CAN THE UNITED STATES INCREASE OIL ROYALTIES?

HEARING

BEFORE THE

SUBCOMMITTEE ON GOVERNMENT MANAGEMENT, INFORMATION, AND TECHNOLOGY

OF THE

COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT HOUSE OF REPRESENTATIVES

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CAN THE UNITED STATES INCREASE OIL ROYALTIES?

MONDAY, JUNE 17, 1996

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GOVERNMENT MANAGEMENT,
INFORMATION, AND TECHNOLOGY,
COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 2154, Rayburn House Office Building, Hon. Stephen Horn (chairman of the subcommittee) presiding.

Present: Representatives Horn and Maloney.

Staff present: J. Russell George, staff director and counsel; Mark Brasher, professional staff member; Ian Davison, staff assistant; and Mark Stephenson and David McMillen, minority professional staff members.

Mr. HORN. Good morning. A quorum being present, the Subcommittee on Government Management, Information, and Technology will come to order.

On April 25, 1996, the Debt Collection Improvement Act passed the House of Representatives and was subsequently enacted into law. The purpose of that measure, which I introduced and was joined by the ranking minority member, Mrs. Maloney of New York, was to provide the Federal Government with the tools that it needs to collect the money that is due it. The Nation's enormous deficits demand that the Federal Government take every step to collect outstanding amounts.

In today's hearing, the subcommittee asks: one, has the valuation of the oil produced on Federal leases been fair and reasonable, and, two, are the Federal Government and other entities which might be involved receiving the royalties owed in a timely manner?

On May 16, the Department of the Interior released an interagency report which examined the valuation of California oil produced on Federal lands, and the oil royalty payments which resulted from that production. The report entitled, "Final Interagency Report on the Valuation of Oil Produced from Federal Leases in California," concluded that during the years 1978 through 1993, there was a possible undervaluation of California oil. Query, given the lower grade of oil produced in California compared to Alaska and Texas, is that necessarily so? Those responsible for the administration of Federal oil properties believe that the posted price of oil was understated, and, if so, the Federal royalty received could also be understated. We will be interested to learn how that valuation system works.

The conclusion reached by the Department of the Interior seems supported by a comment attributed to a representative of an oil company which called the posted price a "dinosaur" which bears no relationship to the market value of the oil. The Federal Government must ensure that it has a reliable gauge by which to measure the value of oil so that the Government collects all the revenue to which it is appropriately entitled.

This is potentially an enormous problem. The report concluded that the underpayment ranges from zero dollars to possibly $856 million, for California alone. The report does not consider the other 49 States. It does not cover the natural gas leases. In California, the State portions of the royalty are dedicated to funding kindergarten through 12th grade education. With that most important use of the payment at stake, it is clear that we might well need better management of the Federal oil and gas leasing program.

This issue continues to be the subject of litigation by the States because of vague Federal rules and apparent lack of resources to pursue the matter. Congress needs to work with the administration to identify better ways to manage the leasing programs.

One option is turning the administration of these programs over to those States which already seem eager to audit the oil leasing program. My colleague from California, Representative Ken Calvert, has introduced legislation to accomplish this approach. His bill, H.R. 1975, however, does not provide for retroactivity.

Although his legislation was vetoed by the President when it was included as a part of the budget reconciliation measure, the administration has expressed support for the bill. If enacted, the Calvert approach will solve the undervaluation problem in the future, but leave any undervaluation during the 1978 through 1993 period unresolved.

This morning we hope to learn if the Department of the Interior needs to make improved management and collection of royalties a priority.

Does the ranking minority have an opening statement?

Mrs. MALONEY. Yes, I do, Mr. Chairman, and thank you very much for holding this hearing so swiftly after my office and POGO released a report requesting a hearing and the other task report came out.

First of all, I deeply want to express my appreciation for holding this hearing on Federal royalty undervaluation. This might sound like an old problem but it is a problem that has not yet been solved, and I want to commend you and your staff for bringing this issue before the committee.

I might add, that your great State of California has a deep interest in solving this problem, as half of the money due back on California onshore production would mean at least $142 million for the State of California.

I also want to congratulate the administration's efforts on this issue. The Department of the Interior set up an interagency task force which focused on California crude oil valuation. Their report states clearly that 10 oil companies owe the Federal Government up to $856 million in oil royalty and underpayments in California alone.

This report is strong and to the point. I think our job now is to immediately begin collecting this money for the American people.

The task force report brings up many very important issues from which we must take action. Most important, we must decide how to collect and from what period to collect underpaid royalties. The task force discusses two methodologies on how to collect: No. 1, using Alaskan North Slope spot prices referred to as ANS prices and, No. 2, computing premiums paid on arm's length contracts.

The first method would bring in $856 million, and the second method would likely bring in less than half that. I recommend using the Alaskan North Slope price because it is simpler, more accurate, it is the method the oil companies use themselves, and it will bring in at least twice as much money.

Between 35 and 45 percent of oil refined in California comes from the Alaskan North Slope. That represents a significant quantity. Likewise, less than 20 percent of oil is traded at arm's length, which is not a significant quantity. Yet, Federal regulations require significant quantity when computing arm's length contract premium.

According to the task force report, which is based on the court-sealed documents from the Long Beach cases 1 and 2, the oil companies use the Alaskan North Slope spot prices to base the value of their oil. If it is good enough for the oil companies, it should be good enough for the State of California and the Federal Government.

Calculating underpaid royalties by using the Alaskan North Slope spot prices is very easy because the value of ANS oil is published widely in trade journals; however, trying to calculate premiums paid on arm's length contracts would take not only years to accomplish but would most likely be very inaccurate. The task force report even admits to some of these pitfalls.

For example, on page 18 the task force reports,

> Most oil from Federal oil and gas leases is produced by integrated companies that transfer production from their production arm to a trading or refining arm. After this initial nonarm's length transfer, oil produced from Federal leases loses its identity in companies' accounting systems so that its price subsequent to transfers usually cannot be determined.

Then page 34, it goes on to say: "Rarely is it possible to trace Federal production past the first transfer between the company's production and trading affiliates."

On pages 49 and 50, the report says,

> After transferring Federal crude of a specific type to a company's trading division, the distinction between Federal and non-Federal crude oil was lost. Federal crude oil was not specifically invoiced in companies' records after internal transfers, so it is unlikely that gross proceeds in excess of posted prices can be traced to the production of specific Federal leases.

It is my opinion that the oil companies could easily bury the already understaffed royalty management program audit teams in a maze of company trading transactions. That is not to mention the legal roadblocks and endless appeals the oil companies will use to prevent the release of their affiliate's records. ANS is by far the easiest and most logical method to use.

The second important question is which time period do we use to limit our collection of undervalued royalties? Over the last few months I have uncovered evidence that posted prices have not represented market value since the 1930's. According to the task force report, two task force team members recommended going back to at least 1980. The other team members make no recommendation. I recommend at the very least that we should commit to using 1980 as the reasonable starting point.

Clearly, 74 percent of the undervalued crude oil was sold from 1980 to 1985. Collecting on these 6 years alone would bring the Federal Government over $500 million. Contributing to the undervaluation problem is that some pipelines are not operating as common carrier pipelines. However, Federal law requires that pipelines which cross Federal land operate as common carriers.

Oil companies which use noncommon carrier pipelines exercise tremendous market power over all other oil companies. As long as pipelines are not opened up as common carriers, the California oil market will never be a free market with open competition. As such, I recommend that the Secretary of the Interior use his powers to immediately enforce common carrier access to all California pipelines which cross Federal land.

We have waited long enough. On behalf of the American people, the Federal Government should start collecting royalties based on the market value for oil. The evidence to date shows that we have not been getting our money's worth. We need to fix this problem now and collect all that is owed us from the past. As such, I urge the Department of the Interior to take immediate steps to collect the money owed. We should also change the regulations so that they are more helpful in the future.

Over the last few months very compelling evidence has come to my attention that oil in Texas, New Mexico, Louisiana, Wyoming, and a dozen other States has been undervalued. This is not surprising because oil trading in California is very similar to oil trading in the Gulf States. As such, I have made a request to Assistant Secretary Robert Armstrong that the task force continue their investigation to include oil and gas undervaluation beyond the State of California. A future task force would most likely discover that the $856 million figure for California would probably increase to several billion dollars once offshore and onshore production from the rest of the country is included.

Finally, I strongly believe that all future global settlements should specifically exclude the oil and gas undervaluation issue throughout the country. The Department of the Interior already made the mistake of globally settling with Exxon only to find out later that Exxon owed nearly $200 million in underpaid royalties. With the release of the task force report, we now have convincing evidence that the oil and gas undervaluation issue exists. We would make a huge mistake if we globally settled with additional oil companies and gas companies.

I would like to put into the record, Mr. Chairman, a letter that I wrote to Mr. Armstrong, the Assistant Secretary of Land and Minerals Management, calling upon him not to have any more global settlements until this issue is resolved.

I would likewise like to put into the record the testimony of the Project on Government Oversight. They were not able to testify today. They issued an excellent report, along with my office, on this problem, and I would like to submit to the record their testimony.

Mr. HORN. Without objection, it would be included at this point in the record.

Mrs. MALONEY. Thank you, Mr. Chairman. And I thank you again for calling this hearing in such a timely way.

[The information referred to follows:]

Danielle Brian

EXECUTIVE DIRECTOR

PROJECT ON GOVERNMENT OVERSIGHT

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 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

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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.[1] 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

[1]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.[2] 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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[2]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 od 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.

Mr. HORN. We are delighted to have with us a colleague from California, Mr. Ken Calvert, and welcome. And describe some of your legislation and how it is going to solve this problem.

STATEMENT OF HON. KEN CALVERT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. CALVERT. Thank you, Chairman Horn, and members of the subcommittee. Thank you for inviting me to testify before you today on an issue of importance certainly to my district, the State of California, and certainly the entire Nation, the administration of Federal mineral leases and the proper collection of royalties owed on production therefrom.

I serve on the Committee on Resources and am chairman of the Subcommittee on Energy and Mineral Resources. My subcommittee is the authorizing panel with jurisdiction over the Mineral Leasing Act, governing disposition of oil, gas and coal, and several other mineral commodities from Federal mineral sites onshore and the Outer Continental Shelf Lands Act of 1954, which governs the leasing of offshore mineral rights.

When I assumed the chairmanship last year, I began to review the Interior Department agencies' cost-effective reform of the Minerals Management Service to manage and collect oil and gas leasing revenues from the public lands and the Outer Continental Shelf. In my view, the Federal Government runs an inefficient, complicated, and burdensome system for royalty collection and accounting which has resulted in enormous amounts of litigation over the years. I have introduced H.R. 1975, the Federal Oil and Gas Royalty Simplification and Fairness Act last year to enact provisions which I found lacking in the administration of oil and gas leases.

Expanded delegation authority for States is now the cornerstone of the bill. In addition, the bill creates statute of limitations, defines liabilities, establishes reciprocity on interest payments, and provides for expedited appeals and payments. But with expanded delegable responsibilities, H.R. 1975 is a bill fully endorsed by 14 Governors, both Republicans and Democrats, representing States with 99 percent of onshore Federal oil and gas production.

For the record, I would like to submit a letter that I have from the White House Chief of Staff, Leon Panetta, endorsing the Senate version of this bill.

Mr. HORN. Without objection, it will be inserted at this point in the record.

[The letter referred to follows:]

THE WHITE HOUSE

WASHINGTON

May 30, 1996

The Honorable Ken Calvert
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Calvert:

I am writing to inform you of the Administration's position regarding the pending Oil and Gas Royalty Simplification and Fairness legislation (S. 1014). Let me assure you that the Administration remains committed to ensuring the efficient management of Federal lands and finding new ways for the States to work cooperatively and creatively with the Federal Government. The President shares your hope that an agreement can be reached on the State delegation issue.

In an effort to resolve this issue, Administration representatives, working with the staff of the Senate Energy Committee, were successful in reaching an agreement on language that would expand the list of delegable royalty management authorities, without reducing the Secretary of the Interior's responsibility with respect to the management of Federal lands. That language was included in S. 1014, which was reported out of the Senate Energy Committee on May 1st. The Administration supports S. 1014 as reported out of Committee, but will seek a minor technical amendment. The Administration believes this bill's State delegation language is acceptable, unlike the language included in H.R. 1975, the House Resources Committee bill on Royalty Simplification.

The Administration will continue to work with Congress as the legislative process moves forward, and stands ready to work in support of the language included in the Senate Energy Committee bill. I appreciate your interest and support in this important legislation.

Sincerely,

Leon E. Panetta
Chief of Staff

Mr. CALVERT. There is little doubt that for many Western States the fiscal impacts of mineral revenues deprived from Federal lands within their borders is an important, if not the paramount, consideration in their dealings with the Department of the Interior. The simple fact that half of the receipts go back to the States provide a great incentive for proper oversight by those States.

Federal bureaucratic inefficiencies now cost States twice, once when royalties which may be properly owed go uncollected because MMS is too busy spending dollars to chase dimes, and, second, when the enormous Bureau of Land Management, Forest Service, and MMS costs to run the program are forced upon the States without alternative.

My bill gives the States the opportunity to not only audit Federal leases within their borders, but to enforce the results of such audits.

Without getting into the merits of the allegations that some 10 oil companies may have underreported royalties owed on Federal leases in California and the OCS off California, let me assure the subcommittee that H.R. 1975 would go a long way toward fixing this problem in the future.

Let me add that I have always intended H.R. 1975 to be prospective in its application. When this bill comes to the House floor for action, a technical amendment will ensure that the Federal Government is in no way barred from pursuing demands for payment of royalties owed on oil and gas produced prior to the enactment of my bill. The 7-year statute of limitation affects only production post-enactment and it is the very provision which the CBO and others agree will cause the Secretary or the delegated State officials to be more vigilant in the future than they have been in the past. Furthermore, the statute of limitations would not apply when lessees are shown to be involved in fraud or concealment.

I have never sought to harbor royalty underpayers but rather my goal has been to put some common sense into implementation into part of Federal Government royalty collection.

In summary, Mr. Chairman, oil and gas leases revenue currently collected by the MMS are enormous, nearly $3 billion in 1994. The question remains are there cost-effective improvements which Congress should pass to make royalty collections more efficient and therefore less costly to the States as well as to the Federal Treasury?

The provisions of H.R. 1975 will do just that, saving the Federal Treasury $51 million over 7 years and the States $33 million in net receipts sharing costs. I think it is fair to say that if H.R. 1975 had been law over the last decade, Mr. Chairman, our State of California would have timely pursued allegations of underreporting royalties through a greater delegation of authority than is now possible. I don't know what the result would have been. None of us do. And quite frankly, it is irresponsible to suggest that otherwise in such a complex factual situation as the valuation of crude oil.

If the results of this investigation prove that additional money is due, it should be paid. But there can be no denying that the interests of California citizens are sufficiently great as to cause the

State to be more vigilant in protecting its revenues than the Federal Government has been in protecting all of ours. Let's empower the States to help the Federal Government to police royalty collections in the future by passing H.R. 1975. And I thank you, Mr. Chairman.

[The prepared statement of Mr. Calvert follows:]

Statement of

The Honorable Ken Calvert

to the

Subcommittee on Government Management, Information & Technology
Committee on Government Reform & Oversight

Oversight Hearing on Federal Oil and Gas Royalty Valuation Issues

June 17, 1996

Chairman Horn and Members of the Subcommittee, thank you for inviting me to testify before you today on an issue of importance to my district, state and indeed the entire nation - the administration of federal mineral leases and the proper collection of any and all royalties which may be owed on production therefrom. I serve on the Committee on Resources and was elected chairman of the Subcommittee on Energy & Mineral Resources at the beginning of this Congress by my peers. My subcommittee is the authorizing panel of the House of Representatives with jurisdiction over the Mineral Leasing Act of 1920, *as amended*, governing disposition of oil, gas, coal, and several other mineral commodities from federal mineral estates onshore, and the Outer Continental Shelf Lands Act of 1954, *as amended*, which governs the leasing of offshore mineral rights.

When I assumed the chairmanship last year, together with my full committee chairman, Don Young of Alaska, I began a review of the Interior Department agencies and the mining and mineral laws under our jurisdiction to find ways to encourage development of federal mineral resources - consistent with environmental mandates - as a way to create new wealth for the nation. In this manner, Chairman Young and I joined in the introduction and Congressional passage of legislation to impose a royalty on "hardrock" minerals, such as gold, silver, copper, zinc and many others mined from public lands. Unfortunately, the President saw fit to veto the Balanced Budget Act of which 1872 Mining Law reform was a small part. We will be back next Congress to reform that law to collect royalties for the first time since President Polk signed legislation on July 11, 1846 to repeal royalties on lead mined from public lands.

Another area I have looked upon for cost-effective reform is the manner in which the Minerals Management Service (MMS) of the Department of the Interior carries out the Secretary's responsibility to manage and collect oil and gas leasing revenues from the public lands and the OCS. The MMS is a creature of administrative origin rather than authorizing statute, *per se*. Secretary Watt created MMS from portions of the U.S. Geological Survey and the Bureau of Land Management after a distinguished panel of experts reviewed the sorry state of affairs that existed in federal royalty management in the late 1970's and early '80's.

That panel, the Linnowes Commission, urged the feds to involve the states in the audit of mineral leases. And why not? For decades the States had been recipients of a third of the revenue stream from rents, royalties and bonuses associated with federal leases within their borders. In 1976, Congress increased the states' share to 50% for public domain leases, except in Alaska which has 90/10 split generally. Then in 1978, Congress agreed that coastal states should receive 27% of oil and gas revenues from a three-mile wide strip of the OCS bordering state waters, known as Section 8(g) leases. Legislation known as FOGRMA, the Federal Oil and Gas Royalty Management Act of 1982, at Section 205 codified the recommendation for <u>limited</u> state involvement by granting the Secretary the authority to delegate his responsibility for lease audit to states.

I introduced H.R. 1975, the Federal Oil and Gas Royalty Simplification and Fairness Act, last year to enact provisions which I have I found lacking in the administration of oil and gas leases. While I originally did not include expanded delegation authority for states, as a result of oversight on the Vice President's re-invent government proposals, I felt that greater delegation powers was not only a good thing, but a necessity for good government. In fact, these provisions are now the cornerstone of the bill, in my view. Without greater state involvement the bill ~~still~~ has merit because of the creation of a statute of limitations, definition of lessee liabilities, reciprocity on interest payments and provisions for expedited appeals and payments, to name a few. But, with expanded delegable responsibilities H.R. 1975 is a bill fully endorsed by 14 Governors representing States with 99% of onshore federal oil and gas production.

And that's want I want to emphasize in my testimony today. There is little doubt that to many western states the fiscal impact of mineral revenues derived from federal lands within their borders is an important, if not paramount, consideration in their dealings with the Department of the Interior. While I recognize that the leases in question are on "public lands" held for the benefit of all citizens of this country, the simple fact that half of the receipts go back to the States whence they came gives the States a great incentive for proper oversight. Moreover, since the Congress first mandated through appropriations language several years ago that one-half of the feds' costs to administer mineral leasing be deducted from the receipts to the Treasury before the 50/50 sharing occurs, the States have even more reason to ride herd on federal royalty management. Federal bureaucratic inefficiencies now cost States twice - once when royalties which may be properly owed go uncollected because MMS is too busy spending dollars to chase dimes, and secondly when the BLM, Forest Service and MMS costs to run the program all the way from initial land-use planning through royalty collections are forced upon the states without alternative.

Generally speaking, Mr. Chairman, fairness dictates that when a new burden is imposed on someone an opportunity to shop for the "best deal" to meet the requirement be granted as well. If the "unfunded mandate" rule of this Congress had existed in the 102nd Congress the "net receipts sharing" formula of the Omnibus Budget Reconciliation Act of 1993 might never have become law. But, it is the law now and this Congress should set about to right this inequity by passing my bill to give the States the opportunity to not only audit federal lessees within their borders, but to enforce the results of such audits.

Without getting into the merits of the allegations that some ten oil companies may have under-reported royalties owed on federal leases in California and the OCS off California, let me assure the Subcommittee that H.R. 1975 would go a long way toward fixing this problem in the future. What better way is there to ensure vigilance in collections than to unleash the "junkyard dog" that is the States in search of a royalty "bone?"

Let me add that I have always intended H.R. 1975 to be prospective in its application. After the House passed the bill as part of H.R. 2491, the Balanced Budget Act, we went to conference with the Senate. Under the "Byrd Rule" some non-budgetary provisions were deleted causing a mistaken cross-reference in the effective date section of the bill which may have led to some ambiguity about records-keeping requirements. During the negotiations with the Clinton Administration over the vetoed budget bill no one caught the typo and it remained in my substitute and that of Senator Murkowski. We and the Administration have agreed to fix it so there can be no doubt. Again, in no way is the federal government barred from pursuing demands for payment of royalties owed on oil and gas produced prior to the enactment of my bill. The seven-year statute of limitations affects only production post-enactment, and it is this very provision which the CBO and others agree will cause the Secretary or the delegated state officials to be more vigilant in the future than they have been in the past. Furthermore, the bill expressly provides exception to the statute of limitations where fraud or concealment by lessees is shown. I have never sought to harbor royalty underpayors, but rather my goal has been to put some common sense into implementation of a part of the federal government's revenue collection that is surpassed in size only by the Internal Revenue Service, and perhaps the Customs Bureau.

In summary, Mr. Chairman, oil and gas leasing revenues currently collected by the MMS are enormous, nearly $3 billion in 1994 and likely even greater now given that a half-billion dollars of high bonus bids were proffered in the last Gulf of Mexico lease sale alone. The Royalty Management Program of the agency is a big improvement from its pre-FOGRMA predecessor in the Interior Department. But the question remains, are there cost-effective improvements which Congress should pass to make royalty collections more efficient and therefore less costly to the States as well as the federal Treasury? In my view, a view shared by many Governors and by the Clinton Administration as well, the provisions of H.R. 1975 will do just that, saving the federal treasury $51 million over 7 years and States $33 million in net receipts sharing costs. And, those costs don't even begin to factor in the benefit of broader delegation to the States which are "ready, willing and able" to seek enforcement authority of their audit results.

I think it fair to say that if H.R. 1975 had been law over the last decade, Mr. Chairman, our State of California would have timely pursued allegations of under-reported royalties through a greater delegation of authority than is now possible. I don't know what the result would have been - none of us do - and quite frankly it is irresponsible to suggest otherwise in such a complex factual situation as the valuation of crude oil in less than arms-length markets. But, there can be no denying that the interests of California citizens are sufficiently great as to cause the State to be more vigilant in protecting its revenues than the federal government has been in protecting all of ours. That was demonstrated by the City of Long Beach lawsuits and may be demonstrated again in other litigation pending in state courts throughout the country. Let's empower the States help the federal government police royalty collections in the future by passing H.R. 1975.

Mr. HORN. We thank you for all of your hard work in this area. I would like to ask you just a couple of questions to get it in the record.

In your capacity as the chairman of the relevant committee with legislative jurisdiction, did officials from the State of California ever discuss the issue of royalty underpayments with you?

Mr. CALVERT. I brought the subject up to the Governor's representative here in Washington, and the Governor, by the way, is very much supportive of this legislation. And as a way of protecting us in the future.

Certainly, the State of California is very concerned about collecting any alleged underpayments of royalties.

Mr. HORN. You mentioned that 14 Governors of both parties favored some action in this area. Do you regard this as a nationwide problem or is it a California problem?

Mr. CALVERT. Valuation is a nationwide problem. I started a series of hearings on what we call "Royalty in Kind," or RIK. RIK is a method which the Federal Government would take its share of product instead of cash. And I requested and received appropriations language to continue pilot projects for this Royalty in Kind project. And that way the Federal Government, in fact, would just sell its oil at the marketplace and there can't be any debate as to whether or not it was undervalued at that point.

Mr. HORN. Did your committee get into the valuation system that is commonly used in the oil industry?

Mr. CALVERT. Well, certainly when you get to Ms. Quarterman you can get to the technicalities and minutia of valuation. It is extremely complex. When we talk about Alaskan crude versus California crude or Texas intermediate crude, there are various qualities of oil. Not all oil is the same value. Kern County, CA, crude has a very far heavy gradient versus Alaskan crude, so certain corrections have to take place in order to bring a mean average to that oil.

Mr. HORN. Did your committee get a feeling that some of those corrections were market based or are just an arbitrary decision based on the quality of the oil?

Mr. CALVERT. It is both market based and the quality of the oil. But it is certainly complex. And that is why it has led to so much litigation and will continue to lead to litigation unless we simplify this process.

Mr. HORN. As I understand it, you would give most of the responsibility to the States in this area?

Mr. CALVERT. That is correct; however, in the Senate provisions which we are willing to accept, the Department of the Interior would certainly continue to be involved in that process. And that is the language we have agreed with with the administration, and we are seeking to get that bill through here in the House and in the Senate.

Mr. HORN. Do you know of any opposition to this bill?

Mr. CALVERT. Oh, I am sure there will be some opposition. I haven't heard of any great opposition, no. There was in the beginning, but I think we have negotiated out some disagreements we have had with the Secretary of the Interior and now he is on board on the Senate version of the bill.

Mr. HORN. Since you have jurisdiction over the Department in this part of it, do you feel there are certain improvements that ought to be made within the Department of the Interior that would make for a smoother process and a more accurate process and a more timely process? What is your read on that?

Mr. CALVERT. Certainly, first the passage of this bill I think would be very helpful, and next, when we get to the point of valuation, that is going to be a continuing problem. And I think Royalty in Kind is an interesting way of taking care of that problem.

In effect, the Government would be selling its share of product at the marketplace and that forever more will take care of that problem. I think we need to do that in a bigger fashion than we are today.

Mr. HORN. We thank you.

Does the ranking minority member have some questions?

Mrs. MALONEY. Briefly, I would like to congratulate you for your work on this issue. You mentioned that your bill would have California, or rather the States collect the royalties and the Senate version involved the Department of the Interior. What would be the role of the Department of the Interior in the collection?

Mr. CALVERT. Basically oversight to make sure that the States are capable of collecting those royalties. Certainly, the Federal Government has an interest in making sure that every dollar is collected, as the States are. To be sure they receive their fair share of the royalty.

Mrs. MALONEY. Thank you very much for your testimony.

Mr. HORN. Thank you. Thank you very much for coming.

I would like to add that your staff has been a great assistance to our staff and we appreciate having their technical background newly learned through your hearings. Thank you.

Mr. HORN. Panel two is Ms. Cynthia Quarterman, Director of Minerals Management Service, Department of the Interior; Mr. Robert Berman, economist, Office of Policy Analysis, Department of the Interior; Mr. Abraham Haspel, Acting Principal Deputy Assistant Secretary for Policy and International Affairs, Office of Policy and International Affairs, Department of Energy; and Mr. Robert Speir, economist, Office of Oil and Natural Gas Policy, Department of Energy.

[Witnesses sworn.]

Mr. HORN. Three have affirmed. Do we have a fourth witness? Are you going to testify?

Mr. SPEIR. Yes, sir.

Mr. HORN. Then let's go over the oath again.

[Witness sworn.]

Mr. HORN. All four witnesses have affirmed. We will begin with you, Director Quarterman.

I don't know if they told you the tradition. We have your statement. It goes in immediately after we introduce you. And if you would like to summarize it, feel free to and that would leave more time for questions. Generally, we limit most witnesses to 5 minutes, but since you are the principal actor here; we are glad to give you more time than that to lay down the aspects of the case.

STATEMENTS OF CYNTHIA QUARTERMAN, DIRECTOR, MINERALS MANAGEMENT SERVICE, DEPARTMENT OF THE INTERIOR, ACCOMPANIED BY ROBERT BERMAN, ECONOMIST, OFFICE OF POLICY ANALYSIS, DEPARTMENT OF THE INTERIOR; ABRAHAM E. HASPEL, ACTING PRINCIPAL DEPUTY ASSISTANT SECRETARY FOR POLICY AND INTERNATIONAL AFFAIRS, OFFICE OF POLICY AND INTERNATIONAL AFFAIRS, DEPARTMENT OF ENERGY, ACCOMPANIED BY ROBERT SPEIR, ECONOMIST, OFFICE OF OIL AND NATURAL GAS POLICY, DEPARTMENT OF ENERGY

Ms. QUARTERMAN. Thank you. Good morning, Mr. Chairman, members of the subcommittee. It is my pleasure to appear before you this morning to present testimony in the valuation of crude oil produced from Federal leases in the State of California.

The Minerals Management Service is a bureau created within the Department of the Interior in 1982, which contains two major programs: The royalty management program and the offshore minerals management program. All mineral revenue management functions for Federal offshore lands which MMS has the obligation to manage, and onshore and Indian lands, which the Bureau of Land Management has the obligation to manage, are centralized in the Minerals Management Service within the royalty management program.

The royalty management program is responsible for timely collection, verification, and distribution of mineral revenues from Federal and Indian lands to States, various funds, and the general Treasury. Those revenues are approximately $4 billion a year.

The issue of valuation of crude oil produced from Federal leases in the State of California has been around for more than two decades. Previous administrations had made a decision to not pursue this issue further. However, we felt that it was important to assemble a team to pursue this issue to its conclusion and to determine whether additional royalties are due. As regulator and manager of Federal minerals revenues, MMS has taken the lead in coordinating this administration's review of the California underpayment issue.

I would be remiss if I did not begin my oral testimony today by also recognizing and thanking the Departments of Energy, Commerce, and Justice for providing extremely valuable and knowledgeable representatives to this interagency effort. In addition, I would especially like to thank our partner State, the State of California, for its invaluable assistance, admirable patience and advice and counsel in this matter.

Today, I would like to highlight the recent findings and recommendations of the interagency task force formed to study this issue, and discuss where the Department of the Interior plans to go from here. My written testimony at pages 1 through 4 provides a historical perspective on this issue but I will not address that information in my opening comments. I will briefly summarize the high points.

After the change in administrations in 1993, the Minerals Management Service was asked by the Department of the Interior's Office of Policy Analysis to reevaluate whether to pursue possible underpayments due to crude oil valuation in California, in light of the

State of California's and the city of Long Beach's 1991 settlements of similar issues covering the 1970's and 1980's.

During late 1993 and early 1994, MMS performed a scoping exercise by contacting the Internal Revenue Service, the Department's Office of Inspector General, the Department of Justice, and the State of California to determine if the issue was worth pursuing. MMS's initial estimates of undervaluation based on California consultant's estimates confirmed that the issue should be reviewed more closely but that such review would necessarily require review of documents under seal from the California litigation.

In June 1994, MMS formed an interagency task force including representatives from the Department of the Interior's Solicitor's Office, the Office of the Department of Energy, the Department of Commerce, and the Department of Justice, many of whom had studied extensively the California crude oil market.

The team's first order of business was to gain access to the court-sealed documents from the State of California's litigation. Obtaining access to those documents required that they enter into a confidentiality agreement concerning the matter in which the documents would be used.

After initially reviewing those documents, and meeting with representatives from the State of California, the team suggested that MMS should conduct a special audit of 3 years covering two companies. Upon the recommendation of the team and in consultation with the State of California's Comptroller's Office which performs royalty audits on behalf of the Minerals Management Service on Federal lands in California, MMS conducted those special audits. However, in order to obtain the records necessary to perform the audit, MMS had to request and receive reconsideration of an opinion of the Interior Board of Land Appeals which would have made it extremely difficult for the audits to go forward as planned.

The team also suggested that MMS engage two consultants to provide information regarding the California crude oil market and the valuation of its crude. MMS retained those consultants as requested. Meanwhile, the interagency team continued to review the documents under seal from the California litigation.

At my request in late 1995, the team presented the result of their work and seven options for how to proceed. Possible receipts from the options offered ranged from zero to $856 million, depending on the option chosen.

Assistant Secretary of Land and Minerals Management Bob Armstrong and I requested that the team assemble a final report with recommendations as soon as possible. The team finalized its report on May 16, 1996. It was released to Congress and the public shortly thereafter.

The recommendations of the task force do not precisely mirror any of the options referred to previously. The interagency task force unanimously concluded and recommended that oil companies undervalue crude oil produced on Federal leases in California; that MMS should concentrate its collection efforts on those 10 companies producing 90 percent of the Federal crude in California; that beginning in March 1, 1988, to the present, MMS should compute royalties in California based on premiums paid on arm's length contracts for oil produced from the same field or area; and MMS should modify his oil valuation regulations to place less emphasis on posted price.

For the period prior to March 1, 1988, the team did not reach consensus. The DOE and Commerce representatives recommended valuing California crude oil based on Alaskan North Slope prices adjusted for transportation and quality differentials beginning with 1980. The Interior representatives recommended that the same approach be used before and after 1988, and that the Interior management in consultation with the Department of Justice, should determine how far back to pursue collections. The Department of Justice representative did not participate in the final report because she left the team earlier when the team did not foresee that any antitrust matters were being raised. Those are the team's recommendations.

At this time, the Department of the Interior is carefully considering the recommendations of the team, particularly those that are not unanimous. We are committed to determining a course of action within the next few weeks, after we have the opportunity to consult with the Department of Justice on these matters. In the interim, we have taken affirmative steps to ensure the crude oil valuation does not occur in California or anywhere else in the United States.

Last December, we published an Advanced Notice of Proposed Rulemaking to seek input on crude oil valuation. The comment period closed in March. We are evaluating those comments and expect to have a proposed rule prepared for publication before the end of this year.

In addition, we have worked with our State and tribal audit committee to draft new guidelines on the manner in which we audit Federal leases with crude oil production. We are in the process of auditing the past 6 years of oil production on Federal lands. Our new guidelines will ensure that auditors do not solely rely on posted prices in determining value for those leases, but rather will look to any and all consideration given and to oil companies' affiliates records for third-party transactions. Finally, MMS is assisting the Department of Justice in a nationwide investigation of crude oil valuation.

In closing, let me state the Department of the Interior takes its responsibility to manage public resources very seriously. MMS will aggressively pursue any instances in which oil has been undervalued in California or elsewhere.

Mr. Chairman, that concludes my prepared remarks. I would be pleased to answer any questions you or members of the subcommittee may have. Thank you.

[The prepared statement of Ms. Quarterman follows:]

TESTIMONY OF

Cynthia Quarterman

Director
Minerals Management Service
Department of the Interior

Prepared for the

Subcommittee on Government Management, Information and Technology
Committee on Government Reform and Oversight

House of Representatives

June 17, 1996

Mr. Chairman, and Members of the Subcommittee, I appreciate the opportunity to present testimony on the valuation of crude oil produced from Federal leases in the State of California. I would like to provide you with a historical perspective on this issue, highlight the recent findings of the interagency task force formed to study this issue, and discuss where we go from here.

Background

In 1975, the State of California and the City of Long Beach pursued litigation (hereinafter referred to as "Long Beach I") against seven major oil companies operating in California. They alleged that these companies had conspired to keep posted prices low and that they had been damaged because their oil revenues depended on posted prices. Historically, posted prices were widely accepted as market value by both producers and refiners as well as by both the State and the Federal Government for royalty purposes. Private royalty owners also typically utilized posted prices to measure market value.

In 1984, the U.S. District Court for the Central District of California granted summary judgment dismissing the allegations of conspiracy in Long Beach I. Later in 1986, the State of California and the City of Long Beach filed a second lawsuit (Long Beach II), which alleged that six oil companies violated various state laws by using posted prices that did not reflect real market values and refusing to operate their pipelines as common carriers. During that period, MMS contacted State of California officials and others to obtain information on the State's allegations of improper valuation. After reviewing that information, MMS did not find evidence of under pricing. The basis of MMS's decision not to join in Long Beach II or begin its own investigation was the fact that the State and City had been unsuccessful to that point in their claims against the companies.

Shortly thereafter, the General Accounting Office (GAO), Arthur D. Little (under contract with the Internal Revenue Service (IRS)), and the Department of Energy (DOE) conducted similar studies and reviews to determine whether California posted prices reflected market value. In addition, the Justice Department (DOJ) considered whether to pursue antitrust violations against the companies. These agencies found that occasionally there were differences between posted crude oil prices the major oil companies used to pay some producers and the prices of crude oil sold at auction. The MMS, GAO and IRS did not conclude that posted prices did not reflect market value; however, the DOE study raised questions about the higher levels of refining profit margins in California. None of the studies contained conclusive evidence of illegal activities or undervaluation. The IRS and MMS concluded that, because the posted prices were utilized in many arm's-length transactions by parties unaffiliated with the posting companies, posted prices appeared to reflect market value. The GAO did not dispute that conclusion. DOJ chose not to pursue an investigation.

By 1991, following the Ninth Circuit's reversal of the District Court's summary judgment order, six of the companies involved in the Long Beach litigation (ARCO, Shell, Chevron, Mobil, Texaco, and Unocal) reached settlements to end court actions alleging undervaluation on State and City leases as well as other issues relating to pipelines . A seventh defendant, Exxon, went to trial. On January 31, 1995, the Ninth Circuit upheld the U.S. District Court for the Central District of California ruling in favor of Exxon in a law suit covering 1971 to 1977. Another appeal covering a later time period is still pending.

During the late 1980's and early 1990's, the Minerals Management Service (MMS) and, under its delegated audit authority, the State of California Controller's Office, have conducted routine audits of the same companies' payments on Federal leases in California. The audits have addressed a wide variety of issues for periods back to the late 1970's. Because the records reviewed by the auditors were not necessarily conclusive in establishing that posted prices actually refelected market value, the issue was generally left open.

In 1993, the MMS was asked by the Department of the Interior's Office of Policy Analysis to reevaluate the issue in light of the State of California's and the City of Long Beach's settlements. The MMS initially reviewed the amount of potential underpayments to determine if it was worth a major reevaluation. MMS also contacted the IRS to access records that IRS had obtained during its investigation. However, the IRS would not release its records unless there was a Federal criminal investigation. Since the MMS had no apparent basis for criminal action, it did not obtain the IRS records. Additionally, MMS requested help from California in obtaining access to the documents in Long Beach II. These documents, however, were not available to MMS, as they were sealed by the court. Using estimates from the State of California's legal counsel and their consultants, MMS estimated that underpayments could be as much as $422 million (excluding interest) for 1960-1992. This scoping exercise was the basis for MMS's decision to reevaluate its 1986 conclusion not to pursue this issue further.

MMS began its reevaluation in early 1994 by examining publicly available data for the period 1986-1992. That period was initially evaluated and preliminary conclusions were reached in April 1994. MMS shared its preliminary conclusions with the State of California. The State suggested and MMS agreed that MMS should review data under court seal in the California litigation before concluding its evaluation.

In June, 1994, MMS formed an interagency task force with some of the agencies that had reviewed the matter previously -- DOE, DOJ and the Department of Commerce. The purpose of the task force was to obtain any additional data that would enable a final determination to be made regarding whether the major oil companies wrongfully undervalued crude oil from Federal leases. An important source of information was the court-sealed documents, which had been subpoenaed from companies involved in the Long Beach II litigation. The team was able to gain access to the materials by signing a confidentiality agreement with the companies involved in that litigation.

Those documents, which reflected activities that occurred between 1980 and 1989, showed that California crude oil pricing practices required closer scrutiny. The task force recommended that a special audit be performed to determine if Federal lessees in California received revenues above posted prices that should be subject to royalties. This proposed special audit would differ from conventional audits because it would look beyond intracompany transactions that occurred at posted prices to determine whether any additional revenues may have been received by an affiliate in a later transaction. Previous audits generally relied on posted prices.

However, during several previous audits, MMS had ordered major oil companies in California to provide its affiliates' records to ensure that royalties were paid on gross proceeds. These oil companies refused and filed administrative appeals. In one of these cases, the Interior Board of Land Appeals (IBLA) held that MMS was not entitled to review the affiliates' records.

Before MMS could gain access to records of transactions of oil companies' affiliates, it was necessary to request that the IBLA reconsider the decision that prevented MMS from obtaining affiliate records. Upon reconsideration, IBLA held on May 11, 1995 that MMS may access third-party sales records. That decision is currently under appeal in the District Court for Delaware. The IBLA's decision should enable MMS to better evaluate total proceeds received by integrated firms and make better-informed judgments about oil valuation in general.

The special audit plan was developed by MMS audit staff in consultation with the

California State Controller's Office. The special audit included examination of two companies' Federal oil production in California for three, one-year periods. The auditors looked beyond posted prices to determine whether those companies were receiving premiums above postings and paying royalties based on postings.

While MMS was conducting the special audit, team members also performed a more detailed review of the court-sealed documents. The team discovered that most of the oil in California moves internally within the major oil companies, and that premiums above posted prices were often paid in arm's-length transactions. These findings were confirmed by the MMS special audit.

The results of that special audit were utilized by the task force in formulating its recommendations. In addition, the MMS retained two private consultants to provide additional information on undervaluation of California crude and the value of Alaska North Slope (ANS) crude compared to California crude.

In December 1995, the team briefed the Assistant Secretary for Land and Minerals Management, Bob Armstrong and me on options for addressing the royalty undervaluation issue, ranging from simply modifying the oil valuation regulations prospectively to valuing past oil royalties in California at a price comparable to that of imported ANS crude oil. The Assistant Secretary and I asked the team to develop a final report including recommendations.

Recommendations of the Interagency Task Force

The interagency task force delivered its final report on May 16, 1996. In accordance with the confidentiality agreement covering the Long Beach documents, the final report was sent to companies involved. Congress was provided with copies of the task force report on May 21, 1996, and the report was made publicly available on May 30, 1996. Let me briefly summarize the task force recommendations.

All task force members unanimously recommended that:

> The oil companies undervalued crude oil produced from Federal leases onshore and offshore in California;
>
> MMS should concentrate collection efforts on those ten companies producing at least 90% of Federal crude oil in California;
>
> MMS should compute royalties owed based on premiums paid on arm's-length contracts for oil produced from the same field or area for periods starting with the effective date of MMS's most recent valuation regulations, March 1, 1988; and
>
> MMS should modify its oil royalty valuation regulations to place less emphasis on posted prices.

The task force did not reach consensus on a recommended approach for periods prior to March 1, 1988. The representatives from the Departments of Energy and Commerce recommended valuing California crude oil based on ANS prices beginning with 1980. The Interior representatives recommended that the task force's approach be used for all periods and suggested MMS and Department of the Interior management decide how far back to pursue collections.

The DOJ did not participate in writing the task force's final report. The DOJ representative left the team in late 1995 because its member believed its input related only to antitrust issues, and the team did not foresee action on that basis.

Crude Oil Royalty Valuation Nationwide

In 1988, MMS revised its oil valuation regulations after a long and complex process, which involved States, Indians, industry, and other interested parties. The intent was to clarify and reorganize the regulations, provide valuation criteria resulting in reasonable values, and create more certainty in royalty payments that would correct some of the royalty deficiencies of the past. Although the new regulations provided much more detail than the old ones, the basic principle stayed the same: royalty value is to be based on not less than the gross proceeds accruing to the lessee.

Under the 1988 regulations, royalty value depends on whether the Federal production is disposed of at arm's-length. If so, the proceeds under the arm's-length contract generally represent royalty value. If not, a series of non-arm's-length "benchmarks" represent royalty value. These benchmarks rely heavily on arm's-length posted or contract prices. <u>But</u>, in no case is the lessee's royalty value to be less than its gross proceeds. This means, for example, that if a lessee is reimbursed for a service that it is required to perform at no cost to the lessor (e.g., gathering), its royalty value should be increased by that amount. Furthermore, in general, premiums would be part of gross proceeds.

Under both the current and prior regulations, industry posted prices were relied on heavily as royalty value indicators because traditionally they were thought to represent the purchase prices offered for oil from a particular location. But in recent years, various studies by the Department of the Interior and others have led us to question the continued validity of posted prices as royalty value. This is particularly important where crude oil moves internally within major companies and royalties are paid based on postings. Typically, companies have taken the position that the first intracompany transaction, which often is at a posted price, should govern royalty value under MMS's regulations.

However, since the regulations require that royalty be based on not less than the lessee's gross proceeds, MMS has been seeking records of affiliate sales to third parties where the first movement of Federal crude is between affiliates. The first arm's-length transaction may represent the lessee's true gross proceeds, or at least contribute to the gross proceeds determination. Companies generally have resisted MMS's attempts to obtain these records, but several recent IBLA and court decisions have all supported MMS's right to review such records to aid in valuation determinations.

MMS has also begun to address continued regulatory reliance on posted prices in Federal oil royalty valuation. Last December, Assistant Secretary Armstrong signed an Advance Notice of Proposed Rulemaking that was published in the Federal Register (60 F.R. 65610 (December 20, 1995)), which sought input on crude oil valuation. Specifically, we asked whether commentors believed oil posted prices represent market/royalty value and, if not, what alternative valuation methods would be appropriate.

We received a variety of comments from states, industry, Indians, and individuals on this matter. States, Indians, and individuals generally stated that postings do not represent value and that some form of index pricing would be preferable. Industry comments were limited, primarily because of non-Federal litigation they are involved in related to posted prices throughout the country. They generally stated postings represent value, and asked that MMS delay any rulemaking effort until their litigation is completed.

Next Steps

As I mentioned previously, the task force submitted its final report to Assistant Secretary Armstrong and me on May 16. We are reviewing the team's recommendations to plan appropriate follow-up actions. However, because the team differed on a few key recommendations, we cannot immediately implement all of the interagency team's recommendations. We also need to confer with our Solicitor's Office and the DOJ so as not to affect adversely other potential royalty collections. Although we have not yet committed to a specific course of action, please be assured that we will implement an aggressive, comprehensive plan as expeditiously as possible.

As I also mentioned earlier, we have received comments from various parties regarding the Advance Notice of Proposed Rulemaking and possible changes to our oil royalty valuation regulations. We are currently evaluating options for new regulations that provide alternatives to posted prices to value Federal oil. Regardless of whether industry is willing to participate in a joint rulemaking effort with MMS, states, Indians, and others, we will proceed expeditiously to revise MMS crude oil valuation regulations.

Current MMS oil valuation audit policy conforms with the existing regulations, but we plan to look beyond posted prices to insure that royalties are properly paid. That is, valuation of arm's-length contracts will be determined by the sales contract and revenue accounts representing revenues actually received. Any differences between posted or contract prices and revenues actually received may represent premiums paid for valuing crude oil production, and royalty value will include this additional revenue or any other revenue that is part of gross proceeds to the lessee. Often this will mean that MMS will have to obtain records of affiliate sales to third parties and not rely on intermediate transactions between affiliates. In valuing oil not sold at arm's-length, royalty value is determined by using the first applicable regulatory benchmark. This usually means reliance on arm's-length posted or contract prices for significant quantities of production sold in the field or area. The total consideration received must be determined; royalty value cannot be less than the lessee's gross proceeds. Furthermore, we will insure that any premiums are included in the arm's-length contract prices relied on to value non-arm's-length production. We are currently auditing company records covering the last six years and will apply these new guidelines to those periods.

In closing, let me state that the Department of the Interior takes its responsibility to manage public resources very seriously. MMS will aggressively pursue any instances in which oil has been undervalued in California or elsewhere.

Mr. Chairman, this concludes my prepared rémarks. However, I would be pleased to answer any questions you or Members of the Subcommittee may have.

Mr. HORN. Mr. Haspel, would you like to comment on the situation?

Mr. HASPEL. Thank you. Good morning, Mr. Chairman, and members of the subcommittee. Thank you for the opportunity to come before you today to discuss the Department of Energy's participation in the interagency team that evaluated potential Federal royalty underpayments in California.

I am both the Acting Principal Deputy Assistant Secretary for Policy and International Affairs at the Department of Energy and the Department's chief economist. I am accompanied today by Robert A. Speir, a petroleum analyst on my staff and the Department of Energy's representative on the interagency team that evaluated Federal royalty underpayments in California.

The Department of Energy was invited by the Department of the Interior to contribute to the interagency team's evaluation due to our experience with and knowledge of oil markets in general and matters pertaining to California crude oil markets in particular.

DOE participated actively in all phases of the interagency's team's investigation except for the on site audits of two oil companies, Texaco and Shell. Our activities included: Planning the study; examining court-sealed records compiled in lawsuits against oil companies by the State of California; estimating amounts that might be collected; interpreting Interior's regulations in the context of recommended collection strategies; and documenting study results including options papers and helping to prepare the final report.

As Director Quarterman's written testimony states, the interagency team agreed on a number of key points, the most important of which was that the oil companies undervalued crude oil produced from Federal leases in California. To address this situation, the team recommended that the Minerals Management Service concentrate its collection activities on the 10 companies that produce over 90 percent of Federal royalty oil in the State.

The team further agreed that some method had to be used to speed up the collection process. The team recommended that royalty payers be required to produce records on arm's length purchases and sales of California crude oil to MMS for evaluation. In addition, it recommended that the records from Long Beach be employed extensively to limit or direct subsequent audits.

For royalties due after March 1988, the team recommended using arm's length sales records to establish premia overpostings against which back royalties would be assessed. Where possible, these sales records would be for crude oil from the same area in which Federal royalty oil was produced. All team members agreed and recommended that the MMS oil royalty regulations be revised to consider alternatives to reliance on posted prices and to modify a number of definitions and introductions that may hamper royalty collections.

As Director Quarterman further noted, some of the recommendations were not unanimous. The representatives from the Departments of Energy and Commerce recommended that Alaskan North Slope oil adjusted for quality and location be used as a measure of fair market value for California oil prior to 1988, and that collections should be attempted for royalties due back as far as 1980. This was also mentioned by Congresswoman Maloney.

The reason for going back to 1980 was that most of the royalties that might potentially be collected are for the 1980 to 1985 period when oil prices were high and undervaluation was the greatest. The Interior representatives recommended that the sales contract approach be applied to any period for which back royalty payments are sought, and that the decision about how far to go back in its collection attempts should be reserved for the Department of the Interior.

The Department of Energy appreciated the opportunity to provide the Department of the Interior with technical support on this issue, but the Department of Energy believes that it is the Interior Department's role and responsibility to decide whether and how to implement the recommendations of the interagency team.

Thank you for the opportunity to clarify the Department's role in these issues, and I would be happy to answer any questions you may have.

Mr. HORN. Thank you very much.

Would either Mr. Speir or Mr. Berman like to add anything at this point?

Mr. SPEIR. No, sir.

Mr. HORN. We are going to have 10 minutes a round because this gets complicated and I am sure each of us wants to get into some of the background.

But let me deal with one aspect to start with that I mentioned in my opening statement, and that is the ability of the Federal Government to collect what is due the Federal Government. And obviously this committee has an interest in financial management.

Now, the interagency report that you cited, Director, noted that somewhere between zero and $856 million could be collected depending upon whether collection efforts were initiated and how aggressive they were.

Can you foresee any situation where the Minerals Management Service would receive zero? And what is your best estimate at this time?

Ms. QUARTERMAN. Mr. Chairman, let me clarify what those numbers mean.

The number from zero to $856 million are associated with an earlier option paper that was put together by the team where they had seven different options, the most aggressive being to apply ANS values to California crude for the period 1978 through 1993, and they predicted about $856 million for that. However, there were a couple of caveats with respect to that number that would decrease it, even under that option.

The first is that it assumes that the Interior Department would be able to collect against all 10 of the companies. There are two companies, at least, that there may be an issue in terms of whether or not we can collect because of prior settlements for the periods involved.

Second, there was an open issue of Royalty in Kind volumes that were taken by the Federal Government over that period. For example, in 1984 the Federal Government took about half of its California crude oil production in kind. The early eighties may have similar numbers associated with that. So the $856 million number itself had several caveats associated with it.

And if I could go on, it is not directly associated to any of the recommendations that team has made in its final report. First, it covers 1978 through 1993, using ANS valuation figures. The team even, if you assumed that we pursue the most aggressive recommendations, would only apply ANS for 1980 through March 1, 1988. There would be about $86 million that would not be pursued from that $856 million.

In addition, from 1988 to 1993, the team unanimously agreed that we should pursue that method using the California posting—not postings but California arm's length transactions. About $93 million are associated with those time periods. Those figures would be decreased because of that.

In addition, from the period 1980 to 1987, where there are about $677 million recommended, about 72 percent of that is interest. While the Federal Government does have the authority to collect interest, it might—the equities may make it difficult to collect interest during those periods.

In addition, the Royalty in Kind volumes, as I mentioned, could be quite high during the early 1980's and the two settlements that I mentioned would cover about 27 percent of the production in California during those periods. So there are a number of different caveats. In the end, I cannot give you a firm number.

Mr. HORN. Let me move on then besides the numbers. I am sure we will have plenty of witnesses to speak to that point.

In 1993, the gentleman that is seated on your right, Mr. Berman, who is the economist for the Office of Policy Analysis, suggested that the Department, quote, Proceed immediately to ascertain the amount of additional royalties due and initiate collection procedures, unquote.

Now, we are 3 years after 1993 and the MMS has reached the same conclusion. Why couldn't we have begun collecting those amounts 3 years ago?

Ms. QUARTERMAN. I believe that all of the witnesses would agree that the valuation of crude oil, of gas, of any commodity, is extremely complex. And while you may sense that there is a problem, even one that may have been brought to your attention by prior litigation of similar cases, it doesn't mean that you can go forward without discovering for yourself all of the underlying facts. And that is the reason that we put the task force together.

And the fact that it took them 2 years to come to a conclusion, although many of the Members were quite well-versed in the California market, I think speaks to your question as well.

Mr. HORN. Well, let me add to it. Mr. Hubbard, Dave Hubbard, who could not be here with us today, I understand that his daughter was getting married in Denver, and he couldn't make the hearing. But Mr. Hubbard, the team leader of the interagency team, really relates to the same issue, an e-mail from him. And it was not to us. This is an e-mail secured on discovery by a public interest group dated September 6, 1994.

Hubbard was concerned about the timetable of competing the interagency report noting that he has, quote, Stalled this issue long enough, unquote. That was in 1994. Now we are standing here 2 years later. Why would the team leader believe that MMS and the Interior Department were stalling and who was stalling the report?

Ms. QUARTERMAN. I cannot respond to Mr. Hubbard's e-mail message. I don't know what he had in mind when he said that.

Mr. HORN. Well, he is asking in a memo to James W. Shaw of your office in Denver, he is saying: "Will MMS commit additional audit resources either in the form of MMS auditors or more money for the State of California to do the followup work if the team recommends it? I recognize that this is hard to answer without knowing what the scope may be, but I am hoping for some sort of motherhood statement that I can give the team for our next meeting. I have stalled this issue long enough. Please see the Speir memo I am sending you on this subject."

It seems to me that we have taken an awful long time to get this issue resolved. Are you now on track with that? Could you give us sort of a schedule of how MMS is going to operate in this area now that you have an interagency report and everything else that you know?

Ms. QUARTERMAN. It has taken a long time but the team has accomplished quite a bit in the time that it had available to us. Accessing sealed files from the State of California took several months before they could possibly review that. We audited two companies for 3-year time periods. Just to put that in perspective, on a normal audit cycle for companies of this size, we take 3 years to audit 3 years. We hired two consultants and got their reports back and were able to integrate them.

We went forward on the Interior Board of Land Appeals and asked them to reverse a decision, something that is pretty much up to them to determine how quickly it would happen but it happened within this 2-year timeframe. So it may seem like a long time to some of us on the outside, however, I think it was—they accomplished quite a bit in the timeframe that they were given.

As to how we plan to proceed from here, we will be meeting members of the Department of the Interior, with members of the Department of Justice to get their advice on how to proceed. We will probably make a recommendation to them, and ask them if they have any concerns with that. Once we can resolve those issues, we will move forward hopefully in the next month a final decision on how we plan to preserve this.

Mr. HORN. Mr. Berman, since I quoted you, is that an accurate quote? Could we have collected way back in 1993?

Mr. BERMAN. Could have collected in 1993? Probably not. I recommended that we initiate collection as soon as possible.

Mr. HORN. What are the problems that you found in being able to collect? You have been a number of years I take it in this responsibility?

Mr. BERMAN. Yes. I'm not sure I understand the question.

Mr. HORN. Well, you are familiar with the evaluation problems as an economist. What are the problems here that delay collection? I mean, is it simply MMS starting to do it, or is there a lot that has to be resolved in terms of the pricing system? And maybe you as an economist could educate us on the pricing system.

Mr. BERMAN. I can—I might be able to talk a little bit about the pricing system. The administrative mechanics that MMS goes through in allocating resources for audits and determining what to audit and when is not an issue that I've gotten into in the past.

Mr. HORN. I can understand that, but has the delay been caused at all by the complexity of the valuation system? Or is it just normal practice and it is a matter of adding it up, price per barrel that goes on every day in this country?

Mr. BERMAN. The valuation—the California market is very complex. If you take a valuation system based on the alternative crude, and the market prices of crude, that would lend toward an ANS valuation system which is more straightforward. A valuation system based on audits is more complex. You have to make sure that you get all the records, that you get all pieces of the records, that there may be multiple transactions involved and the premium may be, because of the trading, may be spread off across numerous transactions. So, the process can be lengthy.

Mr. HORN. I just happened to be glancing at the price list of what they—one company will pay during this last April, and as you suggest, it varies all over the lot. There are roughly 31 different fields in California on the pricing, and there is no rhyme nor reason, in my judgment as a layman who did take a few courses on economics, why some of those fields vary since the posted gravity is exactly the same as it was 3 weeks before, yet some go down and some go up.

Can you enlighten me as an economist as to why some of those prices go down and go up when the posted gravity is exactly the same?

Mr. BERMAN. It is hard to say as an economist. Posted prices are not market prices. These are—I'm not even sure they are always offers of one sort or another. These are statements by the company, initial statements as to what the crude may be worth. It is best likened, I think, to posted prices in a car lot. They are a starting point, if you will, perhaps for negotiations.

There is no reason, necessarily, that postings by any two companies would necessarily have to coincide. I'm not particularly disturbed by that at all.

Mr. HORN. Well, thank you. My time is up. And I yield to the ranking minority member for 10 minutes.

Mrs. MALONEY. Thank you very much, Mr. Chairman. I'd like to thank Mr. Berman and Ms. Quarterman for their testimony, and Mr. Haspel.

In late 1993, MMS, the Minerals Management Service, investigated oil royalty payments from 1960 on. Ms. Quarterman, then MMS limited the task force investigation to the 1978 to 1993 years. How far back do you intend to go to collect the royalties?

Ms. QUARTERMAN. At this point in time, the Department has not made a decision on how far back to pursue underpayment of royalties.

As to the statement that we limited the task force, that is not my recollection. We did not limit them in terms of how far they could go back.

Mrs. MALONEY. Well, since the task force report states that 74 percent of the potential undervalued royalty collections are from the years 1980 to 1985, can MMS at least commit to covering 1980 to present?

Ms. QUARTERMAN. Again, we have not made a final determination as to how far to go back. One of the considerations that we must weigh in all of this is how will this affect other cases that we have pending, and what risk is there that we may lose other dollars that are at issue across the United States for the Federal Government statute of limitation cases as opposed to the risk that we will collect these moneys for 1980 to 1985 in California.

Mrs. MALONEY. I fail to understand how stating when you are going to collect it is going to cause a problem in other States collecting. If anything, it is going to help. And why haven't you made a decision? The draft report came out in December.

This problem has been around for 16 even more. When are you going to make a decision, where, at what point are you going to start collecting, and since the majority of money is between 1980 and 1985, I certainly believe—I believe most Californians believe you should at least make a commitment to collect. And when will you make this commitment? If you can't make it now, and how much more time do you need? You have had 16 years. You have had the draft report out since December. How much more time do you need to decide how far back to go to collect?

Ms. QUARTERMAN. As I testified earlier, we are in the process of reviewing the recommendations to the team——

Mrs. MALONEY. Haven't the recommendations been out of the report for 6 months?

Ms. QUARTERMAN. No, they have not.

Mrs. MALONEY. I thought the draft report came out in December.

Ms. QUARTERMAN. No, that was an options list. It was seven different options. It wasn't the recommendations team.

Mrs. MALONEY. It hasn't differed that much from the draft report, so I think when are you going to make a decision? How far back will you go to collect? How long do you think it will take MMS to make a decision? Another 6 months, another year, another 16 years? How long will it take MMS to make a decision?

Ms. QUARTERMAN. Just to clarify for the record, the document that came out in December 1995 was not a draft report. It was a series of seven different options. The final report was not issued until about a month and a day ago, and it has taken us a month so far to begin reviewing that, as I mentioned in my testimony. Within the next few weeks we will determine how far back to proceed.

Mrs. MALONEY. The next few weeks, so is it fair to say within a month you will decide how far back to go to collect?

Ms. QUARTERMAN. I think that is fair to say.

Mrs. MALONEY. I come from New York City government. It is very hard to get any information out of the city of New York. I have a little of the frustration that I had as a member of the city council. I just want to get a timeframe because at one point in my life it took me literally 10 years to get a report. I get upset when I remember that so I want to get a specific timeframe.

The Minerals Management Service hired micronomics consultant Dr. Letzinger, who subsequently came out with a method of royalty collection based on the Alaskan North Slope, so-called ANS spot crisis, which would collect $856 million in royalties and interest.

According to the task force report, the Commerce and Energy representatives supported using that method, but the Interior representatives did not. Do you know why the Interior representatives did not support using the ANS spot price method? Why did they not support that method when the other members, Commerce and the Energy supported it?

Ms. QUARTERMAN. I do not know the reason other than what is stated in the report, and in the report the Interior members mentioned concerns about the ability to collect based on an ANS valuation by applying that to our regulations.

Mrs. MALONEY. OK, in other words, they wanted to use your regulation as opposed to the ANS symbol; is that correct?

Ms. QUARTERMAN. No; I think all parties agreed that MMS is bound by its regulations. I think it is the interpretation of the regulations that were at issue.

Mrs. MALONEY. The interpretation of the regulations. Could you clarify the interpretation of the regulations? In other words, I am confused. You had two members of the team support you in using ANS, which seemed simple to me since according to the report this is the method that the oil companies themselves use and the directive from Congress is to get in the legislation a fair market value.

It seems like the easiest way to determine the fair market value is to use the value that the oil companies themselves are paying. So that seemed to make a lot of sense to me. But Interior did not agree, and I don't understand why, and you are saying it is because they wanted to rely on the regulations; is that it?

Ms. QUARTERMAN. Let me just say the Department of the Interior as a whole has not made any determination at this point how to proceed, whether to use ANS or a different value.

Mrs. MALONEY. My question is about the Interior representative on the task force. Were you the Interior representative on the task force?

Ms. QUARTERMAN. No; I was not. The members of my staff were.

Mrs. MALONEY. When they reported back to you, they did not want to use the ANS method of spot prices. Did they give a reason why they didn't want to?

Ms. QUARTERMAN. As I mentioned, there are reasons that are in the report that they offer. Both—I think all members of the team agree that MMS must issue collection efforts.

Mrs. MALONEY. What were the reasons they gave in the report?

Ms. QUARTERMAN. Based on MMS valuation regulations, I think there was a difference of interpretation between the Interior representatives and others as to how one would interpret those valuation regulations for the period 1980 through 1988.

Mrs. MALONEY. Is it fair to say since there have been many reports that say that the benchmarks or the MMS regulations aren't working? That is why we had the task force. They are doing it wrong. They have done it wrong in the past and it is not giving the true value for the oil. So you know, I just am curious why they are relying on benchmarks that have worked poorly in the past and every report says it has worked poorly in the past anyway.

Ms. QUARTERMAN. If I may, with respect to the benchmarks, those are regulations that came into effect as of March 1, 1988. All members of the team supported a valuation based on California arm's length transactions for that period once those benchmarks were put in place. Whether or not they work or not, as I mention, we are trying to change them going forward, but for the period that they have been in effect, they are, in fact, the law.

Mrs. MALONEY. I would like to ask you a question about these regulations. To defend MMS' interpretation of them you need, "significant quantities of arm's length transactions." However, the regulations do not define, "significant quantity."

Further, near the end of the task force report page 7, appendix 1, states that less than 20 percent of crude oil is traded at arm's length, but that is not a little amount. But it certainly isn't significant in the context of the market. How can we show that significant quantities of California crude oil is not sold in arm's link length transactions?

Ms. QUARTERMAN. I think these are all issues that may come up when we decide to proceed in a methodology that is different from the one that has been recommended by the team for 1988 forward when those regulations were in effect. That is, if we were to go forward with the ANS valuation from 1988 forward we would have to explain, I am sure, in litigation to companies why that is different. At this point in time I am not prepared to get into the legal—the underlying legal arguments associated with those recommendations.

Mrs. MALONEY. Do you dispute the task force's finding that ANS spot prices reflect market value in California?

Ms. QUARTERMAN. I have no reason to dispute it or to confirm it.

Mrs. MALONEY. So you are not confirming it or disputing it?

Ms. QUARTERMAN. I accept it on face value.

Mrs. MALONEY. You accept it on face value.

On page 67, the task force report states that documents from the Long Beach case reveal that the companies themselves use ANS as their measure. Why can't we do the same? Why can't we use the same measure that the companies use? And the report states that that is what the companies use.

Ms. QUARTERMAN. It may be——

Mrs. MALONEY. It means $856 million, too.

Ms. QUARTERMAN. It may be that the Department of the Interior determines that it will use ANS as a valuation point. Again, that has not been decided.

Mrs. MALONEY. When will you make that decision?

Ms. QUARTERMAN. Within the next month.

Mrs. MALONEY. Within the next month.

Why did MMS change the regulations in 1988 to rely more on posted prices when there was mounting evidence to discredit them? And didn't California object to Interior on these grounds specifically? That, I did not understand in the record. Why did MMS change the regulations in 1988 to rely more on posted prices when there was report, after report, after report that they were not proper or fair or did not show fair market value?

Ms. QUARTERMAN. I wasn't at the Department of Interior in 1988. I am afraid I won't be able to answer your question completely. What I know about the regulations that were put into place in 1988 is that they were discussed for a series of many years with all interested parties at the table; that at the time the regulations were changed from a more general regulation to the one that is in existence now that there had been concerns raised much as this concern has been raised by the clarity of valuation, and the purpose at that time was to clarify.

Mrs. MALONEY. A commonsense answer. After reading all the prior reports that it was wrong, that it was undervalued, the court cases substantiating it, don't you agree on a personal level, on a commonsense level that we shouldn't use posted prices? All evidence points to that.

Ms. QUARTERMAN. We have determined that.

Mrs. MALONEY. You will not use posted prices?

Ms. QUARTERMAN. Only to the extent we are required to by the regulations.

Mrs. MALONEY. Maybe the regulations should be changed if everyone agrees posted prices are wrong. Maybe Congress should write the regulation or give specific guidelines. I don't know if every report says you shouldn't use it and you say maybe if the regulations require it, we will use it. It seems to me common sense that you change—that you go back to fair market value. You don't jump through hoops that make it impossible for you to collect fair market value. My time is up, but I look forward to your response.

Ms. QUARTERMAN. I just wanted to add, as I stated earlier, we are in the process of changing our regulations going forward and clarification that in 1988 when the regulations were put into place, that was shortly following a district court decision in the Long Beach case that found that for the defendants, not for the plaintiffs, it was also during a time period where several Federal agencies were looking into the issue of California crude oil and posted prices and did not reach any firm conclusion one way or the other. I don't want to defend the actions of my predecessors, but just to clarify what was happening at that point in time.

Mr. HORN. Let me draw on the brains of the economists that are here for a minute. You have looked at a lot of different value situations. What are two or three top ways to get a fair market price for the Federal Government and the State governments in this leasing operation? How about you, Mr. Berman?

Mr. BERMAN. The question of market value is perhaps more easily determined than the question of how to collect royalties based on market value. The market value is most easily, most directly given by the prices that come out of the market, the free and fair market.

In the mid continent, for example, the best—one of the best measures we have of this is the pricing that came out of the NYMEX, the prices that are posted daily on the P-plus market out of curbing. Prices out of St. James, LA, offer a bench mark for value. On the west coast, the price of ANS is a frequent reference for value.

The question, then, of how to determine value for royalty purposes goes well beyond that. It is how do you account for the differences in the crude? How do you account for locational differences, quality differences, these sorts of things.

Mr. HORN. Let's take that point. Alaska North crude is a higher quality oil than California typically; is that not correct?

Mr. BERMAN. That is correct.

Mr. HORN. There is also a transportation problem; is that not correct? In other words, if I were a refiner, I am going to have to pay certain things that have been added to the producer's cost, I would think.

Mr. BERMAN. They say spot market for ANS on the west coast so that transportation issue, the majority of it would be dealt with by that. You'd have a local movement issue to deal with from wherever the market is from wherever you are getting it from?

Mr. HORN. So is the ANS a fair price guide for most of these transactions?

Mr. BERMAN. For California, I think so.

Mr. HORN. OK, regardless of gravity or anything else.

Mr. BERMAN. The gravity, there are typically gravity-based adjustments that are used by traders. The four corners, line 63 has a gravity bank, so that when gravities of different amounts are put into a pipeline, by different people they—everyone gets their fair share coming out the other end.

Mr. HORN. In other words, is the MMS using the same system of valuation as the oil companies do on an intertransfer? And should they?

Mr. BERMAN. The MMS using the same——

Mr. HORN. Well, in terms of pricing some of this oil when there are sales between oil companies, should the Department of the Interior Minerals Management Service be using that same method or is there something wrong with their method?

Mr. BERMAN. You need to test very carefully what is going on in the transaction. If the transaction is between—unaffiliated companies of opposing economic interest, you can establish that opposing interest at the time of the transaction, then it is a transaction that you can probably rely on for that piece of it. But it gets—it is getting very complicated because there is such extensive trading, and the question of whether or not there is opposing interest.

Mr. HORN. Well, let's pick up on that. Mr. Speir, you were on the task force deliberations. What were the parameters of the deliberation as to whether or not the Alaska North Slope prices should be the basis for the royalty benchmark? What can you tell us about the dialog there and does it make sense ultimately?

Mr. SPEIR. I assume your question is in the context of the task force——

Mr. HORN. Right.

Mr. SPEIR [continuing]. As opposed to the economics of it.

Mr. HORN. No, I am looking now at the dialog within the task force and the pros and the cons.

Mr. SPEIR. We really never got into the question about whether Alaska North Slope oil was a proper method of valuation in an economic sense. Our decision to the extent that it took place centered more along the lines of could we actually do that within the context of the MMS regulations. And the question of significant quantities comes into play there. The benchmark system that was set up in the 1988 regulations required you to successfully reject four benchmarks before you could get to the point where you could clearly identify an ANS-type valuation as being a proper method under the regulations. And because the significant quantities term was not defined, it became sort of a subjective judgment about whether we really saw significant quantities of trading taking place.

Given that you choose to make the subjective judgment that all of the other trading that we saw in the contract records were not significant quantities then, can you fall through this benchmark system to the last one and establish ANS as being a method of valuation? There are a couple of other technicalities you have to resolve about sales from the same area over the same type of crude and so on, but I think basically you could do that under the regulations if you choose to make that judgment.

Mr. HORN. Let's look a minute at those four benchmarks. Was that statutorily mandated or was that a regulation developed to carry out the statute?

Mr. SPEIR. My understanding is it is a regulation pursuant to a statute. I am not familiar with the underlying statute myself, but my perception was it was much more general.

Mr. HORN. Did the task force feel that those benchmarks made sense or should they be basically revised?

Mr. SPEIR. In general, we felt that a significant amount of revision is appropriate for the 1988 regulations. We didn't specifically say how we would revise the benchmarks, but in our deliberations we all had problems with attempting to apply those to the situation which saw it hand mostly because of the necessity to reject one and consider another and reject that. Well, I think that answers your question.

Mr. HORN. It seems to me if you have an unworkable formula the question is should the unworkable formula be changed and what is a fair, equitable, reasonable formula that withstands the test of a court and would stand the test of scrutiny by an intelligent, informed citizen? In other words, should we go back to the drawing board in the Department of the Interior?

Mr. SPEIR. Well, it certainly requires a lot of consideration. The regulations, as they stand right now, have terminology that is crucial and critical to the interpretation, which is not defined in any way, either loosely or tightly. Significant quantities, the nature of an affiliate transaction, which really gave rise to decisions in the LA case that was talked about earlier, all of that should be cleaned up within the current framework.

If you extend that question to how should we obtain the proper value for the oil under the regulations, I think that should be the subject of considerable study. The Department of Energy, of course, and the city of Long Beach take a quite different approach to selling their oil and we always have.

We have never accepted posted prices, and the situation with the city of Long Beach actually gave rise to the lawsuit you were talking about. The city of Long Beach really doesn't do that anymore. There are other broader considerations to take a look at.

Mr. HORN. Are you familiar at all with the University of Texas methods of royalties and leasing? Anybody at the Interior familiar with that?

Mr. SPEIR. I am not.

Mr. HORN. I would suggest that maybe they become familiar because I am informed that that is one of the most effective leasing royalty systems in America, to get the money they want to get for the University of Texas and Texas, generally. And I just wonder at some time you might want to get the task force to reassemble and consider. Do they know what they are doing more than we know what we are doing in the Federal level?

Ms. QUARTERMAN. I was going to say we are fortunate to have Assistant Secretary Bob Armstrong, who is the land manager in Texas for many years.

Mr. HORN. Does he make the statement I am making here and wonder why we haven't kept up with Texas or what?

Ms. QUARTERMAN. I am sure he probably does.

Mr. HORN. That is a diplomatic answer. That is why you are where you are. Thank you. But do take a look at that. It seems to me they have had a lot of the problems we are talking about.

Now, let me ask Director—before my time is completely up—resources that you need to do the job on royalty collection. What is your current situation of people that have been assigned to those projects? Has it been pretty steady over the years? Is there a need for more resources, et cetera? Can you give me some succinct answers on that?

Ms. QUARTERMAN. The Appropriations Committee has been very kind to the Royalty Management Program primarily in the audit area over the years. In fact, in fiscal 1997, we just learned that we were added—$4 million was added to our budget for audit purposes beyond what the President requests.

Mr. HORN. How much did you ask for?

Ms. QUARTERMAN. We didn't ask for it. There was an amendment to the House Interior bill adding $4 million for audit resources that the President had not requested. So I think at this point in time we are in pretty good shape in terms of resources.

Mr. HORN. Had your shop asked for these resources from Interior over the years, do you know? In other words, so can you meet these obligations in a timely manner you need certain resources? Have you asked for them is the question?

Ms. QUARTERMAN. On occasion we have had the need to ask for additional audit resources, yes.

Mr. HORN. And what has been the experience? Has the Secretary approved that?

Ms. QUARTERMAN. Whenever we needed it, yes, he has.

Mr. HORN. And OMB has backed the Secretary up.

Ms. QUARTERMAN. Yes.

Mr. HORN. And Congress has backed OMB up.

Ms. QUARTERMAN. In most instances, yes.

Mr. HORN. So you don't have a problem on that in terms of resources that inhibit collection?

Ms. QUARTERMAN. No, I don't think we do.

Mr. HORN. Is there a time factor here that just because of the size and scope of this area you need more people spread out around the United States or what? What could get collections speeded up, in brief?

Ms. QUARTERMAN. There is a time factor that is associated with this. Last year, we accepted quite a few early outs, buyouts from auditors that will go through March 1997, so our audit resources have been reduced over the past couple of years even though we have had a few new efforts come into place. Quite frankly, we have dollars but the same people who are out there auditing have to train new people to come on board, so that is the real challenge for us.

Mr. HORN. So that is the civil service system?

Ms. QUARTERMAN. Yes.

Mr. HORN. Give me a glimpse as to what the challenge is. What are we talking about GS–5 versus GS–7 and 9, GS–9's?

Ms. QUARTERMAN. No, not in terms of their pay level. I think they are 11's or 12's, I am not certain. But in terms of getting people in and trained and out there doing things immediately, that is the challenge for us.

Mr. HORN. And what are the obstacles to that? Do you provide the training in-house or do you depend on someone else to provide the training?

Ms. QUARTERMAN. Usually the training is done by the people who actually have to perform the audit so the people who are out there reviewing records and collecting are also people who have to provide the training for the new people who come in, and we have had a couple of initiatives with this administration that have increased our need for audit resources substantially and this would be another such initiative.

Mr. HORN. OK. Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman, I found the chronology almost unbelievable. I found it so unbelievable I blew up a chart on it and I would like MMS to comment on the chronology, which I find disturbing and hard to explain. I would just review it very briefly. It is printed right there in August 1993 and an internal Interior memo finds $422 million may be owed in undervalued royalties.

Then 1 month later Interior entered into a global settlement with Exxon completely removing the Government's ability to collect any unpaid royalties from Exxon. Why? A few months later in March Interior comes out with a report saying there is no evidence that posted prices do not reflect market value. That same month, MMS signs a global settlement agreement with Chevron. Then in June, 2 months later, Interior establishes a task force to look into the possibility that posted prices do not reflect value and there may be money owed the Government.

Last month, an Interior-sanctioned task force—and I compliment you on the task force, comes up with the number of $856 million owed. What in the world is going on? You are getting all of these reports back that all of this money is owed, yet you enter into global settlements that really removes the Government's ability to collect.

Ms. QUARTERMAN. With respect to the two global settlements that you mentioned, the first one being Exxon that was signed at the end of 1993, that is a settlement that had been going on for quite a period of time. It settled the period through 1989. We were—the State of California auditors were involved in our discussions on that matter and we included in that settlement a general provision that would allow us to go back in the case of fraud, malfeasance, concealment or misrepresentation of material fact.

I think at that point in time all parties thought that the settlement was a good one. The real factor of a California undervaluation—crude undervaluation issue was not, I think, as large as it is today. Having said that, I would like to note that most of the oil in the case of Exxon had been taken in kind. So we are not talking about very large dollars here associated with Exxon.

In addition, Exxon is the one defendant in the California litigation that did not settle with the State of California and, in fact, they went to hearing and were exonerated on crude oil valuation issues. So to the extent they find State litigation, we may find it difficult to pursue them in Federal litigation.

With respect to Chevron, the Chevron settlements, there were quite a few ongoing negotiations between the Department and the State of California about whether and how to settle the Chevron settlement. With the assistance of the State of California, we came up with language which we thought at the time would be appropriate to leave these issues on the table for future consideration. The periods from 1908 to 1989 excluded any potential claims for crude oil production because of posted prices did not represent reasonable value. It was limited, however, to collusion, fraud, or improper conduct.

Mrs. MALONEY. Well the Exxon case, if I recall correctly, they were exonerated on antitrust, not on the valuation; is that correct?

Ms. QUARTERMAN. That is not my understanding of the Exxon case. They were charged with undervaluation generally with some pipeline—with the antitrust issues and they proceeded and were not held accountable for those costs. I am sure you can ask the person who will be here later on from the State of California.

Mrs. MALONEY. That is a good idea, I will.

According to the agreement, MMS must prove, as I said, fraud concealment or misrepresentation of material before we open any claim. These are extremely difficult hurdles to overcome since we have simply excluded the royalty valuations as an issue. I don't see how in the world you will be able to go back and collect on that.

I did send a letter to Mr. Armstrong requesting that no more global settlements go forward. Can I get a confirmation that you won't go forward with global settlements while we are trying to collect this money? Do you intend to make anymore global settlements?

Ms. QUARTERMAN. Our intention is not to make any global settlements without an exclusion relating to crude oil valuation in general.

Mrs. MALONEY. Great thanks. Thanks.

I would like to go back to the task force report, specifically page 47, and it reads, "The DOI consultants' reports concluded that the pipeline situation contributed to posting substantially understated California crude oil values".

Can you explain the relationship between the common carrier question and the underpayment of royalties, and have you talked to the Bureau of Land Management about it? Why hasn't the Department already required that the pipelines in California operate as common carriers?

And at this point, I would like to put a letter in the record—I already put it in, all right—on the counter carrier question. Would you comment on that?

Ms. QUARTERMAN. Is that addressed to me?

Mrs. MALONEY. Yes.

Ms. QUARTERMAN. The Bureau of Land Management, as you know, is responsible for public lands and Federal lands. The MMS is responsible for collecting moneys on shore and for oversight offshore of public lands. The interrelationship between the two, if I can describe the California market generally, it is an extremely isolated market in that most of the crude oil that is produced in California is used in California and the crude oil pipelines in California are internal to the State of California for large part, which means they are not subject to the jurisdiction of the Federal Energy Regulatory Commission, which is the commission which ordinarily regulates for the Federal Government oil pipelines within California.

The California Public Utility Commission is responsible for regulating oil pipelines. There were a number of claims in the California litigation with respect to why these pipelines were not common carriers. For the most part, the producers there are large producers. They own the pipelines themselves. They use the pipelines to transport crude oil to the refineries, which they also own.

There have been allegations in the past. These pipelines are used essentially to change where the value of the oil is moving it to the pipeline, the transportation aspect as opposed to the pricing when it is sold.

Mrs. MALONEY. So it is really not in your department, it is in MMS.

Ms. QUARTERMAN. It is not in MMS, but it is within the Department of the Interior, and I know——

Mrs. MALONEY. Have you raised it with the Department of the Interior, the Bureau of Land Management since it was in the task force report on page 47 as contributing to the understatement of a California value.

Ms. QUARTERMAN. The Department has had several discussions over the years about the issue of whether or not the Bureau of Land Management should take jurisdiction to the extent that it can over pipelines in California. It only has——

Mrs. MALONEY. They have jurisdictions. Aren't the pipelines on federally owned lands?

Ms. QUARTERMAN. They are not.

Mrs. MALONEY. They are not. They are not on federally owned land?

Ms. QUARTERMAN. In fact, I think there is only one pipeline that traverses Federal land at all.

Mrs. MALONEY. It is on State-owned land.

Ms. QUARTERMAN. It is not on Federal land. Whether it is private or State-owned, I wouldn't know.

Mrs. MALONEY. So it is totally within the jurisdiction of the State of California, that problem?

Ms. QUARTERMAN. Except for the one pipeline. I believe the one pipeline that is remaining, it would be outside of our authority to do anything.

Ms. MALONEY. But you have authority over one pipeline?

Ms. QUARTERMAN. That is my recollection.

Mrs. MALONEY. That would be under the jurisdiction of Interior and the Bureau of Land Management, that one pipeline; correct?

Ms. QUARTERMAN. I believe that is correct.

Mrs. MALONEY. And what do you think you will do about that, the relationship between the common carrier question and the underpayment of royalties on that one particular pipeline that we have jurisdiction on?

Ms. QUARTERMAN. I have not heard any recent discussions about what will happen with respect to that pipeline. Whether the BLM will seek to assert any authority over that pipeline or not.

Mrs. MALONEY. Could you look into that and probably get back to the committee?

Ms. QUARTERMAN. Absolutely.

Mrs. MALONEY. Is the problem of underpaid royalties limited to California?

Ms. QUARTERMAN. I would say probably not.

Mrs. MALONEY. Why did the Interior Department limit its investigation to California? Shouldn't you be investigating all the other States?

Ms. QUARTERMAN. The California market is one that is unique, as was mentioned earlier, and the interagency task force came up through recommendation from the Office of Policy Analysis Office. As we looked into the California situation, we began to become concerned about whether or not this issue might not be reflected throughout the country, and, in fact, many States have begun proceedings to try to change the methodology by which they receive crude oil, and we have been talking about all those States and trying to make sure that we go forward in the same manner that they are throughout the country. We have not planned a full scale investigation in this manner, although as I mentioned earlier, the Department of Justice is in the process of an investigation.

Mrs. MALONEY. As I stated in a letter earlier to you and, I believe, Mr. Armstrong, I personally believe that the task force should go forward with an analysis of the other States, given your own testimony that you believe they do likewise have an undervaluation problem.

I would just like—do you think you will extend the task force? I think you have done excellent work. I congratulate you. The problem has been around for 30 years and you, Mr. Armstrong and Mr. Babbit have moved forward in a positive way to try to bring that money in issuing a task force report that documented that it is out there, and I think you should continue your good work that I congratulate you on by extending it to the other States.

Have you had any discussions about extending the task force on to the other States? Are we going to do that? I think it would be a good idea.

Ms. QUARTERMAN. We haven't had any discussions about extending this particular task force to other States because primarily the task force itself, we thought, had members who had a lot to bring to bear on the California issue in particular. I think the issue of crude oil valuation is one that we will most certainly be studying very, very seriously. Whether that is through a task force or through our regular operating procedures, I don't know. We haven't gotten that far in the process yet.

Mrs. MALONEY. I, for one, feel we should have another task force. You should extend it. I think you did excellent work in documenting the problem, and I think we should move forward in the other States. And my time is up. Thank you.

Mr. HORN. Thank you very much. Let me pursue a couple of these matters. The next panel that will come here are ones that are expert in this area in Long Beach. Did the interagency task force touch base with them at all given their long history of involvement?

Ms. QUARTERMAN. Absolutely. That was their first order of business. In fact, we had done a preliminary scoping exercise in the end of 1993 which was shared with California. They suggested we might want to review some of the documents that are under seal in their litigation before coming to a conclusion. That is why we put the task force together and this was the first thing they did was to review the documents throughout the 2-year period. They studied it, they were in constant contact in the State of California.

Mr. HORN. They suggested a formula that might be helpful and obviously we would like to share some of that testimony with you after this hearing. You will still be under oath. We might ask you a few questions, and so forth and so on. We would like to see this situation resolved.

Let me ask you on getting the history of this out. Have any oil companies ever sent money voluntarily to the MMS or the Department of the Interior in payment for prior royalty undervaluation?

Ms. QUARTERMAN. In fact, they have. Arco, I believe, in about 1993 they came to us and paid us—I don't remember the exact sum, moneys that they said were related to undervaluation of postings. So we have at least one instance, probably the only instance of having had that happen.

Mr. HORN. Was that just covering their California operations?

Ms. QUARTERMAN. No, I believe it covered all Federal production.

Mr. HORN. With Arco you mean even if it was outside of California?

Ms. QUARTERMAN. Yes.

Mr. HORN. I take it the check was cashed.

Ms. QUARTERMAN. Oh, absolutely.

Mr. HORN. You note the interagency team members differed on key recommendations and decisions will be delayed until there is consultation, I take it, with the Department of the Interior Solicitor's Office and the Department of Justice.

Ms. QUARTERMAN. That is correct.

Mr. HORN. What about recommendations on which there were no disagreements? Will they be implemented immediately?

Ms. QUARTERMAN. Throughout the task force process we always reserve the right to be more aggressive or less aggressive than the team recommended. We are considering all the recommendations, even those that are unanimous. Certainly, the fact that they are unanimous will hold a great deal more weight in our decisionmaking process, but we haven't determined that we are going to do everything they suggested.

Mr. HORN. Sometimes there is a good reason for holding things up and getting all the pieces together, but there also could be a good reason for moving on the ones that have general support and helping recoup some of these royalties in a timely way. Are you waiting for perfection or do you plan to implement some of these that make sense?

Ms. QUARTERMAN. I think we will implement many of the suggestions of the team. At this point, we didn't want to go out with the piecemeal response to the team's report. Frankly, we wanted to make sure we had all of our ducks in a row. We knew what we were doing for all time periods and we will go forward in that way.

Mr. HORN. Now, does the implementation come under the Administrative Procedures Act and does that go out for comment or what?

Ms. QUARTERMAN. No, it does not.

Mr. HORN. Can you just do it presumably?

Ms. QUARTERMAN. Yes.

Mr. HORN. Usually, people learn it helps if they consult and get feedback, and just in case they are wrong in some areas, what are your plans in that area?

Ms. QUARTERMAN. We have received informal feedback from States and tribes through our auditing efforts about their concerns and through the Advanced Notice of Proposed Rulemaking we went forward with asking should we change our valuation regulations and how? The industry participants in this have not been forthcoming. They have not responded to our request for information.

Mr. HORN. I notice the interagency team audited Texaco for the years 1989 and 1993, and according to the report recommended sending a bill immediately. Has that bill been sent?

Ms. QUARTERMAN. That bill had not been sent at that point.

Mr. HORN. Why not?

Ms. QUARTERMAN. Again, we didn't want to do a piecemeal approach. If we decide to go forward with the methodology that the team—that our auditors looked at for 1989 and 1993, which is based on unanimous agreement of the team, then we are fully prepared to issue an order to them.

Mr. HORN. Well, that sort of worries me that we are delaying. Every day the taxpayers are losing interest on the money. Let's put it that way. Why are we procrastinating?

Ms. QUARTERMAN. We do receive interest on all of these dollars.

Mr. HORN. From whom?

Ms. QUARTERMAN. From the companies involved.

Mr. HORN. They have it banked somewhere. Can they get a better rate than you can?

Ms. QUARTERMAN. I am sure they get a much better rate than we do.

Mr. HORN. I don't know. Government bonds look better some days than other days. But it seems to me we shouldn't be lagging around here. We should get the money.

The report noted that MMS wants to use its long-established approach to valuation. Now, presumably that would minimize legal challenges, and I guess my query to you is whether avoiding lawsuits is the primary concern in this decision?

Ms. QUARTERMAN. I don't think we are going to be able to avoid lawsuits. One of our primary concerns is that in the case of a lawsuit, the Federal Government be in the best possible litigating position.

Mr. HORN. Well, as I understand it, and I have known a few of these people, private royalty owners are not litigation shy if they feel they can win. And some people aren't litigation shy even if they feel they can't win.

Many private litigators employ a lot of consultants to do a cost-benefit analysis of the situation. Has MMS anticipated doing anything along these lines; in other words, the consultants in taking a look at the situation from a legal standpoint so that we could collect the maximum amounts possible while minimizing litigation? Is that a worry in many of your discussions and that is why we are sort of taking too long to collect?

Ms. QUARTERMAN. That is why we are prolonged, we had not done that. We do not plan to hire a consultant to give us the cost-benefit analysis. We are doing that internally with the help of the Solicitor's office and with the help of the Department of Justice in terms of what the cost and the benefits are of proceeding with each methodology.

Mr. HORN. Let me ask you, as you know, Mrs. Maloney's report jointly issued with POGO, the Project on Government Oversight, is pretty harsh on your agency and the Department of the Interior's management; would you like to comment on that report?

I have it here, it is titled; "A Wink and a Nod: How the Oil Industry and the Department of Interior are Cheating the American Public and California Schoolchildren."

Are you really cheating California schoolchildren every day of your life, Ms. Quarterman? This is your chance to get even.

Ms. QUARTERMAN. Absolutely not. I don't want to get into that, even I would comment that I do like the title. I think POGO's heart is in the right place. In the future I would hope they would come and talk to me before they went forward with reports. That is my only comment.

Mr. HORN. Did you find quite a few errors in the report?

Ms. QUARTERMAN. I didn't review it for that.

Mr. HORN. Did someone in your agency review it?

Ms. QUARTERMAN. Are you talking about the longer version of the report?

Mr. HORN. I am talking about the March 1996 report, which is roughly, let's see—that is the problem with reports, they don't paginate them. These are the appendices. If we can get down to the substance, you have to add a little here, you add 5's, and 4's, and 9's and 10's, I suspect we have 40 pages here, just high-balling it. Did somebody go through this and say this is right, this is wrong, and what did you learn from it?

Ms. QUARTERMAN. We reviewed it. I think much of what was contained in the report in terms of underlying facts and information was based on the December 1995 options paper their team put together. So I think factually the information was correct; I might take issue with the characterization.

Mr. HORN. So you are saying the emotional phrases you will forgive, but basically they are right?

Ms. QUARTERMAN. In many instances, I think they are right.

Mr. HORN. Very good.

Does the ranking minority member have any questions?

Mrs. MALONEY. Yes, I do, Mr. Chairman.

I thought your report, the task force report, was excellent, and I would like to really put on the record some areas of it. Specifically, page 83 of the task force report, MMS defends using lease-by-lease audits to collect underpaid royalties rather than spot prices, because it follows, and I quote, longstanding practice, end quote.

But in several sections of the report that same quote "longstanding practice" is totally discredited. For example, on page 18, and I quote: Most oil from Federal oil and gas leases produced by integrated companies transfer production from their production arm to a trading or refining arm. After this initial nonarm's-length transfer, oil produced from Federal leases loses its identity in companies' accounting systems so that its price and subsequent transfers cannot usually be determined, end quote.

Page 34, and I quote: Rarely is it possible to trace Federal production past the first transfer because of the company's production and trading affiliates, end quote. Page 49, 50, quote: After transferring Federal crude of a specific type to a company's trading division, the distinction between Federal and non-Federal crude oil was lost. Federal crude oil was not specifically invoiced in company's records after internal transfers, so it is unlikely that gross proceeds in excess of posted prices can be traced to the production of specific Federal leases. This implies that value is necessary—determining value is necessary either under the 1988 regulations or their predecessor, end quote.

Are you going to recommend continuing down this same costly path that has probably cost the American taxpayer hundreds of millions of dollars? Sounds sort of like scrambled eggs when you talk about this at arm's length.

Ms. QUARTERMAN. I don't think I follow the question; which costly path are you referring to?

Mrs. MALONEY. Continuing to use this same method of quote, the "longstanding practice" that—in the task force, MMS defends using lease-by-lease audits. In other words, using the audits to determine and to collect underpaid royalties rather than the ANS spot prices because it follows, and I quote, "longstanding practice."

Then I quoted three areas in the report, page 18, page 34 and page 49, that discredited using the audit system to collect, and the longstanding practice. So my question to you representing MMS, are you going to continue to use the lease-by-lease audits to collect underpaid royalties rather than ANS spot prices? Because in the report, in three different areas they totally discredit that collection method.

Ms. QUARTERMAN. I think I understand.

With respect to whether we will continue to use audits generally, the answer is absolutely yes. I think that our history has shown that audits of leases is extremely beneficial to the Federal Government. We bring in in the order of $250 million a year from our audit efforts. That is something we should continue.

As to the question of whether or not we will use case-by-case audits versus ANS, in this particular situation, as I mentioned, we have not made that determination at this point.

Mrs. MALONEY. Well, when you defend using audits or the longstanding department practice, isn't it true that longstanding department practice in determining market value is based upon the assumption that the use of posted prices is a valid benchmark for determining market value? Since the Long Beach litigation demonstrated that this benchmark resulted in the undervaluing of oil for the purpose of determining Federal royalties or oil payments, isn't it time to admit that we were wrong, our Government was wrong, MMS was wrong, and aggressively attempt to force the oil companies to pay the Federal Government the money they were owed?

In other words, if you are going to continue using the longstanding practice of these audits of the arm's-length transaction, which is discredited in the report, where are we? We are back to continuing a system that hasn't worked, that your report documented it hadn't worked?

Ms. QUARTERMAN. I think I may have answered in another question earlier in which I was talking about audits, I was talking about more premia with respect to——

Mrs. MALONEY. No, I am talking about the audits in the Long Beach case and collections cases.

Ms. QUARTERMAN. With respect to longstanding practices on valuation with respect to crude oil, as I testified earlier, we are in the process of changing the basis upon which we value crude throughout the United States. Now, once those valuation regulations have been changed, we will continue to go into companies and audit their compliance with those regulations.

Mrs. MALONEY. How do you propose to change them? What are the options that you are considering to change them?

Ms. QUARTERMAN. I think everything is on the table at this point. We have not reached any conclusion about how to proceed—what the new valuation regs should look like, but we are in the process of looking at that right now.

Mrs. MALONEY. Could you get to us in writing the list of all the options you are looking at for the new regs?

Ms. QUARTERMAN. I would have to check first with my Solicitor's office, we are in a rulemaking proceeding. There may be some APA concerns, but barring that, I would be happy to provide you with all the options we are looking at.

Mrs. MALONEY. Thank you very much. Again I congratulate you on the task force report.

I have a few questions for Mr. Berman.

I am somewhat confused by some of your written statements that I reviewed and materials that Ms. Quarterman has. I have been to my—by the way, at this point, I would like to put into the report two letters that I wrote to Mr. Armstrong and Ms. Quarterman, asking for a Freedom of Information request. They responded with some of the information, but not all the information, and I would like to note that which we did not receive, which we are hoping to receive.

Mr. HORN. Without objection, it will be inserted at this point in the report.

And previously inserted when we began with these witnesses, will be the final interagency report on the valuation of oil-producing Federal leases in California. And still previously will be Mr. Calvert's statement, without objection.

[NOTE.—The report entitled "Final Interagency Report on the Valuation of Oil Produced from Federal Leases in California," can be found in subcommittee files.]

Mr. HORN. Go ahead, then we will move forward.

Mrs. MALONEY. Thank you, Mr. Chairman.

Mr. Berman, I discovered through our information request that you were involved in Interior's 1986 decision not to pursue the underpayment of royalties in question. And I see then you wrote a memo in 1993 recommending that DOI send out bills to the oil industry. And I would like to know where did you change your mind, those were two conflicting statements?

Mr. BERMAN. My role in the 1986 decision was—and I attended a meeting which we were briefed by the State of California and city of Long Beach on their concerns on undervaluation. At that time, the primary basis of their concern was that they had done some refinery modeling to determine refinery values, and these refinery values cannot correspond to posted prices, and we believe the refinery values to be the proper value and that this was evidence of the—of undervaluation.

While I had some concerns about the California market, and they were also alleging at that time a conspiracy to undervalue, I had some concerns about the California market, but I didn't see anything other than a scenario that is that there was not clear evidence in 1986 that there was a—that action had to be taken.

Mrs. MALONEY. What was Interior's reaction to your change of heart when you then wrote the 1993 memo?

Mr. BERMAN. The MMS took it, I believe took note of it when I—unofficially gave them the heads-up in the spring. They did initiate the study, the review that you described up there.

Mrs. MALONEY. Were you a member of the task force?

Mr. BERMAN. No, I was not.

Mrs. MALONEY. Why weren't you a member of it, you are so familiar with the issue and had written all of these memos, although conflicting ones; where were you?

Mr. BERMAN. I was not assigned to the task force.

Mrs. MALONEY. Why not?

Mr. BERMAN. The assignment of responsibilities is a management prerogative and management had currently made a decision that it was better not to involve me.

Mrs. MALONEY. Have you written any other memos since your 1993 memo, I believe it was to Mr. Brooks Yeager, regarding the underpayment of royalties?

Mr. BERMAN. I have written a number of memos about the California issues since 1993.

Mrs. MALONEY. Could you state for the record what those memos were for and the general dates of them?

[The information referred to can be found in subcommittee files.]

Mr. BERMAN. I don't have my notes with me on that. They covered the general areas of the undervaluation, the pipeline issue, as is mentioned in the memo you are referring to. There were a number of——

Mrs. MALONEY. Well, Mr. Berman, just—your memos were not included in the information that I received from the Department of the Interior. In fact, I made an additional special request from your

Congressional Affairs Office that you bring a copy of your work here so that the committee, Mr. Horn and others, can see it. And I just want to know, are you deliberately withholding information from Congress?

Mr. BERMAN. No, ma'am, I apologize for the——

Mrs. MALONEY. Why haven't you given us the memos when we repeatedly asked for them?

Mr. BERMAN. I have received no request from this committee for that information. I was told——

Mrs. MALONEY. And the Congressional Affairs Office did not relay to you my specific request for your memos?

Mr. BERMAN. I was told by somebody at MMS, I believe late on a Friday afternoon, there was some reference to it. I had—and your office had called and asked again about it, I had not—I checked with our Congressional Affairs Office and they didn't have a copy of it either.

Mrs. MALONEY. Right now I am requesting copies of your memos, I would like them submitted to Mr. Horn's committee, all the memos you wrote on the undervaluation.

I would like to ask you something else. After you wrote your 1993 memo, did you have any knowledge that MMS was entering into the global settlement with oil companies? Did you have any knowledge of that as an economist?

Mr. BERMAN. I was not a member of the task force——

Mrs. MALONEY. I didn't ask that, I said did you have any knowledge of them entering into these global settlements, yes or no?

Mr. BERMAN. Yes, ma'am.

Mrs. MALONEY. Did you warn anyone at the Department of the Interior that collecting underpaid royalties might be severely hampered by signing a global settlement, did you warn anybody or did you just write a note yourself?

Mr. BERMAN. Yes, ma'am, I did issue a memorandum expressing my concern.

Mrs. MALONEY. Who did you issue that memorandum to?

Mr. BERMAN. To the director of policy office, Brooks Yeager. Brooks Yeager was the director of office policy at that time, yes.

Mrs. MALONEY. I would like a copy of that memo.

I would also like to know if you did have any discussions with any of your colleagues about this problem and we should not go, not go to a global settlement, there would be a loss of money to the Federal Government and the taxpayers of the country.

Mr. BERMAN. Yes, ma'am.

Mrs. MALONEY. Who did you have conversations with?

Mr. BERMAN. I had conversations with my immediate superior.

Mrs. MALONEY. Who was that?

Mr. BERMAN. Mr. Ted Heinz and I had discussions. As a result of that discussion we immediately had discussions also with Mr. Yeager.

Mrs. MALONEY. Did you have any question—any discussion with anyone else?

Mr. BERMAN. I had discussions with individuals who had provided me some information.

Mrs. MALONEY. How long have you been in your present job?

Mr. BERMAN. Since 1984, 1985.

Mrs. MALONEY. The MMS members of the task force in recommending auditing for premia rather than using—in the task force report, as you know, there was a difference of opinion, the MMS members recommended auditing for premia rather than using MMS, do you believe this is the most effective method?

Mr. BERMAN. As a matter of collecting royalties, that would be an issue for the Solicitor as a matter of determining——

Mrs. MALONEY. I am not asking a bureaucratic mumbo-jumbo. I am asking a person who is paid by the taxpayers to research this. I am asking your opinion, your opinion—if you were on the task force—you should have been on it given your background—if you were on it, which side would you have sided with? Would you have sided with MMS or what was Energy and Commerce—Energy and Commerce, which side would you have gone, MMS or premia?

Mr. BERMAN. I believe the best method of measuring value in California is through reference to ANS, since ANS was entered into California markets.

Mrs. MALONEY. Can you explain to the committee, to Mr. Horn and me, what is the relationship between ANS spot price to postings and premia paid above postings?

Mr. BERMAN. ANS is market crude in California, that is it is a heavily traded crude. It is a very important crude to the refiners in transportation fuel. It is, in fact, then the—as a heavily traded crude it will form the basis for valuing exchanges between companies. That is to ensure that they get the proper value when they deal with one another.

Posted prices, as I indicated before, represent the company's statement of—or initial statement about the market in the field, or at any one point they don't represent market transactions. In a well-functioning market one would expect the premia on the posting to correspond with the market value as it does in the mid-continent market. The problems in the California market, the lack of trades and the transportation restrictions will inhibit this to a significant extent. But the premia then would tend to capture some of the market value.

Mrs. MALONEY. One section of the task force numbers, the MMS ones, recommended relying on Benchmark 1 of the regs, which again relies on posted prices on significant quantities of arm's-length transactions. Does this recommendation make sense to you? Is it possible under the regulations to use ANS as the determiner? Just yes or no.

Mr. BERMAN. Yes, ma'am.

Mrs. MALONEY. And I was confused. Maybe as an economist you can answer this. What constitutes "significant quantities"? Is less than 20 percent significant? What is "significant"?

Mr. BERMAN. It is not that simple. If it was as simple as saying 20 percent was a significant quantity, then we could have done that in the regulations.

The reason it's not in the regulations is because it's not simple. In my mind, the quantity is a significant quantity if you can establish a market price about that quantity.

Mrs. MALONEY. Is ANS significant?

Mr. BERMAN. Yes, ma'am.

Mrs. MALONEY. And why is it significant?

Mr. BERMAN. It is readily available. There is an established spot price on the amount. It's bought and sold at the prices—at those market prices, and it's relied on by the companies as a reference.

Mrs. MALONEY. And have you continued to pursue this question enough to know if this is just limited to California?

Mr. BERMAN. I have initiated an investigation to look at the issue of posted prices generally in the mid-continent, Texas and New Mexico, et cetera.

Mrs. MALONEY. Are those posted prices undervalued in your initial research?

Mr. BERMAN. My initial findings are that those posted prices are below what is generally regarded as market value.

Mrs. MALONEY. And have you only done it in two States? Is that correct, in addition to California?

Mr. BERMAN. I haven't done it in detail in any State. I have been looking at the trading issue generally. It's much easier to look at a broader market outside of California since there are not the transportation restrictions that there are in California and you can find similar market references that can be used in New Mexico or in Texas.

It's more difficult to do that in California. But I found that, as a general rule, that postings do not reflect market value.

Mrs. MALONEY. May the committee have the results of your investigation so far for our study?

Mr. BERMAN. It's really in pieces in my office. I would—I haven't even had a chance to brief my superiors on where we are yet. I'm not—I would be more than happy to provide anything through our Congressional Affairs Office, if it's—if the Department deems it ready to be seen.

Mrs. MALONEY. Thank you very much.

Mr. HORN. Thank you very much.

Let me just ask you one question, Mr. Berman. You are a very expert witness here. In your studies in the use of the price structure, you have advocated namely the Alaska North Slope structure. Do you have any ballpark figure as to what we might be losing as a result of not adopting that particular price structure as an index of what is value? Are we talking hundreds of millions of dollars that we are foregoing by not doing it, or what?

Mr. BERMAN. Well, I would not use—it is not clear that I would use Alaskan North Slope outside of the State of California.

Mr. HORN. OK. What would you use in the mid-continent and Texas?

Mr. BERMAN. Mid-continent and Texas, I would probably use——

Mr. HORN. East Texas?

Mr. BERMAN. Closing price on the NYMEX when it goes from future to spot. Or I would use on a daily basis, I would use the NYMEX or the postings plus, P-plus market out of Cushing. Possibly, for economic reference, the light Louisiana sweet out of St. James. It would depend on the market that I was looking at.

Mr. HORN. Because we would appreciate that ballpark figure. If we are losing a few hundred million, I think we have a little bit of concern here—quite a bit of concern.

Mr. BERMAN. In talking with traders and so forth—I haven't done any estimates myself—I'm told that the undervaluation may be in the range of 3 to 10 percent.

Mr. HORN. Well, that could be significant; right?

Mr. BERMAN. Yes, sir.

Mr. HORN. Especially if it is at the 10 percent level, although I don't sniff at 3 percent either. Money is money.

I want to thank you for your testimony. May I say, as you know, all witnesses and what they say here are protected by laws of Congress.

Mr. HORN. I'm told that Assistant Secretary Armstrong is here today; is that correct? Is he in? There we are.

I thought you were unavailable. Is there anything you would like to say on this subject? We will swear you in, and you can say it.

Mr. ARMSTRONG. I don't think that there is anything that——

Mr. HORN. Why don't you take a microphone.

STATEMENT OF ROBERT L. ARMSTRONG, ASSISTANT SECRETARY OF THE INTERIOR, LAND AND MINERALS MANAGEMENT, U.S. DEPARTMENT OF THE INTERIOR

Mr. ARMSTRONG. I don't think, Mr. Chairman, that there is anything that I would add.

We are going to deal with this within the month, as Cynthia told Congresswoman Maloney. I would add, as a matter of the record, that I managed the University of Texas lands for 12 years and I know a little bit about that. The California situation is extremely complex because you have——

Mr. HORN. Well, could I just interrupt? Do you mind if I just swear you in?

[Witness sworn.]

Mr. HORN. All right. Proceed. I would be interested if you would respond on that question, since you are very familiar with it. Are they getting a better deal than we are?

Mr. ARMSTRONG. Well, they have a different situation. They have a lot of pipelines that transfer oil and gas. They tied an IMEX; at least they are working on that. We are going to meet with the land commissioners next—well, this month in Salt Lake City, and we are going to talk about the various things that they do.

But the plain fact is that the California situation is one alone. It's an integrated situation. It involves a hot pipeline capability. They have to build those. And then when they get through with producing it, they trade amongst themselves.

And so we are looking at—in the Texaco situation, we think the premium is ascertainable and we're going to send a bill. But these kinds of things take time. It has been a long-standing situation, but California is very cooperative with us. And so we'll get on with it.

Mr. HORN. What is your time line on that?

Mr. ARMSTRONG. We should probably have something within a month to 6 weeks.

Mr. HORN. OK. And how much money have we lost by not moving on some of those questions I asked earlier? From 1993, we've had procrastination to 1996, and so forth. What is your take on it?

Mr. ARMSTRONG. Well, you know, it's—it's—it's how long—well, I won't say—we had to get the Leitzinger report. We wouldn't have had that figure of whatever it was, $856 million; that figure comes from him, and so I had to get him to produce it. We can't just do audits as if by magic. It takes a period of time to put the auditors to work.

Let me say in terms of audits, we audit for a lot of things other than just the price of crude. We have transportation costs. That's why we would like to keep those ongoing and set aside the transportation—I mean, set aside the valuation, and we think that we've done that. But I'd hate—the audits have produced us over $1 billion. Last year, we did this. And so, you know, the audits have a very important function for us to play.

The—I guess we just need to do this in a period of time, and we are making progress on it, and I'm—I think that all the reports that we have gotten have contributed to this. All of the people that we have gotten to do things are going to help us.

Mr. HORN. Well——

Mr. ARMSTRONG. But it just takes a period of time to get it done.

Mr. HORN. I suspect we did ask for Assistant Secretary Armstrong to be a witness. Did we?

We thought you were going to be out of the country.

Mr. ARMSTRONG. I was out of the country, and I am operating on whatever it takes to come from Australia and be here. So——

Mr. HORN. Well, nice of you to show up. If you have comments on any other thing that either bothered you or didn't bother you, we'd be glad to have it now or we can followup later.

Mr. ARMSTRONG. I really think that Cynthia has done an excellent job.

Mr. HORN. So you agree with all of her answers to our questions?

Mr. ARMSTRONG. I would not disagree with anything she said.

Mr. HORN. Mrs. Maloney, do you want to ask any questions of the Assistant Secretary?

Mrs. MALONEY. Well, I would like to welcome him here and congratulate him on his task force report, but actually I'd like to ask Mr. Haspel, if that is all right?

Mr. HORN. Fine. Then we will move on to the next panel.

Mrs. MALONEY. Mr. Haspel, were you a member of the task force?

Mr. HASPEL. No, I was not.

Mrs. MALONEY. Should you have been a member of the task force?

Mr. HASPEL. I believe I have the qualifications to be a member of the task force, but I am working on a number of other issues, and Mr. Speir of my staff is an able analyst and could ably represent the Department of Energy on the task force.

Mrs. MALONEY. And what was the date that the task force was created? When was it created?

Mr. HASPEL. June 1994.

Mrs. MALONEY. Then it completed in May 1996.

Mr. HASPEL. Correct.

Mrs. MALONEY. Were you briefed daily or weekly regarding the task force's activities?

Mr. HASPEL. No, I was not.

Mrs. MALONEY. Were you at any of the task force meetings?

Mr. HASPEL. No, I was not.

Mrs. MALONEY. So, when were you briefed to testify about the task force on which you were not a member?

Mr. HASPEL. I was aware of the existence of the task force, that Bob was on the task force. I was aware of where the task force was going because I am familiar with royalty issues, but I was only formally briefed on Friday to prepare for this testimony.

Mrs. MALONEY. So Mr. Speir is your assistant?

Mr. HASPEL. He works for me, yes.

Mrs. MALONEY. Then I would like to ask him: Mr. Speir, were you a member of the task force?

Mr. SPEIR. Yes, ma'am, I was.

Mrs. MALONEY. From the beginning to the end?

Mr. SPEIR. Yes.

Mrs. MALONEY. I'd like to ask a few questions about the task force, specifically page 67 of the task force report. Energy and Commerce representatives recommended using the Alaska North Slope spot price to determine what royalties the oil industry should be paying the Federal Government.

Could you explain why there was this division and why Energy and Commerce supported the ANS prices? Very briefly?

Mr. SPEIR. Well, briefly, we felt that that was the proper valuation of the crude oil.

Mrs. MALONEY. Why?

Mr. SPEIR. It was a—the prices that we were talking about were free and open market transactions. They were readily relatable to California crude oil, because although the density of the oil is somewhat different in some cases, there were readily available industry adjustment factors. ANS was within the range of California oil, so—quality-wise, so the adjustment for transportation and quality was a reasonable thing to do, and we saw the industry doing it themselves in the records.

Mrs. MALONEY. You saw in the records? Could you speak further; how did you see it in the records? Did Energy tell you that is how they used it? Was that their method? Did they tell you, or did you see it in documents?

Mr. SPEIR. No. In our examination of the Long Beach records, we saw a number of instances where companies were analyzing the value of California crude oil they were buying to them and making that analysis relative to Alaska North Slope oil prices and making comments to the effect that California oil was far below its value.

Mrs. MALONEY. And that was in writing?

Mr. SPEIR. Posted prices. Yes, ma'am.

Mrs. MALONEY. Wow, Mr. Chairman. On page 57 of the task force report, "Energy does not recommend using ANS for post-1988." Does that mean you agree with MMS that auditing for premia is preferable to using ANS post-1988?

Mr. SPEIR. Well, I have always felt that Alaska North Slope oil is the proper basis of valuation. I mean, that doesn't change after 1988. The significant difference was in the change in regulations. And this benchmark system that required a judgment of significant quantities before you could reject one benchmark and fall down to the next one, that was simply a confusing situation, combined with the fact that most of the dollars that might be obtained in overcharge settlements or judgments were in the 1980 to 1985 period. I went along with the MMS's feelings that the benchmark system should be used.

Mrs. MALONEY. OK.

Mr. SPEIR. And I might add, a benchmark system should be used as applied to sales premia that were seen in contracts, not posted price.

Mrs. MALONEY. OK. I'm a little confused. You believe that the post-1988 Federal regulations could permit one to value crude at the ANS spot prices for royalty purposes, taking into account gravity and transportation?

Mr. SPEIR. I believe they could, yes. It requires you to make certain judgments, which are largely qualitative judgments, about whether the trading activity that you see in company records was, quote, significant or not significant. If you deemed that the activity, real true arm's length sales and purchases at posted prices or posted prices plus a premium, was not a significant quantity, then you could fall down to the next valuation benchmark, and benchmark No. 5 clearly would allow you to use ANS as a candid valuation system.

Mrs. MALONEY. But jumping over, the other benchmarks are very difficult.

Mr. SPEIR. Because of this subjective judgment about what constitutes a significant quantity.

Mrs. MALONEY. What do you think constitutes a significant quantity?

Mr. SPEIR. I can't make any judgment about that.

Mrs. MALONEY. So then you agree with Ms. Quarterman that the regs need to be rewritten?

Mr. SPEIR. I think we all agree, all of the task force agreed, that the regs need substantial revision, yes.

Mrs. MALONEY. In appendix 1, page 2, the task force argues that they cannot use the ANS spot price method because the regulations require that the crude oil used as the determiner of value come from the same "area." Could ANS be considered from the same area, for comparison's sake, to California?

Mr. SPEIR. Well, it is certainly sold in the same area. It is sold in the Los Angeles spot market. That is the price that Dr. Leitzinger was looking at when he did the side study that Mr. Armstrong just spoke to. It's not produced in the same area, but everyone recognizes that ANS prices are a dominant factor in the California market, and clearly it is refined in the same refineries in California that refine California crude oil.

Mrs. MALONEY. On page 11, "Energy and the Commerce Department representatives recommend going back to at least 1980 to collect undervalued royalties." Why? And would you elaborate.

Mr. SPEIR. Well, first of all, we looked at the year-by-year potentially collectable royalty underpayments, and we found that the majority of those potentially collectable royalty underpayments accrued in the years 1980 to 1985 when prices were high.

We sort of went at it from two different directions. We looked at how much you would obtain for each incremental year going back in time and found out that that was fairly small taken in the context of what might be obtainable between 1980 and 1993.

Further, the question of crude oil price regulations enters into that situation prior to 1980 and enormously complicates the situation, as I think the people in Long Beach found in the Long Beach lawsuits. Rather than muddy the situation up, and recognize there is some practical limit on how far you can go back and still make this whole case look credible, we somewhat arbitrarily established 1980 as the beginning period.

That is not to say that back royalties—that there weren't—that people probably don't or might not owe back royalties from earlier periods but just that the practical limit of collection might be established as 1980, again, as a qualitative judgment on our part.

Mrs. MALONEY. You are the only member on the panel that was a member of the task force; correct?

Mr. SPEIR. Regrettably, yes. It puts me on the spot, kind of.

Mrs. MALONEY. Can you describe the plan of action that came out of the task force's first meeting back in 1994? How did you decide to proceed? And there were four members of the task force; correct?

Mr. SPEIR. Four principal member agencies, as I recall it. Justice really was not an active participant in most of the period.

When we first met, as I recall it—and I don't remember whether this was a face-to-face meeting or a teleconference—there were two things that we generally agreed to; one I think we all agreed to immediately, and that was the necessity of looking at the Long Beach records primarily because the preceding studies that people had pointed at never really looked at the physical information, the contractual records. So we felt it imperative to get access to those records.

The second subject that came up immediately was one of audits, and——

Mrs. MALONEY. When did you look at the records?

Mr. SPEIR. Late October, November, of the same year, 1994.

Well, as I was saying, the second subject was audits, and that was discussed early on. I think the decision on MMS's part was not to commit to the audits until we'd looked at the Long Beach records because of resource problems, et cetera.

Mrs. MALONEY. So when did you start your audits?

Mr. SPEIR. Well, the Interior Board of Land Appeals case sort of confounded the issue, because it inhibited our ability, or the auditors's ability, to look at the trading affiliate part of the company where the Long Beach records showed that the markup in crude sales was predominantly taken; and that was not resolved until May, I think, according to your chart and earlier testimony.

Mrs. MALONEY. May of what year?

Mr. SPEIR. May 1995.

Mrs. MALONEY. So why did it take so long? You started in 1994. Why did it take so long?

Mr. SPEIR. That really is not a question that I can answer, ma'am.

Mr. ARMSTRONG. The IBLA is constrained by a lot of different work.

Mr. HORN. You want to spell that out? I like to avoid euphemisms.

Mr. ARMSTRONG. The Interior Board of Land Appeals. We had a decision that said that the first price was all we could review. I went to them and asked if we couldn't review that decision and get a new look at it. And it was not easy because they were going to have to reverse themselves. Consequently, after a period of time, they did reverse themselves and we were able to look at the subsequent transactions. That was how we discovered that premiums were paid in virtually every situation.

Mrs. MALONEY. Could I clarify further? Was it—it took quite a long time, from 1994 to 1995, and it took a long time. Was it hard to obtain audit resources, or did the task force just procrastinate because they had other things to do? Why did it take so long? You say it was—spell it out for me. Why did it take so long between 1994 and 1995? Were you just asleep at the wheel, or did you have other demands on your time?

Mr. SPEIR. Is that a task force question or a question to Mr. Armstrong?

Mrs. MALONEY. I'd like you to answer and Mr. Armstrong to answer. Did you have other things you had to do? Why did it take you so long?

Mr. SPEIR. Well, we had to decide on who to audit, although fairly early in the process we decided on Texaco and Shell. And resolution of the Interior Board of Land Appeals case was key, and so that was sort of on the critical path.

Now, I think the decision was made somewhere along the line by the Solicitor's Office in the Interior Department that they actually could go ahead prior to resolution of this case and engage Texaco. The IBLA Interior Board of Land Appeals case, by the way, was with Shell. And so an engagement letter was issued to Texaco actually prior to resolution of that case.

The task force was not really engaged in productive activity during that period. We were in sort of a waiting mode.

Mrs. MALONEY. OK. When was the Shell audit?

Mr. SPEIR. As near as I recall it, Shell was engaged in the late summer, August, September time period.

Mrs. MALONEY. Of 1995?

Mr. SPEIR. Of 1995, yes. Maybe a little earlier.

Mrs. MALONEY. Once the audits were finished, were the audits helpful in giving the team, the task force, the information it needed for a thorough report?

Mr. SPEIR. We got—I think the task force felt that we got less from the audits than we initially hoped to get.

Mrs. MALONEY. Then where did you get your information for your report if you didn't get it from the audits?

Mr. SPEIR. In large part from the Long Beach records. The audit process was proceeding rather slowly, particularly with respect to Shell in September 1995.

Mrs. MALONEY. Were the companies not cooperating? What was the problem there?

Mr. SPEIR. I think Shell was having some problems finding their records. We had better information on Texaco that allowed the auditors to more efficiently target certain records, and they did better with Texaco than they did with Shell.

Mrs. MALONEY. So it took you nearly a year and a half to audit one company, and another company it took you 2 years.

How long would it take you to audit nine companies? Sixteen years? How long would it take you? Twenty? I want to know, were you doing other things or were you just working on this task force?

Mr. SPEIR. Me personally?

Mrs. MALONEY. Yes. Why did it take you so long to audit these things?

Mr. SPEIR. I wasn't one of the auditors.

Mrs. MALONEY. Or to get the auditors to audit.

Mr. SPEIR. That was, I think, a resource question, and it goes to your question of how long it will take. It is really a matter of resources. I think they use the same people to do Shell that did Texaco, and so these were done essentially sequentially. Obviously, given more people, then you can do things faster.

Mr. HORN. Mr. Secretary, remind me, who is James W. Shaw? Is he one of your staff?

Mr. ARMSTRONG. He is the director of our Minerals Management Audit—he is director of all of the—what——

Ms. QUARTERMAN. He is the associate director of the Royalty Management Program which is headquartered in Denver.

Mr. HORN. Who is David A. Hubbard?

Mr. QUARTERMAN. David A. Hubbard is a member of his staff. He is Valuation and Standards Division.

Mr. HORN. Was he on the task force?

Ms. QUARTERMAN. Yes, he was on the task force.

Mr. HORN. I don't know if you were in the room when I read this e-mail. Let me read it again. This was from David Hubbard, MMS Denver, to his boss, obviously, James W. Shaw, MMS Denver.

He says, "Will MMS commit additional audit resources either in the form of MMS auditors or more money for the State of California to do followup work if the team recommends it? I recognize this is hard to answer without knowing what the scope may be, but I am hoping for some sort of motherhood statement I can give the team for our next meeting," and then this is the point I'm emphasizing: "I have stalled this issue long enough. Again, please see the Speir memo I'm sending you on this subject."

Now, was there an attempt to just drag this thing out and, as the gentlewoman from New York said, "procrastinate" or, I might say, dillydally?

Mr. ARMSTRONG. I don't know what was going on in Denver, but I do know that all of the auditors that we employ are constantly involved in audits and it is an allocation problem. You have got to pull people off to do things. I don't know anything about the e-mail.

Mr. HORN. So you are saying there is no intent to stall?

Mr. ARMSTRONG. No, I don't think so.

Mr. HORN. And we have a 2-year report, which we have included in the record.

I'm just curious, while I have the chance, Mr. Secretary, was it you who decided to put "For U.S. Government Use Only" on the report? Who classified it as such?

Mr. ARMSTRONG. I don't know anything about that.

Mr. HORN. Ms. Quarterman.

Ms. QUARTERMAN. I don't know anything about that either.

Mr. HORN. Nobody knows anything?

Ms. QUARTERMAN. I don't know who produced the report or where it even says that.

Mr. HORN. Was it the task force who decided to stamp it "For U.S. Government Use Only," or did they want to make sure it was leaked by putting that on?

Mr. ARMSTRONG. That is a distinct possibility.

Ms. QUARTERMAN. My version doesn't even have that.

Mr. HORN. Well, I have two versions. It is rather fascinating. Most of mine is "For U.S. Government Use Only," but occasionally when I ask for a page, it comes without——

Ms. QUARTERMAN. It sounds like you got a draft before we got it.

Mr. SPEIR. Mr. Chairman, maybe I can clarify that a little bit. Back perhaps at least a year before the task force report came out, the correspondence between all of us ended up being branded with that statement, and it was largely because some of it was getting out into the public and we considered it internal documents, so it was sort of a general consensus of opinion that we should treat our things—our correspondence—that way. That carried over, I am afraid, in the task force report. There was nothing malicious.

Mr. HORN. I happened to be holding hearings earlier in the week about classification systems of the Federal Government. This happens to be an example.

Mrs. MALONEY. I have a few followup questions on the common carriers, and I would like to ask Mr. Haspel or Mr. Speir.

The Minerals Leases Act requires that pipelines holding mineral leasing permits must operate as common carriers; correct?

Mr. HASPEL. That is my understanding.

Mrs. MALONEY. And what position did you take while you were at the Department of the Interior on the issue of common carriage enforcement?

Mr. HASPEL. While I was personally at the Department?

Mrs. MALONEY. Yes.

Mr. HASPEL. It was a while ago.

Mrs. MALONEY. How long ago?

Mr. HASPEL. I left the Department of Interior in July 1990.

Mrs. MALONEY. Not that long ago. What was your position when you were there?

Mr. HASPEL. I had a number of positions, one of which was being the Assistant Director of the Minerals Management Service. I was also special assistant to the Assistant Secretary for Land and Minerals Management.

Mrs. MALONEY. What was your position on the common carrier issue?

Mr. HASPEL. The position that the administration took at that time was that if an independent oil producer would come forward and claim and tell us that they could not, in fact, move their oil through a pipeline, then in fact we would have evidence that the pipelines were not operating as common carriers. In fact, no one would come forward publicly and say that. So the administration took the view that, therefore, we could not move forward on that issue.

Mrs. MALONEY. So the administration did not move forward on the common carrier issue.

How many pipelines cross Federal land in California?

Mr. HASPEL. At the time I was studying, it was two; and apparently, according to Ms. Quarterman's testimony, it is now one.

Mrs. MALONEY. I'd like to ask Mr. Berman, Mr. Armstrong, and Mr. Speir the same question.

How many pipelines cross Federal lands in California? since there seems to be a disagreement between Mr. Haspel and Ms. Quarterman.

Let's start on this end.

Mr. HASPEL. I am agreeing with Ms. Quarterman. I said when I studied it there were two. There may be one.

Mrs. MALONEY. Mr. Speir?

Mr. SPEIR. Well, I think Mobil's M–70 line to Los Angeles from the San Joaquin is the most clearly identifiable case, and there is a question whether you were referring to heated and unheated pipelines——

Mrs. MALONEY. How many heated pipelines cross Federal lands in California?

Mr. SPEIR. As far as I know, right now it is only Mobil's M–70 line.

Mr. HORN. So two?

Mr. SPEIR. So just one. That is the one that everybody is talking about.

Mrs. MALONEY. One heated.

How many unheated pipelines cross Federal land in California?

Mr. SPEIR. I don't know the answer to that.

Mrs. MALONEY. You don't know the answer?

Mr. SPEIR. No; I don't.

Mrs. MALONEY. Mr. Armstrong, How many unheated pipelines cross Federal land in California?

Mr. ARMSTRONG. I have no idea, but I am informed that we only have one that is heated.

Mrs. MALONEY. We have four people who agree on one.

I would like to ask Mr. Berman, How many unheated pipelines cross Federal lands in California?

Mr. BERMAN. I don't know how many.

Mrs. MALONEY. How many do you think? Do you think it is more than one?

Mr. BERMAN. There's always been much more interest in the heated pipelines since that's what it takes to move the California heavy. I've never really taken a look at the unheated pipelines.

Mrs. MALONEY. How many heated pipelines cross Federal lands in California?

Mr. BERMAN. There are—in 1986, there were two. It was the Texaco and the Mobil M–70 line. In the last couple of years, Texaco has disconnected a section of its pipeline that went across Federal lands although it still holds the permit, to the best of my knowledge. But I remember verifying that the section that crossed the Federal land had been physically severed and plugged on both sides of the Federal land, that they brought it around it.

Mrs. MALONEY. OK. Well, so you are saying there is one heated pipeline now because Texaco closed its heated pipeline? Is that what you are saying?

Mr. BERMAN. Texaco rerouted the section of their pipeline that went across Federal land.

Mrs. MALONEY. So there is only one going through Federal land now—correct—that is heated.

Mr. BERMAN. To the best of my knowledge, yes.

Mrs. MALONEY. And whose is that?

Mr. BERMAN. That would be the Mobil M–70 line, and I'm not certain whether BLM—whether or not that land is managed by BLM. It may be all managed by the Department of Agriculture.

Mrs. MALONEY. In the task force, actually your very excellent task force report, Mr. Armstrong—and I congratulate you moving forward with this task force report—I understand that even back years ago that the Secretary of the Interior was complaining to FDR about the problems of getting fair value for the oil.

But the fact that there is one closed common carrier there, that Mr. Berman just mentioned, that belonged to Texaco, and since the law says that any carrier going across Federal land belongs—it should be open because it is Federal land, I'd like to ask you, will you open the one heated pipeline that is closed as a common carrier? Because, based on your report, that would bring down—that would bring more revenues to the taxpayers if we just opened up one heated pipeline as a common carrier. That would help the situation tremendously.

I would like to ask, in your situation, as the head of land management development, could you open up the one heated pipeline as a common carrier?

Mr. ARMSTRONG. I don't remember whether we—I—maybe Mr. McMahon will have some answers to this, because I'm not that familiar with California, but if we go with the ANS method, it won't make any difference. This will all be part of our consideration in what method we deal with this, and so I—at one point, we were asked to intervene in a pipeline case, and I think we took the position that California could do that if it wanted to, but there was a lot of dispute about all of the regulatory authority. And you might ask them about that, because we thought that California could do this if it wanted to and open it up and declare them to be common carriers, but for some reason or another it was hesitant.

Mrs. MALONEY. But we happen to have one route on Federal land that, as a Federal Government, we could open up——

Mr. ARMSTRONG. Right; we might do that.

Mrs. MALONEY [continuing]. Common carrier, which would help the revenues coming in.

Anyway, Mr. Haspel, has the Department of Energy taken a position on the pipeline question and the fact that they are not common carriers in California?

Mr. HASPEL. The Department took a position in the Domestic Natural Gas and Oil Initiative suggesting that the pipelines be made common carriers to, in fact, raise prices in the fields in California.

Mrs. MALONEY. And was that the letter from Mr. Bill White to Mr. Babbitt? Is that the position that said——

Mr. HASPEL. That's a letter dated March 29, 1994, from then Deputy Secretary Bill White to Secretary Babbitt, yes.

Mrs. MALONEY. I would like to request that this letter be put into the record, a letter from the Department of Energy to the Department of the Interior urging that oil company pipelines operate as common carriers.

Mr. HORN. Without objection, so ordered. It will be in the record at this point.

[The letter referred to follows:]

The Deputy Secretary of Energy
1000 Independence Avenue., S.W.
Washington, D.C. 20585
(202) 586-5500 • FAX (202) 586-0148

March 29, 1994

APR 2 2 15 PM '94

The Honorable Bruce Babbitt
Secretary of the Interior
Washington, D.C. 20240

Dear Bruce:

This week, the Department of Commerce published draft regulations that will facilitate exporting California heavy crude oil to markets in the Far East. I am soliciting your assistance in making this initiative successful in its attempts to open California's crude oil markets to fair and open pricing.

Export licenses for California crude oil have been granted in the past, but shipping this oil to ports has been incumbered by the Mineral Leasing Act's prohibition on using pipelines that cross Federal lands. The new export regulations will remove this constraint, thereby eliminating a significant barrier that has discouraged prospective exporters.

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 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.

Thank you for your interest and prompt attention to this matter.

Sincerely,

Same as
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Bill White

Bill White

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Mrs. MALONEY. And given the President's announcement—he announced this initiative, I believe, in December 1993—what has the Interior's response been to that? Have you moved forward on the common carriers?

Mr. HORN. Don't all jump at once.

Mrs. MALONEY. Mr. Haspel, I guess.

Mr. HASPEL. I don't represent the Department of the Interior.

Mr. ARMSTRONG. And I don't know at the present time what the status of that is, but we will find out.

Mrs. MALONEY. Thank you very much.

Mr. HORN. We thank you all for coming.

The committee will recess at this point for lunch. It is now 12:15. We will reconvene at 1:30 to hear the Long Beach panel, and we thank each of you for your contribution to this testimony.

[Whereupon, at 12:15 p.m., the subcommittee was recessed for lunch, to reconvene at 1:30 p.m., the same day.]

Mr. HORN. The Subcommittee on Government Management, Information, and Technology, a quorum having been established, reassembles.

Panel three consists of three witnesses: Mr. Brian McMahon, attorney for the city of Long Beach, trustee for the State of California; Mr. Robert Shannon, assistant city attorney, city of Long Beach; Mr. James McCabe, deputy city attorney for the city of Long Beach.

[Witnesses sworn.]

Mr. HORN. All three affirm.

We will just go down the line with Mr. McMahon, the expert in this area.

We are delighted to see you, and we expect you to educate us.

STATEMENT OF M. BRIAN McMAHON, ATTORNEY FOR THE CITY OF LONG BEACH, TRUSTEE FOR THE STATE OF CALIFORNIA, ACCOMPANIED BY ROBERT SHANNON, ASSISTANT CITY ATTORNEY, CITY OF LONG BEACH; AND JAMES McCABE, DEPUTY CITY ATTORNEY, CITY OF LONG BEACH

Mr. MCMAHON. To my right is Robert Shannon, who is assistant city attorney for the beautiful city of Long Beach; and on my left, James McCabe who is the deputy city attorney for the city of Long Beach.

Mr. HORN. You say that about the city because you were under oath.

Mr. MCMAHON. That is correct.

I have a written testimony that I have handed out.

Mr. HORN. That is all in the record at this point, and proceed any way you like.

Mr. MCMAHON. Let me give you a very brief history of my connection to the issues that have been raised before this committee.

Since 1981, I have been involved in litigation on behalf of the city of Long Beach as trustee for the State of California in two large pieces of litigation which we refer to as Long Beach 1 and Long Beach 2.

Long Beach 1 is a case that was filed in 1975, and it alleges or it alleged price fixing among seven major oil companies in California for the period through the 1970's.

Long Beach 2 was filed in 1986, and it covers the period through the 1980's.

Long Beach 1 is basically finished as a case, and the net effect of filing these lawsuits on behalf of the city and the State is that we collected something like $320 million in settlements from major oil companies.

Before I proceed further, I will note for the record that I received a letter from Congresswoman Maloney about 2 weeks ago or thereabouts requesting access to the documents that were produced under seal in the Long Beach litigation. I forwarded those letters, or her letter, to each of the oil companies, my contacts through the years. They got back to me late last week, all of them rejecting the suggestion that the documents be turned over to the committee.

So there is some restriction on what I can talk about in this committee. That is, I will not refer to specific documents that were produced in Long Beach 2 litigation.

The interest of the State in this issue is, under the Federal regulations, money collected by the Federal Government for royalty oil, some of that goes into the State coffers as well. The bases for pricing of the city's crude oil, the State's crude oil, and the royalty oil are the oil companies' posted prices.

In California only three oil companies posted prices throughout the whole of the 1980's. Some others posted for parts of the 1980's. For those who are not terribly familiar with posted prices, they are simply announcements by oil companies that, if they buy crude oil, they will pay so much per barrel, depending on the quality of the crude. They are arbitrary, they are fictitious, they are not the result of negotiations between buyers and sellers.

We have, and this I cannot share with you, but there are admissions in the documents produced from the 1980's that the postings in California were underpriced. There is other evidence of a more public nature to show that the postings are underpriced, and a number of witnesses this morning talked about ANS prices.

I have brought with me a large chart. This was based on information that our experts in the Long Beach litigation for the 1980's came up with.

Mr. Chairman, you asked a few questions this morning about comparing ANS prices with what you described correctly as generally lower quality California crude, and so if I could take just a minute to describe how this chart is generated.

The way it is generated is, you take the ANS price or the spot price in the Los Angeles market. That is the ANS part of it. Then you compare that with comparable California crudes, and there are some, Ventura Avenue, for example, Buena Park Vista. In fact, Ventura is 2 or 3 degrees lighter, that is, more valuable than ANS.

Then you want to figure out what the price of that crude would be if it were brought to Los Angeles. So you need to factor in the transportation to move that crude from the field down to Los Angeles, and that is the basis upon which this chart was done.

That is to say, in 1980, our experts have calculated that the difference between the ANS price in Los Angeles versus a comparable crude on average was about $6 per barrel.

You can also see from the chart that the greatest amount of underpricing per barrel occurred in the early 1980's. The reason that the chart shows that for 1986 there is nothing there is because there was a precipitous decline in prices throughout the world, and our experts tell me that during that year, or most of that year, the price of ANS and the comparable worth of California crudes were about equal.

Throughout the rest of the time period, there is demonstrable evidence of underprices of California crudes.

There are two reasons to think that it is permissible or accurate within the way the oil companies work to compare ANS crude prices in California with the postings. First of all, the oil companies' documents themselves show that they frequently, in evaluating whether to run more ANS through their refineries, and therefore buy more ANS, or, alternatively, to buy more California crude at posted prices.

They compare the values of the two. That is frequently done in a lot of documents.

Second, with regard to the adjustment factor that you need to make between, we call it the average quality of California crude and ANS, oil company practices also were relied upon, and there are two ways of doing is, at least two.

One is—and I think Mr. Berman mentioned it this morning—you can take the quality adjustment on these common carrier pipelines like the Arco or Pena's line, and that pipeline has built in tariffs in a way of adjusting or a price basis for each different quality of crude that might be run in it. So some people are going to put in very-high-quality crudes and get off a stream that is lower-quality, and they have to be compensated for that.

On the other hand, there will be people putting in low-gravity crudes or low-quality crudes, and they will get better quality crude at the end, and they have to pay for that difference. That is something the industry does all the time.

A second way for adjusting for quality of differences is in the posted price table themselves. For any given field—and I think you referred to them this morning—oil companies will often publish a different price for different qualities of crude. It is typically referred to in the oil industry as a technical term, gravity-price differential. That simply means a different price for different qualities of crude within an oil field.

So in short then, there is this ample basis for making the comparison between ANS on the one hand, and the value of California crudes under that test, the value of California crude clearly is underpriced on priced postings.

I am talking, admittedly, as an advocate because this is the methodology we used in the Long Beach case and the task force report, and the testimony today shows there is some dispute about whether that methodology is appropriate either post 1988 or pre 1988, and in a second I will get to that issue. But before I do, I would like to point out that there is other evidence of underpricing.

For example, the Federal Government, the Department of Energy, holds selloffs at Elk Hills on a periodic basis, and throughout the 1980's bonuses were received over posted price. Similarly, the State of California and city of Long Beach have held selloffs over the eighties and every time they get bonused over the posted price.

Then there is an interesting admission, and I have attached it to my presentation here. It is a letter that was written by Texaco in 1984 to the Federal Trade Commission. And at the time, Texaco was acquiring Getty, and the FTC was looking into whether or not there would be some diminution of competition. And through negotiation with Texaco, the FTC demanded that Texaco continue to sell crude to the folks that were receiving crude from Getty. And they said, "You have got to sell it at posted price," and Texaco complained in the last page of this. Referring to this requirement, he says it requires Texaco to sell such former customers of Getty at posted prices which are currently lower than market.

So here you have an instance where a major oil company has an incentive suddenly for higher prices and it goes on public record in 1984 saying they are underprices. You don't often get public admissions by the oil companies in California that their postings are too low.

Now, let me turn to the task force report and make some comments about it. The testimony today was that the members of the task force and Mr. Armstrong and Cynthia Quarterman worked with us, meaning the litigators in the Long Beach case, and our experts, and it is true, and we work very well with them.

I had meetings with all of them at various times and lots of phone calls, requests for information about this and that. And, frankly, I think because they worked with our experts, particularly the ones in Boston, for example, it saved them a lot of time.

The experts in Long Beach have put together a data base for all of the crude oil transactions by the majors throughout the 1990's. Although the task force reports that they looked at two companies for selected years, one of the things I would recommend is, if this process is to go forward, that they use the data base that is already in place so they don't reinvent the wheel here. It would save people a lot of money and also make it much more efficient.

I also commend them for recognizing, as I think they did in the task force, that posted prices do not represent the market value of California crudes. And I also agree with them that the prices that are listed in crude oil exchanges are not set at arm's length, they are not negotiated, they both have incentives that is both part individual incentive for low prices rather than a situation where one wants a higher price and one wants a lower and you end up with a market in between.

I would like to mention—and I don't want to be perceived as an expert, and I am not, for interpreting the regulations for post 1988. I can point out though, based upon experience as we have had in the Long Beach litigation, why the approach that is recommended there; namely, an approach where you look for underpricing based on premium—has a lot of difficulties.

There seems to me three aspects of the regulation that you need to look at. One of them is significant quantities, the second one is same quality of crude, and the third one is same fields. You have to do it on a field-by-field basis. And it seems to me that, well, it should be obvious to everyone at this point, an ANS approach is both economically defensible and is a much more efficient way of determining the amount of undervaluation. The question, though, is whether or not the regulations permit it.

Now, I have two difficulties—I will put it—in applying the regulations to the premia approach. One of them is that there are, as testimony developed today, heated pipelines in California, and a lot of the premia are premia that occur at the end of a heated pipeline. And I don't know how, in theory, even you can trace back the premia at the end of a pipeline to the crude oil fields from which the crude came from that purportedly was sold at a bonus.

It is kind of like a scrambled egg situation. You take 12 eggs, throw them in a bowl, mix them up, make scrambled eggs, take a portion of it, the cooked one, sell it for $5, and then try to trace that piece of egg back and egg shell. I don't know in theory how that could be done.

There is a second tracing problem which the task force report itself identifies, which is that the oil companies have set up affiliated companies in which the company that pays the royalty is not the one who sells the crude at a bonus. That is to say, let's say Texaco or any—let me not use a specific company. But a company pays royalty, sells the crude that it gets from the Federal Government to an affiliated company at posted price; then the affiliated company sells the crude to the public at a bonus.

Now what the task force report says is that the accounting documents of the oil companies do not permit the task force to be able to trace the royalty crude through the accounting process to determine which crude got the bonus.

So that is a second—and I will call that the accounting tracing problem as opposed to the pipeline kind of problem, tracing problem.

I am not saying that I'm the expert at the regulations, but I see that as both of them as problems in applying the premia to the regulations, and, as Mr. Spear pointed out today, once you get through these regulations based upon significant quantities, you can use—that is, if none of them apply, it is appropriate under the present regulations to apply an ANS approach.

Let me address briefly the pipeline issue, because that was raised today. To my knowledge, there is only one heated pipeline coming out of the San Joaquin Valley to Los Angeles, and that is the pipeline identified as the M–70 of Mobil. That goes through the Angeles National Forest, and we know that—and I have seen the documents—that the Mobil Co. received an MLA permit, it is called, a Mineral Leasing Act permit, in order to pass through Federal lands. That permit requires Mobil to dedicate its pipeline as a common carrier.

In fact, Mobil does not dedicate its pipeline as a common carrier, and crude oil producers in the San Joaquin Valley must sell their crude at the price Mobil sets for its crude oil, and that price is posted price.

The common carrier requirement has not been, up until now, required of Mobil by the Federal Government, and Mobil has been content to interpret the regulation as requiring only that they must purchase indiscriminately from all producers up there. That is to say, they can't pay one producer more than another. That is how Mobil interprets the regulation. I think it is incompatible with the statute, and I wish the Federal Government would move on this.

What I would see happening is that the benefit directly is to the independent producer who must sell presently its heavy crude oil to Mobil to get to market.

But I think that overall the effect of loosening up that pipeline would be to increase prices generally in California because there would be a bidding war. You know, other people could—the independent producer could move its crude down into Los Angeles Basin, where there are lots of refineries, and get a competitive price for its crude oil.

Some other suggestions I would have for the future. When I looked at the suggestions in the task force report about changing the pricing regulations, it seemed to me there was something missing that was very important. The proposed changes seemed, in my mind, to be a little better than trying to make a better quill pen.

That is to say, you are trying to make better something that should be thrown out altogether. Why worry about defining significant quantities when that concept is appropriate only if you are going to use posted prices? The better thing to do is to use a marker crude, if you will, in various markets in the United States to price crude from. In California, that would be the price of ANS, in Los Angeles. In the gulf area, it would be west Texas intermediate crude for Cushing, OK, for which, as testimony showed today, there are lots of transactions that take place and are reported publicly every day on the NYMEX, New York Mercantile Exchange.

In fact, one of the oil companies published in one of the trade journals in, I think it was 1992, was quoted as saying the appropriate posted price in Texas should be the price of crude on the NYMEX less transportation costs to get it from the field to Cushing, OK. That is to say, at least one company has gone on record to saying this would be an appropriate way to value crude oil.

So I think—and if I may refer you to other documents, there was—Ms. Quarterman today mentioned that there was a Federal Register announcement in December of last year calling for comments on pricing regulations, and the city of Long Beach sent in its suggested changes on March 19, and also the Western States Lands Commissioners, which represent lots of different western States that have crude oil interests, also submitted a lengthy proposal for pricing and how we could get rid of posted prices and what basis you would want to use. We could provide copies of these things to the committee as possibilities.

Another thing that I think the task force or Mineral Management Service should watch for: There was a proposal in the task force to send a letter out to the oil companies asking them to provide information about arm's length transactions.

The problem that the task force or the MMS will run into—because we have had experience with this—is that often bonuses are hidden in the transactions, and the oil companies will swear that there are no bonuses there when there clearly are. I will give you an instance of that—I will give you a couple of instances.

There are some transactions in which there are exaggerated gathering, handling, and transportation costs, and some of the internal documents of the oil companies will say that is a bonus, but it won't appear as a bonus on the face of the contract.

A second instance of these hidden bonuses: Just free transportation. That is the complete absence of anything in the contract that would indicate there is a bonus. If the crude oil, instead of being delivered in the field, is delivered at a refinery gate and there is no transportation cost included in the contract, then the contract has that hidden bonus; namely, the value of the transportation cost from field to refinery.

What that means is, I think, is that you can't cut corners in looking for information from the oil companies. In my mind, the only way to do it is to ask for all the transactions and let someone else do the review to determine what the true value of the transactions is in each case.

One final point—and it is a small one, I guess—is that I think there is unmistakable evidence that the question of underpricing exists not only in California now but has at least for the last 3 years existed in the gulf coast area. When I say gulf coast, I mean States like Texas, Oklahoma, New Mexico, all in that area.

I can report that the State of New Mexico received a few million dollars from one of the oil companies in September of last year when it confronted the oil company with, "Why are we getting posted price when the true value is something higher?"

There are lawsuits that have been filed in Texas, Oklahoma, that whole area. Filing a lawsuit is easy, and I wouldn't rely on that as evidence alone, but there are objective indicators of below-market activity. No. 1 is the NYMEX itself. There are millions of barrels traded day by day on that exchange. It is not limited to oil companies. It has speculators; it has everybody on that. That is publicly reported on a daily basis. When you compare that price with the postings in Texas, you find it is always above the postings. Even when you adjust for transportation and get it to the curb.

Also the P-plus market, as it was mentioned, bonuses are so frequent in the gulf area. Bonuses are reported as a market in the trade publications on a daily basis.

And the third point is the so-called spot market. Spot market is a 30-day kind of market where you buy crude in small volumes. That is reported publicly in the gulf area. That market coincides almost identically with the NYMEX market, and both of those markets are always above posted prices.

One final point about the gulf is that since about 1992, posted prices by the various oil companies in the gulf area no longer agree with one another, so you have significant differences in postings in the same field by different companies, and the difference continues over years.

Exxon, for example, typically posts very high, at least in the west Texas intermediate fields. Coch, for example, C–O–C–H, typically posts low. Those postings remain disparate over a few years.

I am not an economist, but I don't understand any theory about which crude in the same field could have different postings, and someone in the Federal Government ought to say what is going on there. We can't—it looks completely arbitrary as to which posting the Federal royalty oil is priced against.

Anyway, that completes my prepared comments, if you have any questions.

[The prepared statement of Mr. McMahon follows:]

Testimony of
M. Brian McMahon
Attorney for the City of Long Beach
as Trustee for the State of California

Before the

Government Management,
Information and Technology Subcommittee,
Government Reform and Oversight Committee
House of Representatives

June 17, 1996

Mr. Chairman and members of the Subcommittee, I appreciate the opportunity to appear today to present testimony on money owed to the federal government by oil companies for federal royalty oil produced on and off shore of the State of California. I am an attorney of the law firm of Hoecker & McMahon, located in Los Angeles, representing the City of Long Beach which is trustee for the State of California with regard to crude oil produced in the Wilmington Oil Field. I am accompanied by Robert Shannon, Assistant City Attorney for the City of Long Beach, and James McCabe, Deputy City Attorney for the City of Long Beach.

I would like to take this opportunity to commend Robert Armstrong, Assistant Secretary for Land and Minerals Management, and his staff as well as Cynthia L. Quarterman, Director of the Mineral Management Service, and her staff, especially David Hubbard and Peter Christnacht as well as the other members of the Interagency Task Force investigating the issue of the valuation of crude oil produced from federal leases in the State of California. Secretary Armstrong has taken the time to meet with representatives of the State and the City of Long Beach including myself and Deputy

City Attorney James McCabe and has on numerous occasions discussed by phone issues relating to the valuation of federal royalty oil produced in California. We have had a number of meetings with the members of the Task Force as well as countless phone conversations reflecting their commitment to get to the bottom of the crude oil valuation issues in the State of California. These contacts have been very amicable, professional and have demonstrated a great deal of effort by members of the Task Force and MMS in studying and seeking a resolution of this issue.

I am here to commend the work of the Interagency Task Force which investigated and reported on underpayments for federal royalty oil in California, to give corroborative testimony to the Task Force Report and to offer some suggestions for follow up to the Report. The federal government and the State of California have been underpaid hundreds of millions of dollars by the oil companies for millions of barrels of federal and state crude oil.

History of the Long Beach Litigation

I and my firm have represented the City of Long Beach in two lawsuits against the major oil companies in California alleging that prices paid for the City's crude oil have been underpriced by major oil companies. The Long Beach I case was filed in 1975 and concerned underpricing during the 1970's. Long Beach II was filed in 1986 and concerns underpricing during the 1980's. The defendants in these lawsuits were Texaco, Exxon, Unocal, Mobil, Shell, Chevron and, in Long Beach I, Arco. Six of the oil companies have settled and have paid approximately $320 million.

Most of the money collected from the oil companies in these settlements went for higher education in the State of California.

The State has a vital interest in efforts by the Mineral Management Service (MMS) of the Department of Interior to obtain the market value of crude produced by the oil companies on federal lands. The State of California shares in the money collected by MMS for royalty crude oil. By statute, California receives 50 percent of the money received by the federal government for on-shore production and 27½ percent of the money received by the federal government for off-shore production. The federal government has been underpaid hundreds of millions of dollars by the major oil companies since 1980 and the State of California's share of that amount is tens of millions of dollars.

I must note that the oil companies have refused permission for me to provide documents to this Subcommittee which corroborated the Report of the Interagency Task Force regarding underpricing of crude oil in California. I received a request from Congresswoman Maloney for access to the documents produced in the Long Beach II litigation and relied on by the Interagency Task Force in writing its report and reaching its conclusions. The documents were produced to Long Beach pursuant to confidentiality agreements. The oil companies refused my request to make those documents available to the Committee but have insisted that the Committee subpoena the documents. The purported reason for the confidentiality protection was to prevent sensitive business information from being released to their competitors. They have not attempted to explain in their recent refusal to permit Congressional access to these documents how documents, many of which are older than a decade and all of which are at least seven years old, contain information which is still sensitive to their competitors. I urge this Subcommittee to subpoena the documents and to hold a subsequent hearing when it has access to the documents.

Underpricing of California Crude Oil

The oil companies paid for federal royalty oil on the basis of their posted prices. Posted prices are public announcements by oil companies as to how much money they will pay for crude oil. Posted prices in California are arbitrary, fictitious and not negotiated between buyers and sellers. Only three oil companies posted prices in California throughout the 1980's. A few other oil companies posted prices for only a few years during the decade. Currently there are only six companies that have posted prices in the State of California. Posted prices are used by all oil companies, whether or not they post prices, to value federal royalty oil.

The major oil companies are willing to buy crude at their posted prices, but they are unwilling to sell crude on the basis of their posted prices. Independent refiners in California are rarely able to buy California crudes at posted prices.

There is overwhelming evidence that posted prices in California are below market value. Evidence for this includes the following:

- Alaska North Slope Crude Oil (ANS) is sold in California at prices which are, with the exception of 1986, higher than the posted prices of comparable California crude oils. Documents produced in the Long Beach litigation, which I am presently not permitted by the oil companies to release to the Subcommittee, support the use of ANS prices to value California crude oil.
- Sell-offs of federal, state and Long Beach crude oil have generated successful bids above posted prices.
- Sales of Wilmington crude oil by Arco in recent years have generated prices in excess of posted prices.
- As noted in the Report of the Interagency Task Force, major oil companies have, from time to time, paid crude oil producers bonuses over posted prices for California crude oil.
- Throughout the period, independent (small) refiners in California have been unable to purchase California crude oil at posted price and have been forced to pay premiums. These refiners have complained about their inability to obtain California crudes at posted prices.

- Studies by the Federal Trade Commission and the Department of Energy demonstrate that California postings were underpriced.
- Documents produced to the City of Long Beach in the Long Beach litigation further demonstrate that the California posted prices are underpriced.
- In a written submission to the FTC in connection with its purchase of Getty Oil Company in 1984, Texaco admitted that the posted prices in California were lower than market value (see Exhibit II).
- California crudes are much more profitable than other crudes processed in the oil companies' California refineries. Moreover, California refineries have historically been more profitable than refineries located elsewhere in the United States.

The oil companies have had the market power and a strong financial incentive to keep crude oil posted prices artificially low. From 1980 to the present, most of the oil companies purchased more California crudes than they sold. Additionally, from time to time <u>all</u> of the major oil companies purchased more California crude than they sold. They thus had an incentive to maintain low crude oil posted prices. They also had the power to ensure that the prices they paid for California crude oil remained artificially low. Throughout most of the period between 1980 to the present, California crude oil pipelines were privately owned (as opposed to "common carrier"), and pipeline owners insisted that independent producers of crude oil sell their crude oil to the pipeline owners as a condition for access to the transportation system in California. If crude oil producers wanted to market their crude, the only economically effective means of doing so was to have their crude oil moved through pipelines. Not surprisingly, pipelines were owned by major oil companies and the major oil companies forced independent producers of crude oil to sell their oil to the companies at the companies' posted prices.

Comments on the Report of the Interagency Task Force

We have assisted the Interagency Task Force in its study of the California crude oil market. The Task Force did commendable work and there is much to recommend it. We agree fully with the results of the Task Force that federal royalty oil has been underpriced, because it has been valued at the California posted prices. We agree that the evidence relied on by the Task Force and provided to them by us demonstrates clearly and convincingly that:

- ANS crude oil prices in California were a proper measurement of the value of federal royalty oil, and
- That the oil companies -- even while paying for their federal royalty oil on the basis of posted prices -- were at the same time paying bonuses for some California crudes.

- The prices of crude oil in the oil companies' exchanges and buy/sells are not the result of arms-length negotiations.
- Very little crude oil in California is sold by oil companies at posted prices.

The report of the Interagency Task Force describes several methodologies for valuing federal royalty oil. We believe that the methodology based on ANS crude prices in California is far superior to the other methodologies described in the Report for a number of reasons. From the period 1980 through the present, ANS crude oil equaled 35% to 45% of the crude oil processed in California refineries. There is therefore a significant amount of ANS processed in California refineries. Oil companies in California pay considerably more money for ANS in California than they do for comparable California crude oils. Major oil company documents produced to the City of Long Beach show that the oil companies value California crudes by comparing their value to the price of ANS sold in California. The oil companies agree that the price of ANS sold in California is a valid indicator of the market value of California crude oil. There is no difference in quality between ANS and some of the federal royalty crudes. ANS competes directly with federal crude oil in the California market and yet it has been priced considerably higher for years and years. In contrast to California crudes, ANS is sold in California by a major oil company, British Petroleum among others. British Petroleum and other sellers of ANS have been able to obtain a much higher price for their ANS crude sold in California than the federal government has for its California royalty crude oil. Exhibit 1 attached to my testimony illustrates the amount of underpricing of California crude oil using the price of ANS as the benchmark for establishing the market value of California crude oil. The ANS methodology has the added benefit of ease of application. The value of ANS sold in California can be obtained from readily available sources.

The remaining issue is whether the ANS methodology is consistent with MMS' valuation regulations or whether the methodology described in the Task Force Report which is based upon premiums paid in California must be used. Premiums paid for California crude, although preferable to posted prices, still do not represent the true market price for California crudes. Due to their market power, the major oil companies were able to procure supplies of crude oil at prices that are far below market value. Thus, even when they paid premiums for crude oil, the oil companies, because of their market power, paid less than the market value of California crudes.

The Pre-1988 MMS Valuation Regulations

Section 206.103 of the pre-1988 regulations provides that the value of production for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the associate director. Section 206.103 permits the associate director to look to "relevant matters" in determining the value of crude oil production. This language is broad enough to include the ANS valuation methodology.

The 1988 MMS Valuation Regulations

In the 1988 regulations, crude production is valued for royalty purposes pursuant to 30 C.F.R. § 206.102 which distinguishes between crude oil which is sold pursuant to an arms-length contract, § 206.102 (b)(1), and crude oil which is not sold pursuant to an arms-length contract, § 206.102(c).

The provisions of § 206.102(c) are to be applied in accordance with the first applicable subparagraphs which follow. The first two subparagraphs reference posted prices "used in arm's-length transactions for purchases or sales of significant quantities of like-quality in the same field..." (or the same area). For reasons discussed in the Report of the Task Force, only a small fraction of California crude oil is sold outright in arms-length transactions, and most of that is at prices above posting. Therefore, the first two subparagraphs of § 206.103 are not applicable.

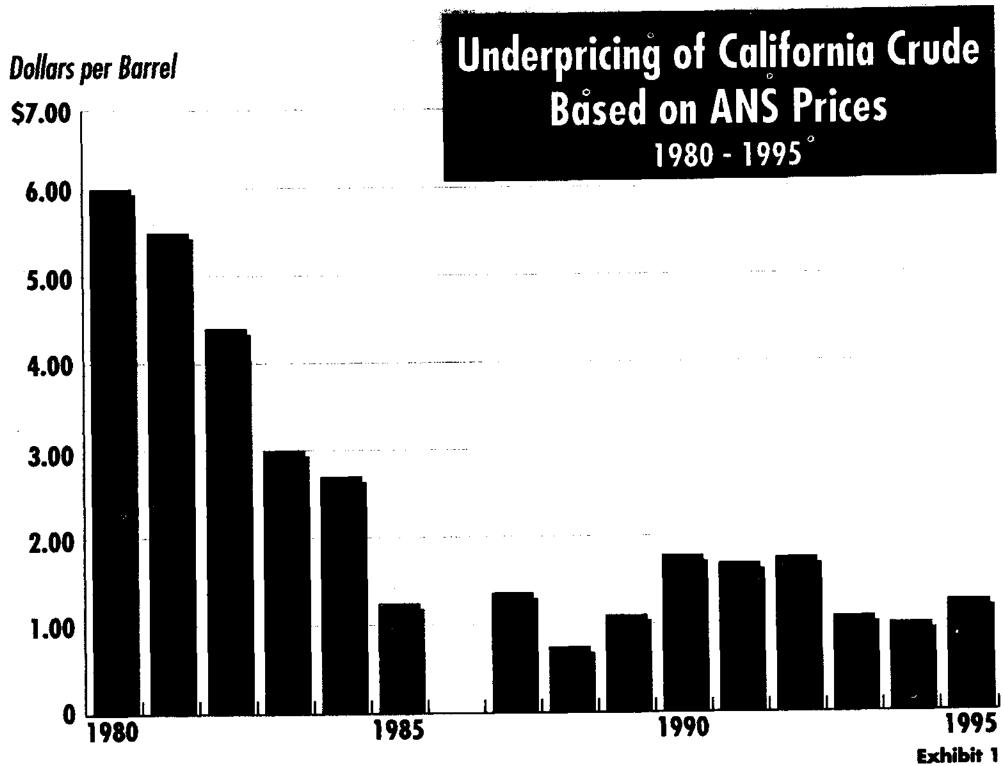
The Task Force Report recommends using prices obtained from arms-length transactions and not the ANS methodology for valuing federal royalty oil. An issue arising from the recommendation of the Task Force Report is to determine whether there are "significant quantities" of arms-length transactions on a field-by-field or area-by-area basis as required under Section 206.103(c)(3) and (4).

The Task Force Report noted that there are only a relatively small number of outright purchases and sales. Moreover, a number of these premiums were paid for crudes at the terminus of crude oil pipelines and at refineries. Such crude oil is a mixture of crudes from a number of crude oil fields and it is very difficult, if not impossible, to trace the crude oil mixtures sold at premiums to specific crude oil fields. A question remains as to whether "significant quantities" of arms-length transactions can be established or whether valuation must be based on the "any other reasonable method to determine value" method of § 206.102(c)(5); i.e., the ANS methodology.

A final issue I want to address is the need identified in the Task Force Report for a revision of the royalty pricing regulations. MMS published an advance Notice of Proposed Rulemaking in the Federal Register on December 20, 1995 (60 Fed.Reg. 65610) requesting public comment on their crude oil valuation regulations. Comments were received from a number of sources on March 19, 1996. Unfortunately, the oil companies did not respond in writing with concrete comments on the valuation regulations. Instead, they urged MMS not to change the current regulations because the oil companies are presently engaged in litigation over crude oil pricing throughout the country. This suggestion by the oil companies is intolerable. The City of Long Beach as trustee for the State of California has been in litigation against the major oil companies for over 20 years and new litigation in the Gulf Coast states against major oil companies can be expected to take five, six or even more years. Surely the process of revising the pricing regulations so as to clarify the basis of valuation of federal royalty oil should and must go on at the present time.

Mr. Chairman, this concludes my prepared remarks. I would be pleased to answer questions you or Members of the Subcommittee may have.

MBM:tb


Underpricing of California Crude
Based on ANS Prices
1980 - 1995
Dollars per Barrel
$7.00
6.00
5.00
4.00
3.00
2.00
1.00
0
1980
1985
1990
1995
Exhibit 1

MAY 7 1984
SECRETARY

TEXACO/GETTY ACQUISITION
File No. 841-0077

Federal Trade Commission/S
Office of the Secretary
Washington, D.C. 20580

Dear Sir or Madam:

These comments are respectfully submitted some 80 days after the Commission provisionally approved the Consent Order negotiated between the Bureau of Competition and Texaco, and as the 60-day period for public comment is ending. Mindful of the heavy burdens upon the Commission, we will attempt to be brief and to the point.

1. Although the Commission has received numerous Comments, perhaps most significant is what has not been received. To our knowledge, there has been an extraordinary dearth of adverse comment from competitors 1/ -- i.e., those who would be most sensitive and alert to any remote, potential anticompetitive consequences that conceivably could flow from the merger, and most zealous in guarding against them. No competitor asserts it will be unable to compete with Texaco after the merger. Indeed, no competing explorer, producer, refiner, transporter or marketer

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1/ The exception is Pennzoil (Comment 125) which concededly sought to control Getty and has its own axe to grind. It purports to see possible competitive concerns not in any market where Pennzoil does business but among California refiners. Pennzoil chose to litigate these and other claims of anticompetitive effects in the United States District Court in Tulsa, Oklahoma. Pennzoil Co. v. Texaco Inc., 1984-1 Trade Cas.(CCH) ¶65,848 (N.D.Okla. Feb. 8, 1984); and before the Court of Appeals for the Tenth Circuit, with singular lack of success, Pennzoil Co. v. Texaco Inc., No.84-1169 (10th Cir. Feb. 9, 1984).

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claims the merger will cause any diminution in the vigor of competition in exploration, production, refining, transportation (crude or product) or marketing. 2/ The absence of such claims by competitors throughout the lengthy comment period underscores the validity of the Commission's conclusion that this is not a merger that should be prohibited under the antitrust laws.

2. Given the Bureau of Competition's considerable experience in the petroleum industry, the vast quantities of documents it called for and reviewed during the Hart-Scott-Rodino period and the "no stone unturned" nature of the investigation it conducted, not surprisingly none of the comments raise new competitive considerations beyond the four specific areas of potential concern dealt with by the Consent Order, to wit:

a. The supply of refined light products in the Northeastern States;
b. The wholesale distribution of gasoline and middle distillates in the Northeast;
c. Pipeline transportation of refined light product into Colorado; and
d. The sale, transportation and refining of California heavy crude oil.

2/ Putting aside the emergence of foreign governments as major factors in the energy world and focusing merely on the United States, competition still has been so intense and dynamic (e.g., the company now ranking second in crude production and first in reserves was not even among the top 20 in production in 1975) that by virtually every measure the combined shares of Texaco and Getty are now less than the percentage of the market Texaco alone enjoyed in 1975.

U.S. Market Share Percentages

	1982 Texaco	1982 Getty	1982 Combined	1975 Texaco Alone
U.S.Crude Production	3.5	2.7	6.2	6.7
U.S.Natural Gas Production	3.9	1.8	5.7	6.8
U.S.Crude Reserves	3.0	3.5	6.5	7.3
U.S.Natural Gas Reserves	3.1	1.2	4.3	6.8
U.S.Refinery Capacity	4.9	1.7	6.6	6.5
U.S. Interstate Pipeline Ownership	4.1	0.5	4.6	7.5
U.S.Motor Gasoline Sales	5.6	1.1	6.7	7.9
U.S.Energy Producing Co.'s (BTU Basis)	2.2	1.7	3.9	4.5

Source: Market Shares and Individual Company Data for U.S. Energy Markets: 1950-1982 (API, Nov. 1983).

Exhibit 2

a. Again, none of the Comments deal with whether the Colorado Pipeline problem is of serious competitive concern or with whether a provision such as Paragraph IV in respect to Colonial might be adequate relief here. No Comment contends that any anticompetitive consequence would flow from Texaco's operation of the El Dorado refinery. 3/ Instead, Comments focus on potential problems that might follow the divestiture of the El Dorado refinery and the other transportation and marketing properties. Indeed, customers, public officials and others contend that it would be competitively preferable for Texaco to operate the El Dorado system than for it to be sold.

b. Although divestiture of the Kansas refinery admittedly is at least one step removed from the Colorado pipeline problem which is its justification, if the Commission still wishes Texaco to do so, Texaco will fully comply with all of the divestiture obligations to which it committed itself, as specified in Schedule A(2). Again, however, it would be utterly inappropriate and unfair for the Government to attempt to add further onerous burdens on Texaco in connection with such divestitures and to mandate long-term supply guarantees.

c. The acquirers of divested properties surely will not be investing millions of dollars to close down operations and lose their investment. They are likely to appreciate the potential and be ready, willing and able to give the business the type of support and commitment needed to realize that potential. The management of an acquirer will have to be satisfied it can do this; its board and possibly its bankers will have to be satisfied and, more, the Commission will have to be satisfied. Whether an acquirer will want more or fewer assets or will want or not want to negotiate for some form of supply arrangement with Texaco or with other companies, will depend, of course, upon the acquirer. Since so much will depend upon the

3/ Texaco has no refinery in Kansas or in any contiguous state. Outside of Texas, its only refinery in any of the 15 states is in Lawrenceville, Illinois. Getty's only refinery in any of the 15 states is that in El Dorado.

> speculative at best, it would be highly unfair and inappropriate for any additional burdens to be imposed upon Texaco in connection with the divestiture of the Eagle Point refinery, including such Draconian proposals as requiring it to guarantee a crude supply to the purchaser or to suffer an inability to integrate Getty's operations pending such divestiture. The proponents of such suggestions appear to have overlooked the fact that the Commission promised that "unless the Commission determines to reject the Consent Order, it will not seek further relief from Texaco with respect to the Acquisition, except that specifically provided for in the Consent Order." (Hold Separate Agreement 4).

4. With respect to the divestiture of Getty's marketing properties in the Northeast pursuant to Paragraph II, Schedule A(1), the comments relate primarily to a matter not before the Commission at this time: whether Power Test, an independent gasoline marketer, should be approved by the Commission as the proposed acquirer of such properties. The Analysis explains (8559) that before Power Test can be approved there will have to be a separate Commission determination of its qualifications following a review of written comments submitted by interested persons during a separate 30-day Public Comment period. Because of this built-in and unavoidable delay factor, and because delay and uncertainty are obviously difficult for and potentially harmful to all concerned, Texaco respectfully submits that the Commission should schedule the 30-day Public Comment period as soon as feasible.

5. Because of a potential competitive concern in relation to Texaco's 40% ownership interest in one (Wyco Pipeline), and Getty's 50% ownership interest in another light product pipeline into Colorado (Chase Pipeline), the Consent Order requires divestiture of Getty's El Dorado, Kansas refinery and related properties in 15 States, Paragraph II, Schedule A(2). The Analysis forthrightly acknowledges:

> "It should be noted that Schedule A(2) of the proposed consent order <u>requires a much broader divestiture than is required to remedy the competitive problem</u> resulting from Texaco's increased ownership share of petroleum-product pipelines in Colorado. Divestiture of these related assets, including the marketing and refining assets connected to the pipeline, <u>appears</u> necessary to assure that a viable competitive entity can be divested." (8561; emphasis added).

Exhibit 2

3. As to the supply of refined light products in the Northeast, the perceived antitrust concern admittedly is not an immediate one (with refineries and Colonial Pipeline now operating below capacity). Even as to the future, it is somewhat conjectural and dependent upon the postulate that certain owners of Colonial might possibly join together for anticompetitive purposes. Thus, the "Analysis of Proposed Consent Order to Aid Public Comment" ("Analysis"), takes two cases:

> "(1) If we . . . include all refined light products that are supplied to the Northeast by each company -- Northeast refinery output, Colonial shipments, tankers from the Gulf Coast, and imports -- the Acquisition results in a change in the HHI of only 60 points, with a post-acquisition HHI of 634; (2) if we assume that certain Colonial owners with Northeast refining capacity, including Texaco, could operate Colonial and their Northeast refining capacity to maximize joint profits and that they could form a voting coalition to block an expansion or possibly raise the tariffs of Colonial, the coalition could increase its control over refining capacity through Texaco's acquisition of the Getty refinery, resulting in an increase in the HHI of 522 points and a post-acquisition HHI of 3011." (8560; emphasis added).

The potential competitive problem rests on the second case "coalition" hypothesis. On that basis, two forms of relief are included in the Consent Order. Paragraph IV requires Texaco, for 10 years, to vote for every expansion north of Dorsey Junction, Maryland, proposed by any other owner of the Colonial Pipeline. In addition, Paragraph II and Schedule A, require the divestiture of Texaco's Eagle Point refinery.

a. None of the Comments deal with the issue of whether this "potential competitive problem" is truly a realistic one, nor do any touch on whether the Paragraph IV relief might not be sufficient, particularly given the hypothetical nature of the competitive concern. Instead, they focus entirely upon the divestiture of the Eagle Point refinery and the problems of assuring its post-divestiture viability for purposes of local employment and otherwise.

b. Unless the Commission determines that the Paragraph IV relief is sufficient and that divestiture of this refinery is not competitively required or in the public interest, Texaco will fully honor its commitment to pursue its divestiture. Since the relief appears redundant and the "potential competitive problem" is

Exhibit 2

acquirer, 4/ and since the approval process is a cumbersome one, it is desirable that the process begin forthwith once the Commission finally determines that the divestitures are needed.

d. Alternatively, given the urgent concerns of public officials and citizens about the consequences of a divestiture of the El Dorado refinery (and given the lack of any antitrust ground compelling such divestiture), Texaco is willing to keep and operate the El Dorado refinery and the related properties described in Schedule A (2) and to agree to other relief to resolve the Colorado pipelines problem. If the Commission concludes pipeline voting restrictions might prove insufficient by themselves, Texaco would agree to dispose of some or all of its 40% interest in the Wyco Pipeline or some or all of the 50% Getty interest on the Chase Pipeline, and would do so either now or at any time over the next 10 years that the Commission perceives any need for Texaco to do so. Also, should the Commission believe there might be a competitive problem were Texaco to retain all of Getty's wholesale marketing assets and service stations in Colorado and/or Oklahoma, Texaco would sell whatever such assets the FTC requires.

6. The Consent Order's Getty California produced crude relief provisions (Paragraph V, Schedule B) are premised, as the Analysis explains, on the possibility that: "As a result of the Acquisition, Texaco may have some incentives to divert the Getty [California] heavy crude oil to its own refinery system". (8562; emphasis added) Since Getty and Texaco each have only a rather small refinery in California, 5/ any such diversion "to

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4/ See attached copy of my letter dated April 27, 1984 to Mr. Schildkraut on the availability of crude oil in Kansas. Since under the present Consent Order Texaco is required to sell the El Dorado system, it has made the following commitment, which we request be included in the Consent Order with respect to supplying crude oil to the El Dorado refinery:

> "Texaco is committed to being the 'crude oil supplier of last resort' and will negotiate with the purchaser for the sale of crude oil on commercial terms in the extremely remote and unforeseeable event that Texaco, or a subsequent trustee, cannot sell the refinery because a prospective purchaser is unable to physically acquire crude oil supplies for the refinery."

5/ The Getty refinery (50,000 BCD capacity) accounts for only about 2% of California refinery capacity and the Texaco refinery (75,000 BCD capacity) for 3%. (Oil and Gas Journal, March 26, 1984, pp. 113-14).

[Texaco's] own refinery system" in that State would be relatively minimal. 6/ Accordingly, to find the possibility of any meaningful diversion, the Analysis first includes Texaco's 78,000 BCD refinery in Anacortes, Washington, and then speculates that Texaco may some day acquire other refineries from unspecified independent refiners in California. Thus, the Analysis states:

> "Getty's [California] crude oil production is about 100 MBD in excess of the operating capacity of its one small refinery in California. Texaco, on the other hand, refines more crude than it produces on the West Coast, with production of only 33 MBD in California, compared to about 153 MBD in refining capacity in California and Washington. (8561; emphasis added)
>
> * * *
>
> "Certain non-integrated California refiners might be vulnerable if Texaco should decide to utilize Getty heavy crude oil in this manner [i.e., diverting it to Texaco's own refining system]. * * * If these refineries were to fail and Texaco were to acquire them in order to process additional heavy crude oil, the West Coast refining HHI would increase by 74 points to 1206" (8562; emphasis added)

a. Respectfully, neither speculation is warranted and thus no factual basis exists for any California competitive concern.

(1) Texaco's Washington refinery is not designed to handle California heavy crude oil; 7/ Texaco has never refined any California heavy crude there; and it would not be economic to transport California heavy crude there for processing even if the Washington refinery were converted to run such crude. Hence, the concern that Texaco would divert Getty's California heavy crude to Washington simply is not a reasonable one.

6/ Over 45% of the crude being run at Texaco's California refinery (33,000 BPD out of 71,000 BPD) comes from Texaco's own California production; about 28% consists of Alaskan North Slope crude (app. 20,000 BPD); about 11% comes from Elk Hills (8100 BPD) and the balance of about 10,000 BPD consists of various Los Angeles Basin crudes.

7/ Of the approximately 75,000 BCD of crude oil being refined there, about 65,000 is Alaskan North Slope and about 10,000 is Canadian.

Exhibit 2

(2) Even assuming arguendo that Texaco were to move 78 MBD of such crude to Washington and that this were to have an adverse impact on some non-integrated refiners, surely it would still be premature to guess now whether Texaco would then want to acquire any of such refineries (let alone all of them) and would then be able to do so.

Focusing on the present Acquisition rather than on what might happen if some other future acquisitions take place, leaves no ground for claiming antitrust violation. 8/

b. Although justification for the California relief is tenuous at best, Texaco is committed to abide by the Consent Order's provisions and will do so. Again, any attempt to

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8/ Texaco's customers for California crude oil have included independent non-integrated refiners for well over the past quarter century, including in 1983 sales and exchanges with the following:

Company	Barrels Delivered Exchanges	Barrels Delivered Sales
Alliance Oil	116,000.00	
Beacon Oil	321,744.60	557.45
Caljet Crude Oil	58,500.00	
Century Resources	718,446.54	
Champlin Petroleum	1,743,733.74	
Clark Oil		87,873.21
Crysen Trading	148,910.00	799,722.03
Huntway Refining	13,044.07	
Kern Oil	1,012,473.40	103,551.49
Koch Oil	129,861.00	
MacMillan Oil	108,177.14	42,378.50
Meek Oil	63,000.00	
Newhall Refining	511,319.66	
Powerine Oil	1,007,015.00	180,000.00
Tosco Corp.	1,166,796.52	77,707.38
U.S. Oil	140,251.20	121,485.73
U.S.A. Petroleum	1,554,713.27	
Witco Chemical	201,533.07	
Total Barrels	9,015,549.21	1,414,275.79

Exhibit 2

expand such relief and make it more onerous to Texaco would be entirely inappropriate and unfair. 9/

7. Finally, Comments were received 10/ urging the Commission to depart from the terms of the Consent Order requiring Texaco to hold separate Getty's oil and gas assets (other than those on Schedule A) for no more than a maximum of 120 days from publication of the Consent Order in the Federal Register, a commitment upon which Texaco relied in investing more than ten billion dollars. This provision -- and the entire Consent Order -- was the result of intense negotiations between Texaco and the FTC staff. Entirely apart from the unfairness to Texaco which such a turnabout would entail, any additional hold separate period would be artificial and wasteful. It causes unnecessary duplications of management and facilities. But more important, instead of the economy benefitting from the sharing of knowledge, ideas and experience among the personnel of these companies, there is a forced inability to communicate. The opportunities missed may never be known. Furthermore, the public interest is advanced when the management of a business is vigorous, cost conscious and innovative. Texaco is dedicated to these principles. However, one can hardly expect them to be the hallmark of operations assigned to the uncertain limbo of a hold separate period. Finally, and we submit most important, is the human factor. To sentence the Getty employees and their families to further prolonged uncertainty about their future would be cruel. Far from extending the hold separate period, it is respectfully submitted that the public interest warrants its being terminated promptly.

Respectfully yours,

William C. Weitzel Jr.

9/ Indeed, the Commission may wish to consider whether the relief is not already too broad. Thus, while Getty was free to sell to the highest bidders on the best terms it could obtain in the market place, the Consent Order, Paragraph V, Schedule B, requires Texaco to sell such former customers of Getty at posted prices which are currently lower than market. A Comment from a refiner who did not purchase from Getty contends this will adversely affect its ability to compete with those refiners who will enjoy below market prices under the Consent Order. (Comment No. 121) Texaco is not in a position to evaluate the seriousness of this complaint. The Commission may well conclude that just as Getty has had pricing freedom, subject only to market forces, the same should prevail for Texaco as well.

10/ Necessarily these comments are prepared before all the comments are publicly available.

Exhibit 2

Mr. HORN. That was very helpful.

Let me just go through a few areas. We have 10 minutes on a side here. I think we are going to take a long time. You will make your plane, however.

In a sense, what you are—what is an interesting analogy here, and I might be off base, but the Davis-Bacon Act of 1931 talks about a prevailing wage in an area which ought to be paid employees on Federal contracts. In a sense, we are trying to find what is the key to the prevailing rate or value per barrel in an area.

Now, you say the ANS would be the benchmark for California, and you have the Texas benchmark—intermediate crude. So can you find one that seems to be averaging out over time as the bellwether or something of the market? Is that easy to find?

Mr. MCMAHON. Easy to find, and I might add, by the way, that the international crudes are never posted—never based on postings, and in fact Saudi crude is tied into the NYMEX market. That is, they base their prices on NYMEX. So the Saudis are ahead of the United States Government in that respect, trying to find an objective standard to price their crude in the international market.

The State of Alaska does the same thing in a little bit different way. They have what you might call a basket of crudes approach. They take a number of the market value of the crude, and they kind of mix them up on a month-to-month basis. They determine what the market value is.

Mr. HORN. Have you or others done a long-term study of posted rate versus what actually happened in the market over a long period of time where the market exists?

Mr. MCMAHON. We did certainly on this scale here.

Mr. HORN. That is based on that?

Mr. MCMAHON. That is correct. But in Texas, no, I have not done that kind of long-term study.

Mr. HORN. That Exxon case, they went to court, and they won.

Mr. MCMAHON. That is right.

Mr. HORN. What do you think the factors are why they won and why everybody else paid up?

Mr. MCMAHON. The issue in that case—and I think Ms. Quarterman was asked that question, and she didn't quite get it right. This was solely an antitrust case. It was not an underpricing full stock case. That is to say, it is a fully consistent inability to prove a conspiracy of seven oil companies to fix prices nonetheless even in the absence of conspiracy the prices are below market. That issue about were prices below market is not by itself an issue that the jury had to determine.

The next point is, this was only for the 1970's, it had nothing to do with the 1980-forward period.

Finally, Exxon was always in the early time period a peripheral player in the market. Unlike Chevron, Mobil, et cetera, Exxon did not have a refinery on the West Coast until 1969. They were not a player in buying crude oil until roughly the late 1969 time period.

At that point in time, there were several Government programs that did affect the price of crude oil, both in the west coast and elsewhere, such as price controls, the entitlement program.

In short, it is difficult to pick out, since the jury didn't have to tell us what they liked and what they didn't like, whether it was the unique situation of Exxon that had got them off the hook or whether, you know, it was more a fundamental problem with proof of conspiracy. So we did at all times think that the case against Exxon was harder to prove because they were a peripheral player.

Mr. HORN. Some companies would claim that they have pricing as the product moves from one part of the company to the other; in other words, if you go from production to pipelines to refineries, so forth, to distribution and marketing.

Is any of that pricing at all realistic, or is that just an arbitrary figure picked by accountants to try to shape people up, or is there a market test somewhere?

Mr. MCMAHON. There is no market test for that, but I have never thought of the oil companies being stupid, and they have long experience with litigation and people looking at their documents and auditors and that sort of thing. They have to be the smart one, at least are consistent, and if they are going to tell the public that the posting price represents market value, then when they are intracompany trading, they'd better use posted prices. So I don't think it tells us anything.

There is some interesting events, let's call it, in the Long Beach 1 case; and this is a public document; I can talk about it. Union Oil Co. was faced with a situation where postings were so low that the production arm of the company couldn't afford to produce crude oil. That is, the cost of production was greater than the posted price at which it would sell to the refining arm of the company. So the production arm writes to the refinery or actually some bigwigs in the company, "Can't we just trade these, the real effect of the value of the crude, and we should share in the production arm with the refining value of the crude oil."

So in other words, they made internal accounting changes in order to account for the fact that the postings were so out of whack with reality that they were actually losing money.

You have some, I won't say a lot of that kind of thing, but once in a while you will see that in the company document.

Mr. HORN. You mention if some of the independents could use Mobil 70 as a common carrier line in the Los Angeles market, they might find a better market for their crude. Now, what is the role of the small refiners in all of this? A number of them were squeezed out in the crunch a few years ago, a rather fairly new refinery in Santa Fe Springs in particular. I think they probably still have lawsuits floating around.

Mr. MCMAHON. What we found in the 1980's with regard to independent refineries, first of all, a lot of them went out of business; and, second, the ones that went out of business or even the ones that stayed in business complained publicly at times that they weren't able to buy crude at posted price.

In fact, it was the public complaints that was one of the factors that led us to file a second lawsuit. Some of these public complaints were made in the context of the FTC Getty-Texaco merger issue. They complained to the FTC, "Don't let this happen because we are going to get squeezed with crude oil. We can't get it."

I have talked with some of the former refinery—small refiner people who are selling pizza in a few places, and they say to me they couldn't get crude at posting. In fact, sometimes they couldn't get it at all. Some have remained in business by becoming specialists. Some of them make asphalt, for example, and they carved out a small niche not a lucrative niche, but allows them to get crude nobody else wants. It is a very heavy kind of crude. That is the best answer I can give you on that.

Mr. HORN. Have you had an opportunity to review Representative Calvert's legislation?

Mr. MCMAHON. No.

Mr. HORN. I just wondered what you thought of the approach that he is talking about.

Mr. MCMAHON. What I heard today is the only comment. I think there is certainly a value in having more State input into collecting the money. I think the States generally—California, New Mexico, Texas, for example—might be more aggressive about getting it, and I would like to share with you an experience that the city of Long Beach had.

A few years ago, the city started hiring outside auditors to monitor the prices in the Wilmington field. Under the Long Beach contract with the oil companies, the contract is called contractors agreement. One, the markers of price that is to be paid are the prices that are actually paid for crude in the field. And the city went out and hired some independent auditors to collect the data. And Jim can talk to this.

We paid them something like—it cost about $250,000 a year roughly, but they collected through the years something like $20 million from the oil companies by aggressively auditing. This is not some sort of thing of underpricing; this is just what happened in the field. So here you had an incentive to go out and do it, and they did a good job, I think.

Mr. HORN. You are saying basically if the State had the responsibility to collect, since they are a joint relationship here at the Federal and State Government, I believe, in most cases, then they could collect the proper royalty and be watching the criterion in terms of the value as a basis for that royalty, then send the part of the pie that goes to the Federal Government to them and it might be done in a more timely way.

Mr. MCMAHON. I don't want to be seen as supporting specific legislation because I haven't read it, but the concept makes sense to me.

Mr. HORN. They are on the scene; they don't have to fly from Denver and, as you say, they have a real need for the money, to say the least. And some in the Federal Government seem to dilly dally. So you wonder if some days we are going to collect anything around here.

Mr. MCMAHON. I put caution on that. There are some States—Wyoming comes to mind—where the amount of crude oil is so little that it may be—and I have talked to people that represent the State in these matters, and they are such a small shop, if you will, it may be difficult for them to audit. I don't know.

Mr. HORN. You heard the discussion this morning on the benchmarks they go through in the MMS. Do you think we should substantially change that, just use a different formula and get over that?

Mr. McMAHON. I think we need what I call a marker crude, as all of the international crudes are based. That is, something like West Texas intermediate pushing on the NYMEX or ANS in California, that sort of approach with adjustments for quality and transportation.

Mr. HORN. That certainly makes sense to me, because I think what we are in the process of seeing is maybe a patchwork that won't work.

As I listen to this discussion on how oil is valued, I am reminded of the Soviet Union where they had State planning and they had no real pricing system that made any sense because there was no market relationship in competition, and I sometimes think we are dealing with the Soviet bureaucracy where now we try to bring accounting to them and put a value on that and it is just a foreign concept.

Mr. McMAHON. That's right.

Mr. HORN. Fascinating.

I yield 10 minutes to the ranking member for questioning.

Mrs. MALONEY. Thank you, Mr. Chairman.

I would like to ask Mr. McMahon: On page 3 of your testimony, the second paragraph, you mentioned that the oil companies have refused permission for you to provide documents to the subcommittee which really verified the report of the interagency task force.

You also mentioned that the oil companies refused the request to make these documents available and insisted that the committee subpoena the documents.

Well, Mr. Chairman, I would like to formally request that we subpoena those documents.

Mr. HORN. That will be passed on to the chairman, who has the power to issue that subpoena.

Mrs. MALONEY. When I read the testimony last night, of all the things in it, this really made me very angry, because the oil companies are insisting that the documents should remain confidential, under seal, because they contain sensitive business information that should not be released to their competitors. But weren't the competitors party to the action, and therefore didn't they have access to the documents?

Mr. McMAHON. They did, of course.

Mrs. MALONEY. So all the competitors have access to the documents. So for them to claim confidentiality and say they must be sealed because they contain sensitive business information, does that make any sense to you? It doesn't make any sense to me.

Mr. McMAHON. No, it doesn't, and I might add to that, a lot of these documents we are talking about were written in the early 1980's, some even before that.

Mrs. MALONEY. They are very old documents, and their competitors have seen them. Why in the world or on what grounds can they claim they remain confidential?

Mr. McMAHON. I don't know. In fact, the interesting thing as reported by the task force, in Shell's case they couldn't find the documents, meaning that is how important it was to keep these things sensitive. They have them destroyed or something. These documents could not today contain information that says anything about the current status of what they are doing, what supplies they are buying, how much they are paying.

Mrs. MALONEY. Why are these documents confidential?

Mr. MCMAHON. They are confidential only because there was an agreement that was entered into before the documents were produced. They went to court, and they got an order saying, "We will produce them, but only if you agree to keep them confidential." So it is confidential only in a legal sense that we are not permitted by the court to make them public. They are not confidential in the sense that they have information that really matters to the oil companies' present business decisions.

Mrs. MALONEY. What do you believe is the real reason the companies don't want the documents to become public if their competitors know what is inside of them? It is not because there is information their competitors don't want them to see?

Mr. MCMAHON. I think it is because they don't want the information in there public in the sense that, you know, there will be evidence of underpricing of crude oil, the evidence that ANS is the proper benchmark of how you price crude oil.

Mrs. MALONEY. The basis for which they are saying they need to be confidential doesn't really apply.

Mr. MCMAHON. That is right. They are hiding behind it.

Mrs. MALONEY. I want to say one of the great research projects out of this particular Congress was a research project initiated in the Commerce Committee on the tobacco records that are, well, 30, 40 years old. They are claiming confidentiality there. I think that is ridiculous, and I think it is ridiculous for them to claim confidentiality here.

If I may——

Mr. HORN. Only if the public has an addiction to oil in the way we do in southern California.

Mrs. MALONEY. We need that oil, I will tell you that much, to run the cars and everything.

But one thing I noticed and I want to know: Are there other lawyers at the table besides you Mr. McMahon?

Mr. MCMAHON. Oh, yes; these two are lawyers here.

Mr. HORN. They are all good lawyers from Long Beach.

Mrs. MALONEY. I want to follow this thread of questioning because I think it is incredibly important, and I recall during my investigatory days on the city council, the minute we demanded a piece of information from a commissioner, he would then have a conversation with his lawyer and then say, "Oh, by the way, now it is attorney-client privilege, and it has existed, and it is proprietary, and it is protected."

I for one, Mr. Chairman, I think you have done a brilliant job this session. I am going to say something very strange for a Democrat. If I lived in your district, I would probably vote for you.

Mr. HORN. If you see any Democrats for Horn——

Mrs. MALONEY. One thing I think this committee should look at, and I mean it very sincerely—I see it in this case, and it makes my blood boil—is how these attorneys are able to claim privileged information because they had a conversation with their client. I think in too many cases they are using this cover to hide information that should go out to the public. And I think it is that case right here in this particular instance. Also—it is unrelated to this hearing—I think it is the same case in the tobacco and the same in many other cases. This practice has got to stop.

Mr. HORN. I agree with the gentlewoman, and we are going to have a full committee meeting this week, and you might want to give that advice to the counsel of the President of the United States to get over the business of client-lawyer relationships as a way to prevent from giving us all the documents. I just suggest that.

Mrs. MALONEY. Well, I am not as familiar with that case as I am with this one.

Mr. HORN. You will be after a few hours.

Mrs. MALONEY. But in this particular one, the gentleman, Mr. McMahon, says he feels no reason why this should be kept secret; there is no—in fact, the competitors were able to see that information.

I would like all three lawyers to comment on this one particular item I am raising on whether or not the information that the oil companies are saying is proprietary information should be released to the public.

Mr. SHANNON. Mr. Chairman, I am the assistant attorney for the city of Long Beach.

I am particularly concerned about the fact that there would be a claim of confidentiality relative to giving the information to a competitor when the competitors themselves have that information.

The stark reality is that corporate parties very commonly stipulate to these kind of what we call protective orders, and the judge basically stamps his approval on it because the parties don't disagree. There is no adversarial desire on either party at the time the agreement is entered into to make the documents public.

I don't have any good answer to your question, but in this particular case you might want to consider inviting the oil companies to articulate in writing a reason why they make a claim that these documents are confidential. Maybe they have a reason that we just haven't been smart enough to come up with.

Mrs. MALONEY. OK.

Mr. MCCABE. Jim McCabe, deputy city attorney.

Just as background, we would appear in Federal court and State court in Los Angeles and get perhaps 40-plus lawyers appearing for the oil industry at the same time. Between all of that legal talent, I haven't heard a reason that I would recognize as a valid reason for not providing these documents. There is a practical reason for not providing them because of the information they contain.

Mrs. MALONEY. I think that Mr. Shannon had an excellent idea, Mr. Chairman, and I would like to join you in a letter to the oil companies requesting them to——

Mr. HORN. Counsel will write them. I just discussed it with Mr. Brasher, and they will be written for what reason they feel they have to be withheld. If they continue to stick with that, why, we would seek subpoenas from the chairman.

Mrs. MALONEY. OK, and you will join me in seeking subpoenas from the chairman.

Can we have a timeframe on that?

Mr. HORN. First we will try the honey approach.

Mrs. MALONEY. How long are we going to let them drag their feet? A week; 2 weeks; 3 years? This has been going on 30 years.

Mr. HORN. I don't let anything drag more than a week. Once they get it, we expect a rapid answer. With all of that high-priced legal talent, they can get us back a one-page legal answer, I am sure.

I suspect what they might have been concerned about is, somewhere in some memo there is probably some embarrassing comment here and there which wouldn't make people look good but it has nothing to do with competitive business secrets, shall we say, from another company. They probably all have some embarrassing comments in those memos. Human beings usually do. We have seen a few here today we have tried out from the director on her own staff.

Mrs. MALONEY. OK. Mr. McMahon, if I could ask you a few questions on—how much did this California State court case you are involved in litigating? There were a lot of resources. How much did it cost overall?

Mr. MCMAHON. My estimate is around $60 million.

Mr. MCCABE. In that neighborhood, yes.

Mr. MCMAHON. That was starting from 1975, two lawsuits.

Mrs. MALONEY. 1975 to what?

Mr. MCMAHON. 1975 to the present.

Mr. HORN. Let me make sure I get it straight. I want to understand, is it $60 million in total cost to bring the case, hire the consultants, the lawyers, so forth and so on, and you gained roughly six times that?

Mr. MCMAHON. Yes, 325 roughly. Plus we made them dedicate their nonheated pipelines to increase competition for crude oil pricing in California. That was included, too, as a part of the result.

Mr. HORN. But Mobil 70 was not included.

Mr. MCMAHON. That's right. It was carved out of the settlement.

Mr. HORN. Was Mobil in the settlement at all?

Mr. MCMAHON. Yes.

Mr. HORN. Why wasn't the thought given to have that Mobil 70——

Mr. MCMAHON. Oh, there was a lot of thought. There was some debate about whether or not to settle, but the State was getting a lot of money, and so they briefed. I think that is basically the answer.

Mr. HORN. We skipped over it, and I think the record should show: What does the State get out of this versus what the city of Long Beach gets out of this?

Mr. MCMAHON. This presentation right here?

Mr. HORN. No, no; out of what they want in the settlement.

Mr. MCMAHON. It is a small amount.

Mr. HORN. I know. It used to be quite different. What is it now, 10 percent?

Mr. MCCABE. Not that much, Mr. Chairman. At present, I doubt that it runs $3 or $4 million a year.

Mr. HORN. Out of a total of what?

Mr. MCCABE. $50, $60 million. I am guessing at that.

Mr. HORN. That is about 8 percent; then another 7 or something.

Mr. MCCABE. I would say that is overstating it a bit.

Mr. HORN. At one time it was all, then it was 50–50. Then it slowly went out as the legislature took the money away. You can see the Long Beach trustees take it seriously, so they have done the State a favor.

Mrs. MALONEY. OK. In your statement that you committed significant State resources, $60 million to bring in roughly $400 million, could you walk us through the highlights that indicated to the State of California that posted prices were suspect and that it was worth it for the State to invest significant sums of money to litigate this issue to bring in even greater sums to this State? Could you sort of walk through and hit the highlights for us?

Mr. MCMAHON. First of all, in the early 1970's the city and the State recognized that the prices they were receiving for crude in California were much less than comparable crudes in the gulf coast area, and they inquired to the oil companies why the difference, and the oil companies didn't give them an answer.

So then there was a legislative committee in the State of California. They subpoenaed documents, and they found out the oil companies had a different trading mechanism amongst themselves than they did with anyone else. They called it the Three Cut Exchange. And the Three Cut Exchange, when they looked at the documents—we looked at the actual documents—why the Three Cut Exchange?

Every single one of them said prices in California are below market and we don't want to trade with one another at these prices. So that is why we filed the first lawsuit.

In the 1980's when we were thinking about the second lawsuit, we saw this admission by Texaco. We looked at the prices of ANS coming into California, and those are so much higher. We were getting bonuses from the early seventies on for the crude sold in Long Beach. The Federal Government at Elk Hills, the Energy Department was getting bonuses. Everyone is getting bonuses but us in the normal contract.

So all of these reasons were reasons to file a second lawsuit. And no legitimate explanation from the oil companies. In fact, typically they don't even answer the letters when you asked. It is just because you get answers like, it is just because that is the way things are. They are arrogant that way.

Mrs. MALONEY. For the record, would you define "arm's length transactions" which we are talking about, and have you looked at the arm's length transactions of California crude oil?

Mr. MCMAHON. Right. There is a slight—there is a need to get a little precise about it. The task force report, in my mind, talks a little loosely about transactions not being arm's length.

The way I would put it is, the prices in transactions are at arm's length, and by that I mean that the companies that are entering into exchanges where two crudes are traded, or another expression they use is a buy-sell two contracts, but they are matched together.

In those instances, the companies do not have an incentive; neither one of them has an incentive for high price, so there is no competition in setting a high price. That is why the prices that are in there are fake prices.

I thought of an analogy, if this might help. Suppose that I'm tired of earthquakes and my friend in Hartford, CT, is tired of snow; so we decide I am going to move to Hartford and he is going to move to California.

And we both have a Ford Taurus, and he has a car that is 1-year younger than mine, and it is worth $2,000 more. We say why should we drive both cars across country; let's just sell it to each other. Then I say OK, I will price yours at $22,000 and you price mine at $20,000, and we will write checks for that amount.

So he says, wait a minute, dummy; if we do that, we are going to have to pay a lot of tax on this stuff; so let's price my car at $3,000 and your car at $1,000. We preserve the $2,000 real difference in price, but we paid much less in taxes. And that is what the oil companies are doing with the posted prices. They trade back and forth with one another the difference in price in the contracts. That is arm's length. That is the relative difference in price, but the absolute value, the posting, if you will, that is a fake price. They both have an incentive to price low.

Mrs. MALONEY. Did you find that a significant portion of the total number of transactions were arm's length?

Mr. MCMAHON. No. You find, at most, 10 to 15 percent are truly at arm's length, and, as I said before, even of those, it is difficult to trace them to specific fields because often those arm's length contracts are on pipelines, and where does the crude come from? God only knows. We talk about molecules. Where does a molecule come from? Which field?

Mrs. MALONEY. Are you familiar with and have you read the 1988 Federal regulations?

Mr. MCMAHON. Right. That is when I offered my opinion, and this is just an opinion, because I am not a legal expert here on the regulations, but I see significant problems in applying this so-called arm's length or bonus methodology to those regulations, because it requires you to trace the bonus or any transaction at arm's length back to the field in which the crude came, and I don't see how that is even theoretically possible.

Mrs. MALONEY. Do you agree with MMS's assertion that the regulations preclude the Department of the Interior from using ANS?

Mr. MCMAHON. From?

Mrs. MALONEY. From using ANS, Alaskan north slope.

Mr. MCMAHON. I think I would be stretching on that. I am not an expert on their regulations and I don't want to make it look like I am stretching my expertise here. I would just say personally I don't see how there is a problem using ANS. That is how I put it.

Mrs. MALONEY. You don't believe that the MMS's recommended method of determining lost revenues is efficient or even feasible?

Mr. MCMAHON. It is not efficient, because you not only have the tracing problems, you have to locate all the bonuses, then you have to trace them back to specific fields, and then there is a further requirement of what they call a weighted averaging of the volumes of crude and that may be impossible.

Compared with the ANS methodology—ANS methodology, you could have the whole thing done in 6 months from start to finish. Because the prices of ANS for the early time period have been computed by our experts for the 1990's, it wouldn't take long at all, and all you need to do, then, is compare it with the posted prices of crude.

So it's very quick to do that. So, in terms of efficiency, the ANS methodology is far more efficient. In terms of feasibility, I have significant problems with figuring out how it would be done, that is, how the alternative methodology using bonuses or premia could possibly work, having seen the documents and having worked with them.

Mrs. MALONEY. When did the State of California begin to look into this question?

Mr. MCMAHON. Well, I think, you know, it has been looking into it since the early 1970's, for the 1980's I think it started with some audits that the city of Long Beach did.

Mrs. MALONEY. When were those audits?

Mr. MCMAHON. 1981, 1982.

Mr. MCCABE. In that time period?

Mr. MCMAHON. Right.

Mrs. MALONEY. In 1981 and 1982 when you started doing these city audits, did the Department of the Interior contact you to obtain evidence for their 1986 study?

Mr. MCMAHON. Not that I know of. The only contact with MMS that I am in a position to testify about was 1986. We had a visit from some people in Denver, and I frankly don't recall their names, from MMS.

Mrs. MALONEY. In 1986?

Mr. MCMAHON. In 1986. And we trotted out all our documents of underpricing for not the 1980's now but the 1970's, because those were the documents at that time we had. And they were explicit admissions of underpricing there. And we argued about them and all this and whoever it was, and I have forgotten his name, just nodded and said, well, Judge Gray threw out your lawsuit. He was the district court judge. He granted a rejudgment but only as to the antitrust claim. For the underpricing contract claim, he had not thrown it out. And he said he didn't want to discuss the evidence, and then a month or two later we got a report saying there is no evidence of underpricing and that was the end of it.

Mrs. MALONEY. So, can you find this gentleman's name who said he didn't want to discuss the evidence of underpricing and maybe get back to the committee later?

Mr. MCMAHON. I will try.

Mr. HORN. If I might, on the Long Beach case, what was it you hoped to get, and what did you sue for originally? Did you have a figure that maybe was descended from that chart? What did you want to ask for and then—versus what you received?

Mr. MCMAHON. I am trying to sort them out. There was—the Long Beach—one time period covered the 1970's, and our experts had calculated something like $240 million of damages for the period June 1971 to the end of 1977. And then there was——

Mr. HORN. And damages being the actual amount of underpricing you thought existed?

Mr. MCMAHON. Correct. That is right.

And then for the 1980's, as I recall initially, there were some—I won't call them exactly back of the envelope—but they weren't sophisticated analyses of prices but they were based on this ANS approach. And frankly, I don't recall what we had hoped to get. We had not completed the damage study in the Long Beach 2 case for the 1980's at the time of the settlements so we had not, if you will, put in concrete what the amount was.

I think it's fair to say we did settle for less than the damages that we thought were accruing during both those Long Beach 1 and Long Beach 2 time periods. That is typical of most litigation; you don't settle for the total value.

Mr. HORN. Well, did you think you received three-fourths or one-half?

Mr. MCMAHON. Something like three-quarters.

Mr. HORN. Well, that is pretty good, I would say.

Mr. MCMAHON. Yes.

Mr. HORN. I am just trying to see what it pays to go into litigation when you have this many facts on your side. OK.

Are there any other questions?

Mrs. MALONEY. I would like to ask you if you think the Federal Government would save millions of dollars using the evidence that you collected in our efforts to collect these underpaid royalties?

Mr. MCMAHON. I think you cannot only save millions but the people that we have worked with, and I am not talking about the attorneys but the experts, are very good and they have done an exhaustive job. They are very bright people and they are very aggressive in terms of finding the evidence. And I would find it shocking were their work not to be used. As I described before, it would be reinventing the wheel here.

Mrs. MALONEY. Earlier in the hearing, I don't know if you were here during the earlier panel, and then really in conversations that I had over lunch with people, there was a feeling that litigation would be so terrible that it would be so horrible. I would just like to ask you, is there reason to believe that the cost of litigation for the Federal Government would be so much higher that it would not be worth the risk?

Mr. MCMAHON. Not at all.

Mrs. MALONEY. Not at all. It would be similar to your experience.

Mr. MCMAHON. Yes.

Mrs. MALONEY. Can you explain the role the pipeline and transportation issues play in the underpricing scheme?

Mr. MCMAHON. Sure. Through the history of California, up until 1991, pipelines were privately owned in California. It was a unique situation to California.

Because they were privately owned, the oil companies who owned them, and these are the major oil companies, thought that they had a right to exclude potential shippers of crude from their pipeline, unless the shippers sold the crude to them at the posted prices. So that the independent producer, and there were a lot of them, had really basically two options. One was to leave the crude in the ground or the other was to sell it to the pipeline.

And I am not sure about this, but it is sort of reminiscent of the railroads in the 18th century where if you wanted to get your crops to the market you had to go through the railroad, and of course your prices aren't very good that way. There was a strangle hold by the major oil companies. That was the device by which they asserted control over pricing in California. You had no other choice.

And so what is essential to opening up the market to competition is to allow producers to put crude on pipelines as a common carrier does, ship it downstream, and then have the ability to let various refiners buy the crude oil.

Now there is one instance in California, starting in 1978, where the Arco company was forced to dedicate its pipelines to common carriage. It's called the four corners pipeline. And, lo and behold, when they did open it up, it opened up a market of bonuses for crude oil along the pipeline. And that is publicly reported now. So, you see, even with one pipeline, what that meant to some of the producers who were able to market their crude.

Mrs. MALONEY. Do you know if the issue of undervaluation is limited to California?

Mr. MCMAHON. I think it's not for reasons I went into. I think the NYMEX price, which is accepted everywhere, even for international crudes, it's recognized by the oil companies as competitive, and the postings just don't match the NYMEX price.

Spot prices in the gulf is consistently higher. By gulf, I mean Texas, Oklahoma, New Mexico, Louisiana. Spot prices, the P-plus market, the fact that the postings don't even agree with one another anymore. I think the posted price is a dinosaur. I think it is a dinosaur and it ought to be just terminated. It is like Jurassic Park.

Mr. HORN. If I might follow that one up, has anyone done a study of the NYMEX price versus the ANS, Texas intermediate, and which is the lower of the two over time? Which is the higher of the two over time? Or are they fairly closely connected?

Mr. MCMAHON. The quick answer is I don't know if anyone has. I will mention a problem with doing that now is that there was a time in which ANS flowed considerable amounts to the gulf, and when that happens, then the WTI and ANS is in the same market and it is easier then to compare the prices in a legitimate way.

There is much less going there. In fact, there is very little going to the gulf anymore. And for that reason, I don't know if anyone's taken the trouble to compare them. ANS mostly goes to California now or apparently it now may move to——

Mr. HORN. Hopefully to Japan and a few other places.

Mr. MCMAHON. Yes, yes. I just don't know whether that has been done. It could be done, and in fact if you want, we could have our people look at that issue.

Mr. HORN. Well, we are just trying to write a law over here; while you are talking I am looking for formulas.

Mrs. MALONEY. I would like to end by asking a question of the chairman, if it would be possible to have a followup hearing with the executives from the oil companies that are involved? Why don't we invite them in for their explanation?

Mr. HORN. Let's talk about it. I don't believe in beating old dogs and cats. I believe in getting something done. Technically, the Resources Committee has jurisdiction on it. We have the oversight on matters of economy and efficiency. And in this case, our concern is primarily the MMS and how are they functioning and are they getting their return for the Federal Government that they should get. And it seems to me, our job is to make sure that they don't get stuck with their own regulations which don't seem to be based in law, just something they dreamed up and they go through these benchmark hurdles which they talk about, which I suggest could be simplified and take either your formula or combine them and say split the difference or take the highest or take the lowest or whatever. But, obviously, we would prefer to take the highest. We are trying to get the royalties for the public interest. So I would rather deal with that than headline hunting investigations.

Mrs. MALONEY. Well, I didn't mean headline hunting, but I mean we have spent a lot of time talking about their reports and their documents, which we don't have. And it seemed to me like a reasonable approach instead of talking through other people, to invite them here with the information that they have, to present their point of view.

Mr. HORN. We'll see them presumably, along with anybody else in the country, when the MMS puts out their proposed regulations will have an opportunity to comment.

Frankly, I think the responsibility is the Department of the Interior to get the best royalty they can get for the Federal Government and related governmental entities. And I think your case is a good example. We know what the solution is, at least based on choices currently available. And the question is, will the administration do it? And I would rather work on that front and get the job done.

Mrs. MALONEY. Are you endorsing my report, Mr. Chairman?

Mr. HORN. Well, I am not addressing that request. I have got about 50 other hearings to do. I think I have learned enough in this one. And I really appreciate, unless you have some more questions, I appreciate the time that you have taken, because I think your case was a pioneer case. I might ask have other areas of the country followed your lead and filed suit similarly?

Mr. MCMAHON. Yes, the State of Texas did so last summer or something. And I understand that some producers, small producers in New Mexico have filed suit. Some suits in Oklahoma. Some suits in Louisiana. I think Louisiana at one time did get—recently in the last few years, $300 million from the oil companies, and I think they were following our lead on that, too.

Mr. HORN. Just offhand, do you know, what is the proportion of offshore versus onshore in California, roughly? I know MMS could answer that, but I am just curious.

Mr. MCMAHON. I am not positive but it is a large amount of crude oil out there. And I am not sure how much you are going to oversee the change in the rules, but there are some real issues with that offshore crude in pricing it that have to be looked at very carefully.

Mr. HORN. What are those?

Mr. MCMAHON. The problem is that the crude offshore is high in sulfur. It is 4.5 to 5 percent; even more than onshore. And legitimately, it should be worth less than crude with less sulfur. But the problem is that the current formula for adjusting for sulfur gives too low a price. It subtracts much too much. And that should be investigated as well.

And as a second thing, and that is the transportation cost to get it from offshore to onshore. Too much money has been allowed to be deducted to get it from offshore to onshore. I cannot go into the documents, but I think it is showing how much discount was given for that crude because of the factors. And there was no objective criteria to look at. There were no regulations to govern it. It was ad hoc. People in Denver just said, that is fine; it looks good to us. But there was no formula in the regulations that would govern that, and I think that has to be looked at because the Government can lose millions of dollars, even if you start with an objective standard of the value of the crude by deducting too much.

Mr. HORN. I'd appreciate you and staff discussing that so we could followup on that.

Mr. MCMAHON. OK.

Mr. HORN. What I would like to know is, my understanding is that with the change in the law, where Alaskan oil might well be going to Asia and not all into California, we have been benefiting from low prices, heaven knows, because of that, apparently hundreds of millions of dollars have been spent at various refineries to handle what will now be a higher sulfur California oil.

Mr. MCMAHON. That is right.

Mr. HORN. As opposed to the better quality Alaskan oil. So it is costing more in the sense of infrastructure, at least, to refine that oil. Now, maybe that is spread out over time and they easily recoup it. I don't know. But what do you think on that?

Mr. MCMAHON. First, the infrastructure was built in the 1980's.

Mr. HORN. They are just rebuilding a lot of it now, that I know, to take more California oil than they have Alaskan oil.

Mr. MCMAHON. I mean, obviously, it is a capital cost, and they do have to recoup that. There is no doubt about that. But typically, you know, you look at the internal documents and, again, this is what is useful about actually seeing them, they analyze, they analyze everything and they analyze the capital costs and how much it adds to a barrel of crude oil and it is never as much as what you hear publicly it adds to the cost. It is like the gasoline prices that go up. The public explanations are never the true ones.

Mr. HORN. Why do you think they have recently gone up to the extent they have?

Mr. MCMAHON. Let me just say that all of the public explanations don't explain it.

Mr. HORN. Well, that is true of Government as well as business. What is your next question? Help me solve that problem.

Mr. MCMAHON. Well, I honestly don't have an explanation. I haven't looked at the—I haven't gotten their internal documents. But when they talk about rocky crude didn't go on stream when it was expected, you would say, where was it supposed to go? The gulf area. Where did the gasoline prices go up the highest? California. So how would the lack of rocky crude possibly explain higher gasoline prices in California? It doesn't. You get all of these explanations in the public that don't explain. You would have expected the prices in the gulf to have gone up higher but they didn't.

Mr. HORN. Do we know who keeps track of what is flowing through pipelines in what direction? Obviously, oil is as fungible as money. It is money.

Mr. MCMAHON. I don't know if anyone keeps track. You can find that out from public sources but I don't know if anyone from the Federal or State government is doing that.

Mr. HORN. Any more questions?

If not, we thank you all for coming. It has been a most useful hearing. And keep in touch. We will have staff, Mr. Brasher in particular, keep in touch with you, and let us see if we cannot solve a few of these other problems.

Let me just thank those that were responsible for this hearing. For the majority staff, Russell George. Russell is the staff director, in the middle back there, and counsel. To my immediate left, your right, Mark Brasher, the professional staff member, Ian Davison, staff assistant. And the members of the Calvert staff, also, because they worked with us since Mr. Calvert had held somewhat comparable hearings on the resources subcommittee he chairs.

The minority staff, Mark Stephenson, David McMillen, professional staff members. Mark Guiton, the counsel to Mrs. Maloney, and our official reporters, Katie Stewart and Joe Strickland, and we thank you all. And with that, this hearing is adjourned.

[Whereupon, at 2:50 p.m., the subcommittee was adjourned.]

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