

# PROJECT ON GOVERNMENT OVERSIGHT

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WRITTEN SUBMISSION FOR THE RECORD

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The Project on Government Oversight is a nonpartisan nonprofit group that investigates and exposes abuse of power, mismanagement and acquiescence to corporate interests by the federal government. Over two years ago, we began investigating the Department of the Interior's record in collecting royalties from the oil industry. After several FOIA requests, and two reports on the subject, it is clear to us today that the current arrangement is unworkable. The Department of the Interior is institutionally unwilling to aggressively collect the money owed to the American people by the oil industry for their right<sup>o</sup> produce on federal land.

For decades the Department of the Interior has given loyal and devoted service to the petroleum industry. This hearing represents one of the few occasions that anyone has bothered to inquire into what they have done for the rest of us. Chairman Horn and Congresswoman Maloney are to be congratulated for this inquiry into how the Department has managed its public trust in the collection of royalties for oil produced on federal land.

The time has long past when the Department of the Interior can be trusted to administer the collection of royalties in the interest of the American taxpayer. Its record in this area is replete with mismanagement, duplicity, evasions, and outright lies. Recent events have done nothing to alter this record.

It has been long understood within the industry and among knowledgeable observers that posted crude oil prices in California did not reflect real market values. As a result royalties based on these prices have been underpaid. This is not an observation that requires a great deal of sophistication. By any standard, California crude oil prices have been among the lowest in the world. On the other hand, prices for refined products such as gasoline have been as high as any in the nation. West Coast refining margins were the highest in the world. Even the Department of Energy had occasion to comment on the anomaly. (Petroleum Marketing Monthly, April 1987.) In 1984 Texaco was ordered by the Federal Trade Commission to supply certain independent refiners at posted prices. Texaco protested on the grounds that everyone knew that posted prices did not reflect market values. Neither DOE or Texaco relied on information that was not commonly available to any who cared to look. Surely it was not too much to expect Interior to recognize what Texaco was willing to publicly admit.

In 1974 the State of California initiated legal action against the major oil companies for the underpricing of crude oil. Throughout the 1970's and 1980's the State pursued its litigation and in the discovery process amassed a large amount of evidence relating to crude oil pricing in California.

In the mid-1980's the disparity between posted prices and market values was reaching spectacular proportions. Sensing a challenge to the system of posted prices, MMS took an incomprehensible step and in 1988 changed its regulations apparently to make it more difficult to question postings as a basis for royalties. In retrospect it is hard to view these changes as

anything except a clumsy attempt by MMS to protect the companies from paying royalties on the full value of their federal production.

In 1994, after decades of an aggressive policy of "see-no-evil", MMS finally bestirred itself into a small step. Embarrassed by the \$320 million obtained by California as a result of its litigation, MMS asked for an internal estimate of how much had been lost to the federal government by undervaluation. When the estimate came back at \$400 million, the staff was immediately ordered to come up with a more acceptable number -- like zero. At this point it was too late; the trade press had the estimate -- and the order to retract it. Bludgeoned by the first report by the Project on Government Oversight and stung by an ABC News report, the Department resorted to the ancient dodge: an "interagency task force".

For once the tactic failed. The Departments of Commerce and Energy sent competent and respected representatives who understood oil markets. As a result the task force examined the appropriate evidence, that compiled in the California litigation, and produced a report that actually confronts the problem. For the first time we have responsible officials of the Department acknowledging that posted prices did not reflect market values and that royalties were underpaid.

Unfortunately this report does not signal the dawn of a new day at the Department. Nothing in the Department's dismal record of negligence, misfeasance, and incompetence provides any hope that MMS is on the brink of doing better. They will not. I fully understand that to accuse a whole government agency of bad faith -- including its politically appointed leadership over several administrations -- is a very serious matter. Let me suggest three tests by which my accusation can be judged.

The first test is whether MMS has any colorable excuse for not pursuing at least the \$856 million found by the Interagency Report to have been lost through the undervaluation.<sup>1</sup> I submit there is none. ANS crude oil was, as a matter of uncontrovertible fact the most widely traded crude oil on the West Coast. Its price clearly represented the marginal value of crude oil in the market. Posted prices, on the other hand, were used only for exploiting the independent producers with no access to transportation, and deceiving complacent government employees. The only responsible thing to do is to ignore the postings and recalculate the royalties based on the real market values as represented by the ANS prices -- an approach clearly permitted by letter of the regulation, and required by the statute. It is also the approach which the industry itself uses for all purposes save calculating royalties.

It is important to understand that no one, not even the Interior members of the Interagency Task Force, has suggested that the ANS prices are not the appropriate market values. It is only as a matter of legal policy that MMS does not want to pursue so large an amount. MMS will seek to justify this position by giving an insane reading to its regulations. First, they will claim that the small amounts of oil that move in arm's-length transactions must be treated as

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<sup>1</sup>This is the amount of underpayment found for the years 1978 to 1993. However there is no good reason why MMS should not seek to recover the underpayment back to 1960. This would involve an amount of about \$1.5 billion.

"significant quantities" whose price has relevance to the value of the vastly greater amounts moving in intracorporate transfers. Second, they will claim that in some mysterious way they need to enshrine in their interpretation of the regulations their "long standing practice". Of course, it is precisely their long standing imbecilic practice that has cost the public hundreds of millions of dollars. What MMS is really doing is refusing to even try to recover what has been lost. The refusal to even make the effort cannot reflect anything except bad faith.

My second test involves the 1993 global settlement Interior entered into with Exxon.<sup>2</sup> The very people who are now asking for our trust are the same ones who entered into this agreement which precludes any recovery for undervaluation. All of the information that is available today was available to them at the time. Had they wanted, they could have know all that the task force knew; all they needed to do was ask. By 1993 there was plenty of reason to ask. Indeed ten years earlier Texaco had given them ample warning. Their ignorance was deliberate and willful. Of course, if the Department did know the facts as presented in the Interagency Report, then the abandonment of tens of millions of public dollars goes far beyond negligence and incompetence.

My third test has to do with the mechanism that originally produced the underpricing of crude oil: the control of pipeline transportation by the major refiners. Until quite recently most pipelines in California refused to acknowledge any common carrier obligation. They refused to ship any oil owned by other firms. In order to be shipped crude oil had to be sold to the owner of the line. Since there are no competing means of transportation, the pipeline owner could post prices well below market values, buy the crude at that price leaving the producer with no recourse.

What made this ironic was that almost all of these pipeline crossed federal lands. Under the Mineral Leasing Act all pipelines crossing must be "constructed and operated" as common carriers. Not surprisingly, given the Department's attitude towards underpricing, the common carrier requirement was never enforced. Despite repeated complaints from the state of California, the Department of Commerce, the Department of Energy, and the Interior Department's own Inspector General, the Bureau of Land Management adamantly refused to look at the issue.

With the settlement of California's litigation most pipelines are now operated as common carriers. Unfortunately, this does not include the three major heated lines capable of carrying heavy crude oil. Two of these lines no longer cross federal lands, but one does: a pipeline owned and operated by Mobil, the M-70 line. This line has recently been expanded with new permits issued by the Bureau of Land Management requiring common carrier operations. Mobil has contemptuously refused to so operate, and BLM has refused to do anything about it. When the regional director of BLM attempted to remind Mobil of its obligation, he was made to retract his warning. More recently, in March of 1994, the Deputy Secretary of Energy, Bill White, wrote to Secretary Babbitt in the context of the removal of the export bans on California crude oil:

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<sup>2</sup>Almost as bad is the global settlement with Chevron signed a month later. While it does not preclude all recovery based on undervaluation, any such recovery would require proof of fraud or collusion and would be limited to California.

The export initiative is most important for California's independent crude oil producers who have long suffered from abnormally low prices. However, without access to California's crude oil pipelines to ship oil to California's ports, this option is not available to them. Fortunately, the Mineral Leasing Act also requires that pipelines that cross Federal lands operate as common carriers. Therefore, I am requesting that you take actions to require that all California pipelines that are subject to Mineral Leasing Act provisions immediately publish tariffs, shipping conditions, and other information relevant to their operation as common carriers.

The action I am suggesting is an integral part of the Administration's Domestic Natural Gas and Oil Initiative, which was announced by President Clinton last December. As noted in the Initiative, the Department of Energy will join with your Department and others to review the tariffs and conditions to guarantee that they are fair and equitable for all oil shippers.

Needless to say, nothing happened. Even in the face of this kind of pressure the Department held fast refusing to enforce the law. The justification given shows the extent of the culture of moral myopia that infests even the Department's Solicitor's Office: The law need not be enforced because BLM has received no complaints. If no one complains, there is nothing wrong. The premise underlying this is that common carrier provisions of the Act have no public purpose. Private parties can agree to conduct their affairs in a manner contrary to the law, and if no one complains, the Department has no reason to enforce the law.

This argument is fatuous. On a simple factual level it is untrue. Independent producers have complained to the Department; the State of California has complained incessantly, the Department's own Inspector General complained repeatedly, more importantly, the MMS should have complained. As the Inspector General pointed out, the failure of BLM to enforce the law was costing the public ten of millions of dollars. If MMS had cared at all it would have complained.

But as a matter of sound public policy the argument is grotesque. The common carrier provisions of the Mineral Leasing Act have public purposes relating to economic efficiency and environmental protection. The notion that BLM can connive with private parties to frustrate these purposes is simply wrong. The fact that the Solicitor's Office endorsed such nonsense is revolting.

I submit on the evidence of these three points the Department of the Interior cannot be trusted on matters relating to the collection of oil royalties. It is incapable of acting in good faith. The task should be taken from them and given to the States, perhaps the IRS, or even privatized, but it should not be left in their hands. As to the past royalties, their collection should be given to a special counsel's office along the lines of that used to collect oil price overcharges during the price control era -- an office outside the Department of the Interior.