

C & K PETROLEUM, INC.

IBLA 76-337

Decided September 17, 1976,

Appeal from a decision of the Director, Geological Survey, denying a request for barging cost deductions on royalties due for oil and gas lease OCS-092.

Reversed.

1. Outer Continental Shelf Lands Act: State Leases: Generally

Leases issued by the State of Texas for offshore oil and gas deposits which have been validated under section 6 of the Outer Continental Shelf Lands Act do not prohibit, for royalty purposes, allowance by the Geological Survey of a reasonable deduction of barging transportation costs for crude oil production from the field to the point of the first market onshore.

APPEARANCES: James C. Johnson, Esq., and Bryan W. Aldridge, Esq., of Baker & Botts, Houston, Texas, for appellant.

OPINION BY ADMINISTRATIVE JUDGE RITVO

C & K Petroleum, Inc., has appealed from a decision of the Director, Geological Survey (GS), dated October 10, 1975, setting an onshore posted price as the value upon which to compute the royalty due on its offshore lease OCS-092, and refusing to deduct barging costs incurred in the transportation of crude oil from appellant's offshore platform to an onshore pipeline. Appellant's leasehold is within Block 189, Galveston Area, Gulf of Mexico, approximately 10 miles from Galveston, Texas.

On November 7, 1947, the General Land Office, State of Texas, issued oil and gas leases Nos. 31646, 31651, and 31652 to appellant's predecessor in interest. Thereafter, pursuant to the provisions of

section 6 of the Outer Continental Shelf Lands Act (OCSLA), 43 U.S.C. § 1335 (1970), the state leases were deemed to meet the requirements of OCSLA and were later consolidated into one lease and designated as federal lease OCS-092. The lease provides that the lessee shall pay:

As a royalty on oil, one-eighth (1/8) of the value of the gross production based on the highest posted price for the same grade of crude oil in the general area, or at the option of Lessor, one-eighth (1/8) of the gross production, the same to be delivered free of cost to the credit of Lessor to the pipeline or to the railroad transporting the oil.

In 1969, appellant submitted to GS an oil sales contract covering production of oil from lease OCS-092. The contract provided that appellant would sell crude oil from its offshore leasehold at the posted price at High Island Field, Texas, minus the cost of transportation by barge from the platform to the onshore market. The purchase price was subject to increase or decrease in an amount equivalent to any change in the posted price for crude oil produced from the High Island Field which is situated onshore approximately 40 miles distant from appellant's leasehold. In 1971, the contract was amended to permit a higher purchase price based upon an increase in the posted price for crude oil for High Island, Texas.

With its submission of the sale contract, appellant requested that GS approve the price paid under the contract (onshore market value less barging costs) as the value basis for computing royalties due to the United States. By letter dated July 23, 1971, the Acting Oil and Gas Supervisor, Gulf Coast Region, rejected appellant's request to pay royalties based upon the contract sales price, and required instead that the royalty value for crude oil produced from lease OCS-092 would be, effective July 1, 1971, equal to the posted price for High Island, Texas. After citing the oil royalty clause of the lease, the Acting Oil and Gas Supervisor stated that "The language of this royalty provision of the lease agreement is regarded as not authorizing any deduction or charges for gathering or transporting oil to the purchaser." Appellant thereupon appealed to the Director, Geological Survey, who affirmed the decision of the Acting Oil and Gas Supervisor. In his decision, the Director, GS, concluded that High Island and the Block 189 field were within the same "general area" as that term was to be construed from the lease provision, and therefore the posted price at High Island was properly applied to production under lease OCS-092. Additionally, the Director determined that under the royalty provision of the lease, GS was not authorized to make allowances for barging costs as this charge was solely the responsibility of the lessee under the royalty terms of the lease. In reference to the royalty oil provision in the lease which requires payment of one-eighth of the gross production

to be delivered "free of cost" to the pipeline or to the railroad transporting the oil, the Director stated:

Regarding appellant's contention that delivery to a barge may be considered as analogous to delivery to the nearest railroad, it is our view that the pick-up of leasehold production by a barge for delivery to a pipeline or railroad siding is more analogous to the pick-up of leasehold production from an on-shore lease by a truck for delivery to a pipeline or railroad.

Appellant filed a timely appeal to this Board. ^{1/}

We agree with the Director's conclusion that appellant's lease in the Galveston Block 189 and the High Island Field are within the same "general area," and therefore the posted price at High Island is applicable to production under lease OCS-092. This is reflected by the fact that appellant's oil sales contract has a variable pricing mechanism which is tied to the posted price at High Island. However, this is only the beginning of the analysis. The royalty provision of appellant's lease requires payment of one-eighth of " * * * the value of the gross production based on the highest posted price for the same grade of crude oil in the general area * * * ." (Emphasis added.) While prices obtained in the "general area" can be resorted to for the purpose of the light they throw on the "value of the gross production" at a wellhead where there is no market, such prices may not be applied inflexibly without consideration of other relevant factors. Haynes v. Southwest Natural Gas Co., 123 F. 2d 1011, 1012 (5th Cir. 1941). The additional relevant factor in the present case concerns barging costs.

We note appellant's contention that while a reasonable barging allowance is considered to be a permissible deduction under leases issued pursuant to section 8 of OCSLA, 43 U.S.C. § 1337 (1970), Shell Oil Co., 70 I.D. 393 (1963), leases originally issued by the states but subsequently validated by the Department of the Interior pursuant to section 6 of OCSLA, 43 U.S.C. § 1335 (1970), are circumscribed in the matter of royalties by the particular terms of each lease. 30 CFR 250.100(a); Ocean Drilling & Exploration Company, 21 IBLA 137, 139 (1975) [hereafter, ODECO]. Appellant argues, among other points, that while there is no direct Texas judicial authority interpreting the royalty provision of the subject lease, opinions of the Attorney General of Texas regarding the deductibility of transportation costs with respect to gas royalty support deductibility of barging costs in this case. The Board is persuaded that this argument is correct and therefore we believe that the decision of the Director, GS, should be reversed.

^{1/} From July 1, 1971, to the present, all royalty payments to the United States have been made under protest.

The question before the Board is the proper construction of the royalty provision of the subject lease with regard to transportation costs. To arrive at an answer we may follow the interpretation of state law advanced by the State Attorney General in the absence of any contrary state court decisions. ODECO, *supra* at 141; Beverly Harrell, 13 IBLA 276 (1973).

In the Opinion of the Attorney General, Texas, No. WW-196 (July 24, 1957), the Attorney General was asked to determine whether the costs of processing and transporting gas obtained from State leases could be deducted from the State's royalty interest. The leases under review were executed pursuant to the same statutory authority as appellant's lease, although the royalty provisions were not identical to the one at hand. In each case analyzed by the Attorney General, no market existed at the wellhead for the gas produced. The lessees, in order to market the gas, constructed various pipelines, compressors and hydrocarbon separators at their own expense.

The Attorney General held that in any lease executed under the subject statute, payment of money royalty was to be based upon the value of the gross production at the wellhead, and if there was no market at the well, evidence which showed the market price in the general area could be used to determine the value of the gross production. He added, however, that while the lessee owed a duty to the State to use diligence in marketing the gas, the State was not entitled to a "free ride" to the marketing point. Relying on two federal court cases, Phillips Petroleum Co. v. Johnson, 155 F.2d 185 (5th Cir.) *cert. denied*, 329 U.S. 730 (1946), and Phillips Petroleum Co. v. Bynum, 155 F.2d 196 (5th Cir. 1946), he determined that it was permissible for a State lessee to deduct for royalty purposes transportation costs where no market existed at the wellhead. The Attorney General concluded:

It, therefore, appears that the State may legally be charged its pro rata share of transportation costs from the wellhead, which is the pricing point for value of royalty gas, to that point where title to the gas passes to the purchaser. This means that where the value of the gross production of gas is computed from a price paid for such gas at a point not at the well, then in arriving at the royalty to be paid the State, a reasonable charge may be assessed for the use of necessary pipelines and processing equipment.

1957 Tex. Op. Att'y. Gen. No. WW-196, at 4.

In 1971, in the Opinion of the Attorney General, Texas, No. M-943 (August 23, 1971), the Attorney General overruled the earlier opinion, No. WW-196, with respect to the deductibility of gas processing charges. The lease in question was situated within the Gulf of Mexico, and after

the gas had been processed, the operator sold it to the purchaser at the platform well. The Attorney General was asked to review Opinion No. WW-196 and determine whether a proportionate cost of preparing natural gas from State leases could be deducted from the State's royalty interest.

The royalty provision in the subject lease required payment to the State of one-sixth of "the value of the gross production * * *." The Attorney General concluded that such value did not include deductions for any part of the expenses for production and sale of the gas and stated:

It is our opinion that California Company vs. Udall, [296 F.2d 384 (D.C. Cir. 1961)] clearly sustains our position that the lessee-producer of gas from a State lease, pursuant to the terms of the lease, must pay royalties without any deductions for the cost of producing, sale or delivery of the gas so produced. [Emphasis added.]

1971 Tex. Op. Att'y. Gen. No. M-943, at 6. It appears that the Attorney General's reference to "delivery" costs was to be given a limited meaning in light of his subsequent comment that:

Attorney General's Opinion WW-196 (1957) specifically deals with the fact situation where the gas must be transported some considerable distance from the leased premises by the lessee in order to sell the gas to a pipeline purchaser. To that extent, Opinion WW-196 is distinguishable from the present situation on the facts and we do not reconsider that portion of the Opinion.

Id. at 7.

A narrow construction of the Attorney General's opinion is also suggested based on the Attorney General's reliance upon California Company v. Udall, supra. In that case, the Court determined that the federal government's royalty on the value of the production was not to be burdened by a deduction for processing costs. The Court added the following caveat, supra at 387:

Let us here insert a cautionary parenthesis. No transportation costs are involved in this case. The Secretary is not here claiming that costs incurred in moving gas from the field in the neighborhood of the wells to a distant selling point are includable in the royalty base. This gas was conditioned by the seller and delivered to the purchaser in the field within a short distance of the wells. There were no transportation

costs. The Kettleman Hills case [Continental Oil Co. v. United States, 184 F. 2d 802 (9th Cir. 1950)] was concerned with an element of comparative transportation costs in the determination of market value * * * [and does not help] us in our present problem. [Footnotes omitted.]

The Continental Oil case affirmed United States v. General Petroleum Corp., 73 F. Supp. 225 (S.D. Cal. 1947), in which the Court held, supra at 263, that "* * * if there is no open market in the place where an article ordinarily would be sold, then the market value of such article in the nearest open market, less cost of transportation to such open market, becomes the market value of the article in question." Both the District and Circuit Courts concluded that, for royalty purposes, it was proper to consider market prices at a distant oil field, less reasonable transportation costs.

In view of the above analysis, we find it unnecessary to review in depth the Director's determination respecting proper construction of the "royalty oil" language of the lease which directs delivery of production "free of cost" to the credit of the United States. The opinion of the Texas Attorney General reflects acceptance of the general rule that the term "free of cost" is to be construed as free of cost of production, which would include the cost of gathering and delivering oil to a pipeline within the field of production, but the lessor must share the expense of transporting his royalty oil to the point at which it is sold when no market for the oil exists at the wellhead. 1971 Tex. Op. Att'y Gen. No. M-943, at 6, and cases cited therein. See also Cameron v. Stephenson, 379 F.2d 953, 956 (10th Cir. 1967).

[1] Accordingly, since the royalty provisions within state leases validated by section 6 of OCSLA are to be construed in light of state law, 30 CFR 250.100(a); ODECO, supra, and the arguments presented by the State's Attorney General are applicable to oil production, as well as gas production, we hold that a reasonable deduction for barging costs may be considered by GS in determining the value of the gross production used as the basis for computing royalties owed by appellant to the United States.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the

decision of the Director, Geological Survey, is reversed and the case is remanded for action consistent with the views expressed herein.

Martin Ritvo
Administrative Judge

I concur:

Douglas E. Henriques
Administrative Judge

ADMINISTRATIVE JUDGE GOSS CONCURRING:

I concur in the result. The lease provides two alternatives for computation of royalty. Under the first alternate royalty provision -- i.e., the royalty in cash based upon values at the well head -- there is no question but that oil located at sea is not as valuable as oil nearer to market, hence transportation charges should be taken into consideration. Ocean Drilling & Exploration Company, supra.

As to the second alternative, whereby "at the option of lessor" one-eighth of the oil produced is "to be delivered free of cost to * * * Lessor to the pipeline or to the railroad transporting the oil," there is no clear showing the Government has ever exercised such option. Hence the Government may not rely upon that provision, and is bound under alternative #1 and the conclusion in Ocean Drilling.

If the option had been exercised, a more difficult problem would be presented. The language used by the parties in the lease seems clear, and none of the cited opinions of the Texas Attorney General rules upon a lease which provides for delivery of oil "free of cost * * * to the pipeline." I believe that Cameron v. Stephenson, supra, is the only decision cited which lends some support to appellant's position. Therein the Court ruled:

Plaintiff was entitled to delivery free of cost at the [existing] pipeline and to receive the market price at that point. Delivery was made without expense to her.

The Court then concluded, in effect, that the best market price at the pipeline is not the value of oil as already delivered to that location, but such value less the 10 cents per barrel charge for transporting the oil there. It would seem that market price at the pipeline should have been computed upon values at the pipeline, and not values some distance away.

While various texts have referred to a weight of authority, which might be important if a business custom exists, none of the texts cites a case in point. The only rationale cited for the conclusion suggests a state of facts not present here. As quoted by appellant, the following language appears in the basic text upon which he relied, 3 Williams, Oil and Gas Law, § 646.2 (1972):

By the weight of authority in cases involving language such as that first quoted above, providing for delivery "free of cost in the pipe line to which Operator may connect his wells," the expense of transportation or of treating oil or gas or of compressing

gas to make it deliverable must be shared by the owner of the nonoperating interest. The language employed suggests that the parties assumed that a pipe line connection at the well [1/] would be available. * * * [Footnote omitted.]

Clearly, the parties herein were under no misunderstanding as to nonavailability of an offshore pipeline at the well.

Joseph W. Goss
Administrative Judge

1/ Emphasis added.

