

Exposing Corruption *Exploring Solutions*
Project On Government Oversight

Testimony of
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Project On Government Oversight (POGO)
before the
House Committee on Natural Resources
on

“The Consolidated Land, Energy, and Aquatic Resources Act of 2009” (H.R. 3534)

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Thank you for inviting me to testify today. I am the Executive Director of the Project On Government Oversight, also known as POGO. POGO was founded in 1981 by Pentagon whistleblowers who were concerned about wasteful spending and weapons that did not work. Throughout its twenty-eight-year history, POGO has worked to remedy waste, fraud, and abuse in government spending in order to achieve a more effective, accountable, open, and ethical federal government. Since 1995, POGO has issued five reports about the underpayment of royalties to the federal government by the major oil and gas companies. Most recently, we issued a report tracing the troubled history of the Department of the Interior’s Royalty-In-Kind (RIK) program and recommending the abolition of the program.

POGO applauds the House Natural Resources Committee for your vigilant oversight of royalty collections, and for writing the Consolidated Land, Energy, and Aquatic Resources (CLEAR) Act of 2009. This legislation will benefit taxpayers by implementing several key reforms that will help to ensure taxpayers are receiving their fair share from their natural resources.

RIK Is a Failed Experiment

Oil and gas royalties collected from drilling on federal lands and waters is one of the largest sources of revenue for the federal government other than taxes. Royalties used to be collected primarily in cash, also known as royalty-in-value. This changed in 1997 when the Minerals Management Service (MMS) began a pilot program called Royalty-In-Kind (RIK).¹ This program accepts royalty payments in the form of product rather than cash, and is one of the Department of Interior’s primary methods of collecting those royalties. Industry influence on the

¹ Deal Consulting & Dispute Resolution, LLC, “Federal Oil & Gas Royalty Valuation, Royalty in Kind and Royalty Relief 1980-2008,” August 2008. http://www.dtdeal.com/pdf/chronology-valuation_royalty_relief1980-2008.pdf (Downloaded September 15, 2009)

RIK program is traceable from the program’s conception, through its expansion, to the full-blown program that exists today.

As this Committee is well aware, MMS’s RIK program has been a failure on many fronts. The Government Accountability Office (GAO) found in 2003,² 2004,³ 2007,⁴ 2008,⁵ and 2009⁶ that MMS could not accurately account for the RIK program’s cost and benefits. In light of that, according to the GAO, RIK operated as an honor system. As the Inspector General discovered and reported to the full committee last fall, this honor system resulted in a culture of “ethical failure” and “substance abuse and promiscuity.”⁷

The reform most fundamental to making this program functional would be a dramatic increase in auditing capacity, yet this fix would wholly undermine MMS’s original justification for the program—that the RIK program would reduce the need for auditing and so would decrease oversight costs. This alone should be reason enough to cancel the failed program. However, the legitimacy of the program is also called into question given the Inspector General’s findings that MMS employees consider themselves exempt from standard ethical provisions that protect the public’s interest.⁸ MMS’s close relationship with industry has been instrumental in preventing the public from getting what is owed to them for industry’s use of public resources. Extensive corruption and collusion in the RIK program, given that it is charged with managing billions of dollars of federal revenue, should be the final nail in the program’s coffin.

POGO supports the CLEAR Act for seeking to eliminate RIK as a method for paying federal oil and gas royalties. However, we are concerned that the language is not strong enough. We recommend that the CLEAR Act be strengthened to cancel the RIK program, or to place the program on a moratorium until an independent audit shows that it is accurately collecting all of

² General Accounting Office, *Report to Congressional Requesters on Mineral Revenues: A More Systematic Evaluation of the Royalty-in-kind Pilots is Needed* (GAO-03-296), January, 2003, Summary page. <http://www.gao.gov/new.items/d03296.pdf> (Downloaded September 15, 2009)

³ General Accounting Office, *Report to Congressional Requesters on Mineral Revenues: Cost and Revenue Information Needed to Compare Different Approaches for Collecting Federal and Gas Royalties* (GAO-04-448), April 2004, Summary page. <http://www.gao.gov/new.items/d04448.pdf> (Downloaded September 15, 2009)

⁴ Government Accountability Office, *Testimony Before Committee on Natural Resources, U.S. House of Representatives on Royalties Collection: Ongoing Problems with Interior’s Efforts to Ensure A Fair Return for Taxpayers Require Attention* (GAO-07-682T), March 28, 2007, Summary page. <http://www.gao.gov/new.items/d07682t.pdf> (Downloaded September 15, 2009)

⁵ Government Accountability Office, *Testimony Before the Subcommittee on Energy and Mineral Resources, Committee on Natural Resources, House of Representatives on Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk* (GAO-08-560T), March 11, 2008, p. 4. http://resourcescommittee.house.gov/images/Documents/20080311/testimony_rusco.pdf (Downloaded September 15, 2009)

⁶ Government Accountability Office, *Royalty-In-Kind Program: MMS Does Not Provide Reasonable Assurance It Receives Its Share of Gas, Resulting in Millions in Forgone Revenue* (GAO-09-744), August 2009, <http://www.gao.gov/new.items/d09744.pdf> (Downloaded September 15, 2009)

⁷ Department of Interior, Office of Inspector General, “Memorandum on OIG Investigations of MMS Employees,” September 9, 2008, p. 2. http://www.doioig.gov/upload/Smith%20REDACTED%20FINAL_080708%20Final%20with%20transmittal%209_10%20date.pdf (Downloaded September 15, 2009) (hereinafter “Memorandum on OIG Investigations of MMS Employees”)

⁸ “Memorandum on OIG Investigations of MMS Employees.” pp. 1-2.

the royalties owed to taxpayers.

Taxpayers Deserve Assurances Royalties Are Collected Accurately

As outlined in our most recent report, *Drilling the Taxpayer: Department of Interior's Royalty-In-Kind Program*, MMS's problems go far deeper than the ethical failures of individuals. The biggest problem is that the royalty management system is broken.

There are three basic and significant structural weaknesses to the MMS's royalty management program. The first is an organizational conflict. The sole mission of a federal royalty management and collection program should be determining and enforcing revenue obligations of private companies operating on public and Indian lands. Yet, currently, auditors and other compliance and enforcement personnel report to officials within MMS whose responsibilities also include leasing and development, and who may be more inclined to make the royalty management program *look* successful rather than *be* successful. As POGO discovered, in some instances MMS told their professional auditors to stop auditing, even when the auditors had discovered evidence that companies were underpaying royalties.

The second structural flaw is methodological. MMS's preference has been to perform compliance reviews rather than audits. Compliance reviews are based entirely on the self-reported data provided by industry—meaning that no third-party reporting is required.

Third, a recent GAO report revealed that the MMS computer system is incapable of identifying in a timely manner instances when industry fails to report revenue and royalty at all.⁹

When it comes to royalty collection, both MMS and its technology are untrustworthy, and these weaknesses may have cost taxpayers hundreds of millions of dollars in much-needed revenue.

The CLEAR Act addresses these structural weaknesses.

First, delegating the compliance and auditing functions to the Inspector General strengthens the independence of those functions, which is essential for the royalty management system to be effective. However, POGO is not sure if the Office of the Inspector General (OIG) is ultimately the right place for these functions to reside, given the OIG's other statutory responsibilities and the need to maintain independence from the federal agencies and programs it oversees. We are also concerned that the CLEAR Act continues some aspects of the current conflict of mission problems between leasing and oversight functions. The Office of Federal Energy and Minerals Leasing that this bill would create will be responsible for both managing leases for development *and* conducting oversight and inspections of those leases—one of the problems that moving compliance and auditing duties to the OIG seeks to remedy. POGO believes that royalty management independence must include regulatory and enforcement independence, and the

⁹ Government Accountability Office, *Mineral Revenues: Data Management Problems and Reliance on Self-Reported Data for Compliance Efforts Put MMS Royalty Collections at Risk* (GAO-08-893R), September 12, 2008, p. 5. <http://www.gao.gov/new.items/d08893r.pdf> (Downloaded September 15, 2009)

Committee should consider the importance of severing oversight functions from the Office of Federal Energy and Minerals Leasing.

Second, the CLEAR Act strengthens royalty accountability by prohibiting compliance reviews from constituting or substituting for audits. The Committee is also taking important steps to restore leasing offices' accounting and auditing credibility by requiring employees who conduct compliance reviews to "meet professional auditor qualifications that are consistent with the latest Government Auditing Standards." In addition, the CLEAR Act's requirement to refer for audit disparities revealed by any compliance reviews is also a step in the right direction.

Finally, POGO sees potential in the CLEAR Act's proposed pilot program for automated transmission of oil and gas volume and quality data to improve production verification systems and ensure accurate royalty collection and audits.

Ending Ethical Misconduct in Royalty Collections

While POGO believes that removing the core auditing functions from MMS—and thereby the conflict of mission within the agency—will go a long way to improve the structural and ethical problems, past investigations reveal that there are significant *cultural* problems at MMS that also need to be resolved. As the Inspector General discovered, MMS's inappropriate relationship with industry—which included "gifts and gratuities"—compromised their objectivity.¹⁰ Additionally, POGO is concerned about industry's entrenched influence at MMS.

Our investigation revealed that MMS justified the expansion of the RIK program over the objections raised by state auditors, Members of Congress, and POGO¹¹ by relying on a so-called "independent" study by Lukens Energy Group.¹² Not only was the Vice President of Lukens a vocal advocate for the RIK program,¹³ the Inspector General determined that Lukens Vice President Hagemeyer was considered a "trusted advisor" by RIK Program Director Greg Smith, and that the two communicated extensively during the contract selection process despite regulations clearly prohibiting such contact between bidding companies and MMS officials. The IG reported that during the same time period Lukens' contract bid was being considered by MMS, Hagemeyer assisted then-RIK Deputy Program Manager Smith in his efforts to market

¹⁰ Department of Interior, Office of the Inspector General, Royalty Initiatives Group, *Evaluation Report: Minerals Management Service Royalty-in-Kind Oil Sales Process* (C-EV-MMS_0001-2008), May 2008, p. 4. <http://www.doi.ig.gov/upload/2008-G-0021.pdf> (Downloaded September 15, 2009)

¹¹ Innovation & Information Consultants, Inc. "Memorandum on MMS Report in RIK Pilot Program in Wyoming," April 24, 2001, p. 1. <http://www.pogoarchives.org/m/ep/ep-rikmemo.pdf> (Downloaded September 15, 2009); Representative Carolyn Maloney, "Maloney Cautions Against Republican Plans to Bolster Oil Industry," June 12, 2001. http://maloney.house.gov/index.php?option=com_content&task=view&id=688&Itemid=61 (Downloaded September 15, 2009); House Subcommittee on Energy and Mineral Resources, "Statement of Danielle Brian at Oversight Hearings on Royalty-In-Kind for Federal Oil and Gas Production," July 31, 1997, pp. 101-102. http://commdocs.house.gov/committees/resources/hii45026.000/hii45026_0.htm (Downloaded September 15, 2009)

¹² Lukens Energy Group, *Assessment of the Federal Royalty-in-Kind ("RIK") Program and Development of RIK Business Plan*, September 30, 2003.

¹³ American Petroleum Institute, "Hagemeyer gets API honor," *API EnCompas: News*, November 13, 2000. <http://web.archive.org/web/20001213110900/www.api.org/release.cgi?days=90> (Downloaded September 15, 2009)

Geomatrix, a firm with which Smith was improperly consulting on the side.¹⁴ POGO remains concerned that Smith was never prosecuted. This sends the wrong message to employees in MMS—that blatant misconduct will go unpunished.

POGO is also deeply troubled by the revolving door between the Department of the Interior and industry. A number of the individuals who went through the revolving door have actually been sentenced to prison for violations of conflict-of-interest laws or obstruction of justice.¹⁵ As long as the door continues to revolve between industry and Interior or MMS, the public cannot be sure that their interests are being served.

Fortunately, there have already been several improvements to ethics policies in the Department of the Interior since our report. POGO applauds President Obama's Executive Order for Ethics Commitments by Executive Branch Personnel,¹⁶ and Interior Secretary Ken Salazar's Memorandum to Employees on their ethical responsibilities.¹⁷ POGO particularly wants to praise Secretary Salazar for enhancing the ethical culture of the agency by urging employees to seek the assistance of bureau or office ethics officials for guidance to avoid even the appearance of impropriety.

While these are important steps, POGO is also happy to see that the CLEAR Act requires the Secretary of the Interior to annually certify that all employees involved in royalty production oversight are in full compliance with all federal employee ethics laws and regulations.

Increasing Transparency in Royalty Management and Collections

Just as adequate auditing is essential to revealing problems, transparency is essential to getting those problems fixed. But copies of RIK contracts and vital information about who operates the program are usually not publicly available to be scrutinized by watchdogs, other issue-area experts, the news media, or the public in general. Many of the problems that have occurred in the RIK program and within MMS could have been prevented or resolved sooner if the Interior Department's actions had been more transparent to Congress and other stakeholders.

Due to the opaqueness of the royalty management system, many of the insights into its problems have come from whistleblowers. As this Committee is well aware, many whistleblowers have tried to draw attention to management and underpayment problems as they saw them occurring,

¹⁴ Department of the Interior, Office of Inspector General, *Investigative Report: Gregory W. Smith*, August 7, 2008, p. 16-17.
http://www.doi.gov/upload/Smith%20REDACTED%20FINAL_080708%20Final%20with%20transmittal%209_10%20date.pdf (Downloaded September 15, 2009)

¹⁵ For a list of these individuals, see our report: Project On Government Oversight, *Drilling the Taxpayer: Department of Interior's Royalty-In-Kind Program*, September 18, 2008, pp. 13-14
<http://pogoarchives.org/m/nr/trik/report-20080918.pdf> (Downloaded September 15, 2009)

¹⁶ White House, "Executive Order -- Ethics Commitments by Executive Branch Personnel," January 21, 2009.
http://www.whitehouse.gov/the_press_office/ExecutiveOrder-EthicsCommitments/ (Downloaded September 15, 2009)

¹⁷ Department of the Interior, "Secretary Salazar Outlines High Ethical Standards for Interior Department in Memo to All Employees," January 26, 2009, http://www.doi.gov/news/09_News_Releases/012609a.html (Downloaded September 15, 2009)

only to be discouraged or retaliated against. For example, the Audit Manager for the North Dakota State Auditor's Office told this Committee's Subcommittee on Energy and Mineral Resources that a high-ranking MMS official advised him and other members of the State and Tribal Royalty Committee not to testify before Congress: "This official expressed to us that Congress only requests that you testify so you aren't obligated to testify and that it is best to keep any problems in house."¹⁸ This is clearly unacceptable and undermines the public interest. We hope that the members of this Committee will keep in mind how essential it is for there to be real protections for whistleblowers.

POGO is also concerned that there is not enough transparency about the influence of organizations outside of MMS that help the agency to shape policy. In our investigation of the development of the RIK program, we learned that industry had a disproportionate amount of influence over the program's development. Because of this, we are particularly concerned about the Regional Outer Continental Shelf Councils created under the CLEAR Act. We hope that this Committee will continue to be vigilant in its oversight to make sure that the public interest is sufficiently represented on the Councils, which will develop future natural resources policies. Additionally, we urge the Committee to remove the current language in the bill that would exempt these Councils from the Federal Advisory Committee Act. The Federal Advisory Committee Act's requirements to make membership, administrative procedures, and hearings public knowledge provide precisely the kind of openness and accountability that our natural resource management system so desperately needs.

POGO also supports provisions in the CLEAR Act that will ensure federal agencies have access to proprietary information for wind and solar projects to assure compliance, but we hope that the Committee will extend this provision to include uranium leases.

And lastly, as a member of the Publish What You Pay Coalition, we hope that the Committee will consider in the future increasing transparency of the U.S.'s royalty revenue collections in order to serve as a model to other countries. As Secretary of State Hillary Clinton recently stated, "Sustainable progress is not possible in countries that fail to be good stewards of their natural resources, where the profits from oil and minerals line the pockets of oligarchs who are corporations a world away, but do little to promote long-term growth and prosperity. The solution starts with transparency."¹⁹ Companies "publishing what you pay" and governments "publishing what you earn" is a necessary first step towards a more accountable system for the management of natural resource revenues.

Thank you again for your oversight of royalty collections and for asking me to testify. I look forward to answering any questions you may have, and to working with your Committee on this issue.

¹⁸ Dennis Roller, "Written Testimony of Dennis Roller, Audit Manager for the North Dakota State Auditor's Office—Royalty Audit Section For the Minerals Management Service Before the Natural Resources Subcommittee on Energy and Mineral Resources United States House of Representatives," March 11, 2008, p. 2. http://resourcescommittee.house.gov/images/Documents/20080311/testimony_roller.pdf (Downloaded September 15, 2009)

¹⁹ Secretary of State, Hillary Rodham Clinton, "Remarks at the 8th Forum of the African Growth and Opportunity Act," August 5, 2009. <http://www.state.gov/secretary/rm/2009a/08/126902.htm> (Downloaded September 15, 2009)