

MOBIL OIL CORP.

IBLA 88-218 Decided August 7, 1990

Appeal from a decision of the Director, Minerals Management Service, affirming an order requiring the payment of additional royalties on gas produced under an Outer Continental Shelf oil and gas lease (MMS 86-0182-OCS) and upholding an order assessing late payment charges (MMS 86-0419-OCS).

Set aside; hearing ordered.

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

The regulated ceiling price of gas under the Natural Gas Policy Act (NGPA) is a relevant factor in determining the value of the gas for royalty purposes. Where an assessment of additional royalty after audit is based on a failure of the producer to file a timely application for classification of the gas under sec. 102 of the NGPA (allowing a higher ceiling price), and where the record discloses an issue of material fact concerning whether the producer knew or should have known the gas would qualify for a higher ceiling price at an earlier time, the case is properly referred for an evidentiary hearing.

APPEARANCES: W. R. Buck, Esq., Dallas, Texas, 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 GRANT

Mobil Oil Corporation (Mobil) appeals from a decision of the Director, Minerals Management Service (MMS), dated November 27, 1987, affirming two orders of the Tulsa Regional Compliance Office (TRCO). The first order required appellant to pay \$360,167.18 in additional royalties for gas produced from Federal offshore lease 054-002559 (also identified as OCS-G-2559). The second order assessed Mobil \$271,989.01 in late payment charges in connection with the underpayments.

This appeal arises out of a 6-year lookback audit performed by the firm of Coopers and Lybrand under contract with the Office of Inspector General (OIG), Department of the Interior. The audit scrutinized royalty payments on appellant's leases for the years 1977 through 1983. Federal Outer Continental Shelf (OCS) lease 054-002559, located in West Cameron Block 617, was issued effective May 1, 1974, and the well at issue, Well No. A-12B, was completed in September 1977. The audit revealed the existence of a question concerning the proper classification of Well No. A-12B under the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. §§ 3301-3432 (1982). The OIG referred this issue to MMS.

For the period beginning with the effective date of the NGPA in December 1978 through October 1984, appellant valued the gas produced from Well No. A-12B at the ceiling rate established by section 104 of the NGPA, 15 U.S.C. § 3314 (1982). After the audit, by letter dated October 31, 1984, appellant applied to MMS for a determination that the gas qualified under section 102(d) of the NGPA, 15 U.S.C. § 3312(d) (1982), for a higher ceiling price, and received subsequent approval. Appellant began paying royalties based on the higher price in November 1984.

By order dated March 3, 1986, the TRCO determined that appellant had underpaid royalties for the period December 1978 through October 1984 because it had valued the gas from Well No. A-12B during that period at the lower NGPA section 104 price instead of at the higher NGPA section 102 price. As a result, appellant was required to pay an additional \$360,167.18 in royalties. By order dated July 1, 1986, the TRCO assessed appellant \$271,989.01 in late payment charges for the royalties due under the March 3, 1986, order.

Appellant appealed both of these orders to the Director, MMS. Mobil noted that the NGPA status of Well No. A-12B prior to November 1984 was based on Well No. 1, which had been completed prior to the drilling of Well No. A-12B. Appellant argued that Well No. 1, which was thought to be producible in the EH-1 Reservoir and which was classified as the discovery well for the West Cameron Block 617 A-12B, was drilled prior to the effective date of the NGPA of 1978. Accordingly, appellant asserted, the subsequent well was reasonably believed to be precluded from pricing under section 102. Appellant argued that its decision to value the gas from Well No. A-12B at the lower section 104 price was made prudently and in good faith based on its technical judgment concerning the status of the well. Mobil contended that it would be unfair to second-guess this judgment several years after the fact, since a reasoned decisionmaking process had been employed in good faith. Appellant asserted that no interest charges should have been assessed because the additional royalties should not have been assessed.

By decision dated November 27, 1987, the Director, MMS, affirmed the assessment of additional royalties and late payment charges. The Director, noting that the Secretary has considerable discretion in determining the

value of production for royalty purposes and that the value may exceed the actual sale price, held that the regulated price is one of the factors to be considered in determining the value of production. The Director found that the gas produced from Well No. A-12B qualified for the higher section 102 price from the date of first production, and that appellant could and should have applied for that price instead of using the lower section 104 price.

Although the Director accepted appellant's assertion that it acted in good faith even though it failed to sell the gas for the higher section 102 price, he emphasized that the royalty value of production from Federal leases may be greater than the sale price when the sale price does not equal the true value of the gas produced. In short, the Director found that "[a]ppellant's mistaken belief that it was charging the highest allowable price for its production, even though held in good faith, does not relieve it of its responsibility to pay royalties based on the actual value of that production as determined by the Secretary" (Decision at 3-4).

The Director determined that the applicable NGPA ceiling price was the proper value of the gas for royalty purposes. He noted that appellant's sales contract for the gas at issue provided for the sales price to be not less than the applicable ceiling price established by the Federal Power Commission or any successor agency. <sup>1/</sup> The Director stated that appellant should have sought an NGPA section 102 determination when the NGPA became effective in 1978 instead of waiting until 1984 to file for such a determination. He further found that appellant had been informed that the applicable NGPA ceiling price would be considered the value of the gas for royalty purposes by letter dated July 5, 1979, from the Geological Survey (GS), MMS' predecessor agency, which stated that "the value for computing royalties shall be based upon \* \* \* the applicable FERC-approved sales price." Because appellant failed to pay royalties based on the appropriate NGPA ceiling price, even though that failure was based on a good faith error, the Director denied appellant's appeal of the additional assessment.

The Director further denied the appeal of the interest assessment because appellant's only argument pertaining to the late payment charge was that the underlying royalty assessment was erroneous. Because the additional royalties were held to be properly assessed, the Director affirmed the interest charges as well.

In the statement of reasons (SOR) for appeal, appellant initially explains the rationale for its 1978 conclusion that Well No. A-12B did not qualify for section 102 ceiling prices:

Prior to the enactment of the NGPA, well No. 1 was drilled and, based upon information available at that time, was determined to

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<sup>1/</sup> The responsibilities of the Federal Power Commission have now been assumed by the Federal Energy Regulatory Commission (FERC).

be producible in the EH-1 Reservoir, and was categorized as the discovery well for West Cameron Block 617. [2/] Subsequent to the drilling of the No. 1 well, [Well No. A-12B] was drilled into this same reservoir. Because of the conclusions reached with respect to the No. 1 well, Mobil believed [Well No. A-12B] to be effectively excluded from Section 102(d) status under the NGPA. [3/]

(SOR at 2).

Appellant further asserts that

[i]n 1984, after accumulating several years of producing history from the No. 1 well, the well logs were re-analyzed and the No. 1 well was redetermined in accordance with OCS Order No. 4. [4/] Essentially, it was determined that the No. 1 well was not capable of production from the EH-1 Reservoir and could no longer be classified as the discovery well for that reservoir. Consequently, [Well No. A-12B] then qualified for Section 102(d) status and Mobil commenced paying royalties based upon the higher rates.

(SOR at 2).

Appellant contends that MMS erred in assuming that it had complete knowledge of all the facts and simply failed to act on that knowledge. Because oil and gas production is not an exact science and oil companies are still unable to make precise determinations as to what is physically true several thousand feet below the surface, appellant argues, this is not a case where it knew that it was entitled to a higher price, but neglected to act. It asserts that it acted prudently based upon the information available to it, and that when new information became available it acted promptly to obtain the higher price for its own and the Government's benefit. Appellant further states that it did comply with the instructions of the GS in its July 5, 1979, letter. Accordingly, appellant requests that the Board reverse MMS' decision.

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2/ Appellant's Oct. 31, 1984, letter to MMS requesting classification of well No. A-12B under section 102 of the NGPA indicates that the earlier classification of the gas well under section 104 was based "on penetration of the reservoir by OCS-G-2559, Well No. 1, July 16, 1974."

3/ Section 102(d) provides in part that gas produced from an OCS lease issued before the enactment of the NGPA (an old lease) "shall qualify for the new natural gas ceiling price if such natural gas is produced from a reservoir which was not discovered before July 27, 1976." 15 U.S.C. § 3312(d)(1) (1982).

4/ OCS Order No. 4, effective Aug. 28, 1969, describes standards for determining whether a well on an OCS lease is capable of producing oil or gas in paying quantities. See OCS Order No. 4 (Revised), 44 FR 76231 (Dec. 21, 1979) (effective Jan. 1, 1980).

In its answer, MMS argues that appellant's belief that the well did not qualify for section 102 prices does not excuse it from paying royalty on the full value of the gas produced from the well. MMS notes that the leasing statute, the regulations, and the lease terms reserve to the Secretary considerable authority to establish reasonable value for royalty purposes. Furthermore, MMS contends that it is not required to accept appellant's gross proceeds as value; rather, gross proceeds are the minimum value for royalty purposes.

MMS asserts that the Director considered all the factors set out in the regulations and determined that the highest regulated price was the best indication of the value of the gas for royalty purposes. MMS further contends that appellant's belief that it could not have sold the gas at a higher price is not sufficient reason to deprive the Government of the royalty to which it is entitled. MMS notes that appellant has the burden of demonstrating that MMS' royalty valuation is erroneous, and argues that, because the Director complied with the regulations and the lease in establishing royalty value, appellant cannot establish that the valuation method is, in fact, erroneous.

MMS additionally argues that appellant breached its duty to obtain the best price available by failing to obtain the higher section 102 price, and asserts that the fact that Well No. A-12B qualified for section 102 prices in 1984 indicates that appellant could have obtained this price in December 1978. MMS also contends that appellant's challenge to the late payment assessment must be rejected because MMS has the authority to assess interest on unpaid and underpaid royalties.

The Secretary of the Interior is authorized under the Outer Continental Shelf Lands Act, 43 U.S.C. § 1337 (1982), to lease OCS tracts for the exploration and development of mineral resources, including oil and gas. In passing this Act, Congress committed the Government to the goal of obtaining fair market value for offshore oil and gas resources. Watt v. Energy Action Educational Foundation, 454 U.S. 151, 162 (1981); Sun Exploration & Production Co., 104 IBLA 178, 184 (1988); Amoco Production Co., 78 IBLA 93 (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) (proper jurisdiction found to be in Claims Court), cert. denied, 56 U.S.L.W. 3891 (U.S. June 28, 1988) (No. 87-372).

The Secretary possesses considerable discretion in determining the value of production for royalty purposes. 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, 107 S. Ct. 1593 (1987); Texaco, Inc., 104 IBLA 304, 308 (1988); Amoco Production Co., supra at 96. That discretion is tempered only by the standard of reasonableness. Texaco Inc., supra at 310.

The regulations at 30 CFR 206.150 (1986) and its predecessor 30 CFR 250.64 (1978) guided the Secretary's exercise of this discretion during the

relevant time period. 5/ The regulation at 30 CFR 250.64 in effect at the time of the first sale of the gas from the lease until December 13, 1979, stated in pertinent part:

The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the supervisor, 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 or area, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any 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.

This regulation was revised effective December 13, 1979, to provide:

The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or a majority of like-quality products produced in the area or field; (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.

44 FR 61892, 61903 (Oct. 26, 1979). 6/

[1] It is well recognized that the value of gas for royalty purposes is not restricted to the actual price received by the lessee where a reasonable basis appears for the value determination. Amoco Production Co. (On Reconsideration), 94 IBLA 129 (1986), aff'd, Amoco Production Co. v. Lujan, 877 F.2d 1243 (5th Cir. 1989), cert. denied, 58 U.S.L.W. 3385 (U.S. Dec. 12, 1989) (No. 89-454); Supron Energy Corp., 46 IBLA 181 (1980), appeal pending, Supron Energy Corp. v. Watt, Civ. No. 0463 (D.N.M. filed June 18, 1980). It is also true that under the relevant regulation in effect since 1979 the regulated price is explicitly recognized as a

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5/ MMS significantly revised the regulations applicable to the valuation of oil and gas for royalty computation purposes effective Mar. 1, 1988. 53 FR 1184, 1230 (Jan. 15, 1988). These new regulations are not applicable to the case before us.

6/ This regulation was subsequently recodified as 30 CFR 206.150 (1986).

relevant factor in determining the value of natural gas. <sup>7/</sup> In a case involving the valuation of gas for royalty purposes under state law, the court held that the value of regulated gas is properly based on comparable sales of gas with the same legal characteristics and subject to the same price restraints of the relevant category of the NGPA. Bowers v. Phillips Petroleum Co., 692 F.2d 1015, 1020 (5th Cir. 1982). If the lessee were receiving less than the maximum ceiling price allowed under the NGPA, then valuation may properly consider the maximum Federal ceiling price. Id.

Section 102(d)(1) of the NGPA provides in pertinent part that "Natural gas determined in accordance with section 3413 of this title to be produced from an old lease on the Outer Continental Shelf shall qualify for the new natural gas ceiling price if such natural gas is produced from a reservoir which was not discovered before July 27, 1976." 15 U.S.C. § 3312(d)(1) (1982). Further, a reservoir is considered to have been discovered if

it was penetrated by a well before July 27, 1976, and the well was found capable of production in paying quantities under the requirements of OCS Order No. 4 approved by the Chief of the Conservation Division, GS, on August 28, 1969. 15 U.S.C. § 3312(d)(2) and (3) (1982). The producer has the burden of proof in establishing that gas produced from old (pre-NGPA) leases on the OCS is produced from a reservoir which was not discovered before July 27, 1976. 15 U.S.C. § 3312(d)(4) (1982). <sup>8/</sup> A Federal agency having regulatory jurisdiction with respect to production of natural gas

is authorized under the NGPA to determine whether natural gas produced from the OCS qualifies for the new natural gas ceiling price permitted by section 102. 15 U.S.C. § 3413 (1982). MMS has regulatory jurisdiction

over oil and gas royalty issues as well as oil and gas operations on Federal leases and, hence, appellant applied to MMS by letter dated October 31, 1984, for classification of the well as eligible for section 102 pricing. Further, it appears from 15 U.S.C. § 3413 (1982) that the regulated price did not become the higher section 102 price until the status of the reservoir was determined by MMS in response to appellant's application.

Accordingly, we find the real issue presented by this case is whether appellant has breached its duty to market the gas by failing to seek classification of the gas under section 102 at an earlier time. <sup>9/</sup> MMS contends

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<sup>7/</sup> Prior to the regulatory revision in 1979, the regulated price was also considered a relevant, although not necessarily dispositive, factor. See Wheless Drilling Co., 13 IBLA 21, 80 I.D. 599 (1973) (severance tax reimbursements properly added to Federal Power Commission approved price to determine value of gas).

<sup>8/</sup> With respect to an OCS reservoir penetrated by a well before July 27, 1976, the producer must establish that there was no production test or other evidence that the well was capable of producing in paying quantities from the reservoir in question. 15 U.S.C. § 3312(d) (1982).

<sup>9/</sup> We note an indication in the record that Mobil has only a one-third interest in the gas produced from the OCS lease at issue. The price paid for the balance of gas produced from this lease could be relevant to the issue of the proper valuation of appellant's gas.

that appellant could have had the well classified for section 102 pricing in December 1978. Mobil asserts that it acted as a prudent lessee on the basis of the information available to it and acted promptly to obtain the higher price when new information became available. Disposition of this case hinges on an issue of material fact which cannot be resolved on the basis of the factual record presently before the Board. In this situation, we find it necessary to set aside the decision appealed from and refer the case to the Hearings Division, Office of Hearings and Appeals, for assignment of an Administrative Law Judge to conduct an evidentiary hearing. See 43 CFR 4.415. The decision of the Administrative Law Judge shall be final for the Department in the absence of a further appeal by any party adversely affected thereby.

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 set aside and the case is referred to the Hearings Division, Office of Hearings and Appeals, for assignment to an Administrative Law Judge for the conduct of an evidentiary hearing.

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C. Randall Grant, Jr.  
Administrative Judge

I concur:

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David L. Hughes  
Administrative Judge