

UNION OIL COMPANY OF CALIFORNIA  
UNION EXPLORATION PARTNERS, LTD.

IBLA 87-748

Decided August 24, 1990

Appeal from a decision of the Director, Minerals Management Service, affirming assessment of additional royalty. MMS 86-0319-OCS.

Affirmed in part, set aside in part, and remanded.

1. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

When, in accordance with the Procedure Paper on Natural Gas Liquid Products Valuation, utilization of spot market prices is the proper methodology to value production and the lessee's price for natural gas liquid products is less than the minimum yardstick value, it is improper for MMS to use the average of the high and low prices in the yardstick range to determine the value of production. The yardstick minimum should be the price employed in such a situation.

2. Oil and Gas Leases: Royalties: Generally--Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

A party challenging a determination as to the value of gas or other hydrocarbons produced from a Federal lease must establish that the methodology used is in fact erroneous. An appellant who alleges that because of market forces contract prices lag behind spot market prices has not established the MMS practice of using the higher of the two prices (i.e., the greater of proceeds or the spot market price) is an erroneous methodology where the relevant regulation authorizes the use of posted prices to value production, but requires that the value shall never be less than the gross proceeds.

3. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

Natural gas liquid products processed in Louisiana may properly be valued according to spot market prices for similar products in Texas.

4. Oil and Gas Leases: Royalties: Generally--Regulations: Interpretation--Statutory Construction: Administrative Construction

Normally an interpretive ruling stating the accounting procedures to be used for royalty calculation may be given retroactive effect. However, an exception exists when certain conditions are met. If (1) for several years the lessee had applied an accounting procedure which conformed with a reasonable interpretation of the applicable regulations when calculating the royalty due for products removed from the lease; (2) the Department had accepted the lessee's royalty accounting procedure for several years before issuing an interpretive ruling that required a different accounting procedure; (3) the new procedure was an abrupt departure from a well-established practice, and not an attempt to fill a void in an unsettled area of the law; and (4) the prejudice to the lessee affected by retroactive application of the new interpretation substantially outweighs the statutory interest and purposes sought to be protected, then the new MMS accounting procedure should be applied prospectively only.

5. Oil and Gas Leases: Royalties: Processing Allowance--Outer Continental Shelf Lands Act: Oil and Gas Leases

Pursuant to 30 CFR 250.67(a)(2) (1978) MMS is authorized to utilize a value determined to be a reasonable allowance for the cost of processing natural gas liquid products, with a maximum of two-thirds, unless a greater allowance is in the interest of conservation. The determination is to be based upon regional plant practices, costs and other pertinent factors.

6. Oil and Gas Leases: Royalties: Processing Allowance--Outer Continental Shelf Lands Act: Oil and Gas Leases

Federal lessees are required to bear the costs of putting oil and gas into marketable condition. Expenses incurred in storage and transportation beyond the point of first potential market are properly excluded from a lessee's manufacturing allowance despite allegations that the expenses are an "integral part" of plant operations.

7. Administrative Practice: Oil and Gas Leases: Royalties: Processing Allowance--Outer Continental Shelf Lands Act: Oil and Gas Leases

MMS must provide a lessee with an adequate basis for accepting or appealing a determination of the

manufacturing allowance to be utilized in royalty calculation. An MMS decision must be supported by a rational basis which is stated in the written decision and supported by the record.

APPEARANCES: Matthew Kepner Brown, Esq., Deborah Bahn Price, Esq., J. Berry St. John, Jr., Esq., Liskow & Lewis, New Orleans, Louisiana, for appellant; Howard W. Chalker, Esq., Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

#### OPINION BY ADMINISTRATIVE JUDGE KELLY

Union Oil Company of California and Union Exploration Partners, Ltd. (Union), have appealed a June 12, 1987, decision of the Director, Minerals Management Service (MMS) (MMS 86-0319-OCS), requiring payment of additional royalties. The additional royalty assessment covers production during the period from May 1978 through December 1983.

The Office of Inspector General (OIG) audited the Cow Island gas processing plant and the Riverside fractionation plant located in Louisiana and completed its audit report in January 1985. OIG stated that appellant owns 50 percent of the plants and that a large portion of the natural gas liquid products (NGLP's) processed in the plants is utilized internally by the owners. The audit report recommended that appellant be assessed additional royalties for leases OCS-297, 549, 559, 560 and OCS-G-935 and 1475.

In a document dated May 1, 1986, the Tulsa Regional Compliance Office, MMS, ordered Union to recalculate royalties due and submit the amount underpaid. As adjusted by MMS, the amount calculated is \$219,218.26. This additional assessment was affirmed by the Director's decision of June 12, 1987, which Union has appealed to this Board.

In preparing its audit OIG relied in part on the "Procedure Paper on Natural Gas Liquid Products Valuation" (Procedure Paper), which was issued on December 14, 1984, and revised on February 25, 1985. Pursuant to the Procedure Paper, when there is an applicable regulated price it will be used as the price for royalty calculation purposes; when there is an arm's-length contract in the same field or area, or a non-arm's-length contract with characteristics similar to arm's-length contracts which represent fair market value, the price from that contract will be utilized for royalty calculation, unless gross proceeds are higher. If there is not a regulated price, an arm's-length contract or a suitable non-arm's-length contract, the price received by the lessee will be utilized as the value, unless that price falls below the yardstick range 1/ established in the Procedure Paper.

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1/ The yardstick range is determined by using the highest and the lowest published prices from certain commercial NGLP price bulletins, as outlined in the Procedure Paper.

When the lessee's price falls below the yardstick range, the Procedure Paper calls for use of the average of the high and low prices that describe the range.

[1] Appellant argues that the MMS valuation is unfair and inconsistent due to the use of the average price, rather than the lowest price in the range. We have previously held that when the Procedure Paper calls for application of the yardstick price, MMS must utilize the lowest price in the yardstick range instead of the average of the high and the low. Mobil Oil Corp., 112 IBLA 198, 207-08 (1989); Conoco Inc., 110 IBLA 232, 243-44 (1989). We find that MMS erred by using the average rather than the low price in the range. Accordingly, we set aside the Director's decision to the extent that it affirmed use of the average spot market price where Union's price fell below the yardstick range.

Union contends that it has been unfairly penalized because MMS bases valuation of NGLP's on the higher of either spot market or contract prices. Appellant states that contract prices follow spot market prices so that during a period when prices are falling, contract prices are above spot market prices, and MMS requires valuation utilizing the contract price. On the other hand, appellant continues, when prices are rising, spot market prices are above contract prices, and MMS requires valuation of the products at the spot market price.

[2] A party challenging a determination as to the value of gas or other hydrocarbons produced from a Federal lease must establish that the methodology used is in fact erroneous. Amoco Production Co., 78 IBLA 93, 100 (1983). Pursuant to 30 CFR 250.64 (1978) (redesignated 30 CFR 206.150, 48 FR 35641 (Aug. 5, 1983)) 2/ MMS is precluded from utilizing a value less than gross proceeds, and is thus precluded from utilizing the spot market price when it is lower than gross proceeds.

Furthermore, pursuant to 30 CFR 250.64 (1978), posted prices are one of the factors MMS is required to consider in valuation. See Conoco Inc., 110 IBLA at 239-42. Posted prices are not the only factor to be considered; however, appellant does not allege that MMS failed to consider the other factors. Moreover, as we outlined in Amoco Production Co., 112 IBLA 77, 81 (1989), the Procedure Paper relies on the factors set forth in 30 CFR 250.64 (1978).

We find that appellant has failed to establish the MMS methodology is erroneous. In the case of falling prices, the regulation requires use of the price received (proceeds) if higher than the spot market price. In the case of rising prices, appellant has not shown use of the higher spot market

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2/ Effective Mar. 1, 1988, the Department completely revised the regulations in 30 CFR relating to gas valuation for royalty purposes. 53 FR 1230 (Jan. 15, 1988).

price is contrary to the regulation. Therefore, we hold that Union has failed to establish that the cyclical lag between spot market prices and contract prices creates reversible error in the MMS methodology. <sup>3/</sup>

[3] Union contends that because MMS is utilizing spot market prices in Mont Belvieu, Texas, approximately 300 miles from the Cow Island Plant, an allowance must be made for transportation costs. In support of this proposition, Union refers to United States v. General Petroleum Corp., 73 F. Supp. 225 (S.D. Cal. 1946), aff'd, Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950). However, that decision, which involved a transportation allowance to move production to the point of first sale, does not support appellant's argument. Transportation allowances are not available to move production beyond the point of first available market. Conoco Inc., 110 IBLA at 242; Arco Oil & Gas Co., 109 IBLA 34, 38 (1989); Mobil Oil Corp., 108 IBLA 216, 220-21 (1989). Appellant has neither alleged nor established that Mont Belvieu is the first available market.

Appellant also cites the Procedure Paper in support of a transportation allowance. That document contains the following:

MMS has determined that commercial bulletin yardstick prices represent fair market value for useable NGLP's. MMS will use these prices as the base value for royalty purposes. However, MMS recognizes that these prices represent a broad, market area value and the lessee must sometimes incur transportation costs to move NGLP's from the processing or fractionation plant to the market area sales point. MMS will allow adjustments made to the market area price for transportation costs incurred, provided the lessee can submit documentation in support of such adjustments.

(Procedure Paper at 9-10). The record contains no evidence that appellant has submitted the documentation called for in the Procedure Paper. Moreover, it seems likely that Union cannot submit such documentation. Appellant must not only submit documentation of the actual costs incurred in moving the NGLP's to Mont Belvieu, but must also show that Mont Belvieu is the closest available market.

We have previously rejected arguments by Louisiana lessees that the spot market price should be adjusted to reflect costs of transporting their production to Mont Belvieu. Mobil Oil Corp., 112 IBLA at 207; Mobil Oil

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<sup>3/</sup> In Amoco Production Co., 112 IBLA at 84-85, we were also presented with the argument that whether the prices were falling or rising the MMS price for valuation purposes was always the higher of either the spot market price or the contract price, accompanied by a request that for the months that the appellant's price was above the yardstick range, it should receive a credit offsetting those months when its price was below the range. We held there was no basis for such an offset.

Corp., 112 IBLA 56, 62 (1989); Union Oil Co., 111 IBLA 369 n.1 (1989). We reject appellant's argument as well.

In its statement of reasons on appeal (SOR), Union contends that MMS should be required to follow the valuation guidance outlined in a January 26, 1976, letter from Geological Survey (Survey), MMS' predecessor, 4/ to appellant. Appellant contends that MMS cannot retroactively change its rules and procedures.

The letter at issue states in relevant part:

In accordance with 30 CFR 250.67(c), the gas value per MCF [thousand cubic feet] for royalty purposes shall be the value computed by dividing the lease delivery volume into:

- a. The gas volume as measured at the lease delivery point times the FPC [Federal Power Commission]-approved price, or a higher price if received;
- b. Minus the value computed at the same price of plant volume reduction due to processing \* \* \*;
- c. Plus the volume of each liquefiable hydrocarbon component contained in the raw make liquid extracted at the Cow Island Processing Plant attributable to the lease, times a certain percentage, now 45%, times the respective prices of the finished products received during the current month for the products sold at the Riverside Fractionation Plant. (The volume of each component will be obtained from Exhibit "E" of the plant report, and the price will be obtained from the actual sales values received at the Riverside Fractionation Plant.) [Emphasis in original.]

(Survey Letter of Jan. 26, 1976, at 2).

This letter advises Union to take the volume of each NGLP from the processing plant and the price from the fractionation plant. 5/ The letter does not specify that the price utilized must be from a transaction to which Union was a party, and we find no barrier to use of prices from actual sales made by other entities at the fractionation plant. The Survey letter does not specify what price should be utilized for those months when there was no actual sale of a particular NGLP at the fractionation plant.

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4/ Effective June 30, 1982, MMS became responsible for royalty collection, which had been previously assigned to Survey's Conservation Division. 47 FR 28368 (June 30, 1982).

5/ Natural gas is separated from raw make at the Cow Island processing plant and the raw make is transported by pipeline to the Riverside fractionation plant. Appellant refers to the two plants together as the Cow Island Complex.

We disagree with Union's argument that it "is entitled to value liquids for royalty purposes according to the [Survey] methodology, and should not be required to pay royalty based on third party invoice prices" (Reply at 9). Rather, if the third party invoice prices are also actual sales, the Survey methodology requires their use. <sup>6/</sup>

Both parties present extensive arguments concerning estoppel. We agree with MMS that estoppel is not appropriate in this case; however, that does not automatically mean MMS can retroactively apply the Procedure Paper. See Sun Exploration & Production Co., 112 IBLA 373, 391, 97 I.D. 1, 10 (1990).

[4] In Sun Exploration & Production Co., we held that normally an interpretive ruling stating the accounting procedures to be used for royalty calculation may be given retroactive effect. However, an exception exists when certain conditions are met. If (1) for several years the lessee had applied an accounting procedure which conformed with a reasonable interpretation of the applicable regulations when calculating the royalty due for oil produced and removed from the lease; (2) the Department had accepted lessee's royalty accounting procedure for several years before issuing an interpretive ruling that required a different accounting procedure; (3) the new procedure was an abrupt departure from a well-established practice, and not an attempt to fill a void in an unsettled area of the law; and (4) the prejudice to the lessee affected by retro-active application of the new interpretation substantially outweighs the statutory interest and purposes sought to be protected, then the new MMS accounting procedure should be applied prospectively only. 112 IBLA at 392, 97 I.D. at 11.

Union's case is distinguishable from the situation we encountered in Sun Exploration & Production Co., and we find that the Survey letter cited by Union does not prevent MMS from applying the Procedure Paper retroactively. Although appellant had received a letter from Survey containing a valuation methodology the record suggests that Union failed to follow that methodology and did not in fact rely upon the Survey letter. Despite the fact that the Survey letter clearly recommends the use of the Riverside fractionation plant prices when available, appellant did not use those prices. See SOR at 6-7. Thus, the Department had clearly not accepted

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<sup>6/</sup> We note the possibility that the Procedure Paper and the Survey letter may call for use of the same price for those NGLPs that were sold at the fractionation plant during a particular month. The Procedure Paper at page 9 states: "If there are not arm's-length contracts for the same field or area, or the non-arm's-length contract does not represent fair market value, the yardstick value is considered fair market value." Actual sales at the fractionation plant, as described in the Survey letter, may also be "arm's-length contracts for the same field or area," meaning that the Procedure Paper and the Survey letter would call for the same valuation. However, as MMS made no finding on this point, and neither party raised the issue, we decline to find that the Procedure Paper and the Survey letter are consistent on this point.

the lessee's royalty accounting procedure before issuing the Procedure Paper. Further, to the extent that the Survey letter failed to specify the price to be used when no actual sale was available from the fractionation plant, the Procedure Paper was not a departure from a well-established practice but instead filled a void in an unsettled area of the law. Thus, we find no barrier to retroactive application of the Procedure Paper in valuation of Union's production.

Union argues MMS has retroactively applied a new regulation concerning calculation of the manufacturing allowance. Union provides this assessment of the history of the Department's manufacturing allowance: "[I]n the mid- 1970's, the MMS switched to a cost accounting basis for manufacturing allowance calculations. Not until 1984, however, did it publish its cost-based calculation methodology" (SOR at 15). <sup>7/</sup> In the case of processed gas, the relevant regulation provides for royalty on the value or amount of:

All natural gasoline, butane, propane, or other products extracted therefrom, subject to deduction of such portion thereof as the supervisor determines to be a reasonable allowance for the cost of processing based upon regional plant practices and costs and other pertinent factors; provided, however, that such reasonable allowance shall not exceed two-thirds of the products extracted unless the Director determines that a greater allowance is in the interest of conservation.

30 CFR 250.67(a)(2) (1978) (redesignated 30 CFR 206.152(a)(2), 48 FR 35641 (Aug. 5, 1983)).

[5] MMS is authorized to utilize a value determined to be a reason-able allowance for the cost of processing with a maximum of two-thirds, unless a greater allowance is in the interest of conservation. The determination is to be based upon regional plant practices, costs and other pertinent factors. We find that this regulation clearly authorizes MMS to determine Union's processing allowance based upon cost. See Supron Energy Corp., 46 IBLA 181, 194 (1980). As the substance of this regulation was in operation throughout the audit period, we reject appellant's argument that MMS retroactively applied a regulation in determining the manufacturing allowance.

Appellant argues that certain items which MMS excluded from its manufacturing allowance are "integral parts" of the production facility and were thus erroneously excluded. Specifically, Union contends,

Without the various storage and pipeline elements of the Cow Island Complex, the equilibrium of the production process would be upset and production could not occur as it currently does.

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<sup>7/</sup> We note that Union fails to give citations to either the regulation it believes has been retroactively applied, or the Federal Register location of its alleged 1984 promulgation.

The fact that removal of the disallowed facilities from the Complex would alter the method of plant operation shows that these are not "marketing" facilities \* \* \*.

(SOR at 16-17).

[6] Federal lessees are required to bear the costs of putting oil or gas in a marketable condition. 30 CFR 250.67(d) (1978) (redesignated 30 CFR 206.152(d), 48 FR 35641 (Aug. 5, 1983)); Mobil Oil Corp., 112 IBLA at 208-09; Mobil Oil Corp., 108 IBLA at 220-21. The test to be applied in this context is not whether an expense represents an "integral part" of plant operation, but rather whether an expense is a marketing cost. We have previously rejected the contention that an expense representing an "integral part" of plant operation must necessarily be included in a lessee's manufacturing allowance. Mobil Oil Corp., 112 IBLA at 208-09; Mobil Oil Corp., 108 IBLA at 220-21. We find Union has failed to establish that MMS erroneously excluded any costs from its manufacturing allowance.

Union contends MMS has not provided enough documentation of the methodology used in calculation of the processing allowance so that Union has been hindered in arguing this appeal. In its SOR, appellant gives the example of plant fuel charges as an issue which it cannot properly raise because it does not know the MMS position. In its response, MMS refers to the Field Report, contending that Union was notified in that document that MMS has accepted appellant's position on the plant fuel charges.

[7] Appellants must be given some basis for understanding and accepting a decision, or alternatively appealing and disputing it. Roger K. Ogden, 77 IBLA 4, 7, 90 I.D. 481, 483-84 (1983); Southern Union Exploration Co., 51 IBLA 89, 92 (1980). If an MMS decision is not supported by a rational basis which is stated in the written decision and supported by the record, the Department is left open to a charge of arbitrariness. Roger K. Ogden, *supra*.

Union has not established that MMS failed to meet this standard. Appellant cites the example of the plant fuel charge issue; however, the record supports the MMS contention that appellant was notified via the Field Report that MMS was no longer contesting that expense. <sup>8/</sup> Although the Director's decision does not provide detail concerning the calculation

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<sup>8/</sup> In support of this argument, Union also states that application of the manufacturing allowance formula contained in an MMS letter of Aug. 14, 1986, produces an allowance of 42.4 percent for the period from May 1978 through April 1980. The May 1, 1986, MMS order required Union to calculate its royalty by using a 39.9 percent processing allowance for that period.

MMS responds to this allegation by arguing that it is correct but irrelevant because the data set in appellant's calculation excluded the other plant owner whereas the manufacturing allowance which should be applied includes all owners. The record supports MMS' response.

of the manufacturing allowance, Union does not dispute that it received copies of the Field Report, the MMS letter dated June 2, 1986, and the MMS order of May 1, 1986, which provide significant detail. Appellant fails to establish that between the various documents it received it was not given some basis for understanding and accepting the decision, or alternatively appealing and disputing it. Nor has it established it was harmed by inadequate information.

Union contends that MMS issued letters changing the manufacturing allowance for no apparent reason and that this renders the "entire process highly suspect" (SOR at 16). By letter dated November 8, 1984, (SOR Exh. H), MMS approved, subject to future audit, a manufacturing allowance of 55.0 percent for the period from May 1, 1982, through April 30, 1984. This determination was based on appellant's report of revenue and expense for the Cow Island processing plant. That figure was changed to 45 percent by letter dated July 23, 1987 (SOR Exh. I), because the processing allowance was incorrectly stated in the previous letter. Appellant utilizes the letters of November 8, 1984, and July 23, 1987, in an attempt to establish that "MMS does not appear to understand how to apply its own standard consistently" (SOR at 15).

Neither of the letters cited is the subject of the current appeal; rather, Union has submitted them in an attempt to establish that the decision of June 12, 1987, is erroneous. We do not find these letters to be particularly persuasive in establishing that point as they are based on a different data set than an audit, and refer in part to a different time period. Even assuming, arguendo, that all three of the manufacturing allowances could not be correct, appellant still has not established that MMS erred in calculating the manufacturing allowance which is the subject of the present appeal.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the June 12, 1987, Director's decision is affirmed in part, set aside in part, and remanded for action consistent with this decision.

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John H. Kelly  
Administrative Judge

I concur:

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C. Randall Grant, Jr.  
Administrative Judge