

Project On Government Oversight

Department of Interior Looks the Other Way:

The Government's Slick Deal for
the Oil Industry

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666 11th Street, NW, Suite 900 • Washington, DC 20001-4542 • (202) 347-1122
Fax: (202) 347-1116 • E-mail: pogo@pogo.org • www.pogo.org

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- A: U.S. Department of Interior Office of Inspector General Draft Audit Report, "Follow-up Review of Enforcement of Common Carrier Statutes for Pipelines Crossing Federal Lands in California", December 1994, p.2.
- B: "California Crude Oil", General Accounting Office Report, GGD 88-114, pp 30-32.
- C: Memoranda from: William Weitzel, Texaco, May 7, 1984; T. Wyman, Standard Oil (now Chevron) November 24, 1961; W.J. Dill, Unocal, March 2, 1966.
- D: Exporting Alaskan North Slope Crude Oil; Benefits and Costs, U.S. Department of Energy, June 1994, p.28.
- E: "Report to Congress on U.S. Crude Oil Exports", U.S. Department of Commerce, August 1989, pp. III-25, III-3.

- F: "Enforcement of Common Carrier Statutes for Pipelines Crossing Federal Lands in California", U.S. Department of Interior Office of the Inspector General, February 1991, Memorandum of Transmittal from The Inspector General to the Secretary.
- G: "Oil Pipeline Rights-of-Way In California", Office of Policy Analysis U.S. Dept. of Interior, undated.
- H: "California Common Carrier and Crude Valuation", DOI internal memo from Bob Berman to Brooks Yeager, August 6, 1993.
- I: "Potential Undervaluation of California Crude Oil, internal Department of Interior Minerals Management Service memo, undated p. 1.
- J: "Transmittal of California Valuation Study", Memorandum from Associate Director for Royalty Management, undated.
- K: "California Royalty Valuation Study", Bernard Kritzer to Dave Hubbard, September 20, 1994.
- L: "California Interagency Oil Undervaluation Team -- Status", David Hubbard to James W. Shaw, MMS, Denver, September 6, 1994.
- M: Minerals Management Service Royalty Management Program, Summary of the California Crude Oil Pricing Issue, October 25, 1994.
- N: Response from the Department of Interior to Senator Dale Bumper's Questions November 16, 1994.
- O: Lee Helfrich, Lobel, Novins, Lamont & Flug, to Lucy Querques, MMS Department of Interior, September 23, 1994.
- P: Minerals Management Service Secretarial Briefing Paper, Possible Undervaluation of California Crude Oil, October 16, 1994.
- Q: Charles Warren, Executive Officer California State Lands Commission, to Richard Borden, Special Projects Coordinator, Angeles National Forest, April 23, 1990.

EXECUTIVE SUMMARY

The Project on Government Oversight (POGO) has compiled substantial evidence that indicates the federal government is owed more than 1.5 billion dollars in uncollected royalties, interest and penalties from seven of the largest oil companies -- Texaco, Shell, Mobil, ARCO, Chevron, Exxon and Unocal -- for their production of crude oil from federal lands in California.

POGO has also obtained a draft Department of Interior Inspector General report that concludes that over a four year period, royalties alone "may have been underpaid by as much as \$29.5 million from 1990 through 1993 and may continue to be underpaid as long as pipelines continue to operate as private carriers."

Crude oil is produced on federal lands by both "integrated" and independent producers. The seven companies identified are "integrated" -- which means they produce crude, in all but one case (Exxon) they own the pipelines that transport the crude to the refineries, and they own the refineries themselves. The only way for any oil producer to transport the crude to refineries efficiently is through the intrastate pipelines owned by these integrated oil companies. For decades, these companies have artificially depressed the price of crude oil, though their refined product prices are comparable to those in the rest of the nation. As a result, it makes economic sense for the integrated companies to push their profits downstream to the refinery end. This way the integrated companies squeeze out competition from the independent producers and refiners, and pay the government less in royalties, as royalties are based on the price of the crude oil.

The June 1994 language accompanying the congressional appropriation for the Department of Interior's (DOI) FY-95 budget required DOI to come up with a plan "for recovering royalties and interest from supposed undervaluations" when submitting the DOI FY-96 budget request in April 1995. The House Report language concludes, "every effort should be made to act as quickly as possible on this issue to avoid further losses due to the Statute of Limitations." After a year, the only action the DOI has taken is to take another six months to prepare to audit two California companies for three selected years.

The Department of Interior (DOI), the agency responsible for collecting these royalties, is a willing partner in this corporate welfare program. In addition to the forthcoming Inspector General report, DOI has ignored the following:

- The U.S. Department of Commerce -- "It seems that all we have seen to this point clearly establishes that **there is a problem**. . . MMS (DOI's Mineral Management Service) needs to do something now to avoid creating the impression that these events have not occurred!"
- The U.S. DOI Office of Policy Analysis -- "I suggest that **the Department proceed immediately to ascertain the amount of additional royalties due, including interest and criminal penalties, if any, and initiate collection procedures.**"
- The U.S. DOI Minerals Management Service (MMS) -- "We have evidence that the major California oil producers may have undervalued California oil production by keeping posted prices low and thus underpaying the royalties based on them. . . The various available court documents, out-of-court settlements, discussions with attorneys, and the work of consultants lead us to conclude that **we should pursue potential Federal royalty underpayments.**"
- These oil companies have already settled for over \$350 million with the State of California for royalties owed to the State for the same reasons money is owed to the Federal Treasury. However, all the evidence used by the State to retrieve this money has been sealed by the courts at the request of the oil companies who feared "potentially prejudicial pretrial publicity."

Despite all of the evidence, the Department of Interior is still looking for excuses not to collect the money from these big oil corporations.

- The DOI's attitude is revealed by an official who wrote in an internal memo that he is, "**hoping for some sort of 'motherhood' statement I can give the team -- I have stalled this issue long enough.**"
- DOI has even gone so far as to mislead Senator Dale Bumpers (D-AR). In one example, MMS assured the Senator that when they recently waived the government's right to collect royalties from Exxon, DOI did so with the State of California's approval. Yet the State's attorney wrote in a scathing letter, ". . . **representatives from MMS and the Solicitor's office** have indicated to others that Interior. . . is justifying this approach based on the approval of that language by (California). If such representations are indeed being made, **they are simply false.**" The misleading DOI memo was sent to Senator Bumpers mid-November, 1994 even though an internal briefing paper prepared for Secretary Babbitt by MMS dated one month earlier -- October 16 -- admitted "Certain State officials recently contacted DOI, asserting that they do not wish MMS to use the same language in settlements now pending."
- The Bureau of Land Management (BLM) has also asked DOI's Office of the Solicitor for a legal ruling as to BLM's ability to enforce common carrier requirements in California. The December 1994 draft Inspector General report states that, "On June 7, 1991, the Bureau (BLM) requested an opinion from the Solicitor to clarify the Bureau's specific authorities under the Act. However, a member of the Solicitor's office said that the opinion had not been issued because of other priorities within the office."

Project on Government Oversight's Recommendations

The Department of Interior must produce clearer regulations and enforce the Mineral Leasing Act's provision requiring pipelines crossing federal lands to be operated as common carriers. This would begin to create a more open market for crude oil, where prices would more closely reflect value. In itself, however, this change is not enough.

The 1988 regulations regarding the collection of royalties (30 CFR Chap. 206 Sec. 101-102) are currently subject to interpretation. In order to avoid future adverse interpretations, these regulations should include at least two new provisions. The first provision should allow MMS to cross-check and challenge prices posted or paid to ensure that those prices comport with the market value of crude. The second should provide that all documents in the possession of the oil companies regarding prices should be available to government auditors. Currently, government auditors do not have full access.

Perhaps the most important, although the most difficult, change will be to convince the Department of Interior to reverse its mind-set from trying to find reasons not to collect money from the big oil companies, to trying, instead, to figure out how to retrieve this windfall for the American people.

The White House and Secretary Babbitt have recently recommended eliminating MMS -- the office that has failed to collect this money. The proposal is to turn the responsibility of collecting royalties due the federal government over to the States and to the Native American Tribes instead. Perhaps this change would be a step in the right direction.

Recovering the \$1.5 billion is equivalent to 1/3 of all President Clinton's proposed budget savings for FY 1996 -- and would not require any cuts of programs or any tax increases.

BACKGROUND

California is the fourth largest oil-producing state in the United States. Approximately 80 percent of California's crude oil is transported by pipeline, as alternative methods of transportation such as trucking, rail or seagoing vessels are frequently unavailable or cost prohibitive. In 1993, 20 percent of the total state crude oil production was from federal land. Oil producers must pay the federal government royalties on their production of oil from federal land. These royalties are collected by the Department of Interior's Minerals Management Service (MMS).

The 11 major intrastate pipelines in California are owned by six major oil companies (ARCO, Chevron, Mobil, Shell, Texaco and Unocal). Of the 11 pipelines, 7 cross federal lands in one or more places. The Department of Interior's Bureau of Land Management (BLM) grants these companies the "right-of-ways" to cross federal land with their pipelines. (APPENDIX A, p. 2)

Crude Oil Prices Do Not Reflect Value

The amount of royalties paid to the federal government for oil produced from federal lands is calculated as a percentage of the well-head price of the crude oil. The royalties in question have accrued for oil produced from California federal lands. The problem is that these crude oil prices are set artificially lower than their market value. In fact, after adjusting for the quality of the oil, the DOE estimated the undervaluation of crude oil prices to be as much as \$2.00 per barrel, and the GAO found California crude oil prices to be 20% lower than in the rest of the country. Finished product prices, however, are essentially comparable to other parts of the United States. (APPENDIX B, pp. 30-32) This report will present evidence that royalties paid to the federal government based upon those posted prices are significantly lower than they should be.

The June 1994 language accompanying the congressional appropriation for the Department of Interior's (DOI) FY-95 budget required DOI to come up with a plan "for recovering royalties and interest from supposed undervaluations" when submitting the DOI FY-96 budget request in April 1995. The House Report language concludes, "every effort should be made to act as quickly as possible on this issue to avoid further losses due to the Statute of Limitations." After a year, the DOI has done nothing more than decide to take an additional six months to prepare to audit two California companies for three selected years -- 1984, 1989, and 1993.¹ As of publication, the Department of Interior has not yet begun to audit the numbers.

The major oil companies have an incentive to keep crude prices low. Crude oil is produced on federal lands by both integrated and independent producers. The seven companies -- Texaco, Shell, Mobil ARCO, Chevron, Exxon and Unocal -- are "integrated", which means they produce crude oil, in all but one case (Exxon) own the pipelines that transport the crude to the refineries, and refine it into finished products. Collectively, they need more crude oil for their refineries than they produce. As refiners, they are, in essence, typically buying the low-priced crude from themselves, independent producers or each other. It is to their advantage, therefore, to keep the price of crude low. They refine the crude oil into gasoline, jet and diesel fuel and heating oil, and then make their profit from these refined products. The only way, however, for any producer to transport the crude to refineries efficiently is through the intrastate pipelines owned by the integrated oil companies. As a result, it makes economic sense for the integrated companies to push their profits downstream to the refinery end. This way the integrated companies squeeze out competition from the independent producers and refiners, and pay the government less in royalties, as royalties are based on the price of the crude oil.

¹ U.S. House of Representatives, Committee on Appropriations Report on "Department of the Interior and Related Agencies Appropriations Bill, 1995" June 15, 1994, pp.45-46.

The independent producers and refiners, however, do not have this luxury. As a result, the independent companies are quickly becoming unable to survive in this market. The Department of Commerce found that in the 1980's, the independents' share of private sector crude oil production in California has declined from 28% in 1980 to 19% in 1989. (APPENDIX E, pp. III-25, III-3)

This California oil market is not a free-market with open competition. As a result, the "posted" price -- the price integrated companies (as pipeline owners) offer to pay for crude oil at the well-head -- does not reflect the market value of the crude oil. By law, federal royalties are to be based on the market value of crude oil. In practice, however, the federal royalties are based on the "posted" price of crude. This price is artificially low. As pipeline owners, the integrated companies set the posted prices. They do not risk losing access to the crude oil by offering too low a price, because they control the only efficient means of transporting the crude oil to refineries. The integrated companies are interdependent, as none of them have sufficient pipelines to move all of their oil to their own refineries. As a result, they cooperate with each other and move each other's oil to the refineries.

The independent producers have no alternative but to sell their crude at the posted price, as they do not own an alternative economic means of transport. It is because of this arrangement, and the unwillingness of the Department of Interior to challenge the posted prices set by the big oil companies -- despite evidence that these prices do not reflect value -- that the Federal Treasury has lost out on over \$1.5 billion in uncollected revenues.

In a September 1988 GAO report, the comparison of average posted prices of crude oil and refined oil from California and from the rest of the U.S. was very telling. **The average posted price of crude oil in California was about 20% lower than the price in the rest of the U.S.** (for a sampling of 16 years between 1950 and 1985), **yet the average price of refined oil products in California was almost exactly the same as the average price in the rest of the U.S (0.38% higher) during those years.** In other words, the margin between the price of crude and the total value of the refined product was almost 90% larger for California oil refiners than for refiners in the rest of the country. Even when accounting for the "gravity" -- roughly meaning "quality" -- of oil, the six-year average posted price of California Ventura was still 13% lower than West Texas Sour Oil. (APPENDIX B, pp. 30-32)

In fact, in 1984 Texaco protested a provision in a Federal Trade Commission (FTC) Consent Order arising from Texaco's acquisition of Getty Oil. The FTC required Texaco to continue to supply crude oil at posted prices to refineries that had been buying Getty's crude oil. They wrote that, ". . . while Getty was free to sell to the highest bidders on the best terms it could obtain in the market place, the Consent Order . . . requires Texaco to sell to such former customers of Getty at **posted prices which are currently lower than the market.**" Posted prices are, of course, the prices upon which royalties are based. In a competitive market, they would have reflected market value. Decades earlier, Unocal also admitted, "Crude prices in California have no relationship to value", and Chevron (then Standard Oil) wrote ". . . currently heavy crudes in California are priced at a level less than their true refining values. **If it became generally recognized throughout the industry that these crudes were underpriced, this would create considerable unfavorable reaction which might ultimately lead to legal action against segments of the oil industry.**" (emphasis added) (APPENDIX C)

The U.S. Department of Energy even found that a significant rise in crude oil prices to reflect its value would not affect consumer prices, as the California refined product prices were already at world market level. "The appropriate conclusion is that the gross margin differential between PADD V (California) and the nation as a whole could amply support an increase in crude oil prices of \$1.50 to \$2.00 per barrel without necessarily causing an increase in consumer prices." (APPENDIX D, p.28)

The sale of Elk Hills crude oil, which is owned and produced by the U.S. government as a Naval Oil Reserve, reveals even the government's recognition that posted prices do not reflect value. Because Elk Hills crude oil is actually produced by the federal government, rather than collecting royalties for the use of the land, the government sells the crude oil directly to a number of private oil companies. Until 1986, these companies offered and paid the government a "bonus" beyond the posted price of crude oil. For example, in FY 1980 (when crude oil prices were high) the government was paid as much as \$5.27 per barrel over posted prices for its crude oil.² After 1986, the Department of Energy, the agency responsible for selling the oil, abandoned posted prices as the benchmark from which to determine the price of crude.

A December 1994, draft Department of Interior Inspector General report concludes that since 1990, royalties alone "may have been underpaid by as much as \$29.5 million from 1990 through 1993 and may continue to be underpaid as long as pipelines continue to operate as private carriers."(APPENDIX A, p.5) The significance of the California oil pipeline monopoly is explained in the next section.

California Oil Pipeline Monopoly

California has always had an unusual arrangement in the way crude oil is transported from the well-head to the refinery. Unlike other states, California has no state law requiring oil pipelines to be operated as "common carriers" over which any potential shipper could transport its oil for a fee. Instead, a few of the big companies have a monopoly over the pipeline system, especially those heated lines capable of carrying California crude. This means that independent producers and refiners are at the mercy of these pipeline owners (Arco, Chevron, Shell, Texaco, Mobil and Unocal). Crude oil owners must sell the oil to the pipeline owner who can exercise monopoly power over crude oil transport. Their monopoly over the pipelines allows them to set the crude prices artificially low -- too low for independent producers to make an adequate profit on their crude, and makes access to the crude at competitive prices nearly impossible for independent refiners.

"California has a somewhat unique approach to regulating crude oil pipelines operating within its jurisdiction. State laws allow intrastate oil pipeline companies the option to operate as private carriers or as public utility corporations. With the exception of the Four Corners Pipeline Company, however, all intrastate crude oil pipelines operating in California are operated as private carriers, and each of these is owned and operated by integrated oil companies. . . .

Private carriers -- owned exclusively by the integrated oil companies -- require that all crude oil be sold to them before transport. Consequently, landlocked independent producers without access to the Four Corners Pipeline System must sell crude to private carriers at the prevailing posted prices or obtain expensive highway tank wagons to move oil to market." (APPENDIX E, pp. III-25, III-3.)

As a result of litigation with the State of California, in 1993 a number of smaller lines have since been dedicated as common carriers. The larger heated trunkline owners, however, continue to deny any common carrier obligation.

² Department of Energy, Naval Petroleum Reserve Annual Report, "Current Fiscal Year (FY 1980): Naval Petroleum Reserve No. 1)" p.29.

DEPARTMENT OF INTERIOR'S PRELIMINARY INVESTIGATIONS

In 1991, the Inspector General's office of the DOI performed an audit on "Enforcement of Common Carrier Statutes for Pipelines Crossing Federal Lands in California." The audit concluded:

". . . six of the seven major California intrastate oil pipelines passing through Federal lands function as private carriers, transporting oil on terms specified solely by the pipeline owners. This violates the Mineral Leasing Act, which requires pipelines crossing Federal lands to operate as common carriers so that oil is accepted from all customers on an equal and nondiscriminatory basis. **As a result of the lack of common carrier pipelines, independent producers sell oil at below fair market prices or pay exorbitant fees to transport the oil. We estimated that from 1980 through 1989, royalties from Federal leases may have been underpaid by at least \$76.6 million and will continue to be underpaid by at least \$8 million annually in future years until the situation is corrected.**" (emphasis added) (APPENDIX F)

According to documents obtained by POGO through the Freedom of Information Act, the Office of Policy Analysis of the DOI issued a number of policy analyses that raised questions as to whether the Federal Treasury is owed money from the integrated California oil companies, and whether the Federal Government is responsible for more aggressively upholding the Mineral Leasing Act (MLA) of 1920 to require oil pipelines to be operated as common carriers. One of these undated analyses states:

"The common carrier provision of the MLA is important to competition in the crude oil and product markets in California. It is also important to support any claim regarding royalty deficiencies resulting from undervaluation of crude oil. Accordingly, clarifying the Departments' policy, and requiring compliance by right-of-way holders will enhance these objectives." (APPENDIX G)

An August 6, 1993 Office of Policy Analysis cover letter to these analyses concludes, "I suggest that the Department proceed immediately to ascertain the amount of additional royalties due, including interest and criminal penalties, if any, and initiate collection procedures." (APPENDIX H)

This series of analyses appears to have led to an internal DOI Minerals Management Service assessment of the totals owed to the Federal Treasury:

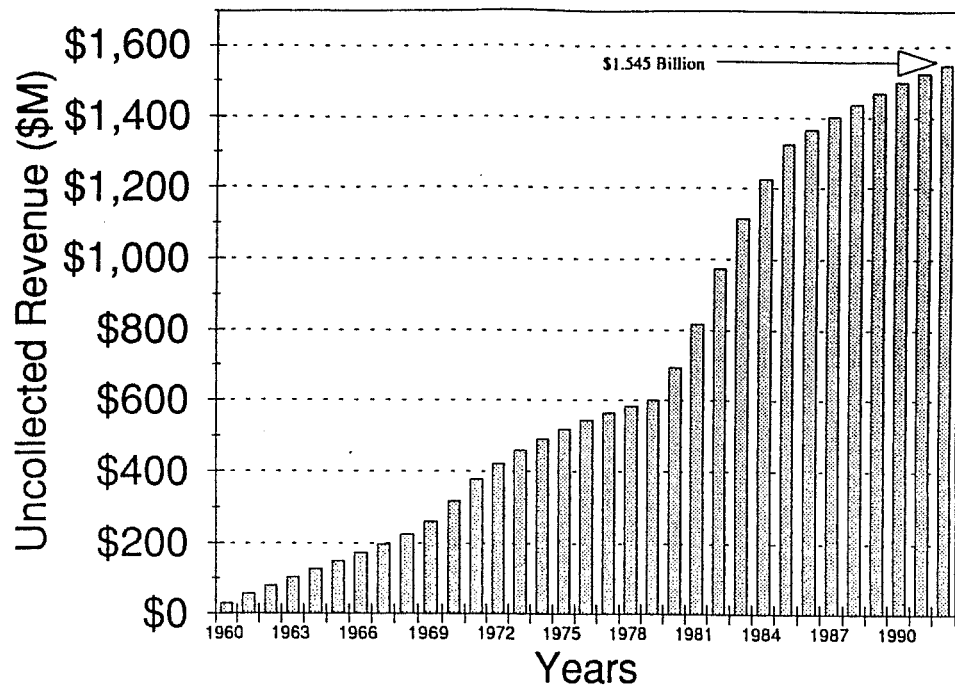
"We have evidence that the major California oil producers may have undervalued California oil production by keeping posted prices low and thus underpaying the royalties based on them. This report outlines the magnitude of this potential undervaluation of California crude from 1960-1992." (APPENDIX I, p.1.)

The memo concluded that **the low estimate of unpaid royalties is \$199 million and the high estimate is \$422 million**, and went on to recommend, **"The various available court documents, out-of-court settlements, discussions with attorneys, and the work of consultants lead us to conclude that we should pursue potential Federal royalty underpayments."** (emphasis added) (APPENDIX I, p. 1.)

When one accounts for interest, these figures balloon to over 1.5 billion.(see chart) On top of this, according to federal regulations, the penalties assessed for noncompliance due to "intentional violations" would be up to \$10,000 for each violation for every day that passes after the Department of Interior sends the oil companies a notice of noncompliance. (30 CFR, Chapter 11, Sec 241.51)

Having reached this fairly well-supported conclusion, MMS sent their findings upstairs for review. Then something appears to have happened.

UNCOLLECTED ACCRUED INTEREST



Estimated Royalty Underpayments Including Lost Interest

Year	Estimated Underpricing*	Volumes (M)	Total Underpricing (\$M)	PVIF**	Uncollected Interest (\$M)	Total Lost Revenue (\$M)
1960	\$0.90	2.024	\$1.82	15.8829	\$27.12	\$28.94
1961	\$0.90	1.958	\$1.76	15.1525	\$24.94	\$26.70
1962	\$0.90	1.848	\$1.66	14.5000	\$22.45	\$24.11
1963	\$0.90	1.936	\$1.74	13.8756	\$22.43	\$24.17
1964	\$0.90	1.925	\$1.73	13.2781	\$21.28	\$23.01
1965	\$0.90	1.696	\$1.77	12.7063	\$20.74	\$22.52
1966	\$0.90	2.181	\$1.96	12.1545	\$21.90	\$23.86
1967	\$0.90	2.404	\$2.16	11.5067	\$22.73	\$24.89
1968	\$0.90	2.784	\$2.51	10.8954	\$24.79	\$27.29
1969	\$0.90	3.913	\$3.52	10.2497	\$32.58	\$36.10
1970	\$0.90	6.579	\$5.92	9.4940	\$50.29	\$56.21
1971	\$0.90	7.517	\$6.77	8.7981	\$52.75	\$59.52
1972	\$0.90	5.927	\$5.33	8.3220	\$39.06	\$44.39
1973	\$0.90	5.209	\$4.69	7.9069	\$32.39	\$37.08
1974	\$0.90	4.894	\$4.40	7.3192	\$27.83	\$32.23
1975	\$0.90	4.737	\$4.26	6.6052	\$23.89	\$28.16
1976	\$0.90	4.438	\$3.99	6.1238	\$20.46	\$24.46
1977	\$0.90	4.149	\$3.73	5.7318	\$17.67	\$21.40
1978	\$0.90	4.102	\$3.69	5.3653	\$16.12	\$19.81
1979	\$0.90	3.734	\$3.36	4.9201	\$13.18	\$16.54
1980	\$5.40	3.852	\$20.80	4.3668	\$70.02	\$90.82
1981	\$5.40	6.032	\$32.57	3.7883	\$90.83	\$123.40
1982	\$5.40	9.183	\$49.59	3.1869	\$108.44	\$158.03
1983	\$5.40	9.304	\$50.24	2.7746	\$89.16	\$139.40
1984	\$5.35	8.257	\$44.18	2.5044	\$66.46	\$110.63
1985	\$5.35	8.380	\$44.83	2.2353	\$55.38	\$100.21
1986	\$2.55	7.744	\$19.75	2.0334	\$20.41	\$40.15
1987	\$2.55	8.010	\$20.43	1.8770	\$17.91	\$38.34
1988	\$2.55	7.744	\$19.75	1.7346	\$14.51	\$34.25
1989	\$2.55	7.974	\$20.33	1.5867	\$11.93	\$32.26
1990	\$2.55	8.318	\$21.21	1.4312	\$9.15	\$30.36
1991	\$2.55	7.277	\$18.56	1.3009	\$5.58	\$24.14
1992	\$2.55	7.300	\$18.62	1.1995	\$3.71	\$22.33
TOTALS:			\$447,650		\$1,098,070	\$1,545,720

* Mineral Management Services Estimate

** Present value interest factor using prime rate of interest for each year

DEPARTMENT OF INTERIOR'S REFUSAL TO ACT

A March 1994 internal MMS memo then completely reversed that decision, asserting:

"1. There is no clear or convincing evidence that oil posted prices were below market value or that they were invalid for royalty valuation purposes. 2. There is no clear or convincing evidence that the California oil market is noncompetitive." (APPENDIX J)

Incredibly, out of the ten documents cited to support inaction on the part of DOI, eight make strong arguments that oil posted prices are below market value, and the remaining two still make tempered cases that crude prices are undervalued. Not a single one of their sources suggests that posted prices reflect value and that the California oil market is competitive.

For example, first they reviewed a National Economic Research Associates (NERA) study of the market from 1961-1977, and concluded, "The **scope of the study is impressive**. . . The NERA presents a **strong case for at least tacit collusion by the defendants**. The analysis is the most thorough of any of the documents we reviewed." The MMS then went on to review Innovation & Information Consultants Inc. (IICI) studies and found, "Mr. Peter Ashton of IICI. . . claims that **the market demonstrated widespread undervaluation** for California production. He supplied us with four comparisons for the period 1981-1990 that he feels demonstrate this undervaluation." (emphasis added) (APPENDIX J)

In this and other documents, MMS cites the fact that they found no evidence of "illegal" behavior on the part of the oil companies as a reason not to pursue this issue. Of course, it is not necessary to prove that the companies have been acting illegally for the DOI to actively pursue the uncollected royalties, interest and potential penalties.

In June 1994, an interagency task force was assembled with representatives from DOE, Commerce, DOI and Justice to review the issue. After a few months of inactivity, the representatives from DOE and Commerce began to articulate their frustration in memoranda.

The U.S. Department of Commerce representative on the task force wrote, "I am concerned about the lack of progress since the working group began this study over three months ago." He went on to quote the Department of Energy representative to the task force, "As summarized in the DOE's July 13, 1994 memo, the MMS stated that to this date it had not conducted any audits, and thus none of its past studies or settlement issues relative to California royalties had the benefit of any audit determination." The Commerce representative concluded in surprisingly unbureaucratic language:

"It seems that all we have seen to this point clearly establishes that there is a problem. The companies themselves testified that posted prices did not represent value and that was why the exchanges were necessary. MMS has agreed with our group that posted prices did not satisfy gross proceeds. We also have a strong indication that a valuation problem exists based on the company settlements with the State of California.(See section on California Lawsuits) Finally, there is certainly a prima facie case that a problem exists, which MMS initially quantified as in excess of \$400 million, exclusive of interest and penalties, from information from the California litigation. MMS needs to do something now to avoid creating the impression that these events have not occurred!" (emphasis added) (APPENDIX K)

It should come as no surprise that at the same time, the recipient of this memo was writing an internal memo to his boss in the Department of Interior about the interagency task force. He asked:

"Will MMS commit additional audit resources, either in the form of MMS auditors or more money for the state of California to do follow-up work, if the team recommends it? I recognize that this is hard to answer without knowing what the scope may be. **I am hoping for some sort of "motherhood" statement I can give the team for our next meeting --I have stalled this issue long enough.**" [emphasis added] (APPENDIX L)

This last comment appears to be a genuine reflection of the attitude the entire Department of Interior has taken in pursuing this issue. Despite the fact that an interagency task force was created, internal working notes and documents suggest that the DOI has made every effort to slow down, or "stall" the process.

The Bureau of Land Management (BLM) has also asked DOI's Office of the Solicitor for a legal ruling as to BLM's ability to enforce common carrier requirements in California. The December 1994 draft Inspector General report states that, "On June 7, 1991, the Bureau (BLM) requested an opinion from the Solicitor to clarify the Bureau's specific authorities under the Act. However, a member of the Solicitor's office said that the opinion had not been issued because of other priorities within the office." (APPENDIX A, p. 9.)

CALIFORNIA LAW SUITS

In 1975, the State of California and the City of Long Beach filed suit in Federal court against the seven oil companies. They sued on the grounds that the City and State were receiving less than their share of payments from state-issued leases because of the undervaluation of crude oil. In 1986, U.S. Department of Interior considered joining in on the suit. However, the DOI Solicitor's office declined. After years of litigation and a suit filed in State Court, the City and State won settlements of over \$350 million from six of the seven companies. The federal government collected nothing. All the evidence used by the State to retrieve this money has been sealed by the courts at the request of the oil companies who feared "potentially prejudicial pretrial publicity."

It is worth noting that despite the turnover of Administrations in the White House, some of the people involved in that 1986 decision still work for both the Solicitor's office as well as MMS. These same people who decided not to act on this issue in the past are using that past failure to act as their current excuse not to collect the money from the big oil companies today.

In defending their 1986 decision not to join in the suit against the seven oil companies, MMS argues that the settlement is not evidence of guilt, as "given the length and circumstances of the preceding litigation, it is not clear whether the companies settled as a practical matter to cut off the litigation, whether they felt their potential exposure warranted settlement, or both." (APPENDIX M) They do not address the obvious point, however, that more than \$350 million is certainly more money to have paid to the State and City than even the lengthiest court battle would have cost in legal expenses.

Exxon was the one company that did not settle and eventually won in court. Exxon's status, however, is unique among the defendants. It was not a refiner in California in the 1960's when the undervaluation practice was developed. Furthermore, it is not a pipeline owner and, therefore, does not "post" prices. Perhaps most importantly, they did not participate in meetings where the other companies agreed on a formula for trading the underpriced crude. Exxon has since, however, become a major integrated company in California. DOI characterized the decision in favor of Exxon as an "exoneration", however, they were merely found not guilty of participating in a conspiracy to keep crude prices low. The jury did not have to determine the question of undervaluation, or whether the other companies were guilty of conspiracy. The case against Exxon for its more recent conduct is still pending in the California State Courts.

MISLEADING SENATOR BUMPERS

DOI's response in late 1994 to questions posed by Senator Dale Bumpers (D-AR) months earlier, also reflected their lack of interest in collecting these royalties, even to go so far as to mislead a U.S. Senator. (APPENDIX N) First, DOI assured the Senator that when they recently waived the government's right to collect royalties from Exxon, DOI did so with the State of California's approval. Yet the State's attorney wrote in a scathing letter, ". . . **representatives from MMS and the Solicitor's office** have indicated to others that Interior. . . is justifying this approach based on the approval of that language by (California). If such representations are indeed being made, **they are simply false.**" (APPENDIX O) The misleading memo was sent to Senator Bumpers mid-November, 1994 even though an internal briefing paper prepared for Secretary Babbitt dated one month earlier -- October 16 -- admitted "Certain State officials recently contacted DOI, asserting that they do not wish MMS to use the same language in settlements now pending." (APPENDIX P)

DOI also cited a 1984 U.S. District Court ruling from the State of California and City of Long Beach lawsuit against the seven oil companies. DOI quoted the judge as ruling that there was "insufficient evidence of conspiracy to try the case", even though that decision was overturned in 1989 specifically because there was sufficient evidence of conspiracy for the case to go to trial. Later, all the parties settled, except Exxon. DOI pointed out to Sen. Bumpers that Exxon did not settle and eventually won their case before a jury. What DOI did not mention, however, is Exxon's unique status.

Perhaps most importantly though, the DOI dismissed the whole question of undervaluation by writing to the Senator, "We have not yet found any convincing evidence of undervaluation." They made this statement despite the DOI's own Inspector General, MMS and Office of Policy Analysis findings, the GAO charts, the Department of Energy and Department of Commerce reports, the assessments of two of the non-DOI Interagency Task Force members and the successful lawsuits by the State of California and the City of Long Beach against these oil companies.

CATCH-22

The DOI has created a catch-22 for itself by relying on two conflicting excuses for their inability to pursue these unpaid royalties. Their first excuse is that the Statute of Limitations has run out, so that DOI probably could not try collect for any years prior to 1988. That is, DOI is saying its past inaction is the justification for its current inaction.

However, the Department of Interior does have a history of successfully demanding royalties despite the six year Statute of Limitations. For instance, recently, Phillips Petroleum Company's attempt to sue the Department of Interior and MMS under the Statute of Limitations for demanding royalties outside the six year limitation period was denied in the Fifth Circuit U.S. Court of Appeals on September 7, 1994. The Court concluded:

". . . the statute of limitations does not bar the agency's action. . . orders issued by MMS seek monies due under a contract with the government. Such contractual obligations cannot be considered compensatory. Agency orders are therefore not barred by the limitations period of (the Statute of Limitations)." ³

Phillips Petroleum has petitioned for certiorari to the U.S. Supreme Court to appeal this decision. It would appear, however, that the Statute of Limitations would not in fact present a serious obstacle for the DOI to demand the uncollected royalties, interest and penalties in the California case.

³ Phillips Petroleum Co. v. Johnson, No. 93-1377 (5th Cir. 1994).

The second excuse DOI has made is that 30 CFR Chap.206 Sec.101-102, was changed in 1988 (two years after DOI "reviewed" the undervaluation issue) to formalize posted prices and to prohibit the DOI from challenging the legitimacy of posted prices after 1988.⁴ This makes the current action on the part of DOI to audit 1984, 1989 and 1993 curious, as according to their own interpretation, two of the three years fall into the period when the government would not have the ability to challenge prices or attempt to recoup the lost royalties anyway. The DOI's current audit plans show that they recognize these regulations are subject to interpretation that is more consistent with the public interest. They do not in fact prevent the government from collecting royalties since 1988.

IMPACT ON CALIFORNIA PUBLIC SCHOOL SYSTEM

Beyond the obvious impact of losing more than \$1.5 billion that is owed to the federal treasury, this sweetheart deal with the oil industry has even more direct harms. By federal law, one half of all money collected by the federal government from oil royalties is to be returned directly to the state from which the oil has been pumped. In the case of California, there is a particularly ironic twist. California State law Sec. 12320 requires that "All money derived from bonuses, royalties, and rentals under the act of Congress referred to in this section and apportioned under the act to the state, **shall be received by the State Treasurer and by him credited to the State School Fund.**" (emphasis added) This is the very same school system that is currently bankrupt. In 1993, California reported that 27 school districts were in serious financial trouble, and nearly half the districts were engaged in deficit spending.⁵ A report on 1993-1994 California School Finance shows that per pupil spending in California was not improving.⁶

ENVIRONMENTAL IMPACT

In addition to the direct losses by the California public school system, this arrangement actually has a serious environmental impact as well. In 1990, the California State Lands Commission wrote:

"One of the most important environmental issues raised by the proposed M-70 (pipeline) project involves the status of the line as a common carrier. . . . In particular, this issue centers on the lack of enforcement of the common carrier requirements of the Section 185 (r) of the Mineral Leasing Act One basic point deserves to be emphasized at the outset: **pipelines are the most economically efficient and the most environmentally safe means of transporting oil.** . . . While the construction of any pipeline involves significant environmental disruption, its subsequent operation involves almost none. The risk of serious spillage is very low, particularly in comparison with the alternatives: tankers, barges, unit trains and trucks. . . . **the enforcement of the common carrier requirements is necessary to an efficient and environmentally safe oil transportation system.**" (APPENDIX Q)

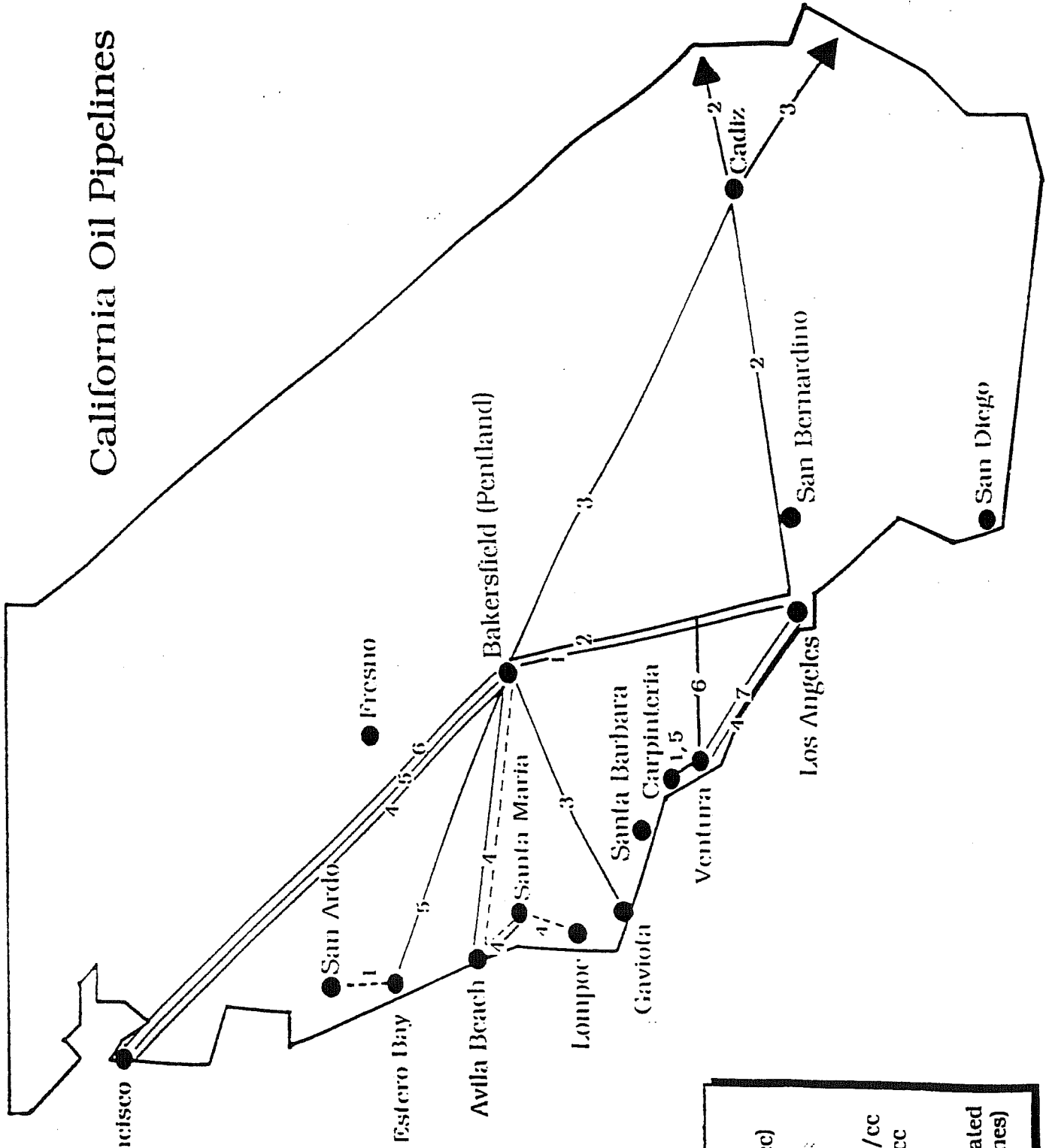
As a result of the DOI's failure to enforce the Mineral Leasing Act, states are crisscrossed with small, inefficient, single-purpose pipelines. The industry has come to rely too much on the alternative -- environmentally risky methods of transport as described above. This predicament would be averted if the Mineral Leasing Act were enforced -- giving all oil companies access to all pipelines. (See Map)

⁴ Federal Lands, "MMS, Stung by Commerce Department Memo, Hopes to Refocus Royalty Probe," November 7, 1994, p.11.

⁵ "School Districts in Financial Bind -- 6 in Bay Area", San Francisco Chronicle, January 23, 1993, A13.

⁶ Lawrence O. Picus. "California School Finance 1993-1994: Schools on Shaky Ground", Annual Meeting of the American Educational Research Association, April 12-16, 1993.

California Oil Pipelines



- 1. Mobil - private/
common carrier (cc)
 - 2. ARCO - cc
 - 3. Goodyear - cc
 - 4. Unocal - cc
 - 5. Chevron - private/cc
 - 6. Texaco - private/cc
 - 7. Shell - cc
- (- - - are the only heated
common carrier lines)

ALASKA

As a result of a dispute over crude oil valuation in Alaska, the State of Alaska has collected \$3.7 billion from ARCO, Exxon, and BP from back taxes and unpaid royalties since 1978. The State is continuing to pursue claims against major oil companies who are in arrears.⁷ This is particularly relevant, as the President of ARCO testified before the U.S. Congress in 1983 that Alaskan crude and California crude prices are "very comparable." If the States of Alaska and California have been successful in collecting billions of dollars, the U.S. should at least be trying to do the same.⁸

DOI'S GLOBAL SETTLEMENTS WITH THE OIL COMPANIES

Because the Department has several unrelated outstanding legal issues with the oil companies, the DOI has been entering into global settlements with each of these companies that will put all legal issues to rest. The DOI has already signed settlements with Chevron and Exxon, and is in the process of settling with Mobil and Shell.

Before this round of settlements, DOI had only entered into settlements over specific legal issues. Now, however, in the "global" settlements, if an issue is not specifically discussed, as in the case of Exxon and the unpaid royalties, it is considered settled and forgiven.

The recent DOI settlement with Chevron leaves them clear from having to pay royalties and back-interest for the twenty years before 1980. As mentioned earlier, the DOI has at times argued that there might be a statute of limitations problem of going back before 1988. Why, then, would Chevron have found it necessary to include that provision in their settlement? The language of the Mobil settlement has not yet been resolved, so it is unclear what stance the DOI will take regarding the government's right to collect unpaid royalties, interest and penalties from Mobil.

THE POWER OF MONEY

According to Federal Election Commission records, these oil companies played a very active role in electoral politics. Perhaps this helps to explain why Democrats and Republicans alike have looked the other way. For the 1994 election, Texaco, Shell, Mobil, ARCO, Chevron, Exxon and Unocal contributed \$2.1 million to the Republican party and candidates, and \$820,000 to the Democratic Party and candidates. From January 1993 to June 1994, four of the companies, Exxon, ARCO, Texaco and Chevron, were listed among the top 50 corporate PACs. (see charts)

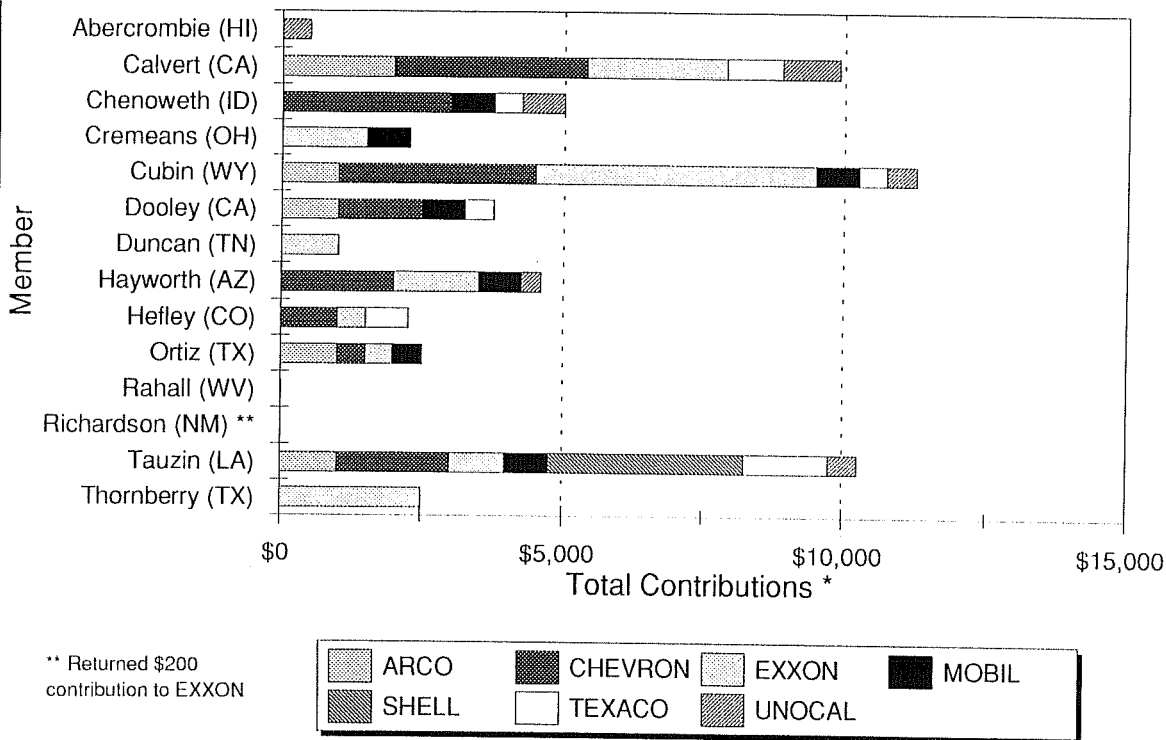
Perhaps even more telling is that in the last Congressional session, 87.5% of the House Natural Resources Energy and Mineral Subcommittee, and 78% of its Oversight and Investigations Subcommittee received contributions from these oil companies, their Directors or Officers.

It does not appear we will have much to look forward to in the new Congress, either. The numbers in the House are even higher. Now, 93% of the Members of the new House Subcommittee on Energy and Mineral Resources have received contributions from these companies, their Directors or Officers.

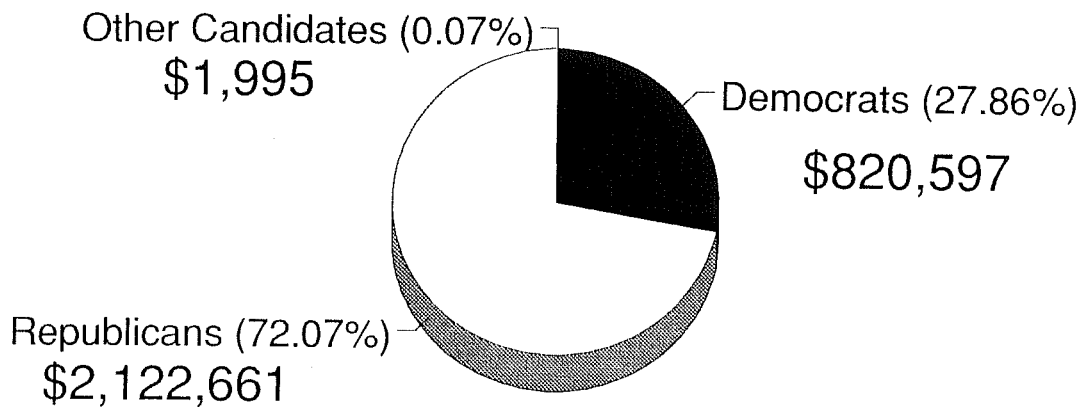
⁷ "British Petroleum Will Pay Alaska \$1.5 Billion in Tax," Wall Street Journal, November 18, 1994.

⁸ Testimony of James S. Morrison, "Windfall Profits Tax", Energy and Commerce Subcommittee on Oversight and Investigations, February 23, 1983, p.5.

**U.S. House Resources Committee
Energy & Mineral Resources Subcommittee
104th Congress**

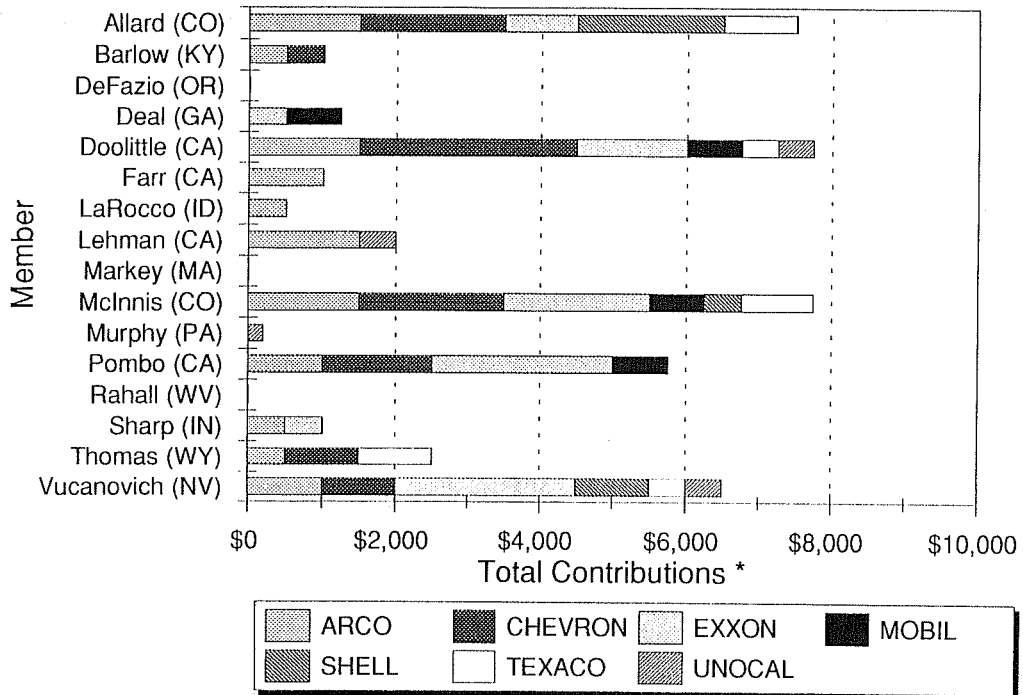


**1994 Campaign Contributions Given By The
Seven Major Oil Companies**

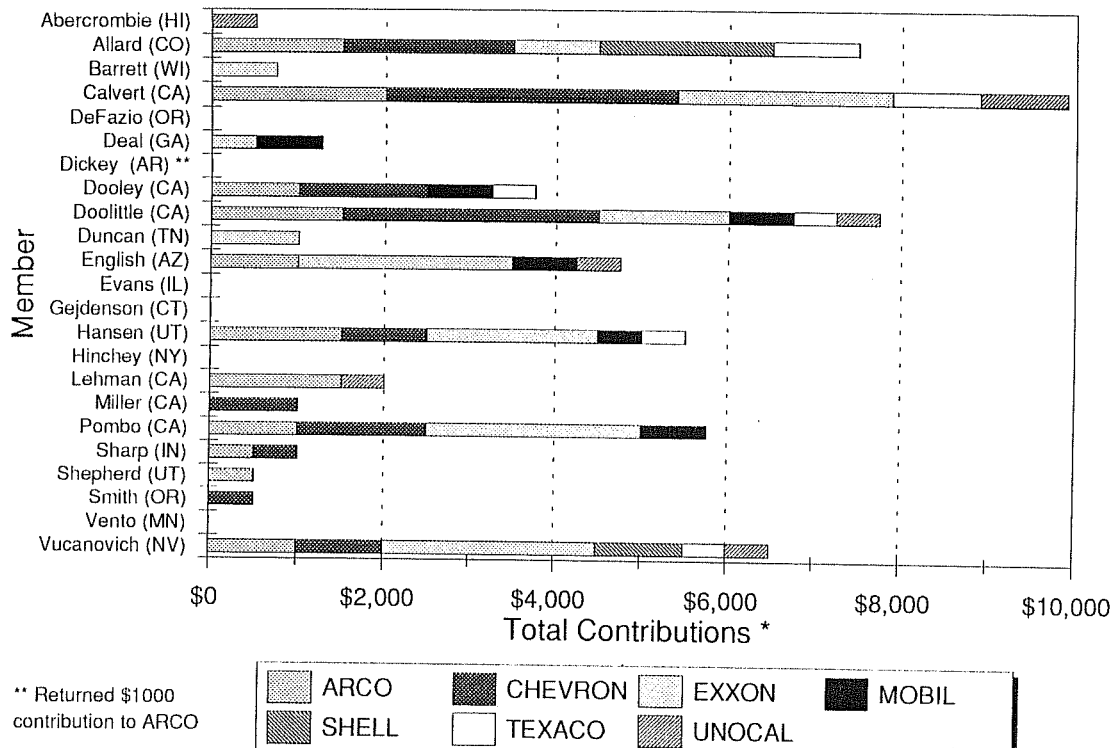


* Federal Election Commission Figures

U.S. House Natural Resources Committee Energy & Mineral Resources Subcommittee 103rd Congress

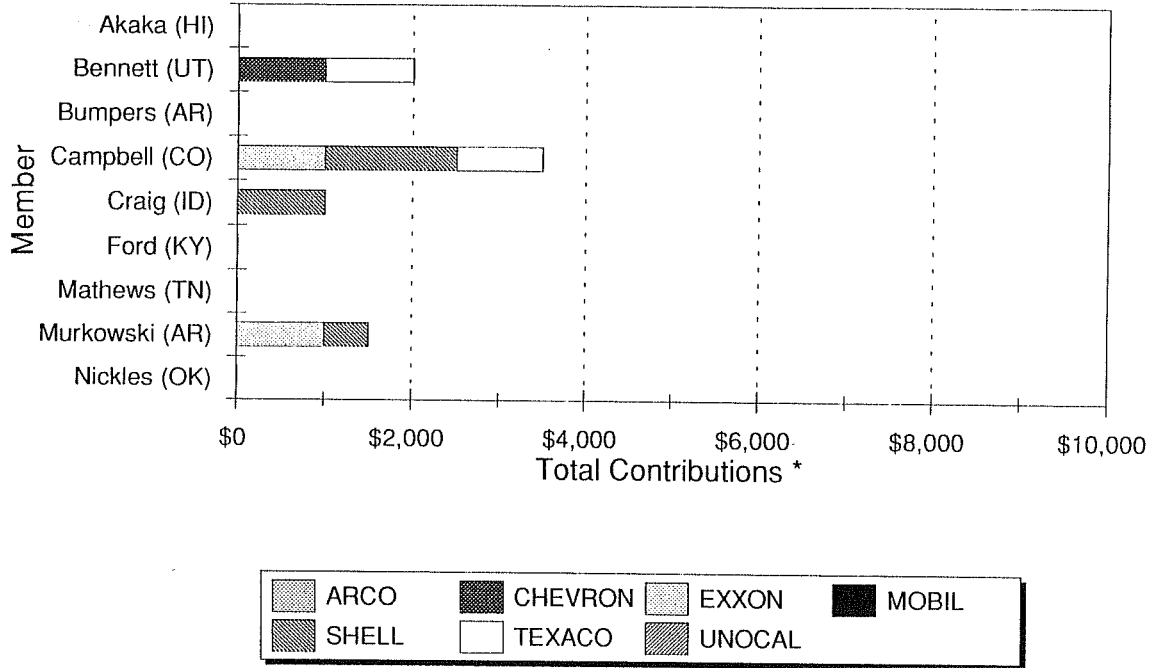


U.S. House Natural Resources Committee Oversight & Investigations Subcommittee 103rd Congress

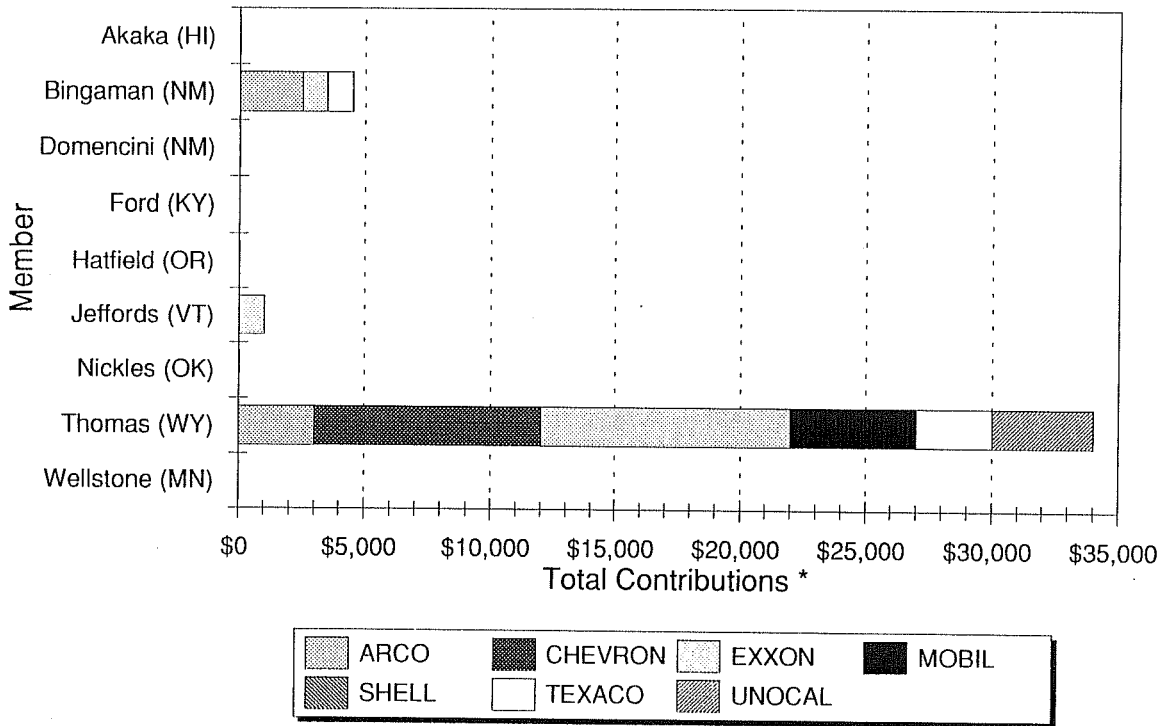


* Federal Election Commission Figures

**U.S. Senate Energy & Natural Resources Committee
Mineral Resources Development & Production Subcommittee
103rd Congress**



**U.S. Senate Resources Committee
Energy Production & Regulation Subcommittee
104th Congress**



* Federal Election Commission Figures

The numbers in the Senate are not as dramatic, but are still significant. Over 40% of the Senators on the Mineral Resources Development and Production Subcommittee during the 103rd Congress, and 33% of the Senators on the Energy Production and Regulation Subcommittee in the 104th Congress received contributions from these companies, their Directors or Officers.

THE DEPARTMENT OF INTERIOR WITHHOLDS INFORMATION

POGO began working on this project in June 1994. Initially, the DOI appeared surprisingly cooperative. FOIA officers were very responsive, and Assistant Secretary Armstrong and his staff voiced interest in our work and findings. However, substantively the DOI was not forthcoming. The Department claims to have released all but seven relevant documents in response to POGO's FOIA request. They listed those seven documents and identified their titles and authors. While we never received those documents, POGO did -- by other means -- obtain several incriminating internal government documents as well as external correspondence directed to DOI. They are included in our report as Appendices.

Another public interest organization, Public Employees for Environmental Responsibility (PEER), has experienced similar intransigence from DOI. PEER activists in the Bureau of Land Management (BLM) revealed the fact that Meridian Oil, another large oil company, had failed to report the production of oil and gas from BLM managed land that would have returned at least \$22 million in royalties to the federal treasury. The activists based their claims on a draft 1993 BLM report. Despite PEER's FOIA requests to compel BLM to make the final version of that 1993 report public, BLM has refused to do so. Although the report found that Meridian Oil had significantly under-reported its production of oil and gas from federal lands over a five year period, the BLM has nonetheless failed to hold Meridian accountable for accurately reporting to the BLM.

It appears that the Department of Interior is consistent in its efforts to protect the interests of big oil, rather than aggressively pursuing the interests of the American public.

SOLUTIONS

First, the Department of Interior must produce clearer regulations and enforce the Mineral Leasing Act's provision requiring pipelines crossing federal lands to be operated as common carriers. This would begin to create a more open market for crude oil, where prices would more closely reflect value. In itself, however, this change is not enough.

Secondly, the 1988 regulations regarding the collection of royalties (30 CFR Chap. 206 Sec. 101-102) are currently subject to interpretation. In order to avoid future adverse interpretations, these regulations should include at least two new provisions. The first provision should allow MMS to cross-check and challenge prices posted or paid to ensure that those prices comport with the market value of crude. The second should provide that all documents in the possession of the oil companies regarding prices should be available to government auditors. Currently, government auditors do not have such full access.

Perhaps the most important, although the most difficult, change will be to convince the DOI to reverse its mind-set from trying to find reasons not to collect money from the big oil companies, to trying, instead, to figure out how to retrieve this windfall for the American people.

The ball is now in the Department of Interior's court. If they want to, they can enforce existing law and pursue the government's right to this huge sum of money. The DOI's actions in the near future will show to whom they feel their allegiance -- the American public or the oil industry.