

Editor's note: 88 I.D. 7; Appealed - reversed, Civ. No 81-461-T (W.D. Okl. Nov. 18, 1981); reversed, No. 82-1074 (10th cir. Dec. 28, 1983), 723 F.2d 1488; cert. denied, 105 S.Ct. 93, 469 US 821 (Oct. 1, 1984)

HOOVER & BRACKEN ENERGIES, INC.
88 I.D. 7

IBLA 80-305

Decided January 5, 1981

Appeal from decision GS 148-0 & G of the Director, Geological Survey and IND 20-0 & G of the Acting Deputy Commissioner of the Bureau of Indian Affairs affirming the order of an oil and gas supervisor setting a different basis for computation of the Government's royalty from an oil and gas lease and demanding payment of additional royalty.

Affirmed.

1. Oil and Gas Leases: Royalties

In determining the amount of royalty due to the United States from an oil and gas lease, it is proper for the Geological Survey to use a base value which includes both the purchase price paid for the natural gas and the amount of severance taxes paid by the purchaser directly to the State where, under Oklahoma law, the purchaser is authorized to deduct the amount of taxes paid from the amount paid to the producer. Decision in Wheless Drilling Co., 13 IBLA 21, 80 I.D. 599 (1973), cited and applied.

APPEARANCES: C. David Stinson, Esq., Bill W. Logsdon, Esq., McAfee, Taft, Mark, Bond, Rucks & Woodruff, Oklahoma City, Oklahoma, for appellant.

OPINION BY ADMINISTRATIVE JUDGE BURSKI

Hoover & Bracken Energies, Inc., has appealed the decision of the Director of the Geological Survey and the Acting Deputy Commissioner of the Bureau of Indian Affairs, dated November 29, 1979, affirming an order of the Survey's Area Oil and Gas Supervisor for Tulsa, Oklahoma. The order required that the value of certain state tax payments be included in the gross value of natural gas sold from appellant's leasehold unit for the purpose of computing Federal royalty payments. Appellant has been basing its royalty payments on the gross proceeds received from the sale of such gas excluding the amount of state taxes.

As authority, the decision cites Departmental regulation, 30 CFR 221.47, which defines the value basis for computing royalties as follows:

The value of production, for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices and

to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

In addition, the decision quotes the royalty provision of the standard form, Oil and Gas Mining Lease for Allotted Indian Lands (Form 5-154h), used by the Bureau of Indian Affairs of the United States Department of the Interior. That provision reads in pertinent part as follows:

During the period of supervision, "value" for the purposes hereof may, in the discretion of the Secretary, be calculated on the basis of the highest price paid or offered (whether calculated on the basis of short or actual volume) at the time of production for the major portion of the oil of the same gravity, and gas, and/or natural gasoline, and/or all other hydrocarbon substances produced and sold from the field where the leased lands are situated, and the actual volume of the marketable product less the content of foreign substances as determined by the oil and gas supervisor. The actual amount realized by the lessee from the sale of said products may, in the discretion of the Secretary, be deemed mere evidence of or conclusive evidence of such value.

The language of the royalty provision in the lease tracks the language in the regulations in 25 CFR 172.16.

In reaching its decision, Survey relied on the principle enunciated in Wheless Drilling Co., 13 IBLA 21, 80 I.D. 599 (1973), that the value of production for royalty purposes and the term "gross proceeds" includes the amount of severance tax paid by the buyer to the seller of the gas. Survey then concluded that the fact that the buyer in this case paid the tax directly to the State did not change the principle: payment still inured to the benefit of the seller and thus should be considered in computing Federal royalty.

Appellant's leases cover lands which have been communitized with privately owned lands in the same governmental section for the purpose of drilling for and producing oil and gas. Under the communitization agreement, costs are borne by each lessee in the proportion that acreage covered by each lease bears to the total acreage in the unit. Where production occurs, each lessee and royalty owner shares in such production in accordance with the terms of the lease.

The State of Oklahoma has levied "a tax * * * equal to seven percent (7%) of the gross value of the production of natural gas." 68 Okla. Stat. Ann. § 1001 (West). By statute, the gross production tax "shall be paid by the purchaser of such products and such purchaser shall * * * deduct in making settlements with the producer and/or royalty owner, the amount of tax so paid." 68 Okla Stat. Ann. § 1009(d) (West). The State has also levied an excise tax equal to 0.085 of 1 percent of the "gross value of all natural gas and/or

casinghead gas produced in the State of Oklahoma which is subject to gross production tax." The excise tax is also paid by the purchaser who is authorized to deduct the amount of the tax when making settlement with the producer. 68 Okla. Stat. Ann. § 1102 (West). Production derived from restricted Indian lands and lands owned by the United States, to the extent the interest in the production is owned by the restricted Indians or United States, is exempt from taxation. See 68 Okla. Stat. Ann. § 1008 (West).

Pursuant to the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. §§ 3301-3432 (Supp. II 1978), the sale of all natural gas produced in the United States is subject to ceiling price limitations. However, section 110(a) of NGPA, 15 U.S.C. § 3320(a) (Supp. II 1978), states that

a price for the first sale of natural gas shall not be considered to exceed the maximum lawful price applicable to the first sale of such natural gas * * * if such first sale price exceeds the maximum lawful price to the extent necessary to recover --

(1) State severance taxes attributable to the production of such natural gas and borne by the seller * * *.^[1/]

Appellant informs the Board that it has executed gas purchase contracts covering sale of its interest in production from the unit including the leased lands. Under each contract, the purchaser is

^{1/} The definition of "State severance tax" includes "any severance, production, or similar tax, fee, or other levy imposed on the production of natural gas" by any State. 15 U.S.C. § 3320(c) (Supp. II 1978).

required to pay to appellant the maximum lawful price applicable to the gas under NGPA and to pay all state severance taxes levied on the gas prior to delivery. Appellant notes that payment of the tax by the purchaser, although not to the lessee, is commonly referred to as "tax reimbursement."

In its statement of reasons, appellant charges that Survey's method for computing royalties is arbitrary, capricious, and an abuse of discretion. Appellant argues that Survey has given no consideration to the "actual value" of the royalty gas. It contends not only that the Board erred in Wheless, supra, by focusing only on the concept of gross proceeds, but also that the present case is distinguishable from Wheless because of the ceiling price limitations set by the NGPA: it argues that reasonable value cannot exceed the ceiling price in a regulated market.

Appellant argues further that the Wheless case also stands for the "patently unfair proposition" that the Federal Government may exempt itself from paying state severance taxes on minerals produced from Federal lands and then benefit from such taxes paid by its lessee and all other parties sharing in production from the unit. Appellant suggests that such an outcome is not mandated by any specific statutory authority and such is not a reasonable interpretation of existing regulations.

Finally, appellant suggests that Survey's method for determining royalty is unreasonable because it leads to incongruous results when

making certain other comparisons. First, it notes that were the Federal Government to take its royalty share of the gas in kind and then sell it, the value received could be no greater than the ceiling price with no tax reimbursement. Then appellant argues that Survey's method is arbitrary because the identity of the seller of the gas is determinative of its value. Second, appellant points out that Survey's method results in the value of the gas produced from the unit varying according to the size of the acreage in the unit owned by the Federal Government.

[1] It is well recognized that the Secretary of the Interior has considerable latitude in determining what is the "value" of production from a lease on which royalty payments are made. Amoco Production Co., 29 IBLA 234, 236 (1977); Wheless Drilling Co., supra at 31; 30 U.S.C. § 226(c) (1976) and 30 U.S.C. § 189 (1976). The Secretary has exercised that discretion by promulgating 30 CFR 221.47 which defines the value basis for computing royalty. In California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961), the Secretary's authority to establish reasonable values for royalty purposes under the Mineral Leasing Act and Departmental regulations was affirmed.

Appellant urges that the Board reconsider its interpretation of 30 CFR 221.47 as set forth in Wheless, supra. We decline to do so. In that case we said that the term gross proceeds as used in the regulation "means the established field price for the natural gas plus any

additional sums paid by the purchaser of the gas to the unit operator as consideration for the purchase of gas from the unit of which the federal lease is a part." 13 IBLA at 30-31. We held that reimbursement by a purchaser of state severance taxes paid by the seller was an "additional sum" properly included in determining value of production for the purpose of computing royalty under 30 CFR 221.47. Accord, Amoco Production Co., supra.

Contrary to appellant's argument, we find that appellant's case, where the price has been set by the NGPA, is no different from that of Wheless, where the price was set by the Federal Power Commission (FPC). Appellant attempts to distinguish the two by noting that Wheless Company could elect to sell in the regulated interstate market or the unregulated intrastate market and by arguing that in an unregulated market the fair value would be the price paid by the purchaser plus tax reimbursement but in the regulated market the value could never be more than the maximum lawful price for which it may be sold. This is a distinction without substance as applied to this case. Appellant itself recognizes that the NGPA expressly allows a price for the gas to be set above the maximum lawful amount to the extent that it reflects state severance taxes paid. 15 U.S.C. § 3320 (Supp. II 1978). Thus regardless of whether we consider the regulated or unregulated market, the amount of tax payments reimbursed does not affect the amount which a producer can receive for its gas under the NGPA. It still may rise to the ceiling. We find that the Wheless principle applies equally in either case.

However, the facts of appellant's case are not exactly the same as in Wheless, and we feel that further discussion of the regulation as applied to appellant's leases is warranted. We focus particularly on the fact that the applicable Oklahoma statutes provide that the purchaser pay the severance taxes and deduct them from the amount paid to the seller. Thus, the amount of the taxes does not result in "proceeds" as that term was used in Wheless and is ordinarily understood. We find, however, that appellant has the same ultimate responsibility for the taxes and receives the same benefit under Oklahoma's method of tax collection as it would in a state where the seller is obligated to pay the taxes directly and benefits from reimbursement by the purchaser. Here appellant still receives the benefit of "tax reimbursement" and consequently the value of that benefit may be added to the amount appellant receives to determine the value of production to appellant for the purpose of computing the royalty. As reported by appellant, the amount it receives under its contracts is the NGPA ceiling amount. Since under Oklahoma law a purchaser must deduct the amount of taxes paid to reach the purchase price, we assume that such price reflects the deduction of that amount and therefore the value to appellant of the gas in this case is the ceiling amount plus the tax paid by the purchaser.

If we turn to the question of what is a reasonable value, as appellant argues, and examine the regulation in that context rather than in terms of the Wheless principle of "gross proceeds" and benefit

to the producer, we reach the same result. First we note that the regulation, when it refers to gross proceeds, simply sets the minimum value of production and we find that the focus of the regulation in setting the value of production is price. However, Survey may consider "other relevant matters." On this, the relevant portions of the regulation bear repeating:

The value of production, for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices and to other relevant matters. * * * In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

Thus the value of production as defined by the regulation is not necessarily gross proceeds; i.e., the amount the producer receives from the purchaser for the gas. If that were true, then appellant arguably would be correct that its royalty should be based solely on the NGPA ceiling because that is the amount it receives under its purchase contracts. Under the regulation, however, all of the circumstances of the pricing of the gas may be considered. One such relevant consideration is that, as we have noted, under the NGPA a producer may set a price for gas exceeding the lawful ceiling to the extent of the amount of taxes it must pay. In Oklahoma, appellant's

purchaser pays the taxes and technically deducts them from its payment to appellant. As we have already concluded, since appellant receives the ceiling amount, the actual price to the purchaser is the ceiling amount plus the amount of taxes paid. Thus the value of production is more than the gross proceeds in this case.

Appellant's argument that the value to the United States of the gas produced changes according to whether the producer sells it and pays royalty, or the United States takes it in kind and sells it, is a misleading over simplification of the situation. Appellant presumes that the value to the United States of in kind gas is only what it could then be sold for. If, however, the Government were to take its royalty interest in kind, the implicit assumption would be that it had a use for the gas. The value of this gas is, therefore, properly computed as the price which the United States would pay on the open market if it were purchasing the gas as an ordinary purchaser. The fact that the United States cannot be assessed state severance tax does not depreciate the value of the gas to it. Immunity from state taxation is a function of the Federal Government's sovereignty, which prevents the state from assessing a severance tax. This benefit flows to the Government, not the lessor.

The essential fallacy of appellant's argument is made clear if we reverse the instant situation and assume that the seller pays the severance tax. Under section 110(a)(1) of the NGPA, supra, the seller

would be permitted to obtain reimbursement of the severance tax above the established ceiling price. This reimbursement is clearly part of the gross proceeds obtained. The fact that a state may make the purchaser liable for payment of the severance tax does not alter the economic results. In both cases it is the seller who makes the severance and who receives the ceiling price as a net proceed (excluding, of course, other costs of production, which would remain the same no matter how the tax was assessed).

Finally, appellant's argument that the basis of the royalty decreases as the amount of leased Federal or Indian land within a unit increases is merely a mathematical reflection of the fact that as the extent of the Federal royalty interest within a unit rises, an increasing proportion of unit production is not subject to state taxation. We would point out that appellant's argument would support a finding that the proper mode of determination would not consider any of the lands within a unit as Federally owned.

Using appellant's hypothesis that the NGPA price is \$2 per Mcf (such gas having a Btu content of 1,000 Btu/cf), and that the State of Oklahoma imposes a state severance tax equal to 10 percent of the value of all gas produced, one could argue that the value for royalty purposes should be \$2.20 per Mcf regardless of the percentage of Federal or Indian lands within the unit. Admittedly, this would not represent "gross proceeds" inasmuch as there would be no severance tax

assessed on the Federal or Indian royalty interests, and thus no reimbursement. But such a figure might, nevertheless, arguably represent the real value of an Mcf of gas. "Gross proceeds" is a floor, not a ceiling, concept. Thus, the regulation provides that "[u]nder no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof" (emphasis supplied). 30 CFR 221.47. To the extent that the Government has elected to utilize actual gross proceeds in order to determine value, rather than merely applying the percentage severance tax imposed by the State to all production had within a unit, the lessees are the beneficiaries.

We agree that the degree of benefit, under the system of value ascertainment adopted by the Geological Survey, will, in fact, vary according to the percentage of Federal and Indian lands within a unit. But inasmuch as the regulation clearly requires that "gross proceeds" serve as the minimum basis for the royalty assessment, the only alternative method would be to ignore "gross proceeds" and proceed on the assumption that all production was subject to severance taxation to determine the value of the gas produced. This would, necessarily, work to the detriment of every Federal oil and gas lessee.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed.

James L. Burski

Administrative Judge

We concur:

Bernard V. Parrette
Chief Administrative Judge

Douglas E. Henriques
Administrative Judge

