SHELL OFFSHORE INC.

IBLA 88-108 Decided November 2, 1989

Appeal from a decision of the Director, Minerals Management Service, affirming assessment of additional royalties due on processed gas from oil and gas leases OCS-G 2865, OCS-G 3529, and OCS-G 3289. MMS 86-0289-OCS.

Affirmed as modified.

1. Oil and Gas Leases: Royalties: Generally--Outer Continental Shelf Lands Act: Oil and Gas Leases

Where a Federal oil and gas lessee paid royalty on the value of production which was less than "gross proceeds accruing to the lessee from the disposition of the produced substances," an underpayment of royalty was made in violation of 30 CFR 206.150 (1987). Although the underpayment was erroneously authorized to be made, the Department was not estopped from correcting its error and collecting the correct payment.

APPEARANCES: Michael E. Coney, Esq., New Orleans, Louisiana, for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., and Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE ARNESS

Shell Offshore Inc. (Shell) 1/ has appealed from an October 2, 1987, decision of the Director, Minerals Management Service (MMS), affirming an April 4, 1986, order by the Regional Manager, Houston Regional Compli-ance Office, Royalty Management Program. That order assessed additional royalties of $2,596,249 on account of alleged underpayment of royalty on processed gas production from Outer Continental Shelf (OCS) leases

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1/ Although no assignment appears in the record before us, Shell Offshore Inc., apparently succeeded to the interests of Shell Oil Company in OCS-G 2865, OCS-G 3529, and OCS-G 3289 subsequent to the issuance of the Office of Inspector General's Audit Report dated February 1985. All three leases show Shell Oil Company was the original lessee.

OCS-G 2865, OCS-G 3529, and OCS-G 3289 2/ for the audit period March 1, 1977, through December 31, 1983. 3/ The MMS order sought to recoup royalties determined to be underpaid by a U.S. Department of the Interior, Office of Inspector General's Audit Report, Audit of Oil and Gas Royalties paid to the United States by Shell Oil Company from January 1, 1977, through August 31, 1981 (OIG Audit Report).

Finding No. 2 of the OIG Audit Report, entitled "Royalties paid on less than Gross Proceeds," concluded that rather than paying royalty using a 55-percent manufacturing allowance authorized by Geological Survey (Survey) in 1979, "Shell should have computed royalties on the gross proceeds it received" from processed gas. "Gross proceeds" was defined by the OIG Audit Report as "the value of the products returned by the plant net of the processing fee, fractionating fee, and excess fuel charges paid by Shell."

Shell received approval from MMS to post a bond in the amount of $5,676,310 to cover "principal and interest through May 1987" and appealed to the Director of MMS (Notice of Appeal dated May 9, 1986). The Director affirmed the MMS order requiring payment of underpaid royalties on all three leases and dismissed that part of the appeal relating to late charges for lack of ripeness because "no late payment charges were assessed." This appeal followed.

At all pertinent times, Shell maintained a 75-percent interest in OCS-G 2865 and a 100-percent interest in OCS-G 3529 and OCS-G 3289. Gas produced from these leases was processed at the Cow Island Gas Processing Plant pursuant to a "Products Processing Agreement" (Agreement) with Mobil Oil Corporation (Mobil), the designated plant operator. Shell had no ownership interest in the plant. Pursuant to the Agreement's terms, Mobil processed Shell's gas in return for 10 percent of plant liquid products not subject to Department of Energy (DOE) pricing regulations, a monthly processing fee, a fractionating fee, and an excess fuel charge where applicable (OIG Audit Report at 13). 4/

Processing of gas production from OCS-G 2865 commenced in March 1977. By letter dated March 16, 1987, bearing the caption "Offshore, Louisiana Vermillion Block 22 OS-257-OCS-G-2865" Shell advised Survey, the predecessor

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2/ The leases were issued with the following effective dates: OCS-G 2865 -Dec. 1, 1974; OCS-G 3289 - Sept. 1, 1975; OCS-G 3529 - Aug. 1, 1977.

3/ $1,663,162 in additional royalties were assessed by MMS covering the period March 1977 through December 1983 attributable to appellant's interest in OCS-G 2865; $2,380 in additional royalties were assessed from February 1981 through December 1983 attributable to OCS-G 3529; and $930,707 in additional royalties were assessed for January 1980 through December 1983 attributable to OCS-G 3289.

4/ The record does not include a copy of the Agreement. However, the Audit Report states the Agreement's terms, the correctness of which Shell does not dispute.

to MMS, 5/ that "[g]as deliveries from the captioned lease commenced on March 1, 1977" and that "Shell Oil Company's 75-percent working interest in the gas is being delivered under contracts as follows: Sea Robin (Southern Natural Gas Co.) 66.667%; Transcontinental Gas Pipe Line Corp. 4.1665%; Florida Gas Transmission Co. 4.1665%." Shell stated that gas was to be processed at the Cow Island plant, enclosed a May 20, 1976, gas processing proposal between Mobil and Shell, and notified Survey that: "Until the gas processing agreement has been completed and forwarded to you for approval, we will remit to the U.S.G.S. [Survey] for plant products on a base factor of 45%. Please advise if this royalty payment procedure is acceptable to you" (Exh. 1 to Shell's Supplemental Statement of Reasons (SOR)). The record does not contain a copy of the referenced proposal.

Acknowledging receipt of Shell's letter requesting approval of a royalty payment allowance, Survey responded on April 8, 1977, that:

> Effective March 1, 1977, * * * value for computing royalties shall be based upon the following:
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> 1. Shell's lease delivery volume (75 percent) times the FPC [Federal Power Commission] approved price, or higher price if received, minus
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> * * * * * * *
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> 3. The volume of the plant products attributable to Shell's gas times 45 percent, times the price received for each respective product.
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> * * * * * * *
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> In accordance with 30 CFR 250.47, please send us copies of your FPC certificate, rate filings, and gas processing agreement, when available. Royalty payment procedures for the gas production of all other parties listed in the enclosure will be considered at a later date when their contracts and FPC certificates have been filed with this office.

(Exh. 2 to SOR).

On April 21, 1977, Shell forwarded Survey the Agreement between Shell and Mobil, together with an FPC order covering sales to Florida Gas Transmission Company, Transcontinental Gas Pipe Line Company, and Southern Natural Gas Pipe Line Corporation, and "[a] copy of the FPC's March 11, 1977 order accepting Shell's contract dated August 18, 1976 with Southern Natural Gas Pipe Line covering the remainder of sales from Vermillion Block 22" (Exh. 3 to SOR).

5/ Effective on June 30, 1982, MMS succeeded to the royalty collection responsibilities previously assigned to Survey's Conservation Division.
See 47 FR 28368 (June 30, 1982).

Referring to Survey's April 8, 1977, letter granting a royalty allowance factor of 55 percent for OCS-G 2865, Shell again wrote to Survey on July 25, 1978, enclosing a copy of the final executed Agreement with Mobil and requesting that Survey review the Agreement and "particularly that section dealing with Mobil's processing fee of $15.00 per MMcf and the fractionation charges, and furnish us with your amended royalty payment instructions" (Exh. 4 to SOR). The Agreement showed that Shell's cost to process gas was substantially less than had been contemplated by Survey when it granted Shell a 55-percent processing allowance. Nonetheless, Survey did not respond to this request. Shell thereafter on May 1, 1979, reiterated the request (Exh. 5 to SOR).

Survey replied to Shell by letter dated June 18, 1979. Outlining a royalty payment procedure for gas production from lease OCS-G 2865, Survey acknowledged receipt of Permanent Federal Energy Regulatory Commission (FERC) certificates covering Florida Gas Exploration Company and Freeport Minerals Company; Temporary FERC Certificates covering Southland Royalty Company; Small Producer Certificates covering Eason Oil Company and Crown Central Petroleum Corporation; gas purchase contracts between Shell's co-lessees and purchasers covering the sale of each of respective lessees or interest owners's share of production and stated inter alia:

> This gas is being processed at the Cow Island Plant in Vermilion Parish, Louisiana, owned by Mobil Oil Corporation and Union Oil Company of California.
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> Cow Island Plant, Vermilion Parish, Louisiana, Hydrocarbons Agreements were executed February 15, 1977, covering the follow-ing grantors:
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> Florida Gas Exploration Company
> Freeport Oil Company
> Southland Royalty Company
> Eason Oil Company
> Crown Central Petroleum Corporation.

(Exh. 6 to SOR, at 2).

Together with Shell, the grantors listed in Survey's letter represented 95.8333 percent of the interest owners in OCS-G 2865. The June 18, 1979, letter continued:

> Shell Oil Company will make royalty payments for all interest owners.
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> * * * * * * *
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> Effective March 1, 1977, royalty shall accrue on the value of:
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> 1. All residue gas remaining after processing, plus

2. The processed liquids value attributable to the lease times 45 percent.

* * * * * * *

In accordance with 30 CFR 250.67(b), the royalty on residue gas and extracted products shall not be less than that which would accrue to the field delivery volume of gas valued at the FERC-approved price, or higher price if received.

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The royalty payment procedure for the additional lease partner (Transco Exploration Company [4.1667 percent]) will be prescribed under separate cover upon receipt of company contracts.

(Exh. 6 to SOR, at 3). The record does not show further instructions relative to Transco Exploration Company's interest.

The record includes one letter concerning payments for OCS-G 3289 and another letter concerning payments for both OCS-G 3529 and OCS-G 3289. A letter from Survey dated June 30, 1980, addresses OCS-G 3289 and is identical to an August 13, 1980, letter dealing with both OCS-G 3289 and OCS-G-3529. Survey's letter of August 13, 1980, acknowledged receipt of the gas sales and purchase contract between Shell, as seller, and Transcontinental Gas Pipe Line Corporation, as buyer, dated March 17, 1978, and stated that, in the event the gas produced should be processed, the processing agreement should be provided to Survey. Processing of gas production at the Cow Island plant from OCS-G 3289 and OCS-G 3529 commenced in January 1980 and February 1981, respectively. The record does not contain any further correspondence between Shell and Survey dealing specifically with OCS-G 3289 and OCS-G 3529. The June 18, 1979, value determination letter did not refer to leases OCS-G 3529 and OCS-G 3289. Although the Director found that the June 18 letter only covered Shell's 75 percent interest in OCS-G 2865, the letter's terms embraced all interests except Transco's.

The OIG Audit Report states that Mobil and Union Oil Company, as plant owners, received MMS authorization to use a manufacturing allowance of "54%.00" in calculating royalty on their share of plant liquid products for the period "May 1, 1976 through April 30, 1980" and "60.85%" for the period "May 1, 1980 to current period" (OIG Audit Report at 13). Although it was not a plant owner, and had negotiated an agreement for processing its lease gas at lower cost than the 55-percent allowance first given by Survey in 1979, Shell nonetheless used the 55-percent allowance to compute the royalty value of plant products for OCS-G 2865, OCS-G 3529, and OCS-G 3289 (OIG Audit Report at 14). The OIG audit discovered that calculation of royalty using the 55-percent processing allowance caused Shell to underpay royalties. Shell's Agreement with Mobil provided for payment by transfer to

Mobil of a percentage of plant liquids, a processing fee, a fractionation fee, and excess fuel charges. Shell does not dispute that the 55-percent allowance used to calculate royalty exceeded its actual cost of processing.

Each of Shell's Federal leases here under review contains identical terms. Section 1 of each of Shell's three leases provides:

> This lease is subject to all the provisions of the Act and to all the terms, conditions and requirements of the valid regulations promulgated by the Secretary of the Interior (hereinafter called the Secretary) thereunder in existence upon the effective date of this lease, all of which are incorporated herein and, by reference, made a part hereof. This lease shall also be subject to regulations hereafter issued by the Secretary pursuant to his authority under section 5(a)(1) of the Act to prescribe and amend at any time such rules and regulations as he may determine to be necessary and proper in order to provide for the prevention of waste and for the conservation of the natural resources of the Outer Continental Shelf, and for the protection of correlative rights therein, which regulations shall be deemed incorporated herein and, by reference, made a part hereof when promulgated.

The royalty provision in each of the three leases provides, pertinently, that Shell will

> pay the Lessor a royalty of 16-2/3 percent in amount or value of production saved, removed, or sold from the leased area. Gas of all kinds (except helium) * * * is subject to royalty.
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> (2) It is expressly agreed that the Secretary may establish minimum values for purposes of computing royalty on products obtained from this lease, 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, or area, to the price received by the Lessee, to posted prices, and to other relevant matters. Each such determination shall be made only after due notice to the Lessee and a reasonable opportunity has been afforded the Lessee to be heard.

At all pertinent times relevant to the instant appeal the substance of applicable regulations has remained unchanged. 30 CFR 250.64, 19 FR 2659 (May 8, 1954). 30 CFR 250.64 provided in 1974, on the effective date of OCS-G 2865, the oldest of the three leases (see note 2), that:

> 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 or area, 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 paid or offered at the time of production in a fair and open market for the major portion of like-quality products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

An almost identical version of the regulation published as 30 CFR 250.64 was promulgated in 1979 and appears at 44 FR 61903 (Oct. 26, 1979). 6/ 30 CFR 250.64 was redesignated without change in 1983 as 30 CFR 206.150, 48 FR 35641 (Aug. 5, 1983). The latest relevant version 7/ appears at 30 CFR 206.105 (1987) and provides:

> The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary. [Emphasis supplied.]

The emphasized language has consistently appeared in the regulation since its inception.

30 CFR 206.152 (1987) 8/ was also in effect when OCS-G 2865 issued and at all pertinent times thereafter and provided:

6/ "The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulation prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary."
44 FR 61903.

7/ On Mar. 1, 1988, revised gas royalty valuation regulations, not here relevant, became effective. 53 FR 1230 (Jan. 15, 1988).

8/ 30 CFR 206.152 (1987), formerly 30 CFR 250.67, 44 FR 61892, 61903 (1979), was redesignated, without change, on Aug. 5, 1983, 48 FR 35641.

> A reasonable allowance, determined by the Director and based upon regional plant practices and actual plant costs and other pertinent factors, may be made for the cost of processing and may be deducted from the royalty payment due on said constituent substances. However, the reasonable allowance shall not exceed two-thirds of the value of the substances extracted unless the Director determines that a greater allowance is in the national interest.

Shell contends the issue on appeal is whether it is arbitrary and capricious for MMS to retroactively attempt to collect additional royalty in direct contradiction of royalty valuation instructions given for the processed gas in question, when such instruction was given by the Director's duly authorized agent pursuant to regularly delegated authority (SOR at 2). Further, Shell avers that the effect of the April 8, 1977, and June 18, 1979, value determinations by Survey was to direct Shell "to pay royalty after taking a plant allowance as well as deducting the PPA [Plant Processing Agreement] fee to Mobil" (SOR at 5).

[1] The issue before us on appeal, however, is somewhat different than as it is stated by appellant, because the instructions given to Shell by Survey were contrary to applicable regulations. The issue before us is whether, granting that Survey issued instructions fixing payment of royalty at a lower rate than was allowed by Departmental regulations, Shell can nonetheless be required to pay at the higher rate required by Departmental regulation. Shell is correct when it argues that the 55-percent allowance granted by Survey did not exceed two-thirds of total value set as an outer limit by 30 CFR 206.152 (1987). Nor are we persuaded that the Director's conclusion that the 55-percent processing allowance approved was not based "upon regional plant practices and actual plant costs" is sound. MMS has not shown that a similar allowance given the two plant owners was in error. However, the OIG revealed that Survey incorrectly equated Shell's cost of processing with the plant owner's cost. Since Shell was not a plant owner, it had not borne the owner's costs. Shell does not dispute that the allowance approved exceeded its actual cost to process the gas. It argues, however, that it has been deprived of the allowance given by Survey in 1979, and later continued after Survey should have become aware that Shell's costs were less than estimated in 1979.

Because it is not a plant owner, Shell's actual costs to process its gas at the plant is the consideration stated in the contract with Mobil. To the extent that the allowance approved by MMS exceeded Shell's actual cost of processing, Shell reaped a windfall and paid royalty on a value less than gross proceeds accruing to the lessee from the disposition of the produced substances. To find otherwise would require that one ignore the language of 30 CFR 206.150, which established that royalty must never be computed using a value lower than "gross proceeds accruing to the lessee from the sale thereof."

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fn. 8 (continued)
30 CFR 250.67 was originally promulgated in 1969, 34 FR 13547 (Aug. 22, 1969) in substantially identical form.

Decisions of this Board and the Federal courts have consistently so interpreted this regulation. Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1386 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 107 S. Ct. 1593 (1987); Hoover & Bracken Energies, Inc., 52 IBLA 27, 39, 88 I.D. 7, 13 (1981), aff'd, Hoover & Bracken Energies, Inc. v. United States Department of the Interior 723 F.2d 1488, 1490-91 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984); Pennzoil Oil & Gas Inc., 109 IBLA 147, 158-59 (1989); Enron Corp., 106 IBLA 394, 396-97 (1989); Tricentrol United States, Inc., 105 IBLA 392, 394-96 (1988). The law is settled that duly promulgated regulations have the force and effect of law and are binding on the Department. American Gilsonite Co. 111 IBLA 1, 96 I.D. 408 (1989). Survey's approval of a 55-percent processing allowance in the April 21, 1977, and June 18, 1979, royalty payment procedure letters was contrary to provision 30 CFR 206.150 and consequently was unauthorized. Where the Department's agents direct a lessee to compute royalty in a manner inconsistent with applicable regulations, the Department is not estopped by acceptance of the erroneous payments from correcting the error. Atlantic Richfield Co. v. Hickel, 432 F.2d 587, 591 (10th Cir. 1979); Supron Energy Corp., 46 IBLA 181 n.6 (1980). Such error cannot create rights not authorized by law. Utah Power & Light Co. v. United States, 243 U.S. 389 (1917); Sonat Exploration Co., 105 IBLA 97 (1988); Hiko Bell Mining & Oil Co. (On Reconsideration), 100 IBLA 371, 95 I.D. 1 (1988); Raymond T. Duncan, 96 IBLA 352 (1987); Supron Energy Corp., 46 IBLA 181 n.6 (1980). Consequently, we affirm MMS' order assessing additional payments of royalties for OCS-G 2865, OCS-G 3289, and OCS-G 3529.

Shell has also challenged the Director's finding that the question whether a late payment charge may be assessed for Shell's failure to make timely payment of the correct amount of royalty is not ripe for decision. MMS has not issued an order that appellant pay a specific sum for making late payment of royalty. MMS has, however, required appellant to include in the bond furnished in support of this appeal a sum to cover future late payment charges. Arguing that this Board should dispose of any question concerning late charges on the record now before us, Shell refers us to Departmental regulation 30 CFR 218.150, which provides, pertinently:

> The failure to make timely or proper payments of any monies due pursuant to leases, permits, and contracts subject to these regulations will result in the collection of the amount past due plus a late payment charge. Exceptions to this late payment charge may be granted when estimated payments on minerals production have already been made timely and otherwise in accordance with instructions provided by MMS to the payor.

30 CFR 218.150(b) (1987). This issue is not, however, before us on the record presented by this appeal. Should MMS assess late charges on this account in the future, and should Shell decide to appeal, it may make such arguments then as it deems fit. Until late payments are assessed, we decline to determine whether they may properly be made.

Therefore, 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 as modified.

Franklin D. Arness
Administrative Judge

I concur:

Bruce R. Harris
Administrative Judge