Editor's note: Appealed -- stipulated dismissal, sub nom. Norfolk Energy, Inc. v. Lujan, Civ.No. 89-18-GF-PGH (D. Mont. Oct. 31, 1989)

TRICENTROL UNITED STATES, INC.

IBLA 86-1512, 86-1645, 87-121 Decided November 30, 1988

Consolidated appeals from decisions of the Director, Minerals Management Service, requiring payment of additional royalty and assessing late payment charges. MMS 85-180-O&G, MMS 86-230-O&G, and MMS 86-139-O&G.

Affirmed.

1. Oil and Gas Leases: Royalties

Where natural gas produced from Federal and Indian leases is sold under an arrangement where the buyers paid the maximum price allowed under the Natural Gas Policy Act of 1978 and, in addition, reimbursed the producer/seller for the severance taxes it paid to the State of Montana, the gross proceeds received by the producer/seller from the leases consisted of the maxi- mum Natural Gas Policy Act price plus the tax reimbursements. Accordingly, in computing the "value" of the gas produced from these leases, MMS properly determined that the "gross proceeds" to which the royalty rate applied included the purchase price and the tax reimbursements and properly demanded additional royalty and late payment charges where royalty payments had been made using a value that excluded the severance tax reimbursements.

APPEARANCES: James P. Sites, Esq., Billings, Montana, and Albert G. Lauber, Esq., Washington, D.C., for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., and Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE HUGHES

By decision dated April 1, 1986, the Director, Minerals Management Service (MMS), affirmed an order of the MMS Royalty Management Program (RMP) directing Tricentrol United States, Inc. (Tricentrol), to pay additional royalty in the amount of $4,713.22 for failure to include tax reimbursements for Montana State severance taxes in the royalty value of natural gas allocated to Federal lease No. 53-021373 under a communitization agreement. This lease is evidently part of a production unit involving leases of both Federally and privately owned mineral interests in Blaine County, Montana.

The Director's decision (MMS 85-180-O&G) was appealed to this Board and docketed as IBLA 86-1512.

On May 30, 1986, the Director issued a second decision affirming an order directing Tricentrol to pay additional royalty of $102,302.40 for failure to include tax reimbursements in the royalty value of natural gas produced from 42 Federal and Indian leases "outside the Bullhook Gas Unit in north-central Montana." That decision (MMS 86-139-O&G) was appealed to this Board and docketed as IBLA 87-121.

On July 18, 1986, the Director affirmed an order directing Tricentrol to pay $51,085.95 in late payment charges on the royalty determined to be due for failure to include tax reimbursements in MMS 86-139-O&G. That decision (MMS 86-230-O&G) was appealed to this Board and docketed as IBLA 86-1645.

By order dated February 25, 1987, owing to the close relationship of the issues presented by these three appeals, we consolidated them for consideration. 1/

Under Federal law, holders of Federal oil and gas leases are required to pay to the United States a royalty on oil or gas that is produced from their leases. Specifically, 30 U.S.C. | 226(b) and (c) (1982), provide
for a royalty of "12-1/2 per centum in amount or value of the production removed or sold from the lease." Indian leases have a royalty of 12-1/2 percent or more. See 25 CFR 211.13, 212.16. These royalties are collected by the Department, through its agency MMS. 2/

When royalty is not taken "in kind," it is calculated as the specified percentage (usually 12-1/2 percent) of the "value of production" from the lease. The Mineral Lands Leasing Act of 1920, as amended, 30 U.S.C. | 181 (1982), reserves to the Department the authority and responsibility to establish reasonable value for royalty purposes. Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1381 (D. Alaska 1985), aff'd, 794 F.2d 1461 (9th Cir. 1986). Accord, California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961); Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); United States v. Ohio Oil Co., 163 F.2d 633, 639-40 (10th Cir. 1947), cert. denied,

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1/ On Nov. 3, 1988, Tricentrol filed a motion seeking "immediate entry of judgment against it in these three consolidated cases." Tricentrol explained that it was submitting the motion in order to permit these cases to be joined with an action currently pending in the U.S. District Court for the District of Montana. On Nov. 9, 1988, counsel for MMS filed a motion concurring in Tricentrol's request, noting that the same issue presented in these three appeals is currently before the District Court in the case of Tricentrol United States, Inc. v. United States, CV 86-212-GF-PGH (D. Mont. filed Nov. 3, 1986). In view of the fact that we are able to issue a decision on the merits it is unnecessary to consider these motions.

2/ Decisions concerning royalty on Indian leases have also been issued in the past by the Deputy Assistant Secretary, Indian Affairs.

333 U.S. 833 (1948). Departmental rules for determining value for royalty purposes are set forth at 30 CFR 206.103 (formerly 30 CFR 221.47), which states:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director [of MMS,] due consideration being given to the highest price paid for a part or for a major-ity 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 purpose 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. [Emphasis added.]

Thus, under this regulation, it is proper to compute royalty as a percentage of "gross proceeds."

The State of Montana (Montana) imposes a severance tax of "2.65 [percent] of the total gross value of natural gas produced from each lease or unit." Mont. Code Ann. | 15-36-101(1)(b) (1983). This tax is paid by the producer/seller of the gas.

In these cases, Tricentrol sold natural gas produced from the leases under an arrangement where the buyers paid the maximum price allowed under the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. || 3301-3432 (1982), and, in addition, reimbursed appellant for the severance taxes it paid to Montana. Thus, the total compensation appellant received for the production from the leases consisted of the maximum NGPA price plus the tax reimbursements. Accordingly, in computing the "value" of the gas produced from these leases, MMS determined that the "gross proceeds" to which the royalty rate applied included the purchase price and the tax reimbursements.

[1] It has been well established for many years that severance tax reimbursements made by the buyer of gas produced from Federal and Indian wells to the Federal lessee/producer/seller are properly included as part of the gross value of the production in computation of the royalty due to the Government. Amoco Production Co., 29 IBLA 234, 235 (1977); Wheless Drilling Co., 13 IBLA 21, 80 I.D. 599 (1973); see Hoover & Bracken Energies, Inc., 52 IBLA 27, 88 I.D. 7 (1981), aff'd, Hoover & Bracken Energies, Inc. v. Dep't of Interior, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S.

821 (1984). 3/ The reasons for this rule are set out in Wheless, which presented circumstances virtually identical to those present here:

> It seems obvious to us that the buyer is paying to the seller an amount greater than the established field price for the natural gas it purchases from the * * * well. It follows, therefore, that it is reasonable to compute the Federal royalty of the natural gas taken from this well on a unit value consisting of the field price established by [the Federal Power Commission] plus the amount of the severance tax reimbursed by the buyer. Within the context of 30 CFR 221.47, "gross proceeds" means the established field price for the natural gas plus any additional sums paid by the producer 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.

Wheless, 13 IBLA at 30, 80 I.D. at 603. We also specifically held in Wheless that "gross proceeds" consisted of "the gas purchase price plus the reimbursed severance tax." 13 IBLA at 32, 80 I.D. at 604.

Since Wheless, the rule that gross proceeds shall include tax reimbursements has been widely disseminated. It was set out expressly more than 11 years ago in Notice to Lessees and Operators of Federal Onshore Oil and Gas Leases -- 1 (NTL-1), 42 FR 4546, 4548 (Jan. 25, 1977):

> Under no circumstances will the royalty be computed on less than the gross proceeds accruing to the operator from the sale of * * * leasehold production. Gross proceeds include * * * tax reimbursements and payments to the operator for gathering, measuring, compressing, dehydrating, or performing other services necessary to market the production. [Emphasis added.]

The same rule was also announced in NTL-5, published at 42 FR 22610 (May 4, 1977). While this appeal was pending, Congress enacted the Notice to Lessees Numbered 5 Gas Royalty Act of 1987 (P.L. 100-234), 101 Stat. 1719 (1988). Although Congress modified one part of NTL-5, it left intact, and thus effectively ratified, the requirement in NTL-5 that tax reimbursements be included in calculating gross proceeds. 4/

3/ In Hoover & Bracken Energies, Inc., supra, we considered a slightly different situation than that presented in this case. Under Oklahoma law, state severance tax must be paid by the buyer, rather than by the producer/lessee/seller, as is the case in Montana. In Hoover, the buyer agreed both to pay the NGPA ceiling price and to pay the state severance tax. We ruled that, even though the obligation to pay under Oklahoma law rested with the buyer, its willingness to pay the severance tax in addition to the maximum NGPA price established a "value" for the gas equal to the actual price to the buyer, that is, the NGPA price plus the severance tax. Id. 52 IBLA at 36, 88 I.D. at 12.

4/ This legislation enacted a change in one requirement of NTL-5 with respect to production from 1982 to 1986 from certain wells. Under NTL-5, the base value for royalty purposes was either the actual price received

Tricentrol, as Federal lessee/producer/seller could presumably have struck a bargain to sell the gas for the NGPA price alone, under which arrangement its payment of the state severance tax would effectively have reduced its proceeds from the sale. However, it was able to find a buyer which valued the gas highly enough to be willing to pay both the NGPA price and to reimburse it for its severance tax payments. As we noted in Hoover & Bracken Energies, Inc., 52 IBLA at 31, 88 I.D. at 11, sec. 110(a) of NGPA, 15 U.S.C. | 3320(a) (1982), expressly provides that a price for the first sale of natural gas will not be considered to exceed the maximum lawful price if the first sale price exceeds the maximum lawful price to the extent necessary to recover state severance taxes attributable to the production of such natural gas and borne by the seller. Thus, it was permissible for Tricentrol to increase its receipts by allowing its buyer to reimburse it for the state severance tax owed on the production. However, doing so increased the amount of the proceeds it received and, as a result, increased the amount of the royalty due to the United States.

Appellant raises several arguments that MMS' decisions are incorrect, but notes that these contentions "fly in the face" of Departmental precedents cited herein, including Wheless. In 1983, the Tenth Circuit characterized Wheless as "persuasive authority," referring to the "soundness of its reasoning," noting that it had been utilized by lessees and lessors for the past 10 years, and finding no basis for abandoning it. Hoover & Bracken Energies, Inc. v. Dep't of Interior, 723 F.2d at 1493. We see no reason to renounce it now. 5/

The only reason appellant gives for appealing MMS' order to pay late payment charges, IBLA 86-1645 (MMS-86-0230-O&G), is that appellant was not required to pay the royalty in the first place, citing the reasons given in the appeals discussed above. Inasmuch as we have held that appellant was properly required to pay the additional royalty, appellant has failed to show any error in the MMS decision requiring appellant to pay late payment charges.

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fn. 4 (continued)
or the ceiling price, whichever was higher. After 1982, actual gas prices in many areas declined below the ceiling price, but lessees were still required to base the royalty on the ceiling price. The new statute provided that the value of production for certain leases between 1982 and 1986 would be based on the actual price received. This provision does not apply here.

As to the balance of NTL-5 (including its rule that gross proceeds include tax reimbursements, section 1(b)(1) of the Act notes Congress' finding that NTL-5 "established the method of calculating the amount of royalties to be paid to the United States on natural gas production from Federal and Indian oil and gas leases."

5/ To the extent they are not specifically addressed herein, appellant's arguments on appeal have been considered and rejected.

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

David L. Hughes
Administrative Judge

I concur:

Kathryn A. Lynn
Administrative Judge
Alternate Member