DRESSER INDUSTRIES, INC.

IBLA 70-99 Decided June 19, 1972

Appeal from decision by Acting Director, Geological Survey, disallowing smelter deficiency payments as deductions in computing royalties due to the United States under a mineral lease.

Affirmed as modified.

Accounts: Generally -- Mineral Lands: Leases

> In determining the gross value of mineral concentrates as a basis for computing royalties due to the United States under a mineral lease which permits the deduction of costs and charges of smelting and refining such concentrates, the Government will not allow as a deduction a smelter deficiency payment consisting of the difference between a minimum quarterly tolling charge for processing concentrates prescribed under a tolling agreement between the lessee and the refiner and the total of the tolling charges applicable to each ton of concentrates actually processed during a calendar quarter, as the tolling agreement was a unique and special arrangement outside of the normal and usual business practices and the smelter deficiency payment was not contemplated by the United States when it issued the lease.

APPEARANCES: Mr. R. A. Flake, Manager, Administration and Development, Dresser Minerals Division of Dresser Industries, Inc., for appellant.

OPINION BY MRS. THOMPSON

Dresser Industries, Inc., has appealed to the Secretary of the Interior from a decision of July 9, 1969, by the Acting Director, Geological Survey, affirming a determination by the Survey's Regional Mining Supervisor, McAlester, Oklahoma, dated December 16, 1968, disallowing certain tolling charges as deductions in computing royalty payments due to the United States under lease BLM-A-047498 (Missouri).

The appeal concerns the proper computation of royalty due under a preference right lease for lead, zinc, copper, iron, and associated minerals, issued effective June 1, 1963, to Magnet Cove Barium

Corporation, for 835.72 acres of acquired lands within the Clark National Forest in Missouri. Magnet Cove Barium Corporation has since been merged with Dresser, and is now known as the Dresser Minerals Division of Dresser Industries, Inc.

The regulations applicable to such a lease provided that the terms and conditions of the lease, including the royalty rates, "will be established on an individual case basis." 43 CFR 200.37(f), renumbered 43 CFR 3221.4(f) (1969). This basic provision is now set forth at 43 CFR 3503.3-2(a)(1)(ii) (1972). Section 2(f) of the lease requires the lessee to furnish for each month, or such other period designated by the Regional Mining Supervisor, statements in detail of the amount and value of output from the leasehold during such period for use in determining royalties. Section 1(c) provides for the payment of royalty within 30 days after the end of each such period. It states that:

> The lessee agrees that the Secretary of the Interior, for the purpose of determining the royalties due hereunder, may establish reasonable minimum values for the minerals mined, due consideration being given to the highest price paid for a part or a majority of the production of minerals of like quality produced from the same general area, the price received by the Lessee, posted prices, and other relevant matters. A royalty rate will be established for each mineral or group of minerals following discovery and prior to mining.

An addendum to the lease form prescribes the royalties under section 2(c) of the lease as follows:

> A royalty based on the gross value of any and all concentrates produced at the following rates:
>
> * 4 percent for the first 10 lease years
> 4 1/2 percent for the 11th through 15th lease years 5 percent for the 16th through 20th lease years

Royalties to be paid in cash or taken in kind at the option of the lessor. * As provided in Section 2, paragraph (c), of this lease, such royalty shall be, for the periods indicated above, the above percentages of the gross value of the minerals mined under this lease at the point of shipment to market, such point of shipment to be the mine or preparation plant, as the case may be.

> For the purposes of this lease, the gross value of the minerals mined hereunder at the point of shipment to market (hereinafter called the "Gross Value") shall, in the discretion of the Secretary of the Interior, be either of the following prices less transportation charges in effect at time of shipment from the place of origin of the concentrates referred to below to the smelter:
>
> (i) the highest price, if any, paid or offered the lessee for all or any part of the concentrates produced from ore mined under this lease, or
>
> (ii) the highest price the lessee would pay for concentrates of substantially similar quality, if such price were determined by contracts then in effect between the lessee and any of its suppliers of concentrates, other than suppliers affiliated with the lessee.
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> If (i) and (ii) are inapplicable in the determination of Gross Value, such value shall be determined by the average posted New York metal price as quoted by the "E. & M. J. Metal and Mineral Markets" for the period prescribed in subsection (f) of Section 2 of this lease less an allowance for average freight and Federal taxes thereon from the treating smelter to destinations to which metal is customarily shipped by lessee and less all of the lessee's costs and charges during such period in connection with lessee's shipping, smelting, refining, handling and selling of all concentrates (other than those produced by lessee) and of all metal produced therefrom.

* * * * *

Since there is no dispute that paragraphs (i) and (ii) are inapplicable here, the last paragraph quoted above governs the determination of the gross value; i.e., the value is determined by the average posted New York metal price less the allowances, costs and charges specified.

On December 31, 1965, the lessee, then Magnet Cove Barium Corporation, assigned an undivided one-half interest in the lease to Cominco American, Incorporated. The two companies, Dresser and Cominco, are at present jointly engaged in a mining venture on what is known as the Magmont Mine. In addition to the 835.72 acres subject to the lease in question, the area of the mine comprises land under another Government lease, as well as land under private ownership. Production at the mine commenced in 1968.

In its first settlement report to the Geological Survey, appellant listed as deductions from the gross value of $538,613, representing its share of the production of the Magmont Mine, smelting and refining costs of $74,367; freight, insurance, taxes and selling costs of $60,580; and smelter deficiency payments of $209,751; 1/ for a total deduction of $344,698; leaving a gross value of $193,915, with a royalty due at 4% or $7,757 (less $418 advance royalty). The Regional Mining Supervisor disallowed the smelter deficiency payment total on the ground it did not represent actual treatment costs but, rather, a penalty imposed for failure to meet delivery requirements of a tolling agreement with a third party. He indicated a royalty debit due of $8,390.

The Acting Director agreed with the contention of appellant that the deficiency payments should be considered as prepayments of tolling charges, rather than a penalty imposed for failure to meet delivery requirements as stated by the Regional Supervisor. He concluded, however, that the deficiency payments were not allowable deductions, as it was the intent of the applicable lease provision quoted above "to allow deduction only for actual charges of processing concentrates from the lease." Appellant contends that such payments should be allowed as deductions.

The smelter deficiency payments in question arise from a tolling agreement. The Director sets forth the basic facts concerning this agreement as follows:

> The record indicates that on September 13, 1965, Cominco American and Dresser (then Magnet Cove Barium Corporation) entered into a tolling agreement with Missouri Lead Smelting Company to smelt lead concentrates produced from the Magmont mine, which includes the land in lease BLM-A-047498 (Missouri) as well as company-owned and other leased fee lands. The agreement provides for delivery of all of Magmont's concentrates to the smelter,

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1/ Dresser's method of computing the deficiency payments as a royalty deduction, as described by the Acting Director, was as follows:

"During the first two quarters of 1968, no concentrates were delivered to the smelter and deficiency payments of $160,000 were made for each quarter. Deliveries, during the third quarter of 1968, amounted to approximately 6,619 tons of concentrates, resulting in a deficiency payment of $99,502.46. Dresser's share of the deficiency payments was 50 percent and amounted to $80,000 for each of the first two quarters and $49,751.23 for the third quarter. In computing royalties on production in the third quarter, Dresser added the deficiency payments for the first two quarters to the deficiency payment for the third quarter and deducted the total deficiency payments for the three quarters in the amount of $209,751.23."

> beginning January 1, 1968, and continuing for an initial period of 10 years with the right of extension for 5 additional years. Further, the agreement provides for a fixed tolling charge of $9.14 for each ton of lead concentrates processed, and if Cominco and Dresser do not ship enough concentrates equal to a minimum charge of $160,000 per calendar quarter they must make up the difference as deficiency payments. In the event Cominco and Dresser pay to the company a total of $9,600,000 in tolling charges prior to processing 1,050,000 tons of concentrates, the fixed tolling charge will be suspended until such an amount of concentrates shall be processed.

Section 9.04 of the tolling agreement, providing for the fixed tolling charge of $9.14 per ton, also stipulates that after (1) the delivery of 1,050,000 tons of processed concentrates by the refiner to the tollers (Cominco and Dresser), (2) the repayment by Missouri Lead Smelting Company of a $13,235,000 loan for construction of the smelter, or (3) the fifteenth anniversary of the effective date of the tolling agreement (September 13, 1980), whichever event should occur first, the requirement to pay a minimum fixed quarterly tolling charge of $160,000 will no longer be applicable. For any calendar quarter after the delivery of 1,050,000 tons of concentrates or repayment of the loan, whichever event should take place earlier, the tolling charge is not to exceed $160,000 under that section.

The Acting Director ruled as an allowable deduction for tolling "only the fixed tolling charge of $9.14 for each ton of lead concentrate produced from [the] lease until 1,050,000 tons of concentrates have been shipped in accordance with the tolling agreement."

In its current appeal appellant maintains that the $160,000 minimum tolling charge, which it describes as applicable to the entire production of the Magmont Mine, including that from land not under the subject lease,

> * * * is no different from the other payments required to be made by Dresser and Cominco to Missouri Lead Smelting Company in order to have their concentrates smelted and * * * the entire $160,000 minimum payment per quarter is therefore deductible in computing royalty under the BLM Lease.

The appeal points out that, in the event of the failure of Dresser and Cominco to make timely payment of the quarterly minimum tolling charge, "Missouri Lead would have the right to terminate the Tolling Agreement promptly in exactly the same way Missouri Lead could terminate if Cominco and Dresser fail to pay the required smelting charges and refining charges." Appellant contends that the right of enforcement of the requirement to pay a minimum tolling charge, regardless of the tonnage of concentrates actually produced, is similar to a lease stipulation prescribing a minimum royalty payment.

Appellant characterizes the tolling agreement as a whole as representing "a special and rather unusual arrangement which enabled Dresser and Cominco to obtain substantially lower smelting and refining costs than they would otherwise obtain," and states that "one of the basic provisions of this arrangement was the requirement to pay the fixed tolling charge of $9.14 per ton but not less than $160,000 per quarter."

With respect to the effect of that portion of the agreement which provides for a temporary suspension of tolling charges in the event that the tollers will have paid $9,600,000 in such charges to the refiner prior to the processing of 1,050,000 tons of concentrate, appellant's arguments appear to be somewhat inconsistent. Reiterating the contention advanced in its earlier appeal that the deficiency payment is deductible as a prepayment of future tolling charges, appellant insists that if the tolling charge is suspended for a time in the future,

> * * * [it] would have to start paying more royalty to the BLM until a total of 1,050,000 tons had been delivered because during that period of time there would be no fixed tolling charge to deduct in computing the BLM royalty. Thus, if we assume that this Tolling Agreement will run for 15 years, the BLM will end up receiving the same amount of royalty in total even though it allows the $160,000 required payments as a current deduction.

At another point in its appeal, however, appellant stresses the fact that there is no certainty that those conditions would arise which would permit suspension of future tolling charges. It argues:

> We believe it is clearly inequitable and not in accordance with general principles of contract interpretation to disallow the deduction of a payment which is required to be made now merely because there is a remote possibility that 15 years from now the $9.14 per ton fixed tolling charge may not have to be paid on a certain amount of the concentrates produced at that time.

One of the reasons cited by the Acting Director for denying deduction of the deficiency payment was the possibility that if the tolling charge is suspended, production in the Magmont Mine may then be coming principally from lands outside the lease, and that in such event "the production from this lease could be charged with an inequitably large proportion of the tolling charges applicable to production from other than Government lands." Appellant attempts to answer this objection by suggesting that it is equally likely that production at the time of suspension will come principally from lands covered by the lease, in which case it maintains that the "the BLM would receive an inequitably large proportion of the royalties paid on all the land included in the Magmont Mine." Appellant offers no explanation as to why this would be so.

With respect to the proportion of the output of the Magmont Mine which it is expected will be derived from the land covered by the subject lease during the anticipated life of the mine, the Geological Survey, in a memorandum of November 12, 1971, stated:

> To date, 100 percent of the output of the Magmont Mine is attributable to acquired lands lease BLM-A-047498. As mining advances to other lands, the proportion of annual production from lease BLM-A-047498 will decrease. However, according to current projections, the ultimate production from BLM-A-047498 will amount to 80 percent of the total ore produced from the Magmont Mine during its life span. Conceivably, in future years, 100 percent of the annual production could be from other lands.

As appellant points out, the minimum tolling charge is applicable to production from all of the land comprising the Magmont Mine. If the deficiency payment involved in the current appeal were to be allowed, appellant would be in a position to deduct from royalties applicable to production exclusively from lands within the subject lease, a future deficiency payment conditioned upon a minimum tolling charge for processing concentrates which may have been produced in part from ore extracted from lands not subject to the lease.

The essential question is whether under the lease the questioned smelter deficiency payments are properly deductible as part of "the lessee's costs and charges during such period in connection with lessee's shipping, smelting, refining, handling and selling of all concentrates (other than those produced by lessee) and of all metal produced therefrom."

The Geological Survey refused to consider the smelter deficiency payment as such a cost and charge contemplated by the lease. It equates allowable costs and charges to those relating to the actual treatment of the ore and has concluded that this payment does not relate to the actual treatment. In considering what was contemplated under the lease by the provision relating to the lessee's costs and charges, we can look to the other provisions of the lease and to normal business practice to throw light on what may have been envisaged by the parties as included within such costs and charges.

As noted before, the lease provides under section 2(c) that the Secretary of the Interior, for the purpose of determining royalties, may establish reasonable minimum values for the minerals. We note that in the addendum to the lease, the gross value is to be set at one of two prices, deducting only the transportation charges. As we have pointed out, however, this case falls within the paragraph determining value by the average New York price. This paragraph determining value by the average New York price. This paragraph gives a broader category of costs and charges than merely transportation charges. This fact, however, takes into account the different situation under which the price is determined. It does not justify a conclusion that costs and charges unrelated to usual commercial "shipping, smelting, refining, handling and selling" expenses were contemplated.

Appellant has not shown nor contended that such smelter deficiency payments are usual and normal costs and charges for smelting and refining. To the contrary, it appears that the tolling agreement which it entered into was a rather special and unique arrangement. Appellant, in its brief to the Director, explained the reasons for entering into the tolling agreement, and the agreement, itself, as follows:

> When the Magmont Mine was first developed there was no lead smelter in Southeast Missouri, and Dresser and Cominco determined that they would not have enough production from the Magmont Mine to justify building their own lead smelter. Amax lead Company of Missouri and Homestake Lead Company of Missouri, the joint owners of Missouri Lead Smelting Company, were in somewhat the same situation-i.e., they did not have enough production from their own mines to justify the building of a lead smelter in Southeast Missouri. However, Amax and Homestake indicated that they were willing to build a smelter provided they could be assured of receiving all of the production of lead concentrates from the Magmont Mine for a period of ten years and providing that Dresser and Cominco would share in some of the risk involved in constructing the new smelter. Accordingly, Dresser and Cominco agreed to enter into the Tolling Agreement of September 13, 1965 with Missouri Lead Smelting Company, and under this Tolling Agreement Dresser and Cominco became in practical effect joint venturers with Missouri Lead Smelting Company in the construction and operation of the smelter. In other words, although Dresser

and Cominco did not obtain any ownership interest in the smelter, they did assume a substantial part of the risk and the burdens in constructing and operating the smelter, and in return Dresser and Cominco were charged a rate for smelting their concentrates from the Magmont Mine considerably below the rate they would have had to pay had they entered into an ordinary tolling agreement with an established smelter.

It is impossible to make any exact comparison between the smelting and refining costs paid by Dresser and Cominco under the Tolling Agreement with Missouri Lead Smelting Company and the smelting and refining costs they would have had to pay under the usual type of tolling agreement with a custom smelter. However, it should be noted that the nearest custom lead smelter to the Magmont Mine was ASARCO'S lead smelter at El Paso, Texas, and had Dresser and Cominco not been able to enter into the favorable arrangement with Missouri Lead Smelting Company, they probably would have had to ship their lead concentrates to ASARCO at El Paso at a freight charge of approximately $12.71 per ton concentrates as compared to their present trucking cost of approximately 30 cents per ton from the Magmont Mine to the Missouri Lead Smelting Company smelter. Freight cost is, of course, only one of the costs involved in the smelting and refining of these lead concentrates, but there can be no question that the other smelting and refining costs also would be substantially higher in the usual tolling agreement with a custom smelter like ASARCO's. Thus, although the payments for smelting and refining are spelled out in somewhat different terms under the Tolling Agreement of September 13, 1965 than they would be under the usual tolling agreement with a custom smelter, the net effect is that Dresser and Cominco enjoy substantially lower smelting and refining costs than they would have had to pay under the usual tolling agreement.

The unique nature of this Tolling Agreement is illustrated by certain key provisions in it. The fifth WHEREAS clause at the bottom of Page 2 and the top of Page 3 indicates that in return for assuming part of the risks and the burdens of construction and operation, Cominco and Dresser are to receive the benefit of a lower cost for smelting in the following language:

> WHEREAS, the Company, recognizing the economic importance to it in the operation of the Smelter of being able to utilize such portion of such initial capacity to toll

> Magmont Concentrates and thus to secure the benefit of a lower cost per unit of production, has agreed to share with the Tollers the incremental benefits that may be derived from increased efficiency in the operation of the Smelter, from the treatment of larger amounts of lead concentrates than presently contemplated by virtue of Constructed Increased capacity or from certain other causes having the effect of decreasing the overall costs of the operation of the Smelter.

In Article 6.05 Dresser and Cominco agreed that they would deliver all of their Magmont concentrates to the smelter for a period of ten years, and the basic reason for this unusual provision is spelled out in Article 6.05 itself reading as follows:

> Since it is recognized by the parties hereto that 50% of the Initial Rated Capacity of the Smelter is being constructed for utilization by the Tollers, and that for such construction to be economically feasible and justifiable it is necessary for the Magmont Concentrate to be committed to such utilization, the Tollers agree to the extent that they can legally and effectively do so under applicable law that * * * they will not sell, toll or otherwise dispose of any Magmont Concentrates or lead ore recovered from the Magmont Mine except pursuant to this Agreement.

In other words, in order to amortize the cost of the smelter, Missouri Lead Smelting Company needed to be assured that its smelter would receive all of the Magmont Concentrates for a period of ten years. Also, in order to further assure itself that all of the Magmont Concentrates would be delivered to its smelter for at least ten years, Missouri Lead Smelting Company required Dresser and Cominco in Article 15.02 not to dispose of their interests in the Magmont Mine without the prior written consent of Missouri Lead Smelting Company.

We now come to Article 9.04 which provides for the fixed tolling charge of $9.14 per ton with a minimum of not less than $160,000 per quarter. An analysis of Article 9.04 reveals that this fixed tolling charge of $9.14 per ton is to be paid in installments of not less than $160,000 per quarter so that the lending banks can

> be assured that Missouri Lead Smelting Company will have a steady income to repay the loan needed to construct the smelter. This is made obvious by the provisions of Article 9.04(b) which provides that $160,000 minimum fixed tolling charge per quarter terminates when the Loan Agreement for $13,235,000 with Bankers Trust Company has been paid off, when the Tollers have delivered an aggregate of 1,050,000 tons of Magmont Concentrates, or the 15th anniversary of the Commencement Date, whichever occurs first. In other words, as a condition of loaning to Missouri Lead Smelting the sum of $13,235,000 for the construction of the smelter, the Bankers Trust Company required that Dresser and Cominco agree to pay the Tolling Charge of $9.14 per ton in installments of not less than $160,000 per quarter, regardless of what happened, until the loan was paid off. Article 9.04(d) provides that after the $13,235,000 loan has been paid off or a minimum of 1,050,000 tons of Magmont Concentrates have been delivered the fixed tolling charge payments shall not exceed $160,000 per quarter. This also demonstrates that the requirement that the $9.14 per ton Tolling Charge be paid in minimum installments of $160,000 per quarter is directly tied in with the repayment of the bank loan and that the $160,000 minimum is in no sense a penalty.

From appellant's own analysis of the tolling agreement, it is apparent that the deficiency payment is not considered a usual or normal "smelting" or "refining" cost or charge. It is not directly a charge assessed by the smelter based on the cost of treating the ore shipped to it for treatment. As appellant has indicated, the deficiency payment was provided in the tolling agreement to assure the lending banks that the smelter would have a guaranteed income.

There is in the record no information or suggestion by appellants that the United States, as lessor, could have contemplated that such a deficiency payment would be made by the lessee, or that tolling charges in excess of those directly attributable to concentrates actually processed from ore mined from lands subject to the lease would be made.

It was not until more than two years after the issuance of the lease on June 1, 1963, that the lessee and its assignee entered into the tolling agreement of August 13, 1965, with Missouri Lead Smelting Company. According to the record, the Government did not receive a copy of the agreement until June 12, 1967, and then only after it had been specifically requested.

Thus, the United States could not have contemplated such an arrangement, or considered such payments as costs and charges when the lease was drafted.

Appellant's arguments that the tolling deficiency payments constitute a prepayment of future tolling charges, and that the Government will realize the same amount of royalties whether or not the deficiency payments are allowed as current deductions from the royalty base, are not substantiated. They assume that the tolling charges to be waived in the future will exactly equal the deficiency payments, and that, therefore, if the deficiency payments are deductible, the royalty base will be increased in the same amount as it is currently reduced. In the first place, as appellant concedes, the prospect that a contingency permitting suspension of any tolling charges will ever occur is purely hypothetical. Moreover, should such a contingency take place, there is little likelihood that the suspended tolling charges would exactly equal the total of deficiency payments.

Finally, even in the improbable event that the additional royalty currently denied to the Government by virtue of allowance of the deficiency payments should be exactly offset by an increase in royalty resulting from suspension of tolling charges for a future period, the Government would not actually receive the full benefit of the royalty money as it becomes due, since it would be deprived of the interest value of the money in the meantime. 2/

In effect by asking for allowance of the deficiency payments, appellant is seeking to protect the interest value of its own money. We see no justification here under the lease terms to shift this interest value from appellant to the Government by means of such an agreement with third persons. This is not to say that we do not realize that appellant's actual expenditures may be less (although appellant admits this cannot be proven) by this arrangement than if it had to ship to smelters farther away, with a consequent greater value base from which the royalty would be computed. Nevertheless, that is not a reason to postpone the time the Government should receive the full royalty, especially in view of the uncertainties mentioned previously regarding the allocation of the production between the leased lands and other lands included within the mine.

For clarification, the decision below is modified with respect to the statement by the Acting Director that the appellant is

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2/ We note that where payment of a royalty is deferred, a lessor may be entitled to interest accruing from the date when the royalty becomes due. See Phillips Petroleum Co. v. Williams, 158 F.2d 723 (5th Cir. 1946); 58 C.J.S. Mines and Minerals § 186 (1948).

"entitled to deduct only the fixed tolling charge of $9.14 for each ton of lead concentrate produced from this lease until 1,050,000 tons of concentrates have been shipped." The tolling agreement does not waive all payment of tolling charges after 1,050,000 tons of concentrates have been shipped; it provides, as discussed above, that if $9,600,000 has been paid in tolls prior to delivery of 1,050,000 tons of concentrates, the tolling charge will be suspended until the 1,050,000 tons have been delivered. Thereafter, the tolling charge again becomes applicable, but may not exceed $160,000 per quarter. This would be regardless of the amount of concentrates refined. Accordingly, in light of the limitation prescribed by the tolling agreement, the decision of the Acting Director is modified to provide that appellant is entitled to deduct the fixed tolling charge of $9.14 for each ton of lead concentrate actually processed from ore mined within the lease, provided that after 1,050,000 tons of lead concentrates have been delivered or the loan to the smelter has been repaid, whichever event should occur first, the tolling charge deductible for any calendar quarter shall not exceed $160,000.

For these reasons, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior (211 DM 13.5/ 35 F.R. 12081), the decision appealed from is affirmed as modified.

Joan B. Thompson, Member

We concur:

Newton Frishberg, Chairman

Anne P. Lewis, Member

Martin Ritvo, Member

Douglas Henriques, Member

Edward W. Stuebing, Member

DISSENTING OPINION BY MR. GOSS

While the issue herein is difficult to resolve, it is submitted that a more literal and ordinary construction should be given to the lease addendum words "all of the lessee's costs and charges during such period in connection with lessee's * * * smelting, refining * * * of all concentrates."

The lessor has contracted to permit deduction of "all * * * costs and charges." "All" is an inclusive word commonly used for emphasis rather than surplusage. "Cost" indicates the price paid as consideration, or that which has to be given for a thing in order to procure it, especially the price paid. City Ice Delivery Co. v. United States, 176 F.2d 347, 352 (4th Cir. 1949). Assuming good faith, the "costs and charges" herein concerned are a part of the consideration required to be paid before further ore will be smelted, and not a voluntary payment by lessee or an investment of lessee in a share of ownership in the smelter.

"During such period" refers to each month or other period designated by the Regional Mining Supervisor under Sec. 2(f) of the lease. Deductible deficiency costs or charges are thus limited to those applicable to the month - or other designated statement period such as the quarter - in which the ore is mined. Lease Sec. 2(c). Any other deficiency costs or charges should not be deducted.

"Connection" has been defined as "the state of being connected * * *; union by * * * relation * * *." State v. Patterson, 95 S.C. 463, 79 S.E. 309, 310 (1913). Under the facts before the Board, the ore which has been processed thus far is 100 percent the ore from lessor's portion of the mine. To hold that the deficiency charge is not connected with or related to lessee's smelting is to hold by implication that the charge has been voluntarily assumed by lessee for some reason entirely unconnected and unrelated to the smelting of lessor's ore.

The value of unrefined ore coming from a mine may be difficult to ascertain. It is not at all unusual for leases to provide for deduction of all smelting costs in order to determine royalties due on raw ore. See In re Roberts Mining and Milling Co. 35 F. Supp. 678 (1940). The question before the Board is whether lessee's acts of performance under the lease - i.e., entering into the smelting agreement and deducting from lessor's royalty the deficiency payments - was permissible within the clear meaning of the words of the lease.

Lessee claims the terms of the smelting contract are in the interest of lessor and that lessee's assumption of the obligation to make extra payments for irregular deliveries is but a part of the lower smelting charges which have been obtained by virtue of the contract. Lessor could have provided in the lease that its approval was required prior to formalization of any smelting contract. Lessor chose not to include this provision. The Board should not rewrite the lease. The obligation of lessee, where the manner of performance under the lease is left to his discretion, is to exercise his discretion reasonably, and not arbitrarily or capriciously. Cf. Pacific Far East Line, Inc. v. United States, 394 F.2d 990, 998, 184 Ct. Cl. 169 (1968).

It is not unreasonable for market value of a raw mineral to be determined -- where otherwise none exists with sufficient definiteness -- by deducting all increase in ultimate sales value attributable to expenses incurred in transporting and processing. Costs which are essential to make a commodity worth more must be proportionally borne by those who benefit. Freeland v. Sun Oil, 277 F.2d 154, 159 (5th Cir. 1960), cert. den. 364 U.S. 826 (1960). Such costs have been held to include a factor for depreciation of a gasoline extraction plant. Myers et al. v. Texas Co., 59 P.2d 132, 136, 6 Cal. 2d 610 (1936).

This Board should take notice of the following facts: (1) that smelters can only be efficiently operated by taking steps to assure as even a flow of ore as practicable; (2) that it is not unusual for a custom refining or smelting contract to encourage an even-flow of raw material; and (3) that it is not unreasonable or unusual for a smelter to make additional charges in one form or another for the smelting of irregular flows of ore. The parties should be deemed to have contemplated that these factors would be inherent in the costs and charges paid by lessee.

Under the inclusive language of the lease regarding "all costs and charges," it would therefore seem most unlikely that the parties intended for lessee to bear the entire burden of higher smelting charges for any irregular deliveries -- some of which may be necessitated from time to time due to difficulties inherently associated with the mining of lessor's own ore. Such a construction would presume that the parties intended lessor to receive a windfall and to not bear his proportionate share of the total costs fairly attributable to getting the ore smelted, contrary to the doctrine of Freeland v. Sun Oil, supra. One way to avoid this unfair result is to permit recovery of a reasonable share of the deficiency charges under the contract.

The execution of a smelting agreement providing some form of additional payment for irregular deliveries thus seems clearly within the ambit of the broad language of the lease addendum. The authorities cited by dissenting Board Member Fishman are persuasive. Does the particular custom smelter contract herein operate so that its execution was unreasonable as to the lessor? Where there is no charge of fraud, want of good faith or arbitrariness, as such, the question is the reasonableness of the costs of extraction payable to the processor. Freeland v. Sun Oil Co., supra.

It is submitted that the problem should be approached on the basis of the operations during a particular statement period [Lease Sec. 2(f)] and with due consideration of lessor's latitude to set minimum values under Section 2(c) of the lease. As noted above, only the deficiency payments charged for a particular statement period may be deducted from royalties due on ore mined during the period. Lessee made deficiency payments of $160,000 during the periods when no ore was delivered for smelting. These costs must be borne entirely by lessee if no ore was mined during the period. Assuming the good faith of lessee's statement that payment of the deficiency charge results in lesser smelting charges to be deducted from lessor's future royalties, lessor will ultimately receive a substantial benefit from deficiency payments borne by lessee.

If this matter were between private parties and before a court, it is possible that a portion of the royalties would be impounded to make certain that in a final accounting an unfair share of smelting costs would not be charged against lessor's ore. However, in the lease under consideration, there are two provisions which make impounding unnecessary. If application of a statement period deficiency charge should be considered unreasonable, the Secretary could act to require more regularly spaced mining under the reasonable diligence provisions of Lease Sec. 2(a). Additionally, the Secretary has authority to establish a minimum value for computation of royalties even after the particular ore has been mined and sold. Lease Sec. 2(c). 30 CFR 231.27. United States v. Southwest Potash Corp. et al., 352 F.2d 113 (10th Cir. 1965), cert. den. 383 U.S. 896 (1966). Setting of a minimum value would establish a price below which the government will not dispose of its ore and would protect against (1) undue irregularity in ore deliveries to the smelter, (2) the smelting contract proving improvident in competition with the smelting costs of other mines, (3) any undue deficiency charges against lessor's ore rather than against other ore which will later be taken from the mine, and (4) any losses from failure of lessee to complete the lease after charging any inordinate deficiency payments against lessor's royalties.

The lease expressly provides a means for protecting lessor and the public interest against improvident or unreasonable smelting or other charges. It therefore seems inappropriate to construe the words of the lease as more limited than their usually accepted meaning - by holding that higher payments due to irregular delivery are not connected with lessee's smelting and refining. If a deficiency payment deduction is considered unreasonable for a period in which ore is mined, a minimum value should be set.

Joseph W. Goss, Member

DISSENTING OPINION BY MR. FISHMAN

I agree with the views enunciated by Member Goss but believe the issues warrant further discussion.

The lease prescribes the base upon which the Government's royalty is to be figured as the

> [g]ross Value * * * less an allowance for average freight and Federal taxes thereon from the treating smelter to destinations to which metal is customarily shipped by lessee and <u>less all of the lessee's costs and charges * * * in connection with lessee's shipping, smelting</u>, refining, labelling and selling of all concentrates. * * * [Emphasis supplied.]

The rationale of the majority opinion apparently rests upon three grounds: (1) the tolling agreement (the agreement to pay a fixed sum periodically even though the aggregate of the unit smelting charges fell below that sum) is "* * * a rather special and unique arrangement * * *"; (2) "* * * the United States could not have contemplated such an arrangement, or considered such payments as costs and charges when the lease was drafted * * *"; and (3) the contractual agreement does not sufficiently protect the interests of the United States in getting its just due in royalties.

Although the above statement of the issues directly poses the crux of the case, <u>i.e.</u>, the interpretation and construction of the contract entered into by the parties, the majority opinion touches this issue only tangentially and is bereft of legal principles governing the construction and interpretation of contracts.

That the tolling agreement may have been a special and unique arrangement does not necessarily remove it from the ambit of the contract.

> [I]f parties understand an agreement differently, and neither of them makes known to the other his construction of it, and it is afterwards reduced to writing and duly executed, they are bound in equity, as well as at law, by the terms of the written instrument which in such cases is to be construed by the court.

4 WILLISTON ON CONTRACTS, § 606 (3d ed. W.H.E. Jaeger 1961) at p. 373-5, quoting Sawyer v. Hovey, 85 Mass. (3 Allen) 331 (1862).

That the United States did not envisage that a tolling charge would be regarded as a smelting cost is irrelevant, since the language used in the contract is broad enough to encompass it.

> The contract between these parties is plain and unambiguous.
>
> The language of a contract must be understood to mean what it clearly expresses. A court may not depart from the plain meaning of a contract where it is free from ambiguity. . . . In constructing the terms of a contract, where the terms are plain and unambiguous, it is the duty of the court to construe it as it stands, even though the parties may have placed a different construction on it. . . . It seems to us that when parties to a contract adopt a provision which does not contravene a principle of public policy, and which contains no element of ambiguity, the court has no right by a process of interpretation to relieve one of them from any disadvantageous terms which he has actually made.

WILLISTON, supra § 609 (at p. 403), quoting Cernohorsky v. Northern Liquid Gas Co., 268 Wis. 586, 68 N.W. 2d 429, 433 (1955).

Although it is true that

> * * * contracts apparently clear in their meaning may be shown by usage of the surrounding circumstances to be ambiguous or perhaps clearly to mean something different from the normal or ordinary meaning of their language, "it is well settled that parties who contract on a subject-matter concerning which known usages prevail, incorporate such usages by implication into their agreement, if nothing is said to the contrary."
>
> There are, however, certain secondary rules for the interpretation of a contract, the meaning of which is doubtful after the primary means which are always available to aid the court in applying the standard accepted by the law (whether that is the standard of limited usage or the standard of reasonable expectation) have been used. Such is the rule that language is construed most strongly against him who uses it. . . . [Footnotes omitted.]

WILLISTON, supra, § 609 at p. 405.

In the case at bar, the contract was drafted by the United States. Therefore, if the language in issue be deemed to be ambiguous, it is properly construed most strongly against its drafter. Bender v. Hearst Corp., 263 F.2d 360, 367 (2d Cir. 1959); Abady v. Hanover Fire Ins. Co., 266 F.2d 362, 364 (4th Cir. 1959); Myers Motors, Inc. v. Kaiser Frazier Sales Corp., 83 F. Supp. 716 (D Minn. 1949).

Whether or not the lessor fully appreciated the import of the language it employed in the contract is not a cogent reason for disregarding the language.

WILLISTON, supra, § 609, at p. 414, quoting John F. Davis Co. v. The Shepard Co., 71 R.I. 499, 47 A. 2d 635 637, (1946), which supports this view as follows:

> The cardinal rule of construction of contracts is to seek first the intention of the parties. But this court has said that such intention is to be deduced from the language of the contract, and that where it is unambiguous the terms of the contract are, in the absence of averment or proof of mistake, conclusive. The true question, the court has said, is "not what intention existed in the minds of the parties but what intention is expressed by the language used. * * * Where the contract evidences care in its preparation, it will be presumed that its words were employed deliberately and with intention." This standard of interpretation of the ordinary contract has, as far as we are aware, never been departed from in this state. [Emphasis supplied.]

The contract drafted by the United States consists of 3 1/2 legal size pages of printed material and 2 1/2 pages of typed material. The whole of a typed page concerns itself with the computation of the royalty. The conclusion seems inescapable that "the contract evidences care in its preparation" leading to the presumption "that its words were employed deliberately and with intention."

Courts must "concern [themselves] with what the parties intended, but only to the extent that they evidenced what they intended by what they wrote." WILLISTON, supra, § 610 A at p. 525, citing Raleigh Associates v. Henry, 302 N. Y. 467, 99 N.E. 2d 289, 291 (1951).

That the lessor's drafting of the terms of the contract perhaps improvidently failed to assure an adequate return to the lessor is not a justifiable basis for ignoring the language of the contract. The lessor could have limited smelting costs specifically to unit smelting charges. It failed to do so.

I note that Member Goss' reliance upon another provision of the contract would adequately protect the lessor. However, the issue is simply what the words of the contract import, not whether our interpretation adequately protects the United States, which, in the posture of a contracting party, should be treated no differently from any other party which had made an improvident contract.

In sum, it is my view that the contract is not ambiguous. Even if it be so deemed, the drafting of the contract by the United States should properly result in having the ambiguity construed against its drafter.