MOBIL BUSINESS RESOURCES CORP.
EXXONMOBIL PRODUCTION COMPANY

176 IBLA 174 Decided November 12, 2008

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

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EXXONMOBIL PRODUCTION COMPANY

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Appeal from a value determination issued by the Acting Director, Minerals Management Service, concluding that a gas sales contract was not an arm's-length contract and that gas disposed of under the contract had to be valued for royalty purposes under the provisions of the applicable Federal and Indian royalty valuation regulations governing gas sold pursuant to non-arm's-length contracts.

Reversed.

1. Contracts: Generally--Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Generally

Under 30 C.F.R. § 206.151, a gas sales contract will be considered an arm's-length contract for royalty valuation purposes where it "has been arrived at in the marketplace between independent, nonaffiliated persons with opposing economic interests regarding that contract." A determination by MMS that a sales contract is not an arm's-length contract because the parties did not have opposing economic interests will be reversed where the lessee has demonstrated that the parties had opposing economic interests and BLM has not refuted that showing.

APPEARANCES: Deborah Bahn Haglund, Esq., Cedar Hill, Texas, for Mobil Business Resources Corp.; Geoffrey Heath, Esq., and Howard Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE PRICE

Mobil Business Resources Corporation (MBRC) and ExxonMobil Production Company (collectively Mobil Business) have appealed a July 2, 2001, value determination by the Acting Director, Minerals Management Service (MMS), concluding that a gas sales contract between Mobil Exploration & Producing U.S. Inc.

(Mobil Ex) and PanEnergy Trading and Market Services, L.L.C. (PanEnergy),[1] was not an arm's-length contract and, therefore, that gas sold under the contract must be valued for royalty purposes under the provisions of the applicable Federal and Indian royalty valuation regulations governing gas sold under non-arm's-length contracts.

On September 3, 1996, Mobil Business requested a value determination from MMS regarding a gas sales and services contract dated August 1, 1996, between its producing affiliate, Mobil Ex, and PanEnergy. Mobil Business sought an MMS determination because PanEnergy was formed as a joint venture between PTMSI, which had a 60 per cent interest in the venture, and Mobil Natural Gas, Inc. (MNGI), which had a 40 per cent interest.[2] Mobil Ex and MNGI were wholly-owned subsidiaries of Mobil Corporation. PTMSI was a wholly-owned subsidiary of PEC.

On December 9, 1998, the Chief, Royalty Valuation Division, MMS, issued a "guidance" letter wherein it advised that the contract constituted a non-arm's length agreement because the parties did not have opposing economic interests. Mobil Ex appealed (IBLA 99-395), but the Board remanded the matter by order dated October 25, 1999, on the ground that a final decision had not been issued and, consequently, the Board lacked jurisdiction. On July 2, 2001, the Acting Director, MMS, issued the decision before us, finding that the gas sales contract is not an arm's-length contract. Mobil Business appealed, asserting that the decision is not supported by the facts.

At the request of the parties, the Board suspended consideration of this appeal by order dated April 15, 2003, to allow them an opportunity to settle. Upon notice that settlement negotiations had failed, the Board resumed consideration of the appeal. June 5, 2008, order (appellant's reply accepted and opportunity for MMS to respond provided).

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[1] MBRC paid the royalties due on Mobil Ex's gas production. Over time, the parties have merged into other companies and, consequently, their names have changed. MBRC and Mobil Ex were subsidiaries of Mobil Corporation (Mobil). Mobil merged with Exxon Corporation to form ExxonMobil Corporation. After that merger, MBRC and Mobil Ex became subsidiaries of ExxonMobil Production Co., a division of ExxonMobil Corporation. PanEnergy Corporation (PEC) was the parent corporation of PanEnergy Trading and Marketing Services, Inc. (PTMSI), and was acquired by Duke Energy. PTMSI is now known as Duke Energy Trading and Marketing L.L.C. (Duke). After we have provided the basic facts and events, for simplicity we will refer to the parties to the two agreements as Mobil and Duke.

[2] The gas sales and services contract was terminated in 2003, and thus this appeal pertains only to Mobil's royalty payments between 1996 and 2003. Reply at 2 n.4.

Background

The underlying facts are not disputed. By letter of intent issued in January 1996 MNGI and PTMSI agreed to create a joint venture company for the purpose of buying, selling, and marketing natural gas and other energy products and services. Prior to that, both MNGI and PTMSI had been engaged in midstream marketing of gas. MNGI purchased gas from Mobil Ex and others at or near the well and processed, transported, and/or sold the gas to third parties downstream. MNGI, for various reasons, decided to restructure its operations to exclude marketing services. The letter of intent contemplated the possibility that, in exchange for an ownership interest in the joint venture, Mobil Ex would enter into a gas sales contract with the joint venture that would be "substantially similar" to the contract Mobil Ex had had with MNGI. However, while the letter of intent provided the structure for further negotiations, it did not purport to bind the parties. Supplemental Statement of Reasons (SSOR) at 6. Ultimately, the parties were unable to reach agreement regarding the question of committing Mobil Ex's gas to the joint venture in exchange for an ownership interest therein, and they abandoned their efforts to do so. *Id.* at 7.

In August 1996 a contract was executed by which PanEnergy was created from substantially all of the assets of MNGI and PTMSI. The respective shares of ownership in the venture were based on the value of the assets each contributed. As stated, PTMSIprovided 60 percent of the joint venture's assets, and MNGI provided 40 percent. It was agreed that, based on its ownership of the majority interest, PTMSI would control the new venture. The final joint venture formation agreement provided that Mobil Ex and PanEnergy would execute a gas sales contract, which was negotiated separately, but while MNGI and PTMSI negotiated the formation of the joint venture.

On August 1, 1996, Mobil Ex entered into a long-term (10 years), stand-alone variable price gas sales contract with PanEnergy. That contract was similar to the Mobil Ex-MNGI contract insofar as it provided for transportation-adjusted, index-based pricing and, as a result of that feature, "no value was assigned to that contract in determining the parties' respective interests in the joint venture." *Id.* at 8. Thus, the final joint venture agreement did not link MNGI's interest therein to the volume of gas to be sold to the joint venture by Mobil Ex. *Id.* at 7. Under the Mobil Ex-PanEnergy gas sale contract, PanEnergy agreed to purchase at least 95 per cent of the gas Mobil Ex made available for sale, and to use its best efforts to buy 100 per cent of Mobil Ex's "problem gas," as a result of which Mobil Ex acquired a guaranteed market for all the gas it might produce and sell, at the arithmetic average of published index prices, adjusted for transportation costs, but without a quantity commitment. *Id.* at 11-12. The contract price guaranteed Mobil Ex fair market value for the duration of the contract, with certain safeguard mechanisms added to ensure that fair market value was received throughout the life of the contract. *Id.* at 12.

By Decision dated July 2, 2001, the Acting Director, MMS, concluded that the contract "is not an arm's-length contract [and] gas disposed of under that contract must be valued for royalty purposes of the applicable Federal and Indian gas royalty valuation rules governing gas not sold under an arm's-length contract." Decision at 1. Applying an MMS' interpretation of "arm's-length" under the pertinent regulations, MMS reasoned that the contracting parties must be "independent and nonaffliated" and have "opposing economic interests." Decision, Supporting Rationale (enclosed with the decision) at 6. Acknowledging that Mobil Ex did not control PanEnergy, the Acting Director did not apply a "dependent and affiliated" test, but determined that the sales agreement was not a contract between parties with opposing economic interests "when viewed in the totality of the relationship and the way the contracts were formed." *Id*. at 9. He surmised that the sales contract "does not reflect the total consideration" inuring to Mobil Ex. *Id*. at 10. Mobil Business appealed, asserting that the decision is not supported by the facts.

Arguments

Mobil argues that MMS cannot simply presume, but must show that Mobil and Duke lack opposing interests. Asserting that there is no presumption to be applied, Mobil contends that Departmental policy and precedent require MMS to show evidence of control or lack of opposing interests where one of the parties with common ownership has a minority interest. Mobil asserts that MMS erred when it decided that the joint venture agreement and gas sales contract are necessarily and inseparably linked and that the "totality of the relationship" supports the conclusion that the contract constitutes a "non-arm's-length" transaction. Mobil claims that the two agreements were negotiated independently and that the timing of the gas sales contract was not driven by the joint venture formation, as the events were not linked. Mobil relies upon the declarations of several Mobil officers involved in the negotiations to demonstrate the agreements are separate arrangements. In addition, Mobil provided the affidavit of Joseph P. Kalt, an expert and independent economic consultant who examined the economic and business circumstances of the gas sales contract. According to Kalt, "the only reasonable economic conclusions are that the parties had opposing economic interests with respect to the contract, and that the contract is and functions as an arm's-length contract." Kalt Affidavit (SSOR Ex. 5) at 2-3; SOR at 17. Observing the parties' behavior, Kalt concluded that Duke's and Mobil's arbitration and adjustments are not consistent with a non-arm's-length contract, and is not consistent with the idea that Mobil received hidden, additional consideration for gas through the joint venture. Kalt Affidavit at 5; SOR at 20. As additional support, Mobil submitted the affidavits of Thomas Case (SSOR Ex. 2), Ben R. Haynes (SSOR Ex. 3), and Kelly P. Geohegan (SSOR at Ex. 4), all of whom had personal knowledge of the thrust and tenor of the negotiations, particularly the gas pricing issues and terms.

In its Answer, MMS argues that the gas sales contract was not arm's-length because it was not arrived at in the open marketplace and there were no opposing economic interests because the contract was part of a package deal. MMS contends it is apparent that, but for the long-term gas sales contract, the joint venture would not have been formed. MMS additionally asserts that the gas sales contract was not arrived at in the marketplace because Mobil approached only Duke and its subsidiary (then PanEnergy) and the negotiated index price does not reflect an open market strategy. MMS suggests that the gas sales contract is structured to ensure that both entities achieve goals not directly related to obtaining the highest possible price, thus making their economic interests aligned and not opposing. MMS further notes that the gas sales contract was an exhibit to the joint venture agreement and that Mobil was required to sell to the joint venture virtually all of its production. In addition, MMS argues that if the sales contract was arm's-length, the proceeds reported did not account for the additional consideration received under the joint venture. MMS asserts that when Mobil chose to enter the joint venture in order to end its midstream marketing operation, the marketing services it received constitutes valuable consideration that must be reflected in the calculation of value for royalty purposes.

In its Reply, Mobil contends that the Board's decision in *Vastar Resources Inc.*, 167 IBLA 17 (2005), is dispositive of the issues in this case. MMS has filed no further response.

Discussion

[1] In 1996, the Federal gas royalty valuation regulations defined "arm's-length contract" as

> a contract or agreement that has been arrived at in the marketplace between independent, nonaffiliated persons with opposing economic interests regarding that contract. For purposes of this subpart, two persons are affiliated if one person controls, is controlled by, or is under common control with another person. For purposes of this subpart, based on the instruments of ownership of the voting securities of an entity, or based on other forms of ownership:
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> (a) Ownership in excess of 50 percent constitutes control;
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> (b) Ownership of 10 through 50 percent creates a presumption of control;
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> (c) Ownership of less than 10 percent creates a presumption of noncontrol which MMS may rebut if it

> demonstrates actual or legal control, including the existence of interlocking directorates.
>
> . . . The MMS may require a lessee to certify ownership control. To be considered arm's-length for any production month, a contract must meet the requirements of this definition for that production month as well when the contract was executed.

30 C.F.R. § 206.151 (1996). MMS acknowledges that in *National Mining Association v. Interior*, 177 F.3d 1, 6-7 (D.C. Cir. 1999), the U.S. Court of Appeals invalidated the presumption of control when one entity owns or commonly owns between 10 and 50 percent of another entity, stating that it now determines control on a case-by-case basis when the lessee's ownership interest falls between 10 and 50 percent, as set forth in its August 21, 2000, non-regulatory guidance.[3] *See* Decision, Supporting Rationale at 4.

In *Vastar*, we reviewed a situation quite similar to this one. In that case, MMS conceded that Vastar, a production company that was also ending its marketing operation, did not control Southern Company Energy Marketing, L.P., the limited partnership formed by Vastar and Southern Energy, Inc., a marketing company. 167 IBLA at 35. MMS' determination regarding the nature of the gas sales contract therefore turned on whether the parties had "opposing economic interests" in that contract. In its appeal, Vastar cited the contentious negotiations leading to the execution of the contract, the terms of the contract, and the parties' subsequent conduct as evincing the parties' opposing economic interests with regard thereto. MMS, on the other hand, looked to the totality of the arrangement among Vastar, Southern Energy, and Southern LP as indicative of the parties' complementary economic interests. Citing several reasons applicable here, we found that Vastar had shown that the gas sales contract was an arm's-length contract and reversed MMS' contrary conclusion.

In the present appeal, MMS has also admitted that Mobil does not control Duke. Decision, Supporting Rationale at 8. Accordingly, the key question addressed in *Vastar* is the same here, *i.e.,* whether the contracting parties had opposing

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[3] To reflect this change in policy, the definition of *arm's-length contract* was amended in 2005 to read as follows:

> Arm's-length contract means a contract or agreement between independent persons who are not affiliates and who have opposing economic interests regarding that contract. To be considered arm's length for any production month, a contract must satisfy this definition for that month, as well as when the contract was executed.

30 C.F.R. § 106.151 (2005); 70 Fed. Reg. 11869 (Mar. 10, 2005).

economic interests with respect to their gas sales contract. As MMS recognized in promulgating the 1988 rules applicable to the issue, the fact that the parties may have common interests elsewhere does not necessarily negate their ability to have opposing economic interests with respect to the contract under review. *See* 53 Fed. Reg. 1230, 1239 (Jan. 15, 1988) ("although the parties may have common interests elsewhere, their interests must be opposing with respect to the contract in issue"). The overall relationship among the parties MMS stresses therefore does not automatically establish that the parties do not have opposing economic interests in the gas sales contract before us.

Mobil relies on the contentious nature of the protracted and difficult negotiations leading to the consummation of the contract; the specific contract provisions ensuring that Mobil attained its economic interests; the gas pricing mechanisms utilizing rates established by an independent third party based on market data reflecting fair market value; the inclusion of detailed operational and arbitration provisions to ensure that Mobil receives fair market value prices for the gas; and the parties' subsequent employment of the adjustment provisions as evidence demonstrating Mobil's and Duke's opposing economic interests and the arm's-length nature of the gas sales contract.

In addition, Mobil's contentions are supported by Kalt's 42-page affidavit setting forth his expert conclusions. Kalt concluded that Mobil retained an arm's-length economic incentive to maximize the price it received and accept nothing less than a fair market value price, while Duke sought to get the lowest possible price. In his opinion, the gas sales contract was entirely prudent, and he found nothing in the motive and circumstances to indicate that Mobil's interest in the joint venture represented additional economic compensation for gas sold under that gas sales contract. Kalt's analysis is not unreasonable, and it is not inconsistent with the Case, Haynes, and Geohegan Affidavits.

As we similarly observed in *Vastar*, 167 IBLA at 36, although MMS contends that the 10-year term of the contract undermines Mobil's claim that the parties had opposing economic interests, it offers no regulatory or precedential basis for presuming that only parties with compatible economic interests enter into long-term contracts. Nor are we persuaded that the use of published index prices, adjusted for transportation costs to the index point for which prices were reported, demonstrates lack of opposing economic interests. In the absence of any evidence that the published index prices utilized in the gas sales contract did not represent the fair market value of Mobil's gas, we have no ground for questioning Mobil's averment that the use of index prices supports, rather than undercuts, the fundamentally opposing nature of the parties' economic interests with regard to this gas sales contract. MMS's Answer does not establish an adequate basis under *Vastar* for rejecting Mobil's evidence regarding the contract at issue, and accordingly, we must conclude that, under *Vastar*, Mobil has established that the gas sales contract in this appeal qualifies as an arm's-length contract.

MMS contends that even if the gas sales contract is held to be arm's-length, the gas must be valued in accordance with 30 C.F.R. § 206.152(c) (setting out the benchmark values applicable for non-arm's-length sales) because the contract does not reflect the total consideration flowing to Mobil for the gas, specifically, the 40 percent of the profits it received from Duke's gas sales. Mobil responds by noting that the uncontroverted evidence establishes that its 40 percent share of Duke's profits represented a return on its investment in the assets contributed to the joint venture only, not additional consideration for the gas Mobil sold to it. MMS further asserts that the contract price does not include the value of Duke's marketing services. Mobil counters that it met its obligation to market the gas at no cost to the United States, not by relying on Duke to do so, but by instead selling the gas to Duke at a price that reflected the maximum possible value for that gas.

Neither of these issues was adjudicated in the decision under appeal. To the contrary, MMS' value determination stated only that "Mobil may have breached its duty to MMS to market the production," noting that "[i]f MMS makes such a determination, ExxonMobil will have the opportunity as provided by the regulations to provide written information justifying its value," but that "such a specific determination is not necessary at this time because of the analysis regarding both opposing economic interests and total consideration set forth above." Decision, Supporting Rationale at 10. In the absence of an initial decision by MMS on these issues, they are not properly raised in this appeal. Having disposed of the question of whether the gas sales agreement was an arm's-length agreement under *Vastar*, it is now up to MMS to determine "whether the contract reflects the total consideration actually transferred either directly or indirectly from the buyer to the seller for the gas" within the meaning of 30 C.F.R. § 206.152(b)(1)(ii), or whether "the gross proceeds accruing to the lessee pursuant to an arm's-length contract do not reflect the reasonable value of the production" within the meaning of 30 C.F.R. § 206.152(b)(1)(iii), and develop the record of its analysis to support its findings and conclusions.

Mobil has requested a hearing under the provisions of 43 C.F.R. § 4.415. In light of our analysis, there is no disputed material issue of fact requiring resolution through the introduction of testimony and other evidence that would alter the disposition of the appeal. Therefore, the request for a hearing is denied. *See, e.g.*, *F.W.A. Holdings, Inc.*, 167 IBLA 93, 98 (2005), and cases cited.

Accordingly, 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 reversed.

/s/
T. Britt Price
Administrative Judge

I concur:

/s/
James F. Roberts
Administrative Judge