TEXACO, INC.

IBLA 91-145 Decided September 8, 1994

Appeal from a decision by the Director, Minerals Management Service, affirming an order of the Royalty Management Program setting a processing allowance for payment of royalty on liquid products. MMS-89-0238-OCS

Affirmed.

1. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Oil and Gas Leases: Processing Allowance

MMS properly refused to include the cost of gas that was not processed into liquid products at the Henry plant as a factor to be used in determining a processing allowance for products produced at the plant.

APPEARANCES: Jeffrey K. Smith, Esq., New Orleans, Louisiana, for appellant; Geoffrey Heath, Esq., Peter J. Schaumberg, Esq., and Howard W. Chalker, Esq., Office of the Solicitor, United States Department of the Interior,
for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE ARNESS

Texaco, Inc. (Texaco), has appealed from so much of a December 4, 1990, decision of the Director, Minerals Management Service (MMS), as affirmed a May 31, 1989, order by MMS' Royalty Management Program (RMP), establishing a processing allowance for liquid plant products from the Henry gas processing facility in Vermillion Parish, Louisiana, for production between December 1, 1986, through November 30, 1988. (A further finding of the decision dealing with a tax rate computation affecting the allowance is
not now at issue.) The May 1989 order required payment of royalty on processed liquid products using an allowance developed by RMP for the Henry plant. On appeal, Texaco challenges the correctness of the allowance developed by RMP.

While the Henry plant used gas originating from Federal leases (for which it was obligated to pay royalty to MMS) to produce liquid products, it also handled liquids derived from gas purchased from other sources in order to meet private contractual obligations owed to third parties. The third party contracts included a contract with Natural Gas Pipeline Company of America (NGPCo). It is gas that was purchased by Texaco in connection with the NGPCo contract that precipitated this appeal concerning whether the manufacturing allowance MMS established for Texaco's Henry operation was calculated in conformity to Departmental regulation 30 CFR 206.152(a)(2) (1987).

Texaco had an agreement with NGPCo to process NGPCo gas at the Henry plant. Under that contract, Texaco kept all extracted liquids in payment for processing the gas, but agreed that the energy content of the residue gas returned to NGPCo's designated agent at the tailgate of the Henry plant would not be reduced. Since removal of liquid products would necessarily lower the energy content of the residue gas, Texaco was obliged to purchase additional gas to supplement the residue in order to deliver the required energy quantum required by the NGPCo agreement. It is the cost of this additive gas that Texaco contends should be included in the Henry equation. If this cost were to be accepted as a factor in the allowance, instead of paying royalty on 53.1969 percent of the value of liquids produced at the Henry plant, Texaco would pay a royalty on 51 percent (amounting to about a $172,924 increase in royalty for the period at issue, according to counsel for MMS).

It was in response to a request from Texaco that RMP had issued the decision of May 31, 1989, setting a processing allowance for the Henry plant of 46.8031 percent (subject to further audit and review), meaning that Texaco was required to pay royalty on the full value of residue gas and on 53.1969 percent of liquids produced from Federal gas at the Henry facility. When Texaco appealed this ruling to the Director, MMS contending that RMP improperly calculated the allowance by omitting the cost of the NGPCo gas supplement from manufacturing costs, RMP replied that it had in fact included the cost of NGPCo gas processed at the plant when calculating the Henry allowance factor. MMS stated that Texaco "is insisting that MMS excluded the [NGPCo] gas in the calculation of the approved processing allowance for the [Henry] plant when in fact the total cost, volume, and value were used in the calculation" (RMP Memorandum dated Aug. 30, 1989, to Chief, Division of Appeals). The NGPCo gas to which RMP referred was, however, wet gas from which liquid products were removed at the Henry plant, not the supplemental gas used to fortify the residue returned to NGPCo at the tailgate. For this reason RMP recommended that the Director, MMS, deny Texaco's appeal as being without foundation in fact.

The Director, MMS, found that all gas purchased from NGPCo that was processed to remove hydrocarbon liquids had been included in the allowance equation in keeping with MMS policy to include "total plant volume, value, and cost." See RMP Memorandum supra at 4. He determined that inclusion in the allowance of the cost to buy the gas supplement needed to boost the energy content of the NGPCo gas in order to achieve the caloric content required by the contract between Texaco and NGPCo, however, was not reason able because that gas was not part of the cost of producing liquid products at the Henry plant. Use of an item of expense that was external to the liquification process, he found, would distort the allowance for calculating royalty on Federal liquid products. See MMS Director's Decision at 7-8. Citing Mobil Oil Corp., 108 IBLA 216, 220 (1989), he determined that

> the cost of the open market gas purchases and the delivery thereof to NGPCo at the Henry tailgate cannot reasonably be characterized as a cost directly or indirectly attributable to the operation or

> maintenance of Henry or otherwise as a relevant [processing] factor. Accordingly, such cost may properly be excluded in the computation of the processing allowance. Instead, such cost must be associated in its entirety with the transfer to NGPCo of residue gas processed elsewhere. Its only effect is to reduce what NGPCo "paid" to Texaco for processing its gas. What Texaco is paid does not in any way affect its costs to process the gas.

(Director's Decision at 8).

[1] Appealing this decision, Texaco contends that the cost of the supplemental gas purchased to honor the energy limitation imposed by the NGPCo contract should nonetheless be included as a factor in the manufacturing allowance because it is directly associated with operations at the Henry plant, increases the economy of scale at the plant by passing through it, and must be treated as an actual plant cost as a consequence. The Departmental regulation applicable here, 30 CFR 206.152(a)(2) (1987), provides pertinently that "[a] reasonable allowance * * * may be made for the cost of processing." The gas at issue, however, was not processed at the plant; it is not, as a consequence, so much shown to be related to the process of manufacturing liquid hydrocarbon products at Henry as it is shown to be the result of contracting practices at Texaco. Although characterized by Texaco as "direct operations expenditures," the purchases at issue have not been shown to be connected to plant operations at the Henry plant, although they were shown to be directly related to the contract obligation with NGPCo that required Texaco to retain a certain caloric content in residue gas delivered at the Henry tailgate.

In the Mobil Oil Corp. decision, relied upon by both parties, it was determined that a manufacturing allowance must realistically reflect all processing costs at a plant if it is to be valid. Id. at 220. Unlike this case, however, Mobil had sought to exclude from calculation of a plant manufacturing allowance any liquids not owned by Mobil, even though they were processed at the plant in question (see 108 IBLA at 219). This approach was rejected as an attempt to distort the processing allowance by increasing the apparent cost of manufacturing liquid products without a basis in fact for doing so, in order to lower royalty payments. The same objection applies in this case, since the effect of including costs to acquire gas not actually processed at the Henry plant in the plant's allowance for cost of processing liquid products would achieve a distortion similar to that rejected by the Mobil Oil Corp. decision.

The argument by Texaco that MMS should consider the contractual obligation with NGPCo to be an actual plant cost ignores the regulatory provision that a processing allowance is to be given for the "cost of processing." See 30 CFR 206.152(a)(2) (1987). The expense necessitated by the energy limitation provision in the NGPCo contract has not been shown to be a processing cost; gas acquired to meet the terms of Texaco's NGPCo contract cannot be included in the manufacturing allowance for the Henry plant for the time at issue because it was not processed to remove hydrocarbon liquids at that plant and was therefore not shown to be an actual plant cost incurred as a cost of processing.

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.

Franklin D. Arness
Administrative Judge

I concur:

C. Randall Grant, Jr.
Administrative Judge