

Appeal from a decision by the Director, Minerals Management Service, denying appeal of an assessment of additional royalties and late payment interest charges for underpayment of royalties due on Federal oil and gas leases. MMS 88-0213-O&G; MMS 88-0314-O&G.

Affirmed.

1. Oil and Gas Leases: Royalties: Generally

When the purchaser of natural gas produced from Federal leases reimburses the lessee for State taxes pursuant to a contract for purchase and sale of the natural gas, gross proceeds received from the leases include the tax reimbursements. Accordingly, in computing the value of the gas produced from these leases, MMS properly determines that the gross proceeds to which the royalty rate applies include the purchase price plus the tax reimbursements and properly demands additional royalty and late payment charges where royalty payments were made using a value that excluded the tax reimbursements.

2. Oil and Gas Leases: Royalties: Generally

Where a lessee enjoys a contractual right to receive reimbursement for "all existing taxes levied on the gas produced and sold" under the contract, and where, for no apparent justifiable reason, it fails to invoke this right, the lessee is properly held responsible for royalty as though the contractual provision had been invoked. Thus, in the absence of any showing of justification, lessee was responsible for paying royalty on all reimbursements owed under the sales contract, regardless of whether lessee ever enforced its contractual rights by actually collecting the reimbursements.

APPEARANCES: Marla J. Williams, Esq., and Thomas H. McCarthy, Jr., Esq., Denver, Colorado, for appellant; Peter J. Schaumberg, Esq., Howard W. Chalker, Esq., Geoffrey Heath, Esq., and George Fishman, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE HUGHES

BWAB, Inc. (BWAB), appeals a decision by the Director, Minerals Management Service (MMS), dated July 26, 1989, assessing royalties on tax reimbursements and corresponding late payment charges concerning seven Federal oil and gas leases in the HA Creek Field, Wyoming. 1/

BWAB sold natural gas from the seven Federal leases to Panhandle Eastern Pipe Line Company (Panhandle) pursuant to a sales contract providing for the purchaser to reimburse the seller for Wyoming ad valorem sales taxes levied on the gas. 2/ Liquid products extracted from the raw gas were evidently sold pursuant to a separate contract having no tax reimbursement provision.

Pursuant to section 205 of the Federal Oil and Gas Royalty Management Act of 1982, 30 U.S.C. § 1735 (1988), the Wyoming State Auditor performed an audit of the subject leases for the period January 1980 through December 1986. The State Auditor determined that BWAB failed to include the tax reimbursement from Panhandle for the State taxes on the royalty value of the residue gas production.

The record establishes that BWAB did not provide the State Auditor with documentation of the actual amounts it received from Panhandle for these tax reimbursements. The State Auditor estimated the amount added to the value of the production by including the tax reimbursements. He did so by using a formula which he did not explain.

The Director's decision explained that, when BWAB failed to provide the actual amounts it received as reimbursements, the State Auditor computed the tax reimbursement by "deducting the liquid products contract price from the proceeds received for the residue gas and the liquid products" (Decision at 2). The State Auditor had indicated only that he was estimating the taxes based upon mill levy rates applicable to the county in which each lease is located. The Director's decision further explained the formula used by the State Auditor, as follows:

The record shows that the State of Wyoming ad valorem taxes accrue also on the value of any reimbursements so that when the tax is calculated on the value or price of the gas, a tax then

1/ Additional royalties and late payment charges were assessed on production from Federal oil and gas leases Nos. 048-321881, 049-007037, 049-009109, 049-018346, 049-030177, 049-035694, and 049-039138, HA Creek Field, Wyoming.

2/ In its review letter (discussed below), the Wyoming State Auditor referred to the State tax as an "ad valorem" tax that is imposed on production. We have previously described the tax as an "ad valorem severance tax." Enron Corp., 106 IBLA 394, 395 (1989). The terminology applicable to the tax appears not to affect the issues presented by the appeal (see note 6, below).

accrues on that tax and so on ad infinitum. The State applied a formula approved by the Council of Petroleum Accountants Societies (COPAS) that removes the exempt Federal share and captures the "spiraling" effect of the incremental calculations of the tax.

Id. ^{3/} Thus, because State law provides that taxes would also accrue on the amount of any reimbursements paid by Panhandle to BWAB, the auditor applied a mathematical formula designed to capture this "spiral effect." The formula also adjusted the reimbursements to account for the Federal share of production, on which no State taxes were owed and reimbursement paid to lessee.

By demand letter dated May 23, 1988, MMS' Royalty Management Program (RMP) directed BWAB to pay additional royalties in the amount of \$65,183.61 representing the royalty on the amount of the reimbursements that the State calculated had been incorrectly excluded from the value basis of the gas. The RMP cited as authority the regulatory provisions of 30 CFR 206.103 (1987), as well as Part III of Notice to Lessees and Operators of Federal Onshore Oil and Gas Leases (NTL-1)--Procedures for Reporting and Accounting for Royalties, 42 FR 4546 (Jan. 25, 1977). BWAB paid the assessment and filed an appeal with the Director (MMS 88-0213-O&G), on June 27, 1988.

On September 20, 1988, RMP assessed interest in the amount of \$31,650.13 for late payment of the royalties. BWAB filed a second appeal with the Director, docketed as MMS 88-0314-O&G.

In his joint decision concerning both appeals, the Director upheld RMP's assessment and concomitant late charges, rejecting BWAB's arguments that royalties are not due on State tax reimbursements; that the reimbursements calculated by the State exceeded gross proceeds; that use of the COPAS formula improperly attributed royalty bearing reimbursements to the tax-exempt portion of the production; and that prices received for the liquids sold separately were different than those provided in the liquids contract, so that the State used inaccurate figures in calculating royalty amounts. Finding that BWAB had underpaid royalties in the amount specified in the audit, the Director sustained the late payment charges in toto. BWAB (appellant) appealed the Director's decision to this Board.

Appellant argues that the Director's decision erroneously increased the value of gas on which royalty payments are made by including the tax reimbursements. Appellant argues that if royalties are due on these reimbursements, then the audit incorrectly determined the amount due by its failure to use appellant's actual tax reimbursements as the basis for calculating royalties. Appellant argues that the Director erred in

^{3/} The basis for the Director's conclusion was evidently the Aug. 5, 1988, field report by the State Auditor, prepared for the Director's use in considering appeals MMS 88-0213-O&G and MMS 88-0314-O&G.

permitting use of the COPAS formula to adjust the estimated tax paid, as industry practice does not reimburse the seller for the "tax on a tax" amount; therefore, it argues, adding such a value to royalties is arbitrary and capricious. Lastly, appellant argues that the auditor failed to properly eliminate tax-exempt production from the royalty calculation.

MMS answers by stating that there is ample legal precedent for inclusion of tax reimbursements to the seller as part of the value of production on which royalties are due. MMS states that appellant did not provide the State with actual information regarding its tax reimbursements, so that it cannot be heard to complain that MMS improperly relied upon the COPAS formula to estimate its tax reimbursements. Finally, MMS argues that it properly assessed royalties on the reimbursements that accrued on the reimbursed taxes.

[1] Federal oil and gas lessees are required to pay a royalty of "12-1/2 per centum in amount or value of the production reserved or sold from the lease." 30 U.S.C. § 226(b) and (c) (1988). When royalty is not taken in kind, it is calculated as 12-1/2 percent of the value of production from the lease. The Mineral Lands Leasing Act of 1920 as amended, 30 U.S.C. § 181 (1988), reserves to the Department the authority and responsibility of establishing reasonable value for royalty purposes. Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1381 (D. Alaska 1985), aff'd, 794 F.2d 1461 (9th Cir. 1986); accord California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961); Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); United States v. Ohio Oil Co., 163 F.2d 633, 639-40 (10th Cir. 1947), cert. denied, 333 U.S. 833 (1948). Departmental rules for determining value for royalty purposes in effect at the time of this audit were set forth at 30 CFR 206.103 (1987): 4/

The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director [of MMS,] 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, 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 of 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. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in

^{4/} The regulations applicable to the valuation of oil and gas for royalty computation purposes were significantly revised effective Mar. 1, 1988, with prospective effect only. 53 FR 1184, 1230 (Jan. 15, 1988). These new regulations are not applicable to the case before us.

a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value. [Emphasis supplied.]

We reject appellant's argument that the Director's decision erroneously increased the value of gas on which royalty payments are made by including tax reimbursements. It is now well established that tax reimbursements made by the buyer of gas produced from Federal wells to the Federal lessee (seller) are properly included as part of the gross value of the production in computation of the royalty due to the Government. CIG Exploration, Inc., 113 IBLA 99 (1990); Enron Corp., *supra*; Tricentrol United States, Inc., 105 IBLA 392 (1988); Amoco Production Co., 29 IBLA 234, 235 (1977); Wheless Drilling Co., 13 IBLA 21, 80 I.D. 599 (1973); see Hoover & Bracken Energies, Inc., 52 IBLA 27, 88 I.D. 7 (1981), *aff'd*, Hoover & Bracken Energies, Inc. v. U.S. Department of the Interior, 723 F.2d 1488 (10th Cir. 1983), *cert. denied*, 469 U.S. 821 (1984).

In Enron Corp., *supra* at 396, which also involved the inclusion of the amount of the Wyoming tax in MMS' royalty valuation, we noted the longstanding history of the rule that gross proceeds include the gas purchase price plus the reimbursed severance tax. We noted that it was specifically held in Wheless that "gross proceeds" consisted of "the gas purchase price plus the reimbursed severance tax." We stated:

Since Wheless, the rule that gross proceeds shall include tax reimbursements has been widely disseminated. It was set out expressly more than 11 years ago in Notice to Lessees and Operators of Federal Onshore Oil and Gas Leases-1 (NTL-1), 42 FR 4546 (Jan. 25, 1977), which states in pertinent part:

Under no circumstances will the royalty value be computed on less than the gross proceeds accruing to the operator from the sale of such leasehold production. Gross proceeds include, * * * tax reimbursements and payments to the operator for gathering, measuring, compressing, dehydrating, or performing other services necessary to market the production. [Emphasis added.]

The same rule was also published in NTL-5, 42 FR 22610, 22611 (May 4, 1977). While this appeal was pending, Congress enacted the Notice to Lessees Numbered 5 Gas Royalty Act of 1987, P.L. 100-234, 101 Stat. 1719 (1988). Although Congress modified one part of the NTL-5, it left intact, and thus effectively ratified, the requirement that tax reimbursements be included in calculating gross proceeds.

Appellant argues that including the tax reimbursement in gross proceeds violates the provisions of the Natural Gas Policy Act of 1978 (NGPA) by exceeding the ceiling price on natural gas. It asserts that this procedure also violates the Mineral Leasing Act by exceeding the

12-1/2-percent royalty amount and by creating "different 'values' for royalty-in-kind gas and gas on which royalty payments are made" (Statement of Reasons at 10). These arguments have been made and rejected in previous cases. See Enron Corp., supra at 398-99 (valuation of production to include tax reimbursements is not violative of the NGPA); Hoover & Bracken Energies, Inc., 52 IBLA at 37, 88 I.D. at 12; Kerr-McGee Oil Industries, Inc., 70 I.D. 464 (1963) (tax-exempt value of royalty-in-kind gas is not indicative of value of gas sold from the lease); Amoco Production Co., supra at 236 (there is no inconsistency between the statute requiring a 12-1/2-percent royalty on production removed or sold and the valuation regulation). Appellant raises no other arguments that persuade us to disregard the NTL-5 Act and judicial precedent and to overrule contrary longstanding Board precedent cited above.

Appellant argues that the audit conducted by the State was arbitrary and capricious because it did not use actual receipts and, instead, estimated the amount of the tax reimbursement. Appellant asserts that MMS' estimates inflate the amount of the tax by applying the COPAS formula to recover tax on the amount of gross proceeds after the tax. Appellant requests a hearing to present evidence of actual receipts.

MMS opposes appellant's request for a hearing, alleging that appellant had ample opportunity to present evidence of such receipts to the State auditor's office, and did not. MMS argues that appellant has not established that the methodology used by MMS to value its gas was erroneous.

Regarding the methods used by the State to calculate the value added to the production by the severance tax reimbursements, the following is instructive:

The formula used by the State of Wyoming and the majority of oil and gas companies to compute tax reimbursements actually has a dual purpose. The first is to exempt 12.5%, which is the Federal Government's royalty portion, from tax reimbursement assessment. The result is that 87.5% (1-12.5 percent) of production is subject to tax reimbursement. * * * The second purpose of this equation is to calculate the spiralling effect of ad valorem tax reimbursement, as a tax on a tax.

Bulletin No. 7, from the Council of Petroleum Accountants Societies (COPAS), addresses the equation in question and the net effect of tax reimbursement. The bulletin states, in part:

"In those instances where tax reimbursement is included in the taxable value, the payment of the additional tax occasioned by the reimbursement would result in additional reimbursement, which in turn would result in additional tax, ad infinitum. The ultimate effect of this spiral can be readily calculated by use of an

easily determined factor which can be applied to the base price of the gas. . . " [Emphasis in original.]

* * * * *

For example, on lease 49-007037, the tax rate in 1980 was 0.056083. BWAB states that the correct equation is $.056083 \times 87.5\% = 0.049073$. This equation would be correct, except for the nature of severance and conservation tax and ad valorem tax, which is that these taxes are themselves subject to taxation. [Emphasis supplied.]

(Aug. 5, 1988, Field Report of the Wyoming State Auditor at 3-4).

Appellant challenges the application of the COPAS formula, asserting that it elevates the tax above the amount appellant actually received. Appellant suggests that it has not been reimbursed for additional taxes that it was required to pay on the initial reimbursement, so that the "spiral" was broken. ^{5/} Thus, according to appellant, use of the COPAS formula, which presumes the presence of the "spiral," overstates the amount of tax reimbursements that appellant actually received and was therefore improper.

[2] The gas purchase and sales agreement expressly provides that appellant enjoyed a contractual right to receive reimbursement for "all existing taxes levied on the gas produced and sold" under the contract. ^{6/}

^{5/} Appellant also evidently represented to the State Auditor "on several occasions" that it was not sure whether it was entitled to any reimbursement or even if it had ever received a reimbursement from Panhandle. Appellant does not deny before us that it received a reimbursement from Panhandle. However, as discussed below, appellant's failure to actually receive the reimbursement would not forgive its obligation to pay royalty on the amount it was owed under the contract.

^{6/} The Director's decision states that "[n]atural gas attributable to the leases was sold pursuant to a contract which provided for reimbursement to the seller of all taxes levied on the gas (emphasis supplied)" (MMS Decision at 1). Appellant has filed a copy of the gas purchase and sales agreement between it and Panhandle for the leases in question. Article 21.1 of that agreement provides that Panhandle would reimburse appellant for "all existing taxes lawfully levied on the gas produced and sold" under the agreement. However, Article 21.3 limits the definition of the term "tax" as follows:

"The term 'tax' shall mean any tax imposed on the production, severance of gas, or other excise taxes or taxes or assessments of a similar nature but shall exclude ad valorem, income, payroll, excess profits, general corporate franchise, real property, leasehold or leasehold equipment taxes, gathering, delivery and sales taxes. [Emphasis supplied.]"

This point might be significant because the State's audit consistently refers to reimbursements allegedly received by appellant for "ad valorem

Where, for no apparent justifiable reason, a lessee fails to invoke a contract clause affording it a benefit, the lessee is properly held responsible for royalty as though the contractual provision had been invoked. See Transco Exploration Co., 110 IBLA 282, 327-28, 96 I.D. 367, 391-92 (1989). ^{7/} Thus, in the absence of any showing of justification, appellant was responsible for paying royalty on all reimbursements owed under the sales contract, regardless of whether appellant ever enforced its contractual rights by actually collecting the reimbursements. We have no basis to conclude that appellant was not owed reimbursements on all taxes owed to the State, including those assessed under the "spiral effect" discussed above.

As to the propriety of MMS' reliance on the COPAS formula, we note that appellant has shown nothing indicating that this formula was not an accurate method of estimating the amount of taxes that were owed to the State and to which appellant had a contractual claim to reimbursement. While we make no ruling that the methodology employed by COPAS is generally entitled to special deference, we see nothing to impeach the accuracy of the COPAS formula employed by the State Auditor and adopted by MMS here.

In addition to the above grounds, which we deem dispositive, we note that, where a party challenges a determination as to the value of gas produced, the party must establish that the methodology used in the Government's computation is, in fact, erroneous. Amoco Production Co., 112 IBLA 77, 86 (1989); Sun Exploration & Production Co., 104 IBLA 178, 186 (1988). Appellant failed to do so in this case. Moreover, in the present case, although presentation of evidence (or convincing offer of proof) might clarify the amount that appellant actually received from its buyer as tax reimbursement, we have held above that the royalty basis would properly

fn. 6 (continued)

taxes." The quoted language raises the possibility that appellant was not owed such reimbursements under the contract.

However, we have dealt with other cases arising in Wyoming, and the tax assessed for production in that State has been referred to as "an ad valorem severance tax" (Enron Corp., *supra* at 395), so that the State tax would appear to be covered by Article 21.1 of the contract. As noted above, the State Auditor treated the State tax as a "tax on production" within the meaning of Article 21.3, so that a reimbursement was owed to appellant.

During the State audit, appellant asserted that royalties were not due on ad valorem tax reimbursements (BWAB's Apr. 29, 1988, letter; State Auditor's Aug. 5, 1988, memorandum). Appellant has not pursued this argument before us and has not affirmatively asserted that it is not due reimbursements for the State tax from Panhandle under the purchase contract. The parties have not referred to an legal distinction between "ad valorem" and "severance" taxes, and we have no basis to conclude that the purchase contract did not entitle appellant to receive reimbursement for the taxes at issue in this dispute.

^{7/} Appeal filed, Transco Exploration Co. v. United States, No. 90-191-L (Ct. Claims filed Mar. 1, 1990).

include all reimbursements to which appellant was entitled under the sales contract. Thus, the exact amount appellant received would not determine the royalty due and would, therefore, likely be irrelevant. ^{8/} Accordingly, appellant's request for a hearing is denied.

Appellant asserts that MMS erred by accepting the audit, which "failed to properly eliminate tax-exempt production from the royalty calculation." The record indicates to the contrary that, in calculating the amount of the reimbursement, MMS was careful to exclude the 12.5-percent tax-exempt portion of production. As a result, the amount of the reimbursement was reduced. That is, MMS did not impute a tax reimbursement for tax-exempt production. Appellant has not convinced us that this method was inadequate.

Appellant offers no specific reasons that MMS' imposition of late payment charges was incorrect. Inasmuch as we have held that BWAB was properly required to pay the additional royalty, MMS' decision requiring it to pay late payment charges must also be affirmed.

Therefore, 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.

David L. Hughes
Administrative Judge

I concur:

Bruce R. Harris
Deputy Chief Administrative Judge

^{8/} Appellant also asserts that MMS' estimate of the amount of the tax reimbursement is inaccurate because it relied on inaccurate estimates of sales of liquid hydrocarbons produced from the leases. Appellant explains that it sells liquid hydrocarbons produced from the leases subject to a separate contract, under which there is no reimbursement for taxes paid to the State. The State audit subtracted a figure of 30 cents/Mcf from the total amount on which appellant paid taxes to account for the taxes paid on liquid hydrocarbons. Appellant asserts that the actual amount received for the liquid hydrocarbons "may be higher or lower than 30 cents/Mcf, depending on a BTU adjustment."

Appellant has utterly failed to support this assertion with any actual data, either before MMS or on appeal. In the absence of such actual data, we are unpersuaded that the State audit was flawed. However, we note that the Director stated in his decision at page 5 that "[i]f BWAB provides adequate documentation to support these claims, the royalties assessed herein will be adjusted accordingly." That invitation is still outstanding.