

CONOCO, INC.

IBLA 88-141

Decided January 30, 1990

Appeal from a decision of the Director, Minerals Management Service, affirming assessment of additional royalty, MMS-85-0056-O&G.

Affirmed.

1. Oil and Gas Leases: Generally--Oil and Gas Leases: Royalties: Payments--Unit and Cooperative Agreements

Where a Federal lessee is required to pay royalty for part of a lease on a sliding-scale at a higher rate than 12-1/2 percent, the part paying at the higher rate is considered an entirety for purposes of royalty calculation, and gross production from a producing well on that portion is properly used to determine the sliding-scale royalty rate.

APPEARANCES: R. Carol Harvey, Esq., Houston, Texas, for appellant.

OPINION BY ADMINISTRATIVE JUDGE ARNESS

Conoco, Inc. (Conoco), has appealed from a decision of the Director, Minerals Management Service (MMS), dated October 16, 1987, affirming an order requiring the payment of additional royalties for gas, associated liquids, and condensates produced from Wells B-1 No. 5 (well 5) on Federal oil and gas lease No. 71-032582-B from 1980 through 1983. MMS found that appellant had incorrectly calculated the applicable royalty rate and, consequently, had underpaid royalty for production from lease No. 71-032582-B in the amount of \$41,652.68.

Well 5 produces gas and condensates from gas on land which was in a known geologic structure (KGS) on August 8, 1946. In 1948 Conoco made a request to certify that fact, and on June 11, 1948, the Acting Director, Geological Survey, replied that

determination is hereby made pursuant to 43 C.F.R. 192.6, (1) that the S2NE4 sec. 1 and the E2NE4 sec. 12, T. 25 S., R. 36 E. are believed to be within the productive limits of the Permian-Yates-Seven Rivers oil and gas deposits of the Jal field, as the limits of such deposits are found to exist on August 8, 1946.

Overall, Conoco's Federal lease No. 71-032582-B comprises 440.07 acres in secs. 1 and 2, T. 25 S., R. 36 E., New Mexico Principal Meridian. Within the lease boundary, 160 acres are in KGS and 320 acres, which include an 80-acre KGS on which well 5 is located, are within a state spacing unit. Well 5 is located in the S½NE¼ of sec. 1.

In July 1980 well 5 produced 158 barrels of oil and 149,630 MCF of gas from Custer Devonian sands and 2,453 barrels of oil and 69,814 MCF of gas from the Custer Ellenberger formation (monthly report of operations dated Sept. 10, 1980, Lease No. 71-032582-B). From July 1980 through June 1983 well 5 was reported to be a consistent producer of oil (Exh. A to Statement of Reasons (SOR), Schedule July 1980 through June 1983 at 2-3).

During the relevant 1980-83 timeframe, well 5 was within a state spacing unit which was located entirely within lease No. 71-032582-B. Conoco explains the effect of this circumstance upon the Director's decision here under review:

The New Mexico Oil Conservation Division ("NMOCD") established the 320-acre spacing unit within which Wells B-1 No. 5 is located. The NMOCD determined that Wells B-1 No. 5 would drain the Custer Devonian-Custer Ellenberger pools within the 320.03-acre spacing unit attached to it. Due to the allowable production under the spacing unit, it would not serve any purpose for Conoco to complete any other well(s) within said spacing unit to the Custer Devonian-Custer Ellenberger pools under the NMOCD spacing order. Wells B-1 No. 5 is the only well producing from the Custer Devonian-Custer Ellenberger pools. Wells B-1 No. 5 is the only well within the KGS boundaries.

(SOR at 2).

A 1935 lease of these lands contained a variable "sliding- or step-scale" royalty rate on production from 12-1/2 to 16-2/3 percent, depending upon the volume of production. 1/ The lease as amended on November 1, 1971, provided that royalty would be paid at the rate of 12-1/2 percent for gas and casing-head gasoline "where the average production per day for the calendar month from land leased is less than 3,000,000 cubic feet and 16-2/3 percent where the average production is 3,000,000 cubic feet or over" (Renewal Lease dated Nov. 1, 1971, at Schedule D, attachment).

The Act of August 8, 1946, 60 Stat. 957, amended the Mineral Leasing Act, 30 U.S.C. § 226(c) (1982), to limit Federal royalty on new production from wells drilled outside an existing KGS to 12-1/2 percent. 2/ Deposits

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1/ The regulation in effect when the decision under review issued, 30 CFR 206.104 (1987), defined "sliding- and step-scale royalties" as royalties "based on the average daily production per well."

2/ Section 12 of the Act of Aug. 8, 1946, 30 U.S.C. § 226(c) (1964), provided in relevant part:

within the productive limits of an oil and gas deposit, as such productive limits were found by the Secretary to exist on August 8, 1946, remained, however, subject to established sliding-scale royalty rates. The 1946 statutory royalty rate change was incorporated in Conoco's 1971 renewal lease, so that production from leased land not within the productive limits of any oil or gas deposit on August 8, 1946, was made subject to payment at 12-1/2 percent, while production of oil from land presumed productive prior to August 8, 1946, continued to be assessed at the variable rate (Lease effective November 1971, Schedule D, attachment).

Nonetheless, according to MMS, royalty on production from well 5 was paid prior to 1982 at the 12-1/2-percent minimum rate despite the location of well 5 within a "1946 Field." On April 22, 1982, MMS issued an order that royalty for production from well 5 be assessed according to the sliding-scale established by the 1971 lease, which required payment at the 16-2/3-percent rate when average daily production exceeded 3 million cubic feet daily. Conoco appealed this order.

On October 14, 1984, the Director, MMS, issued a decision establishing that, for royalty purposes, part of the production from well 5 was subject to the 12-1/2-percent royalty limitation imposed by the 1946 Act. The Director opined:

The Bureau of Land Management Engineer in Roswell, New Mexico, states unequivocally that based upon the depth and strata of the reservoir from which well No. 5 is producing, in his professional judgment, he would conclude that the reservoir is producing from a 320-acre area. He indicated that the spacing requirements of the State of New Mexico were formulated based

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fn. 2 (continued)

"From and after \* \* \* [August 8, 1946], the royalty obligation to the United States under all leases requiring payment of royalty in excess of 12-1/2 per centum, except leases issued or to be issued upon competitive bidding, is reduced to 12-1/2 per centum in amount or value of production removed or sold from said leases as to (1) such leases, or such part of the lands subject thereto, and the deposits underlying the same, as are not believed to be within the productive limits of any oil or gas deposit, as such productive limits are found by the Secretary to exist on \* \* \* [Aug. 8, 1946]; and (2) any production on a lease from an oil or gas deposit which was discovered after May 27, 1941, by a well or wells drilled within the boundaries of the lease, and which is determined by the Secretary to be a new deposit; and (3) any production on or allocated to a lease pursuant to an approved unit or cooperative agreement from an oil or gas deposit which was discovered after May 27, 1941, on land committed to such agreement, and which is determined by the Secretary to be a new deposit, where such lease was included in such agreement at the time of discovery or was included in a duly executed and filed application for the approved of such agreement at the time of discovery."

upon the recommendation of the USGS specialists, and consequently, in New Mexico, the Department of the Interior has traditionally shown deference to the state spacing requirements.

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In the professional judgment of the Department's specialist responsible for this type of technical decision, 75 percent of the production from well No. 5 is from the portion of a reservoir underlying the land that is "not believed to be within the productive limits of an oil or gas deposit as such productive limits are found by the Secretary to exist on August 8, 1946," and therefore qualifies for the 12-1/2 percent maximum royalty rate provided in 30 U.S.C. [§] 226[(c) (1982)].

Thereafter, on January 15, 1985, the Tulsa Regional Compliance Office, MMS, found that Conoco should pay royalty under the variable rate schedule established by the lease on production from well 5. Having established that the sliding-scale rate was applicable to the 1946 KGS within the lease, MMS then proceeded to determine the royalty rate and established how the actual royalty calculation should be made: "On production from the 80 acre area which was within the productive limits of a geologic structure as it was known to exist on August 8, 1946, royalty is to be paid at the applicable variable royalty rate determined using 100 percent of production from well No. 5" (MMS decision letter dated Jan. 15, 1985).

Conoco objected to use of 100 percent of well 5's production to determine which royalty rate should be applied to production from the well. Conoco argued that the royalty rate should instead be determined using 25 percent of production. In a letter decision dated April 3, 1985, MMS rejected Conoco's proposed method for royalty calculation:

The lease royalty schedule and 30 CFR 206.104 (formerly 30 CFR 221.112, changed from 30 CFR 221.49 effective November 26, 1982) require that sliding-scale royalties be based on the average daily production per well. The applicable criteria do not contain provisions for splitting production from a well when calculating sliding-scale rates. Therefore, the calculation of the sliding-scale rates must be based on the full production from Well No. 5.

The [January 15, 1985,] Director's decision established a new procedure for the application of the sliding-scale royalty rate to the lease gas production. The decision requires the higher rate (16-2/3 percent) to be applied to 25 percent of the production from Well No. 5, while the minimum rate (12-1/2 percent) is to be applied to 75 percent of the well production. MMS calculated the unpaid oil royalties of \$41,652.68 on a basis consistent with the procedure prescribed by the Director for the gas royalties. The Director's decision was not, however, construed to have established a new procedure for determining sliding-scale royalty rates.

MMS concludes that the sliding-scale rates for oil must be computed using 100 percent of the production from Well No. 5 as prescribed in the lease and 30 CFR 206.104. MMS further concludes that Conoco's additional information introduces no facts or criteria which compel MMS to except the prescribed method of calculating the sliding-scale rates for oil produced from this lease.

(MMS letter decision dated Apr. 3, 1985).

After recomputing royalty using 100 percent of well 5's production to determine which royalty rate should apply, the Tulsa Office, MMS, directed Conoco to pay \$41,652.68 in additional royalty. Id.

Conoco appealed to the Director, MMS. The Director affirmed the Tulsa Office's method of calculation, stating:

The 1931 lease and the 1971 lease specify that the sliding scale royalty is to be computed based on the total oil production from a well; therefore, the total production from that well should be recognized in determining when the incremental royalty rate is triggered.

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All the production from Well B-1 No. 5 located within the 1946 Field is to be used in computing the sliding scale royalty.

(Director's Decision dated Oct. 16, 1987, at 3-4).

Before us, Conoco reiterates verbatim the arguments made to MMS: it is contended that because MMS found 25 percent of production from well 5 to be subject to the 16-2/3-percent royalty rate, the method for determining volume (and, hence, when the 16-2/3-percent rate would apply) must also have been similarly affected. Conoco argues:

Since the BLM, the State of New Mexico, and the MMS have ruled that 75 percent of the production from Wells B-1 No. 5 is attributable to the non-KGS leased lands, Conoco should receive the full benefit of this ruling. MMS should value a full 75 percent of the production at a flat 12-1/2 percent royalty.

MMS has further ruled that 25 percent of the production from Wells B-1 No. 5 is attributable to the KGS leased lands. Conoco should receive the full benefit of this ruling. Only production attributable to the 80-acre KGS (25 percent) should be used to calculate the average daily production per well for determination of the sliding scale rate.

If MMS uses 100 percent of the average daily condensate production from Wells B-1 No. 5 to calculate any part of the royalty due on the KGS leased lands, MMS is circumventing the

determination by the Director that only 25 percent of production is attributable to the KGS leased lands, and the New Mexico spacing unit requirements conclusively determined in Conoco's previous appeal. Also, in calculating the sliding-scale royalties using 100 percent of the average daily production from Wells B-1 No. 5, MMS is avoiding the clear language in the lease which only requires the sliding-scale royalty to be calculated on production not subject to the flat 12-1/2 percent royalty for non-KGS leased lands. Also, in so calculating the royalties, MMS would be unjustly enriched beyond the royalty due under the lease terms. [Emphasis in original.]

(SOR dated April 22, 1988, at 3-4).

MMS agrees with Conoco that 75 percent of production from well 5 should pay royalty at the 12-1/2-percent rate and 25 percent of production should pay royalty according to the variable rate. See Director's decision dated October 14, 1984; SOR at 3. This allocation assumed production was not from the horizontal boundaries of land known to be productive in 1946, and was to be distinguished from Atlantic Richfield Co. v. Hickel, 432 F.2d 587 (10th Cir. 1970), aff'd Sinclair Oil & Gas Co., 75 I.D. 155 (1968), cases dealing with vertically separated strata later produced in a "1946 Field."

[1] The approach to royalty determination, however, taken by the Director follows the Geological Survey Manual provision entitled "Segregation of Leases for Royalty Purposes" which required that:

When a lease is segregated for royalty purposes, the various portions of the lease are considered as separate entities for determining applicable royalties. Accordingly, step- and sliding-scale leases which include lands subject to a flat 12-1/2 percent royalty rate are segregated for royalty purposes as follows:

(1) Each portion of the lease subject to the 12-1/2 percent royalty rate is considered as an entirety for application of the 12-1/2 percent royalty rate; and

(2) Each portion of the lease subject to the step- or sliding-scale royalty rate is considered as an entirety, and only the wells and production on such portion of the lease are used to determine the applicable royalty rate.

(Geological Survey Conservation Division Manual, Part 647.13.3E (1974)).

The approach taken by the Director was also consistent with provisions of the MMS Audit Procedures Manual and 30 CFR 206.104 (1987) providing that "[s]liding and step-scale royalties are based on the average daily production per well." Id. While the manual provisions are not, of course, binding upon Conoco, a memorandum in the case file explains how these procedures have been used to guide agency enforcement of 43 CFR 206.104:

In implementing royalty schedule "D" leases, MMS has established the following prerequisites for sliding scale rates: (1) wells must be physically located within the boundaries of a known geo-logic structure (KGS); and (2) well count must be pursuant to Title 30 Code of Federal Regulations (CFR), Part 206.104. The provisions of 30 CFR 206.104 require the sliding scale royalty rates to be computed based on the average daily production per well. MMS has consistently and historically used gross well production to calculate sliding scale rates and this is the procedure followed [in this case].

(MMS Memorandum dated June 5, 1985, Tulsa Regional Compliance Office).

It is axiomatic that the Secretary exercises wide discretion in value determination made under the authority of the Mineral Lands Leasing Act of 1920, as amended, 30 U.S.C. § 181 (1982). Amoco Production Co., 78 IBLA 93 (1983). The arguments advanced by Conoco fail to establish that this case is an exception to the regulatory requirement established by 30 CFR 206.104, as that provision has been applied and administered by MMS. There is nothing in the circumstances of this case, as argued by Conoco, to show that the determination by the Director that gross well production from well 5 should be used to calculate royalty was incorrect.

MMS has discretion to determine the value of production from a lease. See Supron Energy Corp., 46 IBLA 181 (1980). Where, as here, MMS has historically and consistently interpreted Departmental regulations to mean that gross production from a well shall be used to compute value for royalty determination, that determination will be sustained if shown to be reasonable. Id. As we found in Supron Energy Corp., supra, the Department has "considerable latitude in determining what is the 'value' of the production from a lease." Id. at 187. The determination of value by MMS must be "reasonable" and, although a competing theory of value offered by the lessee may also be reasonable, it is not required that the lessee's preference should be adopted simply for that reason. Id. at 193-96.

Here, the Director's decision is consistent with 30 CFR 206.104 and supported by past Departmental practice and by the fact that production from well 5 is production from the 1946 KGS. In this regard, as MMS observed concerning the decision to produce from well 5:

It would be inconsistent with the intent of the KGS process to allow a portion of the well production to escape inclusion in the royalty rate calculation when all of the well production was attained at reduced risk by drilling inside a KGS. If Conoco had drilled [well 5] outside the KGS, MMS would accept a flat one-eighth royalty on the total production on the premise the operator incurred a greater risk by drilling outside the KGS, and thus is entitled to realize a higher return on production.

(MMS Memorandum dated June 5, 1985). In the context of this appeal, this argument is persuasive. Where, as here, a lessee challenges a valuation by MMS, the lessee must establish that MMS has calculated incorrectly.

Amoco Production Co., 85 IBLA 121 (1985); Supron Energy Corp., *supra*. The determination by MMS that gross production from well 5 should be used to determine royalty has not been shown to be erroneous and is affirmed. See Shell Offshore Inc., 111 IBLA 330 (1989).

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.

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Franklin D. Arness  
Administrative Judge

I concur:

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David L. Hughes  
Administrative Judge