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Suits Say U.S. Impeded Audits for Oil Leases

By EDMUND L. ANDREWS

WASHINGTON, Sept. 20 — Four government auditors who monitor leases for oil and gas on federal property say the Interior Department suppressed their efforts to recover millions of dollars from companies they said were cheating the government.

The accusations, many of them in four lawsuits that were unsealed last week by federal judges in Oklahoma, represent a rare rebellion by government investigators against their own agency.

The auditors contend that they were blocked by their bosses from pursuing more than $30 million in fraudulent underpayments of royalties for oil produced in publicly owned waters in the Gulf of Mexico.

"The agency has lost its sense of mission, which is to protect American taxpayers," said Bobby L. Maxwell, who was formerly in charge of Gulf of Mexico auditing. "These are assets that belong to the American public, and they are supposed to be used for things like education, public infrastructure and roadways."

The lawsuits have surfaced as Democrats and Republicans alike are questioning the Bush administration's willingness to challenge the oil and gas industry.

The new accusations surfaced just one week after the Interior Department's inspector general, Earl E. Devaney, told a House subcommittee that "short of crime, anything goes" at the top levels of the Interior Department.

In two of the lawsuits, two senior auditors with the Minerals Management Service in Oklahoma City said they were ordered to drop their claim that Shell Oil had fraudulently shortchanged taxpayers out of $18 million.

A third auditor, also in Oklahoma City, charged that senior officials in Denver ordered him to drop his demand that two dozen companies pay $1 million in back interest.

And in a suit that was filed in 2004, Mr. Maxwell charged that senior officials in Washington ordered him not to press claims that the Kerr-McGee Corporation had cheated the government out of $12 million in royalties.

On Wednesday, Interior officials denied that the agency had suppressed any valid claims and implied that the auditors simply wanted a share of any money recovered through their lawsuits.

"If these auditors believed there were fraud and or false claims on the part of the companies they were auditing, they should have followed the proper procedures," the Interior Department said in a written statement. "Instead, they opted to pursue private lawsuits under which, if they prevail, they could receive up to 30 percent of the monies recovered from the companies."

In defying their own agency, the Interior Department's auditors sued the oil companies under a federal law, called the False Claims Act, that was created to allow individuals to expose fraud against the government. People who successfully recover money for the government in such cases are entitled to a portion. A losing company is required to pay triple the amount of recovered money as well as back interest — potentially more than $120 million in the cases brought by the auditors.

Destin Singleton, a spokeswoman for Shell, said the company had not seen the suits and could not comment. John Christiansen, a Kerr-McGee spokesman, said, "We believe the case is without merit and we are defending against it."

In dollar terms, the suspected underpayments amount to a tiny fraction of the $8 billion in royalties that companies paid last year for oil and gas extracted from federal lands.

But the lawsuits come at a time when the Interior Department is already under fire from Congress, accused of covering up ethical lapses and managerial incompetence.

"These accounts, coming from the front lines, point a big red arrow at the large problem of taxpayers being stiffed," said Senator Ron Wyden, Democrat of Oregon, who has been investigating the accusations.

"If it was one isolated instance, you could say that's somebody who had a bad experience and was frustrated," Mr. Wyden said. "But when you have three or four professional, nonpolitical, independent auditors all bringing the same message, that is too important to ignore."

By any measure, the Interior Department under President Bush has placed top priority on increasing oil and gas production in the United States. Under its business-friendly agenda, the department has increased incentives for drilling in risky areas, has speeded approvals for drilling applications and has campaigned to open more coastal areas for oil exploration.

Lawyers who have specialized in lawsuits under the False Claims Act said they had never seen a group of government investigators use the law against their own agency.

"Most whistle-blowers are insiders at a company who spot something that government auditors have missed," said James Moorman, president of Taxpayers Against Fraud Education Fund, a nonprofit organization supported by lawyers that specializes in the False Claims Act.

"But here you have auditors saying, 'We did our job, we found the problems and our superiors don't want to hear about it,' " Mr. Moorman said. "If it were just one auditor, you could dismiss it. But with four auditors, that's a pattern of practice."

In their suits, the auditors contend that they had no choice but to go outside the agency because their supervisors ordered them to "cease work" on five separate investigations and drop their claims.

Documents recently unsealed in Mr. Maxwell's case against Kerr-McGee, which is scheduled for trial in November, show that federal officials abandoned his claims at almost the same moment that state auditors in Louisiana reached the same conclusions as Mr. Maxwell.

Under federal regulations, companies are supposed to pay the federal government a royalty of 12 percent or 16 percent on oil and gas they extract from federal lands or coastal waters.

Mr. Maxwell's job was eliminated in 2004. He received a settlement from the government and is now living in Hawaii.

A much-praised auditor who recovered hundreds of millions of dollars over a 20-year career, Mr. Maxwell concluded in late 2002 that Kerr-McGee had used a clever marketing deal to reduce its apparent sales receipts and royalty payments.

Under the marketing deal, Mr. Maxwell contended, Kerr-McGee sold its oil at $1 to $3 a barrel below market prices to a company called Texon. Mr. Maxwell's auditing team said that Texon was making up for Kerr-McGee's shortfall by providing marketing and administrative services. In effect, Mr. Maxwell contended, Kerr-McGee was being paid in both cash and services but only paying royalties on the cash portion.

Interior officials initially encouraged Mr. Maxwell when he raised the concerns about Kerr-

McGee in early 2003. "I am sure we can make the case," wrote John Price, then head of the agency's appeals division, in an e-mail message to Mr. Maxwell.

But a few days later, lawyers in the Interior Department's solicitor's office urged him to drop the case. "Although I did not understand the reasoning, it was made clear to me that the agency did not want the order issued," Mr. Maxwell wrote in an affidavit for his suit. "The next day, Mr. Price telephoned me and reiterated to me that if I issued the order, the director would be very upset with me."

But Louisiana auditors were investigating the same practices in connection with royalties on state-owned land, and had concluded that Kerr-McGee was lowballing its sales price by $1.50 to $3 a barrel. Louisiana officials demanded more than $1 million in additional state royalties from the company, and eventually settled for $600,000.

In two of the lawsuits that were unsealed last week in Oklahoma, senior auditors in Oklahoma City said they had been ordered to drop claims that Shell Oil had underpaid by $18 million.

The suits were brought by Joel F. Arnold, a supervisory auditor who oversees a team of offshore auditors based in Oklahoma City, and Randall L. Little, a senior auditor on Mr. Arnold's team in Oklahoma City.

Like Mr. Maxwell, both of the Oklahoma auditors have more than two decades of experience in government and industry and have received numerous government awards for the money they have recovered.

In one suit, Mr. Little contends that he found evidence from his audit that Shell had reduced the sales value of oil from six leases by fraudulently inflating transportation costs. One practice, they said, allowed Shell to improperly escape $15 million in royalties. A second practice allowed Shell to save $3.8 million by claiming transportation costs for oil that was being delivered to the government at its own production site in the Gulf.

The Justice Department, which reviews such suits and sometimes joins them, declined to participate in these cases. But it did not urge the courts to dismiss the suits, as some senior Interior Department had wanted.

None of the Oklahoma auditors would agree to an interview. Elizabeth Sharrock, a lawyer for Mr. Arnold and Mr. Little, said both men had already been removed from their usual jobs and were afraid of being fired.

But according to their suits, the auditors presented their findings about Shell last October to their supervisor in Houston, Lonnie Kimball. Mr. Kimball, according to court papers, initially told the auditors to "go straight to Shell" with the complaints.

But in January, after meeting with a Shell executive, Mr. Kimball abruptly reversed course and told the auditors to "cease work on all false claims" against Shell.

In its statement on Wednesday, the Interior Department acknowledged that the auditors had been told not to send "issue letters" — an official notification that a company appears to have underpaid royalties.

But it said that other auditing offices had been investigating the issues and taken certain actions. "In fact," it said, "our actions to date include: issuing late-payment interest bills; continuing an ongoing audit; and determining that an issue was not supported by the regulations."

Interior officials did not say how much money they had recovered from companies named by the auditors. But the agency's own statistics indicate that revenue from auditing and enforcement plunged after President Bush took office.

From 1989 through 2001, according to a report by the Congressional Budget Office, auditing and other enforcement efforts generated an average of $176 million a year. But from 2002 through 2005, according to numbers that the department provided lawmakers last May, those collections averaged only $46 million.

In another clash, frustrated federal auditors have complained that the Interior Department no longer allows them to subpoena documents from oil companies.

"Subpoenas are a very powerful tool to get the information you need, but I don't think they've approved a single subpoena in years," Mr. Maxwell said in an interview. "In the good old days when we were able to issue subpoenas on our own, each of us was able to recover millions of dollars a year."

Agency officials acknowledged that they have not issued any subpoenas in the last three years. "Enforcement of subpoenas by the courts can take years and be very costly," the agency said in a written response to questions. "We have not found them to be a very effective tool."

Minerals Management Service's (MMS) Discussion Points In Response to the New York Times (NYT) Article of September 21, 2006

MMS Audit Program

- The MMS's Minerals Revenue Management (MRM) audit program is a large and important part of an operational strategy to ensure timely and correct payment of the nation's mineral lease revenues. The MRM Audit Program is responsible for verifying that correct royalties are paid and for collecting the additional royalties due that are identified during audits. Since its inception in 1982, the MRM audit program has detected and collected well over $3 billion in additional royalties that would otherwise have been lost. This results from the talented work of our auditors.

- MMS has recently implemented new aggressive compliance goals aimed at shortening the compliance cycle and increasing the percentage of revenues being reviewed and/or audited within three years. In FY 2006, our goal is to review and/or audit 72 percent of all Federal and Indian royalty payments within three years from the date of receipt of payment, using a system that targets the largest royalty payors.

- To resolve underpayments of royalties, many times MRM is able to informally resolve issues with the companies where the companies voluntarily report and pay the additional royalty due. In other cases, MRM will send Issue Letters to the companies, which are not subject to appeal, and in many cases the companies choose to voluntarily comply. And in some cases, MRM will need to send Orders to Pay or to Recalculate and Pay to the companies. Some companies comply with the Order and other companies may choose to appeal the Order.

- In November 2005, an independent certified public accounting firm issued a clean audit opinion of MMS' audit program with no material weaknesses, and no reportable conditions. In its opinion, the accounting firm stated:

  "In our opinion, the system of quality control for the Federal Audit Function of MMS in effect for the 2-year period ending December 31, 2004, has been designed to meet the requirements of the quality control standards established by the Comptroller General of the United States for a Federal Government audit organization and was complied with during the 2-year period ending December 31, 2004, to provide MMS with reasonable assurance of conforming with applicable auditing standards, policies, and procedures."

Federal Government Auditing Standards Govern MMS Audit and Compliance Program

- Audits conducted by Federal agencies are governed by standards developed and published by the Government Accountability Office (GAO). These standards (often referred to as the Generally Accepted Government Auditing Standards ("GAGAS" or the "Yellow Book") provide an overall framework for ensuring that auditors have the competence, integrity, objectivity, and independence in planning, conducting, and reporting on their work.

- MRM uses an Audit Manual to assure that the professional standards are consistently met and all audits are consistently documented, completed and supervised. MMS also documented Compliance Review standards in a Compliance Review Manual that, like the Audit Manual, assures that these reviews are conducted in accordance with established procedures. In addition, MMS's Internal Quality Control Review (IQCR) team reviews the MRM compliance organization's adherence to the professional standards and documented internal procedures.

- <u>Independence of Audit Entity</u>. Chapter 3.03 of the GAGAS requires an audit organization that identifies a personal impairment to independence to resolve that impairment in a timely manner. Where the personal impairment applies to a single individual auditor or on a particular assignment, the audit organization may be able to mitigate the impairment by requiring the auditor to eliminate their personal interest.

    - A False Claims Act (FCA) claim filed by an MMS auditor against an oil and gas company lessee and royalty payor that he or she audited results in a personal impairment in fact (with respect to the company audited) and in appearance (with respect to all other Federal and Indian mineral lessees) that causes both the auditor and MMS to be in violation of GAGAS standards for independence. That personal impairment exists because the auditor stands to gain personally by receiving a percentage of the additional royalties collected from the company against which he files a false claim.

- <u>Reporting Fraud and Abuse</u>. The GAGAS standards and MMS Audit Manual require auditors to report fraud, illegal acts, and violations of provisions of contract or grant agreements, and abuse directly to parties outside the audited entity. In the case of MMS audits, our procedures require that as part of their duties, auditors who detect fraud must report it to MMS's Office of Enforcement (OE) who in turn must report it to the Department of the Interior's Office of Inspector General (OIG). Auditors can also go directly to the OIG.

- Procedures Not Followed by Auditors Identified in NYT article. The auditors referred to in the NYT article did not report their fraud allegations to OE, or to the best of our knowledge, to OIG, as required under GAGAS and MMS procedures. The OIG is currently confirming this to be the case. Thus, neither MMS nor the OIG had an opportunity to investigate the allegations of fraud. We refer you to the OIG for further information.

MMS Actions

- MMS Response to Impairment of Independence. In the cases identified in the NYT article where a MRM auditor filed a claim under FCA, MMS had to ask the affected auditor to recuse himself from matters related to the company or companies against which he has a personal claim and if that was not possible within the current position, we arranged to reassign that auditor to other work. Doing so requires MMS to reassign the audits that the auditor/relator was working on to other auditors, resulting in lost productivity, and delays in completion of audits.

- Mr. Maxwell Was Not Fired. The department did not fire Mr. Maxwell, a senior MMS auditor identified in the NYT article. Mr. Maxwell had earlier retired from the MMS and had been rehired as a reemployed annuitant. MMS implemented reorganization within the MRM program to streamline the Offshore Compliance and Asset Management organization within a new office in Houston. The new position in Houston was advertised and Mr. Maxwell did not apply to be considered for the consolidated, permanent position. When the position was filled as part of the reorganization, Mr. Maxwell's position in Denver no longer existed.

- The statements attributed to Mr. John Price are taken out of context. What Mr. Price stated was that there might be an issue worth investigating through the MMS audit process, but not the one the auditor identified in the draft order. Rather than pursue the issue Mr. Price believed might be worth investigating through the MMS audit process, the auditor brought the False Claims action.

False Claim Act (FCA)

- Prior to 1986, the FCA did not allow actions if the action was based on information from the United States or any of its employees. In 1986, Congress amended the FCA to allow any "person" to bring an FCA action. 31 U.S.C. § 3730(b) (1). In *U.S. ex rel. Holmes v. Consumer Insurance Group*, 279 F.3d 1245 (10th Cir. 2002), *rev'd en banc*, 318 F.3d 1199 (10th Cir. 2003), the Tenth Circuit held that a government employee who obtains information about fraud in the scope of his or her employment and who is required to report that fraud is a "person" entitled to bring an FCA action. If a relator wins the case in court, he can be awarded up to 30% of monies awarded.

- The FCA, 31 U.S.C. § 3729 (e), specifically excludes claims, records, or statements made under the Internal Revenue Code of 1986. That means that no one, including an IRS auditor, can bring FCA claims against individuals or corporations for tax fraud. For the IRS, the issue of independence cannot arise because an IRS auditor cannot use information gained in the course of a tax investigation to bring a FCA tax fraud claim.

- MMS and the Department of Justice investigated and analyzed Mr. Maxwell's claim, and the United States declined to intervene in the *qui tam* lawsuit that Mr. Maxwell brought under the False Claims Act (*U.S. ex rel. Maxwell v. Kerr-McGee Chemical Worldwide, LLC*, No. 04-F-1224 (D. Colo.)). Because that litigation is currently pending, we cannot comment on the merits of the case or the legal theories on which Mr. Maxwell's claim is founded. The validity of his claims remains to be determined by the court.

- With respect to the False Claims actions the auditors brought against Shell, the auditor-relators were told by their Supervisor not to pursue the issue because it was included as part of a larger compliance audit. Indeed, when that compliance audit identified some of the issues the auditor-relators also raised, Shell voluntarily paid $7.7 million in additional royalties. In addition, the Shell compliance audit has identified additional issues, for which MRM plans on issuing an order to Shell by the end of the year unless Shell complies voluntarily.

- The other claims center around the non-payment of interest by the minerals industry and allowable transportation deductions from the royalty payment associated with the movement of RIK volumes.

- With respect to the late payment interest allegations, in FY 2006, MMS issued over 3,800 late payment interest bills for a net amount of $7 million including bills to most of the companies the auditors named in the litigation. The issuance of late payment interest bills is an ongoing process within the MRM auditing and compliance program. What happened in the instance reported by the NYT article was that the auditors were told that MMS Financial Management would issue the interest bills (standard procedure). MMS never told the auditors that MMS would not issue interest bills, and MMS has never refused to issue an interest bill.

- With respect to the relators' allegations of improper transportation deductions, an MMS supervisor investigated the claims and determined the deductions were allowable under MMS regulations.

Louisiana Audit and Compliance Program

- The Louisiana lease terms differ from the federal government's lease terms and they have no regulations. Therefore, the fact that the State collects royalties in any particular instance, as reported in the NTY article, has no bearing on the Federal government's methodology for collecting royalties.