MOBIL OIL CORP.

IBLA 87-751 Decided November 21, 1989

Appeal from a decision of the Director, Minerals Management Service, denying appeals from orders assessing additional royalties and late payment charges. MMS-86-0016-OCS, MMS-86-0102-OCS.

Set aside and remanded.

1. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

In valuing, for royalty computation purposes, natural gas liquid products processed and sold under non-arm's-length contracts in Louisiana, MMS may properly compare the prices reported by the lessee to published spot market prices for similar products in Texas where the lessee fails to establish that its prices are reflective of fair market value received under arm's-length contracts. However, where the reported prices fall below the lowest spot market price constituting the fair market value floor, MMS may not value production according to an average spot market price.

APPEARANCES: W.R. Buck, Esq., Mobil Exploration & Producing U.S. Inc., for appellant; Howard W. Chalker, Esq., Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE HUGHES

The Mobil Oil Corporation (Mobil) has appealed from a decision of the Director, Minerals Management Service (MMS), dated June 29, 1987, denying its appeals from orders of the Regional Manager, Tulsa Regional Compliance Office, Royalty Management Program, MMS, assessing additional royalties in the amount of $104,571.25 and late payment charges in the amount of $69,495.57.

This case stems from a June 1985 Audit Report prepared by the Office of Inspector General, U.S. Department of the Interior (IG Audit Report). That report considered in part the propriety of Mobil's valuation for royalty computation purposes of natural gas liquid products (NGLP) derived from processing natural gas produced from various Outer Continental Shelf (OCS) oil and gas leases in the Gulf of Mexico between January 1980 and December 1983. 1/ All of the gas was processed at the North Terrebonne gas processing plant located in Terrebonne Parish, Louisiana.

In assessing the propriety of Mobil's valuation of the NGLP from the produced gas, the IG Audit Report used the so-called "yardstick" criteria set forth in MMS' "Procedure Paper on Natural Gas NGLP Valuation" (MMS Procedure Paper). As discussed in more detail below, these criteria apply where production is sold either without contracts or with contracts that are not at arm's-length, as was the case with some sales of Mobil's NGLP. Briefly stated, where there is no contract or a contract is not at arm's-length, the price used to value the NGLP will be acceptable if it is above the lowest spot market price. If, however, the price is below the lowest spot market price, value for royalty purposes is set by the procedure paper at the average of spot market prices from a relevant geographical area. Spot market prices are determined from "commercially available NGLP bulletins."

The IG Audit Report, noting that Mobil had valued its NGLP on the basis of both intracompany transfer prices and arm's-length sales transactions, concluded that additional royalties were due because the intracompany transfer prices reported to MMS by Mobil (which were presumably regarded as "non-arm's-length") were less than the lowest Mont Belvieu, Texas, spot market prices. Accordingly, the report recommended that MMS direct Mobil to pay additional royalties, computed on the basis of the average of the lowest and highest Mont Belvieu spot market prices, and assess interest and penalties.

By order dated November 19, 1985, the MMS Regional Manager, relying on the IG Audit Report, concluded that Mobil owed $104,571.25 in additional royalties because, as indicated in the report, it had valued some of its NGLP in accordance with intracompany transfer prices which were less than the lowest Mont Belvieu spot market prices. The Regional Manager stated that appropriate late payment charges would be computed and billed to Mobil upon receipt of payment of these additional royalties. Mobil timely appealed to the Director from the Regional Manager's November 1985 order. 2/ That appeal was docketed as MMS-86-0016-OCS.

1/ These liquid products are derived along with residue gas from the processing of natural gas.

This case involves the following OCS leases: 054-001140, 054-002924, 054-002925, 054-003580, 055-000049 through 055-000054, 055-000057-A, 055-000060-0, 055-000060-A, 055-000071, 055-000000778, 055-000786.

2/ In conjunction with its appeal, received by MMS on Dec. 26, 1985, Mobil submitted a check in payment of the additional royalties deemed to be due.

Mobil argued on appeal to the Director that, in accordance with the policy expressed in the MMS Procedure Paper, the value of its NGLP should be determined on the basis of "comparable sales in the same area." However, Mobil argued that it had complied with this policy because it had valued its NGLP sold in non-arm's-length transactions according either to the price received by Mobil for NGLP sold under an arm's-length contract at the same time and location or, in the absence of such a contract, to the "weighted average price Mobil must pay to purchase the same product in the same geographic area and time." Mobil argued that MMS deviated from its own policy because it relied on Mont Belvieu spot market prices, in a different area: "The North Terrebonne plant is located in Louisiana; Mont Belvieu in Texas, over 350 miles away. Sales at Mont Belvieu are, thus, simply not comparable to market conditions at the North Terrebonne plant."

While the appeal was pending before the Director, on February 19, 1986, the Regional Manager directed Mobil to pay late payment charges with respect to the additional royalties which the Regional Manager had previously required to be paid. Such charges, which totalled $69,495.57, represented interest calculated from the date the royalties were originally due until the date of payment on December 26, 1985. Mobil timely appealed to the Director from the Regional Manager's February 1986 order, challenging the late payment charges on the basis that MMS was not entitled to the additional royalties. The appeal was docketed as MMS-86-0102-OCS. Mobil's appeals from the Regional Manager's November 1985 and February 1986 orders were consolidated for decision by the Director.

In his June 1987 decision, the Director concluded that, although Mobil's use of a weighted average price "may indeed be reasonable," the valuation of natural gas for royalty computation purposes has been committed by Congress to the Secretary of the Interior and "the Secretary's interpretation must be respected * * * if that interpretation is reasonable, in spite of the fact that other interpretations may also be reasonable." The Director concluded that Mobil had failed to establish that MMS' reliance on Mont Belvieu spot market prices, when valuing NGLP subject to intracompany transfers, was erroneous or contrary to law. Rather, the Director held that MMS had properly followed its Procedure Paper in valuing Mobil's NGLP. With respect to Mobil's argument that Mont Belvieu spot market prices cannot be considered comparable to prices at the North Terrebonne plant, the Director stated that "physical distance alone is not sufficient to establish that Mont Belvieu is a separate market or that it is outside the North Terrebonne 'area' for purposes of valuation." Accordingly, the Director denied Mobil's appeals from the Regional Manager's November 1985 and February 1986 orders. Mobil has timely appealed to the Board from the Director's June 1987 decision.

Before addressing the arguments advanced by appellant, we will review the statutory and regulatory context in which MMS determines the value of NGLP resulting from processing the natural gas produced from OCS oil and gas leases. Section 18(a)(4) of the Outer Continental Shelf Lands Act (OCSLA), as amended, 43 U.S.C. § 1344(a)(4) (1982), states that "[l]easing activities shall be conducted to assure receipt of fair market value for the lands leased and the rights conveyed by the Federal Government." In addition, 30 CFR 250.67 (1980) (presently designated 30 CFR 206.152) provided at all relevant times herein that, where natural gas is processed for the recovery of its constituent components, royalty will accrue on the value of all residue gas remaining after processing and "[a]ll natural gasoline, butane, propane, or other substances extracted from the [natural] gas." Departmental regulation 30 CFR 250.64 (1980) (redesignated 30 CFR 206.150) defined the meaning of the "value of production," whether in the case of residue gas or NGLP resulting from the processing of natural gas:

> The value of production shall never be less than the fair market value. * * * In establishing 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.

30 CFR 250.64 (1980). 3/

It is well established that, under the applicable statute and regulations, the Department has considerable discretion in determining the value of production for purposes of royalty computation. Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1382 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 480 U.S. 940 (1987); Amoco Production Co., 78 IBLA 93, 96 n. 7 (referring to Hoover & Bracken Energies, Inc., 52 IBLA 27, 33, 88 I.D. 7, 10 (1981), rev'd, Hoover & Bracken Energies, Inc. v. U.S. Department of the Interior, No. 81-461-T (W.D. Okla. Nov. 18, 1981), rev'd, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984)). 4/

The MMS Procedure Paper was prepared by the Royalty Valuation and Standards Division of the Royalty Compliance Division, MMS, on December 14, 1984, and revised on February 25, 1985. It was intended to devise a "yardstick" method for determining the reasonableness of the NGLP prices adopted by Federal oil and gas lessees for valuation purposes (Procedure Paper at 3). In deciding which yardstick to use, MMS studied sales contracts, prices

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3/ Effective Mar. 1, 1989, the Department completely revised the regulations in 30 CFR prescribing the proper method for valuing natural gas, whether processed or unprocessed, for royalty computation purposes. See 53 FR 1230 (Jan. 15, 1988). It has not been argued that the revision of the regulations has any bearing on the present dispute.

4/ Our decision in Amoco Production was affirmed by the District Court on appeal in Amoco Production Co. v. Hodel, 627 F. Supp. 1375 (W.D. La. 1986), but the Circuit Court vacated that decision for lack of jurisdiction and remanded the case for transfer to the Claims Court. See Amoco Production Co. v. United States, 815 F.2d 352 (5th Cir. 1987), cert. denied, 108 S. Ct. 2898 (1988). The Claims Court subsequently affirmed the Board in Amoco Production Co. v. The United States, No. 344-87-L (Cl. Ct. Aug. 7, 1989).

received by lessees, regulated prices and commercial price bulletins, concluding that commercial price bulletins are the "best available price source and in most instances are indicative of NGLP fair market value." Accordingly, MMS decided to rely on the prices reported in such bulletins as a basis for judging the reasonableness of the NGLP prices adopted by lessees.

The yardstick selected by MMS was the range between the highest and lowest published prices for the month in which the NGLP to be valued was produced. In addition, depending on the area from which production occurred, the MMS Procedure Paper provided a "[s]uggested location" of NGLP prices, that is a geographical market, upon which to base the yardstick and recommended a commercial price bulletin where such prices could be found for particular time periods (Procedure Paper at 6). 5/ In the case of production occurring in the Gulf of Mexico, the suggested location was Mont Belvieu, Texas.

The MMS Procedure Paper also generally set forth, under the subheading entitled "Development of yardstick values," the method for employing the yardstick, stating that the NGLP prices adopted by lessees would be compared to the highest and lowest published prices for the relevant month from the appropriate bulletin:

> If the reported price falls within this range, the value will normally be accepted by MMS for royalty determination purposes. * * * If the prices used to calculate royalties fall below this range, a minimum value that is acceptable to MMS can be determined by developing an average value from the lowest and highest prices in the range.

(Procedure Paper at 6, 7).

The specific direction of when to use the yardstick was set forth under the subheading entitled "Application of the yardstick value." The MMS Procedure Paper set forth two different valuation methods depending on whether the NGLP prices adopted by lessees were taken from arm's-length contracts, on the one hand, or non-arm's-length or no contracts, on the other hand. In the case of arm's-length contracts, the procedure paper provided that: "If lessees have a true arm's-length contract which establishes an NGLP price, MMS will normally accept the arm's-length contract price for royalty purposes unless the gross proceeds received were higher than the contract price" (Procedure Paper at 8). Where there was no contract or a contract that was not at arm's-length (as in this appeal) the procedure paper provided:

> If lessees have a non-arm's-length contract which establishes an NGLP price and the lessee can demonstrate that the contract has

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5/ With respect to the suggested location, however, the Procedure Paper cautioned that "each valuation case should be separately evaluated to determine if an alternate location would be more pertinent than the suggested location."

> characteristics similar to arm's-length contracts which represent fair market value, MMS will accept the non-arm's-length contract price for royalty computation purposes. If there are no arm's-length contracts for the same field or area, or the non-arm's-length contract does not represent fair market value, the yardstick value is considered fair market value. [Emphasis in original.]

(Procedure Paper at 9). 6/

In sum, the preferred method for valuing NGLP for royalty computation purposes under the MMS Procedure Paper is to use an arm's-length contract price. Where the NGLP is not sold pursuant to an arm's-length contract, the prices established in other arm's-length contracts in the same field or area are used when they are deemed to reflect fair market value. See Amoco Production Co. v. Hodel, 627 F. Supp. at 1379; Texaco, Inc., 104 IBLA 304, 310 (1988), and cases cited therein. The procedure paper provides that the yardstick method should be employed only where (1) NGLP is not sold pursuant to an arm's-length contract and (2) there are either no other arm's-length contracts in the same field or area or the non-arm's-length contract cannot be considered indicative of fair market value. Only in this instance does MMS compare the non-arm's-length contract price reported by the lessee to the range of prices published in commercial price bulletins.

Appellant argues that MMS improperly relied on spot market prices in Mont Belvieu, Texas, because sales in that area do not represent comparable sales of NGLP: "[T]he Mont Belvieu market and the lower Mississippi Valley market are geographically and economically distinct markets involving different producers, purchasers and market demands." In addition, appellant states that MMS failed to consider the additional cost that would be involved in transporting NGLP to the Mont Belvieu market, noting that these costs are "likely to be significant given that there are no pipelines available from the Plant location to Mont Belvieu necessitating the use of trucking to transport the product."

As we concluded in Conoco Inc., 110 IBLA 232, 241 (1989), the Mont Belvieu spot market prices for NGLP "clearly qualifies as a posted price," and, since MMS is directed by 30 CFR 250.64 (1980) to consider "posted prices" in valuing production, its use was proper. As in Conoco, appellant herein has failed to establish that the Mont Belvieu and lower Mississippi Valley markets are "economically distinct," that is, that NGLP produced at the North Terrebonne gas processing plant would fetch a different price at Mont Belvieu, Texas, than in Terrebonne Parish, Louisiana. As the Director stated, physical distance is not alone determinative of whether the markets are distinct. Nor has appellant established that any other factor renders the markets distinct. As appellant has failed to demonstrate that this

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6/ The MMS Procedure Paper also provided different rules for valuing production depending on whether it had occurred during the period of control of prices by the U.S. Department of Energy. For our purposes, all of the production involved herein occurred during the period of decontrol (January 1980 to the present).

approach is not soundly based on fact, we decline to disturb MMS' practice of using the Mont Belvieu prices in appropriate circumstances.

We also can find no basis for making any adjustment in the Mont Belvieu spot market prices in order to account for the cost of transporting the NGLP to that distant market. Under the MMS Procedure Paper, NGLP derived from processing in Terrebonne Parish should properly be valued at the price which they would command if produced and processed in the Mont Belvieu area and sold in that market, not on the basis of being produced in the Gulf of Mexico, processed in Terrebonne Parish, and transported to the Mont Belvieu area for sale in that market. The theoretical underpinning for this is that the prices which NGLP processed in the Mont Belvieu area command in that area are the same or sufficiently similar to the prices which comparable NGLP processed in Terrebonne Parish would command in that parish. Allowing a transportation allowance of the type described by appellant would not be consistent with the use of prices from a comparable geographical market to establish value. Therefore, we perceive no reason to account for the cost of transporting the subject NGLP to the Mont Belvieu market.

Appellant contends that, assuming the yardstick method is properly employed to value the subject NGLP, application of that method is arbitrary and capricious. Appellant bases its argument on one of the examples given in the Procedure Paper for application of the yardstick valuation method, i.e., where ethane in a given month is selling for a low price of $31.50 and a high price of $32.25, with an average price of $31.875:

> Using these numbers, if a lessee is selling ethane pursuant to a non-arm's-length contract in a situation in which the yardstick approach is applicable, and the price received is $31.51 (one cent more than the lowest price), that price is within the range and would normally be accepted by the MMS for royalty valuation purposes. If, however, that same lessee is selling the ethane for $31.49 (one cent less than the lowest price in the quotations), the price would not be within the range and the lessee would be required to pay royalty on the average monthly price, which, in the Paper's example, is $31.875. In effect, for a mere two cent difference in price, the lessee is required to pay royalty on an additional $.3650 in assigned value per unit. This procedure can be described as nothing less than arbitrary. * * * Clearly, if the MMS will accept the lowest price in the range, that price should be used when the lessee receives less than that amount. * * * The Director's Order of June 29, 1987 should be reversed and the assessment * * * recalculated based upon the lowest price for the relevant periods.

(SOR at 11-12).

In Conoco Inc., supra at 244, we accepted an argument similar to appellant's:

> [A]cceptance of any settlement price within the range of the low to the high spot market price [even as low as the lowest spot

> market price] as constituting fair market value is inconsistent with requiring payment of the average spot market price where the lessee's settlement price is less than the floor value. * * * If the average spot market price rather than the floor price constituted fair market value, then MMS would be without authority under the statute and regulation to accept royalty settlement prices as low as the floor price as the Procedure Paper indicates MMS has done.

Thus, in Conoco, we held that MMS could not justifiably conclude that the average, rather than the lowest, spot market price was fair market value, and that the lowest spot market price should be deemed to constitute fair market value where the settlement price falls below the lowest price. Accordingly, we remanded the case to MMS for a recomputation of any additional royalty due and any applicable late payment charges. That is the approach which we adopt here.

In the present case, some of the NGLP was sold pursuant to non-arm's-length contracts, and appellant did not use the contract price from these sales in valuing the subject NGLP. Rather, according to appellant, it relied either on the prices for similar production under its own arm's-length contracts in the same field or on a weighted average of the prices for similar production under other arm's-length contracts in the same field. 7/ If this representation were supported, this procedure might have comported with the MMS Procedure Paper's preference for relying on arm's-length contract prices.

However, there is no evidence in the administrative record that appellant attempted to establish to MMS' satisfaction that it valued the subject production on the basis of the prices under its or others' arm's-length contracts in the same field or area, which contracts represented fair market value. The MMS Procedure Paper places the burden on the lessee to demonstrate that its own non-arm's-length contract has characteristics similar to arm's-length contracts in the same field or area and that the arm's-length contract prices represent fair market value. 8/ However, appellant has

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7/ In its statement of reasons, appellant restates the method by which it valued, for royalty computation purposes, the NGLP derived from processing the natural gas produced from the subject leases. Appellant states that it valued these products "in one of two ways":

"Where Mobil was selling comparable NGLP's to a third party under an arm's-length contract at the same time and from the same location, the NGLP's sold under its non-arm's-length contracts were valued * * * at the price actually received under that contract. If, however, Mobil was not selling comparable NGLP's to a third party under an arm's-length contract at that particular time and location, Mobil valued the product using the weighted average price Mobil would have to pay to purchase comparable NGLP's under arm's-length contracts at that time and from that location."

8/ There is a substantial issue as to whether the lessee or MMS should properly bear the burden of establishing whether a price used by lessee to value NGLP is based on arm's-length contracts. Appellant challenges the placing of the burden on it to show that the prices it used to value the NGLP were based on arm's-length contracts, asserting implicitly that MMS, attempted to make such a showing before us, submitting copies of the "backup contracts and calculations utilized by Mobil to implement its approach for one month's production."

Since this case must be remanded to MMS for further calculations and is therefore not finally resolved, it is appropriate in the interest of fairness to appellant to require MMS, on remand, to review any information that lessee has bearing on this question to determine whether the contracts used by appellant were, in fact, arm's-length contracts in the same field or area within the meaning of the MMS Procedure Paper.

Thus, we set aside the Director's June 1987 decision and remand the case to MMS for a recomputation of any additional royalty due and any applicable late payment charges. In the context of this review, MMS should review the material presented by appellant concerning the nature of the contracts on which it based its valuation of the NGLP.

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 set aside and the case is remanded to MMS for further action consistent herewith.

David L. Hughes
Administrative Judge

I concur:

John H. Kelly
Administrative Judge

fn. 8 (continued)
not it, had the responsibility of establishing that there were no arm's-length contracts as a prerequisite to using the yardstick. In effect, requiring a lessee to make such a showing comports with the option extended to lessees by the Board in Getty Oil Co., 51 IBLA 47, 51 (1980), which held that the Department may value production for royalty computation purposes on the basis of prices derived from non-arm's-length transactions where such prices are reflective of the fair market value of the production. However, we note that a lessee could have difficulty in making a showing as to the validity of the price it used to value NGLP, as compared with other contract prices, since a lessee will not likely have complete information regarding all sales contracts in an area. In fact, a lessee might run afoul of pricefixing restrictions if it attempted to assemble this data. On the other hand, MMS, which receives contract information from all Federal lessees, is in a much stronger position to assert, and defend against challenge, a determination as to whether a particular contract price is permissible.

In view of our holding that, in this case, MMS should review the material supplied on appeal, it is unnecessary at this time to resolve whether the burden is properly placed on a lessee to make such showing.