil & Gas Royalty Valuation, Royalty in Kind and Royalty Relief 1980-2008." August 2008. http://www.dtdeal.com/pdf/chronology-valuation_royalty_relief1980-2008.pdf. (Downloaded September 15, 2008)

¹⁰ Department of Interior, Office of Inspector General. *Investigative Report: Gregory W. Smith*. August 7, 2008. http://www.doiig.gov/upload/Smith%20REDACTED%20FINAL_080708%20Final%20with%20transmittal%209_10%20date.pdf. (Downloaded September 15, 2008); and Department of Interior, Office of Inspector General. *Investigative Report: MMS Oil Marketing Group – Lakewood*. August 19, 2008. p. 8. http://www.doiig.gov/upload/RIK%20REDACTED%20FINAL4_082008%20with%20transmittal%209_10%20date.pdf. (Downloaded September 15, 2008); Department of Interior, Office of Inspector General. *Investigative Report: Federal Business Solutions Contracts*. September 4, 2008. http://www.doiig.gov/upload/FBS%20REDACTED%20with%20Transmittal%209_10%20date.pdf. (Downloaded September 15, 2008)

¹¹ Government Accountability Office. *Testimony Before the Subcommittee on Energy and Mineral Resources, Committee on Natural Resources, House of Representatives on Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk* (GAO-08-560T). March 11, 2008. pp. 5-6. http://resourcescommittee.house.gov/images/Documents/20080311/testimony_rusco.pdf (Downloaded September 15, 2008)

¹² Department of Interior, Minerals Management Service. *Budget Justifications and Performance Information*. Fiscal Year 2009. p. 153.

So after 3 years of fighting—and, believe me, I had to stand on my feet and fight long and hard, and so did a lot of my colleagues, and I thank them—we were able to make sure that a fair way of determining the fair market value of that oil was put in place. In the middle of all this comes the payment-in-kind program. In other words, instead of paying cash, we say to the oil and gas companies we are going to try an experiment.¹³

Industry chronologies on the origins of the RIK program reveal that, unlike MMS's current support for the program, MMS initially resisted industry's push for the RIK alternative. David Deal, one of the chief oil and gas industry lobbyists at the time, noted in his chronology that early on there was only "qualified MMS support for an RIK pilot program." According to Deal's chronology, in 1997, MMS published its oil proposal: "to begin protracted and contentious oil valuation rulemaking; **industry** accedes to abandonment of posted prices, but defends use of comparable sales and **promotes RIK. Industry-crafted RIK bill** introduced but goes nowhere; Congress enacts appropriations bills which temporarily delay MMS promulgation of final oil valuation rule."¹⁴ (Emphasis added) Despite the failure of that legislation, the RIK pilot program ballooned over the next decade to being a significant source of royalty collections. (Appendix B)

The American Geological Institute, an industry trade organization, also created an illustrative chronology that details numerous hearings and closed-door meetings on Capitol Hill during 1997 and 1998. During those meetings, industry leaders and their Hill allies pushed MMS officials to move to RIK, and to back down on their proposed more stringent rule to collect RIV based on fair market value. As the chronology states, "Many in industry are opposed to this rule...Instead, oil companies have lobbied in favor of taking royalties in-kind (RIK), eliminating the price question entirely."¹⁵ (Appendix C)

In July 1997 testimony before the House Resources Subcommittee on Energy and Mineral Resources, MMS Director Cynthia Quarterman expressed her doubts about the RIK program and highlighted the pressure the agency was under from some Members of Congress to pursue RIK:

We are undertaking this study as part of our continuing efforts to improve services to the public at reduced cost. We are also responding to a congressional directive to consider additional royalty in kind scenarios....Considering that lessees cannot deduct marketing costs under the Federal in value system, we believe that implementation of an oil RIK program would actually lose revenue because MMS would need to pay these costs under an RIK program without the potential for volume aggregation or downstream value

¹³ Senator Barbara Boxer. "C-Span Congressional Chronicle: Making Continuing Appropriations for the Fiscal Year 2001." October 4, 2000. <http://www.c-spanarchives.org/congress/?q=node/77531&id=8787587> (Downloaded September 16, 2008)

¹⁴ Deal Consulting & Dispute Resolution, LLC. "Federal Oil & Gas Royalty Valuation, Royalty in Kind and Royalty Relief 1980-2008."

¹⁵ American Geological Institute. "Update and Hearing Summary on Royalty Payments for Oil and Gas (11-6-98)." Background Section. <http://www.agiweb.org/hearings/rik797.html> (Downloaded September 15, 2008)

enhancements of a gas RIK. In summary, we are not convinced that crude oil RIK is in the best interests of the United States.¹⁶

In March 1998, MMS Director Quarterman again testified before the House Resources Subcommittee on Energy and Mineral Resources, telling the committee that she would recommend then-President Clinton veto the proposed mandatory RIK legislation because:

RIK is unproven and risky for royalty collection in the U.S. As stewards of public assets, we must have assurance that the revenue and administrative effects of RIK are decidedly positive before moving to implementation. Anything less is a gambler's folly with the taxpayers money....[the bill] clearly represents a dramatic transfer of costs and obligations from the oil and gas industry to the American taxpayer. Our preliminary analysis suggests that the revenue loss would be significant and on the order of hundreds of millions of dollars at a minimum. I believe we must seriously ask ourselves how the American taxpayer would benefit from H.R. 3334. Because of the disastrous effect this bill would have on the taxpayer and the budget, the Department is prepared to recommend a veto.¹⁷

Finally, the American Geological Institute chronology describes a closed Roundtable Discussion between industry executives, oil-state Senators, and MMS officials:

Senators Breaux and Hutchison, co-chairs of the Congressional Oil and Gas Forum, invited the participants to the meeting in hopes of finding common ground between the different sides. Generally, the oil industry is in support of an overall royalty-in-kind program, whereas MMS is hesitant to require all oil and gas royalties be taken in-kind, instead supporting a change in oil valuation regulations to reflect fair market value.¹⁸ (Appendix C)

Many outside of industry were wary of the RIK program before it was implemented—POGO has been raising concerns about the program for more than ten years. During the program's pilot phase in 1997, POGO Executive Director Danielle Brian testified before the House Subcommittee on Energy and Mineral Resources that the RIK proposal was a "diversion tactic." Originally, industry argued RIK would "mean more revenue to the government....now they are saying it is revenue neutral. They are no longer trying to claim it is going to be a revenue enhancer."¹⁹

¹⁶ Department of Interior, Minerals Management Service. "Cynthia Quarterman, Director Minerals Management Service, Congressional Testimony Prepared for the Energy and Mineral Resources Subcommittee." July 31, 1997. <http://www.mms.gov/ooc/testimony/rik73197.htm> (Downloaded September 15, 2008)

¹⁷ Department of Interior, Minerals Management Service. "Testimony of Cynthia L. Quarterman, Director Minerals Management Service U.S. Department of Interior, Before the Subcommittee on Energy and Mineral Resources, Resources House of Representatives." March 19, 1998. <http://www.mms.gov/ooc/testimony/testrik3.htm> (Downloaded September 15, 2008)

¹⁸ American Geological Institute. "Meeting on MMS's Proposed Oil Royalty Valuation Rule at Senate Russell Building." July 9, 1998. <http://www.agiweb.org/hearings/rik797.html#july9> (Downloaded September 15, 2008)

¹⁹ House Subcommittee on Energy and Mineral Resources. "Statement of Danielle Brian at Oversight Hearings on Royalty-In-Kind for Federal Oil and Gas Production." July 31, 1997. pp. 101-102. http://commdocs.house.gov/committees/resources/hii45026.000/hii45026_0.htm (Downloaded September 15, 2008)

Another indication that an expanded RIK program was not going to provide good value to taxpayers could be seen when well-known oil industry advocate Representative Don Young (R-AK) supported making the program mandatory and nationwide—except in his own state, which he would have exempted from the program.²⁰

Some Members of Congress were against RIK. In her 2000 speech on the Senate Floor, Senator Boxer argued that RIK is a good deal for oil companies, but not the taxpayer: “Those guys with those sharp pencils who are in the oil company, they are going to go for payment in kind because there is not any real definition. They are going to give us less oil and less value than we would [otherwise] get [through RIV].”²¹

Then, a 2001 memorandum to the State of California from Innovation & Information Consultants, Inc.²² raised significant concerns about using the 1997 pilot program as a basis for expanding the program:

The evidence indicates that these RIK sales did not result in the realization of market value....Much of the analysis contained in the MMS report has not been validated, however, MMS appears to be using the results of this study to expand the program in Wyoming and perhaps elsewhere. Further data and study are required, **but at this point we do not see this study or the results of the RIK pilot as justification for expansion of the program to other areas in the country.**²³ (Emphasis added)

Also in 2001, when the House Subcommittee on Energy and Mineral Resources revisited expansion of the RIK pilot,²⁴ POGO again urged Congress to be wary after two RIK pilot programs failed to collect more revenue in-kind than it collected in-value, with one pilot losing \$3 million.²⁵ In the same hearing, Representative Carolyn Maloney (D-NY) pointed out that MMS could not estimate the costs of the RIK program. Moreover, she questioned the rush to expand the program without this knowledge: “Since when has Congress considered creating massive new Federal bureaucracies when we have little idea what they may cost?”²⁶

²⁰ Manimoli Dinesh. “RIK Bill Prospects Depends on CBO Score.” *Environment and Energy Daily*, June 22, 1998.

²¹ Senator Barbara Boxer. “C-Span Congressional Chronicle: Making Continuing Appropriations for the Fiscal Year 2001.”

²² Innovation & Information Consultants, Inc. is “an economic and financial consulting firm specializing in the economics of the petroleum industry.” Innovation & Information Consultants, Inc. “Testimony of Peter K. Ashton, President, Innovation & Information Consultants, Inc., before the Permanent Subcommittee on Investigations for the Senate Governmental Affairs Committee.” May 2, 2002. p 1. http://www.senate.gov/~gov_affairs/050202ashton.pdf (Downloaded September 15, 2008)

²³ Innovation & Information Consultants, Inc. “Memorandum: MMS Report in RIK Pilot Program in Wyoming.” April 24, 2001. p. 1. <http://www.pogo.org/m/ep/ep-rikmemo.pdf> (Downloaded September 15, 2008)

²⁴ House Subcommittee on Energy and Mineral Resources. “Oversight Hearing on Collection and Disposition of Federal Oil and Gas Royalties Taken In-Kind.” June 12, 2001. http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_house_hearings&docid=f:73043.wais (Downloaded September 15, 2008)

²⁵ Project On Government Oversight. “Written Testimony of Danielle Brian, Executive Director Project On Government Oversight Royalty-in-Kind Provisions of the Energy Bill.” July 10, 2001. <http://www.pogo.org/p/environment/et-010733-rik.html> (Downloaded September 15, 2008)

²⁶ House of Representatives. “Maloney Cautions Against Republican Plans to Bolster Oil Industry.” June 12, 2001. http://maloney.house.gov/index.php?option=com_content&task=view&id=688&Itemid=61 (Downloaded September 15, 2008)

In 2002, POGO and MMS engaged in a public back-and-forth regarding the merits of the growing RIK program, in which POGO pointed out that MMS's parsed language was misleading, improperly suggesting success in the RIK program when no such evidence existed. (Appendix A)

Despite the efforts of Senator Boxer, Representative Maloney, and others to limit the RIK program until there was evidence that it wasn't losing money for the taxpayer, the program began to grow unabated.

INDUSTRY INFLUENCE: WHO'S IN CHARGE HERE?

Industry's influence on the RIK program has been pervasive, and is traceable from the program's conception, through its expansion, to the full-blown program that exists today. In 2001, a memo from the American Petroleum Institute to Vice President Dick Cheney's energy task force stated that "RIK should be considered part of a comprehensive national energy strategy and a permanent tool for the Minerals Management Service to use in fulfilling its mission." The memo also stated industry's opposition to paying for royalties in cash, and detailed industry's legal challenges aimed at halting the government's efforts to establish regulations for fair market-based royalty payments. (Appendix D)

The GAO also confirmed industry's push to avoid paying royalties in cash:

Although states that receive distributions of these royalties generally support the proposed regulations [to assure fair payment of oil royalties], oil industry representatives generally oppose them, believing that oil companies should not pay royalties on higher prices and that they would suffer increased administrative requirements. As an alternative, the oil industry has suggested that MMS instead be required to accept, as the federal government's royalties, a percentage of the actual oil and gas produced from federal leases (known as royalties in kind).²⁷

In 2003, MMS contracted with the Lukens Energy Group²⁸ to conduct an independent assessment of the RIK program's transition from a pilot program to a full-scale operation and chart a five-year business plan.²⁹ Lukens' report to MMS concluded that the RIK program had

²⁷ General Accounting Office. *Report to Congressional Requesters on Federal Oil Valuation: Efforts to Revise Regulations and an Analysis of Royalties in Kind*. (GAO/RCED-98-242). August 1998. pp. 1-2. <http://www.gao.gov/archive/1998/rc98242.pdf> (Downloaded September 15, 2008)

²⁸ Lukens Energy Group is an energy consulting firm described by its parent company as "a preeminent management consulting group serving senior management in the oil and gas industry in strategy, risk mitigation, valuation and regulatory matters." Black and Veatch. "News Release: Black & Veatch Acquires R.J. Rudden Associates, Inc. And Lukens Energy Group, Inc." January 14, 2005. http://www.bv.com/news_3_publications/press_releases/2005/0114.aspx (Downloaded September 16, 2008)

²⁹ Black & Veatch. "News Release: Black & Veatch Acquires R.J. Rudden Associates, Inc. and Lukens Energy Group, Inc."

“performed remarkably” and that “the pilots have proven that RIK can succeed operationally while at the same time representing a viable option when compared to royalty-in-value.”³⁰

This finding is not surprising: the independent review by Lukens turns out not to be so independent. From 1998 to 2000, Lukens Vice President Fred Hagemeyer had chaired the industry’s Royalty Strategy Task Force, which vigorously supported the use of royalty-in-kind. In 2000, Mr. Hagemeyer even received an award from the American Petroleum Institute, for his “policy development which led to significant improvements to the Minerals Management Service’s oil valuation rule **and expansion of its fledgling royalty-in-kind projects.**”³¹ (Emphasis added)

Not only was Lukens not independent in its position about RIK, but the RIK program was not independent of relationships with Lukens. A recently released DOI IG report determined that Lukens Vice President Hagemeyer was considered a “trusted advisor” by RIK Program Director Greg Smith, and that the two communicated extensively during the contract selection process, despite regulations clearly prohibiting such contact between bidding companies and MMS officials.³² The IG further reported that during the same time period Lukens’ contract bid was being considered by MMS, Hagemeyer assisted then-RIK Deputy Program Manager Smith in his efforts to market Geomatrix,³³ a firm with which Smith was improperly consulting on the side.³⁴

Using Lukens’ “independent” findings as justification, MMS expanded the RIK program and made it fully operational in 2004.³⁵ (Appendix E)

Revolving Door

Industry influence doesn’t stop at “independent” reviews and recommendations. Industry also has significant influence over MMS and the RIK program through the revolving door. The revolving door between the government and the companies it regulates or contracts with is a story of money, information, influence, and access—access that ensures that phone calls get through to policymakers and meetings get scheduled. The American taxpayer is left with a system that sometimes compromises the way the government buys goods and services from its contractors. There are existing prohibitions against the revolving door because of the need to protect the integrity of the government.

Concerns about industry’s overly close relationship with MMS have been exacerbated by several publicly documented instances of MMS (or DOI officials who oversee MMS) leaving the agency to work for the companies they used to oversee:

³⁰ Lukens Energy Group, *Assessment of the Federal Royalty-in-Kind (“RIK”) Program and Development of RIK Business Plan*, September 30, 2003, pp. 4, 9.

³¹ “Hagemeyer gets API honor.” *API EnCompass: News*, November 13, 2000.

<http://web.archive.org/web/20001213110900/www.api.org/release.cgi?days=90> (Downloaded September 16, 2008)

³² Department of Interior, Office of Inspector General. *Investigative Report: Gregory W. Smith*. August 7, 2008. p. 16.

³³ Geomatrix is a California-based consulting firm that sought business with oil and gas companies.

³⁴ Department of Interior, Office of Inspector General. *Investigative Report: Gregory W. Smith*. August 7, 2008. p. 17.

³⁵ Department of Interior, Minerals Management Service. “RIK History and Program Development.” <http://www.mrm.mms.gov/RIKweb/PDFDocs/RIKBackground.pdf> (Downloaded September 16, 2008)

- J. Steven Griles lobbied for coal, oil, and gas interests before he served as Deputy Secretary of DOI from 2001 to 2004.³⁶ He left DOI in December 2004 to start his own lobbying firm, Lundquist, Nethercutt & Griles, whose client list included American Petroleum Institute and BP.³⁷ In 2007, Griles was sentenced to 10 months in prison for obstructing the Senate’s investigation into the corruption allegations surrounding Washington lobbyist Jack A. Abramoff.³⁸
- Gale Norton served as DOI Secretary from 2001 to 2006, then took a position as the general counsel for Royal Dutch Shell’s exploration and production business.³⁹
- William Gerry Myers III served as a solicitor for DOI from 2001 to 2003, then returned to Holland and Hart, a firm that represents several extractive industries.⁴⁰
- Rebecca Watson served as Assistant Secretary of DOI for Lands and Minerals Management from 2001 to 2005,⁴¹ and is now a partner at Hogan and Hartson, whose client list includes Unocal Pipeline Company, PacifiCorp, and MidAmerican Energy Holdings Company.⁴²
- L. Poe Leggette served as Assistant Solicitor for DOI for over a decade, “advising the Bureau of Land Management and the Minerals Management Service on their onshore and offshore energy programs, and MMS’s Royalty Management Program on questions of royalty valuation,” and now heads the Western Lands and Energy Practice at Fulbright & Jaworski.⁴³

³⁶ Robert F. Kennedy Jr. “Texas Chainsaw Management.” *Vanity Fair*, May 2007.
<http://www.vanityfair.com/politics/features/2007/05/revolvingdoor200705?currentPage=1> (Downloaded September 15, 2008)

³⁷ The firm is now called Bluewater Strategies, LLC. The Center for Responsive Politics. “Influence and Lobbying: Lundquist Nethercutt, & Griles.”

<http://www.opensecrets.org/lobby/firmsum.php?lname=Lundquist%2C+Nethercutt+%26+Griles&year=2005> (Downloaded September 16, 2008)

³⁸ Department of Justice. “Former Interior Deputy Secretary Steven Griles Sentenced to 10 Months in Prison for Obstructing U.S. Senate Investigation into Abramoff Corruption Scandal.” June 26, 2007.

http://www.usdoj.gov/opa/pr/2007/June/07_crm_455.html (Downloaded September 15, 2008)

³⁹ Steve McMillan. “Norton will join Royal Dutch Shell.” *Denver Post*, December 27, 2006.

http://www.denverpost.com/business/ci_4910177 (Downloaded September 15, 2008)

⁴⁰ Robert F. Kennedy Jr. “Texas Chainsaw Management.” *Vanity Fair*, May 2007.

⁴¹ Department of Interior, Office of Congressional and Legislative Affairs. “OCL 2001 Hearings/Testimony”

http://www.doi.gov/ocl/2001/archive_01.html (Downloaded September 16, 2008); Department of Interior.

“Secretary Gale Norton Praises Leadership of Assistant Secretary for Land and Minerals Management Rebecca Watson.” *News*. http://www.doi.gov/news/05_News_Releases/051014.htm (Downloaded September 16, 2008)

⁴² Hogan and Hartson. “Practices & Industries: Environmental.” <http://www.hhlaw.com/environmental/> (Downloaded September 15, 2008)

⁴³ Fulbright & Jaworski L.L.P. “Fulbright & Jaworski L.L.P.” <http://www.fulbright.com/pleggette> (Downloaded September 15, 2008)

- Paul Stang served as Regional Supervisor for Leasing and Environment for MMS,⁴⁴ then went to work for Shell in 2007 on its Arctic Ocean programs.⁴⁵
- Greg Smith served as the Deputy Program Manager of RIK between 2001 and 2004. In 2005, he was promoted to be the RIK Director where he remained until he was detailed out of RIK in January 2007.⁴⁶ While working in the RIK program, Smith received over \$30,000 in consulting fees from Geomatrix, a California-based consulting firm that sought business with oil and gas companies. He retired from the federal government during an IG investigation into his conduct, and went to work at Tenaska Marketing Ventures, an international power development company and energy marketer.⁴⁷
- Jimmy Mayberry served as Special Assistant to the Associate Director of Minerals Revenue Management (MRM), which is managed by MMS, from 2000 to January 2003. After retiring, he created an energy consultancy firm, Federal Business Solutions, that received an MMS contract in February 2003—after he and his supervisor (now-retired MMS Associate Director Lucy Denett) rigged the competition. Mayberry pleaded guilty to a violation of federal conflict-of-interest law and is facing up to five years in prison.⁴⁸
- Milton Dial served as MMS Assistant Program Director and retired in September 2004. He then joined Mayberry’s consultancy firm, Federal Business Solutions, in February 2005.⁴⁹ On September 15, 2008, Dial pleaded guilty to a felony violation of post employment conflict-of-interest law.⁵⁰

As long as the door continues to revolve between industry and DOI or MMS, the public cannot be sure that their interests are being served.

⁴⁴ Department of Interior, Minerals Management Service. “Public Hearings on Liberty Development and Production Plan.” March 19, 2001. p. 2.

<http://www.mms.gov/alaska/ref/PublicHearingsArctic/2001%20Liberty%20Nuiqsut.pdf> (Downloaded September 15, 2008)

⁴⁵ Public Employees for Environmental Responsibility. “Shell’s Revolving Door Swings U.S. Arctic Drilling Program.” May 20, 2008. http://www.peer.org/news/news_id.php?row_id=1049 (Downloaded September 15, 2008)

⁴⁶ Department of Interior, Office of Inspector General. *Investigative Report: Gregory W. Smith*. August 7, 2008. p. 1. http://www.doiig.gov/upload/Smith%20REDACTED%20FINAL_080708%20Final%20with%20transmittal%209_10%20date.pdf. (Downloaded September 15, 2008)

⁴⁷ Tenaska Marketing Ventures. “TMV Associates: Gulf Coast Region.” <http://www.tenaska.com/staff.aspx?id=21#137> (Downloaded September 16, 2008)

⁴⁸ Department of Interior, Office of Inspector General. *Investigative Report: Federal Business Solutions Contracts*. September 4, 2008. pp. 1-3.

http://www.doiig.gov/upload/FBS%20REDACTED%20with%20Transmittal%209_10%20date.pdf. (Downloaded September 15, 2008); and Department of Justice. “Former Department of Interior Official Pleads Guilty to Conflict of Interest Charge.” July 30, 2008. <http://www.usdoj.gov/opa/pr/2008/July/08-crm-672.html> (Downloaded September 15, 2008)

⁴⁹ Department of Interior, Office of Inspector General. *Investigative Report: Federal Business Solutions Contracts*. September 4, 2008. p. 1.

http://www.doiig.gov/upload/FBS%20REDACTED%20with%20Transmittal%209_10%20date.pdf. (Downloaded September 15, 2008)

⁵⁰ Department of Justice. “Former Department of Interior Official Pleads Guilty to Felony Violation of Post Employment Conflict Law.” <http://www.usdoj.gov/opa/pr/2008/September/08-crm-818.html> (Downloaded September 16, 2008)

Dangerous Liaisons: MMS and Industry in Bed Together—Literally

The close relationship between MMS and the oil and gas industry helps to explain the agency's willingness to expand the RIK program without any real evidence that it is successful. In fact, the DOI Inspector General (IG) found that "RIK staff had inappropriate relationships with industry that could compromise their objectivity."⁵¹ Indeed, "between 2002 and 2006, nearly 1/3 of the entire RIK staff socialized with, and received a wide array of gifts and gratuities from, oil and gas companies with whom RIK was conducting official business." The IG also described a culture of "ethical failure" and "substance abuse and promiscuity" in the RIK office.⁵²

For example, Shell Director of Marketing for Exploration and Production Michael Faulise not only hosted golfing and skiing events for RIK officials, but also said that he considered RIK to be "a fellow industry partner."⁵³ In a gesture that seemed to suggest mutual admiration between colleagues, MMS honored Faulise in 2003 with the MMS Corporate Leadership Award.⁵⁴

The IG report pointed out that MMS has:

a pervasive culture of exclusivity, exempt from the rules that govern all other employees of the Federal government....[RIK] marketers donned a private sector approach to essentially everything they did. This included effectively opting themselves out of the Ethics in Government Act, both in practice, and, at one point, even explored doing so by policy or regulation.⁵⁵

As further evidence that MMS simply does not recognize the gravity of the problem, in an email to MRM staff, MMS Director Randall Luthi said "it is important to remember that the investigation uncovered a very small number of employees whose behavior has been unacceptable." This indifference from the highest level to the corruption within the office—after the behavior of fully one-third of the office had been found improper—is evidence this program is beyond repair. (Appendix F)

⁵¹ Department of Interior, Office of the Inspector General, Royalty Initiatives Group. *Evaluation Report: Minerals Management Service Royalty-in-Kind Oil Sales Process*, (C-EV-MMS_0001-2008). May 2008. p. 4. <http://www.doioig.gov/upload/2008-G-0021.pdf> (Downloaded September 15, 2008)

⁵² Department of Interior, Office of Inspector General. "Memorandum on OIG Investigations of MMS Employees." September 9, 2008. pp. 1-2. http://www.doioig.gov/upload/Smith%20REDACTED%20FINAL_080708%20Final%20with%20transmittal%209_10%20date.pdf (Downloaded September 15, 2008)

⁵³ Department of Interior, Office of Inspector General. *Investigative Report: MMS Oil Marketing Group – Lakewood*. August 19, 2008. p. 15. http://www.doioig.gov/upload/RIK%20REDACTED%20FINAL4_082008%20with%20transmittal%209_10%20date.pdf (Downloaded September 15, 2008)

⁵⁴ Department of Interior, Minerals Management Service. "Interior Department Honors Best in the Oil and Gas Industry." April 29, 2003. <http://www.mms.gov/ooc/press/2003/pressdoi429.htm> (Downloaded September 15, 2008)

⁵⁵ Department of Interior, Office of Inspector General. "Memorandum on OIG Investigations of MMS Employees." September 9, 2008. pp. 1-2.

WHY DOES MMS THINK RIK IS WORKING?

MMS claims that the RIK program has been independently evaluated and that its expansion is warranted and in the taxpayers' interest. But rather than listening to federal government evaluations of the program, MMS instead relies on industry insider Lukens Energy Group. MMS consistently puts more weight in Lukens' findings than those of the GAO, the DOI IG, or the Department of Energy Inspector General (DOE IG).

In 2003, the same year that the Lukens Group reported the success of the RIK program, the GAO released a report raising serious questions about MMS's ability to determine whether the RIK program was effective:

To date, MMS has not developed clear strategic objectives linked to statutory requirements nor collected the necessary information to effectively monitor and evaluate the Royalty-in-Kind Program.⁵⁶

Then in 2004, following the early failures of RIK pilot programs identified earlier, the GAO found that some RIK sales yet again *lost* money for the government. According to that GAO report, "RIK oil sales in the Gulf of Mexico decreased revenues by \$7.2 million, for a loss of 5.5 percent on sales of \$131 million."⁵⁷

Since 2004, MMS has annually supported the RIK program by providing statistics detailing its success, and GAO has repeatedly challenged those figures. The GAO found that in 2003,⁵⁸ 2004,⁵⁹ 2007,⁶⁰ and 2008,⁶¹ MMS could not accurately account for the RIK program's costs and benefits. One GAO report challenged the agency's belief that the program has generated \$87 million more than it would have by accepting royalties in cash over the 2004-2006 period (the most recent years for which statistics are available).⁶²

⁵⁶ General Accounting Office. *Report to Congressional Requesters on Mineral Revenues: A More Systematic Evaluation of the Royalty-in-kind Pilots is Needed* (GAO-03-296). January, 2003. Summary page. <http://www.gao.gov/new.items/d03296.pdf> (Downloaded September 15, 2008)

⁵⁷ General Accounting Office. *Report to Congressional Requesters on Mineral Revenues: Cost and Revenue Information Needed to Compare Different Approaches for Collecting Federal Oil and Gas Royalties* (GAO-04-448). April 2004. pp. 15, 29-30. <http://www.gao.gov/new.items/d04448.pdf> (Downloaded September 15, 2008)

⁵⁸ General Accounting Office. *Report to Congressional Requesters on Mineral Revenues: A More Systematic Evaluation of the Royalty-in-kind Pilots is Needed* (GAO-03-296). January, 2003. Summary page.

⁵⁹ Government Accountability Office. *Report to Congressional Requesters on Mineral Revenues: Cost and Revenue Information Needed to Compare Different Approaches for Collecting Federal and Gas Royalties* (GAO-04-448). April 2004. Summary page.

⁶⁰ Government Accountability Office. *Testimony Before Committee on Natural Resources, U.S. House of Representatives on Royalties Collection: Ongoing Problems with Interior's Efforts to Ensure A Fair Return for Taxpayers Require Attention* (GAO-07-682T). March 28, 2007. Summary page. <http://www.gao.gov/new.items/d07682t.pdf> (Downloaded September 15, 2008)

⁶¹ Government Accountability Office. *Testimony Before the Subcommittee on Energy and Mineral Resources, Committee on Natural Resources, House of Representatives on Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk* (GAO-08-560T). March 11, 2008. p. 4. http://resourcescommittee.house.gov/images/Documents/20080311/testimony_rusco.pdf (Downloaded September 15, 2008)

⁶² Government Accountability Office. *Testimony Before the Subcommittee on Energy and Mineral Resources, Committee on Natural Resources, House of Representatives on Mineral Revenues: Data Management Problems and*

Despite unverifiable statistics about the program's success and MMS's unwillingness to subject itself to unbiased scrutiny, MMS continued to expand the RIK program. In 2004, the GAO stated that, "We recognized MMS's progress in establishing management control and documenting the results of its RIK sales. However, as RIK sales have continued to grow, it is still difficult to completely quantify the administrative cost and revenue impact of the RIK program."⁶³ Nevertheless, MMS continued to expand the program.

In 2007, the GAO once again raised the red flag in congressional testimony, stating that the RIK program's expansion was cause for concern, and that data limitations prevent the agency from confirming the program's effectiveness.⁶⁴ The DOI claims that the RIK program increased the net return to the government in 2006 by \$31.1 million over what would have been taken as cash payments.⁶⁵ However, the GAO again reported problems with the agency's figures in 2008, saying that this calculation did not appropriately account for uncertainty in interest, did not include significant costs, and did not reflect that "in many individual sales, MMS sold the oil it collected in kind for less than it estimates it would have collected in cash."⁶⁶ In response to congressional questions for the record, the GAO again told Congress that MMS estimated that it sold "64 percent of all the oil it collected in kind, for less than it would have collected in cash."⁶⁷ (Appendix G)

In the one place where the RIK program might have made the most sense—filling the DOE's Strategic Petroleum Reserve—the program again failed.⁶⁸ While Congress recently halted that program in order to sell the oil on the market while prices were high,⁶⁹ a recent DOE IG report concluded that MMS and DOE were using the same contractor across the board in a large portion of deliveries: "Contractors acted as both the shipping agent for MMS and receiving contractor for the Department [of Energy] in about 20 percent (18 of 93) of the oil transfer contractor

Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk (GAO-08-560T). March 11, 2008. p. 4.

⁶³ General Accounting Office. *Report to Congressional Requesters on Mineral Revenues: Cost and Revenue Information Needed to Compare Different Approaches for Collecting Federal Oil and Gas Royalties* (GAO-04-448). April 2004. p. 4.

⁶⁴ Government Accountability Office. *Testimony Before the Subcommittee on Energy and Mineral Resources, Committee on Natural Resources, House of Representatives on Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk* (GAO-08-560T). March 11, 2008. pp. 10-11.

⁶⁵ Department of Interior, Minerals Management Service. *Budget Justifications and Performance Information*. Fiscal Year 2009. p. 152.

⁶⁶ Government Accountability Office. *Testimony Before the Subcommittee on Energy and Mineral Resources, Committee on Natural Resources, House of Representatives on Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk* (GAO-08-560T). March 11, 2008. p. 15.

⁶⁷ Government Accountability Office. *Testimony Before the Subcommittee on Energy and Mineral Resources, Committee on Natural Resources, House of Representatives on Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk* (GAO-08-560T). March 11, 2008. p. 15.

⁶⁸ Department of Interior Office of the Inspector General. *Evaluation Report: Minerals Management Service Royalty-in-Kind Oil Sales Process* (Report No. C-EV-MMS-01-2008). May 2008, p. 2. <http://www.doiig.gov/upload/2008-G-0021.pdf> (Downloaded September 16, 2008)

⁶⁹ Nancy Pelosi. "Pelosi Statement on Senate Passage of the SPR Fill Suspension and Consumer Protection Act." May 14, 2008. <http://www.speaker.gov/newsroom/pressreleases?id=0660> (Downloaded September 16, 2008)

relationships reviewed.” This created a situation where “unauthorized transactions could go undetected.” In other words, if the same company both delivered and received the oil, it would be easy to steal oil without detection. And not surprisingly, the IG found that 32,000 barrels of oil, valued at \$1 million, could not be accounted for.⁷⁰

SEE NO EVIL: RIK AS AN “HONOR SYSTEM”

With all the concerns about the integrity of both the RIK program and the people who run it, it would seem imperative that there be a strong auditing function checking the RIK books. Without proper auditing, there is no way to know whether or not the RIK program is collecting the full amount of royalties.

Not surprisingly, industry sees things differently. As the DOI IG wrote in one of its recent reports, “Throughout our investigation, we heard that the oil and gas industry preferred the RIK Program to the RIV Program. One RIK marketer explained this preference to us as follows: ‘There is definitely an advantage to the industry, so that they wouldn’t have to be subject to audit.’”⁷¹

There are two basic and significant structural weaknesses to the auditing of the RIK system. The first is an organizational conflict: the auditors looking at the RIK program report to the people in MMS who are running the program, who are more inclined to make their program *look* successful than to actually *be* successful. The second structural flaw is methodological: the audits and compliance reviews are based entirely on the self-reported data provided by industry. To make matters worse, a recent GAO report revealed that the MMS computer system is incapable of identifying, in a timely manner, instances when industry fails to report revenue and royalty at all.⁷²

For their part, MMS argues that taking royalties in kind lessens the need to audit because it places the government in control of selling the oil and gas, thereby reducing conflicts over valuing the product.⁷³ When the government controls the negotiation of sales price and transportation contracts, MMS argues, the volume of the oil or gas produced is the only variable to be agreed upon by the government and industry; variables are removed from the hands of industry, thereby limiting the need for auditing.

⁷⁰ Department of Energy, Office of Inspector General, Office of Audit Services. *Department of Energy’s Receipt of Royalty Oil* (DOE/IG-0786). January 2008. pp. 2-3. <http://ig.energy.gov/documents/IG-0786.pdf> (Downloaded September 16, 2008)

⁷¹ Department of Interior, Office of Inspector General. *Investigative Report: MMS Oil Marketing Group – Lakewood*. August 19, 2008. p. 8. http://www.doiig.gov/upload/RIK%20REDACTED%20FINAL4_082008%20with%20transmittal%209_10%20date.pdf. (Downloaded September 15, 2008)

⁷² Government Accountability Office. *Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk* (GAO-08-893R). Mineral Revenues p. 5. <http://www.gao.gov/new.items/d08893r.pdf> (Downloaded September 16, 2008)

⁷³ Department of Interior, Minerals Revenue Management Service. “Performance Measurement.” <http://www.mrm.mms.gov/RIKweb/PDFDocs/PerformanceMeasurement.pdf> (Downloaded September 15, 2008)

According to the MMS, taxpayers' interests are sufficiently protected through the use of "compliance reviews."⁷⁴ In contrast to audits, which assess the accuracy and completeness of self-reported production and royalty data against source documents, compliance reviews examine the "reasonableness" of the data and do not include systemic examination of source documents,⁷⁵ and do not follow Government Auditing Standards.⁷⁶ As a result, compliance reviews constitute superficial oversight that is reliant upon companies accurately reporting the royalties they owe to the government.

Based on the logic that there is less of a need for auditing, and that compliance reviews can fill most of that need, MMS has reduced its auditing capacity for all royalty collection methods.⁷⁷ The emphasis on reduced auditing led MMS to shift staff out of its auditing program and into the RIK program. MMS's FY2009 Budget Justifications show that since 2001, MMS has downsized the full-time employees conducting onshore and offshore auditing and compliance activities by 60 positions, moving 35 of those positions over to operate the RIK program.⁷⁸ MMS's own public statements show that audits of the RIK program are now rarely performed or required, even though these contracts are worth millions, if not billions, of dollars.⁷⁹

MMS even told its professional auditors to stop auditing the RIK program, even when they discovered evidence of companies underpaying royalties. In March 2007, Bobby Maxwell—a highly decorated former senior auditor from MMS with 25 years of experience—testified before the House Committee on Natural Resources: "I was ordered not to get any information from the Royalty-in-Kind division of MMS, or review their contracts for sales of the oil and gas....I was told not to pursue the issue any further."⁸⁰ POGO has spoken with several other MMS auditors who also report having been told repeatedly to stop auditing RIK leases.

⁷⁴ Department of Interior, Minerals Management Service. "Statement of C. Stephen Allred, Assistant Secretary, Land and Minerals Management before the Senate Committee on Appropriations, Subcommittee on Interior and Related Agencies." February 13, 2007. p. 7. <http://www.mms.gov/ooc/testimony/TestimonyAllred021307.pdf>. (Downloaded September 15, 2008)

⁷⁵ Government Accountability Office. *Testimony Before the Subcommittee on Energy and Mineral Resources, Committee on Natural Resources, House of Representatives on Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk* (GAO-08-560T). March 11, 2008. p. 3.

⁷⁶ Government Auditing Standards, frequently referred to as the Yellow Book, are issued by the Comptroller of the United States to provide government auditors "a framework for performing high-quality audit work with competence, integrity, objectivity, and independence." Government Accountability Office. *Government Auditing Standards by the Comptroller General of the United States* (GAO-07-731G). July 2007. p. 1.

<http://www.gao.gov/new.items/d07731g.pdf> (Downloaded September 15, 2008); Department of Interior, Minerals Management Service. *Budget Justifications and Performance Information*. Fiscal Year 2009. p. 148.

http://www.doi.gov/budget/2009/data/greenbook/FY2009_MMS_Greenbook.pdf (Downloaded September 15, 2008)

⁷⁷ Department of Interior, Minerals Management Service. *Budget Justifications and Performance Information*. Fiscal Year 2009. p. 148.

⁷⁸ Department of Interior, Minerals Management Service. *Budget Justifications and Performance Information*. Fiscal Year 2009. p.139.

⁷⁹ Department of Interior, Minerals Management Service. *Budget Justifications and Performance Information*. Fiscal Year 2009. p.148.

⁸⁰ House of Representatives. "Testimony of Bobby Maxwell Before the Subcommittee on Energy and Mineral Resources United States House of Representatives." March 28, 2007. pp. 1-2. http://resourcescommittee.house.gov/images/Documents/20070328/testimony_maxwell.pdf (Downloaded September 15, 2008)

In addition, the GAO found that MMS failed to fulfill “statutory obligations or agency targets for conducting inspections of meters and other equipment used to measure oil and gas production, which raises questions about the accuracy of oil and gas measurement.”⁸¹ In 2007, the federal advisory Royalty Policy Committee found that MMS “do[es] not consistently request gas analysis reports to verify BTU values reported by oil and gas operators. . . MMS has not recently requested gas analysis reports from operators in the Gulf of Mexico.”⁸² For example, the GAO recently informed Congress that when it comes to natural gas records for offshore production, there are virtually no third-party checks on volume accuracy.⁸³ A recent government report confirmed that consistent staff decreases in MRM’s Compliance and Asset Management (CAM) program, the division responsible for reviewing the accuracy of royalty collections, resulted in the oversight of natural gas volumes being pushed to another department, the Offshore Minerals Management, which only has *one* engineer capable of handling thousands of needed reviews of natural gas volumes.⁸⁴ Currently, the DOI IG is conducting an audit into the MMS process for verifying volumes delivered in the RIK program.⁸⁵

Essentially, the RIK program asks taxpayers to trust that industry delivers the correct amount of oil or gas to the government in lieu of cash, but has reduced oversight to such a degree that the GAO labeled RIK’s management “an honor system.”⁸⁶

A History of Bad Faith

Without auditing and verification, the system is vulnerable to exploitation by industry. Numerous instances of royalty underpayments by the oil and gas industry have demonstrated the need to hold that industry accountable to the taxpayers. POGO found that from 1986 to 2002, false claims lawsuits and settlements recovered over \$11 billion in underpaid oil and gas royalties.⁸⁷

⁸¹ Government Accountability Office. *Testimony Before the Subcommittee on Energy and Mineral Resources, Committee on Natural Resources, House of Representatives on Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk* (GAO-08-560T). March 11, 2008. p. 6.

⁸² The Subcommittee on Royalty Management. “Report to the Royalty Policy Committee, Mineral Revenue Collection from Federal and Indian Lands and Outer Continental Shelf.” December 17, 2007. p. 20, http://www.mrm.mms.gov/Laws_R_D/RoyPC/PDFDocs/RPCRMS1207.pdf (Downloaded September 16, 2008)

⁸³ Government Accountability Office. *Testimony Before the Subcommittee on Energy and Mineral Resources, Committee on Natural Resources, House of Representatives on Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk* (GAO-08-560T). March 11, 2008. p. 6.

⁸⁴ The Subcommittee on Royalty Management. “Report to the Royalty Policy Committee, Mineral Revenue Collection from Federal and Indian Lands and Outer Continental Shelf.” December 17, 2007. pp. 37-38, http://www.mrm.mms.gov/Laws_R_D/RoyPC/PDFDocs/RPCRMS1207.pdf (Downloaded September 16, 2008)

⁸⁵ Department of Interior, Office of the Inspector General. *Semiannual Report to Congress*, April 2008. p. 1. <http://www.doiig.gov/upload/April2008SAR.pdf> (Downloaded September 16, 2008)

⁸⁶ Government Accountability Office. *Testimony Before the Subcommittee on Energy and Mineral Resources, Committee on Natural Resources, House of Representatives on Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk* (GAO-08-560T). March 11, 2008. p. 17.

⁸⁷ Project On Government Oversight. “Written Testimony of Beth Daley, Director of Investigations, Project On Government Oversight, to the House Government Reform Committee Interior Department: A Culture of Managerial Irresponsibility and Lack of Accountability?” September 14, 2006, <http://www.pogo.org/p/environment/et-060901-oilgas.html> (Downloaded September 16, 2008)

Industry royalty underpayments have also been confirmed by former MMS auditor Bobby Maxwell and the 10th Circuit Court. Maxwell filed a *qui tam* lawsuit in 2004 against Kerr-McGee for substantially underpaying royalties. On September 10, 2008, the 10th Circuit court ruled in favor of Maxwell, upholding the jury's finding that the company had knowingly underpaid royalties by about \$7.5 million.⁸⁸

In 2007, Conoco Phillips' subsidiary Burlington Resources, Inc. agreed to pay the U.S. government \$97.5 million to resolve claims that it underpaid royalties owed on natural gas produced from federal and Indian leases from March 1, 1988 to March 31, 2005.⁸⁹

In addition to numerous lawsuits demonstrating a history of oil and gas companies underpaying their royalties, a recent GAO report revealed that these companies continue to try to cheat the taxpayers. The report cited instances of companies diverting natural gas to private residences via illegal pipelines, creating bypasses to allow gas to flow without being measured, and keeping "two sets of conflicting production data—one used by the company and another reported to MMS." In all of these instances, MMS told the companies to correct the action, but did not fine or otherwise punish them for their misconduct.⁹⁰

Further evidence of this industry's two sets of books was uncovered by an investigation by *New York Times* business reporter Edmund Andrews. Andrews found that companies reported much higher levels of oil and gas production to the Securities Exchange Commission than they reported to MMS. His investigation also found that if royalty payments had risen in-step with market prices during FY2005, the government would have received \$700 million more than it did.⁹¹

Verifying that self-reported oil and gas collection data matches available third-party data, and resolving any discrepancies between the two reports, is key to protecting taxpayers' interests. It is only through resolving these discrepancies that MMS can know whether or not the taxpayers are receiving the correct amount of product to sell.⁹²

⁸⁸ United States Court of Appeals, Tenth Circuit. "United States of America, ex rel. Bobby Maxwell v. Kerr-McGee Oil & Gas Corporation." September 10, 2008. p. 2. <http://pogoarchives.org/m/ep/oil/maxwell-decision-20080910.pdf> (Downloaded September 16, 2008)

⁸⁹ Department of Justice. "Conoco Phillips' Subsidiary to Pay United States \$97.5 Million for Fraudulent Underpayment of Natural Gas Royalties." August 15, 2007. http://www.usdoj.gov/opa/pr/2007/August/07_civ_616.html (Downloaded September 16, 2008)

⁹⁰ Government Accountability Office. *Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk* (GAO-08-893R). p. 7. September 12, 2008. <http://www.gao.gov/new.items/d08893r.pdf> (Downloaded September 16, 2008)

⁹¹ Edmund L. Andrews. "As Profits Soar, Companies Pay U.S. Less for Gas Rights." *New York Times*, January 22, 2006, A1.

⁹² The Subcommittee on Royalty Management. *Report to the Royalty Policy Committee, Mineral Revenue Collection from Federal and Indian Lands and Outer Continental Shelf*. December 17, 2007. p. 37. http://www.mrm.mms.gov/Laws_R_D/RoyPC/PDFDocs/PCRMS1207.pdf (Downloaded September 16, 2008)

INADEQUATE MANAGEMENT

Even before the recent DOI IG reports, in December 2006 the DOI IG criticized the MMS auditing and compliance program, verifying what many already believed—that the RIK program’s management was so weak that it could not effectively evaluate its own progress. According to the report:

MMS lacks reliable information for managing the CAM [Compliance and Asset Management]⁹³ Program...MMS cannot: effectively use existing systems for day-to-day management and reporting purposes...provide accurate information on CAM Program operations and results to stakeholders, including the Congress and state and tribal organizations; and determine the true cost and benefits of compliance reviews and audits.⁹⁴

Basic management guidance on how to run the RIK program simply doesn’t exist. The DOI IG found that the RIK program’s *RIK Procedures Manual* lacked written procedures or guidelines regarding the overall oil and gas sales process. For instance, it lacked guidance on internal controls for how to analyze bids for federal oil and gas leases, how to develop minimum acceptable bids, how to amend bids, or even how to document their decisions.⁹⁵

Furthermore, MMS has failed to initiate a rulemaking in order to establish regulations for the RIK program. While MMS has issued regulations for all kinds of other royalty collection efforts such as oil and natural gas royalty valuations, it has yet to see the need to formalize the enormous and complicated RIK program.⁹⁶ Even the Royalty Policy Committee, a federal advisory committee for the DOI, pointed out this basic weakness. In its 2007 report, it stated that MMS’s management of the RIK program “is relatively informal, in terms of published guidelines or regulations, than what is typically encountered with the major expansion of an important Federal program.”⁹⁷

External auditors have repeatedly informed RIK program managers of the program’s management weaknesses, but the call for reform has been largely ignored. A DOI IG report requested by Interior Secretary Dirk Kempthorne to assess differences between the auditors and the agency revealed heated internal disagreements about whether the RIK program’s policies

⁹³ Division responsible for reviewing accuracy of royalty collections.

⁹⁴ Department of Interior, Office of Inspector General. *Audit Report: Minerals Management Service’s Compliance Review Process* (Report No. C-IN-MMS-0006-2006). December 2006. pp. 2-3, <http://www.doioig.gov/upload/2007-G-00011.pdf> (Downloaded September 16, 2008)

⁹⁵ Department of Interior, Office of Inspector General. *Investigative Report: MMS Oil Marketing Group – Lakewood*. August 19, 2008. p. 8. http://www.doioig.gov/upload/RIK%20REDACTED%20FINAL4_082008%20with%20transmittal%209_10%20date.pdf (Downloaded September 16, 2008)

⁹⁶ Department of Interior, Office of the Inspector General Royalties Initiative Group. *Evaluation Report: Minerals Management Service Royalty-in-Kind Oil Sales Process*. (C-EV-MMS-0001-2008). May 2008. p. 6. <http://www.doioig.gov/upload/2008-G-0021.pdf> (Downloaded September 16, 2008)

⁹⁷ The Subcommittee on Royalty Management with staff support from U.S. Department of Interior. *Report to the Royalty Policy Committee on Mineral Revenue Collection from Federal and Indian Lands and Outer Continental Shelf*. December 17, 2007. p. 106. http://www.mrm.mms.gov/Laws_R_D/RoyPC/PDFDocs/RPCRMS1207.pdf (Downloaded September 16, 2008)

were resulting in accurate collections of royalties.⁹⁸ The DOI IG findings “call for a number of improvements in the management of the MRM program, particularly in regard to document control, [and] guidance clarification.”⁹⁹

Even the Lukens study acknowledged that MMS may not be equipped to manage the RIK program: “MMS’s level of commercial expertise was found to be improved, but thin to support an expansion. Capabilities in performance measurement, quantitative economic analysis, and more complex marketing and sales were found to need enhancement.”¹⁰⁰

TRANSPARENCY ISSUES

Just as adequate auditing is essential to revealing problems, transparency is essential to getting those problems fixed. But copies of RIK contracts and other vital information about who operates the program are usually not publicly available to be scrutinized by watchdogs, other issue-area experts, the news media, or the public in general.

For instance, MMS responded to a POGO Freedom of Information Act (FOIA) request for details about RIK policies and enforcement by withholding some documents in their entirety, and sending others that were completely redacted, including manuals, risk metrics, and outside studies evaluating the business plan and performance of the RIK program. (Appendix H)

Among the many documents the MMS FOIA office withheld in full from POGO were those that were clearly overviews of the RIK program, including:

- MMS Royalty-in-Kind Risk Metrics Program Prototype Manual
- Implementation of RIK Performance Metric and Measurement Tools – Procedures Manual

The extraordinary excuse offered by the MMS FOIA office for withholding these documents was that their methodology for collecting billions of dollars is not of significant public interest. Two of the documents redacted in full for POGO were withheld under the “low b-2” exemption of FOIA law, which the Supreme Court found to be an exemption designed to protect “internal agency matters so routine or trivial they could not be ‘subject to...a genuine and significant public interest.’”¹⁰¹ (Appendix H)

⁹⁸ Department of Interior, Office of Inspector General. *Investigative Report: Minerals Management Service False Claims Allegations.* September 7, 2007. p. 17. <http://www.doi.ig.gov/upload/QUI%20tam.pdf> (Downloaded September 16, 2008)

⁹⁹ Department of Interior, Office of Inspector General. *Investigative Report: Minerals Management Service False Claims Allegations.* September 7, 2007. p. 2.

¹⁰⁰ Department of Interior, Minerals Management Service. “RIK History and Program Development.” p. 8. <http://www.mrm.mms.gov/RIKweb/PDFDocs/RIKBackground.pdf> (Downloaded September 16, 2008)

¹⁰¹ Department of Justice. “FOIA Guide 2007.” p. 259. http://www.usdoj.gov/oip/foia_guide07/exemption2.pdf (Downloaded September 16, 2008)

Equally disturbing is that a couple of the documents POGO requested were redacted in full for being financial or commercial proprietary information,¹⁰² while a recent DOI IG report reveals that MMS does not apply the same standards of secrecy to friends in industry that it did to POGO.

Management analysts at the MMS FOIA office forgave then-RIK Director Greg Smith for releasing information that was clearly labeled “proprietary” to the clients of his consulting firm. These FOIA officers told IG investigators that Smith did not violate FOIA rules: “information concerning Incidents of Non-Compliance was not considered to be confidential business information and did not fall into the trade secrets or commercial or financial information exemption and was therefore releasable under FOIA”¹⁰³—even though those documents had been marked “proprietary.”

In addition to the lack of document transparency, there is also a sense in the RIK program that outsiders should not be invited to second-guess their work. For example, the Audit Manager for the North Dakota State Auditor’s Office told the House Natural Resources Subcommittee on Energy and Mineral Resources that a high-ranking MMS official advised him and other members of the State and Tribal Royalty Committee not to testify before Congress: “This official expressed to us that Congress only requests that you testify so you aren’t obligated to testify and that it is best to keep any problems in house.”¹⁰⁴

The reduction in oversight by the MMS of the RIK program makes transparency of the program that much more essential to avoid mismanagement and abuse.

CONCLUSION

Countless management weaknesses and abuses in the RIK program make it clear that this is a program that needs to be terminated. POGO and others have been skeptical of this program for over ten years, and even now MMS still lacks the evidence necessary to show that this program benefits taxpayers.

Even though the operations of the program remain largely opaque, the information available strongly indicates that RIK exists to benefit the oil and gas industry, to the detriment of the public. A dramatic increase in auditing capacity is required to even begin to make this program

¹⁰² The two redacted documents were *Wyoming Gas Study - NARG Analysis of Rocky Mountain Gas Price and Assessment of the Federal Royalty-in-Kind (RIK) Program and Development of RIK Business Plan Deliverable 3: Alternative Approaches for marketing strategies and risk assessment for RIK sales volumes and supporting appendices*.

¹⁰³ Department of Interior, Office of Inspector General. *Investigative Report: Gregory W. Smith*. August 7, 2008. p. 15.

¹⁰⁴ Dennis Roller. “Written Testimony of Dennis Roller, Audit Manager for the North Dakota State Auditor’s Office—Royalty Audit Section For the Minerals Management Service Before the Natural Resources Subcommittee on Energy and Mineral Resources United States House of Representatives.” March 11, 2008. p. 2. http://resourcescommittee.house.gov/images/Documents/20080311/testimony_roller.pdf (Downloaded September 16, 2008)

functional. Yet the primary justification for taking royalties in kind rather than in value is that RIK requires less auditing. In other words, the only way to fix the program is to wholly undermine its original premise. This alone should be reason enough to cancel the failed program. However, there have also been the recent findings that MMS employees consider themselves exempt from standard ethical provisions that protect the public's interest. This has further prevented the public from getting what is owed to them for industry's use of public resources. The extensive corruption and collusion in the RIK program, given that it is charged with managing billions of dollars of federal revenue, should be the final nail in the program's coffin.

RECOMMENDATIONS

- The Secretary of Interior should immediately begin phasing out the RIK program, and should return to relying on a market price-based RIV program instead.
 - RIK should only be used for the purposes of filling the Strategic Petroleum Reserve when prices are low.
- Congress should remove the auditing functions from MMS, and move these tasks to a separate and independent agency.
- MMS should establish strict guidelines and restrictions on what outside work MMS employees can perform while working for the agency.

If the RIK program is not canceled, there must be more institutional checks and increased oversight of this program:

- Congress should prohibit MMS's proposed expansion of the RIK program.
- Until auditing functions are removed from MMS, the DOI should institute regular auditing of the RIK program to improve oversight and management, and only use compliance reviews as a tool to identify leases that need auditing rather than as a replacement for audits.
- The DOI should disclose detailed bi-annual reports concerning the profitability and performance of the RIK program to the Congress.