**<u>Editor's note</u>: 97 I.D. 243**

CITIES SERVICE OIL AND GAS CORP.

IBLA 88-140, 88-169 Decided November 26, 1990

Appeals from separate decisions of the Director, Minerals Management Service, determining the proper fractionation allowance and affirming in part and reversing in part an order to recalculate and pay additional royalties. MMS-86-0345-OCS, MMS-86-0375-OCS, MMS-87-0006-OCS, MMS-87-0027-OCS.

Affirmed in part; reversed in part; set aside and remanded in part.

1. Administrative Practice--Administrative Procedure: Adjudication

   As a general rule, adjudications should be so structured that determinations of subsidiary or interrelated questions are made within the confines of a single unified decision so as to avoid needless multiplicity of appeals and the resulting confusion which piecemeal adjudication engenders.

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

   Since, pursuant to the provisions of 30 CFR 206.152(a)(2) (1987), the reasonable allowance for the costs of processing natural gas liquid products was, as a general matter, to be based on "actual plant costs," the fact that other lessees were permitted a greater allowance is a legal irrelevancy so long as each lessee's allowance is based on its actual plant costs.

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

Where the calculation of a processing allowance involves consideration of a profit factor based on the sales values of natural gas liquid products, and where it is necessary to provide a separate extraction and fractionation allowance, the profit factor is properly computed only once in the combined extraction/fractionation allowance computation.

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

Where the determination of the processing allowance to be permitted for natural gas liquid products requires the separate determination of an extraction and fractionation allowance, these two allowances are properly added together to arrive at the combined processing allowance.

5. Administrative Procedure: Rulemaking--Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

The "Procedure Paper on Natural Gas Liquid Products Valuation," developed by MMS, is not a substantive regulation subject to the rulemaking requirements of the Administrative Procedure Act, 5 U.S.C. § 553(b) (1988).

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

Since, unless otherwise expressly provided, all royalty payments are accepted subject to audit, a subsequent determination that additional royalties are due does not give rise to a question of retroactive application of a new rule if the determination that a deficiency exists was made under the regulation applicable at the time that the payment was originally made.

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

In the absence of acceptance of a lessee's royalty valuation as conclusive by an official authorized to bind the Department on such matters, the fact that the Office of Inspector General may have conducted an audit of payments made on a lessee's behalf does not prevent the duly authorized officials from thereafter timely reviewing the lessee's original valuation and determining that royalty is still owing.

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

Where it is MMS policy to accept DOE ceiling prices for natural gas liquid products as representing fair market value for royalty purposes in certain instances, and MMS has followed that policy in a number of cases, its refusal in another case to accept those ceiling prices in favor of the monthly average spot market price must be deemed arbitrary and capricious.

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

Where a floor price was established generally for natural gas liquid product valuation for royalty calculation, royalty could not be assessed using a higher rate than the floor price.

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OPINION BY ADMINISTRATIVE JUDGE BURSKI

These two consolidated appeals involve separate, but interrelated, decisions of the Director, Minerals Management Service (MMS), generally requiring the submission by Cities Service Oil & Gas Corporation (Cities Service) 1/ of increased royalties for natural gas liquid products (NGLP's)

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1/ Since initiating the instant appeal, Cities Service has changed its name to OXY USA Inc. For purposes of clarity, however, we shall continue to refer to appellant as Cities Service in this decision.

produced from Outer Continental Shelf lands (OCS) leases and processed at the Grand Chenier Processing Plant (Grand Chenier) and the Lake Charles Fractionator. In light of the identity of some of the issues presented, they have been consolidated for purposes of decision.

Grand Chenier, while denominated a "processing plant," is actually a plant for the extraction of the liquid constituents (or raw make) from the natural gas stream. Grand Chenier is owned by a number of parties, including appellant, and is operated by Conoco Inc. on their behalf, processing natural gas from approximately 40 OCS leases. After the liquid components have been separated from the wet gas, they are sent to the Lake Charles Fractionator where they are further processed to obtain ethane, propane, butanes, and pentanes (NGLP's). While Grand Chenier, as indicated above, is owned by a number of companies, the Lake Charles Fractionator is totally owned by appellant. Appellant receives 12.4 percent of the NGLP's processed at Lake Charles as its fee for fractionating the liquid components extracted from the natural gas stream for other lessees. 2/

Sometime in 1983, the Office of Inspector General (OIG) conducted an audit of royalty payments made on NGLP's processed at Grand Chenier and the Lake Charles Fractionator for the years 1977 through 1982. In its final audit report, issued in February 1984, OIG noted various areas in

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2/ We note that in its supplemental statement of reasons (SOR) before the Director, MMS, Cities Service argued that, in fact, its fractionation fee was 13.1 percent. See Supplemental SOR at 8. This contention, however, has not been pursued before the Board and the actual fee is, in any event, irrelevant to the determination of the legal principles involved in this appeal.

which it felt adjustments were necessary and would result in higher roy-alty assessments. Included, inter alia, were determinations that numerous companies had undervalued NGLP's for royalty purposes and had understated revenues and overstated plant expenditures for the 1979/1981 biennial period. Of particular relevance to the instant appeal, OIG also challenged appellant's entire fractionation fee, noting that Cities Service had declined to provide it with revenue and expense information relating to the operation of the Lake Charles Fractionator. The fractionation fee which appellant had claimed was the same 12.4 percent which it charged other companies for fractionating at the Lake Charles facility.

Thereafter, MMS conducted its own review of the royalty payments relating to NGLP's processed at Grand Chenier and the Lake Charles Fractionator. This review led to a series of orders which are the subject of the instant appeals.

The appeal docketed as IBLA 88-140 arose from a decision of the Director, MMS, dated November 3, 1987, granting, in part, separate appeals from three orders issued by the Regional Manager, Tulsa Regional Compliance Office (TRCO), Royalty Management Program (RMP). Prior to the issuance of these three orders, the Regional Manager had, by letter dated April 14, 1986, informed appellant that a preliminary review of its operations had led to an initial determination to disallow the fractionation deduction which appellant had taken. Appellant was afforded an opportunity both to provide the actual cost and expenditures figures related to the Lake Charles Fractionator and to make any other comments it deemed warranted. Pursuant to this invitation, Cities Service responded on May 16, 1987, arguing that, in its view, the fractionation allowance which it took, even if it were deemed not to have been the result of an arm's-length transaction, possessed the same characteristics manifested by other arm's-length transactions which MMS had accepted as indicative of fair market value for other producers. Accordingly, Cities Service requested that it be permitted to take the same deduction allowed the other lessees who used the Lake Charles Fractionator.

Following receipt of this response, MMS began the adjudicative process which resulted in the eventual issuance of the four orders under review herein. The first of these orders, dated June 4, 1986, directed appellant to recompute the amount of royalty due based on a disallowance of the entire fractionation fee. This order noted, however, that the recalculations for leases OCS 0767 and OCS 0768 could exclude the period from April 1982 through October 1982, as that period was being covered by a separate compliance action. This order was timely appealed and docketed before the Director, MMS, as MMS-86-0345-OCS.

The second order was dated June 10, 1986, and covered leases OCS 0767 and OCS 0768 for the period April 1982 through October 1982. Like the June 4 order, it rejected any deduction for processing costs attributable to fractionation. Unlike the June 4 order, however, rather than directing Cities Service to recompute the amount of royalties due, MMS determined that the amount due was $7,842.68. This order was duly appealed and docketed before the Director, MMS, as MMS-86-0375-OCS.

The third order issued on November 17, 1986. Subsequent to its appeal of the June 4 and June 10 decisions, Cities Service had submitted actual cost information relating to the Lake Charles Fractionator for the period from January 1977 through December 1982 (the period of the audit). In his November 17 decision, the Regional Manager, TRCO, approved a fractionation allowance of 1.42 cents per gallon for the period from October 1977 through September 1979, and a fractionation allowance of 1.91 cents per gallon for the period from October 1979 through September 1981. In this decision, the Regional Manager rejected any fractionation allowance for the period from January 1977 through September 1977 and from October 1981 through December 1982 because actual costs for the full biennial period had not been submitted. The Regional Manager also disallowed any consideration of insur-ance costs and rejected attempts by appellant to obtain either a return on investment (ROI) or imputed interest. Appellant timely appealed this decision to the Director, MMS, where it was docketed as MMS-87-0006-OCS.

It should also be noted that one day after this third order, the Regional Manager, TRCO, sent a letter to appellant's attorney informing her that, in view of the November 17 order, the original order of June 4 was being amended to conform thereto. This letter also noted that, since no fractionation allowance had been approved for any period after September 1981, no change in the June 10 order was effected by the November 17 order.

The end result of these three orders was that Cities Service was directed to recompute royalties for the period from January 1977 through

September 1977 with no fractionation allowance deduction, to recompute royalties for the period from October 1977 through September 1981 using the deductions specified in the November 17 order, to recompute the royalties for the period from October 1981 through December 1982 (except for royal-ties due for leases OCS 0767 and OCS 0768 for the period from April 1982 through October 1982) without any deduction for fractionation, and to remit $7,842.68 in past due royalties accruing from leases OCS 0767 and OCS 0768 for the April 1982 through October 1982 period, which represented no deduction for the fractionation allowance.

In its appeal to the Director, MMS, appellant assailed the orders of the Regional Manager on a number of bases. Thus, appellant noted that it had utilized the same fractionation deduction that all other lessees who used the Lake Charles Fractionator had employed. Yet, while MMS had permitted these lessees to make this deduction it had refused to allow the same deduction for appellant. In his November 3, 1987, decision, the Director reviewed the three orders described above, affirming the June 4 order, as revised by the November 17 order, and the June 10 order. Appellant thereupon appealed to the Board.

The second appeal, IBLA 88-169, arose from a decision of the Director, MMS, dated October 16, 1987. While this decision actually issued prior to the decision in IBLA 88-140, 3/ the underlying order of the Regional

3/ While the MMS decision in IBLA 88-169 was issued prior to the MMS decision in IBLA 88-140, the relevant case files in IBLA 88-169 were not transmitted to the Board until Jan. 7, 1988. The case files in IBLA 88-140, however, were received by the Board on Dec. 23, 1987. Since appeals are docketed upon receipt of the case files, the unexplained tardiness in transmission of the case files for IBLA 88-169 has further confused these appeals since the earlier MMS decision now bears a later IBLA docket number.

Manager, TRCO, had issued on December 12, 1986, subsequent to the three orders involved in IBLA 88-140. In this order, the Regional Manager detailed the results of the MMS review of the OIG audit and specified various revisions which should be made in computing royalties. In addi-tion to again disallowing the 12.4-percent fractionation allowance which had already been the subject of the three earlier orders, the Regional Manager directed additional changes in the manufacturing allowance claimed and adjustments to gross liquid production figures submitted, and further held that royalty for NGLP's should be recomputed in accordance with the "Procedure Paper on Natural Gas Liquid Products Valuation" (Procedure Paper), utilizing the monthly average Mont Belvieu spot market price for those non-arm's-length transactions where the value reported by Cities Service for determining royalty was below the low Mont Belvieu price for that month. With two exceptions not relevant to the instant appeal, 4/ the October 21 decision of the Director affirmed the order of the Regional Manager. Cities Service duly appealed this decision.

[1] Before examining the arguments pressed on appeal before the Board, we are constrained to comment upon the adjudicative procedures followed by MMS with respect to the instant appeals. In essence, the Regional Manager issued four separate orders directing recalculation of royalties paid on NGLP's produced from Grand Chenier, three of which cov-ered only the fractionation allowance, while the last order covered the

4/ With respect to a dispute over transportation allowances, the Director granted appellant 90 days in which to submit documentation to the RMP (Decision at 11). Also, the Director's decision noted that an earlier mis-application of the yardstick values to Conoco Inc.'s sales figures rather than appellant's had been corrected (Decision at 19).

fractionation allowance in addition to other matters. Thus, appellant was required to file four separate appeals to the Director, MMS and, eventually, two appeals to this Board, even though the last order, issued while the prior orders were on appeal to the MMS Director, subsumed all of the issues covered by the prior orders. The MMS Director, for his part, decided the last appeal first which essentially rendered his decision relating to the earlier issued three orders a foregone conclusion.

The multiplicity of orders relating to the calculation of royalty for the NGLP's by the Regional Manager, as well as the failure of the Director, MMS, to either decide the earlier appeals first or consolidate all four appeals in one decision, have added significantly to the confusion engendered in attempting to review these appeals.

It seems an elementary matter of adjudicative practice to attempt to determine all subsidiary questions relating to a specific determina-tion within the confines of a single decision, if at all possible. Herein, in his order of June 4, 1986, which was the first of the orders involved herein, the Regional Manager expressly noted that: "This letter addresses the fractionation allowance percentage which was used to compute and pay royalties on Cities' interests in the OCS leases processed at the Lake Charles Fractionator. <u>All other areas of interest to MMS associated with these leases remains subject to further review</u>" (emphasis supplied). Thus, MMS knew, almost for a certainty, that further adjustments would be required in order to arrive at the royalty payment MMS thought was justified, yet, nevetheless, chose to proceed with a fragmented adjudicatory approach.

We see little purpose to be served in the issuance of piecemeal decisions covering the same essential question, namely the proper royalty to be paid for the NGLP's during the period in issue. All of the issues ultimately covered in the Regional Manager's fourth order were included in the OIG audit report. All of them necessarily bore on the determina-tion of the proper royalty assessment. The first three orders of the Regional Manager involve but one element in the determination of the proper royalty rate, i.e., the fractionation allowance. Each of these three orders instructed appellant to recompute the royalty due based only on changes of the fractionation allowance, despite the fact that the Regional Manager was already considering other modifications suggested by the OIG report. Even if appellant had agreed to the original order issued by the Regional Man-ager and proceeded to recompute the royalty due, its actions would have been useless. It would have been forced, under the fourth order, to redo all of the computations since other changes not directed in the initial three orders were involved.

There seems little utility in issuing an independent determination on the question of the fractionation allowance when it is merely one aspect of the entire controversy. Our opinion is strengthened by the fact that the MMS Director was apparently of the same mind as he chose to adjudicate the appeal of the fourth order before entertaining the appeals of the earlier three orders. 5/ We believe the approach followed below not only puts an appellant to the unfair burden of simultaneously defending numerous sep-arate, but intrinsically related, matters but also adds a considerable burden to this Board's adjudications in sorting out the resulting confusion.

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5/ Why these appeals were not consolidated, however, is unexplained.

With respect to the substance of the instant appeals, inasmuch as questions relating to the fractionation allowance are common to both decisions under review, we will examine that issue first. Thereafter, we will adjudicate those matters which were solely the subject of the Director's October 16, 1987, decision.

As noted above, while MMS originally disallowed any deduction for fractionation because of appellant's failure to submit its revenue and expense information relating to the Lake Charles Fractionator, it ulti-mately relented when Cities Service submitted these figures, at least with respect to the two biennial periods for which appellant submitted complete information. For those two periods, MMS allowed a deduction of 1.42 cents per gallon and 1.91 cents per gallon, respectively. Appellant challenges this allowance primarily on the ground that, as computed by MMS, the fractionation allowance is limited solely to actual costs and does not include the allowance of any profit factor with respect to appellant's investment in the Lake Charles Fractionator. Additionally, appellant asserts that the sales values of its NGLP's were improperly calculated. Finally, appellant alleges that the Director failed to make any allowance for insurance costs associated with the Lake Charles Fractionator. For reasons which we shall set forth, we find ourselves in substantial agreement with the decision of the Director, MMS, and expressly hold that where the processing allowance is based on a profit factor derived from the value of the NGLP's sold, rather than on a return on investment, the profit factor may only be counted once in the computation of the processing allowance.

In his decision, the Director noted that the processing allowance for OCS leases (as opposed to onshore leases) was determined by RMP according to the following formula:

$$\text{Processing Allowance} = \frac{\text{Costs + Profit Factor + Depreciation}}{\text{Sales Value of Liquids}}$$

(Decision at 2). Thus, the ultimate processing allowance permitted is expressed as a percentage of the value of the NGLP's. The question, of course, is the determination of the proper processing allowance in the instant case.

The starting point for the Director's analysis of this issue was 30 CFR 206.152(a)(2) (1987). 6/ That regulation provided, in relevant part, for the payment of royalty on all natural gasoline, butane, propane and other substances extracted from the natural gas, but further provided that: "A reasonable allowance, determined by the Director and based upon regional plant practices and actual plant costs and other pertinent factors, may be made for the cost of processing and may be deducted from the royalty payment due on said constituent substances." Based on this language, the Director concluded that this regulation required that the fractionation allowance be based on actual costs (Decision at 2). The Director noted that, inasmuch as the other lessees who used the Lake Charles Fractionator were charged 12.4 percent of the NGLP's processed as a service charge, this figure represented their actual costs and was properly deductible under the

6/ The oil and gas valuation regulations were substantially revised in 1988. See 53 FR 1272 (Jan. 15, 1988); 53 FR 45084 (Nov. 8, 1988). We express no opinion as to the proper interpretation of these new provisions with respect to the issues determined by this decision.

regulation. But, since Cities Service owned the Lake Charles Fractionator, its use of the 12.4-percent figure could not be justified because this did not represent an actual cost to Cities Service.

The Director noted that, in the alternative, Cities Service had argued that the actual costs used in calculating the fractionation allow-ance should include factors other than simply out-of-pocket expenditures, viz., either an ROI or a profit factor, and insurance costs. The Director disagreed. With respect to insurance costs, the Director noted that Cities Service was largely self-insured and that, in any event, it had failed to prove any insurance costs. More importantly for this appeal, while the Director agreed that a profit factor should be applied to the extraction allowance, he held that no such profit factor was applicable to the fractionation allowance because, in the Director's view, use of a profit factor based on total sales value in both the extraction allowance and the fractionation allowance would constitute double-counting (Decision at 6-7).

Appellant makes a number of arguments to counter the Director's analysis. First, it notes that the regulation does not, in any way, pro-vide that a profit factor may be taken for the extraction process but may not be taken for the fractionation process. Indeed, the regulation does not refer to either of these two processes but merely references "the cost of processing." Thus, appellant argues that allowance of a profitability factor for one of these elements without also allowing it for another can scarcely be based on the regulatory language.

Second, it argues that the Director's decision is internally inconsistent since at one point it suggests that the fractionation allowance applicable to offshore leases includes a profit factor in lieu of return of investment (Decision at 3), while at another point it states that no profit factor could be allowed in the fractionation allowance because it would duplicate the profit factor already granted in the extraction allowance (Decision at 7).

Finally, with respect to the actual computation of its allowances, appellant argues that MMS made both theoretical and computational errors. We turn now to a consideration of these questions.

[2] Before the Director, MMS, appellant had argued that it should be allowed the same deduction as allowed to those lessees for whom it fractionated NGLP's at Lake Charles, since these agreements were the result of arm's-length transactions and established a fair market value for the fractionation of the NGLP's. In this regard, we note that where a lessee disposes of NGLP's in a non-arm's-length transaction, the Procedure Paper does provide the lessee with an opportunity to show that its non-arm's-length contracts had characteristics similar to arm's-length contracts so that the valuation of NGLP's under its non-arm's-length contract might be used for the purpose of establishing fair market value. See, e.g., Shell Offshore Inc., 116 IBLA 246 (1990); Cities Service Oil & Gas Corp., 113 IBLA 255, 262-63 (1990). However, nothing in either the Procedure Paper or the applicable regulations authorizes a similar comparison where the issue involved concerns the allowance to be granted for the cost of processing. Nor would we deem such an approach appropriate.

Questions pertaining to the establishment of fair market value necessarily partake of an element of inexactitude. Fair market value can fluctuate greatly over a short period of time and the determination of the market value of a commodity at any specific point in time has inher-ent uncertainties. Thus, in attempting to determine fair market value in those situations involving interaffiliate and subsidiary transactions, the Procedure Paper has provided a mechanism by which a lessee can attempt to show that its non-arm's-length contract had characteristics similar to arm's-length contracts negotiated at the same time in the same general area for the same product so as to support reliance upon the price provided for in the non-arm's-length contract as establishing fair market value. See generally Shell Offshore Inc., supra at 250, 251.

With respect to the determination of actual costs, however, no such uncertainties should exist. In determining such costs, the Department is not concerned with an idealized concept such as "fair market value." Rather, it is concerned with actual expenditures made by each lessee. In this regard, it is essentially irrelevant what costs another lessee absorbs since the purpose of 30 CFR 206.152(a)(2) (1987) is to compensate each lessee for its expenses in processing NGLP's. Thus, the fact that every other lessee was permitted a fractionation deduction equal to 12.4 percent of the total NGLP's which it produced must be seen in light of the fact that this represented each of those lessee's actual expenditures. This deduction has no necessary relationship, however, to appellant's actual expenditures. The Director properly rejected appellant's attempt to justify a 12.4-percent fractionation deduction for its NGLP production on the ground that this was the amount which all other lessees were allowed. This 12.4 percent represented the "actual costs" of those lessees; it does not represent the "actual costs" borne by appellant.

The foregoing, however, is subject to one important caveat. The regulation expressly authorizes the Director to look at "other pertinent factors," in addition to actual costs in determining the processing allowance. The real question which this appeal presents is whether or not the Director has considered these "other pertinent factors." The essential thrust of appellant's objection is that he did not and the failure to either provide appellant with an ROI for its expenditures at Lake Charles or to separately provide for a profit factor in computing its fractionation allowance was arbitrary and capricious.

[3] Initially, we note that had this case involved onshore rather than OCS leases there seems little question that an ROI for the Lake Charles Fractionator would have been permitted. The reason for this is that a dichotomy had developed between the computation of processing allowances. As noted above, NGLP's processed from OCS leases were granted a profit factor in computing processing allowances. Onshore, lessees were not allowed a profit factor. Rather, the value of imputed interest on the undepreciated investment was allowed. While the genesis of this disparity is unclear, 7/ all parties agree that the profit factor normally results in a higher processing allowance than the imputed interest factor

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7/ There are, however, indications that the profit factor was intention-ally chosen for OCS leases because of the increased costs associated with production on the OCS.

because it is adjusted to an after-tax rate. See Statement of Reasons (SOR) (IBLA 88-140) at 9; Answer (IBLA 88-140) at 5. The important point to keep in mind, however, is that allowance of the profit factor is a substitution for an ROI based on imputed interest.

Appellant's main objection, however, is not to the failure of MMS to allow imputed interest rather than a profit factor. Instead, appellant focuses on the perceived failure of MMS to allow a separate profit factor in the computation of the fractionation allowance. It is this failure which appellant contends is arbitrary and capricious. Our analysis of the computations utilized to derive a processing allowance, however, convinces us that, in point of fact, MMS correctly refused to compute the extraction allowance using a profit factor and then separately compute the fractionation allowance again using a profit factor.

We noted above that RMP used the following formula to derive the processing allowance:

$$\text{Processing Allowance} = \frac{\text{Costs + Profit Factor + Depreciation}}{\text{Sales Value of Liquids}}$$

Since the profit factor allowed is based on a 15-percent rate of return on sales after income taxes, the formula can also be stated as:

$$PA = \frac{B + \frac{.15A}{.54} + D}{A}$$

where:

PA = Processing Allowance
A = Liquids Value
B = Operating Expenses
D = Depreciation
.15 = Profitability Range Limit
.54 = Nontaxable Portion of the Income Tax Base.

Counsel for MMS suggests that where, as here, it was necessary to compute both an extraction allowance and a fractionation allowance, MMS first computes the extraction allowance with a profit factor, next com-putes the fractionation allowance without a profit factor, and then adds the two allowances to arrive at the processing allowance. Thus, under this approach the formula may be stated as follows:

$$PA = \frac{B + \frac{.15A}{.54} + D}{A} + \frac{B^1 + D^1}{A}$$

where:

PA = Processing Allowance
A = Liquids Value
B = Operating Expenses (Extraction)
$B^1$ = Operating Expenses (Fractionation)
D = Depreciation (Extraction)
$D^1$ = Depreciation (Fractionation)

Appellant argues that, under this approach, it is only receiving a profit factor on the costs and expenses associated with extraction and not on fractionation. This argument, however, is based on a misinterpretation of the algebraic formulation. Thus, the above formula may also be expressed in a single equation as follows:

$$PA = \frac{\frac{.15A}{.54} + (B + D) + (B^1 + D^1)}{A}$$

This formulation clearly shows that the profit factor applies equally (to the extent that it applies at all) to the cost and depreciation aspects of both the extraction and fractionation processes.

The mistake which appellant makes is in assuming that the profit factor being granted by MMS has any correlation to the level of its investment and an acceptable ROI. It does not. The profit factor being allowed is strictly a function of the sales values of the NGLP's and does not vary regardless of the size of the expenditures being deducted for either costs or depreciation. While MMS states that it performed two separate computations to arrive at the total processing allowance, it could have done it in one computation. Indeed, in the instant case, MMS could also have placed the profit factor in the fractionation computation rather than the extraction computation without making any change, whatsoever, in the ultimate processing allowance granted.

The simple fact of the matter is that while MMS may authorize a profit factor based on total sales in lieu of a return on investment they are not equivalent concepts. Appellant is, in essence, attempting to meld the onshore approach which grants an ROI, instead of a profit factor, with the OCS approach which grants a profit factor in place of an ROI. They are, however, simply not compatible. By attempting to have the profit factor counted both in the computation of the extraction allowance and in the computation of the fractionation allowance, appellant is, as the Director argued, attempting to recoup a double profit. The Director correctly rejected this attempt.

We note that the foregoing presupposes that the Liquids Value (fac-tor A) remains constant. In his October 16, 1987, decision, the Director pointed out that

> [t]he RMP included 100 percent of the plant's operating expenses (factor B) and depreciation (factor D) in its calculation of the processing allowance. Therefore, the "liquid sales value" (factor A) had to include the value of 100 percent of the plant's liquid production, regardless of the ownership or disposition of the liquids.

(Decision at 14). The problem, however, is that only if Lake Charles processed all of the Grand Chenier NGLP's, and only the Grand Chenier NGLP's, would factor A remain constant for both the extraction and fractionation calculation when factor A is based on total plant throughput. If, on the other hand, Lake Charles processed NGLP's in addition to those processed at Grand Chenier, it would make a difference where the profit factor was allocated since the profit factor is a direct function of the Liquid Values figure and the Liquid Values figure would be different in the two computations.

In such an eventuality, the proper method for computing the processing allowance for appellant would be to determine Cities Service's aliquot portion (i.e., the portion of each plant's total throughput which represents Cities Service's share of production) of the operating expenses and depreciation at both Grand Chenier and Lake Charles and utilize Cities Service's gross NGLP sales rather than either of the plant runs. By doing this, one would arrive at a constant value for A for purposes of computing both the extraction allowance and the fractionation allowance. Our affirmation of this aspect of the Director's determination is thus premised on the assumption that the Liquid Values figure used was the same for both the extrac-tion allowance and the fractionation allowance. If it was not, on remand MMS is directed to recompute appellant's processing allowance as indicated above. 8/

[4] Appellant also challenges the manner in which MMS calculated the combined processing allowance. It notes that these two allowances should be added together and then subtracted from the gross value. Appellant argues that the following formula reflects the approach that should be taken:

Value - (Extraction + Fractionation) = Net Value x Royalty Rate

Thus, appellant suggests that, assuming a value of 100, an extraction allowance of 30 and a fractionation allowance of 10, the computation should be:

100 - (30 + 10) = 100 - 40 = 60 x Royalty Rate

Appellant complains that, rather than make this relatively simple mathematical calculation, MMS reduced the fractionation rate by the percentage of the extraction allowance and that this improperly reduced the

8/ No alteration would be needed in any event with respect to any other user of the Lake Charles Fractionator since MMS permitted these users to subtract their actual costs (12.4 percent of the NGLP's processed) as their fractionation fee.

amount of its total processing allowance. 9/ Accordingly, it requests that corrections be made to the computations.

This aspect of the case is particularly troubling. We note that in a memorandum dated May 18, 1987, to the Chief, Division of Appeals, MMS, the Regional Manager stated that the correct MMS formula is:

Value x [(1.0 - Processing allowance) x (1.0 - Fractionation Fee)] = Net Value Subject to Royalty

(Memorandum of May 18, 1987, at 4).

We must admit that we find it difficult to understand the theoretical basis for this formula. In effect, this formula calls for the multiplication of the reciprocal of the processing allowance and the fractionation fee, the product of which is then multiplied by the gross value to arrive at net value subject to royalty. Not only is there no explanation of the theory by which this calculation can be said to arrive at the net value subject to royalty, it is also obvious that this formula results in a varying net value subject to royalty even in situations in which the combined extraction/fractionation allowance is the same.

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9/ In its SOR, appellant argued that the formula to represent this calculation would be: "Value - [Extraction + (Extraction x Fractionation)] = Net Value."
The problem, however, is that since the extraction and fractionation elements of the equation represent real numbers and not percentages, the equation cannot work. An accurate algebraic expression of this calculation would be considerably more involved: "Value - [(Value x Extraction %) + [[Value - (Value x Extraction %)] x Fractionation %]] = Net Value."

Thus, if we assume a gross value of $100, an extraction allowance of 20 percent, and a fractionation fee of 20 percent (for a total of 40-percent allowable costs), the computation works as follows:

$100 x [(1.00 - .20) x (1.00 - .20)] = $100 x [.80 x .80] =
$100 x .64 = $64 Net value subject to royalty

If, however, we assume a gross value of $100, an extraction allowance of 30 percent, and a fractionation fee of 10 percent (still a total of 40 per- ent of allowable costs), the computation works as follows:

$100 x [(1.00 - .30) x (1.00 - .10)] = $100 x [.70 x .90] =
$100 x .63 = $63 Net value subject to royalty

Quite apart from the failure of MMS to submit any theoretical justification for its approach, the fact that different net-value figures can be obtained even while the total allowance remains constant must compel a conclusion that use of this formula is inherently arbitrary and capricious. Had MMS utilized this formula to compute the combined extraction/fractionation allowance we would find it necessary to reverse its actions.

The problem, however, is that it does not appear that MMS actually used this formula in computing the allowance. Thus, the Regional Manager's memorandum of May 18, 1987, noted that "[t]he formula actually required by MMS is 100 x (100% - 30%) - cents per gallon frac deduction = Value subject to royalty" (Memorandum at 4). Thus, MMS asserts that, in fact, it did not multiply the reciprocals of the allowances but rather effectively subtracted both of the allowances from the gross value. We note further that counsel for MMS asserts in its answer that after calculating the separate extraction and fractionation allowance, MMS "then added the two allowances together to arrive at Cities' processing allowance" (Answer (IBLA 88-140) at 6). Assuming that these statements correctly reflect the reality of the calculations, it is obvious that the formula set forth above was not utilized as the basis for determining appellant's deductions. Cities Service's objections on this point are therefore overruled.

In summary, on the issue of the proper processing allowance, we conclude that MMS was not required to permit appellant to deduct 12.4 percent of the NGLP's, but rather properly required Cities Service to submit proof of its actual costs and expenses; that, since the profit factor allowed is based on the sales values of NGLP's, it is properly computed only once in the combined extraction/fractionation allowance computation; and that the extraction and fractionation allowances are properly added together to arrive at the combined processing allowance. 10/

We turn now to the issues presented which are specific to the appeal in IBLA 88-169. With respect to this appeal, appellant makes a number of

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10/ Our affirmation is without prejudice to any subsequent submission by appellant with respect to the two biennial periods for which no fractionation allowance was permitted. In this regard, we note that the order of the Regional Manager merely requested that appellant submit cost and expenditure data for the 6-year period of the audit. If MMS desired the data for all 8 years encompassed by the four biennial periods it should have expressly requested it. We note that there might be some question as to the authority of MMS to request data for the biennial period from October 1975 through September 1977. See Phillips Petroleum Co. v. Lujan, No. 86-C-1487-E (N.D. Okla., Oct. 18, 1989), appeal docketed No. 90-5122 (10th Cir.). Inasmuch as this issue has not been raised by either party, we consider it inappropriate to address it at the present time.

arguments. First, it contends that the adoption of the Procedure Paper constitutes improper rulemaking in violation of the relevant provisions of the Administrative Procedure Act (APA), 5 U.S.C. § 553 (1988). Next, it argues that even if the adoption of the Procedure Paper did not vio-late the provisions of the APA, it should not be applied retroactively to payments made before its adoption. Moreover, with respect to the period 1978 through 1980, appellant specifically argues that since these payments, made on its behalf by Conoco, had already been subject to an OIG audit, MMS was precluded from re-auditing payments made by Conoco on appellant's behalf. Finally, appellant challenges the valuation of NGLP's utilized by MMS, arguing, inter alia, that the "yardstick" valuation therein outlined results in valuations in excess of Department of Energy (DOE) maximum prices during the period of DOE mandatory price control.

We note that all of these arguments have been examined in a number of prior Board decisions. In Cities Service Oil & Gas Corp., supra, we briefly described those portions of the Procedure Paper relevant to the consideration of the instant appeal:

> [T]he Procedure Paper is designed to assure that proper royal-ties are tendered on NGLP production. To effectuate this intent, the Procedure Paper set out to develop what it referred to as a "'yardstick' valuation technique" (Procedure Paper at 3). The Procedure Paper noted that a review of various factors such as the NGLP sales contracts, prices received by lessees, Table 7 (DOE) prices, and commercially available NGLP bulletins, had led to the conclusion that the price bulletins represented the best available price source and would, in most instances, be indicative of NGLP fair market value (Procedure Paper at 5). Accordingly, use of three bulletins were recommended. The "yardstick" price was to be derived by using the highest and lowest prices for each month from the appropriate bulletin. Any reported value falling within this range would be within the "yardstick" valuation. If

> the reported value was below the range of values for a specific month, the average value of the "yardstick" for that month would be the minimum value accepted by MMS (Procedure Paper at 6-7). [Footnote omitted.]

Id. at 257-58.

It must also be noted, however, that while the Procedure Paper provided for development of a "yardstick" valuation, this "yardstick" valuation would only be applied in limited circumstances. Thus, if an arm's-length contract existed, the Procedure Paper provided that the contract price would normally be considered to establish fair market value unless the actual proceeds received were higher. Of particular note for the instant appeal, the Procedure Paper also provided that if, during the period in which NGLP prices were controlled by DOE regulations, a lessee received a maximum permissible price under the DOE regulations, this price would be accepted as fair market value, even if it were less than the price called for in an existing sales contract or under the "yardstick" valuation. The applicability of this latter provision is examined subsequently in the text of this opinion.

[5] Appellant's generalized objections to MMS's use of the Procedure Paper may be quickly disposed of. With respect to appellant's assertion that the adoption of the Procedure Paper constituted improper rulemaking in derogation of the provisions of 30 CFR 206.150 (1987), we noted in Amoco Production Co., 112 IBLA 77 (1989), that:

> In fact, the Procedure Paper itself relies on the factors set forth in the regulation--the lessee's price, regulated prices,

> posted prices, and gross proceeds. It provides guidance by specifying which of the factors listed in 30 CFR 250.64 (1982) is to be given the most weight in various circumstances.

Id. at 81. Similarly, in Conoco Inc., 110 IBLA 232, 242-43 (1989), we held that:

> The Procedure Paper merely clarified the existing regulations by setting forth a yardstick by which MMS would measure the reasonableness of royalty values reported by lessees. It did not require lessees to value their production by any spe-cific method, nor did it modify any existing regulation. Rather, it found that, after consideration of the factors listed in the regulations, the best measurement of the reasonable value of NGLP in situations where no arm's-length contract existed was the commercially available spot price bulletins. We find the Procedure Paper to be essentially a policy guideline adopted by MMS to assist in valuing NGLP production for royalty purposes under the provisions of the relevant regulation. As such, it does not have the force and effect of law as a duly promulgated regulation does, and the Board will decline to follow it where it is inconsistent with the terms of the relevant regulations.

Consistent with our past holdings, we reject appellant's assertion that the Procedure Paper constitutes a substantive rule of law adopted in violation of the applicable provisions of the APA. Rather, the Procedure Paper merely establishes internal guidelines to be used in implementing the relevant regulatory and statutory mandates. Accord Cities Service Oil & Gas Corp., supra; Amoco Production Co., supra; Conoco Inc., supra,

[6] In addition, to the extent that appellant's argument concerning retroactive application of a new rule is premised on the contention that the Procedure Paper constitutes a substantive rule of law, this contention also must fail. Nor does the initial acceptance of its payments by MMS

officials compel a different result. In the absence of an express state-ment to the contrary, "all royalty payments are accepted subject to audit and the 'silent acceptance of royalty when initially tendered does not constitute an express determination of the proper royalty level.'" Cities Service Oil & Gas Corp., supra at 260, citing Supron Energy Corp., 55 IBLA 318, 321 (1981).

Thus, the mere fact that appellant valued its production under one method and submitted royalty based on this valuation does not give rise to any right in appellant to insist on the acceptance of its valuation method. As we noted in Cities Service Oil & Gas Corp., supra,

> where Government acceptance of the tender of royalties is made subject to post audit, the mere recomputation of the royalty payments due to the Government to correctly reflect fair market value of NGLP's does not constitute imposition of a penalty or give rise to an issue of retroactive application of a new rule. [Footnote omitted.]

Id. at 261.

[7] We recognize that appellant argues that a prior OIG audit of Conoco, which included royalty payments made on behalf of Cities Service, should estop the Government from challenging these royalty payments essentially on the theory that the failure of that audit to challenge the NGLP valuation should be interpreted as constituting "an express determination of the proper royalty level," within the meaning of Supron Energy Corp., supra. We do not agree.

In Conoco Inc., supra, we rejected this precise contention when it was argued by Conoco. In that case, the Board examined at some length the OIG audit in question:

> In 1981, the Office of the Inspector General (OIG), U.S. Department of the Interior, conducted a general audit of Conoco's Federal oil and gas leases for the years 1978 through 1980. The purpose of the audit was to determine if Conoco's settlement procedures adequately provided for the proper computation and payment of royalties for the gas removed from its Federal leases. The OIG concluded that, with certain exceptions, Conoco's settlement system for the payment of royalties did not contain any material weaknesses and adequately provided for the reasonable payment of royalties. The OIG also noted that Conoco used actual net-back values as the basis for its determination of the value of NGLP produced from the leases. Although the OIG found certain problems with the calculation of royalties on NGLP, these problems did not directly relate to the net-back method of valuing NGLP. The OIG recommended that the Geological Survey (GS), the predecessor of MMS, direct Conoco to pay additional royalties based on the audit. As a result of this audit, Conoco has indicated that it paid $572,498 in additional royalties for the years 1978 through 1980.
>
> Subsequently, the OIG conducted a specific audit of the royalties paid on NGLP removed from Federal leases and processed at the Grand Chenier Gas Processing Plant for the years 1977 through 1988. * * *
>
> After review of the OIG audit report and appellants' com-ments on that report, the Tulsa Regional Manager, MMS, informed Conoco * * * of his preliminary royalty underpayment determinations by letters dated August 20, 1985.

Id. at 234.

In analyzing Conoco's contention that MMS should be bound by OIG's earlier audit, the Board noted that, during the time in question, the authority for valuation of production for royalty purposes was vested in the Director, Geological Survey, and those officials under his supervision. Thus, the failure of the earlier OIG audit to challenge the net-back valuation could not constitute approval by the Departmental official with delegated authority to approve valuation of production. Moreover, the Board expressly noted that "[a]ppellants have not presented the Board with any documentation regarding the additional royalty paid as a consequence of the earlier OIG nationwide audit from which it can be concluded that acceptance of the payment constituted a ruling on the issue of valuation of NGLP processed at Grand Chenier in 1980." Id. at 243. Accordingly, the Board concluded that failure of the OIG nationwide audit of Conoco's payments to challenge the net-back valuation on which royalties were paid did not constitute "an express determination of the proper royalty level" such as would bar, under the Board's decision in Supron Energy Corp., supra, a subsequent MMS audit specifically directed to production processed at Grand Chenier.

The same ruling must follow in this case. The present record is equally devoid of any documentation which would support the conclusion that acceptance of Conoco's tender of additional royalties subsequent to the 1981 OIG audit constituted a ruling on the issue of the valuation of NGLP's processed at Grand Chenier for the period prior to 1981. Therefore, we hold in conformity with our prior decision in Conoco Inc., supra, that MMS was not estopped from reviewing the valuation of NGLP's processed at Grand Chenier prior to 1981.

[8] Cities Service also challenges the application of the Procedure Paper's "yardstick" valuation to those sales of NGLP's which occurred during the period of DOE price control. Appellant notes that the Procedure Paper expressly provides that during those periods in which non-ethane NGLP's were subject to DOE price controls, those prices would be presumed to be the fair

market value unless the prices actually received by a lessee were greater. Inasmuch as Cities Service internally consumed rather than sold most of its NGLP's, there was no way in which it could have received prices in excess of the DOE maximum prices. Accordingly, appellant argues that the MMS order should be reversed to the extent that it directed that the "yardstick" prices should be used instead of the DOE maximum prices.

In our recent decision in Shell Offshore Inc., supra, we explored this exact argument. Therein, we noted that the essence of MMS's posi-tion was that under 10 CFR 212.83(c)(ii) (1980) appellant, as a refiner, was permitted to allocate increased product costs (which would be recoverable through an increase in maximum permissible pricing under 10 CFR 212.161) "to a particular general refinery product in whatever amounts it deems appropriate." Therefore, MMS argued, the maximum price under which appellant valued the NGLP's should not necessarily be considered the max-imum permissible price under DOE regulations because appellant had it within its power to so allocate any increased product costs (and thereby raise the maximum permissible price) to any particular refinery product as appellant saw fit. Thus, MMS concluded that the prices which appellant asserts were the maximum permissible prices under DOE regulations may not, in fact, have been the maximum prices allowable.

In our decision in Shell Offshore Inc., supra, however, we rejected the MMS position which had disallowed appellant's reliance on the maximum DOE prices:

> Initially we note that there is nothing in the record submitted to the Board to indicate that appellant did, in

> fact, allocate such increased product costs in a manner designed to lower its royalty payments. In any event, in Phillips Petroleum Co., 109 IBLA 4 (1989), a panel of this Board held that a similar refusal to accept DOE ceiling prices as representing fair market value must be deemed arbitrary and capricious, given the instructions of the Procedure Paper. Accordingly, to the extent that the decision below instructed appellant to recompute the value of non-ethane NGLP's during the period in which these products were subject to DOE price controls, the decision must be reversed. [Footnote omitted.]

Id. at 253. We believe that the decisions in Shell Offshore Inc., supra, and Phillips Petroleum Co., supra, must control the result in the instant appeal. Accordingly, to the extent that the decision below rejected valuations of non-ethane NGLP's where the value reported was the maximum permissible price under the DOE regulations, the decision herein must be reversed. 11/

[9] There remains one further modification which we must make in the application of the Procedure Paper herein. As written, the Procedure

11/ However, to the extent that appellant has argued that the Table 7 DOE prices were not properly applied to its propane sales because of existing arm's-length contracts establishing a lower price, its contention was properly rejected. Thus, the Director, MMS, noted that appellant had supplied only an incomplete copy of such a contract and that, in any event, the agreement concerned bulk sales and did not specify a specific source of the product. Accordingly, he rejected appellant's contention that these contracts should be interpreted as establishing an arm's-length contract price for propane processed at Grand Chenier and Lake Charles within the meaning of the Procedure Paper. We agree.

While an agreement for the bulk sale of NGLP's might be used as an arm's-length contract for the purpose of comparison with a non-arm's-length contract in order to establish the acceptability of the non-arm's-length contract, as provided for in the Procedure Paper (see Shell Offshore Inc., supra at 253-55), it cannot be used to establish that any specific production of NGLP's were sold under an arm's-length contract absent a showing that the production in question was, indeed, transmitted to the purchaser under that agreement and was required to be transmitted to the purchaser under that agreement. See generally Amoco Production Co., 78 IBLA 93, 99 (1983), aff'd, Amoco Production Co. v. Hodel, 627 F. Supp. 1375 (W.D. La. 1986). Appellant has made no such showing here and, in the absence thereof, the Table 7 DOE prices are properly used to value the NGLP's.

Paper provided that in those situations in which the "yardstick" valuation applied, the average value of the "yardstick" for that month would be the minimum value accepted by MMS. However, in Conoco Inc., supra, we rejected use of the average value of the "yardstick," noting that, since the lowest value of the "yardstick" established a floor price for royalty valuation and such price must, itself, constitute fair market value in order to be acceptable, the floor price rather than the average value of the "yardstick" should be used to recompute the royalty due to the United States. Id. at 244. See also Shell Offshore Inc., supra at 250; Cities Service Oil & Gas Corp., supra at 263; Union Oil Co., 111 IBLA 369 (1989). We hereby modify the instant decision to conform to this holding.

Appellant has requested oral argument before the Board, pursuant to 43 CFR 4.25. In view of our disposition of the instant appeal, the Board has concluded that oral argument would serve no useful purpose and it is hereby denied.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decisions appealed from are affirmed in part, reversed in part, and set aside and remanded in part as explained above.

James L. Burski
Administrative Judge

I concur:

John H. Kelly
Administrative Judge