

WALTER VAN NORMAN, JR.

IBLA 90-100

Decided July 1, 1993

Appeal from a decision of the Director, Minerals Management Service, affirming on reconsideration a previous decision, which had affirmed an order of the Manager, Houston Regional Compliance Office, directing the payment of additional royalties on wet gas production from various Federal leases. MMS-87-0180-O&G.

Affirmed.

1. Oil and Gas Leases: Royalties: Wet Gas--Oil and Gas Leases: Royalties

Where applicable regulations require that the Minerals Management Service value wet gas production from a Federal lease on the greater of the gross proceeds accruing to the lessee from the sale thereof or the aggregate value determined by the Secretary of all the commodities, including residue gas, a valuation determination that royalty shall be paid on the value of one-third of all liquids extracted from the gas and 100 percent of the residue gas must be affirmed.

APPEARANCES: K. Ray Campbell, Esq., Houston, Texas, for appellant; Howard W. Chalker, Esq., Peter J. Schaumberg, Esq., and 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 BURSKI

Walter Van Norman, Jr., has appealed from a decision of the Director, Minerals Management Service (MMS), dated September 14, 1989, denying reconsideration of a June 22, 1988, decision of the MMS Director requiring the payment of additional royalties in the amount of \$18,244.48 for production attributable to Federal leases Nos. 048-220694-D, 048-316841-A, and 049-015520-A in Boggy Creek field, Wyoming. For reasons set forth below, we must affirm the decision assessing increased royalties.

In his June 22, 1988, decision, the MMS Director had affirmed a March 19, 1987, order of the Manager, Houston Regional Compliance Office (HRCO), determining that Van Norman had underpaid royalties on casinghead gas production from the subject leases in the amount of \$18,244.40 because

Van Norman had valued the production based on 50 percent of the proceeds of the sale of the residue gas and 50 percent of the proceeds of the sale of the natural gas liquid products (NGLP's), in accordance with his sales contract with MGPC, Inc., the operator of the Newcastle Gas Plant. ^{1/} Relying on various provisions of the regulations (e.g., 30 CFR 206.105(c) (1987) and 30 CFR 206.106 (1987)), ^{2/} the Regional Manager had determined that appellant was required to tender royalties based upon 100 percent of the value of the residue gas and one-third of the value of the NGLP's extracted, resulting in a deficiency in royalty payments of \$18,244.48 for the period from December 1982 (the start of sales to MGPC) through August 1984.

In affirming the HRCO determinations, the MMS Director did not challenge appellant's assertion that it had, in fact, tendered royalties based on the payments which it actually received from MGPC, nor did he contravene appellant's assertion that all production from the Boggy Creek field was processed under similar contracts because there was no market at the field and the Newcastle plant provided the only market for the casinghead gas. Rather, the MMS Director relied on the applicable language of the regulations in affirming the HRCO decision.

Citing Hoover & Bracken Energies, Inc., 52 IBLA 27, 88 I.D. 7 (1991), aff'd, 723 F.2d 1388 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984), the Director noted that, under 30 CFR 206.103 (1987) and section 2(d) of the standard Federal oil and gas lease form, the Secretary is afforded broad authority to determine the reasonable value of production and the exercise of this authority has been upheld in a number of cases. In addition to this general declaration of authority, however, the Director also pointed out that specific regulations were applicable to casinghead gas. Thus, after first citing 30 CFR 206.105(a) (1987) which provided that "royalty accrues on dry gas, whether produced as such or as residue gas after the extraction of gasoline," the Director then focussed on 30 CFR 206.105(c) (1987) and 30 CFR 206.106. The former provided that: "For the purpose of computing royalty, the value of wet gas shall be either the gross proceeds accruing to the lessee from the sale thereof or the aggregate value determined by the Secretary of all commodities, including residue gas, obtained therefrom, whichever is greater." The latter provision, 30 CFR 206.106 (1987), declared, in relevant part, that:

^{1/} Appellant's contract is generally referred to as a "percentage of proceeds" contract. See, e.g., Amoco Production Co., 126 IBLA 124 (1993); Kerr-McGee Corp., 106 IBLA 72 (1988).

^{2/} We note that, effective Mar. 1, 1988, the Department substantially revised the regulations relating to gas valuation for royalty purposes. See 53 FR 1230 (Jan. 15, 1988). These provisions, however, operate only prospectively, covering the value determinations of gas produced on or after Mar. 1, 1988. See BWAB Inc., 108 IBLA 250, 257 n.2 (1989). All references in the text will be to the regulations as they existed prior to these revisions.

A royalty as provided in the lease shall be paid on the value of one-third (or the lessee's portion if greater than one-third) of all casing-head or natural gasoline, butane, propane, or other liquid hydrocarbon substances extracted from the gas produced from the leasehold. The value of the remainder is an allowance for the cost of manufacture, and no royalty thereon is required. The value shall be so determined that the minimum royalty accruing to the lessor shall be the percentage established by the lease of the amount or value of all extracted hydrocarbon substances accruing to the lessee under an arrangement, by contract or otherwise, for extraction and sale that has been approved by the Associate Director.

The effect of the foregoing provisions, the Director declared, was to require that MMS compare the gross proceeds accruing to the lessee with the value of the various commodities separated at the processing plant (100 percent of the residue gas and one-third of the NGLP's) and assess the royalty based on the method which resulted in the higher royalty payment. Since, in this case, greater royalty would accrue under the aggregate value approach, the Director held that Van Norman was properly directed to compute the royalties due on that basis.

Van Norman timely appealed the Director's decision to this Board. While that appeal was pending, the Board issued a decision styled Kerr-McGee Corp., 106 IBLA 72 (1988) (Kerr-McGee I), which also dealt with the question of royalty assessments on casinghead gas. That decision covered consolidated appeals involving, inter alia, a determination by MMS that royalty had been underpaid on certain casinghead gas which Kerr-McGee delivered to Koch Hydrocarbon Company (Koch) under a percentage of proceeds contract in which Koch paid Kerr-McGee 70 percent of the value it received for the residue gas, NGLP's, and sulphur recovered and sold. As he had herein, the MMS Director rejected Kerr-McGee's assertion that royalty should be tendered based on the gross proceeds which it received. Rather, the Director held that Kerr-McGee was required, consistent with 30 CFR 260.105 and 260.106 (1987), to tender royalty based on 100 percent of the value of the residue gas and one-third of the value of the NGLP's and sulphur.

In its decision in Kerr-McGee I, the Board reviewed at length the historical development of the Department's treatment of royalty assessments for wet gas production from Federal lands. See 106 IBLA at 76-81. ^{3/} Suffice it for present purposes to note that the Board concluded that, while it was clear that MMS was not bound to accept the contract price as the reasonable value of production, Kerr-McGee had raised factual issues concerning the application of both Notice to Lessees and Operators No. 5 (NTL-5), 42 FR 22610 (May 4, 1977), and the subsequently adopted Notice to Lessees Numbered

^{3/} An analysis of the historical conditions which led to the initial selection of the allowance of two-thirds of the NGLP's for the cost of manufacturing is set out in Exxon Corp., 118 IBLA 221, 248-49 n.26, 98 I.D. 110, 124 n.26 (1991).

5 Gas Royalty Act (NTL-5 Act), Act of January 6, 1988, 101 Stat. 1719, particularly with respect to the valuation of the residue gas component of the royalty assessment, 4/ which required that the matter be remanded for further clarification and reconsideration by MMS.

On March 6, 1989, following the decision in Kerr-McGee I, MMS filed a motion in the instant case, requesting that the Board set aside the Director's decision of June 22, 1988, and remand the matter to it for further consideration in light of the NTL-5 Act and the decision in Kerr-McGee I. By order dated April 28, 1989, the Board granted this request.

Upon receipt of the case file, MMS conducted a review of the issues involved in the context of the NTL-5 Act. By order dated September 14, 1989, the Director denied the appeal on reconsideration. In this order, the Director noted that the unit values used by MMS to compute the royalty due on the residue gas were the values actually received by MGPC and tendered to Van Norman. Thus, no revision was required in light of the NTL-5 Act. Accordingly, the Director reaffirmed his original decision. Van Norman timely appealed from this order. 5/

4/ Under NTL-5, the Department had determined that, except for sales from wells commenced prior to June 1, 1977, and which were subject to arm's-length contracts entered into prior to that date, the base value for natural gas sold in interstate sales would be the higher of the price received by the lessee or the highest applicable ceiling rate then established by the Federal Power Commission (which became, after the adoption of the Natural Gas Policy Act (NGPA), 15 U.S.C. §§ 3301 to 3432 (1988), the maximum lawful price established under the NGPA). On Aug. 1, 1986, recognizing the significant decline in gas prices below the maximum legal price established under the NGPA, the Department prospectively amended NTL-5 to permit valuation of gas production under 30 CFR Part 206, rather than the more restrictive NTL-5 provisions. Thereafter, the NTL-5 Act directed that the 30 CFR Part 206 valuations be retroactively applied to production from Federal and Indian leases for the period from Jan. 1, 1982, through July 31, 1986. It is clear that, in setting aside and remanding the decision in Kerr-McGee I, the Board was uncertain as to whether or not the gas valuation used had been based on the highest applicable ceiling rate or on the price actually received by the lessee. As noted in the text, subsequent developments showed that the MMS valuation had been based on the latter. See Kerr-McGee Corp., 125 IBLA 279 (1993).

5/ Appellant's statement of reasons for appeal (SOR) filed subsequent to the denial of reconsideration is almost totally directed at what he perceives to be the disparate treatment of his appeal and that of Kerr-McGee. However, as is obvious from the discussion subsequently in the text of this decision, as the Kerr-McGee appeal was ultimately decided, there was no difference in the treatment of these two appellants. In his original SOR, Van Norman questioned the substance of the decision ordering recomputation of royalties and, in light of the fact that the remand of this case, at MMS's request, failed to alter any of the original predicates upon which MMS acted, we deem it appropriate to consider appellant's concerns as expressed in his original SOR.

[1] The Board has recently decided two separate appeals assailing the use of the aggregate value approach to determine value for royalty purposes in those circumstances in which the aggregate value computation resulted in a valuation greater than that obtainable under the gross proceeds approach. See, e.g., Amoco Production Co., 126 IBLA 124 (1993); Kerr-McGee Corp., 125 IBLA 279 (1993) (Kerr-McGee II). In both cases, the Board rejected challenges to this practice, noting that it was clearly in accord with the regulatory framework set out above and expressly holding that nothing in the NTL-5 Act mandated a differing result. These decisions are controlling herein.

As explained in these decisions, the evolution of regulatory practice with regard to royalty valuation of NGLP's has been premised on two considerations which have remained relatively unchanged since the adoption of the original regulations in 1920. See 47 L.D. 552 (1920). On the one hand, the Department has recognized the need to allow deductions for the reasonable cost of manufacture of NGLP's in determining royalty value, while, on the other hand, the Department has refused to bind itself to an unwavering acceptance of the proposition that the costs which a lessee has actually paid are necessarily the "reasonable costs" which must be allowed.

As the decision in Exxon Corp., supra, recounted, the residue gas obtained from processing was originally treated as a waste product and, thus, processing agreements were generally structured so as to provide payment for processing solely from the NGLP's, primarily casinghead gasoline. Thus, the initial regulations proceeded on the assumption that the payment for processing would usually consist of a retention by the processor of two-thirds of the NGLP's as payment in kind. 6/ See generally 47 L.D. 552-56 (1920). Aware, however, that situations might exist in which the actual contract provided for a lower in-kind payment to the processor, the regulations provided that where the lessee received a higher price than the equivalent of one-third of the value of the product, the royalty would be computed at the price received. Id. at 555.

Subsequently, as markets developed for natural (and residue) gas, the Department took care to expressly require that it receive royalties for residue gas when it was recovered and sold. See 52 L.D. 1, 10 (1926). These regulations also took note that "[a] royalty of 16 2/3 per cent shall be paid on the value as fixed by the Secretary of the Interior of one-third of all natural-gas gasoline extracted and sold from the natural gas produced on the leased land," and further provided that, if the lessee derived revenue from both residue gas and casinghead gasoline, royalty would be payable on both products.

In 1936, the oil and gas operating regulations were published in the Federal Register. See 1 FR 1996 (Nov. 20, 1936). As codified therein, the

6/ The two-thirds/one-third split was also in accord with the general contractual practice of that time. Id.

regulations provided that royalty on casinghead gasoline "shall be paid on the value of one-third (or the lessee's portion if greater than one-third) of all casing-head or natural gasoline extracted from the leasehold." Id. at 2001. While this regulation could be seen as attempting to express the Department's past pronouncements on valuation of NGLP's in a single sentence, this attempted compression contained within it the seeds of a future problem, since, as literally written, royalty was to be paid on the value of the lessee's portion of casinghead gasoline whenever the lessee's portion was greater than one-third.

Thereafter, in Instructions issued on June 7, 1937, the Acting Secretary, noting that changes in processing methods had, in some cases, resulted in lowering the charge assessed by processors below two-thirds of the NGLP's, reiterated that:

It is fundamental that a lessee's natural-gas production cannot be valued for royalty purposes at less than the net amount which the lessee actually realizes from his current disposals of such natural gas in the field. * * * It follows that the net field realization method of computing royalties so provided for and illustrated must be considered as placing a minimum limitation upon valuations arrived at by any other method of computation, and it follows also that a lessee may and should be required to pay his natural gas royalties upon the basis of the actual money value of such gas to him in the field whenever such actual values exceed the valuation arrived at by using the section 4 (d) formula for dry gas, casinghead gasoline, and drip gasoline as fixed by the Secretary of the Interior.

You are therefore instructed in computing royalties due the United States on natural gas, including its derivative products, to charge Government oil and gas lessees royalty either on the basis of the combined value of such products as measured by the lessee's gross field realizations less his actual extraction costs (net field realization value), or on the basis of the section 4 (d) formula, whichever may result in the higher valuation.

56 I.D. 462, 464-65 (1937). It is important to note, in this context, that the section 4(d) formula referenced above provided assessment of royalty on 100 percent of the natural gas production and for a flat two-thirds deduction for the cost of extraction of NGLP's, unmodified by language limiting the deduction to the portion actually charged by the lessor. Such a limitation would be redundant where, as subsequently provided in the Instructions, provision was made for use of the net field realization value as a floor for royalty assessments because application of the floor principle would, necessarily, result in higher royalty assessments whenever the processing charge was less than the standard two-thirds allowed.

So long as processing plants based their charges solely on the value of the NGLP's, it made no difference whether one applied the 1936 regulations which expressly limited the deduction for NGLP's to the amount actually charged or the 1937 Instructions which allowed a flat two-thirds reduction regardless of the amount actually charged but required use of the net field realization value as a floor value, since both approaches would recover any excess over the one-third portion assumed to be the normal return to the Government's lessee. Anomalies did develop, however, as processors, in attempting to protect themselves from fluctuating markets for natural gasoline, began to apportion processing costs to both the residue gas and the casinghead gasoline. Thus, if a processor retained 25 percent of both the residue gas and the casinghead gasoline, royalties would be computed under the 1937 Instructions based on the higher of the net field realization value or the section 4(d) formula, which would, in effect, permit the Government lessee to deduct his actual payments to the processor, up to the value of two-thirds of the NGLP's. ^{7/} However, if the 1936 regulations were used, the lessee would pay royalty on 100 percent of the residue gas but would be required to pay royalty on 75 percent of the NGLP's, since that was the portion which he had actually received. In essence, the 1937 Instructions would permit the lessee to deduct his actual costs of manufacture up to the two-thirds limit, whereas the 1936 regulations would permit the deduction of only that portion of the costs expressly allocated to the NGLP's in the contract between the lessee and the processor.

In 1947, the Department finally confronted this problem directly. In a memorandum to the Secretary dated January 29, 1947, the Director of the Geological Survey recounted the problem described above. Noting that, because of the benefits derived by the processors, it was likely that an increasing number of contracts would reflect the allocation of processing costs to both residue gas and NGLP's, the Director proposed that:

[I]n computing royalties due the United States on natural gas, including its derivative products, produced from any Federal oil and gas lease[,] that such royalty be computed on one of the following bases, whichever results in the greater royalty, whenever it appears to the satisfaction of the Geological Survey that the cost of manufacture is reflected in both gas and liquids retained by the processor.

1. The basis of the gross market value of all such products less extraction costs; or on

^{7/} Thus, if the total charges equalled or exceeded two-thirds of the NGLP's, the lessee would be permitted to use the section 4(d) formula. If they were less than two-thirds, the net field realization formula would result in a higher royalty and would serve as a floor for the lessee's royalty payments.

2. The basis of one-third of the gasoline, butane, propane, and other liquid substances extracted from the gas and all of the residue dry gas available for sale at not less than the established minimum prices. If no minimum prices have been established, the market value obtainable by the lessee shall be used.

(Memorandum of Jan. 29, 1947, at 3-4). On February 28, 1947, Secretary Chapman approved these recommendations. In effect, these guidelines directed the application of the 1937 Instructions in interpreting the 1936 regulations to royalty payments where the cost of manufacture was assessed on both the residue gas and the NGLP's. And while, through the period in question herein, the regulatory language never substantially varied from the 1936 regulations, the fact of the matter is that both Geological Survey and, when royalty collection responsibilities devolved to it, MMS, have consistently interpreted the language of 30 CFR 206.106 (1987) in accord with the approach approved by Secretary Chapman.

Thus, in the Kerr-McGee appeals, MMS rejected royalty payments computed on the basis of the amounts actually received by Kerr-McGee (gross market value less extraction costs) and, instead, assessed royalties on the basis of 100 percent of the residue gas and one-third of the value of the NGLP's, even though, under its arrangement with Koch, Kerr-McGee was actually paid 70 percent of the value of the NGLP's. A similar result obtained in the Amoco decision, which involved an identical arrangement between the appellant and Koch. And, in the instant appeal, MMS rejected the computation of royalties based on the monies paid to Van Norman by MGPC (gross market value less extraction costs), requiring him to tender the royalties based on 100 percent of the value of the residue gas and one-third of the value of the NGLP's, rather than one-half of the NGLP-value which might have arguably been assessed under a literal reading of the regulations. In short, the actions complained of herein were totally in consonance with the regulatory mandates which had guided Departmental royalty assessments since, at least, 1947. Inasmuch as the decision appealed is clearly consistent with the applicable regulations effective during the period under review, it must be affirmed.

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.

James L. Burski
Administrative Judge

I concur:

Kathryn A. Lynn
Administrative Judge
Alternate Member