

STATE OF WYOMING

IBLA 89-266

Decided January 24, 1991

Appeal from a decision of the Wyoming State Director, Bureau of Land Management, approving a request by Union Oil Company of California for a royalty rate reduction. Cheyenne 037867.

Affirmed.

1. Mineral Leasing Act: Royalties--Oil and Gas Leases: Royalties: Generally

The discretionary authority conferred by 30 U.S.C. § 209 (1988), enables BLM to exercise prudent business judgment in considering whether to grant or deny an application for royalty reduction. Where BLM grants such a reduction "for the purpose of encouraging the greatest ultimate recovery of \* \* \* oil, \* \* \* and in the interest of conservation of natural resources," and where in its judgment "it is necessary to do so in order to promote development," BLM's determination will not be disturbed on appeal where it is amply supported by the facts of record and appellant has failed to show that the determination was either arbitrary, capricious, or an abuse of discretion.

APPEARANCES: Vicci M. Colgan, Esq., Office of the Attorney General, Cheyenne, Wyoming, for the State of Wyoming; William R. Murray, Esq., Office of the Solicitor, Washington, D.C., for the Bureau of Land Management; George D. Bennett, Esq., Midland, Texas, and Charles L. Kaiser, Esq., Denver, Colorado, for Intervenor Union Oil Company of California.

OPINION BY ADMINISTRATIVE JUDGE KELLY

The State of Wyoming (State) has appealed from a January 18, 1989, decision of the State Director, Wyoming, Bureau of Land Management (BLM). That decision authorized a royalty rate reduction for the period from October 1, 1981, through January 17, 1985, on Federal lease Cheyenne 037867. At all times pertinent to this appeal, Union Oil Company of California (Union), was the owner of 100-percent working interest in the lease, which is located in the South Casper Creek Field, Natrona County, Wyoming. The State asserts that under 30 U.S.C. § 191 (1988), it is entitled to 50 percent of the royalty receipts from the lease.

Factual Background

By letter of December 17, 1980, Union notified Geological Survey (Survey) that it planned to conduct a steam injection project on the lease. Union stated that the purpose of the project was "to recover additional heavy oil reserves from the Tensleep formation." Union noted that fuel requirements for the steam generators "are approximately 1400 MCF/day, and arrangements have been made with Northern Utilities to obtain fuel gas as needed."

By letter of April 24, 1981, Union notified Survey that it had entered into a gas sales agreement with Northern Utilities to obtain "an alternate 'clean' fuel for steam generator and accessory facilities firing." Union noted that while it had access to royalty-free crude oil produced from the lease as fuel for firing the steam generators, 1/ the use of such fuel was impractical for three reasons: (1) the volume of South Casper Creek Field crude production was inadequate to meet the fuel oil requirements of the steam generators; (2) crude oil from the lease, upon combustion, would produce pollution, particularly sulfur dioxide, which would exceed acceptable air quality pollution emission rates; and (3) difficulty in preparing high viscosity lease crude oil for firing in an oil field steam generator. Union pointed out that under its plan, the steam drive project could be initiated immediately, without harmful environmental consequences, and all production attributable to the steam drive project would be available for sale. Accordingly, Union requested the United States to "bear its proportionate share of the substitute fuel through a royalty elimination on a thermally equivalent amount of indigenous produced Tensleep zone crude oil."

On October 1, 1981, Survey's Casper office approved, effective October 1, 1981, Union's request for a royalty credit for alternate fuel. 2/ Subsequently, by memorandum of December 20, 1985, the Chief, Royalty Valuation and Standards Division of the Minerals Management Service (MMS), advised the Chief of the Royalty Compliance Division that a review of Survey's October 1, 1981, approval of Union's royalty credit had been performed.

1/ Pursuant to the terms of Notice to Lessees and Operators (NTL-4A) effective Jan. 1, 1980, onshore oil production subject to royalty includes royalty "produced and sold" from a lease, excluding oil or gas produced from a lease which is used for the benefit of that lease for "operating or producing purposes such as \* \* \* (4) fuel for firing steam generators for the enhanced recovery of oil." NTL-4A, 44 FR 76600 (Dec. 27, 1979).

2/ Survey issued its approval subject to a number of conditions. One was that "one barrel of outside fuel oil will equal one barrel of produced oil as a royalty credit." Another was that if gas were used, "5.296 Mcf of gas will credit as one barrel of lease oil for royalty accounting." A third was that outside fuel credit could never exceed production royalty volume for any monthly period.

The memorandum states in pertinent part as follows:

We have determined that no authority exists to exchange lease production for a different type of fuel and receive a royalty credit. \* \* \*.

Section 39 of the Mineral Leasing Act of 1920 [30 U.S.C. § 209 (1988)] as amended, only authorizes the Secretary of the Interior to reduce the royalty rate. That Act does not provide authorization for waiving a royalty that is due under the lease. As to the requested credit against royalties that would be due from the sale of the oil that would not be used on the lease, granting a credit such as that approved in 1981 places the Department of the Interior \* \* \*, as lessor in the position of sharing in the costs of producing the lease. The Department has long held that it is the lessee's responsibility to bear these costs.

By memorandum of August 4, 1988, to the Wyoming State Director, BLM's Deputy Director advised that "we are in agreement with the conclusion of MMS that no authority exists to exchange lease production for a different type of fuel from other sources and receive a royalty credit." The Deputy Director suggested that Union be notified of termination of the 1981 royalty credit.

However, on November 2, 1988, the Solicitor's office issued an opinion concluding that the circumstances described by Union in its April 24, 1981, letter to Survey "were within the scope of the royalty reduction authority under section 39 [30 U.S.C. § 209 (1988)]." Relying on that opinion, the Wyoming State Director issued his January 18, 1989, decision. He held that Survey's 1981 action approving a credit "was based upon a thermal enhanced oil recovery project that was unproven for the area \* \* \* [which] increased oil production on lease Cheyenne 037867." He noted that the intent of the October 1981 approval was to "promote development and to encourage the greatest ultimate recovery of oil and, as such, was in the interest of conservation of natural resources." He therefore authorized Survey's 1981 approval "to be valid as a royalty rate reduction," from October 1, 1981, through January 17, 1985. <sup>3/</sup>

#### Contentions of the Parties

The State argues that no statute, regulation, or notice to lessees provided authority for allowing a credit for the use of off-lease fuel

<sup>3/</sup> On Dec. 8, 1988, the State Director had issued a letter-decision notifying Union that rather than a royalty credit, a "royalty rate reduction" should have been issued. Citing section 39 of the Mineral Leasing Act (30 U.S.C. § 209 (1988)), he issued such a royalty rate reduction, effective Oct. 1, 1981. On Jan. 4, 1989, the State Director vacated his Dec. 8, 1988, decision to allow Union to present new information. Thereafter, he issued the decision under appeal.

on the lease. The State contends that it was arbitrary and capricious to grant a royalty credit in the guise of a royalty rate reduction and in reliance on 30 U.S.C. § 209 (1988), because the prerequisites of that statute and its implementing regulations were not met. The State asserts that no statute, regulation, or notice to lessees authorized a credit for use of off-lease fuel on the lease, and therefore the grant of such a credit, as well as the subsequent ratification of that action as a royalty reduction, were arbitrary and capricious. The State contends that under 30 U.S.C. § 209 (1988), a royalty reduction may be allowed "only when development could not otherwise economically occur" (Statement of Reasons (SOR) at 9-10). The State points out that 43 CFR 3103.4-1(b) and (c) (previously 43 CFR 3103.3-7), require the submission of detailed financial information concerning the costs of operating the lease, the income from the sale of production, and all facts tending to show whether successful operation can occur on fixed royalty or rental. The State contends that BLM erred in granting the royalty rate reduction without making a finding that lease operations would otherwise be economically unfeasible, and in ignoring the requirements of the above regulations, longstanding Departmental interpretation on royalty reduction, and its own guidelines. The State stresses that regulations have the force and effect of law but acknowledges that BLM's internal guidelines do not. As an example of longstanding Departmental interpretation, the State quotes from an August 5, 1933, memorandum by the Director, Survey:

Granting of reductions in royalty in cases where warranted effectuates continuation for the longest possible time operation of existing wells which would otherwise be abandoned for economic reasons, encourages the extraction of a maximum percentage of recoverable oil to the benefit of the government and the lessee, and therefore results in the conservation of natural resources. [Emphasis in original.]

(Quoted in the SOR at 11, emphasis by the State). The State alleges that the record fails to show either that the reduction was needed to promote development, or was in the interest of conservation of oil and air quality. The State suggests that the reduction was given for an "enhanced recovery project" and sets a precedent for such actions in the future, where lessees, though operating at a profit may still obtain a royalty reduction.

BLM suggests that while the regulations (43 CFR 3103.4-1) require that an application for royalty reduction should contain certain information, the regulatory requirement does not alter BLM's authority to grant a royalty reduction under either of the criteria in 30 U.S.C. § 209 (1988), and that it is for BLM to determine whether sufficient information was provided. Further, BLM argues that since Survey and BLM analyzed all pertinent factors, the decision to grant the royalty rate reduction was neither arbitrary nor capricious. BLM points out that the result of the decision has been receipt by the Government of additional royalties from increased production, particularly since February 1985.

Union explains in its brief that its steam injection tertiary recovery program was a response to a substantial decline in production on Cheyenne 037867 and the South Casper Creek field in 1980. Union reiterates the reasons why it chose to use off-lease fuel for its steam generators stated in its April 24, 1981, letter to Survey:

First, because Lease oil possesses a sulfur content approximately 4.40% by weight, expensive "scrubbers" would have been required if such oil were used to fuel the steam generators. Acquisition and installation of such scrubbers would have delayed the proposed program and the anticipated breakdown of scrubbers during winter months when atomization of low gravity crude oil is difficult, would have resulted in either downtime that was inimical to the program or pollution control problems. \* \* \* Second, given that each of the steam generators would consume 250 barrels of oil per day, oil production from the Lease was significantly less than that necessary to satisfy those requirements, and the anticipated lag in production even after the program was commenced, the proposed program could not be properly commenced at least in its early stages through use of Lease oil. \* \* \* Third, because gas rather than oil would be used to fuel the generators and oil production would increase after tertiary operations were commenced, additional quantities of oil would be produced and marketed.

(Answer at 3-4).

Union contends that as a result of its tertiary recovery program "production increased dramatically; [4/] increased gross royalties from enhanced production are \$1,281,539.26 and increased net royalties \* \* \* are \$534,603.26." Although active steam injection operations ceased in 1985 "enhanced production continues to date because oil within the Lease has been heated to temperatures substantially greater than those that prevailed prior to commencement of tertiary recovery operations" (Answer at 5).

Union disputes the State's position to the effect that the Department has long held that a grant of section 39 (30 U.S.C. § 209 (1988)) royalty relief is available only if the lessee can demonstrate that the lease cannot otherwise be successfully operated. Union asserts that the plain language of section 39 authorizes royalty relief to promote development consistent with the interests of conservation of natural resources and for the purpose of encouraging the greatest ultimate recovery of oil and gas, and that such relief is not limited to circumstances where the lease cannot be successfully operated. Thus, Union notes that the 1933 Survey memorandum relied

4/ In an affidavit filed with its SOR, Union's District Joint Venture Manager states that the tertiary recovery program resulted in an increased production of 655,751.4 barrels of oil which would not have been realized if the program had not been undertaken.

on by the State does not reflect the Department's authority because the "promote development" standard was not enacted until 1946. <sup>5/</sup>

Discussion

The Secretary of the Interior is authorized by 30 U.S.C. § 209 (1988) to grant reductions in production royalties. That section reads in relevant part:

The Secretary of the Interior, for the purpose of encouraging the greatest ultimate recovery of \* \* \* oil, gas, \* \* \*, and in the interest of conservation of natural resources, is authorized to \* \* \* reduce the rental, or minimum royalty, or reduce the royalty on an entire leasehold, or on any tract or portion thereof segregated for royalty purposes, whenever in his judgment it is necessary to do so in order to promote development, or whenever in his judgment the leases cannot be successfully operated under the terms provided therein.

In Peabody Coal Co., 93 IBLA 317, 321, 93 I.D. 394, 396 (1986), we stated that "[t]he ultimate issue in the adjudication of any royalty reduction request is whether BLM may properly conclude, on the basis of material submitted by an appellant, that granting a reduction would best serve the interests of the Government." We held that 30 U.S.C. § 209 (1988), confers upon BLM

[t]he discretionary authority \* \* \* to exercise prudent business judgment to accept the alternative that best protects the economic interest of the United States as owner of the mineral resource. It necessarily follows that if the circumstances of a given case do not confront BLM with such a choice, the case presents no opportunity for BLM to exercise the discretion conferred by section 209. This conclusion is underscored by the fact that section 209 requires BLM to make one of two alternative threshold determinations before its discretionary authority can be invoked: (1) that a reduction "is necessary to promote development," or (2) "the leases cannot be successfully operated under the terms provided therein." [Footnote omitted.]

Id. at 326-27, 93 I.D. at 399-400.

The developmental scenario proposed in 1981 by Union, and the carrying out of those operations with ultimate resource recovery and benefits of increased royalties to the Government, as demonstrated in the record before

<sup>5/</sup> In Solicitor's Opinion, M-36920, 87 I.D. 69, 73 (1980), the Deputy Solicitor noted that the criterion "whenever \* \* \* necessary \* \* \* in order to promote development" consistent with the interests of conservation and the greatest ultimate recovery, was added in 1946, when Congress amended section 39 to essentially its present form.

us, is unrefuted by the State. That record shows, contrary to the assertions of the State, that Union's tertiary production was carried out so as to achieve ultimate recovery utilizing methods protective of air quality. The statute authorizes a royalty reduction when, in the judgment of the Secretary such a reduction is necessary to promote development. Thus, the question of necessity is one for the judgment of the Secretary, or his delegate, BLM. Here, BLM evaluated Union's 1981 scenario for tertiary recovery as necessary to promote development. In effect, BLM made a business judgment that Union's tertiary recovery program would best serve the economic interests of the Government. <sup>6/</sup> We are unable to find, based on this record, that this finding was either arbitrary, capricious, or unreasonable. On the contrary, it appears that the best economic interests of the Government have been served.

In response to the State's argument that applicable regulations were ignored, we note that the information furnished to Survey in 1981 essentially satisfies the intent of 43 CFR 3103.4-1(c), because it does address the expenses and costs of operating the lease, and provides for a method, commensurate with statutory goals, of promoting development. In the SOR at page 9, the State asserts that 43 CFR 3103.4-1 "requires that royalty reduction be based on economics." It can hardly be argued, in view of the record, that BLM's action was not based on economics.

The State has also urged that the Department has consistently interpreted 30 U.S.C. § 209 (1988) to allow a royalty reduction to promote development only when the development could not otherwise economically occur. The State asserts that "this is clear" from 43 CFR 3103.4-1 (SOR at 10-11). Neither the statute nor the regulations limit the exercise of the Secretary's discretion to this criterion. Nor did we hold in Peabody or any other Board decision that the only circumstance authorizing royalty reduction to promote development is when development cannot otherwise economically occur. To so hold would render the section 209 language "whenever \* \* \* necessary \* \* \* to promote development" meaningless. As noted in Solicitor's Opinion, M-36920, 87 I.D. at 73, this language was added to

<sup>6/</sup> In a Dec. 23, 1986, memorandum to the State Director, the Casper District Manager stated in part:

"At the time the application was made, it was believed that much of the oil to be produced would be incremental oil, or oil which would have otherwise remained in the reservoir without the benefit of steamflooding, an enhanced oil recovery method. The terms of the approval recognized that oil produced on the lease would be an undesirable lease fuel, and allowed royalty credit to be applied to lease oil for each barrel of off-lease oil used to operate the leasehold steam generating facilities. Further, a provision setting the gas equivalent of a barrel of fuel oil was also approved so that royalty credit could be given when natural gas from off-lease was used for the same purpose. The approval in no way affected the royalty payments due on the substitute fuel."

(Emphasis supplied.)

section 209 "as an alternative to finding that the lease 'cannot be successfully operated'" and gave the Secretary "greater discretion in granting relief." (Emphasis added.) Thus, the Department has not interpreted section 209 in the manner alleged by the State. On the contrary, the Department has acknowledged that finding a lease cannot be economically developed is not a prerequisite for finding royalty reduction is necessary to promote development.

Insofar as they have not been discussed herein, the State's other arguments have been considered and rejected.

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

John H. Kelly  
Administrative Judge

I concur:

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C. Randall Grant, Jr.  
Administrative Judge

ADMINISTRATIVE JUDGE ARNESS DISSENTING:

On October 1, 1981, Geological Survey (Survey) approved a royalty credit for alternative fuel used by Union Oil Company of California (Union) to generate steam for secondary recovery operations on Federal lease Cheyenne 037867 in the South Casper Creek Field. Union had earlier applied for approval of a steam injection project to enhance recovery from the field, where discovery had occurred in 1922. After the project was approved, Union sought and obtained the royalty credit from Survey for use of fuel produced from sources not located on the lease where the enhanced recovery operations were located.

In May 1985, the Minerals Management Service (MMS), a successor agency, challenged the alternative fuel credit, concluding it lacked a legal foundation. An evaluation prepared by MMS in May 1985 found that, insofar as a royalty credit to a Federal lessee for use of fuel produced off the Federal lease was concerned:

The Federal lessee has sole responsibility to provide the necessary power to operate lease equipment and put lease production in marketable condition. The fact that the preferred type of lease hydrocarbons--or even that there are no combustible hydrocarbons--is not available in the field does not obligate the lessor either to share the cost of providing the necessary energy or to allow a royalty credit for a substitute fuel. Although the lease and regulations provide for royalty-free use of hydrocarbons for lease fuel, they do not grant the lessee the right to substitute fuels which are not available on the lease and to receive a royalty credit for such use.

Id. at 4. 1/

Nonetheless, on December 6, 1989, the Wyoming State Office, Bureau of Land Management (BLM), approved the royalty credit granted in 1981 by Survey, explaining that "[a]lthough the fuel substitution approval was appropriate, it has been determined that the royalty credit should have been issued as a royalty rate reduction." This decision was withdrawn however, and on January 18, 1989, the decision appealed by the State of Wyoming was issued.

The decision of January 18, 1989, which is now before us on review, purported to rely on section 39 of the Mineral Leasing Act (MLA), 30 U.S.C. § 209 (1988), which confers authority on the Secretary of the Interior to reduce royalty under certain conditions. Citing an Assistant Solicitor's opinion, the January 18, 1989, decision found that the 1981 royalty credit

1/ MMS suggests that a misinterpretation of NTL-4A, effective Jan. 1, 1980, may underlie the initial error made by Survey (MMS Findings and Conclusions at 3). The State discusses this aspect of the appeal, observing that Union relied on NTL-4A "as authority for allowance of the royalty-free substitution" (SOR at 7).

allowed by Survey was properly allowable as a royalty rate reduction under MLA section 39, because "[t]he intent of the October 1981 approval was to promote development and to encourage the greatest ultimate recovery of oil and, as such, was in the interest of conservation of natural resources." Id. at 1. The decision under review then quoted from the Assistant Solicitor to the effect that

the circumstances described by Union in its 1981 letter to USGS [requesting that the United States "bear its proportionate share of the substitute fuel though a royalty elimination" on the Federal lease, referred to by Union as a "jointly held asset"] were within the scope of royalty reduction authority under [MLA] section 39. You may ratify the action taken by USGS in 1981 by recognizing it as a royalty reduction which was to "promote development" of oil and which was "in the interest of the conservation of both oil and air quality."

Id. at 2.

The State contends that this advice was acted upon by BLM in error, compounded

in the following ways: 1) it granted a royalty rate reduction to a lease operation that was or appeared to be financially successful in violation of its longstanding regulatory interpretation of 30 USC 209; 2) it granted a royalty rate reduction without lessee's submission of specific information required by the [Departmental] regulations; 3) it granted a royalty rate reduction in violation of its longstanding guidelines; and 4) it granted a royalty rate reduction with nothing in the record to show that the reduction was "necessary \* \* \* to promote development."

(Statement of Reasons (SOR) at 8, 9). All four of these contentions are correct. The contrary position taken by the lead opinion violates MLA section 209, Departmental regulations, past decisions of the Department, the Survey manual and Instruction Memoranda issued by the Director of BLM. The first and third of the contentions raised by the State are of primary importance on appeal. 2/ The lead opinion has correctly quoted MLA

2/ As the State points out, there is an implication in the documents submitted by Union that use of off-lease fuel was better from an environmental standpoint than was use of the oil recovered from the lease. The State points out that this is not a supportable position, whatever relevance it may have, since the State's Air Quality Division had approved use of oil from the lease for the steam recovery project, having found that such usage was permissible within existing environmental laws affecting emissions.

In this same vein, the State invites attention to the fact that two Instruction Memoranda (IM) issued by the Director of BLM in 1988, established standards for royalty reduction (eligibility criteria) for credits for fuel substitution which Union's operation could not meet, because it had not used off-lease fuel for the required minimum time set by the

section 209, including the language quoted by Wyoming's SOR in the fourth assignment of error. Portions of our opinion in Peabody Coal Co., 93 IBLA 317, 93 I.D. 394 (1986), construing MLA section 209, are also quoted. Neither the statute nor the Board opinion are analyzed in light of the facts of this appeal, however, and the result is a perpetuation of error committed by BLM.

Prior to our decision in Peabody, the Solicitor had considered the effect and operation of MLA section 209 in an "M" opinion by Deputy Solicitor Ferguson, Reduction of Production Royalties Below Statutory Minimum Rates, M-36920, 87 I.D. 69 (1979). The opinion found the authority conferred by section 209 to be limited by prudential considerations. Following an analysis of Kerr-McGee Corp., 12 IBLA 348 (1973), the Ferguson opinion concluded that section 209 is "essentially a relief provision, to be applied to modify the fixed lease terms when, and only so long, as necessary." Id. at 78. Applying this same fundamental logic in Peabody, we found that any relief granted under section 209 must be predicated upon a finding of necessity, which must first be documented by an applicant before relief can be granted. Contrary to the instant decision by BLM, we found that section 209 cannot, alone, give rise to entitlement to a reduction. Peabody, 93 IBLA at 326, 93 I.D. at 399.

Peabody, like Kerr-McGee Corp., was a coal case. Peabody had acquired a Federal lease with a bonus royalty in competitive bidding, which it then sought to have reduced because economic conditions changed after the lease issued. The coal leased was a "bypass" deposit, eligible for leasing at a time when leasing was otherwise prohibited, in order to conserve the Federal coal resource because it was located next to a mine where continuing operations by Peabody might have isolated the tract before leasing again became allowable.

After considering the Ferguson opinion we concluded that "to the extent the interest of the United States may require lowering the statutory minimum royalty \* \* \* to whatever level is necessary to ensure successful operation

fn. 2 (continued)

IM's when the request for royalty relief was submitted in 1981 (see IM No. 88-602, Aug. 2, 1988, and Change 1, Oct. 3, 1988). (Arguably, of course, these 1988 instructions do not apply to the 1981 reduction.)

And finally, the State correctly argues that the Survey Manual established a threshold requirement that it be shown, before royalty reduction could be allowed, "[t]he lease must be, or soon will be, operating at an economic loss and a reduction of royalty is necessary to allow the continued production of oil or gas." Survey Manual Part 646.1.3.A.(1) (1980). No such showing was ever made by Union here. The State contends that while the instruction memoranda issued by BLM and the Manual used by Survey are not binding on this Board, they are binding on the agencies using them, and both BLM and Survey were prevented from allowing royalty reduction contrary to their guidelines. United States v. Kaycee Bentonite Corp., 64 IBLA 183, 89 I.D. 262 (1982).

of a lease, section 209 provides such authority." Peabody, 93 IBLA at 334, 93 I.D. at 404. We then stated this general rule governing royalty reduction:

But this holding rests on the premise that section 209 gives BLM authority to grant such relief only when it is in the economic interest of the United States to do so. \* \* \* Section 209 cannot be construed so as to provide a loophole for lessees to circumvent the requirement that the Government receive fair market value for a lease as determined by conditions in effect at the time of lease issuance.

Id.

In Peabody we also considered the meaning and effect of the phrase "to promote development," explaining:

Although appellant emphasizes the phrase "to promote development" in the statutory authorization for reducing royalty, appellant fails to notice the statute includes the limiting word "necessary." Because a royalty operates as a direct cost on development, reduction of royalty would almost always promote development, all other things being equal. Thus, the statute cannot be read to authorize reduction of a royalty whenever doing so would promote development; indeed, the statute only authorizes such action where it is necessary. \* \* \* Unless an applicant shows that [resource conservation cannot be achieved] without a royalty reduction, [section 209] confers no authority on the Department to grant such a reduction. [Emphasis in original.]

93 IBLA at 327, 93 I.D. at 400.

We also considered when and how BLM should consider royalty reduction, stating that "[s]ection 209 specifies no circumstance which requires BLM to reduce royalty. Under the statute, no entitlement to such a reduction can ever arise." 93 IBLA at 326, 93 I.D. at 399. The opinion explains this conclusion:

BLM remains free to accept the economic consequences of denying royalty relief, which may vary from case to case. These consequences may be sufficiently severe to compel a lessee to seek suspension of the condition of continued operation \* \* \*. Or a lessee might be impelled to relinquish the lease. The discretionary authority conferred by section 209 enables BLM to exercise prudent business judgment to accept the alternative that best protects the economic interest of the United States as owner of the mineral resource. It necessarily follows that if the circumstances of a given case do not confront BLM with such a choice, the case presents no opportunity for BLM to exercise the discretion conferred by section 209. This conclusion is underscored by

the fact that section 209 requires BLM to make one of two alternative threshold determinations before its discretionary authority can be invoked: (1) that a reduction "is necessary to promote development," or (2) "the leases cannot be successfully operated under the terms provided therein." On the basis of material that an appellant is required to submit in its application, BLM must be able to find there is a reasonable probability operations would cease or development, recovery, or conservation of the resource would be jeopardized before it can even consider exercising its discretion to grant relief. Otherwise, the Federal mineral owner has nothing to gain by reducing the royalty. [Footnote omitted.]

93 IBLA at 326, 327, 93 I.D. at 399, 400. Although Peabody had argued that royalty reduction was justified, both to promote development and because of economic necessity, we denied relief, finding that the record developed by Peabody was insufficient to establish either alleged ground for relief.

The same conclusion should be reached here. As the State points out, Departmental regulation 43 CFR 3103.4-1, establishing minimum requirements for an application for royalty reduction, have not been met. (Cf. also, 30 CFR 203.50 (Reduction of royalty or net profit share)). Union did not submit the application required by 43 CFR 3103.4-1(b) and (c), of course, because it did not apply for a royalty reduction, having instead sought a royalty credit under provisions of NTL-4A (1980). Since there was no application for royalty reduction by the lessee in this case, naturally the regulations respecting such applications were not followed. What Union wanted, according to its letter dated April 24, 1981, was cost sharing by the United States to help develop a steam recovery operation on the Federal lease, which it referred to as the "common goal of the Union Oil Company of California and the United States Government." Id. at 2. This assumption, that the United States was a candidate for a joint venture in the sense that it should be willing to share in production costs for a common benefit, was false. Later attempts to legitimize the allowance of royalty credit granted in error by Survey also fail because of this flawed beginning. It is a fundamental rule of administrative law that post hoc rationalizations by counsel that are not grounded in the record cannot be validated on review. Burlington Truck Lines v. United States, 371 U.S. 156 (1962); S.E.C. v. Chenery Corp., 332 U.S. 194 (1947). On the record before us, therefore, the decision to reduce royalty is unsupported because there has been no showing that it was needed to obtain continued production.

Because no application for royalty reduction was ever before BLM for evaluation, there was no consideration given to whether Union had satisfied the requirements imposed by law on lessees seeking the benefits of section 209. That statute was first seized upon, not by Union, but by BLM, acting in 1989 to rectify the error committed by Survey in 1981. This attempt to "paper-over" a blunder by another agency of the Department fails, because there is nothing in the administrative record before us to show that royalty reduction was necessary to promote development. There is no such showing, partly because there was never an application for royalty reduction, but also because there is no suggestion that such relief was ever

necessary in fact. On the record before us, it does not appear that Union's lease operations were ever in economic difficulty or that there were problems in resource recovery. It is apparent, therefore, that neither statutory ground for royalty reduction exists. 43 CFR 3163.4-1.

"Necessity," in the sense of that word as explained by the Peabody opinion, must be shown in any case where there is an application for royalty reduction, regardless whether the reason offered for reduction is that it is needed to promote development or that it is necessary because of economic duress. Peabody Coal Co., 93 IBLA at 327, 93 I.D. at 400. Since there has been no such showing here, the State correctly argues that the decision to allow a reduction anyway is without legal and factual foundation. Moreover, to allow a belated reduction "application" in the instant case has the future effect of allowing royalty rate reduction for any enhanced recovery project under the rubric of promotion of development. This result is contrary to the interest of the Federal lessor, who is not a joint venturer with its lessees and cannot, as MMS has pointed out, allow itself to be placed in such a position, because to do so violates the public interest. It is contrary to section 209, which requires a showing of necessity. Peabody Coal Co., *supra*.

As a result, the decision under review lacks a discernable standard of application, unless it can be said that all secondary steam recovery operations are entitled to royalty reduction. If the power to reduce royalty is so broad as the lead opinion would have it, then royalty reduction is allowable to all lessees, simply on a showing that they are engaged in enhanced recovery operations on a Federal lease. This result is not consistent with the limitations established by section 209, which requires the Department to follow rigorous standards established so as to protect the public interest in royalty collection. Peabody Coal Co., *supra*; Solicitor's Opinion, M-36920, *supra*; Kerr-McGee Corp., *supra*.

Accordingly, I respectfully dissent.

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Franklin D. Arness  
Administrative Judge