As Profits Soar, Companies Pay U.S. Less for Gas Rights

Energy Giants Report Different Sale Prices to Investors and Federal Government

By EDMUND L. ANDREWS

WASHINGTON, Jan. 22 — At a time when energy prices and industry profits are soaring, the federal government collected little more money last year than it did five years ago from the companies that extracted more than $60 billion in oil and gas from publicly owned lands and coastal waters.

If royalty payments in fiscal 2005 for natural gas had risen in step with market prices, the government would have received about $700 million more than it actually did, a three-month investigation by The New York Times has found.

But an often Byzantine set of federal regulations, largely shaped and fiercely defended by the energy industry itself, allowed companies producing natural gas to provide the Interior Department with much lower sale prices — the crucial determinant for calculating government royalties — than they reported to their shareholders.

As a result, the nation’s taxpayers, collectively, the biggest owner of American oil and gas reserves, have missed much of the recent energy bonanza.

The disparities in gas prices parallel those uncovered just five years ago in a wave of scandals involving royalty payments for oil. From 1998 to 2001, a dozen major companies, while admitting no wrongdoing, paid a total of $438 million to settle charges that they had fraudulently understated their sale prices for oil.

Since then, the government has tightened its rules for oil payments. But with natural gas, the Bush administration recently loosened the rules and eased its audits intended to uncover cheating.

Industry executives deny any wrongdoing, arguing that the disparities stem primarily from different rules for calculating the sale prices for paying royalties and the sale prices for informing shareholders.

“The price of gas downstream is always going to be higher because you have costs that have to be recouped for getting it to the customer,” said Robert H. Davis, a spokesman for Exxon Mobil. “You have to process the gas. You have to transport it, and you have to sell it. There will always be a discrepancy there.”

Companies that pump oil and gas on federal property are required to pay the government royalties, usually 12 percent to 16 percent of the value of what they sell.

Royalties for natural gas have climbed sharply in the last three years. But while prices nearly doubled from 2001 to 2005, the $5.15 billion in gas royalties for 2005 was less than the $5.35 billion in 2001. When oil and gas are combined, royalties were about $8 billion in 2005, almost

Continued on Page A16
the same as in 2001.

Because much of the information about specific transactions is kept secret, it re-

mains unclear to what extent, if at all, the weaknesses in royalty payments stem from
deliberate cheating or from issues with the rules themselves.

But one major producer, Burlington Re-

sources, admitted to shareholders last year
that it might have underpaid about $76 mil-
lion in gas royalties in the 1990's. And in Al-

abama, a jury ruled in 2003 that Exxon had
 cheated on $63.6 million worth of royalties
from gas wells in state-owned waters. The
jury awarded $11.9 billion in punitive dam-
ages, which a judge later reduced to $3.5 bil-
lion. Exxon disputes the charges and is ap-
pealing the verdict.

The possible losses to taxpayers in gas
could be even higher than the losses tied to

Shifting Numbers
On Price Reports

After admitting their surprise that com-
panies were reporting much higher sales
prices for oil and gas to shareholders than to
the Interior Department, the Minerals Man-
agement service supplied The New York Times with new statistics that seemed to
make the gap disappear.

In its new analysis, the agency said the published statistics for each year included
scores of adjustments that companies had made to reports from earlier years. It then
produced a markedly different new chart, saying it had put those adjustments into the
proper years.

In effect, the changes shifted about 15 per-
cent of gas production from 2004, a year of high prices, to 2001, when prices were much
lower. As if waving a wand, the statisticians declared that the government's average
“sales value” for gas in 2004 and 2005 was actually “very comparable” to the sales
prices that companies like Chevron had re-
ported to shareholders.

But the new statistics were wrong. They
showed big swings in annual gas production that contradicted data compiled by the En-
ergy Information Administration.

Two days after being asked to clarify the discrepancy, a spokesman for the Minerals Management Service said the new numbers contained a huge error: the statisticians had erroneously shifted 800 billion cubic feet of gas from 2004 to 2001, when they should only have shifted about 8 million cubic feet. The error invalidated all the other new num-
bers.

“It was the leaseholder’s mistake,” said
Patrick Etchart, a spokesman for the Min-
eral Management Service, adding that an
energy company had put down “more ze-
roes than they should have.”

EDMUND L. ANDREWS

A Pro-Industry Approach

But the Bush administration did not close
any loopholes for valuing natural gas. In-

deed, in March 2005 it expanded the list of
deductions and decided against valuing sales at spot-market prices when companies
were selling to their own affiliates.

The industry-friendly stance was inten-
tional. Mr. Bush and top White House offi-
cials also placed a top priority on promoting
domestic energy production. Vice President
Dick Cheney’s energy task force called for
giving lucrative new incentives to compa-
nies that drill in the Gulf of Mexico and oth-
er high-risk areas.

The Bush administration also took a much
more relaxed approach to auditing and
fraud prevention. In 2003, the Interior De-
partment’s inspector general declared that
the auditing process was “ineffective” and
“lacked accountability” and that many of the auditors were unqualified.

In one instance, inspectors discovered
that auditors had lost the working papers for
an important audit and tried to cover up
their blunder by creating and back-dating
false documents. Rather than punish any-
body, the inspector general recounted, the
minerals service gave the employee who pro-
duced the new documents a financial bon-
us for “creativity.”

Administration officials said last week
that they had addressed most of the criti-
cisms and that the inspector general had
defined since said its corrective actions were “suffi-
cient.”

The Interior Department also fired two of
its most aggressive and successful auditors.
One of them was Bobby L. Maxwell, a vet-
eran auditor who had recovered hundreds of
millions of dollars in underpayments over a
22-year career and received an award for meritorious service in 2003 from Interior
Secretary Gale A. Norton.

Mr. Maxwell was fired in early 2005 after
clashing with superiors over his belief that
Kerr-McGee had shortchanged the govern-
ment $12 million. Mr. Maxwell charged that
he had been wrongfully fired, and the gov-
ernment paid him an undisclosed amount of
money to settle out of court.

Mr. Maxwell is now pursuing Kerr-
McGee, which has denied any guilt, with his
own lawsuit under the False Claims Act,
which allows private citizens who prove
fraud to collect some of the money they help recover.

Patrick Etchart, a spokesman for the Min-
erals Management Service in Denver, said
that Mr. Maxwell lost his job because of a
reorganization and that he had declined an
offer to move to a different city.

But lawmakers who wrestled with the
Coming Up Short?

In return for the right to extract natural gas from territory controlled by the federal government, energy companies pay a royalty based on the amount and the value of the energy produced and sold. Over the last two years, the companies reported to the government that they received lower prices than what they disclosed to their shareholders. As a result, the government’s royalties have been lower than if the higher prices had been used.

Energy companies pay royalties for gas and oil taken from federal lands and offshore fields like this one in the Gulf of Mexico. government over previous royalty scandals are dubious.

“It’s all gotten worse, not better,” said Representative Carolyn B. Maloney, Democrat of New York, who led Congressional investigations into cheating on oil royalties in the 1990’s. “They make the process so complicated that no one can really follow the money.”

Ending Detailed Inspections

Perhaps the most striking example of sluggish auditing is the government’s effort to collect back royalties from companies that blatantly ignored one of the government’s basic rules.

Under current rules aimed at promoting energy production in deep waters, companies can produce large volumes of oil and gas without paying royalties at all. But the rules also require companies to start paying royalties if market prices climb above certain “threshold” levels.

As it happens, market prices have been above those levels since the 2003 fiscal year. But even though dozens of companies never bothered to start paying, Ms. Burton said earlier this month that the government had yet to demand repayment three months into the 2006 fiscal year.

“It’s more complicated than you might think,” said Lucy Querques Dennett, associate director of the Minerals Management Service in charge of the issue.

But enforcing the rules about price thresholds is easy compared with verifying the actual sale value of natural gas.
Over the last four years, the Bush administration has ordered its auditors to move away from detailed inspections in favor of a more cursory approach of looking for anomalies in company reports. If a company in Louisiana, say, reported prices that differed from those of other companies in the same region, it would attract closer scrutiny.

Mr. Etchart, the agency’s spokesman, said that the number of full-scale audits had declined slightly over the past few years and that the budget for compliance had fallen.

But he said the government still took a “close look” at 71 percent of oil and gas production. “Our strategy would obviously be to focus on anomalies,” he said, “but it is also to focus on large producing areas.”

The agency’s strategy has drawn protests, however, from many states, which are entitled to a share of federal royalties, and from some of the Interior Department’s most aggressive auditors.

One of those auditors was Kevin Gambrell, director of the Federal Indian Minerals Office in Farmington, N.M. Mr. Gambrell fought with his superiors over many issues, one of which was their demand that he do fewer audits and simply monitor posted prices of companies in the same area.

“Where the M.M.S. approach falls short is that there are so many different types of deductions you can take in getting gas and oil to the market, and there are so many premiums and bonuses in the contracts,” Mr. Gambrell said in a recent interview. “You have to take a detailed look at the contracts to know what’s going on.”

The Interior Department forced Mr. Gambrell out in 2003, charging that he had improperly destroyed office documents. Mr. Gambrell sued for wrongful termination, arguing that he had discarded only copies of documents. He also presented evidence that his office had recovered eight times as much money as offices that used the administration’s preferred approach.

The government settled his case in 2004 by clearing him of any wrongdoing and paying him an undisclosed amount of money.

For practical purposes, the biggest cost to taxpayers may have less to do with cheating and fraud than with the government’s inscrutable rules.

Consider the case of Burlington Resources, a Houston-based producer that ConocoPhillips acquired in December for $35.6 billion. Burlington paid $8.5 million in 2001 to settle charges of cheating related to its oil royalties. Last March, Burlington disclosed that it might also have underpaid gas royalties by about $76 million during the 1990’s. It set aside $81 million to cover possible litigation costs.

Unlike others, Burlington executives provided information to The Times on the royalties it paid for natural gas and on the sale prices that it has reported to the Interior Department since 2002.

During those four years, Burlington said it paid $657 million in gas royalties and that its annual payment shot up from $89 million in 2002 to $233 million in 2005.

That surge in royalties does track closely with the rise in market prices. But Burlington’s numbers also highlight the essential issue raised by many critics: the rules let companies understate the value of their gas sales by taking scores of deductions.

Those deductions include the cost of transportation, processing, brokerage fees, pipeline reservation fees and even certain “theoretical losses” for companies that own their own pipelines.

In 2001, Burlington reported an average price of $1.98 per thousand cubic feet to the government but an average sale price of $3.20 to its shareholders. In 2005, the company reported an average sale price of $5.75 to the government and $6.46 to shareholders.

### Keeping Royalties Secret

James Bartlett, a spokesman for Burlington, said part of the discrepancy resulted from the fact that much of Burlington’s production is in the Rocky Mountains, where natural gas fetches lower prices.

The federal government does not require companies to divulge the amount of royalties they pay or what they tell the government about sale prices. And unlike Burlington Resources, Exxon and most other major oil companies refused to disclose the information when asked.

“It’s not required information,” said Mr. Davis of Exxon, echoing responses from Chevron, Royal Dutch/Shell and other big producers. “We’re not going to publish it.”
U.S. ROYALTY PLAN
TO GIVE WINDFALL
TO OIL COMPANIES

$7 BILLION OVER 5 YEARS

Incentives for Exploration Are Backfiring in Time of Higher Prices

By EDMUND L. ANDREWS
WASHINGTON, Feb. 13 — The federal government is on the verge of one of the biggest giveaways of oil and gas in American history, worth an estimated $7 billion over five years.

New projections, buried in the Interior Department’s just-published budget plan, anticipate that the government will let companies pump about $65 billion worth of oil and natural gas from federal territory over the next five years without paying any royalties to the government.

Based on the administration figures, the government will give up more than $7 billion in payments between now and 2011. The companies are expected to get the largess, known as royalty relief, even though the administration assumes that oil prices will remain above $50 a barrel throughout that period.

Administration officials say that the benefits are dictated by laws and regulations that date back to 1996, when energy prices were relatively low and Congress wanted to encourage more exploration and drilling in the high-cost, high-risk deep waters of the Gulf of Mexico.

“We need to remember the primary reason that incentives are given,” said Johnnie M. Burton, director of the federal Minerals Management Service. “It’s not to make more money, necessarily. It’s to make more oil, more gas, because production of fuel for our nation is essential to our economy and essential to our people.”

But what seemed like modest incentives 10 years ago have ballooned to levels that have alarmed even ardent supporters of the oil and gas industry, partly because of added sweeteners approved during the Clinton administration but also because of ambiguities in the law that energy companies have successfully exploited in court.

Short of imposing new taxes on the industry, there may be little Congress can do to reverse its earlier

Continued on Page C2
giveaways. The new projections come at a moment when President Bush and Republican leaders are on the defensive about record-high energy prices, soaring profits at major oil companies and big cuts in domestic spending.

Indeed, Mr. Bush and House Republicans are trying to kill a one-year, $5 billion windfall profits tax for oil companies that the Senate passed last fall.

Moreover, the projected largess could be just the start. Last week, Kerr-McGee Exploration and Development, a major industry player, began a brash but utterly serious court challenge that could, if it succeeds, cost the government another $28 billion in royalties over the next five years.

In what administration officials and industry executives alike view as a major test case, Kerr-McGee told the Interior Department last week that it planned to challenge one of the government’s biggest limitations on royalty relief if it could not work out an acceptable deal in its favor. If Kerr-McGee is successful, administration projections indicate that about 80 percent of all oil and gas from federal waters in the Gulf of Mexico would be royalty-free.

“It’s one of the greatest train robberies in the history of the world,” said Representative George Miller, a California Democrat who has fought royalty concessions on oil and gas for more than a decade. “It’s the gift that keeps on giving.”

Republican lawmakers are also concerned about how the royalty relief program is working out.

“I don’t think there is a single member of Congress who thinks you should get royalty relief at $70 a barrel!” for oil, said Representative Richard W. Pombo, Republican of California and chairman of the House Resources Committee.

“It was Congress’s intent,” Mr. Pombo said in an interview on Friday, “that if oil was at $10 a barrel, there should be royalty relief so companies could have some kind of incentive to invest capital. But at $70 a barrel, don’t expect royalty relief.”

Tina Kreisher, a spokeswoman for the Interior Department, said Monday that the giveaways might turn out to be less than the basic forecasts indicate because of “certain variables.”

The government does not disclose how much individual companies benefit from the incentives, and most companies refuse to disclose either how much they pay in royalties or how much they are allowed to avoid.

But the benefits are almost entirely for gas and oil produced in the Gulf of Mexico.

The biggest producers include Shell, BP, Chevron and Exxon Mobil as well as smaller independent companies like Anadarko and Devon Energy.

Executives at some companies, including Exxon Mobil, said they had already stopped claiming royalty relief because they knew market prices had exceeded the government’s price triggers.

About one-quarter of all oil and gas produced in the United States comes from federal lands and federal waters in the Gulf of Mexico.

As it happens, oil and gas royalties to the government have climbed much more slowly than market prices over the last five years.

The New York Times reported last month that one major reason for the lag appeared to be a widening gap between the average sales prices that companies are reporting to the government when paying royalties and average spot market prices on the open market.

Industry executives and administration officials contend that the disparity mainly reflects different rules for defining sales prices. Administration officials also contend that the disparity is illusory, because the government’s annual statistics are muddled up with big corrections from previous years.

Both House and Senate lawmakers are now investigating the issue, as is the Government Accountability Office, Congress’s watchdog arm.

But the much bigger issue for the years ahead is royalty relief for deepwater drilling.

The original law, known as the Deep Water Royalty Relief Act, had bipartisan support and was intended to promote exploration and production in deep waters of the outer continental shelf.

At the time, oil and gas prices were comparatively low and few companies were interested in the high costs and high risks of drilling in water thousands of feet deep.

The law authorized the Interior Department, which leases out tens of millions of acres in the Gulf of Mexico, to forgo its normal 12 percent royalty for much of the oil and gas produced in very deep waters.

Because it take years to explore and then build the huge offshore platforms, most of the oil and gas from the new leases is just beginning to flow.

The Minerals Management Serv-
Royalty-Free Oil and Gas

Interior Department projections indicate that the federal government will let companies pump about $65 billion worth of oil and gas from federal lands over the next five years without paying royalties to the government.

Value of oil pumped royalty-free*

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>Total</th>
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<td>$1.6</td>
<td>$1.9</td>
<td>$3.0</td>
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Value of gas pumped royalty-free*

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<th>Fiscal Year</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
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<tr>
<td>Value</td>
<td>$7.9</td>
<td>$9.1</td>
<td>$8.8</td>
<td>$8.7</td>
<td>$8.1</td>
<td>$7.9</td>
<td>$50.4</td>
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Source: Minerals Management Service

*Data are estimates for the Gulf of Mexico

The dispute has been simmering for months, with some industry executives warning the Bush administration that they would sue the government if it tried to demand royalties.

Last week, the fight broke out into the open. The Interior Department announced that 41 oil companies had improperly claimed more than $500 million in royalty relief for 2004. Most of the companies agreed to pay up in January, but Kerr-McGee said it would fight the issue in court.

The fight is not simply about one company. Interior officials said last week that Kerr-McGee presented itself in December as a “test case” for the entire industry. It also offered a “compromise,” but Interior officials rejected it and issued a formal order in January demanding that Kerr-McGee pay its back royalties.

On Feb. 6, according to administration officials, Kerr-McGee formally notified the Minerals Management Service that it would challenge its order in court.

Industry lawyers contend they have a strong case, because Congress never mentioned price thresholds when it authorized royalty relief for all deepwater leases awarded from 1996 through 2000.

“Congress offered those deepwater leases with royalty relief as an incentive,” said Jonathan Hunter, a lawyer in New Orleans who represented oil companies in a similar lawsuit two years ago that knocked out another major federal restriction on royalty relief.

“The M.M.S. only has the authority that Congress gives it,” Mr. Hunter said. “The legislation said that royalty relief for these leases is automatic.”

If that view prevails, the government said it would lose a total of nearly $35 billion in royalties to taxpayers by 2011 — about the same amount that Mr. Bush is proposing to cut from Medicare, Medicaid and child support enforcement programs over the same period.
Vague Law and Hard Lobbying
Add Up to Billions for Big Oil

By EDMUND L. ANDREWS

WASHINGTON, March 26 — It was after midnight and every lawmaker in the committee room wanted to go home, but there was still time to sweeten a deal encouraging oil and gas companies to drill in the Gulf of Mexico.

“There is no cost,” declared Representative Joe L. Barton, a Texas Republican who was presiding over Congressional negotiations on the sprawling energy bill last July. An obscure provision on new drilling incentives was “so noncontroversial,” he added, that senior House and Senate negotiators had not even discussed it.

Mr. Barton’s claim had a long history. For more than a decade, lawmakers and administration officials, both Republicans and Democrats, have promised there would be no cost to taxpayers for a program allowing companies to avoid paying the government royalties on oil and gas produced in publicly owned waters in the Gulf.

But last month, the Bush administration confirmed that it expected the government to waive about $7 billion in royalties over the next five years, even though the industry incentive was expressly conceived of for times when energy prices were low. And that number could quadruple to more than $28 billion if a lawsuit filed last week challenging one of the program’s remaining restrictions proves successful.

“The big lie about this whole program is that it doesn’t cost anything,” said Representative Edward J. Markey, a Massachusetts Democrat who tried to block its expansion last July. “Taxpayers are being asked to provide huge subsidies to oil companies to produce oil — it’s like subsidizing a fish to swim.”

How did a supposedly cost-free incentive become a multibillion-dollar break to an industry making record profits?

The answer is a familiar Washington story of special-interest politics at work: the people who pay the closest attention and make the fewest mistakes are those with the most profit at stake.

It is an account of legislators who passed a law riddled with ambiguities; of crucial errors by midlevel bureaucrats under President Bill Clinton; of $2 billion in inducements from the Bush administration, which was intent on promoting energy production; and of Republican lawmakers who wanted to do even more. At each turn, through shrewd lobbying

Continued on Page A16
and litigation, oil and gas companies ended up with bigger incentives than before.

Until last month, hardly anyone noticed — or even knew — the real costs. They were obscured in part by the long gap between the time incentives are offered and when new offshore wells start producing. But lawmakers shrouded the costs with rosy projections. And administration officials consistently declined to tally up the money they were forfeiting.

Most industry executives say that the royalty relief spurred drilling and exploration when prices were relatively low. But the industry is divided about whether it is appropriate to continue the incentives with prices at current levels. Michael Coney, a lawyer for Shell Oil, said, “Under the current environment, we don’t need royalty relief.”

The program’s original architect said he was surprised by what had happened. “The one thing I can tell you is that this is not what we intended,” said J. Bennett Johnston, a former Democratic senator from Louisiana who had pushed for the original incentives that Congress passed in 1995.

Mr. Johnston conceded that he was confused by his own law. “I got out the language a few days ago,” he said in a recent interview. “I had it out just long enough to know that it’s got a lot of very obscure language.”

**A Subsidy of Disputed Need**

Things looked bleak for oil and gas companies in 1995, especially for those along the Gulf Coast.

Energy prices had been so low for so long that investment had dried up. With crude oil selling for about $16 a barrel, scores of wildcatters and small exploration companies had gone out of business. Few companies had any stomach for drilling in water thousands of feet deep, and industry leaders like Exxon and Royal Dutch Shell were increasingly focused on opportunities abroad.

“At the time, the Gulf of Mexico was like the Dead Sea,” recalled John Northington, then an Energy Department policy adviser and now an industry lobbyist.

Senator Johnston, convinced that the Gulf’s vast reservoirs and Louisiana’s oil-based economy were being neglected, had argued for years that Congress should offer incentives for deep-water drilling and exploration.

“Failure to invest in the Gulf of Mexico is a lost opportunity for the U.S.,” Mr. Johnston pleaded in a letter to other lawmakers. “Those dollars will not move into other domestic development, they will move to Asia, South America, the Middle East or the former Soviet Union.”

Working closely with industry executives, he wrote legislation that would allow a company drilling in deep water to escape the standard 12 percent royalty on up to 87.5 million barrels of oil or its equivalent in natural gas. The coastal waters are mostly owned by the federal government, which leases tens of millions of acres in exchange for upfront fees and a share of sales, or royalties.

Mr. Johnston and other supporters argued that the incentives would actually generate money for the government by increasing production and prompting companies to bid higher prices for new leases.

“The provision will result in a minimum net benefit to the Treasury of $200 million by the year 2000,” Mr. Johnston declared in November 1995, denouncing what he called “outrageous allegations” that the plan was a giveaway.

He won support from oil-state Democrats, Republicans and the Clinton administration. Hazel O’Leary, the energy secretary at the time, said the assistance would reduce American dependence on foreign oil and “enhance national security.”

Representative Robert Livingston of Louisiana, then a rising Republican leader, declared that the incentives would “create thousands of jobs” and “reduce the deficit.”

Many budget experts agree that the rosy estimates were misleading. The reason, they say, is that it often takes seven years before a new offshore field begins producing. As a result, almost all the costs of royalty relief would occur outside of Congress’s five-year budget timeframe.

Opponents protested that the cost estimates were wrong, that the incentives amounted to corporate welfare and that companies did not need government incentives to invest.

“They are going to the Gulf of Mexico because that’s where the oil is,” said Representative George Miller, Democrat of California, during a House debate. “What we do here is not going to change that. We are just going to decide whether or not we are going to give away the taxpayers’ dollars to a lot of oil companies that do not need it.”

Industry executives and lobbyists fanned out across Capitol Hill to shore up support for the program, visiting 150 lawmakers in October 1995. The effort succeeded. A month later, Congress passed Mr. Johnston’s bill.

**A Missing Escape Clause**

To hear lawmakers today, they never intended to waive royalties when energy prices were high.

The 1995 law, according to Republicans and Democrats alike, was supposed to include an escape clause: in any year when average spot prices for oil or gas climbed above certain threshold levels, companies would pay full royalties instead.

“Royalty relief is an effective tool for two things: keeping investment in America during times of super-low prices, and spurring American energy production when massive capital and technological risks would

### Giving Away $7 Billion In Royalties

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<th>Date</th>
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<tr>
<td>NOVEMBER 1995</td>
<td>Deep Water Royalty Relief Act is passed, allowing companies to avoid paying some royalties on oil and gas produced in deep water in the Gulf of Mexico. Bill has bipartisan support.</td>
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<tr>
<td>1998-99</td>
<td>Interior Department makes big mistake on leases awarded in these two years. The department omits price thresholds that would cut royalty relief if oil and gas prices rose above about $34 a barrel for crude and about $4 per thousand cubic feet of natural gas.</td>
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<tr>
<td>2000</td>
<td>Interior realizes the error and quietly adds price thresholds into new leases — but the old leases remain valid.</td>
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<td>2001</td>
<td>A vice presidential task force issues National Energy Policy recommendations, urging the government to open up more federal lands and waters to oil and gas development to “explore opportunities for royalty reductions.”</td>
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<tr>
<td>MARCH 2003</td>
<td>U.S. District Court in Louisiana knocks down a restriction on the volume of royalty-free oil and gas a company can produce. This effectively doubles or triples the incentives.</td>
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Giving Away
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Mr. Johnston and other supporters
Congress about it until last month.

The fight was not even close. In
January 2003, a federal district judge
declared that the Interior Depart-
ment’s rules violated the 1995 law. If
the department “disagrees with Con-
gress’s policy choices,” Judge James
T. Trimble Jr. wrote, “then such ar-
guments are best addressed to Con-
gress.”

What might have been a $2 billion
mistake in the Clinton administra-
tion suddenly ballooned into a $5 bil-
lion headache under Mr. Bush.

But even as the Bush administra-
tion was losing in court, it was of-
fering new incentives for the energy
industry.

Mr. Bush placed a top priority on
expanding oil and gas production as
soon as he took office in 2001. Vice
President Dick Cheney’s task force
on energy, warning of a deepening
shortfall in domestic energy produc-
tion, urged the government to “ex-
ploration opportunities for royalty re-
duction” and to open areas like the
Arctic National Wildlife Refuge to

Gale A. Norton, who stepped down
this month as interior secretary, moved
quickly to speed up approvals of
new drilling permits. Starting in
2001, she offered royalty incentives
to shallow-water producers who
drilled more than 15,000 feet below
the sea bottom.

In January 2004, Ms. Norton made
the incentives far more generous by
raising the threshold prices. Her de-
cision meant that deep-gas drillers
were able to escape royalties in 2005,
when prices spiked to record levels,
and would probably escape them this
year as well.

She also offered to sweeten less-
genorous contracts the drillers had
signed before the regulation was ap-
proved.

“These incentives will help ensure
we have a reliable supply of natural
gas in the future,” Ms. Norton pro-
claimed, predicting that American
consumers would save “an estimat-
ed $570 million a year” in lower fuel
prices.

Ms. Norton’s decision was influ-
enced by the industry. The Interior
Department had originally proposed
a cut-off price for royalty exemp-
tions of $5 per million British ther-
mal units, or B.T.U.’s, of gas. But the
Independent Petroleum Association
of America, which represents small-
er producers, argued that the new
incentive would have little value be-
cause natural gas prices were al-
ready above $5. Ms. Norton set the
threshold at $9.34.

Based on administration assump-
tions about future production and
prices, that change could cost the
government about $1.9 billion in lost
royalties.

“There is no cost rationale,” said
Shirley J. Neff, an economist at Co-
lumbia University and Senator
Johnston’s top legislative aide in
drafting the 1995 royalty law. “It is
astounding to me that the adminis-
tration would so blatantly cave in to
the industry’s demands.”

Incentives Keep Grow

Last April, President Bush himself
expressed skepticism about giving
new incentives to oil and gas drillers.
“With oil at $50 a barrel,” Mr. Bush
remarked, “I don’t think energy
companies need taxpayer-funded in-
centives to explore.”

But on Aug. 8, Mr. Bush signed a
sweeping energy bill that contained
$2.6 billion in new tax breaks for oil
and gas drillers and a modest expan-
sion of the 10-year-old “royalty re-
lied” program. For the most part, the
law locked in incentives that the In-
terior Department was already offer-
ing for another five years. But it in-
cluded some embellishments, like an

otherwise preclude it,” said Repre-
sentative Richard W. Pombo, Repub-
lican of California and chairman of
the House Resources Committee.

“Absent those criteria, I do not be-
lieve any relief should be granted.”
But in what administration offi-
cials said appeared to have been a
mistake, Clinton administration
managers omitted the crucial escape
clause in all offshore leases signed in

At the time, with oil prices still be-
low $20 a barrel, the mistake seemed
harmless. But energy prices have
been above the cutoff points since
2002, and Interior Department offi-
cials estimate that about one-sixth of
production in the Gulf of Mexico is
still exempt from royalties.

Walter Cruckshank, a senior offi-
cial in both the Clinton and Bush ad-
mnistrations, told lawmakers last
month that officials writing the lease
contracts thought the price thresh-
olds were spelled out in the new reg-
ulations, which were completed in
1998. But officials writing the reg-
ulations left those details out, pre-
ferring to set the precise rules at
each new lease sale.

“It seems to have been a massive
crew-up,” said Mr. Northrington,
who was then in the Energy De-
partment. No one noticed the error
for two years, and no one informed
Congress about it until last month.

Five years later, the costs of that
lapse were compounded. A group of
oil companies, led by Shell, defeated
the Bush administration in court.

The decision more than doubled the
amount of oil and gas that companies
could produce without paying roy-
alties.

The case began as a relatively ob-
scure dispute. Shell paid $3.8 million
in 1997 for a Gulf lease and soon
drilled a successful well. But the In-
terior Department denied the com-
pany royalty relief, saying that Shell
had drilled into an older field already
producing oil and gas. The decision
hinged on undersea geography and
the court’s interpretation of lan-
guage in the 1995 law.

A typical field, or geological reser-
voir, often encompasses two or three
separately leased tracts of ocean
floor. Interior Department officials
insisted that the maximum amount
of royalty-free oil and gas was based
on each field. Shell and its partners
argued that limit applied only to
each lease.

Perhaps shrewdly, the oil com-
panies sued the Bush administration
in Louisiana, where federal courts pre-
viously had sided with the industry in
spats with the government.

The fight was not even close. In
January 2003, a federal district judge
declared that the Interior Depart-
ment’s rules violated the 1995 law. If
the department “disagrees with Con-
gress’s policy choices,” Judge James
T. Trimble Jr. wrote, “then such ar-
guments are best addressed to Con-
gress.”

What might have been a $2 billion
mistake in the Clinton administra-
tion suddenly ballooned into a $5 bil-
lion headache under Mr. Bush.

But even as the Bush administra-
tion was losing in court, it was of-
fering new incentives for the energy
industry.

Mr. Bush placed a top priority on
expanding oil and gas production as
soon as he took office in 2001. Vice
President Dick Cheney’s task force
on energy, warning of a deepening
shortfall in domestic energy produc-
tion, urged the government to “ex-
ploration opportunities for royalty re-
duction” and to open areas like the
Arctic National Wildlife Refuge to

Gale A. Norton, who stepped down
this month as interior secretary,
moved quickly to speed up approvals
of new drilling permits. Starting in
2001, she offered royalty incentives
to shallow-water producers who
drilled more than 15,000 feet below
the sea bottom.

In January 2004, Ms. Norton made
the incentives far more generous by
raising the threshold prices. Her de-
cision meant that deep-gas drillers
were able to escape royalties in 2005,
when prices spiked to record levels,
and would probably escape them this
year as well.

She also offered to sweeten less-
Giving Away

"tended," said J. Bennett Johnston, a
you is that this is not what we in-
relatively low. But the industry is di-

Continued From Page A1

had any stomach for drilling in water

royalty relief." 

price thresholds that

department omits

But on Aug. 8, Mr. Bush signed a

Incentives Keep Growing

The program's original architect

royalty provisions. "We

Mr. Barton, the Texas Republican,

 brushed aside the objections. He re-

visions would not cost taxpayers

When Mr. Markey proposed a

more modest change — having Con-

gress prohibit incentives if crude oil

prices rose above $40 a barrel — Re-

publicans quickly voted him down

"The only reason they waited until

after midnight to bring up these is-

sues is that they couldn't stand up in

the light of day," Mr. Markey said in

a recent interview. "They all expect-

ed me to give up because it was so

late and I didn't have the votes. But if

nothing else, I wanted to get these

things on the record."

A Royalty-Free Future?

It is still not clear how much im-

pact the reduced royalties had in en-

couraging deep-water drilling. While

activity in the Gulf has increased

since 1995, prices for oil and gas have

more than quadrupled over the same

period, providing a powerful motiva-

tion, experts say.

"It's hard to make a case for roy-

alty relief, especially at these high

prices," said Jack Overstreet, owner

of an independent oil exploration

company in Texas. "But the oil in-

dustry is like the farm lobby and will

have its hand out at every opportuni-

ty."

The size of the subsidies will soar

far higher if oil companies win their

newest court battle.

In a lawsuit filed March 17, Kerr-

McGee Exploration and Production

argued that Congress never author-

ized the government to set price cut-

offs for incentives on leases awarded

from 1996 through 2000. If the com-

pany wins, the Interior Department re-

cently estimated, about three-quar-

ters of oil and gas produced in the

Gulf of Mexico will be royalty-free

for the next five years.

Mr. Markey and other Democrats

recently introduced legislation that

would pressure companies to pay full

royalties when energy prices are high,

regardless of what their leases allow.

But Republican lawmakers and the

Bush administration have sig-

naled their opposition.

"These are binding contracts that

the government signed with compa-

nies," Ms. Norton recently re-

marked. "I don't think we can change

them just because we don't like

them."
Chevron Could Avoid Huge Royalties From Oil Find in the Gulf

By EDMUND L. ANDREWS
WASHINGTON, Sept. 11 — A group of oil companies led by Chevron, which said last week that they had discovered a huge new oil field in the Gulf of Mexico, could avoid more than $1 billion in royalty payments to the federal government for the oil.

The potential bonus to Chevron and its partners stems from a mistake the Interior Department made in signing offshore leases in the late 1990’s for drilling in federal waters. The magnitude of the oil discovery — estimated in a range of 3 billion to 15 billion barrels — is likely to intensify a battle in Congress over incentives for drilling in publicly owned waters.

Under pressure from lawmakers, Chevron and other big producers have said that they would renegotiate their leases. But they have not said how much they are willing to give up, and the Interior Department has virtually no bargaining power under current law.

Chevron and its partners, Devon Energy and Statoil ASA of Norway, have six leases in the Jack oil field, about 175 miles off the coast of Louisiana. Two of the leases allow the companies to avoid royalties on as much as 87.5 million barrels of oil per lease.

The benefit, known as royalty relief, was supposed to be halted if the price of oil climbed above $36 a barrel. But that restriction was omitted on all leases signed in 1998 and 1999, including the two held by Chevron and its partners.

The exact value of the potential break on federal payments will depend both on the price of oil and how much of it comes from the two leases. At $70 a barrel, the Chevron group could save about $1.5 billion in royalties if the government agreed that both leases were contributing to Chevron’s production.

But the actual savings would be much lower if oil prices slumped to $40 a barrel. And the savings would disappear if the government insisted that none of Chevron’s output was coming from the two leases, but from the four not eligible for the break.

A spokesman for Chevron, Don Campbell, said Monday that “any conjecture about forgone royalties” would be “pure speculation and an academic exercise.”

The Chevron leases are the biggest, but hardly the only leases that allow oil companies to avoid roy-

Continued on Page 5
A halt to royalty relief in '98 and '99 leases was somehow omitted.

The hearings this week are expected to focus on how the Interior Department blundered on the leases. The inspector general, Earl E. Devaney, has concluded that the leases were a mistake rather than a result of any collusion with industry.

But Mr. Devaney is also expected to say that the Interior Department continues to suffer from a “lack of accountability.” Investigators have combed through 5,000 e-mail messages and are believed to have found some written as recently as this summer in which frustrated midlevel officials warned that the Interior Department had not fixed the bureaucratic and procedural problems that led to the original mistake.

Representative Davis and Representative Darrell Issa, Republican of California and chairman of the Government Reform energy and resources subcommittee, accused the Interior Department in August of deliberately obstructing their investigation.

“We are deeply concerned that the department may have intentionally withheld critical information from the subcommittee,” the two lawmakers wrote in a letter on Aug. 3 to Dirk Kempthorne, the new Interior secretary. “If this is the case, then it has intentionally impeded this duly authorized Congressional investigation.”
STUDY SUGGESTS INCENTIVES ON OIL BARELY HELP U.S.

BILLIONS TO SPUR DRILLING

By EDMUND L. ANDREWS

WASHINGTON, Dec. 21 — The United States offers some of the most lucrative incentives in the world to companies that drill for oil in publicly owned coastal waters, but a newly released study suggests that the government is getting very little for its money.

The study, which the Interior Department refused to release for more than a year, estimates that current inducements could allow drilling companies in the Gulf of Mexico to escape tens of billions of dollars in royalties that they would otherwise pay the government for oil and gas produced in areas that belong to American taxpayers.

But the study predicts that the inducements would cause only a tiny increase in production even if they were offered without some of the limitations now in place.

It also suggests that the cost of that additional oil could be as much as $80 a barrel, far more than the government would have to pay if it simply bought the oil on its own.

“They are giving up a lot of money and not getting much in return,” said Robert A. Speir, a former analyst at the Energy Department who worked on the report. “If they took that money, they could buy a whole lot more oil with it on the open market.”

Oil closed Thursday at $62.66 a barrel in regular trading.

The Interior Department study, commissioned to analyze the costs of royalty incentives and their effectiveness at increasing energy supplies, was completed in fall 2005. But the study was not released until last month because senior officials said they considered it incomplete.

After repeated requests, the department provided a copy to The New York Times with a “note to readers” that said the report did not show the “actual effects” of incentives. Indeed, Interior officials contended that the cost of the incentives would turn out to be far less than the study concluded.

They also said that the nation benefits from even small amounts of additional domestic fossil fuels.

But industry analysts who compare oil policies around the world said the United States was much more generous to oil companies than most other countries, demanding a

Continued on Page 4
smaller share of revenues than others that let private companies drill on public lands and in public waters. In addition, they said, the United States has sweetened some of its incentives in recent years, while dozens of other countries demanded a bigger share of revenue.

In the United States, the federal government’s take — royalties as well as corporate taxes — is about 40 percent of revenue from oil and gas produced on federal property, according to Van Meurs Associates, an industry consulting firm that compares the taxes of all oil-producing countries.

By contrast, according to Van Meurs, the worldwide average “government take” is about 60 to 85 percent. And that figure, of course, excludes countries that do not allow any private ownership in oil production.

Democratic leaders in Congress have already vowed to roll back royalty incentives and tax breaks for drilling companies when they take control of the House and Senate in January.

“Royalty relief is the gift that keeps on giving,” said Representative Nick J. Rahall, Democrat of West Virginia, who will become chairman of the House Resources Committee. “It seems painfully obvious that when the government gives tax breaks in the form of royalty relief to Big Oil, the American people are footing the bill.”

Supporters of drilling incentives say they make sense for a country that wants to reduce its dependence on foreign oil and whose biggest untapped reserves are in water thousands of feet deep where the cost of drilling a dry hole can hit $100 million.

“The amount of exploration investment that a company has to endure to find and develop reserves in the U.S. is far more than in a place like Angola,” said Michael Rodgers, a senior economist at PFC Energy, a consulting firm that analyzes the tax regimes in oil-producing countries.

As oil and gas prices have surged in recent years, moreover, many countries have forced companies to give up a bigger share of revenues. Venezuela, Nigeria and Kazakhstan are among several dozen countries that have forced foreign oil companies to pay more money through either higher taxes or bigger equity stakes for the government.

“They’ve become emboldened by higher oil prices but they’re also being emboldened by muted response from investors,” said Michelle Billig, director of political risk analysis at the Energy Group in New York. “Companies don’t have the luxury of contesting and taking a hard line.”

Starting this year, Britain imposed the second of two new supplemental taxes on petroleum revenue from the North Sea, pushing the government’s share to 50 percent. Norway keeps at least 70 percent of revenues, but the government share increases automatically as oil prices rise and tops out at 78 percent.

Norway is on the growing list of countries that have adopted “progressive” systems that automatically increase the tax rate on oil and gas production as energy prices climb. Several Canadian provinces have adopted similar policies, and Alaska signed leases in 1988 and 1999 enjoy an untapped loophole that entitles them to royalty-free oil and gas regardless of high prices climb.

Last week, the Bush administration persuaded five companies to give up the loophole. But about 50 other companies have thus far refused to follow suit.

The Bush administration scaled back the incentive for new leases, but in 2004, the administration offered lucrative new royalty incentives for companies that drill extremely deep natural gas wells in shallow water. Congress, meanwhile, added several billion dollars worth of new tax breaks in 2004 and 2005 for exploration and drilling.

James A. Watt, chief executive of Remington Oil in Dallas before it was acquired by Helix Energy Solutions in July, said the federal incentives help reduce the risks and high cost of exploring in more difficult areas of the Gulf of Mexico.

“Tax issues are extraordinarily important,” Mr. Watt said, in an interview this year: “Having said that, my view is that we just drilled a $50 million dry hole. That swamps the tax benefits we’re getting.”

The big issue for both lawmakers and the Interior Department is whether royalty relief has much of an impact.

The new study, prepared under contract to the Minerals Management Service of the Interior Department by Innovation and Information Consultants of Concord, Mass., is one of the few attempts to assess the impact through a rigorous econometric analysis.

The report estimates that the current incentives would have a tiny impact that is far exceeded by swings in market prices.

The report predicted that the current incentives would lead to the discovery of only 1.1 percent more reserves than if there had been no in-
centives at all. Total oil production from 2003 to 2042 would be about 300 million barrels more, or less than 1 percent, than it would have been anyway. Natural gas production would be 0.6 percent greater than it would have been otherwise.

But the cost of those royalty incentives would be high: about $48 billion less in royalty payments over the 40-year period. That loss would be offset by a slight increase in the prices that companies pay when bidding for leases in government auctions, but analysts said the net cost would still be above $40 billion.

The Interior Department, in a written response to questions, said the actual cost of its incentives would be much lower than $40 billion because most leases in the Gulf of Mexico include an escape clause that requires companies to pay full royalties if prices are above $34 a barrel.

But officials conceded that oil companies are still poised to escape billions of dollars in royalties in the next five years alone.

Dozens of companies signed leases in the late 1990’s under a Clinton administration program that offered highly generous incentives and, apparently because of a bureaucratic error, omitted the escape clause. The government has estimated that it would have received as much as $10 billion more over the next five years if the mistake had not been made. It is trying to renegotiate the terms.

But as much as half of that money is out of reach. The Bush administration also endorsed a new royalty holiday for “deep gas” drilling in shallow waters even if natural gas prices climb above today’s levels. According to internal budget estimates last year, the deep gas incentives account for half of the $10 billion that the government stands to lose.

To be sure, the newly released study found that the extra incentives prompted companies to pay more money upfront when bidding on off-shore drilling leases and predicted that they would lead to a small increase in exploration and production.

The actual impact of the incentives depends on what happens to oil prices. But under any of the projections, the cost ended up exceeding the market price for oil.

Analysts said the meager impact of royalty incentives was not surprising: for oil and gas companies deciding whether to drill in deep water, the potential money involved in royalty incentives is small compared with the money at stake in changes of market prices.

Eliminating royalties on oil or gas will save a company 12 to 16 percent on some of its production. But those savings are minuscule compared with the nearly fourfold increase in oil prices from $15 a barrel in 1999 to more than $70 this summer.

At today’s prices, even the risk of a $100 million dry hole is not so daunting.
Blowing the Whistle on Big Oil

By EDMUND L. ANDREWS

HONOLULU

DURING a 22-year career, Bobby L. Maxwell routinely won accolades and awards as one of the Interior Department’s best auditors in the nation’s oil patch, snaring promotions that eventually had him supervising a staff of 120 people.

He and his team scrutinized the books of major oil producers that collectively pumped billions of dollars worth of oil and gas every year from land and coastal waters owned by the public. Along the way, the auditors recovered hundreds of millions of dollars from companies that shortchanged the government on royalties.

“Mr. Maxwell’s career has been characterized by exceptional performance and significant contributions,” wrote Gale A. Norton, then the secretary of the interior, in a 2003 citation. Ms. Norton praised Mr. Maxwell’s “perseverance and leadership” while cataloguing his “many outstanding achievements.”

Less than two years later, the Interior Department eliminated his job in what it called a “reorganization.” That came exactly one week after a federal judge in Denver unsealed a lawsuit in which Mr. Maxwell contended that a major oil company had spent years cheating on royalty payments.

“When I got this citation, they told me this would be very good for my career,” said Mr. Maxwell, smiling during an interview here. “Next thing I knew, they fired me.” Today, at 53, Mr. Maxwell lives on a $44,000 annual pension in a two-bedroom bungalow in the hills outside the Hawaiian capital.

But Mr. Maxwell has hardly disappeared. Instead, he is at the center of an escalating battle between the oil industry and the Bush administration over how the federal government oversees about $60 billion worth of oil and gas produced every year on federal property. In the process, he has become one of the most nettlesome whistle-blowers Big Oil has ever encountered, a face-off that offers an inside look at how the industry and the government do business together.

Invoking a law that rewards private citizens who expose Continued on Page 8
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Invoking a law that rewards private citizens who expose

Continued on Page 8
Continued From Page 1

fraud against the government, Mr. Maxwell has filed a suit in federal court in Denver against the Kerr-McGee Corporation. The suit accuses the company, which was recently acquired by Anadarko Petroleum, of bilking the government out of royalty payments. It also contends that the Interior Department ignored audits indicating that Kerr-McGee was cheating. Three other federal auditors, who once worked for Mr. Maxwell and still work at the Interior Department, have since filed similar suits of their own against other energy companies.

Several of the nation's biggest oil producers, including Exxon Mobil, Chevron, Shell and ConocoPhillips, failed in an effort to block Mr. Maxwell's suit, arguing before an appellate judge that his case would "open the floodgates" to suits by other federal auditors. But the court rejected their pleas, and a trial is set to start on Jan. 16.

Mr. Maxwell's self-interest is as much in play in the suit as is the public interest. If he wins, Kerr-McGee could be forced to pay more than $50 million in unpaid royalties and penalties, Mr. Maxwell said. Mr. Maxwell and his lawyers could be entitled to keep as much as 30 percent of any funds the government recovers — enough to make him a wealthy man.

Anadarko says that the government's rules were followed and that it owes no money because the Interior Department never asked it to pay more. But it is now trying to negotiate a settlement before the trial begins.

"We believe the case is without merit," said John Christiansen, an Anadarko spokesman. "However, as is a fairly common practice, both sides have agreed to meet with a mediator prior to trial."

The actions of Mr. Maxwell and the other auditors have coincided with broader investigations by Congress and the Interior Department's own inspector general into whether the agency properly collects the money for oil and gas pumped from public land. Investigators say they have found evidence of myriad problems at the department: cronyism and cover-ups of management blunders; capitulation to oil companies in disputes about payments; plunging morale among auditors; and unreliable data-gathering that often makes it impossible to determine how much money companies actually owe.

In February, the Interior Department admitted that energy companies might escape more than $7 billion in royalty payments over the next five years because of errors in leases signed in the 1990s that officials are now scrambling to renegotiate. The errors were discovered in 2000, but were ignored for the next six years and have yet to be fixed.

Congressional investigators are worried about other problems, as well. The Interior Department's inspector general told a House subcommittee in September that senior officials at the agency had repeatedly glossed over ethical lapses and bungling. "Short of crime, anything goes at the highest levels of the Department of the Interior," declared Earl E. Devaney, the inspector general.

The Interior Department, which has described Mr. Maxwell as a renegade former employee motivated by the riches his lawsuit might bring, said its auditing efforts received a clean bill of health from an outside accounting firm in 2005. "The results are clear and irrefutable," the agency said in a statement, adding that it was "accomplishing its job on behalf of the American public."

But Republican leaders on the House Government Reform Committee, which has been reviewing the flawed leases, recently accused Interior officials of perpetuating a "culture of irresponsibility and lack of accountability" at the agency.

The committee ordered the Gov-
ernment Accountability Office, the investigative arm of Congress, to begin a broad examination of issues ranging from the agency’s rules and enforcement practices to the accuracy of its most rudimentary data.

The Interior Department “clearly doesn’t view their responsibility as maximizing revenue to the American people for resources that belong to the American people,” said Representative Darrell E. Issa, a California Republican who oversaw hearings on the flawed leases. “We don’t have a system that accurately tells us how much oil is being taken out of the ground.”

No one, says Mr. Maxwell, knows that better than he does.

Born “Bobby,” not “Robert,” Mr. Maxwell is bald, burly and speaks with a back-country drawl that is occasionally punctuated by a cackling laugh. He said he thrived in the world of wells, pipelines and offshore rigs and meshed comfortably with the oil cultures of Texas and Oklahoma. Genial and unflappable, he describes his politics as “very conservative” and cringes at being labeled a rebel.

“I like the oil and gas industry,” he said, as he reminisced about his years as a federal auditor. “We are neither for nor against the profits they make. Our job is to make sure the American public gets a fair return on its assets.”

Mr. Maxwell grew up in a poor family in rural Tennessee. After serving in the Army in Hawaii, he earned a bachelor’s degree in business at Chaminade University here. He later became a certified public accountant and earned a master’s degree in business from Texas A&M. In 1983, after stints as an auditor with the Air Force and the Department of Energy, he joined the Minerals Management Service of the Interior Department.

The M.M.S. is responsible for collecting and overseeing the royalties for all the oil, gas, timber and coal that is produced on federal property. Last year, companies paid nearly $10 billion in royalties on oil and gas alone.

“I loved going to the oil companies,” Mr. Maxwell recalled, saying he spent about half of his time on the road — some of it at offshore drilling rigs. “Sometimes, there would be nothing more than a room and a helicopter pad to land on. But it was an education, and it was highly practical.”

Despite Mr. Maxwell’s placid demeanor, friends and former colleagues say he was a dogged auditor who sometimes rankled his own bosses. In 1988, he visited a coal mine on federal land in Montana even though, he says, his supervisors scoffed at the trip because they thought that the mine was too small to scrutinize. When Mr. Maxwell arrived, he found that the mine only looked small because it had been underpaying royalties for years. Within months, the company agreed to pay $43 million in back royalties, and it eventually paid more than $100 million.

In 1993, during the Clinton administration, officials in Washington told him to drop a complex dispute with ARCO because they thought his reasoning was dubious. But just as he was about to back down, ARCO executives volunteered to pay $20 million.
The oil platform Petronius in a leased field in the Gulf of Mexico. About $60 billion of oil and gas is produced every year on federal property.

Less Oversight?
The federal government maintains programs to detect and collect underpayments on royalties for leases on oil and gas fields. But revenue from such auditing programs has declined steeply in recent years. At the same time, because of rising energy prices, royalty revenues have climbed sharply.

Government revenue from:

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<th>ROYALTY PAYMENT ENFORCEMENT PROGRAMS</th>
<th>ROYALTY PAYMENTS FOR OIL AND GAS LEASES</th>
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Sources: Project on Government Oversight, Congressional Budget Office, Minerals Management Service

The Interior Department gave Mr. Maxwell an award that year, noting that he had “vehemently pressed his position” even though “support seemed lacking.” It attributed his success to both his “measured combatant style” and his personal rapport with ARCO executives.

“If he thought there was a case, he had a reason,” said Barbara Rothway, a retired Interior Department auditor. But, she added, “I could see how he might sometimes bother the people he worked for.”

Patient and stubborn, Mr. Maxwell spent years poring over the accounts of the Jicarilla Apache Tribe in New Mexico, which had long complained that companies were underpaying them for natural gas extracted on their tribal lands. Tribal officials said Interior Department officials had paid little heed until Mr. Maxwell came along. He collected and organized data going back 30 years and found pervasive errors by both oil companies and the government. The tribe eventually recovered more than $20 million in back royalties.

“Anyone knowledgeable about the way Interior processes payments knows there are all sorts of ways for companies to underpay,” said Alan R. Taradash, a lawyer in Albuquerque who has represented the tribe for years. “Bobby was one of the few who stood up with us and demanded that the auditing be done properly.”

Mr. Maxwell says his first serious doubts about the Interior Department originated in 1998, when the agency reluctantly began to investigate accusations of systematic cheating on royalties for oil.

Several of the nation’s biggest oil companies eventually settled that investigation by paying nearly $440 million. The investigation occurred only after outside whistle-blowers argued for years that the government was losing billions.

The cases had been sparked in part by a former oil trader at ARCO named J. Benjamín Johnson Jr., known as Benji, who contended that oil companies had used elaborate swapping schemes to cheat on royalties owed to private and state landowners, as well as the federal government.

Mr. Johnson and another former ARCO trader quit their jobs and became expert witnesses for landowners and state governments who wanted to sue oil companies for back payments. The two traders soon realized that the biggest case by far belonged to the federal government. But no federal officials were interested.

“It was unbelievably difficult,” Mr. Johnson recalled in a recent interview. “They brought me to Denver, to the M.M.S. office, in a room with about 30 auditors and managers from the solicitor’s office. Their re-
action was that I was crazy, that it was impossible, that there was no way they could have actually missed this.”

But Mr. Johnson found a way to recover the federal royalties on his own. In 1995, he filed suit under the False Claims Act, a longstanding law intended to encourage whistle-blowers. Under the act, best known for its use against overbilling by military contractors, a private citizen can sue a company, contending that it defrauded the federal government. Companies found guilty have to pay as much as three times the amount of their fraudulent gains, and any person who files a suit is entitled to keep up to 30 percent of the money recovered.

The Justice Department initially refused to join Mr. Johnson’s suit, but it eventually did so, in 1998 after concluding that he and other whistle-blowers — including a nonprofit group called the Project on Government Oversight — were on to something. That was when Mr. Maxwell became involved. Working for the Interior Department, he collected data on a number of oil companies, pooling his material with that of Mr. Johnson.

“Bobby was with us,” Mr. Johnson recalled. “He was a straight-shooter, and he saw it.” Mobil was the first to settle and paid more than $40 million in 1998. Chevron paid $95 million. Shell paid $110 million. By 2002, 15 oil companies had paid a total of almost $440 million.

The Johnson lawsuit taught Mr. Maxwell three lessons. One was that Mr. Johnson became a wealthy man.

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(The oil trader and his lawyers received more than $30 million, while two other groups of whistle-blowers received more than $40 million.) The second was that top Interior officials had been obstinately blind to the oil industry’s practices. The third was about the power of the False Claims Act. Until Mr. Johnson came along, no one had used it to go after royalty underpayments.

Created in 1849 to manage the nation’s publicly owned natural resources, from national forests to parks and waterways, the Interior Department oversees timber, grazing, mining and oil drilling operations over many tens of millions of acres. And while the agency has often tried to increase drilling and mining under Democrats and Republicans alike, current and former officials say the Bush administration elevated that goal above almost all of the department’s other mandates.

Mr. Maxwell says his frustrations with the Interior Department escalated after the Bush administration took office in 2001. The Interior Department’s top priorities became increasing domestic oil and gas production, offering more incentives to drillers in the Gulf of Mexico and pushing to open the Arctic National Wildlife Refuge and other wilderness areas to drilling. The department trimmed spending on enforcement and cut back on auditors, and sped up approvals for drilling applications.

The agency’s senior ranks also became more heavily populated with officials friendly to the energy industry. For example, its new deputy secretary, J. Steven Griles, worked as an oil industry lobbyist before joining the department, and Chevron and Shell had paid him as an expert witness on their behalf in the Benji Johnson case. Mr. Griles declined to comment. Auditors, according to Mr. Maxwell and many others, were told to devote less energy to time-consuming audits and rely more on a computerized monitoring system called “compliance review.” Auditors complained that the new system was superficial and riddled with technical problems. Even when the new system flagged potential underpayments, Mr. Maxwell said, it often failed to supply conclusive information.

“We were getting shut down on all kinds of cases,” he said. “We started to wish that someone would come along and file a False Claims suit, so we could jump onboard.”

Auditing and compliance review had generated an average of about $176 million annually in the 1990s, with an extraordinary peak of $331 million in 2000, according to data from the Congressional Budget Office
Earl E. Devaney, the Interior Department inspector general, testified in September that officials at the agency had repeatedly glossed over ethical lapses and bungling.

According to Mr. Maxwell and Interior Department officials, when Mr. Maxwell presented his findings to his superiors, agency lawyers told him to drop the case. When he continued to argue, he recounts in his lawsuit, the agency’s chief of enforcement warned him that the director of the M.M.S., Johnnie M. Burton, would be “very upset” if he persisted.

“The word came down from the top, not to issue this order,’” Mr. Maxwell said in an interview, speaking about the Interior Department. “There have always been people who don’t want to pursue things. But now it’s grown into a major illness. It’s dysfunctional.”

In a written response to questions from The New York Times, the Minerals Management Service said it was “rare” to overrule an auditor but that Mr. Maxwell’s contentions involved a “questionable application of M.M.S. regulations.”

The matter might have ended there, except that Mr. Maxwell decided to retire in June 2003. As soon as he left the agency, he began researching the possibility of emulating Benji Johnson and filing his own suit under the False Claims Act. As it happened, Mr. Maxwell’s “retirement” was brief. In October, the Interior Department rehired him to fill a management gap in its Denver office, and it put him in charge of a 120-person auditing team monitoring the Gulf of Mexico.

Despite rejoining the government, Mr. Maxwell filed his suit against Kerr-McGee in June 2004. The case was unsealed on Jan. 20, 2005; a week later, Mr. Maxwell lost his job.

Arriving at his office shortly before 8 a.m. on Jan. 27, Mr. Maxwell said he was summoned to a meeting with a senior M.M.S. official, who had flown in from Washington. The official handed him a memo, explaining that his job responsibilities were being moved to Houston and that his position would be eliminated.

To this day, Interior officials say they never fired Mr. Maxwell. They say, according to court papers, that he was merely a “re-employed annuitant” who was no longer needed. “The position disappeared,” said Ms. Burton, the M.M.S. director, in a meeting with energy reporters in September.

Mr. Maxwell protested. He said he would have relocated or taken a different job. He added that he was a certified public accountant and had a master’s degree in business administration; his successor lacked those degrees. But the fight did not last long. When Interior officials offered Mr. Maxwell a confidential financial settlement to leave without a fight, he took the deal and moved to Hawaii.
And he continued to press his case against Kerr-McGee. The company tried and failed to have the suit dismissed, arguing that a federal auditor should not be allowed to take information from work and file a lawsuit under the False Claims Act. In October, eight major oil companies including Chevron and Exxon Mobil weighed in on Kerr-McGee’s side.

“Government employees who uncover suspected fraud in the course of carrying out their jobs will receive a tacit invitation” to sue as private citizens, the companies argued in their brief. After the appellate court rejected the industry’s plea, Mr. Maxwell’s trial was rescheduled for January. Settlement talks are scheduled to begin in Denver this week.

Interior officials contend that Mr. Maxwell and other auditors have a conflict of interest when they stand to gain personally from their enforcement work. “These people could be entitled to collect 30 percent of the money that is owed to the government, for work they were already being paid to do,” Ms. Burton told reporters in September.

If Mr. Maxwell had not acted, of course, the government would have had no chance of recovering any money at all. James W. Moorman, president of Taxpayers Against Fraud, a nonprofit organization that specializes in the False Claims Act, acknowledged that it was less than ideal for federal investigators to have a financial stake in rebelling against their bosses. But he said the alternatives might be worse.

“You’re talking about a situation where there seems to be complete breakdown in the system,” Mr. Moorman said. “If they’ve got evidence of fraud, why shouldn’t a court hear it?”

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TANDING in his garage recently, Mr. Maxwell pointed to six big cartons stacked along the wall. They contained 60,000 pages of documents that Kerr-McGee and the Interior Department had provided as part of the discovery process in his lawsuit. Mr. Maxwell, true to form, has gone through every page, and distilled his case into seven modestly sized binders he keeps in his living room. He says he is ready for trial, and even for the possibility of losing.

If he does lose, his lawyers will not charge for their work but he will have to pay about $125,000 to expert witnesses he has hired. “I can manage it,” he said. He has saved money all his life, he said, and can live on his savings and his pension.

“He’s thought about all the options, and none of them seem life-threatening to him,” said his daughter, Angela Maxwell Horn. “What can they do him? They’ve already fired him.”
U.S. Official Overseeing Oil Program Faces Inquiry

By EDMUND L. ANDREWS

WASHINGTON, Dec. 29 — The Justice Department is investigating whether the director of a multi-billion-dollar oil-trading program at the Interior Department has been paid as a consultant for oil companies hoping for contracts.

The director of the program and three subordinates, all based in Denver, have been transferred to different jobs and have been ordered to cease all contacts with the oil industry until the investigation is completed some time next spring, according to officials involved.

The officials, who spoke on condition of anonymity because the investigation had not been announced publicly, said investigators were worried that senior government officials had been steering huge oil-trading contracts to favored companies.

Any such favoritism would probably reduce the money that the federal government receives on nearly $4 billion worth of oil and gas, because it would reduce competition

Was a director paid as a consultant, too?

among companies that compete to sell the fuel on behalf of the government.

If the allegations prove correct, they would constitute a major new blot on the Interior Department’s much-criticized effort to properly collect royalties on vast amounts of oil and gas produced on land or in coastal waters.

The Interior Department’s Minerals Management Service, which oversees royalty collections, is now the target of multiple investigations by Congress and the Interior Department’s inspector general.

Those investigations are focused on allegations that the agency ordered its own auditors to abandon claims of cheating by large oil companies; that the agency’s arcane rules for calculating sales value and royalties make it easier for companies to understate their obligations; and that the agency’s basic sources of data are riddled with inaccuracies and are unreliable.

Interior officials have promoted “royalties in kind” as a much simpler and more efficient way for the government to get its proper share, because it eliminates much of the arcane accounting and reduces the opportunities for sleight-of-hand bookkeeping.

About a quarter of all oil and gas produced in the United States comes from federal property, and the Interior Department collected about $10

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billion in royalties last year on about $60 billion in oil and gas.

At issue is the “royalty in kind” program, a fast-growing program under which companies pay their royalties in the form oil or gas rather than in the traditional form of cash.

For the 12 months ending last April, the government collected about $3.7 billion in oil and gas. Until recently, most of the oil simply went to the government’s Strategic Petroleum Reserve. But the strategic reserve was essentially filled this year, so the Interior Department hires private companies to resell the fuel on the open market.

To ensure that it gets the best price, the Interior Department takes bids for contracts in which companies typically offer to pay a specific premium over the daily spot-market prices quoted on the Nymex commodity exchange. The companies offering the biggest premium over the spot market get the contracts.

People familiar with the investigation said it had begun several months ago, but had picked up speed in the last few weeks.

The most prominent figure in the inquiry is Gregory W. Smith, who was director of the royalty-in-kind program at the Minerals Management Service in Denver. Mr. Smith oversaw the entire program, which now covers 75 percent of royalties for all oil and 30 percent of royalties for all natural gas produced in the Gulf of Mexico.

One person familiar with the investigation said it originally had focused on potentially improper social ties between some of Mr. Smith’s subordinates and executives at companies vying for contracts. The subordinates include two women, including one who is said to be in charge of oil marketing, and a second man.

All four people were transferred out of the royalty-in-kind office several weeks ago. Mr. Smith was reassigned as a “special assistant” to Lucy Querques Dennett, associate director of the Mineral Management Service in Washington. He was given strict orders to avoid any contact with industry executives, according to one official.

One official said investigators were now looking at possible consulting arrangements between the Denver officials and oil companies. The official said the most recent information had, if anything, hardened the suspicions of investigators, and said the potential ramifications could turn out to be far-reaching.

Mr. Smith did not return calls to his office in Denver. Spokesmen for the Interior Department in Washington as well as in the inspector general’s office, which began the investigation before referring the matter to the Justice Department, refused to comment on the matter.
Interior Official Assails Agency For Ethics Slide

At Oil Lease Hearing, a Broad Attack

By EDMUND L. ANDREWS

WASHINGTON, Sept. 13 — The Interior Department’s chief official responsible for investigating abuses and overseeing operations accused the top officials at the agency on Wednesday of tolerating widespread ethical failures, from cronynism to cover-ups of incompetence.

“Simply stated, short of a crime, anything goes at the highest levels of the Department of the Interior,” charged Earl E. Devaney, the Interior Department’s inspector general, at a hearing of the House Government Reform subcommittee on energy.

“I have observed one instance after another when the good work of my office has been disregarded by the department,” he continued. “Ethics failures on the part of senior department officials — taking the form of appearances of impropriety, favoritism and bias — have been routinely dismissed with a promise ‘not to do it again.’”

The blistering attack was part of Mr. Devaney’s report on what he called the Interior Department’s “bureaucratic bungling” of oil and gas leases signed in the late 1990’s, mistakes that are now expected to cost the government billions of dollars but were covered up for six years.

While these leases were the specific focus of the hearing, Mr. Devaney directed most of his criticism at what he called a broader organizational culture at the Interior Department of denial and “defending the indefensible.”

He expressed particular fury at the willingness to dismiss two dozen potential ethical lapses by J. Steven Griles, a former industry lobbyist who served as deputy secretary of the interior during President Bush’s first term.

Mr. Griles resigned after allegations surfaced that he pushed policy decisions that favored some of his former oil and gas industry clients and that he tried to steer a $2 million contract to a technology firm that had also been one of his clients.

In a 145-page report in 2004, the inspector general described Mr. Griles

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as a “train wreck waiting to happen.” But on Wednesday, Mr. Devaney said he was appalled that the Interior Department’s office of ethics dismissed 23 out of 25 potential ethical breaches against Mr. Griles and that Gale A. Norton, then secretary of the interior, decided not to act on the two remaining allegations.

Mr. Griles is once again a lobbyist in Washington. Efforts to reach Mr. Griles on Wednesday evening at his lobbying firm, Lundquist, Nethercutt & Griles, were unsuccessful.

Mr. Devaney said that case was typical of a much broader “culture of managerial irresponsibility and lack of accountability” in the top reaches of the Interior Department.

“I have unfortunately watched a number of high-level Interior officials leave the department under the cloud of O.I.G. investigations,” Mr. Devaney said, referring to the Office of Inspector General.

“Absent criminal charges, however, they are sent off in the usual fashion, with a party paying tribute to their good service and the secretary wishing them well, to spend more time with their family or seek new opportunities.”

That was almost exactly what happened to Mr. Griles, who was never charged with any wrongdoing, though he admitted to using bad judgment in some cases.

Dirk Kempthorne, who succeeded Ms. Norton as interior secretary earlier this year, said Wednesday that he took the inspector general’s allegations “very seriously” and had sent a letter to all employees on his first day at the department on the need to follow ethical guidelines.

Mr. Kempthorne declined to say what additional actions he might take until he saw Mr. Devaney’s final report.

Mr. Devaney, a burly man who began his career as a police officer in Massachusetts, is no stranger to combative investigations or confrontations with top officials.

He spent more than 20 years as a special agent in the Secret Service, specializing in white-collar crime, eventually being put in charge of the service’s fraud division. In the 1990’s, he became director of criminal enforcement at the Environmental Protection Agency.

He was named inspector general at the Interior Department in 1999, just as whistle-blowers outside the government were pressing huge lawsuits alleging that oil companies were fraudulently underpaying royalties.

Three years ago, Mr. Devaney scathingly criticized the Interior Department’s auditing program for oil and gas royalties.

Beyond finding that investigators had missed millions of dollars in underpayments, his office uncovered evidence that agency auditors had lost key files, then tried to fool investigators by forging and backdating the missing documents. In an acid rebuke of the agency, Mr. Devaney noted that the agency gave a bonus to the official who came up with the false papers.

Mr. Devaney’s broadside against the Interior Department’s culture dovetailed with his tentative conclusions in his most recent investigation, into how the department had managed to sign 1,100 leases for offshore drilling that inadvertently let energy companies escape billions of dollars in royalties on gas and oil produced in the Gulf of Mexico.

The leases, signed in 1998 and 1999 during the Clinton administration, allowed companies to escape normal federal royalties — usually 12.5 percent of sales — on the tens of millions of barrels of oil on each lease.

The royalty break was intended as an incentive for deepwater drilling, but it was also supposed to end if oil prices climbed above a “threshold” level of about $34 a barrel. The leases at issue omitted that restriction, and department officials kept quiet about their mistake for six years after they discovered it.

The problem was first disclosed by The New York Times in March. Government officials now estimate that the mistake could cost the Treasury as much as $10 billion over the next decade.

“The Interior Department holds our natural resources in trust for the American people,” said Representative Darrell Issa, Republican of California and chairman of the House Government Reform subcommittee on energy and resources. “It squandered billions instead.”

Mr. Devaney said the error, a result of compartmentalized thinking within the department, might have remained buried if senior officials had had their way.

“We do not have a ‘smoking gun,’ ” Mr. Devaney said. “We do, however, have a very costly mistake which might never have been aired publicly absent the New York Times, the interest of this committee, the Senate Committee on Energy and Natural Resources and several other interested members of Congress.”
Earl Devaney, the Interior Department inspector general, told a House hearing, “short of a crime, anything goes” at high levels of the agency.