TXP OPERATING CO.

IBLA 88-644 Decided July 3, 1990

Appeal from a decision of the Director, Minerals Management Service, denying specified transportation allowances for royalty valuation purposes. MMS-87-0271-OCS.

Affirmed.

1. Oil and Gas Leases: Royalties: Generally--Outer Continental Shelf Lands Act: Oil and Gas Leases

When computing the royalties for offshore oil and gas, the Minerals Management Service allows a transportation allowance for costs reasonably incurred in moving oil and gas from the point of offshore production to the first available market onshore. A transportation allowance may not be taken for the costs of storage, handling, and accounting incurred because it is necessary to accumulate sufficient condensate to meet a minimum volume required for delivery, as those costs are related to marketing the product, i.e., to accumulating a marketable quantity of the product.

APPEARANCES: Hugh V. Schaefer, Esq., and Stephen M. Brainerd, Esq., Denver, Colorado, for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., and Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE MULLEN

TXP Operating Company (TXP) has appealed from a July 8, 1988, decision of the Director, Minerals Management Service (MMS), affirming an April 22, 1987, ruling of the Chief, Royalty Valuation and Standards Division (RVSD), Royalty Management Program, MMS. In the underlying decision the Chief, RVSD, had denied TXP's request for a 1986 transportation allowance for condensate produced from Outer Continental Shelf oil and gas lease Nos. OCS-G 3061 and OCS-G 3068 (Mustang Island Blocks A-85 and A-111, respectively) offshore Texas.

TXP is the operator and working interest owner of these Federal offshore leases, which are producing natural gas. Throughout 1986 TXP separated the condensate from the natural gas, and treated and measured it at the offshore platform. The condensate was then vaporized, reinjected into the natural gas stream, and transported to shore through a Transcontinental Gas Pipeline Corporation (TGPL) pipeline. 1/ After transportation to shore, the condensate was again separated from the natural gas stream at TGPL's Markham, Texas, separation facility and shipped a short distance to the Markham Gas Plant, owned by Marathon Oil Company and Sun Gas Company (referred to collectively as Marathon). 2/ The condensate was stored in tank facilities at the Markham Gas Plant until a sufficient quantity had been accumulated for delivery to Texas Pipeline's crude oil line located at the outlet of the Markham Gas Plant. Marathon charged TXP approximately 25 cents per barrel for the storage, handling, and accounting services it provided.

In January and February 1986, TXP sold condensate produced from the leases pursuant to a contract with Conoco, Inc. (Conoco). The contract called for the delivery of a specified quantity of condensate into the Texas Pipeline crude oil pipeline at the outlet of the Markham Gas Plant. Title and risk of loss passed upon delivery. Beginning in March 1986, Petro Source Corporation (Petro) purchased TXP's condensate production under a similar contract, with title and risk of loss passing upon delivery into the same Texas Pipeline oil pipeline. This agreement was amended effective July 1, 1986, to provide for transfer of title and risk of loss upon delivery to TGPL.

In a letter dated March 2, 1987, TXP sought a transportation allowance for the year 1986 for the charges Marathon had levied for storing and handling the crude oil, and accounting services. On April 22, 1987, the Chief, RVSD, denied TXP's transportation allowance request. Noting the MMS policy to grant a transportation allowance for the reasonable, actual costs incurred to transport lease production to the nearest off lease point of sale, the Chief stated that Marathon's condensate handling fee was not associated with the transportation of lease production. The basis for his conclusion was his finding that the Marathon charges were more properly associated with condensate separation, which is necessary to reduce the product to a marketable condition, and that the costs of reducing the product to a marketable condition are borne solely by the lessee. 3/

1/ Petro Source Corporation, TGPL, and Transco Exploration Company (TXC) are subsidiaries of Transco Energy Company. TXC is the managing general partner of TXP.

2/ TGPL did not charge TXP for any of its services.

3/ The RVSD findings and conclusions, attached to the Chief's decision, included the finding that "[i]n a telephone conversation on March 25, 1987, Ms. Parnell [TXP's liquid hydrocarbons marketing coordinator who signed the transportation allowance request] stated that the handling fee charged TXP by Marathon Oil Company at the Markham Lease Facility [was] actually a condensate separation fee." In its initial argument before the Director, TXP contended that MMS incorrectly recorded its telephone conversation with Ms. Parnell, because Marathon's fee was for storage, handling, and accounting services performed at the gas plant and not incurred for separation ser-vices. MMS has subsequently treated the fee as being for storage, handling, and accounting services, rather than for separation.

TXP appealed the RVSD decision to the Director, MMS. According to TXP, the nearest sales point for its production was the outlet at Marathon's gas plant storage tank facilities, and this was the only place a purchaser could take delivery of the condensate. TXP asserted that, because the physical arrangements associated with transporting the condensate to the sales point necessitated using Marathon's services, Marathon's fee was a reasonable, actual transportation related cost, and it was entitled to deduct that cost as a transportation allowance. TXP concluded:

> Since the transportation allowance is nothing more or less than a mechanism for adjusting the price at which royalty is sold after having been transported to a market onshore to reflect its value where the [G]overnment is entitled to have it valued -- at the wellhead -- the allowance must include all of the costs reasonably and necessarily incurred in getting the royalty to the nearest open, onshore market. [Emphasis in original.]

(Appeal to Director, MMS, at 5).

In his July 8, 1988, decision denying TXP's appeal, the Director identified three bases for not allowing the deduction of the fees charged by Marathon as a transportation allowance. First, after briefly noting the Secretarial authority and discretion to establish value for royalty purposes, he indicated that, in the exercise of this discretion, the Secretary had determined that royalties must be based upon the value of production after it has been placed into marketable condition, citing California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961) (California Co.), as in support of his determination. He noted that, according to TXP, the condensate was stored at the gas plant until a sufficient quantity had accumulated for delivery into the crude oil pipeline. The Director concluded that, under the circumstances in this case, Marathon's charges for storage, handling, and accounting services were functions normally incidental to the producer's duty to market the production, and were not deductible when computing royalties. As a result, he held, "the cost of these services may not be deducted in computing royalties even where the producer paid for the performance thereof under an arm's length contract" (Director's Decision at 3).

As his second reason for denying the deduction, the Director rejected TXP's allegation that Marathon's services were a necessary, integral part of the transportation required to physically transfer the production from the offshore platforms to the onshore sales point. He indicated that TXP's amended contract with Petro established that, effective July 1, 1986, title and risk of loss passed to Petro upon delivery to TGPL's pipeline at the offshore platforms. 4/ He concluded that the transportation allowance was properly denied because, after July 1, 1986, the sales point of the conden-sate was located offshore and not at the outlet of the gas plant.

4/ Under the amended contract, TXP pays for transportation through TGPL's pipeline and pays Marathon's fee for injecting the condensate into Texas Pipeline's pipeline.

Finally, the Director noted that the Secretary has discretion to determine the precise factors affecting a transportation allowance and
the weight to be accorded to any given factor. He reaffirmed his holding in an earlier decision that "fees paid 'for the temporary accumulation and storage of lease production' may be considered as unrelated to 'the loading, unloading, or transportation of the product'" (MMS Decision at 4). Accordingly, the Director affirmed the decision of the Chief, RVSD, denying the transportation allowance.

TXP frames the issue on appeal to this Board, 5/ as whether it is entitled to include Marathon's fee for the storage, handling, and accounting of condensate delivered to the Markham Gas Plant in the calculation of its transportation allowance. It contends that MMS' denial of its transportation allowance request, based on a conclusion that the expenses were necessary to place the lease production into marketable condition (rather than to transport the production), ignores the unique circumstances surrounding the transportation of gas and gas liquids from offshore platforms to the onshore delivery point. TXP asserts that the condensate has been placed into marketable condition when the wet gas condensate is separated from the dry natural gas and separately measured at the platform. It argues that, for most of 1986, there was no offshore market for the condensate which would have enabled it to obtain the highest price it actually received, and it was thus required to transport the condensate to an onshore facility for delivery to its purchaser. 6/ It asserts that the reinjection of the condensate into the natural gas stream was the most efficient and economical means for transporting the gas to shore. TXP contends that all the expenses it incurred after shipment of the condensate from the TGPL onshore facility were necessary to obtain the highest price for the product, and the subsequent storage, handling, and accounting charges were actual costs of the required transportation services (SOR 1 at 2-3).

TXP asserts that MMS improperly relied on California Co., supra, as a basis for denying the TXP transportation allowance. Recognizing that, under California Co., a Federal oil and gas lease expressly obligates the lessee to market the product, and thus imposes the implied requirement that the lessee incur the cost of placing the product in a marketable condition, TXP contends that its condensate had been reduced to a marketable condition before leaving the offshore platforms. TXP notes that it is not attempting to recoup costs associated with separating the condensate from the natural gas to make it marketable, but contends that MMS is erroneously trying to extend the holding in the California Co. decision to costs necessary to ensure delivery of a gas product, because those costs were not in issue the California Co. case. TXP contends that, under California Co., once the product is in a marketable condition, the lessee has complied with the lease requirement that the product be placed in a marketable condition at

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5/ TXP submitted a preliminary and a supplemental statement of reasons, referred to as SOR 1 and SOR 2, respectively.
6/ TXP does not dispute MMS's conclusion that, beginning July 1, 1986, the delivery point was offshore.

its cost, and subsequent expenses are properly deemed a part of the cost incurred for delivery to the sales point, especially when those expenses occur a considerable distance from the lease, constitute an integral part of the transportation phase, and do not involve any form of wellsite preparation.

TXP further argues that MMS' claim that these expenses are incidental to marketing and not deductible under 30 CFR 206.152(d) overlooks the fact that it was necessary to ready the gas for market in order to meet pipeline standards. It asserts that "[a]ny further expenses which arise during or after transportation are includable in a transportation allowance" (SOR 2 at 5). It challenges MMS' determination that the services performed by Marathon are ordinarily rendered by a producer incident to the producer's duty to market the production, claiming that a reasoned analysis does not support the conclusion that the storage and handling services are ordinarily rendered by a producer or explain how those services relate to marketing gas. TXP emphasizes that the services in this case were not rendered by the producer but were performed by a third party incidental to the product's delivery to market.

TXP asserts that the MMS decision is inconsistent with Marathon Oil Co. v. United States, 807 F.2d 759 (9th Cir. 1986), cert. denied, 107 S. Ct. 1593 (1987). TXP interprets that case as clearly holding that the cost of storage while processing a product to enhance its transportation are deductible for royalty valuation. TXP also finds the MMS decision in conflict with Diamond Shamrock v. Hodel, 853 F.2d 1159 (5th Cir. 1988) (Diamond Shamrock), which held that royalties are not due on a purchaser's take-or-pay payments submitted to a lessee when the purchaser fails to take the contractual minimum quantities of gas. In so holding, the court concluded that production, for royalty purposes, requires the actual physical severance of the minerals. TXP contends that production must therefore be valued at the point of such physical severance and, if the product has no market at this point,

> the value should be calculated by deducting all expenses incurred in getting the product to the market from the price received -- subject to the exception noted in California Co. for expenses related to conditioning the product for market.
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> From the Diamond Shamrock decision, it is clear that costs and expenses related to the downstream transportation of a product should not be considered part of the "value of production" upon which royalty values are calculated and paid.

(SOR 2 at 8).

Finally, TXP argues that the expenses at issue in this case are post-production costs which have no effect on the value of production or gross proceeds for royalty purposes. It asserts that state and Federal law provide that royalties based on the value of production can only be based on the wellhead value of the gas. Thus, according to TXP, Marathon's fees involve services rendered after production, do not affect the value of the produced gas, and are properly deducted from gross proceeds when determining the royalty due. Similarly, TXP urges a finding that charges for postproduction services are properly deducted when determining the gross proceeds accruing to the lessee (which form the floor for royalty value under 30 CFR 206.150 (1987)). TXP concludes that the fees at issue were transportation related costs, incurred after its production and marketing duties had been fulfilled, and MMS' denial of its transportation allowance was therefore improper.

In its Answer MMS asserts that the Director properly affirmed the exclusion of Marathon's storage, handling, and accounting charges from the transportation allowance because those charges were not transportation expenses. MMS acknowledges the Department's policy of permitting transportation allowance deductions, emphasizing that an allowance is made for the actual costs incurred in physically transporting the product from the point of production to the first available market, and that the precise factors to be considered in determining a transportation allowance are within the discretion of the Secretary.

MMS contends that the Marathon storage, handling, and accounting charges are costs incident to marketing the production which must be borne by the lessee, and are not transportation costs. MMS notes that the storage of the condensate was necessary to accumulate sufficient condensate for delivery to Texas Pipeline's crude oil pipeline. Thus, MMS asserts, the condensate was not marketable until a sufficient quantity was accumulated to allow delivery, and therefore Marathon's charges are actually for providing services which were necessary to put the product into marketable condition for sale. MMS hypothesizes that if TXP could produce and deliver the condensate without having to store it until sufficient quantities are accumulated, TXP would have done so. MMS finds no rational reason for TXP to incur storage expenses if it is not necessary to do so in order to market it. According to MMS, if TXP had sold the condensate adjacent to the lease, it would still have been necessary to store condensate in order to accumulate a marketable volume. MMS argues that the need to accumulate a sufficient quantity to permit the sale of the condensate has no relationship to the actual point of delivery, and therefore the costs incurred for storage cannot be deducted simply because the condensate was stored off lease. Additionally MMS contends that the regulations and case law, including California Co., supra, support its position that costs necessary to put production into marketable condition may not be deducted from royalty value because the lessee has a duty to place the production into marketable condition. Thus, according to MMS, TXP's request for a transportation allowance for storage charges required to obtain a marketable volume of condensate was properly denied.

MMS repeats its earlier statement that transportation allowances are not allowed when the transportation costs are incurred beyond the point of sale. It notes that, effective July 1, 1986, title and risk of loss to the condensate were transferred to Petro offshore, at Mustang Island, Blocks A-85 and A-111. According to MMS, after June 30, 1986, the costs TXP seeks to deduct as a transportation allowance embraced costs incurred after the point where the condensate was sold, and this is another reason for denying a transportation allowance for those costs.

MMS devotes the remainder of its Answer to discussing and distinguishing the cases cited by TXP in support of its argument that it is entitled to the transportation allowance. MMS contends that TXP's references to the storage charges allowed as deductions from value in Marathon Oil Co. v. United States, supra, are not sufficiently specific to enable a direct response. MMS admits that storage charges are properly approved when those costs are incurred as an integral part of the transportation process. It then reiterates its contention that the storage charges in question do not meet this criterion. According to MMS, they were unrelated to transportation because they would have been incurred regardless of any need to transport the condensate from the lease to the market.

MMS disagrees with TXP's characterization of Diamond Shamrock, supra, and contends that the holding in Diamond Shamrock has no bearing on the issue now being considered. It notes that the Diamond Shamrock case considered "take or pay" provisions and turned on the court's conclusion that the proceeds at issue were not attributable to produced gas, and that no royalty was due until the make-up gas had been produced. MMS asserts that in this case the gross proceeds were from condensate actually produced and sold by TXP.

Additionally, according to MMS, the issue in this case is not whether production has occurred or whether proceeds correspond to past production, but concerns costs incurred by TXP when placing condensate into marketable condition. MMS contends that nothing in Diamond Shamrock indicates that the court intended to repudiate regulations and longstanding precedent that "production" means "production in marketable condition," or that the court intended to limit the royalty value of gas to the value in a raw condition. MMS also contends that other cases cited by TXP are irrelevant to this case, and concludes that the Director's decision must be affirmed.

[1] The Secretary of the Interior is authorized to lease land on the outer continental shelf under the Outer Continental Shelf Lands Act, as amended (OCSLA), 43 U.S.C. § 1337 (1982), for the exploration and development of mineral resources, including oil and gas. The provisions of OCSLA, 43 U.S.C. §§ 1331-1356 (1982), and leases issued pursuant to that Act require payment of royalties equal to a specified percentage of the amount or value of the oil and gas produced. When it passed this Act, Congress committed the Government to the goal of obtaining fair market value for offshore oil and gas resources. Watt v. Energy Action Educational Foundation, 454 U.S. 151, 162 (1981); Conoco Inc., 110 IBLA 232, 239 (1989); Sun Exploration & Production Co., 104 IBLA 178, 184 (1988); Amoco Production Co., 78 IBLA 93 (1983), aff'd, Amoco Production Co. v. Hodel, 627 F. Supp. 1375 (W.D. La. 1986), vacated and remanded, 815 F.2d 352 (5th Cir. 1987), cert. denied, 108 S. Ct. 2898 (1988). 7/

7/ The district court decision was vacated for lack of jurisdiction and the case was remanded for transfer to the Claims Court. 815 F.2d at 368.

The Secretary has considerable discretion in determining the value of production for royalty purposes. Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1382 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 107 S. Ct. 1593 (1987); Conoco Inc., supra at 240; Texaco, Inc., 104 IBLA 304, 308 (1988); Amoco Production Co., supra at 96. That discretion is tempered only by the standard of reasonableness. Conoco Inc., supra; Texaco Inc., supra at 310. The exercise of Secretarial discretion was governed by the provisions of the royalty valuation regulation at 30 CFR 206.150 (1987), during the time period relevant to this decision. 8/ That regulation provided:

> The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or a majority of like-quality products produced in the area or field; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary.

The cost of transportation of gas to an onshore market has long been recognized to be one of the "relevant matters" taken into consider-ation when there is no market at the offshore point of production. In the absence of a market for the gas at the wellhead, where production is ordinarily sold and valued, the Board and the courts have upheld a transportation allowance (a deduction from the market value of the gas) for transportation costs from the leasehold to the nearest market. United States v. General Petroleum Corp., 73 F. Supp. 225, 263 (S.D. Cal.), aff'd, Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); Conoco, Inc., 109 IBLA 89, 94 (1989); ARCO Oil & Gas Co., 109 IBLA 34, 38 (1989); Shell Oil Co., 52 IBLA 15, 88 I.D. 1 (1981); C & K Petroleum, Inc., 27 IBLA 15 (1976); Kerr-McGee Corp., 22 IBLA 124 (1975); Superior Oil Co., 12 IBLA 212 (1973); Shell Oil Co., 70 I.D. 393 (1963).

An allowance may be taken for the actual costs incurred in transporting gas from offshore to the first available onshore market, but costs incidental to marketing are not deductible from the value of gas for royalty purposes. California Co., supra; Davis Exploration, 112 IBLA 254, 259 (1989); see also 30 CFR 206.152(d) (1987) and 30 CFR 250.42. A lessee must bear marketing costs as part of the duty to market the gas. Amoco Production Co., 112 IBLA 77, 87 (1989); see California Co., supra at 387-88. None

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8/ This regulation has been superseded. The royalty product valuation regulations at 30 CFR Part 206 Subpart D were extensively amended, effective Mar. 1, 1988. 53 FR 1272-1284 (Jan. 15, 1988). The current regulations specifically provide for transportation allowances and establish procedures for determining those allowances. See 30 CFR 206.156 and 206.157. The cur-rent regulations are prospective in effect. 53 FR 1230.

of the cases cited by TXP convinces us that marketing costs should be allowed as deductions from the value of production for royalty purposes. 9/

The issue before us is whether the storage, handling, and accounting fees charged by Marathon are transportation costs incurred by TXP when transporting the condensate to the first available market. They are not. These expenses were incurred because it was necessary for TXP to accumulate a marketable quantity of condensate, rather than as a part of the transportation of the product to market. Thus, they are costs incidental to marketing the condensate and, as such, are not deductible from the royalty value of the production.

The Marathon charges were not incurred for moving the TXP condensate from the offshore production point to the onshore sales point. TXP was not charged for those services. The services rendered by Marathon were performed after the condensate had been transported onshore. In somewhat analogous cases we held that storage costs incurred after processing may not be included as part of a manufacturing allowance under 30 CFR 206.152 (1987). See Mobil Oil Corp., 112 IBLA 198, 209 (1989); Mobil Oil Corp., 108 IBLA 216, 220-21 (1989). Similarly, the Marathon storage and handling charges were not incurred by TXP as an integral part of the transportation process, and thus cannot be considered transportation costs.

TXP was obligated to make its deliveries to the pipeline in lots containing a specified minimum amount of condensate. Although TXP argues that Marathon's storage, handling, and accounting fees are costs associated with the transportation process, it uses Marathon's facilities to store condensate until it has accumulated sufficient quantities to permit delivery to Texas Pipeline's oil pipeline. Because of its rates of production, TXP was required to store condensate in order to accumulate the required volume.

9/ Strictly speaking, these costs are not associated with placing the condensate "in a marketable condition" as in California Co. Here, the condensate was in a marketable condition when it was separated, i.e., no later than when it left the onshore separation facility. After separation, no further conditioning was required to place the condensate "in a marketable condition." The costs at issue here are storage costs, not costs of conditioning the production.

Nevertheless, TXP is not entitled to deduct these costs, and it is mistaken when it argues that, if California Co. does not apply, "any further expenses which arise during or after transportation are includable in a transportation allowance" (SOR 2 at 5). Costs of producing oil or gas from Federal leases are not generally deductible from royalty value. We have often held that "costs of marketing" production (including "marketing costs--overhead, storage, stock loss, inventory, receivables, and equipment") are not automatically deductible from value of production for royalty purposes. E.g., Amoco Production Co., supra. These costs may be deducted when justified as transportation allowances or as costs of manufacture.

TXP does not argue that these costs qualify as costs of manufacture, and we agree -- nothing is being made. TXP contends that they are transportation costs.

Thus these storage related expenses are not transportation costs. The costs were incurred to accumulate a marketable quantity of condensate, were expenses necessary to place the condensate into marketable condition, and are not deductible from the value of the condensate for royalty purposes. The fact that a third party performed this function and charged TXP for its services does not change this result. See ARCO Oil & Gas, 112 IBLA 8, 10 (1989); Walter Oil & Gas Corp., 111 IBLA 260, 265 (1989); Placid Oil Co., 70 I.D. 438, 439-40 (1963).

If we were to disregard the foregoing, the Marathon charges would not be cognizable transportation costs. They were incurred after the point of first potential sale--the separation facility onshore. TXP incurred these expenses too late in the delivery process for them to be cognizable as a transportation allowance.

Our holding should not be construed to mean that storage costs are never a proper part of a transportation allowance. MMS has indicated that storage charges may be approved when the storage is an integral part of the transportation process. TXP has presented no persuasive evidence that MMS is in error. TXP, the party challenging MMS' royalty valuation, has the burden of showing that MMS' determination is erroneous. Mobil Oil Corp., supra; Walter Oil & Gas Corp., supra; Amoco Production Co., 85 IBLA 121 (1985); Amoco Production Co., supra. Thus, we affirm MMS' denial of the requested transportation allowance.

To the extent not specifically addressed herein, TXP's arguments have been considered and rejected.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed.

R. W. Mullen
Administrative Judge

I concur:

David L. Hughes
Administrative Judge