Written Testimony of Ryan Alexander, President
Taxpayers for Common Sense
before the Committee on Natural Resources
U.S. House of Representative
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Good morning Chairman Rahall and members of the committee. Thank you for the opportunity to testify today. My name is Ryan Alexander and I am the President of Taxpayers for Common Sense (TCS), a national, non-partisan budget watchdog organization. The mission of Taxpayers for Common Sense is to fight wasteful government spending and subsidies to achieve an efficient and responsible government that lives within its means. We believe in competitive and clean contracting -- from the Iraq war, to Katrina, to DOD procurement, to MMS contracts. We believe in transparency: taxpayers should be able to easily see how their tax dollars are spent, whether in the $460 billion defense budget or $300 million MMS budget. We believe in accurate and independent auditing. In short, we believe that taxpayers have a right to demand excellence and accountability from our government.

For more than a decade, TCS has actively worked to ensure that taxpayers receive a fair return on minerals and resources extracted from federal lands and waters. The mismanagement at the Mineral Management Service (MMS) offends all our core values and in the absence of corrective action will continue to waste tax dollars. TCS is committed to reforming our revenue collection process, ensuring fair contracting, and increasing accounting accuracy at MMS. TCS is also committed to holding the oil and gas industry accountable for fair and accurate reporting of minerals extracted from federal lands and supporting efforts to eliminate royalty relief provisions. We will continue to actively pursue each of these goals and look forward to working with the committee on other efforts to achieve these ends.

In addition to the mismanagement and enforcement problems at MMS, we believe there are structural problems with the current royalty system that subsidize the oil and gas industry at the expense of the taxpayer.

As you know, oil and gas companies that drill on federal and Indian lands or off-shore pay royalties for the oil, gas and some other minerals they remove. Generally, this payment is a percentage of the total value of the oil or gas extracted. It is the responsibility of MMS to ensure fair collection, calculation and

distribution of royalties on behalf of the American taxpayer. The collection of royalties is a significant source of revenue for the federal government: In fiscal year 2006, the Minerals Management Service reported more than $10 billion in royalty revenue.

Royalty Relief

With the oil and gas industry continuing to experience record profits, there is little need for taxpayers to continue to subsidize it.

Given the current fiscal climate, we commend the House for recognizing the need to reel in royalty relief provisions. Earlier this Congress, the House passed legislation requiring the repeal of royalty relief provisions included in the Energy Policy Act of 2005. We also applaud the MMS for proposing the repeal of sections 344 and 345 of the Energy Policy Act in their FY08 budget request. Taxpayers for Common Sense opposed the inclusion of these provisions in the Energy Policy Act and looks forward to working with Congress and MMS to see these sections repealed.

Royalty- In- Kind Program

Another area which Taxpayers for Common Sense fears is ripe for abuse is the Royalty- In- Kind program. From our standpoint, "in kind" contributions across government programs almost always end up being a bad deal for taxpayers. We saw a red flag when MMS began pursing an expansion of their in-kind program in the mid-1990s. The Royalty- In- Kind program allows oil and gas companies to pay their royalty dues in the form of oil or gas instead of cash. This forces the federal government to market the oil and gas themselves. The burden of marketing and selling oil and gas complicates government bureaucracy and leads to a lack of transparency.

It may be true that the Royalty-In-Kind program makes it easier for MMS and the industry to calculate the royalties that are due because they need only determine a percentage of the amount of oil produced and do not need to be concerned with the sale price. But the benefit for the government ends there. In effect, the process adds layers of complication and inefficiency by requiring the federal government to resell oil and gas. Involving the government in the sale of oil can easily lead to abuse. Given the current track record of MMS, we have little faith that this system can operate efficiently and for the benefit of taxpayers.

Auditing and Compliance

To ensure the adequate collection of royalties, MMS has an auditing and compliance division whose goal is to oversee leases and complete audits. In decades past, this division collected over $100 million annually through the audit process. However, in recent years this amount has significantly declined to less than half of that number. In fact, a more than twenty percent decrease in the number of audits was reported in the last five years. Not only has the collection of revenues dropped dramatically in recent years, MMS has clearly shown less commitment to this division, as demonstrated by shrinking budgets and significant cutbacks in staffing.

In the last decade, MMS began transitioning from a traditional audit process to a new, automated royalty verification process, known as compliance review. This shift has not been cost-effective and is an important contributing factor in the drop in revenues collected by MMS. Further, relying on self-reported data from the oil and gas industry is not an accurate way to monitor royalty collection.

Proponents of compliance review correctly point out that the process allows MMS to check data pertaining to more transactions than the traditional audit process; however, the superficial review does not allow for an in-depth analysis or encourage improved accounting procedures. As the Department of Interior Inspector General Earl Devaney testified before the committee in February, the compliance review process does not provide the same level of detail or accuracy a traditional audit provides.

The IG audit report released in December 2006 detailed many weaknesses in this program. The report highlighted MMS's inability to access accurate and complete information on the program and the inability to use it for daily management and reporting purposes. Further, the current system does not provide states, tribes and Congress with accurate information on the Compliance and Asset Management Program.

The report went on to conclude that MMS could not establish the true cost and benefit of compliance reviews and audits. When considering the impact on federal taxpayers, one of the most egregious findings of the IG report was that anomalies rarely lead to a full audit. The report concluded that "MMS may not detect underpaid royalties."

Additionally, the fact that the data relied on for this process is self-reported by the companies should be of grave concern. The combination of self-reporting and superficial data reviews provides companies with an incentive to under-report and under-pay royalties owed.

As demonstrated in the case brought forth by our fellow witness, Mr. Bobby Maxwell, as well as other auditors at the agency, a negligent MMS appears to be serving the interests of the oil and gas industry over those of the taxpayer. In a glaring example of mismanagement within the agency, these auditors were

prohibited by the MMS from collecting gross underpayments of royalties they had uncovered in their investigations.

Contracting and 1998 and 1999 Leases

Perhaps the best-known example of mismanagement at the MMS is the errors made in the leasing contracts of 1998 and 1999. In 1995, Congress passed the Outer Continental Shelf Deep Water Royalty Relief Act which awarded the oil and gas industry a waiver of royalty payments for leases issued from 1996-2000. These leases were all intended to include price thresholds that would trigger the collection of royalties when the price of oil reached above $36/barrel.

A little more than a year ago it came to light that a gross error had occurred in more than 1,000 leases issued in 1998 and 1999. Contracts had omitted the price threshold language, unlike those for leases issued in 1996, 1997 and 2000. When this error was uncovered in a *New York Times* expose, a series of congressionally driven investigations determined it was merely a clerical error. This clerical error has already cost taxpayers at least $1 billion in lost revenue.

Adding insult to injury, Johnnie Burton, Director of MMS, was made aware of the error as early as 2004, despite congressional testimony she had given late last year to the contrary. The information was uncovered by the Interior Inspector General and documented in a series of emails sent to Ms. Burton.

While the original omission of the price threshold language was obviously a very serious error, MMS's failure to devise and implement a fair remedy in the nearly three years the agency has been aware of the problem is emblematic of the lack of accountability and culture of mismanagement at MMS.

On the subject of price thresholds, we would like to call one additional matter to the Committee's request. MMS finalized the "Shallow Water, Deep Natural Gas" rule in 2004. The rule is designed to spur development of natural gas far below ground in shallow waters. Unlike the 1998 and 1999 leases, this rule does include a price threshold. Unfortunately, MMS set the price threshold at the sky high level of $9.34 per thousand cubic feet of natural gas. The threshold is indexed to inflation and rose to $9.91 for 2006. MMS data show that this threshold is so high that companies would have avoided royalties even in 2005 and 2006, in a time of record high prices following the Gulf Coast hurricanes. A threshold this high is no better than no threshold at all.

We would also note that the threshold increased dramatically as the shallow water deep gas rule moved forward - from $5.00 in the proposed rule to $9.34 in the final version. The result will be billions in foregone revenues for the federal taxpayer. We encourage the Committee to look into this matter in greater depth.

Culture of Mismanagement at the MMS

Federal taxpayers continue to bear the burden of these multi-billion dollar errors. The problem will only be compounded in the coming years. Director Burton has shown little initiative to remedy the problems within the agency. In addition to failing to correct the missing lease language when it was first brought to her attention, several employees who have attempted to remedy the under-collection of royalties have been dismissed on her watch.

The Department of Interior estimates in the next five years that energy companies will likely extract $65 billion in oil and gas from federal lands and pay little or no royalties for it. This will cost taxpayers $7-$9 billion in lost revenue. The problem will only escalate as more oil comes online. By 2011, the Department of Interior estimates that royalty-free oil will quadruple and natural gas will see a 50% increase. Taxpayers cannot afford to have a grossly mismanaged agency overseeing this important source of revenue.

Remedies and Solutions

It is clear that several actions at the MMS must occur to remedy the current situation. Senior employees must be held accountable for their actions and committed to the mission of the agency, not the pocketbooks of Big Oil. Too many examples of close connections with the oil industry have surfaced to ignore this problem. We encourage the committee to continue rigorous oversight to ensure MMS is operating in the interest of federal taxpayers.

Furthermore, compliance review cannot be relied upon to ensure adequate collection of royalty revenues. Steps must be taken to ensure independent audits occur and royalty underpayments cease. The current system heavily relies on self-reporting, which can only lead to abuse. The system has to be reformed so that it is more transparent and can easily account for royalty payments. Furthermore this system needs to be publicly accessible via the Internet.

Past errors must also be corrected. Contracts that omitted the price threshold language must be renegotiated. We applaud Congress for beginning to take steps in this direction. It is clear in testimony provided by several of the oil companies involved with leases that the industry was aware of the error and was also fully aware of Congress's intent to keep the price thresholds in the contracts. Contracts are renegotiated all the time, and this situation must be addressed or taxpayers stand to lose billions more. Gross negligence on the part of government employees is an unacceptable reason to allow the oil and gas companies to exploit congressional intent and avoid the dues that are rightfully

owed to taxpayers. These oversight hearings will help reveal to the general public any companies that refuse to pay. As we have already mentioned, it is outrageous to imagine giveaways to oil and gas companies while they are experiencing such enormous profits.

It is the federal government's responsibility to protect taxpayers' resources and ensure they are adequately compensated for their sale. It is clear the agency responsible for this taxpayer protection is in need of an accountability overhaul.

MMS's Royalty-In-Kind system has fundamental flaws that make it hard for taxpayers to be sure they are getting their money's worth from their resources. Under the best conditions, this type of system would be prone to abuse, particularly at an agency as flawed as MMS. At the very least the Royalty-In-Kind system should be thoroughly evaluated, and, if not found to benefit the taxpayer, scrapped.

The oil and gas industry runs on a boom and bust cycle. While seductive, the offer of royalty relief to stimulate production can skew the marketplace and have long-term unintended consequences of diminished returns for taxpayers. We urge Congress to be very judicious before pursuing royalty relief in the future.

Again, we are pleased to see such rigorous oversight by this Congress. The absence of energetic oversight or the checks and balances inherent in the oversight process invariably leads to problems, particularly in agencies that by the very nature of their missions have close ties with the industries they regulate. We are pleased the committee has begun to address this issue and look forward to working more to see this embattled agency reformed.