Investigative Report

On the Lack of Price Thresholds in Gulf of Mexico Oil and Gas Leases

Results in Brief

In March 2006, the U.S. Department of the Interior (DOI), Office of Inspector General (OIG), opened an investigation to determine how the Mineral Management Service (MMS) omitted price threshold language from 1998 and 1999 Gulf of Mexico oil and gas leases. This language would have required oil and gas companies to pay royalties when oil and gas prices reached a certain level. According to MMS, 1,032 leases were issued during this period without price thresholds, and 570 of these leases remain active. During the course of our investigation, we conducted 44 interviews and reviewed approximately 19,000 e-mails and 20,000 pages of documents. We focused on determining how MMS omitted price thresholds from oil and gas leases – as well as determining when various MMS officials learned of these omissions and what actions they took in response.

We found that shortly after the inception of the Outer Continental Shelf Deep Water Royalty Relief Act in 1995, MMS made the policy decision to include price thresholds in the leases issued between 1995 and 2000. MMS field personnel initially attached addenda to the leases containing price threshold language but stopped for 2 years and instead cited a regulation that they thought contained threshold language, when, in fact, it did not. MMS' review process, which included the Office of the Solicitor (SOL), simply failed to identify this discrepancy.

We found that when the omission was first brought to the attention of the former Associate Director for Offshore Minerals Management (OMM) in 2000, she chose not to inform the former MMS Director, preferring to "work out a solution within OMM." The former MMS Director and Deputy Director both said they had only become aware of the issue contemporaneously with a January 2006 *New York Times* article. The present Director testified before Congress that she became aware of the issue either contemporaneously with, or just prior to, the article being run. A series of uncovered e-mails, however, suggest that the present Director may have been told of the omissions as early as 2004, and upon reviewing these e-mails, she conceded to us that she must have been advised in 2004.

Background

In 1995, Congress passed the Outer Continental Shelf Deep Water Royalty Relief Act[1] (the Act) in an effort to spur oil and gas exploration in the Gulf of Mexico. The Act accomplished this by granting the oil and gas industry relief from paying royalties to the U.S. Government for the right to drill for oil and gas on federal property. The Act mandated certain restrictions on this royalty relief in the form of price thresholds and volume suspensions for leases issued prior to passage of the Act (pre-Act leases) – meaning that when oil and gas prices reached a certain level or companies began producing a certain volume, companies would be required to pay royalties.

However, the Act did not apply the same restrictions for leases issued after passage of the Act (new leases). The Act still mandated royalty relief restrictions in the form of volume suspensions, but it did not include price thresholds. MMS, however, contended that while the Act did not *mandate* the use of price thresholds for new leases, it provided discretionary authority to apply this restriction.

Below is a description of Sections 302, 303, and 304 of the Act, which details the use of price thresholds for both pre-Act leases and new leases.

[1] Codified in Public Law 104-58, Title III, §§301-306, 109 Stat. 557 (1995).

Sections 302, 303, and 304 of the Act

Section 302 of the Act allows for lessees to apply for relief of royalty payments due on new production of oil or natural gas under pre-Act leases – issued prior to 1995. This royalty relief is granted at the discretion of the Secretary of the Interior based upon the requirements outlined in Section 302. Section 302(C) mandates restriction on the relief, however, by stating that the relief would come to an end if "in any year during which the arithmetic average of the closing prices on the New York Mercantile Exchange for light sweet crude oil exceeds $28.00 per barrel, any production of oil [natural gas] will be subject to royalties at the lease stipulated royalty rate." This restriction on royalty relief has been termed as a "price threshold," "price ceiling," or "price trigger." For consistency purposes, the term "price threshold" will be used in this report unless directly quoted otherwise from a source document.

Section 304[2] of the Act states that for new leases – sold between 1995 and 2000 – the Secretary is required to grant royalty relief, except in situations when volume of production reaches a certain level. Section 303 of the Act specifies that new leases are subject to "suspension of royalties for a period, volume, or value of production determined by the Secretary, *which suspensions may vary based on the price of production from the lease*" (emphasis added). MMS has interpreted this section as authority to apply price thresholds to royalty relief on new leases, at its own discretion, even though the Act does not require MMS to do so, as it did with respect to pre-Act leases in Section 302. ***Agent's Note:*** *A recently filed lawsuit against DOI contests that Section 303 does* ***not*** *grant MMS discretionary authority to apply price thresholds in oil and gas leases issued between 1995 and 2000.*

MMS Regulations

Following the passage of the Act in November 1995, MMS was required to promulgate regulations that would implement the new authority for royalty relief under the Act. As a result, on February 23, 1996, MMS published in Volume 61, Number 37, of the *Federal Register* an Advance Notice of Proposed Rulemaking (ANPR) for Title 30 of the CFR, parts 203, 256, and 260, dated February 20, 1996 (61 FR 6958; February 23, 1996).

In the ANPR summary, MMS stated that the Act authorized the Secretary "to modify the terms of certain existing leases and to establish new terms for leases in water depths of 200 meters or greater in parts of the Central and Western Gulf of Mexico. This document solicits recommendations and comments on rules that would implement the new authority under the Act." After MMS drafted the ANPR, several MMS officials and attorneys from SOL reviewed it prior to its approval by the DOI Assistant Secretary for Land and Minerals Management for publication in the *Federal Register*. This review is known as a "surname process."

In the ANPR section titled, "Supplementary Information," MMS requested responses to several questions in its "Issues and Informational Needs" section. Section II of this section was titled, "Existing Deep-Water Leases." Part (4) of Section II reads:

> For existing leases, the suspensions cease when oil or natural gas prices exceed specified ceilings [thresholds]. When leases produce both oil and natural gas or related products, and only one of the ceiling prices is reached, should the MMS lift the suspension for the entire

[2] Section 304: "… any lease sale within five years of the date of enactment of this title, shall use the bidding system authorized in section 8(a)(1)(H) of the [Act], as amended by this title, except that the suspension of royalties shall be set at a volume of not less than" certain volume suspension levels.

production or just the product for which the price ceiling is reached? *For tracts offered in upcoming sales, should price ceilings affect suspension volumes in the same ways as for existing leases and units?* (emphasis added)

Several oil and gas companies, the State of Louisiana, and the American Petroleum Institute responded to the question posed by MMS in Section II, Part (4), regarding whether they believed price thresholds should apply to new leases. Some companies clearly accepted price thresholds on new leases, while other companies clearly contested MMS' ability to do so. A complete itemization of the responses received by MMS is attached. After receiving recommendations and comments in response to the ANPR, MMS continued the rulemaking process by issuing the following publications in the *Federal Register*:

- Interim rule for 30 CFR 260 (61 FR 12022; March 25, 1996)
- Interim rule for 30 CFR 203 (61 FR 27263; May 31, 1996)
- Final rule for 30 CFR 203 (63 FR 2605; January 16, 1998)
- Final rule for 30 CFR 260 (63 FR 2626; January 16, 1998)

30 CFR 203 set terms and conditions for pre-Act leases, whereas 30 CFR 260 set terms and conditions for new leases. 30 CFR 260 did *not* contain language stating that price thresholds would apply to the issuance of new leases under the Act.

MMS Lease Sales in the Gulf of Mexico

During 1996 and 1997, MMS issued four separate Final Notices of Sales (FNOS) for oil and gas lease Sales held in those years; all four FNOS (Sales 157, 161, 166, and 168) issued during these 2 years contained explicit language stating that price thresholds would apply to leases issued under those Sales. Additionally, all leases issued under the four Sales in 1996 and 1997 contained addenda incorporating price thresholds into the terms of the leases.

During 1998, MMS issued two separate FNOS (Sales 169 and 171) that no longer contained explicit language stating that price thresholds would apply to leases issued under those Sales. In lieu of explicit price threshold language, the FNOS stated: "The final rule specifying royalty suspension terms for lease sales in the Central and Western Gulf was published in the **Federal Register** on January 16, 1998 (63 FR 2626)"; this citation corresponds to 30 CFR 260, which, as noted above, did not contain price threshold language. Additionally, the leases issued under those Sales no longer contained addenda incorporating price thresholds, but rather the footnote on the leases stated that "the instrument will be superseded by 30 CFR 260."

During 1999, MMS issued two additional FNOS (Sales 172 and 174) that did not contain explicit price threshold language. These FNOS stated: "See 30 CFR 203 for the final rule specifying royalty suspension terms." As with the leases issued under Sales 169 and 171, these leases did not contain addenda incorporating price thresholds, and the footnote on the leases continued to state that "the instrument will be superseded by 30 CFR 260."

On February 2, 2000, MMS issued the FNOS for Sale 175. This FNOS again did not contain explicit language stating that price thresholds would apply to leases issued under the Sale and, instead, referenced 30 CFR 203. The leases issued under Sale 175 in 2000 *did*, however, include addenda incorporating price thresholds – similar to the addenda attached to the 1996 and 1997 leases.

On July 11, 2000, MMS issued the FNOS for Sale 177. This FNOS stated: "See 30 CFR 260 for the final rule specifying royalty suspension terms. Threshold prices will be applied to royalty suspension

determinations; see paragraph (1) of the document 'Information To Lessees, Western Gulf of Mexico Sale 177' included in the Sale Notice Package." Additionally, the leases issued under Sale 177 contained addenda incorporating price thresholds.

Details of Investigation

On January 23, 2006, the *New York Times* published an article alleging that oil and gas companies were not paying the correct amount of royalties due to the American taxpayer. The article focused on the fact that the increase in royalty payments made to the government in 2005 had not paralleled the increase in profits the oil and gas companies reported to their shareholders. In response to this article, MMS Deputy Director Walter Cruickshank was called to testify before the U.S. House of Representatives Committee on Government Reform, Subcommittee on Energy and Resources (House Subcommittee).

Cruickshank testified on March 1, 2006, before the House Subcommittee and stated that part of the reason MMS' royalty collections had not paralleled industry market sales was due to the passage of the Act in 1995. Cruickshank explained that price thresholds were applied to the leases issued in 1996, 1997, and 2000 in order to "protect the public interest." He noted, however, that "Leases issued in 1998 and 1999 were issued without price thresholds, and thus no royalties are due even though prices are high." When questioned as to why the price thresholds were not included in the 1998 and 1999 leases issued by MMS, Cruickshank stated that the removal of the price thresholds for those 2 years was the result of a mistake, rather than a policy decision of MMS. He further stated that MMS could not determine how the mistake occurred.

Following Cruickshank's March 1, 2006 testimony before the House Subcommittee, we received several congressional requests, along with a separate request from MMS Director R.M. "Johnnie" Burton, to conduct an investigation to determine how/why price thresholds were omitted from the 1998 and 1999 leases and what MMS was doing to address this issue. In response to these requests, we conducted 44 interviews of former and current MMS employees and SOL attorneys, in addition to reviewing approximately 19,000 e-mails and 20,000 pages of documents, in order to establish the facts and circumstances surrounding the omissions.

MMS' Policy Decision to Apply Price Thresholds to New Leases

We determined that on March 12 and 13, 1996, MMS held a public meeting on "Implementing the Outer Continental Shelf Deep Water Royalty Relief Act" in New Orleans, Louisiana. During this 2-day meeting, then MMS Chief, Offshore Minerals Analysis Division, Policy and Management Improvement, Walter Cruickshank (currently MMS Deputy Director), made a PowerPoint presentation titled, "Implementation of the OCS [Outer Continental Shelf] Deep Water Royalty Relief Act For Sale 157," which detailed how MMS intended to implement the Act with regard to royalty suspensions for new leases. Slide 27 of the 28-slide presentation stated:

> Price Ceilings. In any year during which the average of the closing prices on the MERC exceeds $28.00 per barrel of oil ($3.50 per mmBtu of natural gas), any production of oil (natural gas) will be subject to royalties at the lease stipulated royalty rate. Production during such years counts toward the royalty suspension volume.

When interviewed, Cruickshank stated that, based upon Section 303 of the Act, MMS made the policy decision in 1995 to apply price thresholds to all new leases issued under the Act. When asked if MMS ever changed its policy regarding the application of price thresholds for new leases, Cruickshank stated that MMS did not have any official memoranda or document stating that this policy had changed.

All MMS officials that we interviewed regarding this matter confirmed that MMS never changed its policy, including the Deputy Director for MMS in 1998 and 1999 (Acting Director between February 1999 and May 1999). The former Deputy Director stated that he was certain the MMS Directorate never changed its policy to apply price thresholds to new leases during 1998 and 1999. He said he would have "screamed bloody murder" if someone tried to change this policy while he was the Deputy Director.

The former MMS Directors for the periods 1995 – 1999 and 1999 – 2000 both confirmed the former Deputy Director's statement that the Directorate never changed the policy decision to apply price thresholds to the new oil and gas leases issued under the Act. In fact, both former Directors stated that they believed the price thresholds were actually mandated under the Act.

MMS' Decision to Not Include Price Thresholds in Regulation for New Leases

Cruickshank told us that the policy decision to apply price thresholds to new leases, however, was never envisioned to be included in the regulation concerning royalty suspension for new leases, 30 CFR 260. Cruickshank said he was the leader of the team that drafted 30 CFR 260, which was newly promulgated in 1998 and dealt with the technical application of suspension volumes. Cruickshank stated that since the price thresholds were not mandated by the Act for new leases (as opposed to pre-Act leases), MMS determined that it would not include the thresholds into the regulation implementing the Act for new leases because MMS wished to remain flexible in deciding whether the thresholds would apply on a sale-by-sale basis.

Milo Mason was the SOL attorney who provided counsel to MMS regarding its decision to not include price thresholds in the new regulation. During his testimony before the House Subcommittee on June 21, 2006, Mason confirmed that he advised MMS that since the Act did not mandate price thresholds for new leases, the agency could retain greater flexibility in applying price thresholds if it did not include them in the regulation. Mason could not produce any written memorandum documenting his legal advice. He stated that he provided this advice orally "because most of my legal advice is oral."

When questioned by then House Subcommittee Chairman Darrell Issa as to why he would not keep written records of his legal opinions, Mason acknowledged that such memorialization would be advantageous. Mason stated that he did keep a chronological file for the first 15 years of his federal career in his file drawer; later in his testimony, however, he said, "[My] drawer got full, and I quit doing that because I don't have enough time to chronicle every opinion I render orally in different meetings and back to back things – maybe I should start doing that more often now."

1996 and 1997 Leases and Promulgation of Regulations

On March 25, 1996, MMS published in the *Federal Register* the FNOS for Sale 157, dated March 11, 1996; explicit price threshold language was included in the FNOS. MMS' Gulf of Mexico Regional Office's (GOM) Sales and Support Division drafted the FNOS prior to it being sent to MMS headquarters in Washington, D.C., to undergo the surname process. Similar to the rulemaking review, the surname process for FNOS documents included the review of several MMS officials and SOL attorneys prior to the document being forwarded to the DOI Assistant Secretary for Land and Minerals Management for final approval.

During 1996, MMS' GOM issued all leases purchased during Sale 157 to the winning lessees. The leases were to contain the exact terms and conditions described in the FNOS. The leases issued under Sale 157 incorporated price thresholds into the leases by referencing attached addenda that included explicit price threshold language. The lease addenda were incorporated into the leases by listing the following language at the bottom of each lease: "This lease is eligible for a royalty suspension volume of 87.5 million barrels of oil

equivalent pursuant to PL 104-58; therefore Sections 5 and 6 of this lease instrument are amended by addendum, pages 2a and 2b, attached hereto and made a part hereof." Page 2b of the addenda included specific price threshold language. The leases issued by GOM did not undergo a surname process, and they were not reviewed by any legal counsel prior to their issuance to lessees.

On March 25, 1996, MMS published in the *Federal Register* Interim Rule 30 CFR 260 (61 FR 12022). Interim Rule 30 CFR 260 did *not* contain price threshold restrictions on royalty relief. MMS published in the *Federal Register* on May 31, 1996, Interim Rule 30 CFR 203 for pre-Act leases (61 FR 27263). As mandated by the Act, this rule contained price threshold restrictions on royalty relief granted to pre-Act leases. Final rules for both 30 CFR 260 and 203 were published in the *Federal Register* on January 16, 1998; as with the interim rule, the final version of Rule 30 CFR 260 did not contain price thresholds.

MMS published the FNOS for Sale 161, 166, and 168 on August 16, 1996; January 31, 1997; and July 24, 1997, respectively. All three of these FNOS contained explicit price threshold language restricting royalty relief, and all corresponding leases issued under the Sales contained addenda that included explicit price threshold language.

Removal of Price Threshold Language

Sale 169

On November 18, 1997, MMS issued the Proposed Notice of Sale (PNOS) for Sale 169. ***Agent's Note:*** *a PNOS outlining the terms and conditions of an upcoming sale typically precedes an FNOS by 2 to 3 months.* Unlike the prior four FNOS documents related to Sales under the Act, the PNOS for Sale 169 did not contain explicit price threshold language but rather stated:

> An interim rule, published in the Federal Register (61 FR 12022; March 25, 1996), has been used to specify royalty suspension terms for recent lease sales in the Central and Western Gulf. A final rule, under which the Secretary will make tracts available for this sale, is expected to be published prior to the issuance of the Final Notice of Sale.

This language referred to the promulgation of Rule 30 CFR 260. As noted above, the final rules for both 30 CFR 260 and 203 were published in the *Federal Register* on January 16, 1998.

On February 13, 1998, MMS published in the *Federal Register* the FNOS for Sale 169. The FNOS no longer contained explicit price threshold language in its royalty suspension section, as it did for the four previous Sales under the Act. In substitution of the explicit price threshold language, the FNOS stated: "The final rule specifying royalty suspension terms for lease sales in the Central and Western Gulf was published in the **Federal Register** on January 16, 1998 (63 FR 2626). Additional information pertaining to royalty suspension matters may be found in the document 'Information to Lessees,' contained in the Sale Notice Package." The *Federal Register* citation of 63 FR 2626 corresponds to 30 CFR 260. Price threshold language was not included in any of the documents contained in the Sale Notice Package.

We interviewed John Rodi, who was supervisor of the GOM Sales and Support Division between June 1990 and April 2006. This division is responsible for making the actual changes to lease language and drafting the FNOS. Rodi stated that prior to issuance of the FNOS for Sale 169 on February 5, 1998, he received a telephone call "at the 11th hour" from either MMS' Washington, D.C., headquarters or from MMS' Economics Division (then known as the Branch of Economics) in Herndon, Virginia, informing him that the "final rule" implementing restrictions on royalty relief had been published. Rodi said he was not certain who in MMS'

Washington, D.C., headquarters or MMS' Economics Division specifically provided this information to him; however, he said it must have been either an economist in the Economics Division, a program analyst in the Leasing Division, or Marshall Rose, chief, Economics Division.

Rodi said that in response to this information, he specifically asked whether the FNOS should continue to have explicit royalty suspension language, including price threshold language, or whether it should simply cite the final rule. Furthermore, he said he asked if the leases should still include the addenda incorporating royalty relief restrictions, as they did in 1996 and 1997, or whether the 1998 leases should simply reference the final rule, in conjunction with removing all addenda and language incorporating royalty relief restrictions. According to Rodi, he was directed to remove all royalty suspension language from the FNOS in lieu of citing the final rule and to no longer attach the addenda containing royalty relief restriction language to the leases but rather simply reference the final rule on the lease.

Rodi stated that during the telephone conversation in which he received direction to cite the final rule, he did not remember specifically discussing price thresholds. According to Rodi, since the conversation was conducted by telephone, its contents were not memorialized in an e-mail or other documentation. He said that after 30 CFR 260 was published in January 1998, there was a "rush" to prepare the new FNOS in February 1998, which determined the language in the leases. Rodi said this created a very "hasty situation" in which MMS was "under the gun."

[Ex. 7E]

After interviewing Rodi and the MMS Sales and Support Division program analyst who was responsible for physically drafting the FNOS, we discovered that the program analyst drafted the 1998 and 1999 FNOS per Rodi's direction. When interviewed, the program analyst stated that he did not remember receiving specific direction to remove the price threshold language from the FNOS for Sale 169 in lieu of citing the final rule. Upon being informed that Rodi claimed he remembered receiving a telephone call from the Economics Division directing him to drop the price threshold language and instead cite the final rule, the program analyst stated that this direction would have been typical of how "we operated back then."

The MMS Sales and Support Division program analyst said he would begin the process of drafting an FNOS by starting with the previous Sale's FNOS and then modify the terms of the FNOS based upon input from other divisions and headquarters. The program analyst stated that he, personally, would never modify the language in the FNOS unless he was directed to do so by Rodi. According to the analyst, "I didn't care what the language was – I just put it in how people wanted it." Furthermore, the program analyst stated his belief that Rodi did not unilaterally direct him to modify the language of the FNOS, but rather Rodi would only do so after he received input from other divisions or headquarters.

When interviewed, the OMM economist in the Economics Division denied that he directed Rodi to remove the price threshold language from the FNOS in lieu of citing the final rule. [Ex. 7E]

During his interview, the program analyst in the Leasing Division stated that he did not remember giving Rodi direction to drop the price threshold language in lieu of citing the final rule. The Leasing Division analyst stated that he was never involved in drafting the language in the FNOS since the Leasing Division was not responsible for developing such language. He said GOM drafted the FNOS, with the assistance of the Economics Division, with respect to economic-related language. [Ex. 7E]

We interviewed Marshall Rose, who also denied giving Rodi direction to remove price threshold language in lieu of citing the final rule. In a sworn statement, Rose stated:

> It was well known that 1) the rule was being written by PMI [Policy and Management Improvement Branch – Cruickshank's team], not Econ [Economics Branch – Rose's team], and 2) the rule did not contain explicit price thresholds, which were not required by the DWRRA [Act] and which we had agreed would be reviewed for their absolute levels on a sale by sale basis. Accordingly, there is no way I would have given any approval to make such a substitution.
>
> Whenever my office asks for changes in sale documents, we review those revisions. This is the case so that any oral or written communication is not misunderstood. Given that the rule referenced did not have price thresholds, and in some sale documents even the rule section was improperly cited, it is not possible that either myself or my staff members would have approved the change made to the documents. Taken together, my staff members and I have been doing this for about 55 years.
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> The changes made were never viewed by GOMR [GOM] or related to policy. Rather, they were simply editorial changes for the same policy. As such, there would be ordinarily no need to check with me or my office to get "approval" for the change. And, as stated above, any such provisional approval would have been followed by a request by my office to review the revised text, which obviously did not occur.

[Ex. 7E]

MMS Review of Sale 169 FNOS

As with all prior FNOS, the FNOS for Sale 169 went through the surname process. Several MMS officials signed the FNOS as "surnames." According to several of the MMS surname signatories, the surname process usually involved receipt of the document with a "cover page" that should flag any "important" or "substantive" changes made to the FNOS since the previous FNOS. This cover page is provided because the FNOS is extremely voluminous with all of its attachments and is often up to 12 inches thick. The cover page for Sale 169 did not, in fact, contain any mention of the price threshold language being removed.

During his interview, Tom Readinger, former OMM Associate Director, and one of the signatories for Sale 169, stated that he completed only a cursory review of its contents. He pointed out that the FNOS surname list indicated that several MMS officials reviewed and surnamed the 12-inch-thick document on the very same date.

Readinger stated that the Sales packages, including the FNOS, typically undergo many reviews that have "hashed out" the terms of the document prior to the surname process. He said that as a result, the surname process is generally a formality as opposed to a thorough review of the FNOS. He said the FNOS usually arrives at his desk in a red file indicating it is "hot" and needs to be handled expeditiously.

During their interviews, OMM Deputy Associate Director Robert LaBelle and the former MMS Deputy Director from 1998-1999 said they reviewed only the cover memorandum of the FNOS.

When interviewed, MMS employees Cruickshank, the OMM economist, Readinger, and LaBelle attributed MMS' failure to detect the omission of price threshold language from the FNOS to the lack of overlap between divisional reviews. According to Cruickshank, this is where MMS' "system was broke" because those involved with promulgating 30 CFR 260, including Cruickshank, were not in the chain of review

for the leases, and thus they were not provided with the opportunity to point out leases lacked price threshold language. He stated that furthermore, the Economics Division of MMS did not start reviewing the leases until 2000.

Cruickshank said MMS simply "screwed up" as a result of "internal miscommunication." He said that in 1998 and 1999, there was no "nexus between the rulemaking people and the lease language people," resulting in a situation where the "process did not work."

SOL Review of Sale 169 FNOS

In addition to MMS officials, attorneys from SOL were also involved in the surname process. The SOL is essentially the law firm that provides legal counsel to all of the bureaus within DOI. As such, one of its functions is to perform a legal review of the FNOS on behalf of MMS. Two attorneys from SOL surnamed the FNOS for Sale 169: staff attorney Milo Mason and his supervisor, the former Associate Solicitor of the Mineral Resources Division.

Regarding the FNOS for Sale 169, as with the FNOS for all Sales made under the Act, Milo Mason was the staff attorney who was responsible for performing the in-depth legal review of the FNOS. Mason's SOL supervisors, including the former Associate Solicitor of the Mineral Resources Division, Geoff Heath, and Peter Schaumberg, all stated that they performed only cursory reviews and relied on the reviews of staff attorneys (Milo Mason).

When interviewed, Mason said he reviewed and surnamed both the PNOS and FNOS documents for 1998 and 1999 – the 2 years in which price thresholds were omitted from oil and gas leases issued by MMS. Mason stated that he read the PNOS documents "completely" for "legal sufficiency." However, Mason said that depending on MMS' urgency to finalize the FNOS, he may only re-read the sections of the FNOS that are noted to have been changed from the PNOS. Mason stated that similar to the legal advice he renders, he does not formally document his review of Notice of Sale (NOS) documents.

In addition to reviewing the FNOS, Mason acknowledged that he personally assisted MMS in reviewing and redrafting the language of the interim and final regulations 30 CFR §§ 260 and 203, and he was familiar with the contents of these two regulations. Mason also stated that he knew of MMS' policy decision to apply price thresholds for the life of the Act.

Based upon his knowledge of the contents of 30 CFR 260 (which did *not* include price threshold language), and his knowledge of the MMS policy decision to include price thresholds, we asked Mason why he did not note in his legal review that removal of explicit price threshold language from the FNOS – and citing a regulation that did not contain price thresholds – would result in the lack of price thresholds. Mason stated that he must "have forgotten" that price thresholds were not included in the regulation, or, in the alternative, he must have assumed the thresholds were set forth in other materials provided to the lessees (e.g., the lease itself or the Sales Notice Package), which the SOL did not review. Mason further stated that "it must have slipped through the cracks."

According to Mason, his surname on the FNOS merely indicated that he reviewed the document in order to ensure it was "legally sufficient to withstand a lawsuit," not to ensure MMS policy decisions were adequately covered. He said that since price thresholds were not mandated by the Act, but were simply discretionary restrictions, the SOL was not responsible for ensuring their presence in the FNOS.

Agent's Note: *The 1998/1999 SOL departmental manual states: "An attorney's surname on a document constitutes certification that, in the attorney's judgment, a good faith legal argument exists to support the position taken in the document. If such a certification cannot be made, the matter should be resolved with the originator of the document or elevated within the Office, as appropriate" (Chapter 5, Section 7A).*

Upon his swearing-in as Solicitor on October 5, 2006, David Bernhardt issued a clarifying memorandum to SOL attorneys describing his expectation of SOL surname responsibilities. The memorandum states: "It is essential to the proper functioning of the Department that Solicitor's Office attorneys take the surnaming of documents seriously and that they use their best efforts in reviewing documents. Placing your surname on a document is an attestation by you that you have inquired into and analyzed the factual and legal matters presented by the matter addressed in the document that are within your area of responsibility and that you are satisfied that the matter is in compliance with all applicable law. It is appropriate to consider including comments with your surname that specify the scope of your review or articulate reservations to which your surname is subject consistent with the duty of due diligence."

We provided OMM Associate Director Readinger with Mason's explanation for failing to recognize that the FNOS no longer contained price thresholds by stating that inclusion of price thresholds was not a "legal issue" and that the SOL is not responsible for ensuring documents such as the FNOS contain MMS' policy decisions. Readinger retorted that MMS depends on the SOL to ensure MMS policy decisions are contained in these documents when the SOL is fully aware of MMS' policy decisions, as Mason was in this matter. Readinger stated that in his opinion, this "excuse" from the SOL is unacceptable.

Readinger stated that MMS relies upon the SOL to act as its attorney in ensuring that all of the details, policy decisions, and intentions of MMS of which the SOL is aware (e.g., price thresholds) are included in the document.

When interviewed, MMS Director Burton similarly stated that if the SOL is aware of a certain policy decision of MMS when reviewing MMS documents, it has a duty to notify MMS if it believes the document does not incorporate that decision.

During his interview, Readinger stated that since the issue was raised by the *New York Times* article in early 2006, he remembered having a discussion with Mason about the issue in his (Readinger's) office. He stated that during this discussion, Mason admitted to him that he (Mason) should have caught the omission during his review of the FNOS in 1998 since he was the one person who both participated on the team that helped draft 30 CFR 260 and reviewed the FNOS.

In response to Readinger's recollection of the meeting between himself and Mason, Mason provided the following sworn statement on June 2, 2006:

> I remember speaking w/ Tom Readinger sometime in the past 2 or 3 months about this issue. I recall expressing my disappointment that the price threshold language was not included in those 2 years of lease issuance and I may have expressed the feeling that I wish I could have (or should have) figured out that the leases issued in the 1998 and 1999 time period omitted the price threshold language. I think I also expressed to him that I did not know why that omission occurred or what happened to cause it.

Agent's Note: *GOM issued leases in relation to Sale 169 that contained a different footnote than those leases issued prior to Sale 169. As opposed to referring to an addendum, which contained explicit price thresholds, the new footnote language simply read: "This lease may be eligible for royalty suspension pursuant to PL 104-58.*

If eligible, Sections 5 and 6 of this lease instrument will be superseded by 30 CFR Part 260, published in the Federal Register on January 16, 1998 (63 FR 2626)." The actual leases issued under Sale 169, as with all other Sales, did not undergo the surname process and were not reviewed by legal counsel prior to their issuance.

Sale 171

On July 24, 1998, MMS published in the *Federal Register* the FNOS for Sale 171 (Sale 170 did not involve Gulf of Mexico leases). As with the FNOS for Sale 169, the document did not contain any explicit price threshold language but rather simply stated: "The final rule specifying royalty suspension terms for lease sales in the Central and Western Gulf was published in the **Federal Register** on January 16, 1998 (63 FR 2626). Additional information pertaining to royalty suspension matters may be found in the document "Information to Lessees," contained in the Sale Notice Package." The footnote on the leases issued pursuant to Sale 171 was also identical to the leases issued under Sale 169, and thus the leases did not contain addenda incorporating price thresholds into the leases.

Sale 172

The FNOS for Sale 172 was published in the *Federal Register* on February 12, 1999. The FNOS once again did not contain any explicit price threshold language, yet the language related to royalty suspension was different than that included in the FNOS for Sale 169 and 171. Rather than citing the "final rule … published in the **Federal Register** on January 16, 1998 (63 FR 2626)," which corresponded to 30 CFR 260, the new language read: "See 30 CFR 203 for the final rule specifying royalty suspension terms." As discussed above, 30 CFR 203 sets the terms and conditions for *pre-Act leases*, not new leases. Its citation in an FNOS that sets terms and conditions for leases being sold in an upcoming Sale would not apply.

The change of citation from 63 FR 2626 (30 CFR 260) to 30 CFR 203 had no effect on the application of price thresholds to the leases inasmuch as neither regulation would have incorporated the price thresholds into the leases. However, Cruickshank speculated that someone in GOM may have discovered their mistake in omitting price threshold language in the 1998 leases, in lieu of reference to 63 FR 2626 (30 CFR 260), and therefore made an attempt to remedy the situation by changing the reference to 30 CFR 203.

He said he based his speculation on the fact that 30 CFR 203 refers to Section 302 of the Act, which contains explicit price threshold language. He stated, however, that Section 302 only applies to pre-Act leases, and thus does not set terms and conditions for 1999 (new) leases.

Regarding who directed the change of citation from 63 FR 2626 (30 CFR 260) to 30 CFR 203 in the FNOS for Sale 172, we conducted interviews of MMS employees in the Washington, D.C., headquarters; MMS Economics Division in Herndon, Virginia; and GOM, along with SOL attorneys. Additionally, we conducted reviews of all draft and finalized FNOS documents still in existence within MMS and the SOL. Not one person interviewed admitted knowledge regarding how the citation change occurred. Additionally, the document review failed to identify who was responsible for making the citation change.

Specifically, Rodi stated that he would never have made such a citation change without receiving direction from the Economics Division; however, he said that if he had not received this direction from the Economics Division, the only other person who may have suggested such a change would be an MMS employee at the Gulf Region's Office of Production and Development (OPD). Rodi also said that even if he did receive the suggestion to change the citation from the OPD employee, he would have sought clearance from the Economics Division prior to making such a change. According to Rodi, the Economics Division is the "final

word" on all substantial changes in lease terms. He also pointed out that the citation change in the FNOS may have occurred at the headquarters level during the review process.

When interviewed, Economics Division Chief Rose stated that Rodi's assertion that the Economics Division directed or cleared this change was "ridiculous." Additionally, all MMS officials involved in the surname process who were interviewed denied changing the citation after receiving the FNOS draft from GOM.

During his interview, the OPD employee also denied recommending to Rodi that the 63 FR 2626 (30 CFR 260) citation in Sale 171's FNOS be changed to 30 CFR 203 in Sale 172's FNOS. The OPD employee stated that he is well aware that citing 30 CFR 203 in the 1999 FNOS would be "meaningless" since that rule concerns only pre-Act leases. He speculated that whoever drafted the FNOS may have simply made a mistake when attempting to change the FR citation used in the 1998 FNOS to its corresponding CFR citation for the 1999 FNOS. The OPD employee stated that this could be an easy mistake to make since the two regulations were published on the exact same date, on sequential pages of the *Federal Register*.[3]

SOL Review of Sale 172

As with the previous FNOS, Mason was the SOL staff attorney responsible for providing legal review. When interviewed, Mason said he did not remember making or suggesting the citation change from 63 FR 2626 (30 CFR 260) in Sale 171's FNOS to 30 CFR 203 in Sale 172's FNOS. He acknowledged that making this change did not make sense to him. He stated, "I certainly didn't tell them to change it from 260 to 203."

Regardless of whether Mason made or suggested the citation change, we asked him why, during his legal review, he did not identify the newly referenced citation as being meaningless to the document inasmuch as 30 CFR 203 only sets terms and conditions of royalty suspension for *pre-Act leases*, not new leases. The rule's Summary in the *Federal Register* reads:

> This rule establishes conditions for reducing royalties on producing leases; provides for suspension of royalty payments on certain deep water leases issued as the result of lease sales held *before* November 28, 1995 [pre-Act leases]; and describes the information required for a complete application for royalty relief. (emphasis added)

Mason stated that even though 30 CFR 203 did not set any terms or conditions of royalty suspension for the leases being offered in the Sale, it could potentially apply to new leases at some point in the future. Conversely, MMS employees Cruickshank, Rose, the OPD employee, and the OMM economist all stated that the citation of 30 CFR 203 in the FNOS for Sale 172 had no legal application whatsoever since the regulation did not set any terms or conditions for the leases being offered in the Sale.

We then asked Mason whether or not it was his practice to look up an unfamiliar rule or law if it was cited in a document that he was reviewing. Mason stated that he would "try to look it up," yet sometimes he would not research the regulation "if he [did] not have enough time." He further explained that the SOL did "not have enough money to buy current" CFR books and he did not have access to the Internet to download regulations; in fact, Mason said he would often have to borrow CFR books from his boss. He said he sometimes would attempt to contact the agency that was responsible for the document and ask what the regulation stated and whether it was the regulation the agency wanted to cite in the document.

[3] January 16, 1998, Vol. 63, No. 11, 30 CFR 203 – pages 2605-2626, 30 CFR 260 – pages 2626-2630.

Agent's Note: *As with Sale 169 and 171, the language at the bottom of the leases issued under Sale 172 read: "This lease may be eligible for royalty suspension pursuant to PL 104-58. If eligible, Sections 5 and 6 of this lease instrument will be superseded by 30 CFR Part 260, published in the Federal Register on January 16, 1998 (63 FR 2626)." According to all MMS employees conversant with the process, the terms and conditions in the leases should mirror the FNOS, yet this footnote did not mirror the FNOS' citation of 30 CFR 203.*

During his interview, Rodi stated that the leases should definitely mirror the language in the FNOS, and he was unsure why the Sale 172 leases did not mirror the language in the FNOS. He acknowledged that someone in his unit must have "missed" noting the citation change from Sale 171's FNOS to Sale 172's FNOS – and thus failed to incorporate the citation change into the leases.

Sale 174

On July 16, 1999, MMS published in the *Federal Register* the FNOS for Sale 174 (Sale 173 did not involve Gulf of Mexico leases). As with the FNOS for Sale 172, the document did not contain any explicit price threshold language but rather stated: "See 30 CFR 203 for the final rule specifying royalty suspension terms." The footnote on the leases issued pursuant to Sale 174 was also identical to the leases issued under Sale 169, 171, and 172 (referencing 30 CFR 260), and thus the leases did not contain addenda incorporating price thresholds into the leases.

Sale 175

On February 14, 2000, MMS published in the *Federal Register* the FNOS for Sale 175. As with the FNOS for Sale 172 and 174, the document did not contain any explicit price threshold language but rather stated: "See 30 CFR 203 for the final rule specifying royalty suspension terms."

Discovering the Omission

AAPL Committee Meetings

The American Association of Professional Landmen's Outer Continental Shelf Committee (AAPL Committee) consists of representatives of 20 or more companies engaged in oil and gas exploration and production on the Outer Continental Shelf. The AAPL Committee has been meeting with MMS for many years on a quarterly basis in order to discuss a variety of issues related to MMS' administration of offshore oil and gas leasing. GOM Regional Director Chris Oynes and his staff usually attend these meetings on behalf of MMS.

Two current employees of Chevron, Gordon Cain and J. Keith Couvillion, were members of the AAPL Committee in 1998 and 1999 and attended most of the meetings with MMS during this time period. During their testimony before the House Subcommittee on June 27, 2006, both Cain and Couvillion recalled an AAPL Committee meeting with Oynes and his staff that occurred in the fall of 1998 in which several committee members questioned Oynes and his staff as to why the leases issued under the 1998 Sales did not contain addenda detailing royalty relief volume suspensions and price thresholds. According to Cain and Couvillion, Oynes and his staff responded that they believed the addenda were no longer necessary since MMS had finalized its regulation pertaining to royalty relief suspensions and the leases reference the regulation.

In testimony before the House Subcommittee, Cain and Couvillion stated that following the 1998 AAPL Committee meeting, committee members reviewed the Act and the MMS regulation implementing the Act and concluded that neither the Act nor the regulation explicitly contained price threshold language applicable to new leases. Cain and Couvillion said committee members brought this conclusion to the attention of Oynes during a

1999 AAPL Committee meeting and claimed that Oynes responded by stating that he would have his staff look into the issue.

During the July 27, 2006 House Subcommittee hearing, Oynes provided testimony that he had no recollection that AAPL Committee members informed him that price thresholds were not contained in the 1998 leases during the fall AAPL Committee meeting. Furthermore, Oynes provided testimony that he did not recall AAPL Committee members informing him in a 1999 AAPL Committee meeting that neither the Act nor the regulation contained price threshold provisions.

Oynes did not deny Cain's and Couvillion's allegations that AAPL Committee members raised the issue to him during these meetings; however, Oynes stated that many other important matters were discussed during the meetings, and he simply did not remember them telling him such things.

[Ex. 7E]

We conducted a review of the personal notes taken by Oynes and GOM Deputy Director Charles Schoennagel at the AAPL meetings. Neither Oynes nor Schoennagel had notes from the fall 1998 meeting; however, they both possessed personal notes from the AAPL Committee meeting held on April 9, 1999. Along with several other issues apparently discussed in the meeting that he noted in his personal, handwritten notes, Schoennagel entered the notation "new lease form issue." Similarly, Oynes made the handwritten notation "asked about – status of lease form" in his personal notes taken during the meeting, in addition to several other issues discussed. However, neither set of notes indicated price thresholds were specifically discussed.

Confirmed Discovery

We interviewed MMS economist Sam Fraser, who stated that on February 17, 2000, he discovered that there appeared to be a "mixture of treatments" for the new leases issued under the Act. Fraser said he inadvertently discovered this fact while reviewing the leases in consideration of how MMS planned on handling "minimum royalties" – a separate issue from price thresholds. He said that after reading the leases issued in 1996 and 1997, in comparison to the leases issued in 1998 and 1999, he questioned whether price thresholds did not apply to the latter set of leases since 30 CFR 260 made no mention of them. Fraser said he e-mailed Rose relaying his findings, and Rose asked Fraser the same day to work with the OMM economist to ensure the price thresholds were reinstated on the leases yet to be issued in 2000. Accordingly, Fraser sent an e-mail to the OMM economist on February 17, 2000, stating that "Marshall said he wants to be sure the price suspension conditions, like applied to the 1997 lease below, get applied to 2000 leases in the GOM."

The Aftermath of the Discovery

E-mails disclose that after being informed of the potential lack of price thresholds by Fraser on February 17, 2000, Rose realized that the recently published February 2, 2000 FNOS for upcoming Sale 175 also failed to include explicit price threshold language. Rose concluded that the leases to be issued under Sale 175 would most likely also lack price thresholds unless GOM was informed about the issue. Rose consequently contacted Rodi and informed him of his conclusions; as a result, GOM drafted and attached an addendum, similar to one used in 1996 and 1997, to the leases issued under Sale 175.

The leases issued under Sale 175 contained the following footnote: "This lease may be eligible for a royalty suspension volume of 87.5 million barrels of oil equivalent pursuant to PL 104-58. If eligible, Sections 5 and 6 of this lease instrument will be amended by addendum, page 2a, attached hereto and made a part hereof." Pages 2a of the addendum included explicit price threshold language.

Sale 177

On July 20, 2000, MMS published in the *Federal Register* the FNOS for Sale 177. The FNOS cites 30 CFR 260 in addition to stating: "Threshold prices will be applied …." Furthermore, the footnote on leases issued pursuant to Sale 177 incorporated an addendum that included explicit price threshold language.

In addition to taking action to include price thresholds into the leases issued in 2000, 5 days after Fraser discovered the lack of price thresholds, on February 22, 2000, Rose e-mailed the OMM Associate Director, explaining, "[I]t has been discovered that, to my surprise," price thresholds were not included in the leases issued during 1998 and 1999. In the e-mail, Rose asked the OMM Associate Director if she thought the MMS Director should be informed about the omissions in an upcoming meeting or "attempt to fix [the problems] ourselves." In response, the OMM Associate Director e-mailed Rose that same day, stating, "Regarding possible inconsistencies, my preferred approach is that we try and work out a solution within OMM." Oynes was copied on this e-mail exchange.

During his interview, the former MMS Director confirmed that he was never informed in 2000 by OMM about the omission of price thresholds from the leases issued in 1998 and 1999. In fact, he stated that he first learned of the omissions from reading the newspapers in early 2006.

Marshall Rose stated that after he inquired with the then OMM Associate Director as to what headquarters wanted to do about the issue, she simply told Rose to "fix it." Rose said that when he asked management at headquarters how they wanted to treat the leases issued in 1998 and 1999, they informed Rose that they "would think about it."

Agent's Note: *The former OMM Associate Director passed away in 2003.*

On May 8, 2000, the MMS GOM OPD employee sent an e-mail to SOL attorney Mason relating a conversation he had with a representative from the oil and gas company Elf. According to the OPD employee, Elf was inquiring "whether or not they keep the relief during periods where oil and gas prices average" above the price thresholds. In the e-mail, the supervisor stated to Mason:

> The lease agreements for the Post-Act leases obtained prior to Sale 169 had a Lease Addendum clearly stating the price ceilings are applicable. However, starting with Sale 169, the lease agreement simply refers to the CFR 260 Regulations (Royalty Relief for New Leases) and there is no such Lease Addendum specifically addressing prices. The problem is that the CFR 260 regulations do not mention any price ceilings. Although we are not sure if the intent was to treat all the Post-Act leases (November 1995 – November 2000) the same, it doesn't appear that we can enforce any price ceilings for this lease. Do you agree?

Mason responded on May 15, 2000, by stating, "no. let's chat. Who s/n [surnamed] the lease Change? Why wasn't I consulted or someone think of this potential issue??? Please inquire. Thanks."

From 1997 until 2002, Walter Cruickshank was the Associate Director for MMS' Policy and Management Improvement Division, at which point he became MMS' Deputy Director – the position he presently holds. During his interview, when initially asked when he learned of the price threshold omissions from the 1998 and 1999 leases, Cruickshank responded that he first learned of the issue in early 2006, or late 2005 – just prior to the first *New York Times* article addressing the issue. We then showed Cruickshank a June

26, 2000 e-mail he authored that referenced the omissions of price thresholds. Specifically, in preparation for a June 27, 2000 meeting on the Sale Notice for Sale 177, Cruickshank wrote:

> As we discussed, here's my position on the sale notice issues:
>
> 1) Price ceiling: I have no problem including this provision, as long as the price thresholds for this sale are the same as those in the Act. I am a bit curious why the provision has only been in half the sale notices.

After reviewing this e-mail, Cruickshank stated that, based upon the content of the e-mail, he "must have learned" of the omissions at that time (June 2000). He stated that he may have forgotten that he learned of the omissions at that time because he simply did not recognize the implications of the omissions.

Agent's Note: *During his testimony on March 1, 2006, Cruickshank was not asked when he learned of the omissions.*

On June 28, 2000, the former Chief, Resource Evaluation Division, forwarded Cruickshank, via e-mail, a summary of the Sale 177 meeting prepared by a program analyst in the Leasing Division; Cruickshank received this summary of the meeting on June 29, 2000, which began with the following two paragraphs:

> At issue was whether to include a minimum royalty suspension and a price threshold provision in deepwater leases eligible for royalty suspension, and if so, what form should those provisions take.
>
> We briefly discussed the history of these provisions – MMS has intended to use them in all sales since Sale 157; they were included in the first four DW [Deep Water] royalty relief sales and in Sale 175 but were inadvertently omitted from the 1998 and 1999 sales.

We obtained an e-mail certification which revealed that Cruickshank opened/read this e-mail on Thursday, June 29, 2000, at 05:28:38.

The former MMS Deputy Director left MMS in November 2001. During his initial interview, the former MMS Deputy Director had stated that he was not informed of the price threshold omissions in 2000 by OMM, and he first learned of the omissions from newspaper articles published in early 2006. However, in forwarding the above June 28, 2000 e-mail to Cruickshank and Readinger, the former Chief of the Resource Evaluation Division wrote that "Milo, G. Heath, [a program analyst in the Leasing Division], & I met with [the MMS Deputy Director], with Marshall & GOMR [Gulf of Mexico region] staff via telecom." The then MMS Deputy Director was not a recipient of the e-mail containing the summary.

After reviewing the e-mail, the former Deputy Director stated that he did not remember hearing about the price threshold omissions in the meeting. He acknowledged that according to the e-mail, he was probably in the room during part of the meeting. He pointed out that these meetings often contained many pertinent issues regarding upcoming Sales, and a matter concerning past leases may simply not have registered with him as a current issue that needed thoughtful consideration from the Directorate. He said he is certain nobody ever brought the omissions to his attention as an issue that required a decision; otherwise, he is certain he would have acted upon the issue and would have remembered being informed of the matter. He said he is positive that he was never provided a briefing where the mistaken omission of price thresholds was the focus.

On March 15, 2004, the GOM OPD employee e-mailed Rose to inquire, "What is the latest on the price threshold issue for sales held in 1998 and 1999?" Specifically, the supervisor wrote: "[I] think we all need to reach a consensus so that we can inform MRM [Minerals Resource Management Division], continue to answer industry questions, and correct the web page as soon as possible." ***Agent's Note:*** *Inasmuch as the leases issued during 1998 and 1999 did not contain explicit price thresholds, the industry had been contacting the GOM OPD employee in order to inquire about MMS' official stance on this issue.*

On March 16, 2004, Rose responded to the OPD employee via e-mail by stating:

> [OPD employee's first name]: My personal view on this situation coincides with yours. However, the decision must come from the Directorate, with advice from the Solicitor. If you or I tell companies what our views are, or if we publish something on our website that suggests a particular policy position, then we would be preempting that decision from the Directorate. This is not appropriate, and that's why I have been consistent in my opposition to the actions taken and proposed by GOMR on this issue.
>
> I have spoken to the AD [Readinger], who I thought would make the decision. He told me the Director [current MMS Director Burton] wants to make that call. I also checked with SOL, who indicted a perspective similar to the one you and I both hold. I conveyed that information to the AD and am awaiting a decision. Following preparation of this note, I'll remind him again of the need to make a "timely" decision. When that decision will get made is not clear – I'll ask that of the AD today, and get back to you when I receive his response.

Rose, 6 minutes later, sent Readinger the following e-mail:

> Tom: See the note below from GOMR. I responded that you and the Director were aware of the need to make a decision on this matter. Also, I spoke to Geoff Heath [SOL attorney] who told me that since there was nothing specific in the FNOS or lease contracts, and the regulations are silent about specific terms regarding of the price thresholds (for new leases the rules simply give us the authority to apply price thresholds that would be described in detail in the lease documents themselves), none should legally apply for sales held in 1998 and 1999.

Readinger responded to Rose approximately 4 hours later, stating, "Sounds like we have an answer. Let's go with it. Tom R."

Approximately 1 hour after receiving Readinger's e-mail, Rose responded, "Great, we'll go with it."

Six minutes after Rose responded to Readinger, Rose e-mailed the GOM OPD employee the following message:

> [OPD employee's first name]: The Directorate has decided that oil and gas price thresholds do not apply for leases sold in GOM sales held in 1998 and 1999, for the reasons we discussed earlier today and based on discussions held with SOL. I'll ask [another OMM economist] to work with you in preparing a statement on our price threshold web site that reflects this decision. Once you are both satisfied with the language, it can be posted immediately thereafter.

During his interview, Rose stated that he was unsure whether Readinger actually had informed Director Burton about the omissions of price thresholds or whether the Director actually made the decision not to pursue

price thresholds for the 1998 and 1999 leases. Rose stated that the omissions may have come up "in passing" during a meeting concerning the application of price thresholds in future Sales with Burton; however, he did not remember ever participating in a meeting with Burton where the focus of the meeting was the omissions of price thresholds.

We also showed Readinger the e-mail exchange. He stated that "he was sure" that the omissions of price thresholds from the 1998 and 1999 leases "came up" in a briefing with Director Burton. He said he remembered sitting with Burton and Rose during a briefing on how MMS planned to apply price thresholds to future Sales when Rose mentioned that the 1998 and 1999 leases failed to contain the thresholds due to an oversight.

Readinger stated that he believed Burton, Rose, Cruickshank, and possibly SOL attorney Mason were all at the briefing, which occurred before the March 15-16, 2004 e-mail exchange. He said he remembered that the general consensus was that there was nothing MMS could do about the contracts because SOL had opined to MMS that there were no legal options. When asked, Cruickshank and Mason did not recall a briefing in early 2004 where Burton was informed about the omission of price thresholds from the 1998 and 1999 leases.

During his interview, Readinger reviewed an e-mail that Rose wrote to him, stating, "I responded that you and the Director were aware of the need to make a decision on this matter." He also reviewed an e-mail from Rose to GOM OPD employee, stating, "I have spoken to the AD [Readinger], who I thought would make the decision. He told me the Director wants to make that call."

Readinger said he was certain he must have discussed the need to make a decision with Burton. He said that given the 4-hour time lapse between Rose's e-mail to Readinger and Readinger's response to Rose, he believed he may have approached Burton about the need to make a decision, and she did so. However, he said he simply could not specifically remember if such a conversation did actually occur.

Readinger stated that the first time he learned of the omissions from Rose, he "was floored." He said he remembered asking what could be done about the issue and was told that SOL attorney Mason had opined that "they were stuck" and nothing could be done because "a contract is a contract." Readinger said he had several conversations with Rose that "covered the waterfront" about possible options to remedy the omissions, yet the SOL was steadfast in its opinion that nothing could be done to reinstate the price thresholds.

Readinger stated that the SOL was emphatic in giving MMS the "red light" regarding its options in having the price thresholds apply to the 1998 and 1999 leases. He said he did not remember if he discussed the option of trying to approach the concerned companies in an effort to renegotiate the contracts to include the price thresholds; however, he said every idea MMS proffered to SOL was rebuffed with a "very resounding no, no, no, no." Readinger said at that point, he felt everyone within MMS gave a "unanimous shrug," "threw up their hands," and simply hoped the oil and gas prices would not rise too high.

During her testimony before Congress, Director Burton stated that she first learned about the lack of price thresholds from the 1998 and 1999 leases in late 2005 or early 2006. During her interview with the OIG, Burton confirmed this statement; however, she qualified her statement by acknowledging that she may have been told of the mistake prior, but "not much before," a *New York Times* reporter began "probing" into the issue.

Burton said that if she had been informed about the lack of price thresholds prior to the importance of the issue "registering" with her in late 2005, she may have simply dismissed the fact as a non-issue since she knew the application of price thresholds was discretionary, and thus it was not "illegal" to not have them included in the leases. In fact, she said that after Readinger informed her of the inadvertent omissions, she asked him if their

omission from the leases was "illegal," and Readinger informed her that it was not illegal since the price thresholds were not mandated by law.

We then asked Burton what she would have done, if anything, if she had been informed in 2002, upon becoming Director of MMS, that price thresholds were omitted from the 1998 and 1999 leases due to an administrative error rather than an affirmative decision by MMS. Burton stated that she would have informed the Secretary about the issue; however, she would have also pointed out to the Secretary that the contracts were "legal contracts," and thus MMS could not unilaterally modify their terms.

Beyond noting the legal restrictions regarding the issue, Burton did acknowledge that MMS "would have had more negotiating tools" if the Secretary decided to try to renegotiate the leases back in 2002, in order to include price thresholds, rather than in 2006 because the prices of oil and gas were still low and the industry may not have yet made significant investments in the leases.

After reviewing the 2004 e-mail exchange between the GOM OPD employee, Readinger, and Rose, Burton stated that Readinger must have mentioned the issue to her at that time; however, she said she did not remember putting a great deal of thought into the matter. She speculated that she was probably told of the mistake in conjunction with being informed that SOL had opined that nothing could be legally done to remedy the issue. She said that if this were the case, she probably dismissed the issue as immutable and redirected her thoughts to current issues. Given the advice provided by SOL attorney Heath mentioned in Rose's e-mail – that price thresholds could not legally apply to the concerned leases – Burton opined that she did not see how MMS could have decided differently.

Agent's Note: *If MMS had decided differently in 2004 and sought royalties on the 1998 and 1999 leases that exceeded price thresholds regardless of the SOL's opinion, MMS' Economics Division estimated that approximately $865 million of royalties would have been subject to collection by MMS. This estimate is based upon "the average NYMEX oil and gas prices during the relevant production months" in 2004, 2005, and 2006, less the average "transportation costs of $3.00 per barrel for oil and $0.25 per Mcf for gas."*

Burton stated that if a similar "mistake" occurred today, she would expect to be informed immediately upon its discovery. She stated that she "hates surprises" and is certain that all current MMS associate directors know that she would want to be promptly informed of such a significant issue.

MMS Current Review Process for NOS and Leases

Prior to 2000, and the discovery of price threshold omissions, MMS headquarters and attorneys within SOL constituted the surname process for the NOS. Regarding the issuance of leases prior to 2000, GOM drafted the leases based on the lease terms and conditions specified in the FNOS. Neither MMS headquarters nor MMS' Economics Division or the SOL reviewed lease documents prior to their issuance to lessees by GOM.

Since 2000, the Economics Division is now included in the FNOS surname process. Regarding leases, GOM drafts the lease documents based on lease terms and conditions specified in the FNOS. The FNOS includes the detailed information contained in the "Leasing Activities Information – Royalty Suspension Provisions" document, which specifies the types of royalty relief offered in each Sale as well as the applicable price thresholds.

The "Leasing Activities Information – Royalty Suspension Provisions" document is reviewed by the Economics Division for each Sale; additionally, the Economics Division now reviews the royalty suspension addenda to the leases to ensure that they contain price threshold language consistent with the FNOS. Following

the Economics Division's review of the lease addenda, GOM issues the leases and ultimately is responsible for the correctness of the lease terms and conditions that are specified in the lease instrument.

According to Associate Solicitor James Harris, SOL Division of Mineral Resources, similar to the pre-2000 process, the actual lease documents are still not subject to any legal review prior to their issuance by GOM. Harris stated that MMS uses a standard lease form that contains boilerplate language that has been legally reviewed, and the language "has not changed" significantly in years. However, the lease form contains "blank" areas where the terms and conditions of the lease need to be added, such as the following: lease rental rate, cash bonus payments, minimum royalty rate per acre, royalty rate, amount of acres, and the existence of addenda (via footnote language). Harris stated that GOM is responsible for inputting this information prior to its issuance of the leases, and SOL does not review the leases after GOM inputs this information.

According to Director Burton, the MMS process for reviewing documents has "gotten a bit tighter" over the past few years, but they "still have a long way to go."

Present Issues Regarding Application of Price Thresholds for New Leases

During our e-mail review, we discovered several e-mail transmissions occurring on March 30 and 31, 2006, indicating MMS employees' continued frustration in determining how they should apply price thresholds to new leases. On March 30, 2006, an MMS Leasing Division employee sent the Economics Division economist an e-mail, stating:

> [A program analyst in the GOMR Sales and Support unit] is concerned that the Royalty Suspension Provision document that is part of the PNOS for WGOM [Western GOM] Sale 200 package (and attached) does not sufficiently address price thresholds for deep wells. I share her concern.

The economist responded by stating:

> I share your concern as well. I will ask Marshall [Rose] for guidance. The problem is that the Department does not want to commit to a price threshold at this time, so the deep gas price threshold could be between $3 and $10, but we don't know what it will be. The potential for problems like those associated with the 1998-99 DW [Deep Water] leases certainly exists. I will get back to you as soon as I get a response from Marshall.

On March 31, 2006, the OMM economist sent an e-mail to an MMS Leasing Division employee, stating:

> I know that it makes me uneasy not to have explicit price thresholds for deep gas in the NOS and lease documents. With all of the bad press that MMS is receiving, this issue probably should be brought to [the Chief of Leasing Division]'s attention. In my opinion, it's better to let upper management know that this may be a potential problem now rather than wait until the 11th hour and hope that everything falls into place. Also, it would be good to have SOL on record with their written guidance on this issue. It's totally amazing to me that for important issues we never seem to get "official" direction – where's the paper trail?

Later that same day, the OMM economist sent an e-mail to OMM Associate Director Tom Readinger, stating:

> I got a call from [a GOMR employee], asking for verbal approval that the lease addendum language (royalty relief and price thresholds) for the Sale 198 leases is appropriate. Apparently, the GOMR is ready to start awarding leases based on the Phase 1 evaluation. Given our royalty relief controversies, neither I nor Marshall, if he was here, are the ones to make this call. Last time I checked, the Leasing Division was administratively in charge of lease sales, not the Economics Division.
>
> I know that I have concerns because the addendum for shallow water, deep gas leases does not contain explicit price threshold language. Someone in upper management needs to make a call because if price thresholds in the addendum are not supportable, a great deal of royalty revenues could be lost. Quite frankly, my opinion is that we should get explicit **written** approval from SOL that the addendum language actually accomplishes what we intend. However, I just work here and no one has listened to me in 24 years, so why should anything change now. (emphasis included in original e-mail)
>
> [The Chief of the Leasing Division] and Marshall are not here today, so I'm putting the ball in your court.

We asked Readinger if MMS was continuing, to this day, to have confusion regarding how it applies price thresholds to leases. Readinger stated, "I will go on record agreeing that I am not satisfied with the current process."

Disposition

This case is closed with no further investigation anticipated. The facts of this investigation will be referred to the Assistant Secretary for Land and Minerals Management for whatever action he deems appropriate.