PHILLIPS PETROLEUM CO.

IBLA 87-350 Decided May 23, 1989

Appeal from a decision by the Director, Minerals Management Service, affirming assessment of additional royalties on wet gas production from various oil and gas leases and late payment charges thereon. MMS-85-0107-O&G, MMS-85-0249-O&G, MMS-85-0137-O&G, MMS-86-0165-O&G.

Appeal dismissed in part; decision affirmed in part; set aside and remanded in part; and vacated and remanded in part.

1. Oil and Gas Leases: Royalties: Natural Gas Liquid Products

Where it is MMS policy to accept the Department of Energy ceiling prices for natural gas liquid products as representing fair market value for royalty purposes in certain instances, and MMS has followed that policy in a number of cases, its refusal in another case to accept those ceiling prices, in favor of a weighted average price that the royalty payor paid for other liquids which it purchased, is arbitrary and capricious.

2. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Oil and Gas Leases: Royalties: Processing Allowance

Where the actual costs of processing wet gas are less than two-thirds the value of the natural gas liquids produced, calculation of a processing allowance based on actual costs, rather than that two-thirds value, pursuant to 30 CFR 221.51 (1976), will be affirmed.

3. Oil and Gas Leases: Royalties: Processing Allowance

Where MMS is valuing production from onshore oil and gas leases at the tailgate of the processing plant for the period from 1976-1982, the costs of gathering and compressing wet gas for movement to the plant are not expenses incidental to marketing within the meaning of

30 CFR 221.51(b) (1976), nor are they expenses that may be included as part of the manufacturing or processing allowance; however, the costs associated with moving the gas from the field to the processing plant may be separately deductible as a transportation allowance.

4. Oil and Gas Leases: Royalties: Generally

Where, in its royalty valuation, MMS applies a rate of return based on the prime interest rate on Jan. 1, 1975, but the time for valuation is January 1976-December 1982, that determination will be set aside.

5. Administrative Procedure: Standing--Appeals: Generally--Oil and Gas Leases: Royalties: Generally--Rules of Practice: Appeals: Dismissal

Where the Director, MMS, issues a decision in which he reserves the right to conduct further audits of certain Federal oil and gas leases and processing plants, the royalty payor is not adversely affected and, therefore, lacks standing to appeal that declaration.

6. Oil and Gas Leases: Royalties: Interest--Payments: Generally

MMS is authorized to impose an interest charge where it determines that a royalty payor has failed to pay timely the proper amount of royalty due on the value of production of wet gas.

7. Oil and Gas Leases: Royalties: Interest--Payments: Generally

Where a royalty payor submits funds to MMS in response to a demand for alleged underpayments of royalties, and MMS subsequently refunds a portion of those funds, the payor is not entitled to interest on the refunded amount.

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OPINION BY ADMINISTRATIVE JUDGE HARRIS

Phillips Petroleum Company (Phillips) has appealed from a December 23, 1986, decision by the Director, Minerals Management Service (MMS), affirming the assessment of additional royalties for underpayments on the production of wet gas from various Federal oil and gas leases and late payment charges based thereon.

During the time period at issue in this appeal (January 1976 through December 1982), Phillips held working interests in and was the designated royalty payor for the leases in question which are located in New Mexico and in the area surrounding Douglas, Wyoming. Phillips produced wet gas from the leases and also purchased wet gas at the wellhead, all of which was processed either at its Douglas plant in Wyoming or its Lee or Lusk plants in New Mexico. 1/ Phillips sold the residue gas from these plants and used all of the natural gas liquid products (NGLP's). Phillips was also a purchaser of NGLP's from other processors in those areas.

The Office of Inspector General (OIG) conducted an audit of Phillips for the period in question in order to determine whether Federal lease production had been properly accounted for and royalties properly computed and paid. Based on the OIG audit, the Royalty Management Program (RMP), MMS, assessed additional royalties and late payment charges relating to Phillips' Lee and Lusk plants in New Mexico and its Douglas plant in Wyoming. 2/ The additional royalties were based on several differences between the way that Phillips calculated royalties at the time of payment and the methods adopted by RMP following the OIG audit.

At the Douglas plant, Phillips had calculated the value of production using wet gas contracts with local producers from whom it purchased wet gas. The RMP utilized the Department of Energy (DOE) price regulations for NGLP's, when applicable, less manufacturing allowances based on actual processing costs. For the period following price controls, RMP valued liquids based on prices paid by Phillips for liquids from other area producers, less actual processing costs. Royalties on the residue gas were calculated based on 100 percent of the value of the gas.

At the Lee and Lusk plants, Phillips calculated royalties based on 100 percent of the value of the residue gas and one-third of the value of the liquids. OIG concluded that Phillips was properly valuing the residue gas, but that the royalties on the liquids were underpaid for two reasons. First, although Phillips had valued the liquids at the maximum allowable

1/ Phillips 66 Natural Gas Company has since taken over responsibility for all of these functions, except production of the wet gas.

2/ By demand letter dated May 15, 1985, RMP assessed $67,913.63 for alleged underpayments on wet gas produced from 44 leases and processed in the Douglas plant. It also, by demand letter dated Sept. 11, 1985, assessed late payment charges of $39,386.66 relating to the underpayments. Phillips appealed both letters and MMS assigned them docket numbers MMS-85-0107-O&G and MMS-85-0249-O&G, respectively.

In a May 24, 1985, demand letter, RMP assessed additional royalties of $443,105.47 for alleged underpayments for wet gas processed at the Lee and Lusk plants. Phillips appealed this assessment and docket number MMS-85-0137-O&G was assigned. RMP subsequently reduced the amount of this demand to $287,270.35. RMP assessed interest on the Lee and Lusk plant underpayments by demand letter dated Mar. 3, 1986, and MMS docketed Phillips' appeal thereof as MMS-86-0165-O&G. The Director, MMS, consolidated these four appeals for decision.

price established by DOE regulation, OIG concluded that the proper valuation was the weighted average prices paid by Phillips for liquids in the area. Second, the two-thirds processing allowance taken by Phillips was not based on actual costs. RMP applied a processing allowance based on actual costs.

Phillips appealed the assessments to the Director, MMS, who affirmed them by decision dated December 23, 1986.

[1] The first issue raised by appellant pertains to the Lee and Lusk plants and concerns the proper method of valuing NGLP's. Appellant argues that the value of NGLP's for royalty purposes is limited to the Federally mandated ceiling price, if one applies. Phillips objects to the MMS valuation to the extent that it is based on the weighted average price Phillips paid for liquids it purchased, rather than the ceiling price which would have applied to the production had it been sold rather than used.

When valuation of production is challenged, the appellant must not merely show that the methodology is susceptible to error. Rather, it must show that error did in fact occur. Sun Exploration & Production Co., 104 IBLA 178 (1988); Amoco Production Co., 78 IBLA 93 (1983); Supron Energy Corp., 55 IBLA 318 (1981).

The applicable regulation 3/ provided:

> 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 * * *. 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

3/ It should also be noted that Notice to Lessees and Operators (NTL)-5 was applicable to Phillips beginning June 1, 1977, and the Notice to Lessees Numbered 5 Gas Royalty Act (NTL-5 Act), P.L. 11-234, 101 Stat. 1719 (1988), was applicable retroactively to Jan. 1, 1982. See Kerr-McGee Corp., 106 IBLA 72 (1988); Wexpro Co., 106 IBLA 57 (1988). However, application of NTL-5 and the NTL-5 Act do not appear to affect the outcome of this matter. However, to the extent that MMS may determine that they do, they should be applied on remand.

leased lands are situated will be considered to be a reasonable value.

30 CFR 221.47 (1976). 4/

This provision gives MMS wide latitude in establishing the value of production. Nevertheless, Phillips' argument is appealing because it is clear that MMS has accepted the DOE ceiling prices as representing fair market value for NGLP's in other cases, 5/ as well as accepting those prices for the Douglas plant in this case. In a Procedure Paper on Natural Gas Liquid Production Valuation (Procedure Paper), dated December 14, 1984, revised February 25, 1985, MMS explained that the purpose of the paper was "to develop a 'yardstick' valuation technique for determining the reasonableness of a lessee's NGLP prices" (Procedure Paper at 3). 6/ That paper identified the relevant time periods for its coverage as "1973 to January 1980 (February 1981 for propane) or the 'Control Period,'" when DOE price controls were effective, and "January 1980 (February 1981 for propane) to the present and prospectively, or the 'Decontrol Period,'" after NGLP price restrictions were lifted (Procedure Paper at 4). MMS explained its policy as follows:

> MMS regulations require royalties to be calculated using a fair market value for NGLP's. A lessee may be using a maximum permissible price that is less than the fair market yardstick value established by MMS. Since the maximum permissible price was the highest price a lessee could have received under the DOE regulations, MMS will consider this price to be the fair market value for royalty purposes. The maximum permissible price is the price computed using all available costs that could be allocated to an individual product. [Emphasis added.]

(Procedure Paper at 8).

4/ Effective Dec. 13, 1979 (44 FR 61892 (Oct. 26, 1979)), the wording of this provision was changed slightly, but it remained substantively unchanged during the time period involved in the challenged audit. However, major changes in the applicable regulations were adopted effective Mar. 1, 1988. 53 FR 1230 (Jan. 15, 1988). Currently, under 30 CFR 206.153(d)(1), "if the maximum price permitted by Federal law at which residue gas or gas plant products may be sold is less than the value determined pursuant to this section, then MMS shall accept such maximum price as the value," unless, in accordance with 30 CFR 206.153(h), the gross proceeds accruing to the lessee, less applicable allowances, is greater than such maximum ceiling price.

5/ See MMS Director's decisions in Shell Offshore Inc., MMS-86-0119-OCS, et al. (Jan. 30, 1987); Union Oil Co. of California, MMS-86-0319-OCS, (June 12, 1987), and others cited in Gower Federal Service, Royalty Valuation and Management, Index Digest of Decisions Reported at 10-134.

6/ The Procedure Paper was not part of the record forwarded to the Board by MMS nor was it submitted by either party in their pleadings on appeal; however, the Board takes official notice of it in accordance with 43 CFR 4.24(b).

Although the Procedure Paper was not issued until after completion of the OIG audit in this case, it was in effect at the time the Director issued his decision herein. In addition, the paper indicated it was to apply from 1973 forward. The audit period in this case was from January 1976 through December 1982. Thus, it appears that application of MMS' policy, as set forth in the Procedure Paper, to the valuation of production of NGLP's at Phillips' Lee and Lusk plants for the audit period would benefit Phillips, and we find no impediment to application of that policy in this case.

Moreover, Phillips argues that since MMS accepted the DOE ceiling prices for NGLP's at the Douglas plant, its rejection of applicable DOE ceiling prices for valuation at the Lee and Lusk plants was arbitrary and capricious. That point is well taken, and MMS' response underscores that fact. MMS explained that DOE prices were accepted at the Douglas plant "because a second computation using outside purchase prices would not significantly affect the royalties due" (Answer at 6). Either DOE prices represented fair market value, or they did not. MMS concluded in its Procedure Paper that they did, and it accepted them for production from the Douglas plant. Its failure to do so for the Lee and Lusk plants was arbitrary and capricious and establishes error in MMS' valuation. The Director's decision is vacated to the extent it approved a valuation of NGLP's from the Lee and Lusk plants based on a weighted average price, rather than the DOE ceiling prices, during the price control period.

[2] Phillips argues that MMS has unlawfully abandoned its regulations and past practice by applying a manufacturing or processing allowance based on actual costs instead of allowing two-thirds the value of the NGLP's as a manufacturing allowance. Phillips attempts to establish that Departmental regulations have never authorized royalties to be based on more than one-third the value of the NGLP's, plus 100 percent of the value of the residue gas. It argues that the Department has historically allowed a manufacturing allowance of two-thirds the value of the NGLP's, regardless of the actual cost of manufacture. Phillips is simply wrong in its contention.

In Wexpro Co., supra, and Kerr McGee Corp., supra, we outlined the history of the relevant wet gas regulations from the time of enactment of the Mineral Leasing Act of 1920 to the present. As we stated in Wexpro Co., supra at 63:

> The Secretary republished the 1936 oil and gas regulations, effective June 1, 1942, with only minor changes, and they were codified in the Code of Federal Regulations at Title 30. 7 FR 4132 (June 2, 1942). Those regulations remained in effect, virtually unchanged, except for CFR section numbers, until 1988 (see discussion infra). Thus, from early on the Departmental regulations in 30 CFR provided for collection of royalty on wet gas based on the greater of the lessee's proceeds from the sale of wet gas, if it was sold that way, or the combined value of the dry residue gas after processing and one-third of the liquids extracted (or more

than one-third, if the lessee's share was greater than one-third). [7/] [Emphasis supplied.]

Therefore, the applicable regulation, 30 CFR 221.51 (1976) (later 30 CFR 206.106), at all times during the time period of the audit at issue required a processing allowance of less than two-thirds the value of the liquids when the costs of manufacture were less than that amount. 8/ Both MMS and this Board are required to comply with duly promulgated regulations. See Conoco, Inc., 103 IBLA 108, 109 (1988); Western Slope Carbon, Inc., 98 IBLA 198 (1987).

Phillips also cites various letters of instruction from MMS, arguing that these letters establish a history and practice of basing royalty on one-third the value of the NGLP's plus 100 percent of the value of the residue gas (Statement of Reasons (SOR), Appendices A and C). Despite this claim by Phillips, many of those letters include the parenthetical phrase: "or the lessee's portion if greater than one-third," which is consistent with the applicable regulation. Clearly, Phillips cannot rely on those letters to justify a departure from its obligations under the applicable regulations. Phillips' interpretation of the regulations is not binding on the Department. The Government retains the authority under the regulations to reduce the allowance where the lessee's share of the liquids was greater than one-third. Even if it could be concluded that Phillips had been given erroneous advice, it is also well established that the Secretary is not bound by erroneous advice provided by his subordinates. Peabody Coal Co., 93 IBLA 317, 323, 93 I.D. 394, 398 (1986).

We therefore reject appellant's argument that the Department is without authority to apply a processing allowance of less than two-thirds the value of the NGLP's produced.

[3] We now turn to appellant's argument that if the processing or manufacturing allowance is to be based upon actual costs, the Department erred in calculating the amount of the allowance. Phillips contends that the allowance must include among allowable costs those expenses related to

7/ The next sentence reads: "Despite the consistency in the regulatory language, the Department, through the Conservation Division, [Geological Survey] GS, and later MMS, indulged in various valuation methods." Wexpro Co., supra at 63. However, it is not clear that automatic application of a manufacturing allowance equal to two-thirds of the value of the liquids, despite the fact that the lessee's actual costs were less than that, was ever one of the "various valuation methods" utilized, and even if it were, it would not negate MMS' reliance on the regulation.

8/ The processing allowance provisions are now located at 30 CFR 206.158 and 30 CFR 206.159. The current regulations, although substantially changed from those in effect during the audit period, set two-thirds of the value of the liquids as the ceiling above which the processing allowance may not rise. If actual processing costs are less than two-thirds the value of the NGLP's, the processing allowance is also less than that amount. See 53 FR 1281-84 (Jan. 15, 1988).

gathering and compressing wet gas. Phillips asserts that all such costs from the "wellhead to the plant" must be deducted as part of the processing allowance (SOR at 44). 9/

MMS responds that these types of expenses are covered by 30 CFR 206.106(b) (1986), and that the pertinent language of that regulation "prohibits MMS from granting a gathering and processing allowance" (Answer at 11). The language relied on by MMS is: "[N]o allowance shall be made for boosting residue gas, or other expenses incidental to marketing." 10/ In reply Phillips argues that the regulation is completely inapplicable to its situation. It claims that it is not "boosting residue gas," since residue gas only exists at the tailgate of the processing plant. Moreover, it asserts that its gathering and compression costs are costs of manufacturing and not expenses incidental to marketing.

Clearly, that part of the regulation relating to boosting residue gas has no application in this case. The question, therefore, is whether the gathering and compression costs in this case were properly excluded as expenses incidental to marketing.

Phillips contends that the case cited by MMS in support of its position, California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961), is inapplicable. Phillips urges that United States v. General Petroleum Corp., 73 F. Supp. 225 (S.D. Cal. 1946), aff'd, Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950), provides the proper guidance.

We will first examine the case cited by MMS, California Co. v. Udall, to determine if it bolsters MMS' position that the gathering and compression costs in this case are incidental to marketing. The California Co. case is factually distinguishable from the present case. In California Co., the lessee sold its gas at the lease under a contract which specified maximum water content and liquifiables content, as well as designating a particular pipeline pressure. The lessee expended various sums conditioning the gas to remove excess water and liquifiables and compressing the gas to bring it to the required pressure. The lessee sought an allowance for those expenses. The court disallowed those expenses on the basis that there was no market for the gas, except in the condition specified in the contract. The court

9/ In arguing that the expenses of gathering should be included in the manufacturing allowance, Phillips apparently includes all pipelines from the wellhead to the processing plant in the category of gathering lines. Williams and Meyers, Manual of Oil & Gas Terms, 6th ed. (1984) makes a distinction between gathering lines and a transmission line. The former are "[p]ipes used to transport oil or gas from the lease to the main pipeline in the area." Id. at 366. The latter is "[a] pipeline extending from a producing area to a refinery or terminal." Id. at 921.

10/ That language, formerly included in 30 CFR 221.51(b) (1976), remained unchanged during the time period covered by the OIG audit. The new regulations include definitions of "processing allowance" and "transportation allowance" at 30 CFR 206.151. See 53 FR 1272 (Jan. 15, 1988).

specifically noted that the case did not involve transportation or processing costs.

In the present case, Phillips incurred costs gathering and compressing the wet gas in order to deliver it to its Douglas, Lee, or Lusk plants for processing. Those costs, unlike the expenses in California Co., were not incurred in order to make the gas pipeline quality; rather, they were expended to move the wet gas from the wellhead to the processing plant. In the General Petroleum Corp. case cited by Phillips, the court noted that the Department had approved an allowance for the costs associated with the gathering and delivery of wet gas from various leases to certain processing plants located at the field. 73 F. Supp. at 257.

MMS states in its answer that it "basically agrees with this concept," i.e., requiring the Government royalty to bear its proportionate share of such costs, but, it asserts, that is why it "gives a separate transportation allowance in appropriate circumstances" (Answer at 11). To that assertion, Phillips responds:

> While it is true that offshore such transportation allowances are granted, during the audit period, for onshore gathering, there was no requirement and indeed, no application vehicle for applying for transportation allowances for onshore gathering and compression. Indeed, under the General Petroleum Corporation case, there was no need for such a requirement as the agency had recognized that royalty is not due on the value added by the lessee, and that, therefore, the costs of adding such value must be deducted.

(Phillips Reply at 10).

We agree with Phillips that its expenses for gathering and compression in this case are not expenses incidental to marketing within the meaning of the regulation. It does not follow, however, that gathering and compression costs are includable as part of the manufacturing or processing allowance. The court in the General Petroleum Corp. case did not hold that gathering costs were to be included as part of the actual costs of extraction for purposes of determining what Departmental Instructions dated June 7, 1937, 56 I.D. 462, 465 (1937), termed the net field realization. See Wexpro Co., 106 IBLA at 62-63. Rather, the court merely noted that the Department had "allowed the actual cost of operating this gathering system." 73 F. Supp. at 257. The Department's position, however, apparently has not been consistent. In The Texas Co., 64 I.D. 76, 80 (1957), the Department considered whether gathering costs for wet gas were deductible from the lessee's royalty payment and found:

> Here a market for oil well gas exists in the Duck Lake Field and the cost of gathering the gas from the wells and transporting it to the point of sale in the field is deemed to be one of the ordinary incidents of lease operations.

> Nor is the situation with which we are here confronted comparable to those situations in which the courts have allowed lessees to deduct the cost of manufacturing the gas into gasoline or other products.

Thus, in The Texas Co. case, gathering and transportation costs in the field were determined not to be deductible expenses and were not considered as costs attributable to the manufacturing allowance. We believe The Texas Co. case represents the better approach, and, therefore, we find in this case that the costs of gathering and compression are not includable as part of the manufacturing or processing allowance. Cf. Mobil Oil Corp., 108 IBLA 216, 220-21 (1989) (transportation and storage costs incurred after processing is complete may not be included in developing a manufacturing allowance for an offshore oil and gas lease).

A deduction may be available, nevertheless, for some of those expenses as a transportation allowance, despite Phillips' claim that there was no way to seek a transportation allowance for onshore leases during the audit period. Although a transportation deduction for costs incurred in moving production to a selling point in the field was disallowed in The Texas Co. case, the Department has allowed reasonable expenses for transportation of production from the field to the point of first sale. See Petro-Lewis Corp., 108 IBLA 20, 35, 96 I.D. 127, 135 (1989); Kerr-McGee Corp., 22 IBLA 124, 128 (1975). In this case, to the extent Phillips has incurred costs in moving wet gas from the field to any of its processing plants in order to extract the NGLP's and, thereafter, market the production, MMS should determine the amount of those expenses which are deductible as a transportation allowance.

Under 30 CFR 206.105(c) (1986), MMS has the authority to seek royalty on the basis of the gross proceeds accruing to the lessee from the sale of the wet gas or the aggregate value of all commodities, including residue gas, obtained therefrom, whichever is greater. Where, as in this case, MMS has determined that valuation should take place at the tailgate of the processing plant, the royalty payor should be entitled to a reasonable deduction for those costs associated with moving the wet gas from the field to the processing plant. If those costs and the processing allowance reduce the aggregate value of the commodities obtained from the wet gas below the gross proceeds of the wet gas accruing to the lessee, MMS' remedy is to seek the royalty on the basis of those gross proceeds.

Therefore, we set side the Director's decision to the extent he concluded that the costs of gathering and compression were nondeductible expenses incidental to the marketing of the gas and remand for a determination of the amount of those expenses which may be deducted as reasonable transportation costs.

[4] Phillips next argues that the 10-percent rate of return on investment utilized by the OIG auditor and adopted by the Director, MMS, in his decision, is confiscatory and unreasonably low. As Phillips correctly points out, the Director provides no rationale for acceptance of the rate

of return other than to state that it "appears reasonable under the circumstances" (Director's Decision at 8). Phillips maintains that the best evidence of a fair rate of return at its Douglas plant is an arm's-length processing agreement between it and Panhandle Eastern Pipe Line Company (Exh. E to Phillips' SOR). It argues further that the rate of return on investment selected by MMS ignores the risks inherent in its business. It offers the rates of return on Government bonds and the rates of return used by the Federal Energy Regulatory Commission in its calculations for producers, pipelines, and public utilities as examples of rates which more accurately reflect a proper rate of return. A comparison of the MMS rate to these other rates, Phillips asserts, establishes that the MMS rate is too low.

In its answer, MMS contends that OIG arrived at the rate of return using guidance found in the U.S. Geological Survey Conservation Division Manual (CDM) at 647.7.3E(4). 11/ It claims that "Phillips had not calculated a rate of return, therefore, OIG calculated the rate as of January 1, 1975. At that time the prime interest rate was 10 percent" (Answer at 12). Phillips has not justified another rate, MMS contends.

In reply, Phillips admits that it did not calculate a rate of return for purposes of royalty calculation because its methodology did not require one, but that it did have a rate of return for business purposes and that rate is reflected in its processing agreement for the Douglas plant.

In Shell Oil Co., 52 IBLA 15 (1981), this Board addressed the argument that the fair rate of return on investment is that rate found in arm's-length agreements with certain third parties. We found that such a rate "may well result from a fair arm's-length transaction in the market place [sic] but not necessarily represent a fair rate of return with respect to the valuation of Shell's own oil for royalty purposes." Shell Oil Co., supra at 22. This finding was largely based on the fact that although the agreements were at arm's length, Shell held what was virtually a monopolistic position in the local market for transportation of offshore oil. The third parties involved were forced to either accept Shell's price offered in the field or seek alternative methods of transporting their oil to the onshore market, such as constructing their own pipeline or barging their production.

Based on the rationale in the Shell Oil Co. case, we find that MMS is not bound to accept the rate included in an arm's-length contract, but it

11/ MMS quotes that provision as follows on page 12 of its answer:

"Imputed interest in dollars per annum on the balance of undepreciated investment. Unless otherwise justified to the satisfaction of the Supervisor, the prime interest rate in effect at the time of initial allowance approval should be used as the rate of allowable return on the balance of undepreciated investment. Once established, the rate will be continuous (fixed) over the life of the plant items, including any subsequent plant investments."

should investigate the circumstances of the contract in order to determine its utility in establishing the proper rate of return.

The arm's-length contract aside, the record fails to support MMS' selection of the 10-percent rate, if only for the reason that it reflects the prime rate on January 1, 1975. The audit period in question was from January 1976 through December 1982. As we stated in Shell Oil Co., "[i]t is evident from our investigation that a fair rate of return depends greatly on the economic conditions and other circumstances of the case at the time involved." 52 IBLA at 26 (emphasis added).

While MMS is not bound to accept the rate of return offered by Phillips, the record must reflect a rational basis for its selection of a rate of return and the relationship of that return to the time period in question. In this case, it does not. Therefore, we must set aside the Director's decision as it relates to the rate of return. 12/ Upon remand, MMS should review all relevant sources in determining the proper rate of return.

[5] In its demand letters, RMP asserted that it reserved the right to conduct further audits of the same plants and leases. Phillips challenged that right, and the Director affirmed. Phillips again objects, arguing that OIG was provided with all of the data and documents necessary to perform complete audits of all of the leases and plants involved and that OIG has in fact completed its audits (SOR at 58-59).

Appeals to this Board from MMS decisions are governed by 30 CFR 290.7, which provides: "Any party to a case adversely affected by a final decision of the Director, Minerals Management Service * * * shall have a right of appeal to the Board of Land Appeals * * *." Phillips has not been adversely affected by the MMS assertion that it is reserving the right to conduct further audits. We have held that where an adverse impact on a party is contingent upon some future occurrence or where the adverse impact is merely hypothetical, it is premature for this Board to decide the matter. State of Alaska, 85 IBLA 170 (1985); Lone Star Steel Co., 77 IBLA 96 (1983). In this case, the adverse impact of the Director's ruling is merely hypothetical. Although MMS reserved the right to audit, it did not state with certainty that another audit would take place. Moreover, if another audit were to take place, it is possible that the results could be favorable to Phillips. The appeal as it relates to MMS' reservation of a right to conduct additional audits is dismissed for lack of standing. 13/

12/ We note that in its 1988 revision of its valuation regulations, MMS discussed methodologies for establishing rates of return in relation to the transportation allowance. It concluded that the rate of return should be based on the Standard and Poor's BBB industrial bond rate. It stated, however, that because of the "substantial and diverse comments" received on the rate of return issue, it would issue a notice of proposed rulemaking to consider further modifications of the rate of return section. 53 FR 1263 (Jan. 15, 1988).
13/ We note that section 101 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. | 1711 (1982), provides the Secretary with

[6] Finally, Phillips challenges the authority of MMS to assess interest for underpayment of royalties. Specifically, it argues that until nearly the end of the audit period, the Department was without statutory or regulatory authorization to assess interest on underpayments, that imposition of interest is inequitable, and that Phillips is entitled to a credit for interest arising from an erroneous MMS demand for royalty payments.

First, Phillips' claim of lack of statutory or regulatory authority to assess interest is unfounded. As we stated in Sun Oil Co., 91 IBLA 1, 48, 93 I.D. 95, 120 (1986), "[Geological] Survey [now MMS] has the authority independent of any specific statutory, regulatory, or contractual authority, to make a unilateral determination of interest owed where equity requires that it be imposed." See Atlantic Richfield Co., 21 IBLA 98, 107, 82 I.D. 316, 320 (1975). 14/ Although Phillips correctly claims that the regulatory provision authorizing assessment of interest, 30 CFR 221.80 (45 FR 84762 (Dec. 23, 1980)), was not effective until February 1, 1981, virtually the end of the audit period in question, MMS only assessed interest in this case for the period after March 1, 1981. 15/ Thus, at all relevant times there was a specific regulatory basis for collection of interest in this case.

Phillips asserts that even for the period during which the regulation authorizing late payments was in effect, it is eligible for the estimated payments exception allowed in that provision. The estimated payments exception was not included in 30 CFR 221.80 until June 1, 1982. See 47 FR 22527 (May 25, 1982). Under that provision, "[e]xceptions to this late payment charge may be granted when estimated payments on minerals production have already been made timely and in accordance with instructions provided by MMS." We recently stated in responding to a similar argument in a coal royalty case, construing a comparable provision in the regulations governing such royalties (30 CFR 218.200(a) (1986)), "[t]he lessee's characterization of a royalty payment as an 'estimated payment' does not govern the applicability of the late payment regulation." Utah International, Inc., 107 IBLA 217, 221 (1989). A lessee may not invoke the estimated payment exception when the record fails to show evidence that the lessee sought prior authorization from MMS to make estimated payments. Id. at 220. In this case, there is no evidence that Phillips sought prior authorization from MMS to make estimated royalty payments.

fn. 13 (continued)
extensive authority to audit and reconcile Federal oil and gas royalty payments, including all current and past lease accounts and take appropriate actions to make additional collections or refunds, as warranted.

14/ Since the enactment of section 111 of FOGRMA, 30 U.S.C. | 1721 (1982), on Jan. 12, 1983, there has been specific statutory authority for imposition of interest charges on late royalty payments.

15/ This fact is revealed by the record for the Lee and Lusk plant leases. Although the record regarding interest assessments for the Douglas plant leases is not so clear, MMS asserts in its answer that no interest was assessed prior to Mar. 1, 1981, and Phillips makes no attempt to refute this assertion in its reply.

Phillips also argues that until a claim is liquidated, there cannot be assessment of prejudgment interest. This argument lacks merit. It is settled that the Department is authorized to assess prejudgment interest in such circumstances. Atlantic Richfield Co., 21 IBLA at 107-108, 82 I.D. at 320-21.

[7] Phillips maintains that MMS must compensate it for the time value of money during the period when MMS held certain funds assessed and collected from appellant, but later credited to appellant. 16/ Citing Gould v. United States, 301 F.2d 557 (D.C. Cir. 1962), Phillips admits the general rule is that "interest is not recoverable against the United States in the absence of a statute or contract authorizing the payment of interest," but notes that an exception is recognized "as part of a claim for just compensation from the time the government took the property until the date of payment of the award" (SOR at 66). Phillips fails to recognize that the exception discussed in Gould applies only to the taking of private property via eminent domain. Furthermore, the court in Getty Oil Co. v. United States, 767 F.2d 886 (Fed. Cir. 1985), held that failure to include interest with a refund of royalty payments did not constitute a taking without just compensation and found no act of Congress expressly providing for interest on returned royalty assessments. Thus, Phillips is not entitled to interest on a refund of a royalty payment.

To the extent that Phillips raised other issues on appeal, they have been considered and rejected. Based on the alleged existence of various factual disputes, Phillips requested a hearing in this case. By order dated September 25, 1987, we took that request under advisement pending our further consideration of the merits of the appeal. As all of the issues raised by Phillips are capable of resolution on the record presented to us, we deny the request for hearing.

Therefore, in summary we (1) vacate the Director's decision to the extent he approved a valuation of NGLP's from the Lee and Lusk plants based on a weighted average price, rather than the DOE ceiling prices, during the price control period and remand the case to MMS for revaluation of those liquids; (2) affirm the Director's ruling that a processing allowance for extraction of NGLP's is to be determined on the basis of actual costs, not to exceed two-thirds of the value of the liquids; (3) set aside the Director's decision to the extent he concluded that the costs of gathering and compression were expenses incidental to the marketing of the gas and remand for a determination of the amount of those expenses that may be deducted as reasonable transportation costs; (4) set aside the Director's decision as it relates to the rate of return and remand for MMS to reexamine the question of the proper rate of return to be applied; (5) dismiss the appeal as it regards MMS' reservation of a right to conduct additional audits; and (6) affirm the authority of MMS to collect interest on late payments of royalties.

16/ This claim arose when the assessment in docket number MMS-85-0137-O&G was reduced from $443,105.47 to $287,270.35. See note 2, supra.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the appeal is dismissed in part, and the decision appealed from is affirmed in part, set aside in part, and vacated in part and the cases remanded for action consistent with our opinion.

Bruce R. Harris
Administrative Judge

I concur:

Franklin D. Arness
Administrative Judge