

Office of
INSPECTOR GENERAL

U.S. Department of the Interior



Evaluation of Bureau of Land Management's Oil and Gas Lease Auction Process

Report No. CR-EV-BLM-0002-2009

August 2009



United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, DC 20240

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Memorandum

To: Robert V. Abbey
Director, Bureau of Land Management

From: Mary L. Kendall *Mary L. Kendall*
Acting Inspector General

Subject: Evaluation Report of Bureau of Land Management's Oil and Gas Lease Auction Process (Report No. CR-EV-BLM-0002-2009)

This memorandum transmits our report detailing the results of our evaluation of the Bureau of Land Management's (BLM) oil and gas lease auction process. Our review was prompted by a highly publicized incident in which an individual who, in an act of environmental protest, disrupted a BLM lease auction by bidding for parcels without the intent or ability to pay for or develop the leases.

We focused on BLM's implemented and proposed revised measures to its lease auction process as a result of the incident and obtained information on other federal and state auction processes to identify practices that could improve or enhance BLM's lease auction process.

We found that BLM took swift action to initiate improvements to the lease auction process after the incident by drafting an Instruction Memorandum with new measures designed to reduce the likelihood of individuals participating in auctions without the intent to complete their purchase. Although the new measures should reduce the risks associated with bad-faith bidders, we are recommending additional steps to further minimize the risks of fraudulent bidders and improve the lease auction process.

We ask that you inform us of your course of action within 30 days. Should you have any questions about this report, please do not hesitate to contact me at 202-208-5745.

Attachment

cc: Assistant Secretary, Land and Minerals Management

INTRODUCTION

In December 2008, in an act of environmental protest, an individual exploited the Bureau of Land Management's (BLM) oil and gas lease auction program by bidding for parcels without the intent or ability to pay for or develop the leases. The individual won 14 parcels totaling \$1.8 million in lease revenue.

In April 2009, the individual was indicted by a federal grand jury for violation of the Federal Onshore Oil and Gas Leasing Reform Act of 1987 for knowingly interfering with the competitive bidding process and knowingly making a false and fraudulent statement when he completed and signed a bidder registration form.

In response to the incident, we initiated an evaluation of BLM's lease auction process. We concentrated our efforts on three main areas:

- assessing BLM's implemented and proposed changes to the lease auction process as a result of the incident;
- reviewing BLM's Internet lease auction pilot program; and
- obtaining information on other federal and state auction processes to identify practices that could improve or enhance BLM's lease auction process.

We conducted our evaluation work in accordance with the Quality Standards for Inspections issued by the President's Council on Integrity and Efficiency.

BACKGROUND

BLM'S OIL AND GAS LEASING PROGRAM

The Mineral Leasing Act of 1920 (MLA), as amended, authorizes leasing of federal lands for development of oil and gas resources. The MLA requires each BLM state office to conduct quarterly oil and gas lease sales by oral bidding where eligible lands are available. It also establishes the minimum bonus bid¹ of \$2 per acre. Parcels unsold at the oral auctions are available noncompetitively starting the day after the sale.

The Code of Federal Regulations (43 C.F.R. § 3120.5-2) requires winning bidders to pay the first year's rental (\$1.50 per acre), a processing fee (\$140), and the minimum bonus bid (\$2 per acre) the day of the lease sale. Any additional bonus over the \$2 per acre is due within 10 working days of the sale; failure to make this payment will result in the forfeiture of the

¹ Bonus bid refers to the minimum bid amount of \$2 an acre and any amounts bid over the \$2.

initial deposit and rejection of the bid. The only requirements outlined in the CFR for bidder qualification are that the bidder must be a U.S. citizen or an alien stockholder in a corporation organized under state or federal law, and 18 years of age or older.

The oral lease auction represents a small fraction of the entire leasing process, described in Appendix 1. BLM's Division of Fluid Minerals manages the leasing program at the national level, providing guidance to its state offices. BLM's "Oil and Gas Adjudication Handbook - Competitive Leases" (H-3120-1) is the written guidance for conducting the lease sales.

BLM has received nearly \$1.2 billion dollars in bonus bid revenue from the sale of over 14,000 leases from 2004 through 2008.² The majority of leases and the resulting revenue come from the western states of New Mexico, Wyoming, Colorado, Utah, and Montana.

WHAT WE FOUND

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*For the purpose of this evaluation, individuals or companies defaulting on winning bids are referred to as **bid-walkers** and separated into two categories: bad-faith and non-paying bidders.*

*An individual or company that bids with ulterior motives and no intention of paying, exemplifies a **bad-faith bidder**.*

*A **non-paying bidder** is an individual or company that defaults without malfeasance; the most prevalent reason cited was insufficient funds.*

The effect of both bad-faith and non-paying bidders is the disruption of the lease auction process.

We found that BLM did not view bid-walkers as a significant threat to the lease auction program and had few deterrents in place to limit the risk of occurrence. BLM's lease auctions are designed to maximize bidder participation by providing easy access for prospective bidders. This open process results in a higher risk that individuals with hidden agendas may participate in the auction and cause disruption.

According to BLM's records, in the last 5 years, there were 35 bid-walkers who defaulted on 152 of the approximately 14,000 parcels sold. We estimated the monetary loss³ to be \$3.4 million which is less than 1 percent of the nearly \$1.2 billion in lease auction revenue. Non-monetary considerations associated with bid-walkers include delays in issuing federal leases and in developing the Nation's energy resources, fairness to other bidding parties, and disruption of BLM's lease auction process.

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To date, the occurrence of bad-faith bidders has been rare, with only two known cases in the last 5 years.

However, there is growing concern that lease auctions may become a forum for future protests due to the publicity of the Utah incident.

² Alaska is governed by different laws and therefore excluded from the statistics.

³ Monetary impact to BLM reflects bonus bid revenue lost or gained upon resale and the loss of rental revenue.

We found that prior to the Utah incident BLM did not have adequate measures to deter bid-walkers from disrupting oil and gas lease auctions. Specifically:

- BLM did not publicize that there are criminal and civil penalties associated with the fraudulent actions of a bidder.
- BLM did not clarify the liability incurred by the winning bidder for the monies due the day of sale.
- BLM did not have a policy requiring verification of identification for lease bidders.
- BLM did not have a formalized billing and collection process for bid-walkers. BLM state offices were inconsistent in their efforts to collect unpaid amounts due on the day of sale.
- Some BLM state officials were not familiar with the BLM Handbook requirement to ban potential bidders who defaulted three times in a single state. Also, the Handbook was unclear about whether the three defaults were represented by parcels or by lease sales. We identified instances in which bidders were allowed to participate in subsequent sales after defaulting on more than three parcels.
- BLM did not track bid-walkers and, thus, did not implement the bid-walker ban as required in its Handbook.

BLM ACTIONS TO IMPROVE THE PROCESS

The Utah incident set in motion BLM's internal assessment of its auction process and controls. BLM's Division of Fluid Minerals drafted an Instruction Memorandum (IM), "Measures to Better Safeguard Competitive Oil and Gas Lease Auctions," planned to be issued this summer. The draft IM includes the following short-term measures.

- Requires BLM to centrally track bid-walkers and distribute reports to BLM state offices prior to lease sales.
- Requires changes to the pre-sale lease auction process to include: (1) verification of a government issued identification for all bidders, (2) prevention of persons or companies with an outstanding balance from registering to bid, and (3) clarification of the debt created by a winning bid in the opening oral remarks at lease auctions.
- Requires changes to the post-sale process including: (1) issuing a bill through BLM's Collection and Billing System to those individuals or companies that do not pay the amount of money due the day of the sale and (2) mandating rejection of any bid for which any payment is not paid as required.

- Amends the Bidder Registration Form and the Notice of Competitive Oil and Gas Lease Sale to incorporate the changes above and to inform bidders of their responsibilities.

During the course of our evaluation, BLM state offices were directed by the Division of Fluid Minerals to immediately implement the provisions in the draft IM.

Although the above actions should reduce the risks associated with bid-walkers, the IM did not emphasize the criminal penalties associated with bad-faith bidding by specifically citing imprisonment and fines, or include the citation and the language from 30 U.S.C. Section 195(a) and (b) in the Bidder Registration Form and the Notice of Competitive Oil and Gas Lease Sale. This Section makes it unlawful to organize or participate in any scheme to defeat provisions of the mineral leasing regulations punishable by a fine of not more than \$500,000, imprisonment of not more than 5 years, or both. Also, the IM did not contain provisions for banning repetitive bid-walkers.

Furthermore, the IM does not provide the detailed procedures required to effectively implement the short term measures. In order for the IM to be effective, specific procedures need to be developed and distributed throughout the Bureau, thereby providing guidance to the field and consistency in implementation. For example, the IM does not specify acceptable forms of government issued identification and does not define the roles and responsibilities related to the distribution and maintenance of the list of non-responsible persons or companies.

In BLM's deliberation of proposed controls, requiring proof of financial capacity was considered, but not included as a proposed measure. BLM cited staffing constraints and costs exceeding the benefits as reasons for not implementing proof of financial capacity. We agree that requiring proof of financial capacity may not be warranted at this time; however, it may need to be considered in the future if the occurrence of bid-walkers increases.

The draft IM clarifies that a winning bid creates a debt to the U.S. for the amount due the day of sale. BLM plans to recommend to the Department a proposed regulation to clearly establish that a winning bid creates a debt for the *entire* amount of the bonus bid. This requirement would not only increase the level of commitment required of bidders, but also the penalty for defaulting, thereby further reducing the risk of bid-walkers.

INTERNET AUCTION PROCESS

In the Fiscal Year 2008 Consolidated Appropriations Act, Congress directed BLM to pilot an Internet lease auction as an alternative to the oral auctions required by the MLA. BLM's Colorado State Office was selected as the location for the pilot. In September 2009, 38 parcels will be available for bid on BLM's Oil and Gas Lease Internet Auction Pilot System.

Bidders will be allowed to pre-register from 60 days before the auction to the day of auction. Potential bidders will have to submit a credit card to validate identity only. A deposit or credit card authorization will not be required.

The Internet leasing auction presents potential benefits such as increased bidder participation and accessibility; savings to bidders; electronic verification of disqualified bidders; additional identification and financial verification through pre-registration and pre-certification; the potential for nationwide bidding instead of individual state auctions; and the capture of lease auction data for analysis, planning, and reporting.

The Internet leasing auction, however, also presents new risks. For example, this method allows for potential anonymous participation in the auction process increasing the risk of fraudulent bidding. Even though a credit card will be required for bidders to pre-register in order to verify identity, it would not preclude an individual from using a stolen or unauthorized credit card. As with any Internet accessible system, the risk for cyber attacks also exists. BLM reports that the pilot system will comply with all aspects of the National Institute of Standards and Technology's Special Publications and Certification and Accreditation of Federal Information Systems. We did not attempt to validate this assertion.

The Internet leasing auction is a promising prospect for BLM in the evolution of its oil and gas leasing process. For BLM to fully implement the Internet leasing auction concept, however, Congress will need to amend the MLA to eliminate the requirement for oral auctions.

AUCTION PROCESS COMPARISON

We obtained information on other federal and state lease programs to identify promising auction practices and bidding methods. We reviewed state oil and gas lease auction programs that were similar to BLM's. Specifically, we selected New Mexico, Colorado, and Wyoming. We also considered other programs that conduct auctions of natural resources or other products including BLM's timber, coal, and geothermal programs; Minerals Management Service's (MMS) Offshore Energy and Minerals Management (MMS-OEMM) oil and gas program; Federal Communications Commission (FCC); and MMS' Royalty-In-Kind (RIK) program (for pre-qualification only). See Appendix 2 for a summary of the leasing practices identified.

The following are several processes identified that are different from BLM's current lease auction program:

- **Sealed Bidding.** The State of New Mexico, MMS-OEMM, BLM Alaska, and BLM coal and timber programs use the sealed bid method. A representative from the State of New Mexico said that the bonus income generated is higher than when holding an oral auction. All the agencies above required a certain percentage of the bid as an

upfront bid deposit. Due to the oral auction requirements in the MLA, BLM is not currently allowed to auction parcels with this method.

- **Pre-registration.** MMS-OEMM requires a certified statement indicating the state in which the company is registered, if it is authorized to hold a mineral lease, and a list of authorized officers in order to submit bids. Once approved, MMS will issue a qualification approval letter containing a unique MMS qualification number that can be used on all future lease auction sales. FCC also requires pre-registration of potential bidders.
- **Internet Auction.** Internet-based auctions offer the potential for increased participation given the ease of accessibility. The FCC is the only agency we found conducting auctions via the Internet. BLM has initiated a pilot program to develop and test the feasibility of conducting future auctions via the Internet.
- **Bid-walker Ban.** The State of Wyoming will ban a bid-walker from auction participation for 1 year. If the party participates after 1 year, Wyoming will require full payment with certified funds the day of the sale. Although Wyoming has an auction law allowing it to sue for the money due, a Wyoming official stated that barring the bidder has a greater, immediate impact.
- **Amount Due on the Day of the Sale.** The States of New Mexico and Colorado require full payment the day of the sale. Increasing the amount due on the day of sale is more consistent with similar oil and gas leasing programs. This also increases the penalty for those individuals or companies who default on winning bids.
- **Bid Deposits.** MMS-OEMM, BLM coal, BLM Alaska, and the State of New Mexico require partial or full payment of the bonus bid with the submission of the bid. These organizations all conduct sealed or written bid auctions. None of the oral auctions reviewed required a bid deposit.
- **Pre-qualify Bidders.** RIK and FCC are the only organizations we identified that verified financial capacity prior to the lease auction. The FCC expends a large effort in pre-qualifying bidders to determine the bidder's financial capacity. FCC and RIK pre-qualification, and the absence of such requirements in oil and gas leasing programs, suggests that pre-qualification may be more appropriate for more expensive lease acquisitions. BLM onshore lease parcels can be as small as 40 acres, for which a bidder can acquire the lease for a minimum of \$280.
- **Oral Auction Initiated with Written Bid.** BLM timber auction sales require the bidders to complete a written bid and submit a certified funds deposit of 10 percent of the written bid. The written bid has to be at least the minimum amount established by BLM. The oral auction begins with the highest written bid. The highest oral bidder will be the successful bidder.

Through our evaluation, we concluded that other auction methods such as sealed bids and Internet-based, could provide BLM some benefits such as increased revenues or streamlined processes. BLM is precluded, however, from employing alternative auction methods until the oral requirement is removed from the MLA.

Implementing BLM's short term measures outlined in the IM, as well as our recommendations outlined below, may not completely eliminate bid-walkers, but will add extra levels of control to minimize the risk of occurrence.

The possibility for increased bad-faith participants in BLM's lease auction process may be affected by the outcome of the pending prosecution of the individual in Utah. If the individual is convicted, the severity of the penalties associated with that conviction will be crucial to reinforcing the implemented measures and serve as a major deterrent to future bad-faith bidders. If he is acquitted, the absence of consequences for such actions may encourage similar incidents such as the one in Utah and require BLM to reassess its controls.

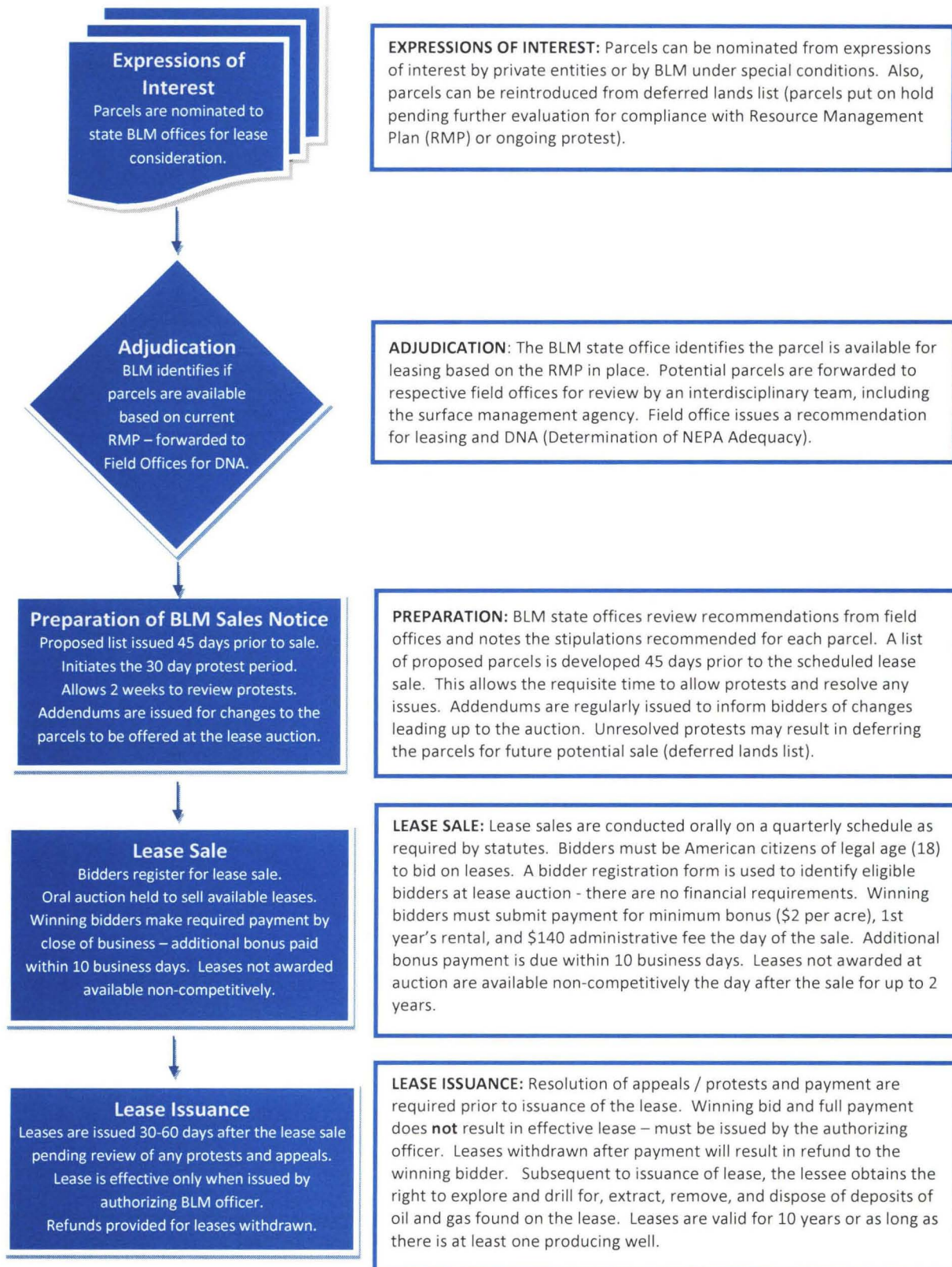
RECOMMENDATIONS

We recommend the Director, BLM:

1. Amend the Draft IM to include the following provisions:
 - a) Emphasize the criminal penalties associated with the statutes cited in the Bidder Registration Form and the Notice of Competitive Oil and Gas Lease Sale by specifically stating prison and monetary penalties.
 - b) Include the citation and the language from 30 U.S.C. Section 195(a) and (b) in the Bidder Registration Form and the Notice of Competitive Oil and Gas Lease Sale which makes it unlawful to organize or participate in any scheme to defeat provisions of the mineral leasing regulations punishable by a fine of not more than \$500,000, imprisonment of not more than 5 years, or both.
 - c) Establish a nationwide ban that prohibits a person or company from all lease sales after repetitive defaults. This would expand the existing statewide ban included in the BLM Handbook (H-3120-1, Competitive Leases) which states, "Any entity who forfeits the right of issuance of a lease (failure to submit the remaining monies due) totaling three times in the (Name) State Office, shall be prohibited from bidding at any future sale in this State." In developing a ban policy, BLM should (1) clarify in its nationwide ban whether three defaults represents sales or parcels; (2) expand the ban to include default on monies due the day of sale; and (3) consider a ban for a certain period of time for a single default, such as the State of Wyoming's 1 year bid-walker ban.

2. Develop and distribute supplemental guidance on implementing the IM throughout the Bureau and update the BLM Handbook (H-3120-1, Competitive Leases) to incorporate the new guidance as soon as possible.
3. If BLM does not implement the policy to make the entire bonus bid a debt to the U.S., BLM should increase the amount due on the day of sale from \$2 per acre to a specified percentage (e.g. 20 percent) of the bonus bid to be determined by BLM.
4. Conduct an analysis to determine which auction process is best suited for oil and gas leases including oral, sealed, and Internet bidding.
5. Work with Congress to revise or amend the Mineral Leasing Act of 1920 to eliminate the requirement for quarterly oral auctions and allow for alternative auction processes, e.g., sealed bid or Internet.

BLM OIL AND GAS LEASE AUCTION PROCESS



COMPARISON OF AUCTION PRACTICES

Appendix 2

Entity	Type of Auction	How Often are Auctions Held	Financial Pre-Qualification	Financial Requirement to Bid	Required to Register Before Day of Sale	Required to Register Day of Sale	Bid Deposit	Amount Due Day of Sale	Remainder Due	Track Bid-Walkers
BLM Onshore	Oral	Quarterly	No	No	No	Yes	No	\$1.50/acre rent, \$2 minimum bonus, and \$140 processing fee	10 working days	No
Other Onshore Oil & Gas Agencies										
BLM AK	Sealed	Once/2-yrs	No	No	Yes	No	Yes	1/5 of sealed bonus bid	15 days after receipt of the lease	No
State of CO	Oral	Monthly	No	No	No	Yes	No	1st year rental, bonus, and processing fee	Total due day of sale	No
State of NM	Sealed/Oral	Monthly	No	No	Yes	No	Yes	Bonus and \$30 application fee	Total due day of sale	No
State of WY	Oral	3 Times/Yr	No	No	No	Yes	Yes	\$1/Acre min bonus, \$1/acre rental, filing fee, and \$0.12/Acre advertising fee	10 days from date of sale	No
Other DOI Programs										
BLM Coal	Sealed/Application	Varies	No	No	No	Yes	Yes	1/5 of bid	4-annual installments	No
BLM Timber	Sealed/Oral	Varies	No	No	No	Yes	Yes	10% of appraisal price	20% due end of 1st year; 40% end of 2nd year; balance prior to expiration of contract	Yes
BLM Geothermal	Oral	Every two years	No	No	No	Yes	Yes	20% of bonus bid, 1st year's rental, and processing fee	15 calendar days after the sale	No
MS RIK	*	*	Yes	Yes	Yes	*	*	*	*	*
MMS-OEMM	Sealed	Varies	No	No	Yes	N/A	Yes	1/5 of cash bonus	Remaining 4/5 and total first year's rental due within a prescribed time.	No
Other Auction Entities										
FCC	Internet	4 to 6 months	Yes	Yes	Yes	N/A	Yes	Covered by deposit	10 working days	Yes

*For MMS-RIK, we only obtained information regarding pre-qualification.

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