AMERAC ENERGY CORP.

IBLA 97-118 Decided March 24, 1999

Appeal from a decision of the Minerals Management Service affirming an order directing recalculation and payment of additional royalties. MMS-93-0868-OCS.

Affirmed.

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

Where lessee sold all its production to a marketer at posted prices, but marketing agreement provided that marketer would deduct from the income from its subsequent sales all its costs, including the purchase price of the crude oil/condensate, the agreement constituted a marketing agreement.

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

A lessee is required to place its production in marketable condition at no cost to the lessor. An element of this so-called marketable condition rule is the duty to market production. The creation and development of markets for production is the very essence of the lessee's implied obligation to prudently market production from the lease at the highest price obtainable for the mutual benefit of the lessee and lessor, and it is the lessee's duty to perform that service free of expense to the lessor. Nothing prevents a lessee from engaging an agent to sell its production. It is established, however, that the duty to market exists without regard to whether the lessee chooses to market its production using its own staff and efforts, or engages an affiliate or a third party to perform such services.

APPEARANCES: L. Poe Leggette, Esq., and Thad S. Huffman, Esq., Washington, D.C., for Appellant; Howard W. Chalker, Esq., Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., Sarah Inderbitzin, Esq., and Lisa Hemmer, Esq., Office of the Solicitor, U.S. Department of the Interior, for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE PRICE

Amerac Energy Corporation (Amerac) has appealed the April 2, 1996, Decision (MMS-93-0868-OCS) of the Associate Director for Policy and Management Improvement (Associate Director), Minerals Management Service (MMS), affirming an Order of the Royalty Management Program (RMP) dated October 21, 1993, which directed Wolverine Exploration Company (Wolverine) 1/ to recalculate and pay additional royalties due under Outer Continental Shelf Lease No. 054-008150-0 arising from the improper deduction of marketing costs (Order).

At issue are three contracts between Wolverine and Essex Refining Company (Essex). Two of these contracts, Essex Contract Nos. 3571 and 3572, are dated October 2, 1989, were for a 90-day term, and thereafter could be renewed on a month-to-month basis, with the right to cancel upon 30 days notice by either party. Contract No. 3571 provided for the sale of "[a] volume of crude oil/condensate equal to Wolverine's interest ownership produced from the properties listed on attached Exhibit `A.'" Exhibit A to both contracts identifies the High Island Block 178 lease, OCS-G 8150, on which Union Pacific Resources Company was then operator.

Contract No. 3571 provided for delivery into barges at the lease for subsequent delivery to Marathon Petroleum Company's (Marathon) Texas City refinery, title and risk of loss to pass when the product passed the barge flange connection to Marathon's unloading facility. The contract further provided that the cost of barging to Marathon's refinery, including insurance, was to be borne by Wolverine. The price to be paid was the monthly average posted price published by Union Pacific Fuels, Inc., during the month of delivery.

Contract No. 3572 provided for the sale of "a volume of condensate equal to Wolverine's interest ownership" as described in Exhibit A to the contract. The Contract further provided that delivery, title, and risk of loss would pass "f[ro]m the account of Wolverine to the account of Essex as the condensate passes through the tailgate of Transcontinental Gas Pipe Line Corporation's North High Island Plant at Johnson's Bayou as evidenced by the Cameron Meadows Condensate Allocation statement issued by Texaco USA." Like No. 3571, Contract No. 3572 provided that the cost of delivery was to be borne by Wolverine. The price to be paid also was the posted monthly average.

The third contract, styled a Marketing Agreement Contract No. 3573, is also dated October 2, 1989. It is an agreement to "share the marketing

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1/ Wolverine Exploration Company's corporate name was changed to Amerac in March 1995. (Amerac's Statement of Reasons at 1, n.1. and Declaration of Jeffrey L. Stevens, Attachment D thereto.) When discussing the events underlying this appeal, the parties have chosen to refer to Appellant by its former name of Wolverine, and we shall do so as well. In discussing the merits of the appeal, however, we shall refer to Appellant as such or by its current name.

net profits realized from crude oil/condensate (`crude oil') purchase contracts (Essex Contracts 3571 and 3572) between Wolverine and ESSEX dated October 2, 1989." The parties agreed to execute the "participation agreement," the central clause of which provides as follows:

> (1) ESSEX will undertake certain marketing activities relating to this crude oil in order to maximize its marketing profit potential. Marketing activities may include term sales agreements with refineries, spot sales agreements, trading and hedging activities on the New York Mercantile Exchange, "Wet Barrel" trading operations, crude oil processing and any other generally accepted marketing activity. Determination of these marketing activities will be the sole discretion of ESSEX for which it will provide all required personnel.

Contract No. 3573 further provides that Wolverine would receive half of the "marketing net profits generated by ESSEX in the subsequent marketing activities," and defines marketing net profits as any and all income received as a result of marketing activities, "less all directly attributable marketing costs incurred by ESSEX." Lastly, Contract No. 3573 became effective on the same date as Essex Contract Nos. 3571 and 3572, and was to terminate on the effective date of the last of the two to terminate.

RMP reviewed Wolverine's royalty accounting practices and determined that Wolverine had failed to calculate royalties on the total value received from its sales to Essex for the period August 1, 1987, through July 31, 1992, concluding that Essex was merely a "conduit to facilitate the transfer and sale of oil from Wolverine to ultimate buyers." (October 21, 1993, RMP Order at 1.) Wolverine had calculated and paid royalties only of its half of the net marketing profits realized by Essex, rather than on the total profits realized, in violation of the provisions of 30 C.F.R. § 206.102(b)(ii) (1992), which authorized MMS to require payment of royalties on the basis of the total consideration received directly or indirectly by a lessee. Wolverine therefore was directed to identify all the leases from which Essex had purchased oil under similar contracts, to recalculate royalty on all proceeds received, and to pay the additional royalty due. Wolverine timely appealed. The May 17, 1994, Field Report upheld the RMP Order. On April 2, 1996, the Associate Director of MMS affirmed the Order, noting that royalty is to be computed on gross proceeds and not first sale proceeds. Specifically, the Associate Director concluded that "[c]ertain costs, whether they be described as marketing, maximizing profits, or selling, are not properly deductible from the gross proceeds when determining royalties. [Citations omitted.]" (Decision at 2.)

In its Statement of Reasons (SOR), Amerac urges three principal arguments. It contends that Wolverine complied with applicable valuation standards, argues that Essex's activities were not necessary to market Wolverine's product, and asserts the existence of "other relevant matters," as contemplated by section 6(b) of Amerac's oil and gas lease, that weigh against valuing royalty on the basis of total proceeds received by Essex and Wolverine. In addition to the relevant contracts, Amerac has provided a declaration from Jeffrey L. Stevens, Appellant's Senior Vice President and Chief Financial Officer (Stevens Declaration) and an affidavit executed by Phil Rykhoek, Wolverine's Vice President and Chief Accounting Officer (Rykhoek Affidavit), submitted as Exhibits D and E to SOR, respectively.

More specifically, Amerac argues that MMS is required to value the production pursuant to the applicable benchmark under 30 C.F.R. § 206.102(c)(2) through (5), as provided by 30 C.F.R. § 206.102(b)(1)(iii). (SOR at 1-2.) Thus, according to Appellant, the first applicable benchmark is an average of posted prices used in arm's-length transactions among persons other than the lessee. Since Essex paid Wolverine the average monthly posted price for the month in which the sale occurred, it is argued that there is no ground for seeking additional royalties.

It is further argued that Wolverine complied with its obligation to place the oil in marketable condition in that its oil fully satisfied the requirements of 30 C.F.R. § 206.101 at the time it was sold to Essex. (SOR at 5.) In support of this interpretation, Appellant advances the related argument that Essex's activities were not necessary to market Wolverine's oil as proven by Essex's purchase of the oil at market prices, and attempts to distinguish Wolverine's transactions from Board precedents explicating the duty to market production. (SOR at 6-7.) Thus, it is noted that Mobil Oil Corp. and Mobil Exploration & Producing Services Inc., 108 IBLA 216 (1989), involved deductions from gross proceeds of first sales of gas; that ARCO Oil & Gas Co., 112 IBLA 8 (1989), involved a deduction of the fee ARCO paid a nonexclusive marketing agent for first sales of gas; and that in Walter Oil and Gas Corp., 111 IBLA 260 (1989), Walter attempted to deduct the fees paid to an independent marketer for various marketing services which varied with the prices paid by purchasers to Walters. (SOR at 7-9.) Indeed, Amerac characterizes Wolverine's marketing agreement contract as "nothing more than an indefinite price escalation clause tailored to the needs of the current oil market," and asserts that Essex's "post-sale" marketing was possible "only because it pooled the production from Wolverine with that purchased from others." (SOR at 8.) As characterized by Appellant, the marketing agreement was merely a device by which Essex protected itself from price fluctuations, so that when the resale market obtained a price higher than the average posted price, Wolverine received more, and when Essex was unable to make a profit in reselling the oil, the average posted price served as the royalty basis. (SOR at 8-9.)

The concluding contention in this line of argument is that Essex's post-sale marketing activities were the same as those performed by affiliates of oil producers, and that Wolverine should be treated like an affiliate for purposes of calculating royalties. Amerac argues that in such cases, MMS calculates royalty by comparing the first sale price to the benchmarks prescribed by 30 C.F.R. § 206.102(c). (SOR at 10-11.)

Appellant's final assertion is that "other relevant matters" argue against valuing royalty based upon the total consideration received by Wolverine. In particular, Amerac states that, with the exception of the months of November 1989 through March 1990, it has been unable to locate any information regarding transactions pursuant to Contract No. 3573. It is not known whether Essex ever provided the information to Wolverine, although it is said that it was requested many times. (SOR at 13, citing Stevens Declaration ¶¶ 7-8.) Essex ultimately declared bankruptcy, in the course of which its assets were liquidated. As a result, Amerac avers that it now is impossible to obtain the relevant information regarding Essex's marketing activities, and that it therefore cannot determine whether the activities generated a profit. (SOR at 13.)

In its Answer, MMS argues that the only issue presented in this appeal is whether Wolverine fulfilled its duty to market production. Noting that Wolverine admits that it is proper to value royalty at a price that exceeds the lessee's gross proceeds if it fails to market production or if it fails to place production in marketable condition, MMS challenges Wolverine's assertion that Essex's activities under Contract No. 3573 were not necessary to market its production. (Answer at 4.) Walter Oil and Gas Corp., supra, and Arco Oil and Gas Co., supra, are cited as authority for the principle that a Federal lessee has a duty to market its production at no expense to the lessor, and that it is immaterial whether such costs are borne by the lessee or an independent marketer. (Answer at 5.)

As to the nature of the agreement between Wolverine and Essex, MMS disputes Appellant's characterization thereof, by quoting relevant portions of the agreement which, it is argued, constitute evidence that Essex performed marketing activities that are not deductible from royalty value. (Answer at 6.) MMS thus concludes:

> Wolverine was using Essex as a conduit to facilitate the transfer and sale of crude oil production from it to the ultimate buyers. Wolverine saw the need to have the crude oil marketed to maximize its profit potential. Therefore, Wolverine must include the profits retained by Essex from marketing Wolverine's production in Wolverine's royalty calculations because it has an obligation as lessee to market the production and at no expense to the lessor.

(Answer at 7 (citation omitted).)

In response to the assertion that the crude oil production should have been valued according to the first applicable benchmark identified in 30 C.F.R. § 206.102(c)(2) through (5), MMS notes that benchmarks are used only with respect to transactions that are not arm's length. Since there is no allegation that the Essex contacts were not arm's length, the cited regulation does not apply. (Answer at 8, n.7.) Regarding Amerac's argument that Wolverine is entitled to be treated in the same manner as an affiliate of an operator who performs marketing services after purchasing production, MMS similarly responds that in fact it is being treated in the same manner, because the proceeds of an affiliate are included in royalty basis. (Answer at 8, n.7.)

Amerac filed a Reply to MMS' Answer in which two new arguments are advanced. First, it is asserted that there is no duty imposed on the lessee to bear all the costs of marketing incurred after the point of the first sale of production, and none can be implied because no such duty is stated in the OCSLA. (Reply at 1-2.) Amerac expands the argument as follows:

> [T]he Department's right and ability to take oil in kind are sufficient in themselves to prevent the creation of an implied duty to market. "If the lessor's share of the oil, under the royalty provisions of the lease, is deliverable in kind to the lessor, the oil is theoretically under the control of the lessor and arguably he should be the one to market it, not the lessee." OIL AND GAS LAW § 853. The Department cannot imply a duty to serve the same purpose and achieve the same result as a duty already expressed. The lease expressly creates a duty in the lessee to provide the royalty on oil in kind, and MMS may market that share to its maximum advantage. (Id. at § 6.) The lessee, of course, is not responsible for MMS's costs of marketing in that setting. So the lease cannot contain an implied promise for the lessee to pay those costs when the Secretary takes his royalty share in value.

(Reply at 3.)

In the same vein, Amerac states that the first mention of a duty to market occurred in 1943, in newly amended and redesignated 30 C.F.R. § 221.135, which imposed the duty to market as a means of preventing waste, and did not state that it was free of expense to the lessor. Amerac thus concludes that "OCS leases never were subject to an express duty to market," only an express duty to put production into marketable condition, and only for leases executed after 1954. (Reply at 4.)

The second major argument is that even if the duty to market is properly construed to impose all costs on the lessee, it is not applicable to Wolverine's transactions with Essex because they occurred downstream of the point of first sale. More particularly, Amerac states that

> the profits generated by Essex resulted not from either creating and developing first-sale markets or a simple resale of production, but rather were in large part dependent on Essex's ability to pool the oil/condensate it purchased from Wolverine with that purchased from others. (Stevens Declaration ¶ 3(c); Rykhoek Affidavit ¶ 10.) The expenses Essex incurred from its activities were not expenses a lessee would have had to incur anyway to market production at the lease.

(Reply at 9.)

[1] We begin with the marketing agreement between Wolverine and Essex. Despite Appellant's characterization of the agreement as an "indefinite price escalation clause," the contract as a whole appears to be and declares itself to be a marketing agreement pursuant to which Essex was to market Wolverine's oil to the ultimate purchasers for the best possible price. Appellant emphasizes that under Contract Nos. 3571 and 3572, Wolverine was obligated to sell its entire output to Essex, thus constituting the first sale under an arm's-length contract. However, Essex's marketing net profit was the sum remaining after the deduction, if applicable, of the cost of the crude oil purchased from Wolverine under the subject contracts, transportation costs from the leasehold, pipeline tariffs and fees, commissions, inspection fees, and exchange differential fees. Only general and administrative costs were to be borne solely by Essex.

Thus, under the terms of the marketing agreement, the first sale did not occur until Essex sold the oil/condensate to third parties, contrary to Appellant's assertion, because Essex was to be reimbursed for all costs it incurred, excepting its own general and administrative costs in providing marketing services. In return, Essex was paid one-half of the profit remaining after its costs were reimbursed. As noted, Amerac submitted the Stevens Declaration and the Rykhoek Affidavit in support of its SOR. Although both aver that transportation costs were paid by Wolverine, neither otherwise addresses this reimbursement provision. We therefore assume that Essex in fact was reimbursed for the enumerated costs it paid, including the prices it paid for Wolverine's crude oil/condensate, and accordingly, attach no significance to the assertion that the profits garnered by Essex are attributable to its ability to pool Wolverine's oil/condensate with other production. Consequently, we conclude that MMS correctly determined that Essex was merely a conduit to the ultimate purchasers, and that its share of the marketing net profits constituted a marketing fee.

[2] A lessee is required to place its production in marketable condition at no cost to the lessor. 30 C.F.R. § 206.102(i). An element of this so-called marketable condition rule is the duty to market production. The Texas Company, A-27427, 64 I.D. 76, 79 (1957). The creation and development of markets for production is the very essence of the lessee's implied obligation to prudently market production from the lease at the highest price obtainable for the mutual benefit of the lessee and lessor, and it is the lessee's duty to perform that service free of expense to the lessor. Taylor Energy Co., 143 IBLA 80, 81 (1998); ARCO Oil & Gas Co., 112 IBLA 8, 11 (1989). As we have observed in the past, nothing prevents a lessee from engaging an agent to sell its production. It is established, however, that the duty to market exists without regard to whether the lessee chooses to market its production using its own staff and efforts, or engages an affiliate or a third party to perform such services. Exxon Co., U.S.A., 121 IBLA 234, 247, 98 I.D. 409, 416 (1991); Walter Oil and Gas Corp., supra at 265 (1989). Moreover, it is irrelevant that title to the

production may have passed prior to the commencement of marketing activities. Apache Corp., 127 IBLA 125, 134 (1993); Exxon Company, U.S.A., supra at 247. Marketing costs would not have been deductible if Wolverine had marketed its crude oil/condensate itself; they are therefore not deductible because Essex performed them. Placid Oil Company, A-29577, 70 I.D. 438, 440 (1963).

It is equally clear that the holder of a Federal OCS lease is obligated to pay royalty on the value of its production, as determined according to 30 C.F.R. § 206.102. That regulation provides that the value of oil sold pursuant to an arm's-length contract shall be the gross proceeds accruing to the lessee, unless subparagraphs (b)(1)(ii) and (iii) thereof are applicable, in which case MMS can require the valuation to reflect the total consideration received. The value of production in no circumstances can be less than the gross proceeds less applicable deductions. 30 C.F.R. § 206.102(h); Pennzoil Oil & Gas, Inc., 109 IBLA 147, 159 (1989). This is also stated in Appellant's lease. (Lease No. OCS-G 8150, sec. 6(b).) For royalty purposes, gross proceeds is defined as the total monies and other consideration accruing to a lessee for disposition of the production. 30 C.F.R. § 206.101. Appellant's lease is expressly subject to applicable regulations. (Lease No. OCS-G 8150, secs. 1, 10.) As lessee bears the duty to market production free of expense to the lessor, any fees paid to a third party for marketing services are properly regarded as gross proceeds accruing to Wolverine. Taylor Energy Co., supra; Apache Corp., supra; Exxon Company, U.S.A., supra; ARCO Oil & Gas Co., supra; Walter Oil and Gas Corp., supra.

As to Appellant's argument that the benchmarks set forth at 30 C.F.R. § 206.102(c)(2) through (5) are the appropriate measure of value, MMS correctly notes that such provisions are applicable to contracts that are not arm's length. MMS is also correct in stating that the proceeds of an affiliate may be considered part of a lessee's gross proceeds for royalty purposes in appropriate circumstances. Compare Shell Oil Co. (On Reconsideration), 132 IBLA 354, 356 (1994); Santa Fe Energy Products Co., 127 IBLA 265, 268 (1993) with Xeno, Inc., 134 IBLA 172, 182-83 (1995).

One final argument deserves comment. As noted, Appellant argues that "other relevant matters," meaning the present unavailability of Wolverine's documentation of the transactions with Essex, should lead us to reverse MMS. The phrase appears in section 6(b) of Appellant's lease and in 30 C.F.R. § 206.103 (1985), styled Value basis for computing royalties. Decisions of this Board have discussed versions of the regulation in which the phrase appeared without construing it. See, e.g., Santa Fe Energy Products Co., supra at 267; Amoco Production Co., 112 IBLA 77, 80 (1989). Citing ARCO Oil and Gas Co., 109 IBLA 34, 38 (1989), in Walter Oil and Gas Corp., supra at 265, this Board noted that transportation allowances have been considered a relevant factor pursuant to 30 C.F.R.

§ 206.150 (1987), a subsequent version of the regulation cited by Appellant. The regulation, 30 C.F.R. § 206.103 (1985), provided as follows:

> The value on production, for purposes of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director 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, to regulated prices, and to other relevant matters. Under no circumstances shall the value of production * * * for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof * * *.

(Emphasis added.)

Plainly, the focus of the regulation is information of an objective nature that is necessary to ascertain or estimate the market value of production of like quality in the same field. The phrase "other relevant matters" refers back to the types of information deemed to be appropriate indicators of true market value, not to the kind of individual circumstances here articulated by Appellant as a defense to MMS' Order. Moreover, the emphasized language, which appears in virtually identical form in the Appellant's lease, completely negates Amerac's argument that it should not be required to pay royalties on the basis of gross proceeds. Accordingly, we find no support for Appellant's interpretation. The Decision must be affirmed.

Other arguments not specifically addressed herein have been considered and rejected.

Therefore, in accordance with the authority delegated to the Interior Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the Decision is affirmed.

T. Britt Price
Administrative Judge

I concur:

James L. Byrnes
Chief Administrative Judge