<u>Editor's note</u>: Reconsideration denied by Order dated April 22, 1991; Appealed -- <u>aff'd</u>, Civ.No. 90-0071 (D.Wyo. April 29,1 991), <u>aff'd</u> No. 91-8030 (10th Cir. April 8, 1992), 961 F.2d 219 (table)

DAVIS EXPLORATION

IBLA 87-686 Decided December 28, 1989

Appeal from a decision of the Director, Minerals Management Service, determining value of crude oil for royalty purposes. MMS-87-0109-O&G.

Affirmed.

1. Oil and Gas Leases: Royalties: Generally

Costs incurred in placing crude oil into a marketable condition are costs of production and generally not deductible for royalty purposes, so that the proper basis for royalty valuation is the crude oil after it has been rendered marketable, not as it comes from the well.

2. Administrative Procedure: Hearings--Constitutional Law: Due Process--Rules of Practice: Appeals: Effect of--Rules of Practice: Hearings

Due process does not require notice and a prior right to be heard in all cases in which there is alleged impairment of property rights so long as the person is given notice and an opportunity to be heard before the alleged impairment becomes final. Appeal to the Board of Land Appeals satisfies due process requirements.

APPEARANCES: Daniel T. Davis, Worland, Wyoming, 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 IRWIN

Davis Exploration (Davis) appeals the May 22, 1987, decision of the Director, Minerals Management Service (MMS), determining the value of crude oil for royalty purposes.

Davis is the operator of two producing wells on Federal oil and gas leases W-64842-A and W-56322-A in Big Horn County, Wyoming. These wells produce 12.6- to 12.7-degree American Petroleum Institute (API) gravity oil which has a high water content. Before selling the oil, Davis mixes it in surface tanks with 40-degree API gravity condensate purchased elsewhere. This enhancement enables Davis to avoid a substantial deduction in selling price which would otherwise be imposed because of the low gravity of the crude oil produced by the wells.

By letter of July 17, 1986, Davis sought approval from MMS' Royalty Management Program (RMP) to pay royalties "based upon the value of the oil as it comes from the ground rather than the enhanced value." By letter dated September 25, 1986, the RMP denied the request, ruling that Davis should pay royalties on the average net price of the enhanced oil less a deduction for the volume of the high gravity oil added. Davis appealed to the Director of MMS. See 30 CFR 290.3.

In its appeal to the Director Davis argued that its blending was "essentially a manufacturing process [resulting in] * * * a highly modified, highly improved substance" (October 17, 1986, letter from Davis to RMP at 4). Davis explained:

> The cost of blending is quite high. There is * * * little condensate production in the immediate area, necessitating large shipping costs. Blending is not a simple procedure and requires many man hours for its accomplishment. Extra pumps and tanks are required.
>
> Before the price of oil fell in early 1986, I paid royal-ties based on the sale price of the blended product which we sold. After the price of oil went down, I was no longer able
> to make a profit because of the high royalty cost and the high cost of blending.

(Oct. 17, 1986, letter from Davis to RMP at 2).

In his May 22, 1987, decision, the Director found that Davis' production as it comes from the well "cannot be profitably marketed, that the enhancement is for marketing purposes, and that the basic character of the product after enhancement remains the same" (Decision at 3). The Director quoted with approval RMP's March 10, 1987, rationale for rejecting a processing allowance for Davis' enhancement process:

> Enhancement through mixing does not result in the "manufacture" of other chemically-distinct products, such as results from the extraction of natural gas liquids (NGL's) from gas. Mixing of low and high gravity crude results in a crude with a gravity somewhere between the original gravities of the mixed oils. The primary reason Davis mixes the oil is to "knock out," or displace, the water produced with the low gravity lease crude. This improves the quality of the oil by reducing the BS&W (basic sediment and water) content as well as raising the quality of
> the lease crude. * * * The final product is still crude oil.

(Decision at 3). The Director cited the lessee's responsibility to put the oil into a marketable condition, 43 CFR 3162.7-1(a), and concluded that the value of production for royalty purposes "means the value of the product in marketable condition (which includes any necessary enhancement)" (Decision at 3). He therefore upheld the RMP's denial of Davis' request to value the oil as it comes from the well. The Director modified the RMP's September 26, 1986, decision that allowed a deduction for the volume of the high gravity oil added, however, and instead allowed Davis to deduct the full cost of the oil used for product enhancement. 1/

On appeal, Davis states:

> There appears to be two issues. The first, a factual issue[,] depends wholly on my statement of the facts. The Minerals Management Service Director's statement of the critical fact is: "It is clear from the record that Davis' production as it comes from the well cannot be profitably marketed. That the enhancement is for marketing purposes and that the basic character of the product after enhancement remains the same.
>
> First, the Director's statement that my product cannot be profitably marketed as it comes from the well is wrong. The following is a quote from my appeal to the Minerals Management Service's original ruling on this subject. [2/]
>
> > "It is true that there were several months after the price crash that we would not have been able to make a profit on our unblended crude. If we didn't blend, our expenses would run about $8[,]000 per month. We produce about 130 barrels of oil per day, so that we would need about $11,500 per month to break even, after taxes

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1/ "RMP admits that the use of the load oil procedures found in NTL-1 and CDM [Conservation Division Manual] 647.4A.3 is inappropriate in situations where low gravity lease production is enhanced at the surface through mixing with high gravity oil brought in from outside the lease. By using load oil procedures in valuing surface enhancement, royalties are assessed on oil for which royalties have already been paid (if imported from another Federal lease) or for which no royalty is due (if imported from a State or fee lease). Thus, MMS erred in its Sept. 26, 1986, decision in granting a deduction for the high gravity oil imported by Davis which was limited to the average net price received for the enhanced product. Davis should instead have been granted a deduction based on the full cost of the imported (from offlease) oil."
(Decision at 4).

2/ Davis' reasons for its appeal to the Director of the Sept. 25, 1986, decision were set forth in accordance with 30 CFR 290.3(a) in a letter to the RMP dated Oct. 17, 1986. The RMP prepared an eight-page report to the Director dated Mar. 10, 1987, in accordance with 30 CFR 290.3(b). RMP sent a copy of its report to Davis on Mar. 24, 1987, and offered Davis 2 weeks from its receipt to file a response with the Director. This quote is from Davis' Apr. 10, 1987, response to the RMP report.

and royalties. This amounts to $2.95 per barrel that we would need to break even.

"We would have lost money during the following dates:

March 18, 1986 to May 20, 1986
June 6, 1986 to August 19, 1986

"These are the only three months in 1986 that we would have lost money if we didn't blend. Of course, now with the new price structure, we would have consistently made a small profit in 1987.

"I made the following statement on page 2 of my appeal:

'Before the price of oil fell in early 1986, I paid royalties based on the sale price of the blended product which we sold. After the price of oil went down, I was no longer able to make a profit because of the high royalty costs and the high cost of blending.'

"I should have been more careful here. I made this statement to demonstrate why the timing of our decision to change our royalty payment practice coincided with the price drop. Actually we did make a profit in these months, except for the months where we had some sort of production problems. The word 'fair', 'good' or 'reasonable' before the word profit would have made this statement more accurate.

"Mr. Feldmiller [Chief, Royalty Valuation and Standards Division, RMP] makes it sound like I have a duty to blend. He says, "The Minerals Management Service cannot accept the sale to an affiliate at a posted price that does not represent the value of [a] 'marketable product.'"

"I think Mr. Feldmiller is assuming here that I have to blend in order to cause our product to become marketable. As indicated above, this is not true. * * *"

* * * * * * *

It appears from the Director's ruling that the only legal issue is whether my blending operation is necessary to cause the oil to become marketable. The Director seems to say that market- ability has something to do with price. The case law indicates

> that this just simply isn't true. [3/] Marketability has to do with the quality of the crude. In our case, our crude is not marketable until water and basic sediment is removed.

(Statement of Reasons at 1-2).

MMS argues in response that under the royalty clause of the lease and 30 CFR 206.103 the value of production for royalty purposes may not be less than the gross proceeds accruing to the lessee and that Davis' gross proceeds for the oil it produces from the leases is the price it receives for the blended oil less the cost of the offlease oil used for blending. 30 CFR 206.103 (1986) provides:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director 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 prices received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production for any of the 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 per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be reasonable value. [4/]

3/ This conclusion is apparently based on Davis' statement of the applicable law:

"The text book: Natural Resources by Frank J. Trelease, et al., West Publishing Company, has such a section at page 925 entitled: "Value of Royalty." The law is clear that the lessee must bear the full cost of causing the wells' production to become marketable. These measures would include dehydration or treating of oil; and dehydration and compression for delivery into a pipeline of gas. Additional costs, such as a gas gathering system, or the cost of transporting crude oil to a market may be deducted. See Matzen v. Hugoton Production Co., 182 Kan[.] 456, 321 P. 2nd 576 [(1958)], at 581, and Gilmore v. Superior Oil Co.[, 192 Kan. 388] 388 P. 2nd 602 [(1964)]. (Letter of Oct. 17, 1986, from Davis to RMP at 2).

4/ The Department has revised the rules applicable to the valuation of oil and gas for royalty purposes. Effective Mar. 1, 1988, the Department removed 30 CFR 206.103 (1986) and revised 206.102 to govern valuation standards. 53 FR 1184, 1218, 1220-21 (Jan. 15, 1988).

In reply Davis argues that BLM did not comply with the royalty clause of the lease because "[t]o my knowledge, no investigation has ever been made as to whether or not the posted price, or any other relevant matter, such as my cost to manufacture has been examined * * *. In addition, I was not notified that such a determination was made, nor was I given an opportunity to be heard concerning the issues of such a decision." 5/

[1] The Mineral Lands Leasing Act of 1920, as amended, 30 U.S.C. § 181 (1982), reserves to the Department the authority and responsibility to establish reasonable value for royalty purposes. Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1381-82 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986). Accord California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961); Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); United States v. Ohio Oil Co., 163 F.2d 633, 639-40 (10th Cir. 1947), cert. denied, 333 U.S. 833 (1948). Under these provisions, the Secretary was given wide latitude to determine the value of production from a lease. Amoco Production Co., 78 IBLA 93, 96 (1983).

The Department has held that costs encountered in placing oil or gas in a marketable condition are part of the costs of production and, hence, not deductible for royalty purposes. California Co., 66 I.D. 54 (1959), aff'd, California Co. v. Udall, supra. Where a party challenges a determination as to the value of gas or other hydrocarbons produced from a lease with the United States, the party must establish that the methodol-ogy used is, in fact, erroneous. Amoco Production Co., 85 IBLA 121, 129 (1985); Supron Energy Corp., 55 IBLA 318, 322 (1981), appeal filed sub nom. Atlantic Richfield Co. v. Watt, Civ. No. 81-0615 (D.N.M. filed July 29, 1981).

Although Davis argues that its blending constitutes manufacturing, we agree with BLM that it is not manufacturing because the blending does not transform the crude oil it produces. Although Davis might have been able to sell its crude oil unblended, that would not meet its obligation to render the product marketable, see California Co. v. Udall, supra at 387-88, and Davis acknowledges that until the water and basic sediment are removed its product is not marketable. We therefore conclude that Davis has not met its burden of demonstrating that the basis for BLM's royalty determination--the price received for the blended product less the cost of the offlease condensate, i.e., the gross proceeds from the sale of the product--was in error. See Shell Offshore Inc., 111 IBLA 350, 357-58 (1989).

5/ Davis quotes the royalty provision of its lease as follows:

It is expressly agreed that the Secretary of the Interior may establish reasonable minimum values for purposes of computing royalty on any or all oil, gas, natural gasoline, and other products obtained from gas, 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 and, whenever appropriate, after notice and opportunity to be heard.

[2] Concerning Davis' complaint regarding lack of notice and opportunity to be heard, due process does not require notice and a prior opportunity to be heard in all cases in which there is an alleged impairment of property rights so long as the person is given notice and an opportunity to be heard before the alleged impairment becomes final. Appeal to the Board of Land Appeals satisfies the due process requirements. Santa Fe Pacific Railroad Co., 90 IBLA 200, 220 (1986).

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.

Will A. Irwin
Administrative Judge

I concur:

Franklin D. Arness
Administrative Judge