

Appeal from a decision of the Deputy to the Assistant Secretary - Indian Affairs (Operations), affirming an order of the Minerals Management Service, directing payment of additional royalties. MMS-89-0036-IND.

Affirmed.

1. Indians: Mineral Resources: Oil and Gas: Generally--Oil and Gas Leases: Royalties: Generally

A Federal oil and gas lessee is under an obligation to assume the expenses of placing any gas produced and sold into "marketable condition." No deduction from royalty is allowed for the expenses of gathering and compressing gas required to place it in marketable condition regardless of whether these costs are paid directly by the lessee or by a third party. The price of gas sold at the wellhead which has been reduced from the price of gas in marketable condition by the costs of gathering the gas and compressing it as required for marketing to a pipeline purchaser does not establish the value of the gas in marketable condition.

APPEARANCES: David L. Benefield, Esq., Duncan, Oklahoma, for appellant; Howard W. Chalker, Esq., Geoffrey Heath, Esq., and Peter J. Schaumberg, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Bureau of Indian Affairs.

OPINION BY ADMINISTRATIVE JUDGE GRANT

R. E. Yarbrough & Company has appealed from a decision of the Deputy to the Assistant Secretary - Indian Affairs (Operations), dated June 13, 1990, affirming an order of the Houston Area Compliance Office, Minerals Management Service (MMS), directing payment of additional royalties. The MMS order, dated December 27, 1988, held that appellant Yarbrough underreported royalties by \$3,316.76 on natural gas produced and sold from Indian lease 607-061502 for the period January 1984 through December 1987.

The MMS order explained that the underreporting was caused by unauthorized deductions for expenses of transportation, compression, and dehydration of gas production which were claimed by appellant as a transportation allowance on royalty reporting Form MMS-2014. Accompanying the MMS order was a list by month of deducted "compression charges" totalling \$3,316.76.

MMS relied upon Notice to Lessees and Operators of Indian Oil and Gas Leases (NTL-1A) to hold that appellant improperly deducted this sum from royalties due MMS for January 1984 through December 1987. NTL-1A states that "no deduction will be allowed for the cost which an operator incurs by reason of placing the gas in a marketable condition as an operator is obligated to do so at no cost to the lessor." 42 FR 18135, 18137 (Apr. 5, 1977).

Upon appeal to the Bureau of Indian Affairs (BIA), the Deputy to the Assistant Secretary - Indian Affairs (Operations), found that Yarbrough had sold its gas production to Natural Gas Operations Company (NGO), which maintained a low pressure gas gathering pipeline system. NGO gathered the gas into this system and then ran it through its dehydration unit and compressor. NGO then sold this gas to Lone Star Gas Company (Lone Star). Compression was necessary, BIA found, to enable the gas to be marketed in a standard high pressure gas pipeline.

BIA found that Yarbrough received from NGO a price that was determined by subtracting NGO's gathering, compression, and dehydration costs from the price received by NGO from Lone Star. In determining its royalty obligation to BIA, Yarbrough valued its gas production at the NGO-Yarbrough price (Decision, June 13, 1990, at 2). On the basis of these facts, BIA concluded that Yarbrough had erroneously computed its royalty obligation by deducting marketing costs.

BIA summarized its holding in these words:

[T]he lessee, without contribution by the Federal or Indian lessor, must extract the gas from the ground and place it into marketable condition. In this case marketable condition means that the gas must be placed in a condition that will allow it to be accepted by a high pressure gas pipeline so it can be transported to the normal commercial market for methane gas. The marketable condition required in this rule is not satisfied by the lessee compressing the gas only to the pressure necessary to be accepted into a low pressure gathering system.

* * * * *

Whether a lessee hires a third party to gather, dehydrate, and compress the gas, and deducts the payments made to the third party from the value of the gas production, or in the alternative, sells the gas to a third party at a reduced price to reflect the costs of gathering, dehydrating, and compressing the gas, and uses that reduced price as the value of the gas production, the effect is the same. In either case, the gas is undervalued for royalty purposes.

(Decision at 6-7).

In support of its decision, BIA relied upon the regulation at 43 CFR 3162.7-1(a), which states: "The operator shall put into marketable

condition, if economically feasible, all oil, other hydrocarbons, gas, and sulphur produced from the leased land." The agency also cited NTL-1A, supra, and quoted from NTL-5, which states in part:

Under no circumstances will royalty be computed on less than the gross proceeds accruing to the lessee or operator from the sale of leasehold production. Gross proceeds include, but are not limited to, tax reimbursements and payments to the lessee or operator for the performance of certain services such as measuring, field gathering, compressing, sweetening, and dehydrating which are necessary to place the gas into marketable condition and which the lessee or operator is obligated to perform at no cost to the lessor. Likewise, no deductions will be allowed for the uncompensated cost of placing the gas into marketable condition. [Emphasis added.]

42 FR 22610, 22611 (May 4, 1977). 1/

In its statement of reasons (SOR), appellant does not dispute its duty to put into marketable condition, if commercially feasible, all lease products at no cost to the lessor. Yarbrough states, however, that at all relevant times it provided such services as were necessary to cause the gas at issue to be marketed. Appellant here refers to certain costs, known as Phase I costs, attributable to a separator and low-pressure compressor that it operates at the well site. No charge was made against the royalty interests for these Phase I costs, appellant observes.

Following Phase I, appellant argues, it was unable to sell its gas directly to a standard high pressure gas pipeline because of the absence of an available connection. This forced appellant to sell its gas to NGO, which operated the only gas gathering system in the area (SOR, Aug. 22, 1990, at 2). The contract of sale for this gas, Yarbrough notes, was solely with NGO. All gas accepted by NGO from appellant was considered sold upon acceptance into NGO's gas gathering system, appellant states. No other economically feasible alternative existed. Id. at 7. NGO then dehydrated and further compressed the gas, giving rise to Phase II costs and the disputed deductions on appeal.

These facts, inter alia, dictate a result different from the hard and fast rule of BIA, Yarbrough contends. Although BIA may insist that gas is in marketable condition only when ready to be accepted in a high pressure pipeline, appellant states, the instant facts suggest that the gas here was

1/ The terms of NTL-5 are set forth at 42 FR 22610 (May 4, 1977). On Aug. 1, 1986, the notice was amended, but the above-quoted passage was not affected. 51 FR 26759 (July 25, 1986). On Jan. 6, 1988, P.L. 100-234 was approved. 101 Stat. 1719. This law is referred to as the Notice to Lessees Numbered 5 Gas Royalty Act of 1987. Regulation 30 CFR 206.151 terminated NTL-5, as amended, on Mar. 1, 1988. 53 FR 1230, 1272 (Jan. 15, 1988).

in marketable condition when readied for sale to NGO. Under the particular facts of this case, appellant argues, it would appear that all obligations placed upon it by law were satisfied.

Appellant also raises a second argument, which focuses upon the language of 43 CFR 3162.7-1(a) requiring an operator to put its production into marketable condition if economically feasible. Appellant contends that BIA erred in assuming that the gas at issue could have been economically marketed by appellant to Lone Star. In support, Yarbrough offers an analysis by W. P. Foster, a registered professional engineer, which shows that Yarbrough would have lost money had it installed its own compressor and dehydrator so as to ready production for Lone Star's high pressure pipeline.

[1] It is well established that a Federal oil and gas lessee is under an obligation to assume the expenses of marketing any gas produced from the leasehold. The Texas Co., 64 I.D. 76, 79 (1957). ^{2/} In that case the lessee operated only two wells in a much larger field and contracted with Humble Oil, the operator of gathering pipelines and compressor stations, to transport the low-pressure gas from appellant's separator at the wellhead to the point of market at the pipeline and to compress the gas to the pressure required for entry into the buyer's pipeline. Like appellant in the present case, the lessee argued that it was not economically feasible for it, as the operator of only two wells in the field, to install equipment to gather and compress the small amount of gas produced from its wells. Hence, the lessee sought to deduct the costs charged by Humble for gathering and compressing the gas. The Department explicitly rejected appellant's contention that lessee's duty was limited to marketing the low pressure gas at the wellhead thus entitling the lessee to deduct the cost of transporting the gas to the point of market in the field and placing the gas in such condition that it can enter that market:

The lease requires the lessee to market the production from the lease and until the gas from the wells is in such a condition that it can be sold in the market, it cannot be said that the lessee has fulfilled his obligations under the lease. The lessee has not shown that the gas can be marketed at the pressure with which it comes from the wells.

The Texas Co., 64 I.D. at 79.

^{2/} The duty of the Federal lessee to market the gas was held to be clearly spelled out in the regulation at 30 CFR 221.35 (1959) requiring the lessee to avoid waste of gas and to either market it, consume it beneficially, or return it to the producing formation. 64 I.D. at 79. A similar requirement is found in the operating regulations currently in effect which mandate that: "The operator shall put into marketable condition, if economically feasible, all oil, other hydrocarbons, gas, and sulphur produced from the leased land." 43 CFR 3162.7-1(a).

We find this precedent to be controlling in the present case. The only arguably material distinction between the facts of The Texas Co. case and the present appeal is that the lessee in the former contracted with a third party to undertake gathering and compression of the gas for the market whereas, in the present appeal, the lessee sold the low-pressure gas to the party undertaking the gathering and compression for a price reduced from the market price by the amount of the costs of gathering and compression. We find this distinction to be immaterial. Whether the lessee assumes the expense of gathering and compression himself or pays a third party to perform this function for him, the cost is an obligation of the lessee. Further, it makes no difference whether the lessee transfers title to the gas at the wellhead separator for a price reflecting a reduction from the market price by the amount of the gathering and compression costs or whether the lessee retains title and pays a contractor to undertake this function. Case law clearly establishes that Yarbrough's sale of gas to NGO does not compel a finding that the gas was in marketable condition at the time of sale. Big Piney Oil & Gas Co., A-29895 (July 27, 1964) (compression and gathering costs incurred after sale of gas to operator of gathering system were not deductible); Placid Oil Co., 70 I.D. 438 (1963) (transfer of title did not alter nondeductibility of certain expenses incurred thereafter); cf. Arco Oil & Gas Co., 109 IBLA 34 (1989) (the point of first "sale" is generally an indicium of the existence of a market, but the transfer of title to oil at an offshore platform may not establish a market at that point where the oil was subsequently transported to market by pipeline and held for the account of the producer).

The principles set forth in The Texas Co. case have been upheld by the courts. In California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961), the operator of a Federal oil and gas lease produced gas that it sold for 12 cents per thousand cubic feet (mcf). The contract of sale called for gas produced from the wells conditioned as necessary to meet certain specifications required to make the gas suitable for pipeline transmission. Maximum water content and liquefiable hydrocarbons were specified in the contract, and the parties further provided that the gas would be delivered at pipeline pressure.

California Company, the operator, spent 5.05 cents per mcf in making the gas suitable for pipeline transmission and paid royalty upon the difference between its sale proceeds (12 cents per mcf) and its post production costs (5.05 cents per mcf). ^{3/} The Secretary disagreed and billed California Company for royalties based upon 12 cents per mcf. The court held that section 17 of the Mineral Leasing Act, 30 U.S.C. § 226(c) (1988), required a Federal lessee to pay a royalty of 12-1/2 percent on the value of production. 296 F.2d at 386-87.

The Court of Appeals for the District of Columbia Circuit found that California Company was required by regulation to market the gas removed from

^{3/} California Co. v. Seaton, 187 F. Supp. 445, 447 (D.D.C. 1960), sets forth in detail the calculation used by California Company in valuing production at 6.95 cents per mcf (12 cents per mcf less 5.05 cents per mcf).

its leasehold. Because of this duty to market (and not merely sell) the gas, the court held that the Secretary could reasonably construe the statutory term "production" to mean gas conditioned for market. Gas conditioned for market was gas that satisfied market specifications for water content, liquefiable hydrocarbons, and compression, such as those set forth in the sales contract of California Company. 296 F.2d at 388. The Secretary's valuation of production at 12 cents per mcf was, accordingly, affirmed.

Key to the relevance of the Circuit Court's holding in resolving Yarbrough's appeal is the following paragraph from the court's opinion:

The premise for the Secretary's decision in the case before us was that, since the lessee was obliged to market the product, he was obligated to put it in marketable condition; and that the "production" was the product in marketable condition. Theoretically, any gas--any "production" --is "marketable". We can assume that, if the price were low enough to justify capital expenditures for conditioning equipment, someone would undertake to buy low pressure gas having a high water and hydrocarbon content. A lessee who sold unconditioned gas at such a price would, in a rhetorical sense, be fulfilling his obligation to "market" the gas, and by thus saving on overhead he might find such business profitable. There is a clear difference between "marketing" and merely selling. For the former there must be a market, an established demand for an identified product. We suppose almost anything can be sold, if the price is no consideration. In the record before us there is no evidence of a market for the gas in the condition it comes from the wells. The only market, as far as this record shows, was for this gas at certain pressure and certain minimum water and hydrocarbon content. [Footnote omitted.]

296 F.2d at 387-88. Although the appellant seeks to distinguish the present case on the basis that the gas was marketed near the wellhead after separation and after sufficient compression to place the gas in the gathering line, we find that this does not constitute marketing of the gas. Regardless of the fact the gas could be sold at this point to the operator of the field gathering system and the compressor plant necessary to introduce the gas into a pipeline (other than a low-pressure gathering system pipeline), we cannot uphold this effort to place the cost of production of gas in "marketable condition" on the lessor. Although we think it is clear from the above-quoted discussion that the court in California Co. distinguished this type of "sale" from "marketing" of gas production, it is evident from cases such as Big Piney Oil & Gas Co., supra, and Placid Oil Co., supra, that deduction from market value for costs of gathering and compression necessary to market the gas are not deductible even where incurred after transfer of title from the lessee. Recent litigation has confirmed that the "Marketable Condition Rule" requires valuation of gas production without deduction of the costs of gathering and compressing the gas necessary to place the gas in marketable condition. Mesa Operating Ltd. v. U.S. Department of the Interior, 931 F.2d 318, 325. (1991).

Finally, we note that the price that Yarbrough receives from NGO is unknown to both NGO and Yarbrough at the time NGO receives Yarbrough's production. The determination of this price must await a further sale, that involving NGO and Lone Star. Yarbrough cannot be paid by NGO until NGO is paid by Lone Star. It is not unreasonable under these circumstances to view NGO as a conduit to facilitate the transfer of gas from Yarbrough to Lone Star. See The Texas Co., supra. Yarbrough virtually concedes this point in correspondence to MMS. By letter of November 18, 1989, Yarbrough wrote to MMS:

We believe we have complied with the regulation [43 CFR 3162.7-1(a)] in full due to the fact that we called and explained to BIA's Tulsa office and received an OK to market this gas through Natural Gas Operations Company.

* * * * *

* * * The charges that you have picked up and are claiming to be compression costs are in fact a combination of charges: primarily transportation, but including dehydration, further compression and numerous other charges that Natural Gas Operations must use to market the gas. They market gas not only for us but for the numerous other leases entering this common line to their dehydration-compression station. [Emphasis added.]

Thus, it is clear that the gas had not been placed in marketable condition until it had been prepared by NGO, on appellant's behalf, for delivery to the pipeline buyer.

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.

C. Randall Grant, Jr.
Administrative Judge

I concur:

David L. Hughes
Administrative Judge