KERR-McGEE OIL & GAS CORP.

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United States Department of the Interior
Office of Hearings and Appeals
Interior Board of Land Appeals
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Arlington, VA 22203

KERR-McGEE OIL & GAS CORP.

IBLA 2006-272 Decided August 29, 2007

Appeal from a decision by the Regional Supervisor, Production and Development, Gulf of Mexico OCS Region, Minerals Management Service, which determined that Lease OCS-G 6136, High Island Block 21, had terminated by operation of law for failure to maintain production in paying quantities for a period exceeding 180 days. OMM G-2006-002.

Affirmed.

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

When production in paying quantities ceases on an oil and gas lease which has been continued beyond its initial term by such production pursuant to section 8 of the Outer Continental Shelf Lands Act, *as amended*, 43 U.S.C. § 1337(b)(2000), the lease expires by operation of law unless production in paying quantities is resumed, drilling or well reworking is undertaken, or a suspension of operations or production is approved by the Department within 180 days.

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

When operations cease and extraordinary events occur or force majeure conditions exist which adversely affect or could adversely affect an Outer Continental Shelf oil and gas lessee's ability to resume operations within 180 days of ceasing operations on that lease to avoid lease termination by operation of law, the lessee or operator must apply for and secure from the Department a suspension of operations or production within that 180-day period.

3. Oil and Gas Leases: Expiration--Outer Continental Shelf Lands Act: Oil and Gas Leases--Words and Phrases

"Production in paying quantities," for the purpose of continuing a lease beyond its initial term under section 8 of the Outer Continental Shelf Lands Act, *as amended*, 43 U.S.C. § 1337(b)(2000), means sufficient production to yield a net profit when revenue from the lease is reduced by normal expenses, including royalties and direct lease operating costs.

APPEARANCES: Cary V. Bradford, Manager - Regulatory and Compliance, Land & Regulatory Department, Kerr-McGee Oil & Gas Corporation, Houston, Texas, for appellant; Richard H. McNeer, Esq., Branch of Petroleum Resources, Division of Mineral Resources, Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE JACKSON

Kerr-McGee Oil & Gas Corporation (Kerr-McGee) has appealed the June 8, 2006, decision by the Regional Supervisor, Production and Development, Gulf of Mexico Outer Continental Shelf (OCS) Region, Minerals Management Service (MMS), which determined that Kerr-McGee had failed to maintain production in paying quantities on lease OCS-G 6136, High Island Block 21 (lease OCS-G 6136), for a period exceeding 180 days and that this lease had terminated by operation of law on January 3, 2006. We affirm.

BACKGROUND

MMS issued lease OCS-G 6136 (Record at (R.) 132-138) to Kerr-McGee [1] pursuant to section 8 of the Outer Continental Shelf Lands Act (OCSLA), *as amended*, 43 U.S.C. § 1337(a)(1), (b)(2) (2000), effective October 1, 1983, for an initial period of 5 years and as long thereafter as oil or gas is produced in paying quantities, drilling occurs, or well reworking operations are conducted on the lease. *See* Sec. 3, lease OCS-G 6136, R. 133. Production in paying quantities from the lease began in December 1986 and continued with only minor interruptions through March 2004. R. 125-130.

[1] The lease identifies Kerr-McGee as the holder of a 70 percent interest in the lease; during the time at issue, Noble Energy, Inc. (Noble) held the other 30 percent interest. R. 116, R. 132. Kerr-McGee is the sole operator under this lease. R. 116.

On April 2, 2004, Kerr-McGee requested a departure from daily pollution inspections required under 30 C.F.R. § 250.301(a) because its unmanned High Island Block 21 "A" Platform, the only platform on lease OCS-G 6136, was then shut-in,[2] representing that it would inform MMS when production resumed so that its inspection requirements could be adjusted appropriately. R. 119. MMS approved the request (allowing pollution inspections to be conducted at intervals not to exceed every 14 days), provided it was informed "[s]hould operating conditions for the facility change such that the approved frequency is no longer qualified," personnel "physically land on the structure when performing the proposed pollution inspections," and Kerr-McGee logs indicate that a physical boarding occurred. R. 15.

Kerr-McGee resumed production from the lease in July 2004, but did not so inform MMS, as proffered in its departure request or as required under MMS' approval of that request. Production continued intermittently for 10 months (through May 2005), when it ceased. R. 130-31. The only production between May 2005 and the date of the decision on appeal was 2,229 thousand cubic feet (mcf) of gas from well A-2 during a 6-day period in October 2005. R. 131; *see also* R. 94.

By letter dated January 3, 2006, MMS advised Kerr-McGee that it was required either to conduct leasehold operations (*i.e.*, production in paying quantities, drilling, or well reworking) or to obtain a suspension of production or operations (SOP or SOO). R. 101. MMS stated that it had reviewed recent production history and other MMS records which identified only limited production from lease OCS-G 6136 and no drilling, reworking, or SOP/SOO requests for that lease. MMS then informed Kerr-McGee that it would review Kerr-McGee's production and lease operating expense data for the 180-day period prior to January 3, 2006, and determine whether Kerr-McGee had maintained production in paying quantities during that period (*i.e.*, generated sufficient revenue to meet minimum royalty obligations and direct lease operating expenses, citing Notice to Lessees (NTL) No. 2003-N04, "Notice to Lessees and Operations and Interpretive Rule of Federal Oil, Gas, and Sulfur Leases in the Outer Continental Shelf: Extension of Lease Terms by Production in Paying Quantities" (May 9, 2003), R. 121). R. 101. MMS then required Kerr-McGee to provide information showing compliance with its lease terms during that 180-day period, noting that if MMS determined that Kerr-McGee had failed to maintain the lease, its lease would be terminated by operation of law as of January 3, 2006. *Id*. MMS also informed Kerr-McGee that it would not approve any authorizations for leasehold operations until this matter was resolved. R. 102.

Kerr-McGee provided some of the requested information by letter and during a meeting with MMS on February 1, 2006. Kerr-McGee then stated that well A-2 was

[2] This platform hosts three wells, identified as A-1, A-2, and A-3. R. 94.

the only producing well on the platform and that it had produced much less than expected during October 2005 (production ceased after only 6 days when reservoir pressure declined precipitously). R. 94. Kerr-McGee indicated that it had examined options for performing either additional work on well A-2 to increase sustainable flow rates or re-completions of other wells, but it did not then take action due to personnel and equipment issues associated with post-Hurricane Rita repairs and restarts elsewhere in the Gulf of Mexico. *Id.* Kerr-McGee also provided economic data which it claimed demonstrated that this lease had produced in paying quantities during the relevant time period.[3] It later provided revenue and expense data which indicated net income of $317.16 between July and December 2005. R. 59-64. Kerr-McGee continued to provide information in response to MMS requests, including copies of its OCS Discharge Monitoring Report (DMR) forms and information on the frequency, method, and cost of its platform inspections. R. 54-58; *see* R. 25-39.

After reviewing Kerr-McGee's information, MMS issued its decision. R. 16-17. MMS focused primarily on lease operating expenses to conclude that the lease had terminated, pointing out that Kerr-McGee DMRs showed 27 platform inspections in July 2005 but identified only 4 inspection visits to the platform in its expense computations. Relying on Kerr-McGee's reported land, marine, and air transportation expenses, MMS determined that even if the 23 unaccounted for trips in July had been by less expensive air transportation ($340 per trip), the additional $7,820 in transportation expenses, plus the additional $2,745.74 in labor costs associated with those 23 inspections, would increase lease expenses by $10,565.74, far exceeding the net revenue claimed by Kerr-McGee ($317.16). *Id.* Having determined that Kerr-McGee had not maintained production in paying quantities during the 180 days prior to January 3, 2006, MMS concluded that lease OCS-G 6136 had terminated by operation of law on that date. This appeal then followed.

ARGUMENTS ON APPEAL

Kerr-McGee raises three main issues on appeal. It first contends that circumstances related to Hurricanes Katrina and Rita constituted force majeure events or other extraordinary circumstances which prevented MMS from validly assessing whether lease OCS-G 6136 was then producing in paying quantities. Notice of Appeal, R. 6, 7, 9. MMS notes in response that it empathized with the oil and gas industry affected by Hurricanes Katrina and Rita, but did not grant a blanket

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[3] Kerr-McGee operated lease OCS-G 6136 as part of its High Island Field. That field includes High Island Block 22, which contains one manned (HI 22A) and one unmanned (HI 22B) platform, as well as High Island Block 21 with its one unmanned satellite platform (HI 21A). Kerr-McGee treated both blocks as one operating entity and allocated costs between the blocks based on standard industry accounting practices. *See* R. 88, 94.

exemption from compliance with the OCSLA, applicable regulations, NTLs, leases, or permits because of those hurricanes. As to Kerr-McGee's claim to relief under force majeure, MMS avers that the OCSLA, 43 U.S.C. § 1334(a)(1) (2000), and its implementing regulations, 30 C.F.R. §§ 250.168-250.177, authorize the Department to issue suspensions in appropriate circumstances, but do not allow a lessee to unilaterally suspend operations simply by claiming a force majeure event. MMS adds that Kerr-McGee could have applied for a SOP at any time before January 3, 2006, but chose not to do so. MMS argues that Kerr-McGee's attempt to re-write the OCSLA, applicable regulations, and its lease so as to allow it to claim force majeure as an excuse for not producing in paying quantities and not applying for a SOP must be rejected. Answer at 4-6.

Kerr-McGee next argues that its 180-day clock for submitting a well-work request or SOP was unjustly cut short by MMS's January 3, 2006, letter. Kerr-McGee claims that its limited production in October 2005 should have reset the 180-day clock, allowing it to maintain the lease if it resumed operations by April 19, 2006, and maintains that it would have submitted a well-work request on or before March 9, 2006, had it not been precluded from doing so by MMS' January 3, 2006, letter. R. 7, 8. MMS claims that holding an OCS lease by production requires that the lease produce in paying quantities during each and every 180-day interval, with each day beginning a new 180-day period and, as such, production in October 2005 did not reset any clock because each new day established a new, 180-day clock. Answer at 6-7.

Finally, Kerr-McGee contends its lease produced in paying quantities and MMS' decision to the contrary is in error. *See* Ex. 1 to Notice of Appeal, R. 8, 12 -14. It argues that it was not obligated to perform weekly platform pollution inspections and that it properly assumed three visits per month in its economic analysis. Kerr-McGee claims MMS erroneously considered DMRs in determining the number of inspection visits to the platform, explaining that the DMR inspection entries may have been made by landing on the platform, passing over or by the platform in a helicopter or a boat, or observing the platform from a nearby manned platform (*i.e.*, HI 22A, approximately 3/4 mile distant). Kerr-McGee also describes the rationale for its use of assumed visits, averring that it based its cost allocations on log books, and that when no record of an inspection could be located in those books, it added an assumed visit and likely overallocated field operating costs to this lease. R. 12-14.

MMS counters that the reduced frequency of pollution inspections it earlier approved was voided by Kerr-McGee's resumption of production in July 2004 without notice to MMS and, therefore, daily pollution inspection requirements under 30 C.F.R. § 290.301(a) then reattached as a matter of law. Answer at 8-9. MMS characterizes Kerr-McGee's explanation of its DMR-reported pollution inspections and cost allocation as a work of fiction based on "assumed" visits (no actual data). It contends that the DMRs indicate 70 pollution inspections between July and October 2005 (*i.e.*, 27 in July 2005, 20 in August, 12 in September, and 11 in October) and that applying the $340 per inspection expense reported by Kerr-McGee to those inspections greatly exceeds the net revenue claimed by Kerr-McGee. Answer at 10-12.

DISCUSSION

[1] The OCSLA, *as amended*, 43 U.S.C. § 1337(b)(4) (2000), empowers the Secretary of the Interior to lease offshore tracts for the exploration, development, and production of the mineral resources, including oil and gas, contained within the leased area. *See Exxon Co., U.S.A.*, 156 IBLA 387, 397 (2002); *Taylor Energy Co.*, 148 IBLA 286, 290 (1999). OCS leases run for a fixed period and "as long after such initial period as oil or gas is produced from the area in paying quantities, or drilling or well reworking operations as approved by the Secretary are conducted thereon." 43 U.S.C. § 1337(b)(2) (2000); 30 C.F.R. § 256.37(a)(1), (b); *see* Sec. 3, lease OCS-G 6136, R. 133; *Amber Resources Co. v. U.S.*, 68 Fed. Cl. 535, 538 (2005). Once a lease is continued beyond its initial term, 30 C.F.R. § 250.180(d) specifies that if the requisite operations cease, the lease will expire unless such operations are resumed or a SOO/SOP is received within 180 days of such cessation. The rule defines "operations" as "drilling, well-reworking, or production in paying quantities," with the caveat that the "objective of the drilling or well-reworking must be to establish production in paying quantities on the lease." 30 C.F.R. § 250.180(a)(2). Thus, to avoid automatic lease expiration, a lessee must resume production in paying quantities, commence drilling additional wells, rework existing wells, or secure a suspension of operations or production within 180 days of ceasing operations. *See* NTL No. 2003-N04, R. 121.

There is no dispute that the only producing well on lease OCS-G 6136 ceased production and was shut in due to low pressure on May 12, 2005, that no operations were conducted on that lease through January 3, 2006 (except for limited gas production in October 2005), and that Kerr-McGee did not then request or receive a SOO or SOP.[4] *See, e.g.,* Notice of Appeal at 2, R. 6. Kerr-McGee claims MMS should have considered Hurricanes Katrina and Rita as force majeure events and excused its

[4] Once production ceased on May 12, Kerr-McGee had until Nov. 9, 2005, to resume operations or obtain a SOP. *See* 30 C.F.R. § 250.180(d); NTL 2003-N04, R. 121. Although Kerr-McGee asserts that it was improperly denied the full time to request a SOP by MMS' Jan. 3, 2006, letter, it could have sought a SOP at anytime up until that point if it believed that hurricane-related issues would or could prevent it from timely drilling, well-reworking, or resuming production. *See* discussion *infra*. Having failed to so act by Jan. 3, 2006, we find no error in MMS refusing to consider a request for a SOP or other approval(s) thereafter.

noncompliance with applicable requirements for 49 days (while it was shut-in immediately before and after these storms), as well as after November 15, 2005. R. 6, 7. We disagree.

[2] 30 C.F.R. § 250.180 expressly provides that:

> (d) If you stop conducting operations on a lease that has continued beyond its primary term, your lease will expire unless you resume operations[5] or receive an SOO or an SOP from the Regional supervisor under § 250.172, 250.173, 250.174, or 250.175 before the end of the 180th day after you stop operations.
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> (e) You may ask the Regional Supervisor to allow you more than 180 days to resume operations on a lease continued beyond its primary term when operating conditions warrant. The request must be in writing and explain the operating conditions that warrant a longer period. In allowing additional time, the Regional Supervisor must determine that the longer period is in the national interest, and it conserves resources, prevents waste, or protects correlative rights.

These rules go on effectively to address extraordinary events by providing that a SOO may be granted "when necessary to allow you time to begin drilling or other operations when you are prevented by reasons beyond your control, such as unexpected weather, unavoidable accidents, or drilling rig delays." 30 C.F.R. § 250.175(a). In short, applicable agency rules allow lessees to undertake little or no operations on an OCS lease for up to 180 days for any reason or no reason at all. By the end of that period, however, the lessee must either be engaged in operations on its lease or have at least applied for a SOO/SOP.

By mid-to-late October 2005 Kerr-McGee was considering its options and, we believe, knew or should have known that the continuing effect of Hurricanes Katrina and Rita could adversely affect its implementation of those options. Prudence dictated and applicable rules required that it timely apply for a SOO/SOP, yet it did not do so. Having halted operations on this lease for more than 5 months (*i.e.,* between May 12, the date it ceased production, and October 15, when it attempted to resume production), Kerr-McGee's continuing failure to seek a SOO/SOP or otherwise act to maintain its lease is inexplicable. We simply cannot grant relief to Kerr-McGee which it did not timely and appropriately request. *See*

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[5] For purposes of 30 C.F.R. § 250.180, "the term *operations* means, drilling, well-reworking, or production in paying quantities. The objective of the drilling or well-reworking must be to establish production in paying quantities on the lease." 30 C.F.R. § 250.180(a)(2).

30 C.F.R. §§ 250.180(d)-(e), 250.175(a); *Harvey E. Yates Co.*, 156 IBLA 100, 105 (2001); *Union Pacific Resources Co.*, 149 IBLA 294, 303 (1999). Accordingly, we reject its claims based on force majeure or other extraordinary circumstances.[6]

Once producing operations on this lease ceased, Kerr-McGee was required to resume operations by no later than January 3, 2006. Kerr-McGee claims that its production in October satisfied this requirement. As discussed above and absent seeking a SOO/SOP, a lessee that ceases producing operations may maintain its OCS lease only if within 180 days it drills a new well or reworks an existing well (to establish production in paying quantities) or is then producing in paying quantities. Had Kerr-McGee drilled a new well or reworked an existing well, it would have had 180 days from concluding its drilling or reworking operations to again drill or rework that lease or to restore its production in paying quantities. 30 C.F.R. § 250.180(d). Simply producing some oil and gas is not enough; a lessee must resume production in paying quantities and continue producing in paying quantities thereafter. As explained in NTL 2003-N04, "[y]ou must produce in paying quantities to maintain your lease beyond its primary term. . . . The Regional Office will perform lease-holding reviews on leases with minimal and/or intermittent production." Moreover, lessees must not allow their production to fall below paying quantities during any 180-day period or they risk termination of their lease. *Id.* ("If the Regional Supervisor determines that your lease did not produce in paying quantities for a period that exceeds 180 days, MMS . . . may issue a determination that your lease has expired."). Since we reject Kerr-McGee's claim that its limited production in October started a new 180-day clock, the issue to be decided is whether the 2,229 mcf of gas produced in October 2005 constituted production in paying quantities sufficient to prevent this lease from expiring due to a cessation of operations for a period longer than 180 days (*i.e.*, between July 1, 2005, and January 3, 2006).

[3] Although neither the statute nor the regulations define the term "production in paying quantities," MMS has construed that term in NTL No. 2003-N04, R. 121. Relying on prudent operator standards and historical oil and gas precedents, the NTL defines production in paying quantities for purposes of continuing a lease beyond its initial term as:

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[6] We recognize that a court of equity may in an appropriate case and in the absence of express lease or contractual terms recognize a force majeure claim predicated on impossibility of performance. *See generally* "Gas and Oil Lease Force Majeure Provisions: Construction and Effect," 46 ALR 4th 976, 981 (1986). This Board, however, must apply the laws, rules, lease terms, and applicable policies of the Department in deciding cases presented to us and does not sit as a tribunal for meting out equitable relief.

> [P]roduction of enough oil, gas, sulfur or other minerals as specified in the lease to yield a positive stream of income after subtracting normal expenses, which include the sum of: (1) minimum royalty or actual royalty payments, whichever is greater, and (2) the direct lease operating costs. Direct lease operating costs include processing fees, labor costs, fixed and variable operating costs incurred on the lease, and fixed and variable operating costs allocated to the lease when production is processed off the lease.

R. 121; *cf*. 63 Fed. Reg. 7335, 7341 (Feb. 13, 1998). This interpretation is fully consistent with production in paying quantities used and applied in onshore oil and gas situations. *See, e.g.*, *Coronado Oil Co.*, 164 IBLA 309, 324 (2005); *Stove Creek Oil, Inc.*, 162 IBLA 97, 105-106 (2004), *quoting International Metals & Petroleum Corp.*, 158 IBLA 15, 22 (2002). For the purpose of continuing an OCS lease beyond its initial term, we believe "production in paying quantities" means sufficient production to yield a net profit when normal expenses (*e.g.*, royalties and direct lease operating costs such as labor costs and fixed and variable operating costs incurred on or allocated to the lease) are subtracted from lease revenues.

If MMS determines that an OCS lease continued beyond its initial term has stopped producing in paying quantities for a period of more than 180 days, the burden is on the party challenging that determination to prove by a preponderance of the evidence that the lease was then producing in paying quantities or that other operations took place during that period (*e.g.*, drilling a new well or reworking an existing well). *See International Metals & Petroleum Corp.*, 158 IBLA at 22 (onshore oil and gas lease). Kerr-McGee has failed to meet this burden.

Whether the October 2005 production constituted production in paying quantities depends on the amount of expenses properly attributable to the lease during the 180-day period before January 3, 2006. The key to resolving this question turns on the number and type of pollution inspections performed on the lease. Although Kerr-McGee presented cost estimates for those inspections, including both assumed and actual visits, we believe its DMRs provide the most accurate reporting of the number of pollution inspections conducted for the lease's only platform. Kerr-McGee's speculation that the 70 inspections identified in the DMRs might not reflect physical boardings of that platform and may be based on flyovers by helicopter, passbys by boat, or observations from another platform fall far short of establishing by the preponderance of the evidence that those inspections should be disregarded in its cost data (except for certain, "assumed" visits).[7] As operator, Kerr-

[7] We note that the pollution inspections at issue are to determine compliance with applicable effluent limitations for deck drainage and produced water discharges from (continued...)

McGee should possess the data necessary to establish both how many inspections occurred and how each inspection was performed without having to rely on conjecture and assumed visits, yet it has neither provided any reliable data supporting its suppositions and speculation, nor satisfactorily explained its failure to do so. *See Two Bay Petroleum, Inc.*, 166 IBLA 329, 343 (2005).

MMS' net profit calculations adopt Kerr-McGee's revenue figures and rely on its expense data, but do not disregard reported but unaccounted for platform inspections. Our review of its calculations demonstrates clearly that expenses properly attributed to the lease between July 1, 2005, and January 3, 2006, greatly exceed lease revenues for that period. We therefore conclude that Kerr-McGee has failed to meet its burden of establishing by a preponderance of the evidence that lease OCS-G 6136 produced in paying quantities during the 180 days before January 3, 2006, or to demonstrate that other qualifying operations were conducted during that period. Accordingly, we find no error in MMS' determination that this lease expired by operation of law on January 3, 2006.

To the extent not specifically addressed herein, Kerr-McGee's other arguments have been considered and rejected. Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the decision appealed from is affirmed.

/s/
James K. Jackson
Administrative Judge

I concur:

/s/
James F. Roberts
Administrative Judge

[7] (...continued)
the platform (*i.e.*, no discharge that causes "a film, sheen or discoloration on the surface of the water"). 40 C.F.R. §§ 435.11(d), 435.12(b); *see also* 40 C.F.R. § 110.1 (a sheen is an "iridescent appearance on the surface of the water"). Whether a valid inspection could be made by Kerr-McGee from a moving boat or airplane or from a platform 3/4 mile distant is at least questionable.