Editor's Note: Appeal filed, Civ. No. 02-3543 (E.D. LA), aff'd (March 31, 2004), appeal filed No. 04-30435 (5th Cir.), appeal dismissed, No. 04-30435 (5th Cir. Dec. 6, 2004).

NEXEN PETROLEUM U.S.A. INC.
NEXEN PETROLEUM OFFSHORE U.S.A. INC.

IBLA 2002-203 Decided October 28, 2002

Appeal from a decision of the Associate Director for Policy and Management Improvement, Minerals Management Service, affirming an order to pay additional royalties on Outer Continental Shelf leases. MMS-00-018-OCS.

Affirmed.

1. Oil and Gas Leases: Royalties: Generally

A Federal oil and gas lessee is under an obligation to assume the expenses of placing oil produced and sold into "marketable condition." No deduction from royalty is allowed for the expenses of gathering oil from platforms to a treatment facility on an adjacent lease, where it is commingled with other production, placed in marketable condition, and delivered to a common carrier pipeline.

APPEARANCES: M. Hampton Carver, Esq., Stacy Smith Brown, Esq., Robert Spier Stassi, Esq., New Orleans, Louisiana, for appellants; Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE HEMMER

CXY Energy Inc. and CXY Energy Offshore Inc. (CXY) appeal from a decision of the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS), issued to them on December 14, 2001. 1/ The decision denies CXY's appeal to the MMS Director of a January 5, 2000, order of the Area Supervisor, Lakewood Compliance Division, MMS, directing CXY to report and pay additional royalties in the amount of $611,509.71.

1/ On Jan. 24, 2002, and Mar. 22, 2002, appellants' counsel advised the Board that CXY Energy Inc. and CXY Energy Offshore Inc. had changed their names to Nexen Petroleum U.S.A. Inc. and Nexen Petroleum Offshore U.S.A. Inc., respectively. For consistency with the record, this decision will refer to appellants as "CXY."

In this order MMS alleged that CXY had improperly deducted from the value of oil on which royalties were calculated the cost of gathering oil to the point of treatment. The royalty demand pertained to oil produced from three offshore Federal oil and gas leases between July 1992 through December 1995.

BACKGROUND

During the period relevant to this appeal, CXY was a lessee on three Federal oil and gas leases (054-001958-0 (lease 1958), 054-001959-0 (lease 1959), and 054-002103-0 (lease 2103)) located offshore Louisiana in the outer continental shelf (OCS) of the Gulf of Mexico. The leases were issued in 1970 and 1971 pursuant to the Outer Continental Shelf Lands Act (OCSLA), 43 U.S.C. § 1337 (1994). The parties generally agree that, during the period relevant here, from July 1992 through December 1995, CXY produced oil from the leases. Under the terms of the OCSLA, CXY was obligated to pay on this production a "royalty fixed by the Secretary at not less than 12 ½ per centum in amount or value of the production saved, removed or sold." 43 U.S.C. § 1337(a)(1) (1994).

This case involves the proper determination of royalty on CXY's leases and, in particular, the line between costs of transportation, which may be deducted from royalty value, and the costs of gathering, which generally may not. Before describing the facts further, it is thus appropriate to set forth regulations pertaining to this issue.

At all times relevant to this dispute, MMS regulations established that Federal lessees are obligated to place oil in marketable condition at no cost to the Federal Government or Indian lessor. 30 CFR 206.102(i) (1995). "Marketable condition" means "lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area." 30 CFR 206.101 (definitions) (1995).

The regulations further established that, in the case of an arm's length sale, the value of oil production upon which royalty is to be calculated shall be the "gross proceeds" accruing to the lessee. 30 CFR 206.102(b)(1)(i) (1995). The definition of "gross proceeds" verified that a lessee must pay royalties on proceeds which reimburse the lessee for treating gas, including gathering, if the lessee is obligated to perform such services at no cost to the lessor:

> *Gross proceeds* * * * means the total monies and other consideration accruing to an oil and gas lessee for the disposition of the oil produced. Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as dehydration, measurement, and/or gathering to the extent that the lessee is obligated to perform them at no cost to the Federal Government or Indian lessor.

30 CFR 206.101 (definitions) (1995). The rules defined "gathering" as "the movement of lease production to * * * a central accumulation or

treatment point off the lease, unit, or communitized area as approved by * * * MMS OCS operations personnel for * * * offshore leases * * *." 30 CFR 206.101 (definitions) (1995).

MMS rules expressly provided for an "allowance" or "accepted deduction" from royalty value. Id. MMS rules authorized such deductions/ allowances for the "reasonable, actual costs incurred by the lessee to * * * [t]ransport oil from an offshore lease to the point off the lease" where the sale is made or the value is determined. 30 CFR 206.104(a)(2) (1995). In defining "transportation allowances," MMS distinguished gathering costs, which cannot be included within the transportation allowance:

> *Transportation allowance* means an allowance for the reasonable, actual costs incurred by the lessee for moving oil to a point of sale or point of delivery off the lease, unit area, or communitized area, excluding gathering, or an approved or MMS-initially accepted deduction for costs of such transportation * * *.

30 CFR 206.101 (definitions) (1995) (emphasis added). 2/

The three leases at issue here lie in the Eugene Island area of the OCS in an L-shaped pattern. Lease 1958 lies adjacent to and north of lease 1959, which in turn is adjacent to and west of lease 2103. The parties agree that, at least in part, oil produced from the three leases was brought up to seven platforms on the three leases and was commingled at another platform for shipment ultimately to Louisiana.

The record contains diagrams indicating the structure of the platforms and of the pipelines through which oil from CXY's three leases flowed. The platforms are depicted to lie in a roughly semi-circular pattern with platform B/A in the middle of the other seven. Platforms C, D and E lie within the boundaries of lease 2103. To the west, platforms G, I, and J appear on lease 1959, and to the north platform H lies within

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2/ From 1954 to 1988, Department regulations governing the collection of royalty on OCS leases generally applied to both oil and gas production. In 1987, the Department engaged in a comprehensive rulemaking, with notice and comment procedures, to publish, ultimately, separate royalty valuation rules for oil and gas. See 53 FR 1184 (oil) and 53 FR 1230 (gas) (Jan. 15, 1988). The rules governing oil valuation were published at 30 CFR 206.100-206.105, and the rules governing gas valuation were published at 30 CFR 206.150-206.159. The rules described above, however, are virtually identical with respect to both products. See 30 CFR 206.150 (for gas royalty, definitions of "gathering," "gross proceeds," and "marketable condition"); 30 CFR 206.152(b) and 206.153(b) (gross proceeds rule for unprocessed and processed gas); 206.156 (transportation allowances for gas). They are also consistent, as shown below, with rules applicable to OCS leases prior to the 1988 rulemaking. Because of their common genesis and common terms, the cases discussing gathering of oil or of gas, and discussing prior periods, are addressed interchangeably.

lease 1958. 3/ Platform B/A is operated or owned by Shell Oil Company (Shell), and lies within the boundaries of lease 1959. 4/ According to the diagrams employed by both parties, platform B/A is located in the center of the other seven platforms, e.g., CXY Ex. 1, and connected to each of them by pipelines through which CXY delivers hydrocarbon production to platform B/A. This central platform thus receives production from platforms C-E lying to the east and north, and from platforms G-J lying to the west and north. 5/

The parties agree that each platform transferring oil to platform B/A contains several wellheads. CXY produced hydrocarbons and separated oil from gas at platforms C-E and G-I. Then CXY transferred the products from each of these other platforms to platform B/A on lease 1958. Platform B/A is a combination treatment facility. Gas is commingled and treated at platform A, and oil is commingled and treated at platform B. Letters in the record demonstrate that MMS discussed and approved these "commingling, measurement, and allocation procedures" in 1993, and again, upon CXY's request for a revision, in 1994. (MMS Letters dated Oct. 7, 1993, and Apr. 13, 1994, to CXY.)

At platform B/A, CXY performed further treatment to place the oil and gas in marketable condition. CXY explains:

> The production which is accumulated at CXY's C, D and E Platform is separated there. It, like the production from the other wells, is further treated at CXY's A-B Platform and at that point, is placed in marketable condition.

(SOR at 3 (emphasis added).)

CXY transported all treated oil from platform B/A, by way of Shell's common carrier pipeline, to Shell's Gibson terminal and then to an oil refinery at St. James, Louisiana. MMS characterized this movement as follows: "[T]he oil is treated and metered for royalty at the 258B/A platform and is then transported to Shell Oil's header system located on

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3/ In its Statement of Reasons (SOR), CXY refers to platform "F." (SOR at 3.) No platform F appears on CXY's Exhibit 1, which is a diagram of the various platforms copied from an exhibit to MMS' original order to CXY. The challenged MMS decision notes that platform F is located on a lease in which CXY has no interest. (Decision at 9 n.2.) CXY does not refute this conclusion. A letter in the record establishing approved commingling avers to platform F on lease OCS-G 3996. (Apr. 13, 1994, MMS Letter to CXY.)
4/ Platform B/A is identified variously in the record and the parties' pleadings as platform B/A and A-B, and EI 258 [Eugene Island Block 258] B/A.
5/ CXY's exhibit does not complete the line representing the pipeline between platform J and platform B/A. (CXY Ex. 1.) Nonetheless, CXY concedes that oil from platform J is treated at platform B/A, in which case the two must, a fortiori, be connected.

the EI 259A platform. The oil continues to Ship Shoal 28 via a Shell Oil common carrier pipeline and then on to Shell's Gibson Terminal, and subsequently to St. James station." (Aug. 26, 1999, MMS issue letter to CXY at 1-2.) 6/

CXY deducted the costs of delivering oil to platform B/A from platforms C-E and G-I. (SOR at 3.) It also deducted the costs of transporting the gas from platform B/A to the St. James facility. MMS accepts that this latter deduction was an approved transportation allowance not at issue here.

The record indicates that MMS began an audit of CXY's royalty compliance for the period from January 1, 1993, through October 31, 1997. On August 26, 1999, the Area Supervisor, Lakewood Compliance Division, sent an audit issue letter to CXY asserting that CXY had "underpaid oil royalties by $611,509.71, due to disallowed gathering deductions for the period July 1992 through December 1995" on the three leases. MMS noted that CXY had deducted only the proper transportation allowance after December 1995. (Audit Issue Letter at 2.)

CXY responded to the audit issue letter, disagreeing with the conclusion and arguing, inter alia, that platforms C-E and G-J were the "first point[s] of central accumulation" such that all costs incurred in transferring oil production from these platforms to platform B/A are costs of transportation and not gathering. Focusing on the term "central accumulation point" appearing in the definition of gathering as defined in 30 CFR 206.101, CXY argued that the platforms on each lease were the "first" such point, and that platform B/A was merely a subsequent central accumulation point. CXY argued that all costs incurred after the first such point were permissible transportation allowances. See Sept. 28, 1999, CXY Letter to MMS at 2.

On January 5, 2000, the Area Supervisor, Lakewood Compliance Division, MMS, sent CXY the order that forms the basis for this appeal. It required CXY to report and pay $611,509.71 in royalties, rejecting the argument presented by CXY that movement from platforms C-E and G-J to platform B/A constituted transportation for which CXY would be allowed a deduction from royalty value. MMS stated that the "movement of oil from the multiple platforms to the approved commingling point at EI 258B/A meets [the] definition of gathering. * * * [G]athering is considered part of placing lease production in marketable condition and therefore, is not allowable as a transportation cost." (Jan. 5, 2000, order at 2, citing 30 CFR 206.101 and 106.102(i) (1999).)

On February 3, 2000, CXY appealed the order to the MMS Director. MMS prepared an "appeal field report" on June 20, 2000. On July 21, 2000, CXY submitted a response. On December 14, 2001, the Associate Director issued the decision denying the appeal. CXY appealed.

6/ CXY does not object to or characterize differently the transfer of oil beyond platform B/A.

In its SOR, CXY focuses on the following challenges to the Associate Director's decision. First, CXY argues that this case hinges on construction of "the disjunctive 'or'" in the regulation defining gathering. CXY argues that because the MMS regulation at 30 CFR 206.101 defines "gathering" to occur at "a central accumulation *or* treatment point" (SOR at 4 (italics in original)), the Associate Director erred in disallowing all costs of transferring gas to platform B/A from the multiple platforms C-E and G-J. According to CXY, the Associate Director should have agreed that the multiple platforms are "central accumulation points" because several wellheads deliver oil to them. Because the rule uses the disjunctive "or," CXY argues, the Associate Director was obligated to permit deduction of all costs to move oil after the first platform at which the product "accumulates" (platforms C-E and G-J). Otherwise, CXY claims that MMS improperly fails to give meaning to each word of the definition. (SOR at 4.)

CXY goes on to argue that the Associate Director failed to acknowledge that the regulation focused on "a" central accumulation point rather than "the" central accumulation point. (SOR at 6.) CXY asserts that this focus on the word "a" suggests that MMS was aware that more than one such point could be identified in a particular situation and that MMS' rule was "clear cut" in requiring transportation allowances after the first such point. CXY also claims that an MMS guidance letter regarding deepwater wells confirms CXY's construction of "gathering." Id. at 4, citing May 20, 1999, "Guidance for Determining Transportation Allowances for Production from Leases in Water Depth Greater than 200 Meters."

CXY contends that the Associate Director was wrong in relying on the rule that lessees must place oil in marketable condition at no cost to the lessor, pursuant to 30 CFR 206.102(i) (1988). CXY argues that the Associate Director's conclusion that platform B/A was the treatment point is a "non sequitur." The "conclusion does not flow from the premise," CXY claims, because it does not take into account the point of first accumulation of product. (SOR at 7.) CXY cites the Board's decision in Exxon Corporation, 118 IBLA 221 (1991), and a subsequent decision of MMS with respect to Exxon as disproving MMS' construction of the marketable condition rule. (SOR at 7-8.) CXY sets forth its view of how to distinguish various cases in which the Federal courts have required lessees to place gas in marketable condition at no cost to the lessor. (SOR at 9-10.)

Finally, CXY asserts that, even if MMS' construction of applicable rules and precedent is correct, its construction of them with respect to CXY is wrong because the rules upon which MMS relies were promulgated in 1988. CXY's leases were issued in 1970-71, and, according to CXY, do not permit subsequent rules to apply to them.

MMS responds with a discussion in support of the MMS decision based on its construction of the regulations. MMS disagrees with CXY's argument that the 1988 rules do not apply to pre-existing OCS leases. MMS further argues that the same result would obtain even in the absence of the 1988 rules. (MMS Answer; see also CXY Response, and MMS Reply.)

ANALYSIS

[1] It is undisputed that MMS regulations require oil to be placed in marketable condition and that the lessee pay royalty on the gross proceeds CXY received for the oil. CXY may not deduct from its proceeds costs of placing oil in marketable condition. The definition of "gathering" does not alter these longstanding rules.

The marketable condition and gross proceeds rule have been in place for offshore production, unchanged in any respect significant here, since 1954. 30 CFR 250.64 (1954), 250.64 (1979), 206.150 (recodified) (1983) (gross proceeds) 7/, 250.41(b) (1954-1978), 250.42(b) (1979-1987) (marketable condition); see also California Co. v. Udall, 296 F.2d 384, 386-87 (D.C. Cir. 1961) (construing gross proceeds and marketable condition rules then in place). Onshore operational regulations have required for decades that lessees place production in marketable condition: "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) (1982-95). When MMS revised the royalty valuation regulations in 1988 to add the definition of gathering, it consciously retained and re-promulgated these longstanding rules. Thus, the definition of "gathering" must be read in harmony with the marketable condition and gross proceeds rules.

Gathering has long been held to be a part of treating production to place it in marketable condition. Mesa Operating Limited Partnership v. DOI, 931 F.2d 318, 320 n.7 (5th Cir. 1991); The Texas Co., 64 I.D. 76, 78 (1957). For decades, judicial and Board decisions have increasingly focused the line between gathering and transporting production in the case of Federal oil and gas leases. CXY's admission that it brought oil from multiple platforms to platform B/A in order to place the oil in marketable condition (SOR at 3), makes application of that precedent fairly straightforward.

In the onshore context, The Texas Co. discussed the duty to market and the obligation of the lessee of a Federal oil and gas lease to pay royalty on compressed oil well gas gathered to a contractual delivery point. That case distinguished gathering from transportation where the lessee had to "transport the product elsewhere to market it." 64 I.D. at 78-79.

This logic behind distinguishing gathering for purposes of treating gas to place it in marketable condition from transportation to a point of delivery has persisted through subsequent Board and judicial cases. In California Co. v. Udall, 296 F. 2d at 386-87, the United States Court of Appeals for the District of Columbia Circuit upheld an order requiring a

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7/ The "gross proceeds" rule for offshore production was taken from a virtually identical rule published for onshore production no later than 1942. 30 CFR 221.47, promulgated at 7 FR 4132 (June 2, 1942).

Federal oil and gas lessee to place production in marketable condition at no cost to the lessor and refused to permit the lessee to deduct, inter alia, costs of gathering.

In Kerr-McGee Corporation, 22 IBLA 124 (1975), the Board distinguished the obligation of the lessee to place gas in marketable condition at no cost to the lessor and that of the Department to permit transportation deductions for costs to move production to an off-lease market. The Board explained:

> The Department has long held that the costs of conditioning oil or gas in order to put it in a marketable state are not allocable to the federal royalty interest. This result has been premised on the fact that federal oil and gas lessees have the contractual obligation to place the production of such substances in a marketable condition. The California Co., 66 I.D. 54 (1959), aff'd, 296 F.2d 384 (D.C. Cir. 1961); The Texas Co., 64 I.D. 76 (1957). Similarly, the Department has refused to allow deductions from the price received by lessees for transportation costs from one point in the field to a selling point in the same field. The California Co., supra; The Texas Co., supra. This Department has never ruled, however, that transportation costs are not recoverable on a pro rata basis when there is no market in the field. On the contrary, the Department, in Shell Oil Co., 70 I.D. 393 (1963), specifically noted that "[o]il and gas leases * * * have been construed to allow for the deduction of transportation costs in the computation of market values and royalty interests." Id. at 395, fn. 6.
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> In The Texas Co., supra, the Department distinguished transportation to a selling point in the field from transportation out of the field to a market place. Id. at 79-80. In like manner, the D.C. Circuit Court of Appeals noted in The California Co. case, supra, that:
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>> [n]o transportation costs are involved in this case. The Secretary is not here claiming that costs incurred in moving gas from the field in the neighborhood of the wells to a distant selling point are includable in the royalty base. This gas was conditioned by the seller and delivered to the purchaser in the field within a short distance of the wells. There were no transporting costs.
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> Id. at 387.
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> In Superior Oil Company, 12 IBLA 212 (1973), this Board denied a barging allowance for transportation of crude oil from Burns Terminal to Marrero, Louisiana * * *.

> Superior is distinguishable from the case at bar in that Superior was seeking an allowance for transportation beyond the point of the first potential market, Burns Terminal, and at which market the royalty base was deemed to be established. Kerr-McGee is seeking a transportation allowance only from its leasehold to the point of the first market.

Kerr-McGee Corporation, 22 IBLA at 126-27.

In subsequent developments, the Board and the courts were called to address particular fact patterns, and to choose which costs fell on which side of the line between gathering and transportation. Without a full recitation of every case, several recent decisions are instructive. In Bailey D. Gothard, 144 IBLA 17 (1998), this Board confirmed that a lessee may not deduct the costs of gathering from its proceeds upon which royalties are to be calculated, relying on the continued validity, inter alia, of The Texas Co., 64 I.D. at 76, and the marketable condition rule. The Board explained recent cases where lessees had shown in particular scenarios that a product was marketable at the wellhead.

> The marketable condition rule is applicable in cases such as the case now before us, where the gas was sold at the wellhead to a gathering system operator who compressed the gas in order to introduce it into a market pipeline. Deductions from the value of the gas for these expenses are not allowed whether incurred by the lessee or a third party, before or after the initial sale of the gas, when the evidence discloses that this is necessary to market the gas. Xeno, Inc., [134 IBLA 172] 181 [(1995)]; R.E. Yarbrough & Co., 122 IBLA 217, 221 (1992).
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> [T]he Board [has] discussed the distinction between gathering and transportation costs, noting that the latter are allowable as an adjustment to the lessee where transportation of the gas from the wellhead to the point of delivery is not required to put the gas in a marketable condition. [Xeno, Inc.,] at 183-84.

144 IBLA at 22. The Tenth Circuit Court of Appeals upheld MMS's interpretation of the marketable condition rule with respect to treatment costs, including those for gathering, reimbursed to a lessee. Amerada Hess v. DOI, 170 F.3d 1032, 1036-37 (10th Cir. 1999) (distinguishing Xeno, Inc. on grounds that gas in that case was marketable at the wellhead). 8/

8/ In Amerada Hess, as in Mesa Operating Limited Partnership, 931 F.2d at 318, the lessee received reimbursements for costs of treatment, including gathering, under the terms of Federal Energy Regulatory Commission Order 94-A, 48 FR 5152, 5180 (Feb. 3, 1983), issued under the terms of the Natural Gas Policy Act of 1978, 15 U.S.C. § 3321(a)(2) (1978).

In Kerr-McGee Corporation, 147 IBLA 277, 280 (1999), the Board expressly addressed questions raised when a lessee performed treatment of production at an off-lease facility. It thus construed the term "gathering" in 30 CFR 206.101, in a fact pattern virtually identical to CXY's. Kerr-McGee collected gas that surfaced to offshore platforms on leases and transferred the product to platforms on adjacent leases for treatment and sale. The Board concluded that "even though production is moved across lease boundaries, because it is treated and sold on adjacent leases the costs of moving it there are properly regarded as gathering, not transportation." Id. at 283, citing Branch Oil & Gas Co., 144 IBLA 304, 306-08 (1998) (royalties paid on production marketable only after gathering and compression); Xeno, Inc., 134 IBLA at 180-81; Arco Oil & Gas Co., 112 IBLA 8, 10-11 (1989) (costs of marketing agent not deductible); Shell Oil Co., 70 I.D. at 393. 9/

Returning to the facts in this case, MMS determined that the transfer of oil to platform B/A, the central platform within the semi-circle of platforms at which wellheads are located, was gathering to a point of treatment. CXY acknowledges that it brought the oil to platform B/A for treatment to put oil in marketable condition. CXY does not argue that platforms C-E or H-J constituted the "market" or that the oil was "marketable" at those platforms such that any transfer beyond that point was transportation. CXY does not argue that transfer from multiple platforms to central platform B/A for treatment was unnecessary to market the gas, or that it could otherwise be delivered to Shell's common user pipeline whence it was transported onshore.

CXY thus presents the discrete issue of whether the cost of gathering oil to a point of treatment is part of placing gas in marketable condition at no cost to the lessor. 10/ The precedent discussed above squarely addresses this question. As in Kerr-McGee Corporation, 147 IBLA at 283, the cost of gathering oil to the off-lease treatment facility for delivery to the common carrier pipeline was gathering. Failing to present evidence or argument that commingling the oil from the various platforms at platform B/A for treatment was unnecessary to place oil in marketable condition, CXY fails to show that the costs of delivering the oil constitute a permissible transportation allowance.

9/ The decision also noted that, in the context of addressing whether the Bureau of Land Management had properly construed its operational regulations to require right-of-way grants for pipelines within an operational system, the Board had addressed the attributes of a gathering system in Enron Oil & Gas Co., 122 IBLA 224, 238, 99 I.D. 20, 28 (1992). Citing Enron, the Board held that system lines constitute a gathering system if: "(1) they move lease production to a central accumulation point; (2) they connect to [product] lines; and (3) they bring [production] by separate and individual lines to a central point where it is delivered into a single line." Kerr McGee Corporation, 147 IBLA at 282.

10/ CXY does not appear to suggest that the long-standing view of gathering should be different depending on the nature of the product (oil or gas) or the location of the lease (onshore or offshore).

CXY raises arguments that, if sustained, might cause us to alter the construction of "gathering" or of the MMS rules to reach a different result in the analysis of the line between gathering and transportation. We examine these arguments in turn.

Noting that "gathering" is defined to mean "movement of production to a central accumulation *or* treatment point'" (SOR at 3), CXY claims that MMS must properly account for the words "or" and "a." Doing so, says CXY, necessarily compels that the line between "gathering" and transportation occurs at the "first" of any number of a central accumulation or treatment points. (SOR at 4-6.) CXY argues that MMS erred in finding that gathering occurred before the point of treatment, platform B/A, because the other platforms C-E and H-J were the first central accumulation points in that they accumulated production from wells served by each platform. Id. CXY objects to the contrary conclusion in Kerr McGee Corporation, 147 IBLA at 283, because it allegedly failed to correctly interpret the definition. (SOR at 7.)

We disagree. CXY's construction of the definition would read it to be contrary to the longstanding precedent and rules described above. CXY would interpret the definition of "gathering" to require royalty calculation to be determined on the basis of where product was first commingled or "accumulated" with other product, not on where it was accumulated to treat it or deliver it to market. MMS made clear that its intent in promulgating the definition was otherwise. Regulations in effect prior to the 1988 regulations reflected the Department's intent to ensure that lease production could be commingled for purposes of treatment:

> Subject to such conditions as he may prescribe for measurement and allocation of production, the supervisor may authorize the lessee to move production from the lease to a central point for purposes of treating, measuring, and storing, and in moving such production, the lessee may commingle the production from different wells, leases, pools, and fields, and with production of other operators. The central point may be on shore or at any other convenient place selected by the lessee.

30 CFR 250.68 (1979), promulgated at 19 FR 2660 (May 8, 1954).

The 1988 rulemaking made no effort to revise this concept and was consistent with it. Rather, in setting forth the definition of "gathering," MMS explained:

> The operational regulations of both BLM and MMS require that a lessee place all production in a marketable condition, if economically feasible, and that a lessee properly measure all production in a manner acceptable to the authorized officials of those agencies. Unless specifically approved otherwise, the requirements of the regulations must be met prior to the production leaving the lease. Therefore, when approval has been granted for

> the removal of production from a lease * * * area for the purpose of treating the production or accumulating production for delivery to a purchaser prior to the requirements of the operational regulations having been met, MMS does not believe that any allowances should be granted for costs incurred by a lessee in these instances.

53 FR 1184, 1193 (Jan. 15, 1988) (emphasis added); see also 52 FR 39845, 39857 (Oct. 23, 1987) (second notice of proposed rulemaking). This explanation was consistent with the previously promulgated 30 CFR 250.68, and with the operational rules at 43 CFR 3162.7-1(a) (1988). Likewise, in discussing the transportation allowance, MMS explained its decision to include the term "off the lease" within the discussion of the allowance at 30 CFR 296.104, as based on the following logic: "Thus, transportation off the lease, other than gathering, is subject to an allowance." 52 FR at 39854 (Oct. 23, 1987) (emphasis added).

MMS' language in promulgating the rule directly addresses the facts of this case. On October 7, 1993, MMS sent a letter to CXY approving a number of pipeline transfers for commingling products on CXY's various oil and gas leases. While the letter pertains also to gas, it expressly approved CXY's commingling of oil from leases 1958, 1959 and 2103 at a treatment facility on platform EI 258B/A, on lease 1958. Referring to oil and gas from leases 1958, 1959, 2103, and 3996, MMS approved their transfer to a separator. Then, the

> liquid hydrocarbons from the intermediate-pressure/low-pressure separator will be combined/commingled with the liquid hydrocarbons from the low-pressure separator, will enter a chem-electric treater, will flow through a heat exchanger, will enter an oil surge tank, will be metered, for sales and royalty purposes, by the previously-approved Eugene Island Block 258 B platform ACT unit, and will be delivered into [O]perations System No. 26.0.

(Oct. 7, 1993, MMS Letter to CXY at 3-4.) This letter went on to explain that royalty for oil attributed to the four leases (including 3996) would be determined at the "Eugene Island Block 258 B platform ACT unit," and allocated to each lease based on periodic well tests. Id. at 4. This letter determines, as described in the operational regulations, that platform B/A was a central accumulation point as well as a central treatment point for delivery into the transportation system.

These facts support MMS' view that the critical word in the definition of "gathering" is "central." Where a lessee accumulates product to a central point for delivery to a purchaser, costs of treatment necessary to make it marketable are reasonably construed as "gathering." MMS explains that the reason for the inclusion of the term "central accumulation point," as a disjunctive from the term "treatment point," is that the "point" may be either for "the purpose of treating the production or accumulating production for delivery to a purchaser." 53 FR at 1193. We must reject

CXY's construction of the definition of gathering to limit its coverage to movement prior to the first point where production is "accumulated."

Nor does CXY's citation to the May 20, 1999, guidance for deepwater wells alter MMS' explanation of the "gathering" definition. MMS avers that this memorandum, "Guidance For Determining Transportation Allowances for Production from Leases in Water Depths Greater Than 200 Meters," does not control CXY's case because CXY's wells are at roughly 45 meters depth. CXY does not dispute this fact and, thus, the memorandum is not applicable in these circumstances.

CXY's argument, though, is that the memorandum's language undercuts MMS' application of its rules in CXY's case. Thus, we consider that memorandum in order to address this argument. It states:

- The transportation allowance must be determined in accordance with the current regulations.

  * * * * * * *

- Movement prior to a central accumulation point is considered gathering. A central accumulation point may be a single well, a subsea manifold, the last well in a group of wells connected in a series, or a platform extending above the surface of the water. Movement beyond this point is considered transportation.

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- <u>To qualify for a transportation allowance, the movement must be to a facility that is not located on a lease adjacent to the lease on which the production originates.</u>

(Emphasis added.)

This memorandum does not support CXY's construction of it. Rather, this document makes clear that MMS did not believe the central accumulation point was the "first" such accumulation point. Rather, it could easily be, <u>inter alia</u>, the "last well" in a series. Moreover, transportation allowances relate to movement to a facility "<u>not located</u>" on an adjacent lease. Thus, even were we to interpret this memorandum as controlling or correcting MMS's construction of its "gathering" definition, it would not lead to CXY's outcome.

CXY's efforts to distinguish the precedent cited above do not assist its case. CXY distinguishes the decisions in <u>California Co. v. Udall</u>, 296 F.2d at 387; <u>Mesa Operating Limited Partnership v. DOI</u>, 931 F.2d at 318; <u>Amerada Hess v. DOI</u>, 170 F.3d at 1036-37; and <u>Kerr-McGee Corporation</u>, 147 IBLA at 280, on grounds that those cases "do not say that the lessee's burden of putting the production in 'marketable condition' includes the cost of moving the production to market" and, in some cases, do not cover

gathering at all. (SOR at 9-10.) While CXY is correct that the cases ensure that lessees may obtain a "transportation allowance," its dismissal of those cases as irrelevant or wrongly decided is derivative of its erroneous views regarding the construction of "gathering," addressed above.

CXY also suggests that this case presents the unusual circumstances which justified the Board's express finding that certain treatment costs were deductible in Exxon Corporation, 118 IBLA 221 (1991). Considering the facts of that case, however, we find no correspondence to the facts before us. There, the Board permitted Exxon to deduct costs of initial gas dehydration as a "transportation allowance" because dehydration of the "atypical" sour gas stream was necessary for the long trip to the treatment plant to avoid shutdown of the operating system. Without dehydration to a level not required for marketing under the sales contract, excessive water would freeze and shut down the operating plant. Accordingly, dehydration was necessary to transport the gas, not to sell it or put it in marketable condition. 11/

CXY does not make similar arguments with respect to its oil, or suggest a practical reason for us to consider the collection of oil from platforms C-E and G-I as anything other than gathering oil both to a central accumulation point for delivery to the market and to a central point for treatment. CXY attempts to draw an analogy to Exxon, where it was far cheaper to treat the gas at the distant facility, by arguing that our decision will provide an incentive for the lessee to move the point of treatment as close as possible to the wellhead. However, CXY does not sustain its implication that the opportunity to deduct transportation allowances would control the design of a treatment facility on OCS leases. Nor did Exxon argue this. Exxon dehydrated the product in order to use a conventional pipeline to avoid "construct[ing] a pipeline of exotic materials capable of transporting the highly corrosive [gas]." Id. at 234. It did not construct its plant to permit itself extra deductions from royalty value or to alter the total of its "gross proceeds." CXY provides us no plausible reason to find that it would have constructed its OCS lease facilities differently in order to pay less royalty, and we can make no such finding based on Exxon.

Finally, we must reject CXY's arguments that the 1988 rules do not apply to its 1970 and 1971 leases. CXY has not shown that MMS' decision would be any different in the absence of the 1988 rules. In any event, MMS has attached a copy of lease OCS-G 1958, originally issued to Shell Oil Company, to its Answer. (MMS Ex. B.) This lease states that it

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11/ Indeed, Exxon's gas had to be dehydrated to ".01 lbs. water/mcf * * * as any water would freeze at the -310°F operating temperatures and cause the shutdown of the Manufacturing Facility. Exxon's methane sales contract, by contrast, call[ed] for a maximum of 5 lbs. water/mcf--500 times the amount necessitated by the manufacturing process." 118 IBLA at 235-36 (footnote omitted).

> shall also be subject to regulations hereafter issued by the Secretary pursuant to his authority under section 5(a)(1) of the [OCSLA] to prescribe and amend at any time such rules and regulations as he may determine to be necessary and proper in order to provide for the prevention of waste and for the conservation of the natural resources of the [OCS], and for the protection of correlative rights therein, which regulations shall be deemed incorporated herein and, by reference, made a part hereof when promulgated.

(MMS lease OCS-G 1958 at Sec. 1.)

CXY's theory is that section 5(a) of the OCSLA made a distinction, which has been carried through into the lease form, between regulations which may be applied only to subsequent leases, and those regulations "necessary and proper in order to provide for the prevention of waste and for the conservation of the natural resources of the [OCS], and for the protection of correlative rights therein," which may be incorporated into pre-existing leases. Such a distinction is difficult to find in the OCSLA. The authority to promulgate rules establishing royalty, as with any and all rules under the OCSLA, derives from section 5(a), 43 U.S.C. § 1334(a) (1994). That statute states:

> The Secretary shall * * * prescribe such rules and regulations as may be necessary to carry out such provisions. The Secretary may at any time prescribe and amend such rules and regulations as he determines to be necessary and proper in order to provide for the prevention of waste and conservation of the natural resources of the [OCS] and the protection of correlative rights therein * * * .

These separate sentences do not convey the intent to prohibit the Department from applying royalty regulations to pre-existing leases that CXY finds in them. Federal courts have for decades concluded that the Department has the authority to apply valid revised royalty regulations to onshore and offshore leases. E.g., Independent Petroleum Association of America v. Dewitt, 279 F.3d 1036, 1039-40 (D.C. Cir. 2002); Mesa Operating Limited Partnership v. DOI, 931 F.2d at 322; California Co. v. Udall, 296 F.2d at 387-88. Likewise, in Mesa, the Fifth Circuit Court of Appeals ensured that federal rules, and not state law, as CXY would have it, govern Federal oil and gas lease royalty on the OCS. 931 F.2d at 325 n.48. 12/

12/ CXY suggests that the impact of its construction of the lease is to incorporate State law into the OCS lease. To the contrary, the lease is nonetheless subject to the rules of the Secretary. Id. at Sec. 1. If CXY were correct, the rules applicable in 1970-71, not State law, would govern the lease. We need not address the logic or policy implications of a conclusion to apply regulations haphazardly to Federal leases based upon the date of issuance because we do not believe this consequence is justified by Congressional language or the lease form.

We need not at this point parse out the meaning of section 5(a), or second-guess this precedent, to determine whether the Secretary has authority to promulgate regulations amending royalty valuation rules because the lessee has waived the right to object to that authority under the terms of the lease. At section 3(a)(2) of the lease, "[i]t is expressly agreed that the Secretary may establish minimum values for purposes of computing royalty on products obtained for this lease * * *." Based on this provision, the lessee agrees that the Secretary may, by order or rule, establish the minimum value upon which royalty may be calculated. See also Independent Petroleum Association of America v. Dewitt, 279 F.3d at 1039 (citing same language in standard lease). Accordingly, we reject CXY's assertion that duly promulgated royalty valuation regulations of the MMS do not apply to its Federal oil and gas leases.

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.

Lisa Hemmer
Administrative Judge

I concur:

Bruce R. Harris
Deputy Chief Administrative Judge