HEINTZ DEP.
EXHIBIT 2

Note:

TO: **Ted Heintz**
Brooks Yeager

FROM: **Bob Berman**

SUBJECT: **Status on Underpayment of Royalties on California Crude Oil and Related Enforcement of Common Carrier Provisions of MLA**

You may recall that last April I prepared an issue paper identifying underpayments of royalties in California. These underpayments appeared to be quite large (based on prior settlements payments to the State of California in excess of $335 million as reported in the press), and stemmed, in part, from a failure to enforce the common carrier provision of the MLA. As requested, I expanded the paper and recommended the Department jointly pursue both the additional royalties and the common carrier issues. I provided copy of that paper to MMS.

MMS has completed its review and has concluded that there is substantial evidence that major California oil producers may have undervalued California oil production. MMS further concluded, as described in the earlier issue papers, that this undervaluation was the result of (1) keeping posted prices low and engaging in badger exchanges, and (2) failure to act as a common carrier as required by rights-of-way issued by BLM pursuant to the MLA. Specifically, MMS has conservatively estimated this undervaluation may be in excess of $2.6 billion. MMS calculates that this would result in additional royalties due of $422 million plus interest and penalties. If interest (as much as 33 years) and penalties are included (not considered in the MMS study), the amount due could be more than $1 billion.

The MMS estimates may be considered conservative because they only go back as far as 1960. Documents recently received suggest that the activities resulting in the undervaluation began considerably before 1960; and may date back to the 1930's based on a 2-cut exchange, a variant of the badger (3-cut) exchange.

Moreover, the MMS estimates are based only on production by the integrated major oil companies and do not include crude produced by independent companies. MMS did not consider independent production since such companies were also victims of the business practices of the majors. However, since much of the benefit of the exchange practice derived from underpaying the independent producers of crude from public lands, one may reasonably argue that the integrated majors should be liable for those royalties as well. This later amount may be substantial, particularly if one believes that the purpose of the practice was to obtain crude as cheaply as possible, and only incidentally resulted in under payment of royalties.

HEINTZ DEPO.
EXHIBIT 3

Note:

Dep. Ass't Sec'y for Policy

TO: Brooks Yeager

FROM: Bob Berman

SUBJECT: California Common Carrier and Crude Valuation

DATE: August 6, 1993

The Court recently found in favor of the State of California and City of Long Beach in the 16-year antitrust suit (see attached article in *Platt's Oil Gram News*). Hence, the analysis in the attached issue papers should be regarded as based on established fact rather than allegation or conjecture. The issue addressed the practices and pricing policies, made possible through practices, inconsistent with the common carrier requirement of the right-of-way, that lead to the undervaluation of California crude oils and subsequent denial of the royalties rightfully due the Federal government.

You will recall (see copies of prior issue papers attached) this issue involves BLM and MMS programs. Specifically, BLM grants rights-of-way over Federal lands for oil pipelines on the condition that they be operated as common carriers. MMS collects royalties on oil produced from Federal lands.

I suggest that the Department proceed immediately to ascertain the amount of additional royalties due, including interest and criminal penalties, if any, and initiate collection procedures. This will involve intervening in the on-going litigation to protect Department interests and ensure access to evidence under court protective order. MMS has indicated an interest in pursuing the royalty issues.

The common carrier issues should also be addressed at the same time. This should include (1) an investigation to determine whether rights-of-way agreements were violated; (2) additional clarification or regulations that

may be required; and (3) intervention in the State of California's appeal of the decision regarding Mobil and Mobil's interpretation of the Mineral Leasing Act and inappropriate claims that this interpretation is shared by the Government.

To facilitate the above, it is further suggested that you raise the matter the Assistant Secretary Armstrong and Solicitor Leshy; and form a team of representatives of BLM, MMS, SOL and PPA. The team approach is appropriate due ensure proper coordination due to the interrelatedness of the two issues, and to assist in the specialized economic analysis that may be necessary is quantifying the totally of the damages suffered by the Government.

HEINTZ DEPO.
EXHIBIT 4

Note:

TO: **Brooks Yeager**

FROM: **Bob Berman**

SUBJECT: **Status on California Royalty Deficiency / Common Carrier Issues**

DATE: **December 3, 1993**

Analyses and other staff level activities have progressed about as far as possible without policy direction and decisions. Decisions are required on the following issues:

1. **Should the Department file an *amicus* brief in the pending appeals regarding the Common Carrier requirements of the Mineral Leasing Act? (Note: An affirmative decision is important if the Department is to pursue either of the following royalty matters.)**

2. **Should the Department pursue collection of royalties owing over the time periods covered by the Long Beach I and Long Beach II litigations (and possibly before)?**

3. **Should the Department limit pursuit of royalties to no earlier than 1986?**

Although I have not yet been contacted by the SOL, there is a rumor that a video teleconference will occur within the next couple of weeks to discuss the royalty issues, and that I will be expected to attend. Because of the potentially precedential nature of the common carrier issue, the magnitude of the royalty issue, and the potential for Congressional interest, you may wish to participate in the teleconference. In any event, if you wish to be involved in the decision process, it may be appropriate to mention such interest to Patty Beneke and Tom Fry at this juncture.

1. The MLA requires oil pipelines crossing Federal Lands to operate as common carriers. In spite of

several requests from the State of California and "unofficial complaints" by independent producers, the Department has never pursued alleged violations. Integrated oil companies have advanced an interpretation of the MLA provision inconsistent with the legislative history and contrary to DOI SOL interpretation. Since the Department has never (to my knowledge) issued a full interpretation, nor has ever promulgated regulations in this area, an *amicus* brief may be important to establishing a "clear and consistent Department position" to ensure deference in the future. At a minimum, since any assertion that posted prices were lower than market value must be linked to a failure to effectively act as a common carrier, an *amicus* brief may be necessary to support any claim for additional royalties due.

In considering each of the following decisions, you should know that I have been informed that Inside Energy / Federal Lands is in possession of the MMS analysis showing the $2.6+billion undervaluation and $420+million in additional royalties due.

2. A conspiracy showing is not necessary to demonstrate undervaluation. The undervaluation is substantiated by admissions by the company that (1) the badger exchange was developed because posted prices did not represent value, and (2) that payments outside the four corners of the exchange agreements were necessary. The vast majority of the undervaluation occurred prior to the mid 1980s. Since MMS had no knowledge of either the exchange or side payments until recently (and they appear to have been concealed from auditors), the statute of limitations should not be an issue, even for actions in the 1950s or 1960s.

3. Consideration is being given to a proposal that, *if* additional royalties are pursued, they should only be pursued for the post 1986 time period.* The post-'86

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* The basis of such a limitation is an assertion that the 6 year statute of limitations bars recovery of earlier underpayments. Because full knowledge of the facts (see para 2) was not available until recently, this assertion would appear to be without merit. In the alternative, Congress would certainly request an explanation of why MMS did not pursue collections if it now asserts a position that MMS

underpayments are small relative to the pre-'86 underpayments. Moreover, the difficulty of demonstrating the undervaluation is significantly larger and the arguement is far less convincing if the pre '86 behavior is ignored. Because the Long Beach litigations did not extend beyond 1985, the critical admissions by the companies may not be available/relevant.

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and SOL had such knowledge prior to 1986. The preceding notwithstanding, it has consistently been the SOL position that the statute merely limits judicial remedies and it not a statute of repose. This position underlies the DOI position in both the Gas Contract Settlement litigation and the position on Administrative Offsets and the Debt Collection Act.

HEINTZ DEPO.
EXHIBIT 5

December 4, 1993

Memorandum

To: Ted Heintz

Fr: Brooks Yeager

Re: California Royalty Issues

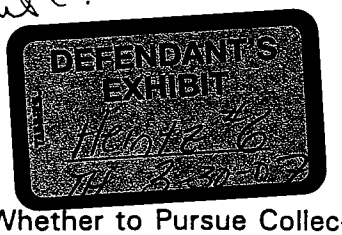
I have received a memo from Bob B. on the Cal. royalty issue, suggesting consideration of an amicus brief in pending appeals. I don't believe that PPA should attempt to fill the Solicitor's role here; however, I would be willing to talk to appropriate folks at SOL about the substance of the issue. In order to do so, I will need a more detailed written briefing on the background of the issue, including a thorough discussion of the actual mechanisms used to reach the undervaluations, and any good summaries or press accounts of the ongoing cases. Bob had done an early memo on the topic -- perhaps he could expand it to meet the need.

I request that you talk to him about this, review the material, and set up a briefing for the week of the 13th.

cc: Bob Berman

HEINTZ DEPO.
EXHIBIT 6

Memo opens inter-agency review date.



Note:

TO: Brooks Yeager

THROUGH: Ted Heintz

FROM: Bob Berman

SUBJECT: Future Review of MMS Revised Analysis of Whether to Pursue Collections of Additional California Royalties Based on Gross Proceeds from Exchange Rather Than On Posted Prices

DATE: May 6, 1994

At the request of the State of California, MMS was has agreed to review additional, factual material, including documents currently under protective order of the court, in determining whether posted prices which were below the gross proceeds from certain exchanges properly represent value for royalty purposes .[1] MMS has also requested that such report, when complete, not be reviewed within PPA; but, instead, receive a limited interagency review prior to release or reliance. The use of protected material, in this instance, coupled with the MMS request to avoid internal review, should be given careful consideration. I recommend the following:

1. MMS should be required to submit its analysis for PPA and SOL review prior to allowing any papers to leave the Department, interagency or otherwise.

2. DOI should attempt to convince the court to vacate its protective order either in its entirety or at least with respect to the documents that relate to programmatic responsibilities of the Department of the Interior.

PPA and SOL Review

Allowing either of these reviews to be waived would set a bad precedent which could weaken the ability of the office to serve the Secretary in the future.

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[1] Note that this does *not* require that MMS reach conclusions regarding price fixing, conspiracy, or degree of market competition. Although price fixing or conspiracy may be sufficient conditions to determine that posted prices do not represent value, they are by no means necessary conditions. Since MMS has traditionally taken the position that royalties are due on the *greater* of gross proceeds or value (one measure of which may be posted prices), it is important to enquire into the gross proceeds or realized value from exchange transactions.

PPA has traditionally reviewed such documents for two purposes. PPA performs technical reviews to ensure correct analysis and application of economic theory; and to ensure consistency with current and past policy of the Department and the Administration. Moreover, PPA's direct client is the Secretary, and it has traditionally been PPA's responsibility to protect the Secretary by advising him of likely or potential responses or reactions that may not be immediately apparent from analyses or positions advocated by individual program offices.

In performing its independent review, PPA has, on occasion, found analyses to be incorrect or incomplete; or has identified inconsistencies between the recommendations of program offices and Department or Administration policy. The current review process adequately provides for instances of disagreement and allows program offices to appeal to the PPA Director, DAS, AS/PMB and the Secretary. To allow a program office to avoid PPA review on request, particularly on contentious issues where a likelihood of disagreement exists, would set a bad precedent as well as deprive the Secretary of necessary protection.

SOL should also have sufficient time to scrutinize this paper. Valuation, by posted prices, of crude entering the market via a 3-Cut or badger exchange may directly affect the Department's long-standing position that value, for royalty purposes, may never be less than gross proceeds. If the value of the 3-cut exchange[2] exceeds the posted price used by the producer for valuing the crude exchanged, there may be an argument that the Department (now knowingly) accepted less than gross proceeds as value. Accordingly, SOL must satisfy itself that this situation cannot be used to weaken its position in other litigation.

Use of Protected Documents

To the extent the MMS paper is to be seriously reviewed by others, the documents reviewed by MMS must also be available. This is especially true if any sort of interagency review is contemplated, whether or not there is a PPA and SOL review. Moreover, to the extent that the document or MMS underlying analysis is used as the basis of a decision, that basis may be questioned by other parties including the IG or GAO auditors, Congressional Committees, or potentially even companies wishing to challenge gross proceeds as a floor value for royalty valuation. The Department would be viewed more favorably if it were in a position to provide the input to the MMS analysis in addition to the output; rather than requiring interested parties to rely solely on the MMS interpretation without ability to investigate. Accordingly, DOI should seek removal of the court seal rather than limiting its request to MMS Access. In the alternative, DOI should request access for itself (DOI generally, rather than only MMS) and

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[2] The value of the exchange is calculated as the refined product prices multiplied by the "agreed" cut factor and by the refinery yield as determined by the assay and badger refining process. This is important because it is how the company recorded the value and was ultimately compensated for the value.

for the Federal Executive Agencies that would potentially review the subsequent MMS study, including the Departments of Treasury, Energy and Commerce, and the Office of Management and Budget.

HEINTZ DEPO.

EXAIBIT 7

Note:

To: Brooks Yeager

Through: Ted Heintz

From: Bob Berman

Subject: MMS Royalty Global Settlements Problems and Secretarial Exposure

Date: September 19, 1994

The problems associated with the Global Royalty Settlements that MMS has been conducting have reached a level that Secretary may be exposed to significant criticism for relinquishing claims to substantial royalty revenues. These relinquishments may be due to a combination of (1) failure to gather sufficient necessary information, including failure to communicate with other bureaus within the Department or with appropriate State agencies; (2) questionable evaluation procedures; (3) inadequate negotiating skills; or (4) lack of appropriate review and oversight prior to committing the Department. In addition to significant budget consequences, these problems also tend to raise program integrity issues as they usually get considerable attention by the press.

Because of both the past problems and the potential for future losses associated with the settlements in process at various stages (Mobil negotiations are nearing completion) and others to be scheduled, it is recommended that the Secretary declare a moratorium and convene a panel to review past procedures and establish a process that will stem these losses. Because these issues cross-cut agency lines, and because of the potential Secretarial fallout, you are an appropriate person to make such a recommendation.

Chevron Settlement: BLM Drainage Issue

Most recently, the BLM completed and released a study reporting royalty and interest losses of approximately $16,000,000 as a result of drainage of Federal resources by wells on adjacent, non-Federal lands. Chevron, the Federal lessee responsible for the drainage, appears to have protected itself from the drainage loss through the use of a operating agreement with the producers on the non-Federal lands. The Government appeared to have been the only loser. Chevron reportedly had admitted to the drainage, although now disputes the amount.

Although the extent of the losses were not known until this summer, the MMS settled the matter with Chevron in a global settlement signed in March, nearly 5 months before BLM had determined the amount. It is not known what basis MMS assigned a value to the drainage issue, or even *if any value* was considered at all. This question may not be resolvable without

a review of the MMS working papers and issue evaluations for this settlement. MMS apparently had not notified BLM of the settlement negotiations, and BLM had not discovered them until late March or early April after the agreement had been signed.

The issue is deemed to have been settled since it was not explicitly preserved in the global settlement agreement. Accordingly, Federal receipts decline as a function of (1) the uncollected revenue, and (2) the 50 percent ($8,000,000) that must be paid to the State of Wyoming as their share of the "settled" claim.

Chevron Settlement: California Crude Valuation

As you are aware, the reasonableness of accepting posted prices as value in the presence of evidence that the lessee may have received considerably more through exchanges in which it took part, is the subject of an interagency review. At the time of this settlement, however, MMS had good reason to believe, through its own preliminary study, that Chevron owed a substantial portion the MMS estimated amount of more than $420,000,000 (plus interest and penalties over 30 years). Accordingly, at the request of this office, MMS agreed to preserve the entire issue. However, the signed agreement only preserved the portion after 1980 (relinquishing claims to 20 years of potential under reporting and associated interest and penalties). MMS appears to have preserved the remaining issues only under the very narrow condition that the Government first prove conspiracy or collusion. MMS also appears to have conceded any statute of limitations issues to Chevron, and has since taken no steps to preserve remaining revenues from potential statute of limitations issues as the interagency review committee gathers evidence and deliberates the implications.

Whether or not the 20 years of relinquished claim was considered in the settlement, or how it was valued if considered, can only be learned from a review of the MMS issue valuation working papers associated with the settlement.

This problem will be compounded if MMS elects to use the text from the Chevron agreement as a model to "preserve" the identical issue in the Mobil global settlement negotiations.

Exxon Settlement: California Crude Valuation

The Exxon global royalty settlement was signed by Exxon in late October and by the MMS in early December. Although MMS had completed its initial estimate of the implications of potential undervaluation in late August or early September, and knew of Exxon's potential involvement, no mention of the issue appeared in the settlement agreement. Thus there was no preservation, and the entirety of the issue appears to be deemed settled. Whether or not there was any consideration of this issue in the settlement can only be learned from the MMS issue valuation working papers associated with the settlement.

HEINTZ DEPO.
EXHIBIT 8

Memorandum

To: Brooks Yeager

Through: Ted Heintz

From: Bob Berman

Subject: Global Royalty Settlement Oversights

Date: December 5, 1994

I have recently learned that additional oversights of the sort highlighted in my September memorandum continue to turn up. In addition to failing to address the BLM drainage issue in the Chevron global settlement, I understand that additional issues may have inadvertently been "settled" to the potential detriment of stake-holders. Specifically, the Shoshone and Arapaho tribes have raised concerns that their issues were not preserved and that they were not consulted during or after the settlement negotiations. The attorney for the tribes will be meeting with MMS staff on Wednesday, December 7, and have indicated they will escalate the issue if it is not resolved at that time.

At this stage, it is likely that the issue would require resolution at the Assistant Secretary and Chief of Staff level (since both MMS and Indian Affairs are involved). Since the matter seems to be moving quickly at this point, it would seem appropriate to ensure the appropriate briefing materials have been forwarded.

It may also be appropriate, at this time, to reconsider the need for reviewing notification, negotiation and oversight procedures for conducting these types of negotiations that cross Assistant Secretary and programmatic lines and involve large amounts of money.