

PHILLIPS PETROLEUM CO.

IBLA 88-47

Decided December 21, 1990

Appeal from a decision of the Director, Minerals Management Service, affirming an order assessing additional royalties upon approval of Natural Gas Policy Act section 102 prices. MMS-85-0109-OCS.

Set aside; hearing ordered.

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

The Outer Continental Shelf Lands Act requires that royalties be paid on the amount or value of the production saved, removed, or sold and requires the Secretary to conduct the leasing program so as to assure receipt of fair market value. The Secretary has authority to determine the value of production upon which royalty payments are made.

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

When an oil and gas lessee has sold its natural gas and paid royalty thereon based on the price specified by section 104 of the Natural Gas Policy Act, 15 U.S.C. § 3314 (1988), and MMS subsequently assesses additional royalty based on the lessee's alleged failure to file a timely application for classification of the gas under sec. 102 of the Natural Gas Policy Act, 15 U.S.C. § 3312 (1988), which would have allowed a higher ceiling price, the issue is whether the lessee breached its duty to market the gas by failing to seek classification of the gas at an earlier time and the Board may refer the case for an evidentiary hearing on that issue.

3. Board of Land Appeals--Constitutional Law: Due Process--Oil and Gas Leases: Royalties: Generally

A Federal oil and gas lease does not require notice and an opportunity to be heard prior to a decision to assess royalties based on a value of production which is higher than the price received by the lessee. The Department is not bound by the price reported by a lessee

and has authority to determine for royalty purposes that the value of gas produced was different than the amount received by the lessee. A lessee is entitled to a reasoned and factual explanation supporting a decision setting a different value and an opportunity to challenge it and obtain review.

APPEARANCES: Jennifer A. Cates, Esq., Bartlesville, Oklahoma, for Phillips Petroleum Company; Howard W. Chalker, Esq., Office of the Solicitor, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE FRAZIER

Phillips Petroleum Company (Phillips) has appealed a decision of the Director of the Minerals Management Service (MMS), dated June 12, 1987, affirming an assessment of additional royalties against Aminoil U.S.A., Inc. Phillips appeals as successor-in-interest to Aminoil.

The assessment was imposed by the Houston Regional Compliance Office for \$298,791 of additional royalties due for oil and gas leases OCS-G 2366, 2372, and 2735 (Bill of Collection No. 04448012). Aminoil paid the total amount assessed and filed an appeal with the Director of MMS contesting \$72,307 of the \$108,799 assessment imposed for OCS-G 2735 issued in 1974 for the High Island Block A-309 (HI-309). As described in the statement of reasons (SOR) filed with the Director, as well as the brief Phillips has filed with the Board, the amount at issue is the difference between the royalties which would be due valuing the gas under section 102 of the Natural Gas Policy Act (NGPA) (15 U.S.C. § 3312 (1988)), and the royalties which were paid for the gas sold at section 104 (15 U.S.C. § 3314 (1988)) prices between October 1979, when Aminoil commenced sales, and September 19, 1980, when Aminoil filed an application with the Federal Energy Regulatory Commission (FERC) to receive section 102 prices.

The demand letter which accompanied the assessment stated that MMS had reviewed an audit report by the Office of Inspector General (OIG) and the "supporting workpapers of Touche Ross & Company" as to OIG's recommendation that MMS bill Aminoil for unpaid royalties "due to the retroactive adjustment of royalties payable upon approval of Section 102 prices" and had determined that royalties paid by Aminoil had not been based on the value of production as defined by 30 CFR 206.150. In particular, MMS concluded that, because Aminoil had requested and received approval from FERC to receive section 102 prices, the company

could have legally collected Section 102 prices from the date of first production of these wells, had Aminoil's request for a category determination been filed in a timely manner. Aminoil's failure to receive NGPA Section 102 prices, from the date of first production, was attributable not to the jurisdictional agency's well category determination but, [sic] to Aminoil's failure in exercising a reasonable standard of diligence in the filing of its application for Section 102 category determination.

In response, Aminoil made three arguments to the Director which Phillips renews and expands on appeal to the Board. In brief they are: (1) Aminoil exercised reasonable diligence in applying for a section 102 price determination and relied on a good faith interpretation of the statute; (2) MMS' authority to determine the minimal value of gas for royalty purposes may not be exercised without notice to the lessee and an opportunity for a hearing; and (3) if the assessment is otherwise proper, the regulation authorizing the use of regulated prices to determine the value of production did not become effective until December 13, 1979, and cannot be applied retroactively.

[1] The Outer Continental Shelf Lands Act requires that royalties be paid on the "amount or value of the production saved, removed, or sold" (43 U.S.C. § 1337(a)(1) (1988)) and grants the Secretary of the Interior authority "to prescribe such rules and regulations as may be necessary to carry out" the provisions of the Act (43 U.S.C. § 1334 (1988)). The Secretary is required to conduct the leasing program so as "to assure receipt of fair market value for the lands leased and the rights conveyed by the Federal Government." 43 U.S.C. § 1344(a)(4) (1988). Under these provisions the Secretary has authority to determine the value of production upon which royalty payments are made. Amoco Production Co. v. Lujan, 877 F.2d 1243, 1245-46 (5th Cir. 1989), cert. denied, 58 U.S.L.W. 3385 (Dec. 12, 1989) (No. 89-454); Amoco Production Co., 78 IBLA 93, 96 n.7 (1983), aff'd, Amoco Production Co. v. Hodel, 627 F. Supp. 1375, 1378 (W.D. La. 1986), vacated, 815 F.2d 352 (9th Cir. 1987) (lack of jurisdiction); see Watt v. Energy Action Educational Foundation, 454 U.S. 151 (1981).

For many years, and at the time Aminoil first sold gas from the lease in controversy, the applicable regulation stated:

The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field or area, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary.

19 FR 2655, 2659 (May 8, 1954). Effective December 13, 1979, the regulation was revised to provide:

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 for a majority of like-quality products produced from the field or area; (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.

30 CFR 206.150 (44 FR 61886, 61903 (Oct. 26, 1979) as redesignated at 48 FR 35639, 35641 (Aug. 5, 1983)). 1/ Since December 1979, the regulated price of gas has been explicitly recognized as a fact to be considered in determining royalty value, while previously it could be properly considered as an additional relevant matter. 2/

Section 104 provides that, for natural gas committed or dedicated to interstate commerce prior to the enactment of the NGPA for which a just and reasonable rate was in effect under the Natural Gas Act, the maximum lawful price for the first sale delivered during any month is the higher of the just and reasonable rate established by FERC for the first sale of such gas on April 20, 1977, adjusted for inflation, or the rate established by FERC after April 27, 1977, and before November 9, 1978, or such higher price as prescribed by FERC. 15 U.S.C. § 3314 (1988). In contrast, section 102 establishes the maximum lawful price as \$1.75 per million Btu's for April 1977, thereafter adjusted for inflation and additional adjustment of 0.035 percent prior to May 1977 and 0.04 percent thereafter. 15 U.S.C. § 3312(b) (1988).

The higher section 102 price applies to "new natural gas" and also to "natural gas produced from any old lease on the Outer Continental Shelf," which qualified for the ceiling price. 15 U.S.C. § 3312(a) (1988). For gas from an "old lease" to qualify, the gas must be "produced from a reservoir which was not discovered before July 27, 1976." 15 U.S.C. § 3312(d)(1) (1988) (emphasis added). As defined by the statute, "a reservoir shall be considered as having been discovered before July 27, 1976," (emphasis supplied) if it was penetrated by a well before July 27, 1976, and, with respect to the well:

(i) the results of any production test meeting the requirements of OCS Order No. 4 demonstrate that, at the time of such test, the reservoir is capable of producing in paying quantities (within the meaning of such Order);

(ii) any production capability evidence meeting the requirements of OCS Order No. 4 demonstrates that, as of the time such evidence is obtained, the reservoir is capable of producing in paying quantities (within the meaning of such Order); or

1/ Effective Mar. 1, 1988, the regulation was removed and a detailed approach to royalty valuation of gas was established at 30 CFR Part 206. 53 FR 1230, 1272 (Jan. 15, 1988).

2/ The fact the regulated price of gas could be considered as a "relevant matter" under the earlier version of the regulation is a sufficient basis for rejecting the argument that use of the regulated price to establish royalty value prior to the revision of the regulation constitutes retroactive application of the later regulation.

(iii) subject to paragraph (3), an induction-electric log, sidewall cores and core analysis, or a wire line formation test indicates that, as of the time of such test, the reservoir is commercially producible.

15 U.S.C. § 3312(d)(2)(B) (1988). Paragraph 3, referred to in (iii), provides that "a reservoir shall not be considered as having been discovered before July 27, 1976," (emphasis supplied) by a well penetrating the reservoir prior to that date if:

(A) a production test meeting the requirements of OCS Order No. 4 was performed and the results of such test fail to demonstrate that, as of the time of such test, such reservoir [sic] was capable of producing in paying quantities (within the meaning of such Order); and

(B) production capability evidence meeting the requirements of OCS Order No. 4 does not exist or, if existing, does not demonstrate that, as of the date such evidence was obtained, such reservoir was capable of producing in paying quantities (within the meaning of such Order).

15 U.S.C. § 3312(d)(3) (1988).

Aminoil also raised its first argument on appeal before the Director in response to MMS's statement that the company had failed to exercise "a reasonable standard of diligence" in filing for section 102 pricing. Aminoil asserted that, in the circumstances, it had acted in a reasonable, prudent, and diligent manner and had timely filed for section 102 pricing. In particular, Aminoil noted that because the HI-309 lease was an "old lease," to qualify for section 102 prices the wells had to fail to meet the standards of subsection (d)(2) so that the reservoir could be regarded as not having been discovered prior to July 27, 1976. Aminoil stated that it "did have information that the reservoir was commercially producible under (B)(iii)" and believed the information to show that the reservoir was capable of producing in paying quantities as stated in paragraph (3)(B) and therefore did not believe the wells qualified for section 102 pricing" (Notice of Appeal to Director at 4). To have filed for section 102 pricing, Aminoil pointed out, would have required filing a sworn statement that the wells were in fact eligible under section 102, which would have been a know-ing and willful violation of the NGPA, subjecting Aminoil, as well as its employee signing the document, to civil and criminal penalties under 15 U.S.C. § 3414 (1988).

Aminoil explained that its understanding of section 102 was based on reading "or" at the end of paragraph (d)(2)(B)(ii) in the disjunctive. Aminoil therefore concluded that a reservoir would be considered to have been discovered prior to July 27, 1976, and would not qualify for section 102 pricing if the available evidence met any of the three provisions of (d)(2)(B). When Aminoil learned that its interpretation of the statute was inconsistent with that adopted by FERC, it asserts that it submitted an application for section 102 prices. Aminoil stated that there was no reporting service or other means of ascertaining the criteria by which section 102 prices were granted or denied by FERC and that it learned

of FERC's interpretation of section 102 only through an informal contact by one of its employees (Notice of Appeal to Director at 5-6).

The Director's decision responded:

The record indicates that gas produced from the well[s] from the date of first production qualified for incentive pricing under § 102 of the NGPA, 15 U.S.C. § 3301 (1983) [sic]. From my review of the facts in this case, it is evident that the Appellant could have applied initially for the § 102 price rather than the § 104 price. Lessees must act prudently to obtain the proper price for the benefit of the royalty interest owner.

(Decision at 2). The decision acknowledged Aminoil's argument but disagreed that it had any effect on the royalties due: "Simply stated, the Appellant's mistaken belief that it was charging the highest allowable price for its production, even though held in good faith, does not relieve it of its responsibility to pay royalties based on the actual value of that production as determined by the Secretary" (Decision at 4; emphasis in original). 3/

On appeal to the Board, Phillips criticizes the decision for failing to respond to Aminoil's arguments. Phillips renews those arguments and further states that FERC had taken a "very narrow and limited" stance on well classification filings, developed its interpretation of NGPA's provisions through case-by-case review of applications, and that basic issues concerning its interpretation of the NGPA remain in litigation (Brief on Appeal at 9). Phillips contends that its interpretation was reasonable and points out that the decision "does not find that Aminoil acted incorrectly, or that it should have made a different interpretation; rather it merely concludes, with benefit of 20-20 hindsight, that the wells always qualified for Section 102 prices" (Brief on Appeal at 10).

In its Answer, MMS restates the Director's conclusion that Aminoil's beliefs about the meaning of section 102 did not excuse it from paying royalties based on the value of production. In particular MMS asserts: "The fact that wells on the lease qualified for § 102 pricing indicates that Aminoil could have obtained this price from the date of first production. Therefore, Aminoil breached its duty to obtain the best price obtainable and the MMS must be compensated for the lost royalties" (Answer at 4).

[2] Our resolution of this appeal is controlled by our decision in Mobil Oil Corp., 115 IBLA 304 (1990). In that case, Mobil valued the gas produced from a well on lease OCS-G 2559 from December 1978 through October 31, 1984, at the NGPA section 104 ceiling price. Following an audit, Mobil applied for a determination that the gas qualified under NGPA section 102 for a higher ceiling price, and received subsequent approval. MMS sought additional royalties for the period December 1978 through October 31, 1984, arguing that the gas should have been valued at NGPA

3/ The Director used this same language in denying the appeal in another case involving section 104 and section 102 pricing, Mobil Oil Corp., 115 IBLA 304, 306 (1990), discussed supra.

section 102 prices during that period. After setting forth the arguments of the parties and the applicable law, we stated: "Accordingly, we find the real issue presented by this case is whether appellant has breached its duty to market the gas by failing to seek classification of the gas under section 102 at an earlier time." Id. at 310.

As argued by the parties, the issue in this case is whether Aminoil breached its duty to market the gas at the highest possible price by failing to seek section 102 pricing at an earlier time. Thus, the issue is identical to that presented in Mobil. ^{4/} For that reason, as in Mobil, we will set aside MMS's decision and refer this case for a hearing on this issue. ^{5/}

We will, however, dispose of appellant's second argument that MMS "may not establish minimum values on a retroactive basis, cannot use an audit as the procedure for establishing such minimum values and can establish such values only after due notice to the Lessee" (Notice of Appeal to Director at 7; Brief on Appeal at 11-12). In particular, Phillips points to section 3(a)(2) of its lease which states:

It is expressly agreed that the Secretary may establish minimum values for purposes of computing royalty on products obtained from this lease, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, or area, to the price received by the Lessee, to posted prices, and to other relevant matters. Each such determination shall be made only after due notice to the Lessee and a reasonable opportunity has been afforded the Lessee to be heard. [Emphasis added.]

Phillips asserts that neither Aminoil nor the co-lessees received notice of a determination of minimum value as referred to in the lease and regulations and there has been no opportunity to be heard (Brief on Appeal at 12). Contrary to the Director's determination that such a procedure is provided by the Department's appeal regulations at 30 CFR Part 290 and 43 CFR Part 4, Phillips argues that the right of appeal "is clearly not the notice required by the lease or the regulation" (Brief at 14). Rather, Phillips argues, the lease and regulation contemplate a separate procedure under which the agency

^{4/} As discussed in Transco Exploration Co. & TXP Operating Co., 110 IBLA 282, 326-27, 96 I.D. 317, 384 (1989), the implied obligation of a lessee

to exercise good faith in the marketing of gas, where royalty payments are dependent upon the price at which the gas is marketed, does not rise to the level of a fiduciary duty and a claim for increased royalties is subject to the defense that the lessee exercised reasonable business judgment in pricing its gas for the market.

^{5/} Although we are referring this case for a hearing, we must note that the record forwarded to the Board by MMS failed to include any documentation regarding how MMS determined the amount of additional royalties due for lease OCS-G Lease 2735 during the period in question or what within that assessment constitutes the contested \$72,307.

provides notice of "what the proper value should be, and allows the lessee to challenge or comply with that determination before a demand is made" (Brief at 15).

Although framed in terms of due process, the issue Phillips raises is not primarily a Constitutional question. Constitutional due process does not in all cases require a notice and opportunity to be heard prior to the issuance of a decision, but may be satisfied by providing an opportunity to be heard prior to the time the initial decision becomes final.

Davis Exploration, 112 IBLA 254, 260 (1989); Transco Exploration Co. & TXP Operating Co., 110 IBLA at 312, 96 I.D. at 384. In this case, appellant has been able to present its position first to the Director of MMS and now this Board. The issue Phillips raises, as we see it, concerns the meaning of the lease provision. Phillips reads it to mean that the Department must provide notice and an opportunity for a hearing prior to making a value determination and can apply the determination only to gas produced after the determination has been made.

[3] Phillips' reading must be rejected as fundamentally flawed. The consequence of such an interpretation of the lease provision would be that royalties would never be paid based on the fair market value of the production for which they are paid. The regulations and lease provision set forth a number of relevant posted and paid prices which may be considered in determining the fair market value of production for royalty purposes. Under the system envisioned by Phillips, the Government would be required to review such prices in relation to each lease, issue a notice to each lessee, review the responses submitted, perhaps hold evidentiary hearings, issue decisions, and allow appeals, following which the value determination could become effective. The oil and gas market, however, is not static. Under such a procedure, a value determination would always be based on prices posted and paid for earlier production and would reflect the value of that production rather than current production.

Instead, it has long been the practice to accept royalty payments subject to audit. See Supron Energy Corp., 46 IBLA 181, 189-91 (1980), appeal filed sub nom. Atlantic Richfield Co. v. Watt, No. 81-0615 (D.N.M. Aug. 29, 1981). Lessees report and pay royalties based on the prices they have received and the Department usually accepts such payments as reflecting the value of the production. In some cases, however, an audit or other review of royalty reports will reveal that the price received was not the value of the production. When this occurs, the Department cannot be bound by the price reported by the lessee and MMS must have authority to determine for royalty purposes that the production had a different value than the amount reported. See Supron Energy Corp., 55 IBLA 318, 321 (1981), appeal filed sub nom. Supron Energy Corp. v. Andrus, 80-0463 (D.N.M. June 18, 1980). Clearly, however, a lessee who is required to pay additional royalties is entitled to a reasoned and factual explanation supporting the decision setting a different value. Exxon Company, U.S.A., 113 IBLA 199, 205 (1990); Amoco Production Co., 78 IBLA at 98. As provided by the lease, the determination will be imposed by the Department only after notice and an opportunity to be heard has been provided. Departmental regulations establish

that the opportunity to be heard is satisfied by appeal to the Director of MMS and subsequent appeal to this Board.

In this case, we have determined that the issue for resolution requires that we refer the case to the Hearings Division for assignment of an Administrative Law Judge.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision of the Director, MMS, dated June 12, 1987, is set aside and the matter is referred to the Hearings Division for assignment of an Administrative Law Judge to conduct a hearing and issue an initial decision, which, if not appealed to this Board, will be final for the Department.
6/

Gail M. Frazier
Administrative Judge

I concur:

Bruce R. Harris
Administrative Judge

6/ The lease was issued with a 25-percent interest in Burmah Oil and Gas Company (which became Aminoil), a 15-percent interest in Texas Pacific Oil Company, Inc., a 15-percent interest in El Paso Natural Gas Company, and a 45-percent interest in Amoco Production Company. The gas sold by Aminoil represented its 25-percent interest in the gas produced. See Exh. A to Gas Purchase Contract dated as of July 5, 1978, between Natural Gas Pipeline Company of America and Aminoil. It is not clear from the record whether the other interest holders in the lease have been notified as to the royalty value determination. See Forest Oil Corp., 113 IBLA 30, 43, 97 I.D. 11, 19 (1990). In addition, the price paid for the balance of the gas produced from this lease and the royalty paid thereon would appear to be relevant to whether or not appellant properly valued its gas during the period in question. See Mobil Oil Corp., 115 IBLA at 310 n.9.