ARCO OIL & GAS CO.

IBLA 88-23 Decided November 9, 1989

Appeal from a decision of the Acting Director, Minerals Management Service, refusing to authorize a "marketing transportation allowance" for gas produced from OCS-G 6155 and OCS-G 6156.

Affirmed as modified.

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

The existence of changed market conditions is insufficient to alter the scope of a Federal lessee's duty to market gas. Where a lessee contracts with a marketing agent to find buyers for unprocessed gas production off the lease, lessee is not entitled to an allowance for this marketing cost, as such costs necessarily are incurred in the lessee's duty to prudently market production, regardless of where the market is located.

APPEARANCES: Gary H. Hoff, Esq., Dallas, Texas, for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., and Howard W. Chalker, Esq., U.S. Department of the Interior, Office of the Solicitor, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE ARNESS

Arco Oil and Gas Company appeals from the August 13, 1987, decision by the Acting Director, Minerals Management Service (MMS), affirming denial of a "marketing transportation allowance" for gas produced from appellant's OCS-G 6155 and OCS-G 6156, High Island Blocks 115 and 116, offshore Texas leases. Arco had sought an allowance for costs associated with marketing the royalty share of gas in accordance with a marketing agreement executed between Arco and Unifield Natural Gas Group, Inc. (Unifield).

Pursuant to the terms of the Arco-Unifield marketing agreement, Unifield acted as Arco's nonexclusive marketing agent and was bound to identify and obtain commercial customers 1/ and industrial end-user markets

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1/ Arco maintains in its SOR at page 2 that "Unifield is to focus its efforts principally on identifying and obtaining distant commercial and with potential sales volumes of up to 2,000 MMBtu per day for Arco's gas (Agreement at 1-2). Unifield markets production from Arco's leases to the extent Arco chooses to make gas volumes available. Services performed by Unifield include, but are not limited to, arranging transportation downstream of the delivery point, aggregating nominations of customers on the same pipeline, and dealing with the local distribution company involved (Director's Decision at 1; Agreement at 1).

Arco maintains that the marketing arrangement with Unifield enhances Arco's ability to market the Government's share of production at a higher price than otherwise may be attainable for sale of production at the wellhead (Statement of Reasons (SOR) at 2). While Arco concedes that the lessee has an obligation to market production at the lease for the benefit of both lessee and lessor, Arco believes the lessor must share the cost of developing a market for the product when a market does not exist at the lease or, as in the instant case, where the lessee's use of a marketing arrangement enhances the lessee's ability to market the Government's share of production at a higher price than otherwise might be attainable (SOR at 2). If MMS were not to share in the cost of what Arco claims to be "extraordinary marketing effort and expense" there would be, according to Arco, an overvaluation of the royalty share of production at the lease (SOR at 3).

Arco disputes MMS' reliance on 30 CFR 206.152(d) as authority to the contrary, because the regulation cited governs processed gas, and the gas at issue here is unprocessed gas (SOR at 5). Challenging the Director's finding that a deduction for marketing charges would result in payment of royalty on less than gross proceeds, appellant points to other allowable transportation and processing allowances to show that MMS does accept less than gross proceeds to arrive at value of production for royalty purposes. Transportation allowances approved by MMS, Arco states, are deducted from royalty received for sale of production at distant markets. An allowance deductible from gross proceeds for marketing costs, Arco contends, is similarly "relevant" to a determination of value of production. Arco argues that to provide an allowance to move production to a distant point of sale, yet to deny allowance for actual costs incurred in creating that same market, is arbitrary and capricious (SOR at 4). Arco urges that it does not request a reduction in the value of production from gross proceeds but, rather, seeks an allowance for costs incurred as provided under MMS policy.

MMS concedes that with a softening of the gas market it has become aware that marketing agents are being used to find customers (Director's Decision at 2). Nonetheless, MMS maintains, the lessee is still obliged to market the royalty share. Gross proceeds for gas, MMS avers, is the total price paid by a buyer. Here, this price includes a reimbursement for Arco's marketing cost; it is the gas buyer who reimburses Arco for the mandatory costs incurred by the contract with Unifield. MMS contends that "[i]f this

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fn. 1 (continued)
industrial end-user markets." (Emphasis added.) The agreement, however, does not use the word "distant" to modify the word "market" (<u>see</u> Agreement at 1).

Board permits Arco to subtract its reimbursed marketing costs from the sales price to determine royalty value, the value of the gas will be less than gross proceeds" in violation of 30 CFR 206.150 (MMS Answer (Answer) at 4). MMS argues that the conclusion that marketing costs cannot be subtracted from the selling price is consistent with 30 CFR 206.152(d) and 30 CFR 250.42 (Answer at 4-5).

Arco concedes that the lessee has an obligation to market production, including the lessor's royalty share, unless the lessor elects to take gas in kind or "in production," in which case the lessor markets his own share. However, Arco maintains that the efforts that it must exert to satisfy the obligation to prudently market production for the mutual benefit of lessee and lessor have become more burdensome than they were in the past, due to recent changes in the market and regulatory environment in which it operates. Consequently, Arco requests that the Government share the costs of marketing the Government's royalty share of production. Arco also requests this Board to create an allowance under the phrase "other relevant matters," appearing in 30 CFR 206.150, to pay for the cost of the marketing agent Arco elected to hire in order to search out, find, and develop markets. Arco relies by analogy on transportation and processing allowances as authority for grant of an allowance under the catch-all "other relevant matters" language in 30 CFR 206.150(e), which authorizes the Director, MMS, to consider various price factors when establishing royalty value.

[1] Relevant royalty jurisprudence recognizes that a transportation allowance may properly be given for reasonable costs incurred to move the royalty portion of production to the nearest market. See, e.g., United States v. General Petroleum Corp., 73 F. Supp. 225 (S.D. Cal.) aff'd, Continental Oil Co. v. United States, 184 F.2d 804 (9th Cir. 1980). The allowance here claimed, however, bears no relationship to movement of production to a point of sale. Consequently the transportation allowance cases are not germane. Nor is the claimed allowance cognizable under regulations governing gas processing under 30 CFR Part 206 (1987), given that the gas at issue is unprocessed gas and the cited regulations pertain only to processed gas.

Benefits of prudent marketing obviously inure to both the lessor and lessee. Although Arco has chosen to contract out for marketing services, no doubt others will and have elected to perform these services for themselves. Had Arco elected to market its own gas, it seems probable an allowance would also have been requested for increased costs incurred in a declining market since the underlying reason for the request (a changed market), would be the same.

The analogy sought to be drawn by Arco between transportation allowances and the allowance requested here is unpersuasive, because it fails to draw upon similar circumstances. In Shell Oil Co., 70 I.D. 393 (1963), the Department recognized an allowance for the cost of transporting the royalty share to an onshore point of sale where there was no market at or adjacent to the offshore lease. But for the fact that the only market was onshore at a point distant from the lease, the transportation costs (for barging) would not have been incurred by lessee. This is simply not the case here. The costs of creating and developing a market for the royalty share of production are not incurred solely because no market exists on or adjacent to the lease. Rather, these costs would have been incurred by lessee, whether or not there was a market for the production at or adjacent to the lease, in an effort to secure the highest price obtainable for disposition of the royalty share of production. No allowance will be recognized by the Department where a lessee, as here, would have borne similar costs attributable to the creation and development of markets regardless whether production was sold on or adjacent to the lease. See JFD, Inc., 49 IBLA 337 (1980).

The creation and development of markets for production is the very essence of the lessee's implied obligation to prudently market production from the lease at the highest price obtainable for the mutual benefit of lessee and lessor. Traditionally, Federal lessees have borne 100 percent of the costs of developing a market for gas. Appellant has cited no authority, nor do we find any, which supports an allowance for creation and development of markets for the royalty share of production. The only justification advanced by appellant for such an allowance is found in changed market conditions.

The scope of the lessee's implied obligation to prudently market gas has not changed since execution of the subject leases: but the cost associated with this obligation has increased as a result of a change in market conditions. We are not persuaded that the existence of changed market conditions is sufficient to alter the scope of Arco's duty to market gas obtained from its Federal leases.

Departmental regulations bolster our conclusion that the Government's royalty on unprocessed gas may not be burdened by marketing costs. 30 CFR 250.42 (1979) 2/ deals with both processed and unprocessed gas and reiterates the general rule that, the cost of treatment to put products into marketable condition do not burden the Federal royalty. The rule provides that: "[t]he lessee shall put into marketable condition, if commercially feasible, all products produced from the leased land. In calculating the royalty payment, the lessee may not deduct the costs of treatment." Moreover, 30 CFR 206.150 (1987) provides that "[u]nder no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances." The Federal courts and this Board have consistently interpreted the term "gross proceeds" to mean the total proceeds or actual consideration received from the purchaser. Pennzoil Oil & Gas, Inc., 109 IBLA 147 (1989); Wheless Drilling Co., 13 IBLA 21, 80 I.D. 599 (1973). Wheless Drilling Co. is persuasive authority; this case has been followed consistently by the Tenth Circuit and this Board. Hoover & Bracken Energies, Inc. v. United States Department of the Interior, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984); Pennzoil Oil & Gas, Inc., supra at 158; Enron Corp., 106 IBLA 394 (1989); Tricentrol United States, Inc., 105 IBLA 392 (1988); Amoco Production Co., 29 IBLA 234 (1977); Knife River Coal Mining Co., 29 IBLA 26 (1977).

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

Finally, the agreement reached between Arco and Unifield precludes
an allowance for the marketing fee. The marketing agreement states: "In exchange for these services, ARCO agrees to pay Unifield a fee based on the attached schedule for all volumes delivered under a contract which Unifield arranged. Unifield's fee per MMBtu will be added to ARCO's netback price to determine the end-user's contracted gas supply price." Id. at 2. The purchaser's, or "ends-user's," price is the total consideration, or the gross proceeds received by Arco. That consideration includes the marketing fee. Consequently the gas marketing fee cannot be deducted from the royalty due the United States royalty under 30 CFR 206.150, which establishes that gross proceeds from sales are a floor for royalty computation purposes.

We agree with Arco that 30 CFR 206.152(d) (1987) 3/ is not directly applicable here because it governs processed gas exclusively. The decision appealed from is modified accordingly. Nonetheless, Arco has offered no explanation why it should be relieved of the cost of hiring a gas marketing agent, considering that a lessee who tenders royalty on processed gas is required to bear costs incidental to marketing. 4/

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 as modified.

Franklin D. Arness
Administrative Judge

I concur:

Wm. Philip Horton
Chief Administrative Judge

3/ 30 CFR 206.152(d) provides pertinently that: "[N]o allowance shall be made for boosting residue gas or other expenses incidental to marketing."
4/ Our holding herein is consistent with the result reached in Walter Oil & Gas Corp., 111 IBLA 260 (1989).