

SHELL OFFSHORE INC.

IBLA 87-441, 87-749

Decided July 3, 1990

Appeals from decisions of the Director, Minerals Management Service, affirming assessment of additional royalties and late payment charges. MMS-86-0119-OCS et al.

Affirmed in part, set aside in part, and remanded.

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

Where Government acceptance of the tender of royalties is made subject to post audit, the mere recomputation of royalty payments due to the Government to correctly reflect fair market value of NGLP's does not constitute imposition of a penalty or give rise to an issue of retroactive application of a new rule.

2. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

A lessee's allegation that its method of valuing production from oil and gas leases is as effective at determining fair market value as the method utilized by MMS is not an adequate basis for reversal of a decision assessing additional royalties.

3. Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

When, in accordance with the Procedure Paper on Natural Gas Liquid Products Valuation, utilization of spot market prices is the proper methodology to value production and the lessee's price for natural gas liquid products is less than the minimum yardstick value, it is improper for MMS to use the average of the high and low prices in the yardstick range to determine the value of production. The yardstick minimum should be the price employed in such a situation.

4. Federal Oil and Gas Royalty Management Act of 1982: Assessments--  
Federal Oil and Gas Royalty Management  
Act of 1982: Royalties--Oil and Gas Leases: Royalties: Interest

Pursuant to sec. 111 of the Federal Oil and Gas Royalty Management Act of 1982, 30 U.S.C. § 1721 (1982), MMS is authorized to assess a higher interest rate for late payment of oil and gas royalties than it had previously been authorized to assess; therefore, for time periods prior to passage of the Federal Oil and Gas Royalty Management Act of 1982, MMS may assess only the lower, previously authorized interest rate.

APPEARANCES: Judith Y. Robertson, Esq., New Orleans, Louisiana, for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., 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 KELLY

Shell Offshore Inc. (Shell) has appealed from two decisions of the Minerals Management Service (MMS), dated January 30 and July 29, 1987, affirming the February 13, 1986, and March 19, 1987, decisions of the Regional Manager, Houston Regional Compliance Office (HRCO), MMS, assessing additional royalties and late payment charges in the amounts, respectively, of \$140,894.74 and \$105,975.80. The decisions involved the computation of royalties due for certain liquid products derived from processing natural gas produced from various Outer Continental Shelf (OCS) oil and gas leases situated in the Gulf of Mexico off the coast of Louisiana and processed at the North Terrebonne Gas Processing Plant. 1/

The assessment of additional royalties was based on a June 1985 Audit Report of the Office of Inspector General (OIG), U.S. Department of the Interior. According to the report, from January 1980 through December 1983, Shell based the value of the liquid products for royalty computation purposes on "intracompany transfer prices and [prices derived from] arm's-length sales transactions" (Audit Report at 5). During the course of the audit, OIG reviewed these prices in accordance with criteria set out by the Royalty Valuation and Standards Division, MMS, in a "Procedure Paper on Natural Gas Liquid Products Valuation" (Procedure Paper), initially prepared on December 14, 1984, and revised on February 25, 1985.

The Procedure Paper was designed to develop a "'yardstick' valuation" for the purposes of assessing the reasonableness of prices of liquid products reported by lessees for royalty computation purposes (Procedure

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1/ This case involves the following OCS oil and gas leases held by Shell: OCS-G 2094, 2280-2282, 2592, and 3146, and OCS 0442, 0478, and 0796.

Paper at 3). The Procedure Paper provides for an initial determination whether the reported prices are established in an arm's-length, a non- arm's-length, or a no-contract transaction. In the case of arm's-length transactions, MMS concludes that it will accept "the greater of the arm's-length contract price or gross proceeds." Id. at 8. In the case of non-arm's-length or no-contract transactions, the Procedure Paper provides a means for comparing the reported price with monthly prices for the products published in "Commercially Available NGLP [natural gas liquid product] Bulletins." Id. at 5. Such bulletins are considered to be, in most instances, "indicative of NGLP fair market value." Id.

Specifically, the Procedure Paper provides that when the reported price falls between the highest and lowest spot market prices set forth in those bulletins during the applicable month the reported price will normally be accepted, but when the reported price falls below the range, an average of the highest and lowest spot market prices will be accepted. Id. at 6, 7. 2/

MMS further states:

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

Id. at 9.

Analyzing the prices used by Shell to value liquid products derived from processing the natural gas produced from the subject leases, OIG, in its audit report, determined that additional royalties were due because the reported prices were "less than the lowest Mont Belvieu spot market prices" (Audit Report at 5). OIG determined that these additional royalties totaled \$140,895 and, accordingly, recommended that MMS assess additional royalties in that amount.

In his February 1986 decision, the Regional Manager stated that, after a review of the audit report, he also concluded that Shell owed additional royalties in the amount of \$140,894.74 because, relying on the criteria set forth in the Procedure Paper, the "intracompany transfer prices reported to MMS by Shell were less than the lowest published prices at Mont Belvieu"

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2/ In the case of production from the Gulf of Mexico, the Procedure Paper suggested in Attachment 1 that, for the period after January 1980, MMS compare reported prices with prices set forth in certain commercially available NGLP bulletins pertaining to production at Mont Belvieu, Texas.

(Feb. 13, 1986, Decision at 2). The decision indicates that MMS regarded the intra-company transfers as non-arm's-length transactions and that, because the reported prices fell below the lowest published prices, MMS had recomputed the royalty owed using the average of the applicable high-est and lowest published prices. The Regional Manager directed Shell to pay the additional royalties deemed to be due, recalculate subsequent royalties in accordance with MMS' policy, and pay any additional royalties found to be due within 45 days of receipt of the decision. Finally, the Regional Manager stated that appropriate late payment charges would be computed and billed to Shell upon receipt of the additional royalties. Shell appealed to the Director from the Regional Manager's February 1986 decision. 3/

In its statements of reasons (SOR) for appeal to the Director, Shell argued that MMS was precluded from computing royalty on the basis of the Procedure Paper to the extent it deviated from 30 CFR 206.150 (1985), because it constituted new regulations which had not been properly promulgated pursuant to the Administrative Procedure Act (APA), as amended, 5 U.S.C. §§ 551-559, 701-706 (1982). Shell also argued that the Procedure Paper was improperly accorded retroactive effect, especially where it represented a departure from MMS' previous acceptance of Shell's reported prices over a period of many years, which practice thus rose to the level of an enforceable regulation.

In the alternative, Shell argued that it could, in accordance with the Procedure Paper, demonstrate that its reported prices actually represented the fair market value of the subject liquid products. Shell noted that its reported prices, averaged over semiannual or annual periods, were the equivalent of the semiannual or annual averages of the published prices endorsed by the Procedure Paper during the period of the current assessment of royalties.

In an additional SOR subsequently filed with the Director, Shell asserted that the required reliance on commercial price bulletins for valuing liquid products for royalty computation purposes posed practical problems for Shell because the bulletins were published 90 days after the date of sale and, therefore, the applicable prices were not available at the time the royalties are due. Shell noted that, in the absence of timely payment, it would be subject to certain penalties. Shell also contended that in many cases the spot market prices set forth in such commercial price bulletins were not indicative of the fair market value of liquid products sold under long-term contracts. Shell paid the required additional royalties under protest on April 16, 1986.

In the January 1987 MMS decision, the Director, MMS, affirmed the Regional Manager's February 1986 decision assessing \$140,894.74 in additional royalties. He concluded that the Procedure Paper, which established the yardstick values by which to judge non-arm's-length contract prices,

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3/ This appeal was docketed as MMS-86-0119-OCS through MMS-86-0130-OCS.

did not constitute new regulations which must be promulgated pursuant to the APA, but at most was merely an interpretation of 30 CFR 206.150 (1985) because those values were derived from a consideration of all of the factors in the regulation (Decision at 4-5). He concluded that, even in the absence of the Procedure Paper, MMS could have relied on published prices when valuing the liquid products in accordance with MMS' discretionary authority under the regulation. He also concluded that, by virtue of reliance on such factors, there were no elements of retroactivity in application of the Procedure Paper. Id. at 5. Finally, the Director noted that, while Shell could have demonstrated that its non-arm's-length contracts had the characteristics of arm's-length contracts in accordance with the Procedure Paper, it had failed to do so. <sup>4/</sup> Shell has appealed from the Director's January 1987 decision. This appeal is docketed as IBLA No. 87-441.

In its SOR before the Board, appellant contends that royalty payments were based on a valid determination of the fair market value of the liquid products produced from its leases, especially where the average intra-company transfer prices were equal to or exceeded the average commercial bulletin prices for the period in question. Appellant argues: "There are many ways to arrive at a fair market value determination and just as many ways to challenge fair market value determination. [Shell's] intra-company prices are just as reasonable and reflective of fair market value as the new MMS policy paper fair market value determinations" (SOR at 2). Moreover, appellant asserts that where its original royalty payments were made without the benefit of the Procedure Paper, to now penalize appellant "in a retroactive manner for failing to guess the ultimate fair market value 'yardstick' to be chosen by MMS is inequitable and violative of due process." Id.

During the pendency of appellant's appeal to the Board regarding the assessment of additional royalties, the Regional Manager, in a March 19, 1987, decision, assessed various charges totaling \$105,975.80 for the late payment of royalties. The Regional Manager required payment of these late payment charges by April 27, 1987. Appellant appealed to the Director from the Regional Manager's March 1987 decision. <sup>5/</sup>

In its SOR to the Director, appellant reiterated the substance of its appeal to the Board from the Director's affirmance of the assessment of additional royalties and requested the Director to authorize the suspension of the payment of the late payment charges pursuant to 30 CFR 243.2 (1986), offering to post a bond sufficient to indemnify the United States from loss.

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<sup>4/</sup> The Director also responded to Shell's assertion that it was impossible to pay royalties in accordance with the commercial price bulletins which were not published until after Shell was required to make royalty payments. He stated that Shell could "avail itself of an estimated payment procedure so as to avoid late payment charges" (Decision at 6).

<sup>5/</sup> This appeal was docketed as MMS-87-0173-OCS.

In the July 1987 MMS decision, the Assistant Director for Program Review, MMS, affirmed the assessment of late payment charges as consistent with the applicable statute and Departmental regulations. The Assistant Director took no action upon appellant's request for suspension of the payment of the late payment charges. Appellant has appealed from the Assistant Director's July 1987 decision. The appeal is docketed as IBLA No. 87-749, and is hereby consolidated with IBLA No. 87-441.

Appellant's SOR before the Board for its appeal of the affirmance of the assessment of late payment charges is a copy of its SOR filed with its appeal to the Director from the assessment. Accordingly, appellant does not challenge MMS' authority to assess charges in the case of the late payment of royalties due for the sale of liquid products produced from Federal OCS oil and gas leases. <sup>6/</sup> The additional royalties were not paid until April 16, 1986, well after the original due dates. Nor does appellant challenge the basis for computation of the late payment charges or the total amount of such charges. It is well established that MMS has the authority to assess late payment charges when such charges represent the interest lost by virtue of the late payment of royalties. 30 CFR 250.49 (1980); Sun Exploration & Production Co., 104 IBLA 178, 186-87 (1988); Amoco Production Co., 78 IBLA 93, 100 (1983), aff'd, Amoco Production Co. v. Hodel, 627 F. Supp. 1375 (W.D. La. 1986), vacated and remanded, 815 F.2d 352 (5th Cir. 1987), cert. denied, 108 S. Ct. 2898 (1988).

Rather, the only question raised by these appeals concerns the propriety of MMS' assessment of additional royalties for the sale of liquid products derived from the processing of natural gas produced from appellant's leases. Specifically, appellant contends that application of the Procedure Paper to periods before it existed is an unconstitutional ex post facto application of a law or regulation and that appellant's method of determining fair market value was just as effective as the Procedure Paper method.

[1] On numerous occasions we have reviewed and rejected arguments that application of the Procedure Paper constituted a retroactive application of a new rule. Thus, in Conoco Inc., 110 IBLA 232 (1989), we rejected an assertion that the Procedure Paper constituted a substantive rule which had not been properly promulgated, noting that it "merely clarified the existing regulations by setting forth a yardstick by which MMS would measure the reasonableness of royalty values reported by lessees." Id. at 242. Similarly, in Amoco Production Co., 112 IBLA 77 (1989), we noted that "the Procedure Paper itself relies on the factors set forth in the regulation--the lessee's price, regulated prices, posted prices and gross proceeds." Id. at 81. Most recently in Cities Service Oil & Gas Corp., 113 IBLA 255

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<sup>6/</sup> Appellant also repeats its request that the Director authorize a suspension of the payment of the late payment charges. However, appellant does not challenge the Assistant Director's failure to act on its request or otherwise direct itself to the Board. Accordingly, we will not address this issue.

(1990), we expressly rejected the contention that any question of retroactivity was involved in the application of the Procedure Paper to cases such as the one at bar:

The problem for appellant, however, is that the requirement that it tender royalty on fair market value of the NGLP's which it produces has always been in existence. The regulation on which such a determination was to be made stayed the same. The factors to be considered remained constant. If, in point of fact, the Procedure Paper has devised a technique which correctly ascertains fair market value in accordance with the statute and regulations, appellant has no cause for complaint based on considerations of retroactivity since appellant has always been required to tender royalty on that basis. In other words, where Government acceptance of the tender of royalties is made subject to post audit, the mere recomputation of royalty payments due to the Government to correctly reflect fair market value of NGLP's does not constitute imposition of a penalty or give rise to an issue of retroactive application of a new rule. [Footnote omitted.]

Id. at 261. This case simply does not involve a retroactive application of a new rule. Rather, it involves a determination by MMS as to whether Shell's valuation of the NGLP's constituted fair market value under the regulations in existence at the time that the payments were made. Accordingly, Shell's assertion that application of the Procedure Paper constitutes an ex post facto application of a regulation must be rejected.

Shell argues that based on an average for the entire audit period, the prices utilized by appellant were not less than the average price established by the Procedure Paper and that therefore, appellant's valuation technique was equal in effectiveness to MMS'. Appellant continues that it is being retroactively penalized "for failing to guess the ultimate fair market value 'yardstick' to be chosen by MMS" (SOR at 2).

[2] When a party challenges a determination as to the value of gas or oil produced from a lease with the United States, the party must establish that the methodology used is, in fact, erroneous. Sun Exploration & Production Co., 104 IBLA at 186. Shell does not show that the MMS methodology is erroneous, but only alleges that its own method is equally effective.

In Amoco Production Co., the lessee also argued that it was being penalized for not adopting the same pricing methodology as MMS. In that case we stated,

There is no penalty involved in these cases. Amoco is not being required to pay a penalty but is simply being assessed royalty on the fair market value of the NGLP's, as established by the Director pursuant to the applicable leases and regulations. The fact that appellant did not, for whatever reasons, calculate royalties using the same methodology MMS eventually used does not turn an assessment for underpayment of royalties into a penalty.

Amoco Production Co., 112 IBLA at 87. Like Amoco, Shell is not being penalized; it is simply being required to pay the fair market value as determined by MMS. Both the lease and the regulations place the discretion to set the fair market value with MMS and not with the lessee. Thus, appellant's argument that its valuation technique was equal in effectiveness to the MMS technique is not a basis for reversal.

[3] In Union Oil Co., 111 IBLA 369 (1989), Amoco Production Co., supra, and Conoco Inc., supra, we remanded assessments for recalculation of the royalty due. We held that when utilization of spot market prices is called for by the Procedure Paper and the lessee's price is less than the minimum yardstick value, it is improper for MMS to use the average of the high and low yardstick prices to determine the value of production. We held that in such cases the yardstick minimum should be the price employed. Herein, MMS applied the average yardstick price, rather than the minimum. Thus, the Director's decision is set aside to the extent that it affirmed use of the average spot market price where Shell's price fell below the yardstick value.

We find we must also remand this matter for a recalculation of the appropriate interest assessment. According to the March 19, 1987, decision by HRCO the interest bill of \$105,975.80 was prepared in accordance with 30 CFR 218.54, which calls for use of the interest rate specified by section 6621 of the Internal Revenue Code of 1954. 30 CFR 218.54(b) (1987). Authorization to utilize this interest rate arose from section 111 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. § 1721 (1982), which became effective on January 12, 1983.

[4] Although prior to passage of 30 U.S.C. § 1721 (1982), MMS was authorized by equity to assess interest in order to compensate the Department for the time value of money, Sun Oil Co., 91 IBLA 1, 48, 93 I.D. 95, 120 (1986), aff'd sub nom. Clark Oil Producing Co. v. Hodel, 667 F. Supp. 281, 292 (E.D. La. 1987), the interest rate authorized by 30 U.S.C. § 1721 (1982) is greater than necessary to compensate for the time value of money. It was the intention of Congress in passing FOGRMA that imposition of such high interest rates against those owing money to the United States would remove any incentive to hold the money and invest it rather than pay it on time. H.R. Rep. No. 859, 97th Cong., 2d Sess. 36, reprinted in 1982 U.S. Code Cong. & Ad. News 4290.

Thus, although MMS was authorized to assess interest prior to passage of FOGRMA, it was not authorized to assess interest at the rate specified by FOGRMA 7/ as it apparently did in computing appellant's interest bill.

7/ While our decision in Dugan Production Corp., 107 IBLA 91 (1989), might be amenable of the interpretation that we were affirming the imposition of the FOGRMA interest rates on pre-FOGRMA debt for the period prior to the adoption of FOGRMA, we believe that it is correctly construed as merely affirming the imposition of FOGRMA interest rates on pre-FOGRMA debt for that period of time subsequent to the adoption of FOGRMA. Hence, it is in accord with the decision herein.

Therefore, the Director's decision is set aside to the extent that it affirms assessment of interest at the post-FOGRMA rates for those periods prior to passage of FOGRMA, and this matter is remanded for recalculation of the interest assessment in a manner consistent with this decision.

Appellant has requested oral argument and a hearing. However, appellant has not demonstrated that oral argument would permit a fuller presentation of its case than the briefs already submitted or that there is a material issue of fact which must be explored at a hearing. Accordingly, we deny appellant's requests.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decisions appealed from are affirmed in part, set aside in part and remanded for action consistent with this opinion.

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John H. Kelly  
Administrative Judge

I concur:

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James L. Burski  
Administrative Judge