

Appeal from a decision of the Acting Director, Minerals Management Service, affirming the denial of a request for a refund of royalties paid for various oil and gas leases. MMS-87-0136-O&G.

Affirmed.

1. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Payments

Federal Energy Regulatory Commission Order No. 94 reimbursements paid to a lessee by a pipeline purchaser for gas for certain production-related expenses, not included in the ceiling price for delivered gas, are properly considered part of the gross proceeds for purposes of calculation of royalties.

2. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Payments

Even where a lessee obtains Federal Energy Regulatory Commission Order No. 94 reimbursements for transportation of gas, the amount of the allowance properly granted is limited to the actual cost of the transportation of the gas which may not be coincidental with the reimbursement received.

APPEARANCES: Patricia Dunmire Bragg, Esq., Tulsa, Oklahoma, for appellant; Howard W. Chalker, Esq., and Peter J. Schaumberg, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE BURSKI

OXY USA Inc. (OXY) (formerly Cities Service Oil and Gas Corporation) has appealed from a decision of the Acting Director, Minerals Management Service (MMS), dated August 14, 1987, which had affirmed the denial of a request for a refund of royalties in the amount of \$1,355,019.01. These royalties had been assessed by MMS on cost reimbursements that OXY had received from purchasers of natural gas pursuant to section 110(a)(2) of the Natural Gas Policy Act of 1982 (NGPA), 15 U.S.C. § 3320(a)(2) (1988), and Federal Energy Regulatory Commission (FERC) Order No. 94. For reasons set forth below, we affirm.

Section 110 of NGPA, 15 U.S.C. § 3320(a)(2) (1988), allows a lessee who sells natural gas to recover costs incurred for "compressing, gathering, processing, treating, liquefying, or transporting * * * natural gas" from the purchasers of the gas. FERC implemented this provision of NGPA by promulgating FERC Order No. 94 which permitted reimbursement of certain production-related expenses even if such reimbursements would result in receipt by producers of monies above the maximum lawful ceiling price of the gas sold. MMS, for its part, took the position that these reimbursements constituted part of gross proceeds under 30 CFR 206.150 (1985) and, hence, were royalty bearing. Accordingly, MMS directed that these reimbursements be added to the sales price in determining the amount of royalty due to the United States. OXY complied with this directive but subsequently filed a request for a refund of the royalties attributable to the reimbursements. By final order dated February 23, 1987, the Regional Manager, Tulsa Regional Compliance Office (TRCO), denied OXY's request. OXY thereupon filed an appeal with the Director, MMS, pursuant to 30 CFR Part 290. Inasmuch as the actual basis and scope of OXY's request for refund is a matter of controversy at the present juncture, we shall set forth OXY's contentions before the Director in some detail.

In its statement of reasons (SOR) accompanying its notice of appeal, OXY merely stated that it "disagrees with the denial as it is not obligated to pay royalty on FERC 94 proceeds under Federal oil and gas and Indian leases." See Notice of Appeal, dated Mar. 24, 1987, at 2. This, of course, was simply a declaration that OXY thought the decision below was in error, not an explanation of why it thought so. The real statement of its reasons for appealing was contained in OXY's supplemental SOR filed on August 23, 1987.

In its supplemental SOR, OXY challenged the assertion by MMS that the reimbursements which it received under FERC Order No. 94 were properly considered to be royalty-bearing. Starting with the proposition that both the Outer Continental Shelf Lands Act (OCSLA), 43 U.S.C. §§ 1331-1356 (1988), and the Mineral Lands Leasing Act of 1920 (MLA), as amended, 30 U.S.C. §§ 181-287 (1988), impose royalties only on the value of production, OXY first argued that, historically, both Acts limited the determination of the value of production to the value at the wellhead of production removed or sold. ^{1/} Appellant noted that "[i]n many cases, however, there is no market for the product at the well * * * and the lessee must incur the expense of making the product marketable and/or delivering it to a market where it can be sold" (SOR at 6-7). Appellant argued that, in virtually all jurisdictions, "[C]ourts have held that royalty owners must bear a proportionate share of these post-production expenses" (SOR at 7).

^{1/} Admittedly, section 8(a)(1) of OCSLA, 43 U.S.C. § 1337(a)(1) (1988) based royalty on "the amount or value of production saved, removed or sold from the lease," but appellant argued that the inclusion of the word "saved" did not essentially vary the meaning of the phrase, at least insofar as the fact that valuation was to be determined by the value of the production at the wellhead.

Appellant recognized that the immediate issue "involves the somewhat different question of whether reimbursements allowed under NGPA and FERC regulations are subject to royalty," but argued that court decisions allowing deductions from royalty payments for post-production expenses were relevant because: (1) they show that courts have recognized that it is the value of the production at the wellhead, as opposed to any increased value attributable to post-production services, which determines the lessee's royalty obligations; (2) they indicate that even though the lessee does have the obligation to market any oil or gas produced, this does not mean that the royalty interest can escape bearing its proportionate share of the costs of such services; and (3) they show that "courts have recognized that the production-related services for which reimbursements are allowed under the NGPA and FERC regulations, *i.e.*, delivery (gathering and transportation), compression, treatment, liquefaction and conditioning, are services that occur after production, and, thus, that the value of these services form no part of the value of production on which royalties must be paid." Id. at 7 (emphasis in original).

OXY then proceeded to review numerous cases which, it asserted, were supportive of the general principles delineated above. ^{2/} Appellant recognized that the Department had taken the position that the lessee was obligated to put the product in a marketable condition (see The Continental Co., 66 I.D. 54 (1959)) and that, at least insofar as compression costs were concerned, this interpretation had been upheld in California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961), but OXY contended that this determination was contrary to the generally prevailing rule in the industry, suggesting that the decision in Marathon Oil Co. v. United States, 604 F. Supp. 1375 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), had undercut the rationale of the Department's position.

Finally, OXY argued that:

Even if it cannot be concluded that, as a matter of statutory interpretation, royalties can be imposed only on the value of the product at the wellhead or that, as a matter of regulatory interpretation, the proceeds received by a lessee as reimbursement for production-related services are not proceeds received for the sale of gas, the FERC has determined that these services are separate and distinct from any production that is sold * * * and [OXY] submits that a consideration of all relevant factors should lead the DOI to the same conclusion.

^{2/} Appellant did criticize two Kansas decisions (Gilmore v. Superior Oil Co., 192 Kan. 388, 388 P.2d 602 (1964), and Schupbach v. Continental Oil Co., 394 P.2d 1 (1964)), as well as a statement appearing in Merrill on Covenants Implied in Oil & Gas Leases, 2d ed., § 85, at 214, upon which the Gilmore court relied for its conclusion that compression costs were not chargeable to the royalty interest, as contrary to the weight of authority on this question. But see California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961).

(Supplemental SOR at 18). The thrust of this argument was that, based on an analysis of the legislative history of section 110 of NGPA, 15 U.S.C. § 3320 (1988), OXY concluded that the purpose of this provision was to permit reimbursements for services that "were considered to have value separate and apart from the value of the gas that was being sold," even if they resulted in total compensation in excess of the maximum allowable ceiling price. Thus, to the extent that FERC had authorized the allowance of reimbursements for the costs involved herein, this constituted a determination by FERC that these services were separate and distinct from the production that was being sold, contrary to the position of TRCO (Supplemental SOR at 19-20).

The Regional Manager, TRCO, responded to OXY's supplemental SOR by memorandum dated May 29, 1987. In this memorandum, the Regional Manager restated his conclusion that, since the reimbursements for production-related services constituted part of the gross proceeds received from the sale of the natural gas, they were necessarily royalty-bearing under 30 CFR 206.150 (1987). Thereafter, OXY filed a response, dated July 9, 1987. In this response, OXY asserted that MMS had failed to address a major portion of its argument: "MMS does not address the argument that if such proceeds are included in the value of the production, deduction should be allowed from the royalty basis for the reasonable cost of production related, *i.e.*, post-production services." This response concluded by noting that "[a] substantial portion of [OXY's] Supplemental Statement of Reasons dealt with the overwhelming case law which allows deductions of such post-production costs for gathering, compression, treating, dehydration, etc. The MMS has failed to address these arguments" (Letter of July 9, 1987, at 3).

As noted above, by decision dated August 14, 1987, the Acting Director, MMS, denied OXY's appeal, holding that "marketing costs, like production costs, do not qualify as a deduction from the lessee's gross proceeds received. * * * In this case the pipeline purchaser is paying for the gas in marketable condition; therefore, the gross proceeds constitute royalty value." OXY then pursued an appeal to this Board.

As it was before the Director, MMS, the bulk of appellant's arguments before the Board were contained in a supplemental SOR. The first 18 pages of this document generally tracked the supplemental SOR filed before MMS. However, this SOR also contained a considerably more extensive discussion of California Co. v. Udall, *supra*, which included a lengthy exegesis on the deductibility of transportation and gathering costs. See Supplemental SOR at 24-26. OXY concluded by noting that "[p]roceeds received pursuant to FERC Order No. 94 are reimbursements for the lessee's post-production costs, the cost of services, and are not consideration for the disposition of the gas" (Supplemental SOR at 36).

Subsequent to the submission of appellant's supplemental SOR, MMS filed a motion seeking to stay further action in a number of appeals involving royalty assessments for FERC Order No. 94 reimbursements, including the instant appeal. In support thereof, MMS noted, *inter alia*, that a lawsuit challenging MMS' position on this matter had been recently filed sub nom. Mesa Operating Limited Partnership v. United States Department of the

Interior, No. 88-0414 LC (W.D. La. filed Feb. 2, 1988) and requested that the Board stay further action on the referenced appeal pending the issuance of a final "nonappealable judgment." By order dated June 7, 1988, styled Pogo Producing Co., IBLA 87-717, the Board stayed consideration of the various appeals for 6 months. Thereafter, a number of other stays were sought and granted. By decision dated May 15, 1991, reported at 931 F.2d 318, the Court of Appeals for the Fifth Circuit affirmed a decision of the District Court entering summary judgment in favor of the Department.

Thereafter, by motion dated November 27, 1991, MMS sought to have the Board continue the stay in consideration, pending a ruling on a petition for a writ of certiorari filed with the Supreme Court by Mesa. On February 5, 1992, OXY filed a response to this request. While not opposing a further stay in consideration, OXY took strong exception to MMS' contention that "a final non-appealable decision in Mesa will be determinative or controlling as to the above-captioned appeals," at least to the extent that it covered the instant appeal. OXY asserted that it was pressing two discrete claims in the present proceedings:

(1) that the reimbursements it received pursuant to FERC Order No. 94 are not part of the gross proceeds upon which royalty may be assessed; and (2) to the extent that it may be determined that such reimbursements are a part of gross proceeds and subject to royalty, all or a portion of these reimbursements are reimbursements for post-production costs which are properly deductible against royalty as either transportation or processing allowances under the MMS's own regulations and policies and, thus, any royalty assessment can only be made after all such allowances have been deducted.

(Response to Motion for Stay at 2). Insofar as the first claim was concerned, OXY attempted to distinguish the Mesa decision by arguing that, in its appeal, Mesa had conceded that the reimbursements were for services performed to render the gas marketable. OXY argued that, unlike Mesa, it did not concede that the FERC Order No. 94 reimbursements were for services necessary to render the gas marketable. Such a determination, OXY suggested, could only be made on a case-by-case examination of each reimbursement. With respect to the second claim delineated above, OXY asserted that a number of the FERC Order No. 94 reimbursements were related to costs for which, under recognized Departmental precedent, allowances should be granted. OXY concluded by requesting that, since the deductibility of individual reimbursements should be initially determined by MMS, the matter should be remanded to MMS for such determinations. By order dated March 12, 1992, the Board granted MMS an extension of time in which to respond both to OXY's supplemental SOR and its request for a remand.

In response, MMS disputed OXY's contention that, because it challenged whether or not the reimbursements which it received were for services necessary to render the natural gas marketable, the decision in Mesa was not dispositive of whether the FERC Order No. 94 reimbursements were properly considered to be part of the "gross proceeds" for purposes of royalty valuation. Additionally, MMS opposed the remand requested by appellant, arguing

that the issue of whether a producer is entitled to a transportation or processing allowance was not related to the issue of assessing royalties on gross proceeds. MMS suggested that if OXY believed that it had incurred transportation and processing costs it should apply to MMS for an allowance, pursuant to procedures set forth in a June 18, 1992, "Dear Payor" letter sent to all royalty payors.

Finally, on September 10, 1992, OXY filed a second supplemental SOR. After noting that the appeal involved \$1,355,019.01 "in FERC 94 proceeds," this document informed the Board that, on August 14, 1992, OXY had filed with MMS requests for transportation allowances as shown in extensive attachments and requested that the Board consider the attached documents in its decision. ^{3/}

[1] As an initial matter, we must agree with MMS that the Court of Appeal's decision in Mesa forecloses any argument that FERC Order No. 94 reimbursements are not part of the "gross proceeds" as that term is used in 30 CFR 206.150 (1988). Even ignoring the fact that OXY's present assertion that it did not concede that the FERC Order No. 94 reimbursements were for services necessary to make the gas marketable does not completely accord with its prior submissions, ^{4/} a reading of the Court's opinion in Mesa makes the conclusion inescapable that the MMS treatment of all FERC Order No. 94 reimbursements as part of "gross proceeds" was affirmed by the Court. See Pogo Producing Co., 124 IBLA 76 (1992). OXY's assertion that components of the FERC Order No. 94 reimbursements covered services, such as transportation, for which even the Department has granted allowances in the past confuses the initial determination of what constitutes "gross proceeds" with the subsequent determination of what allowances a lessee will be permitted to subtract from the "gross proceeds" prior to computation of the actual amount of royalty owed to the United States. This distinction is expressly codified in the applicable regulations. Thus, 30 CFR 206.152(h) provides that: "Notwithstanding any other provision of this section, under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances

^{3/} While this second supplemental SOR noted that "[a]t issue in this case is the sum of \$1,355,019.01 in FERC 94 proceeds," the amount claimed in the attachment as transportation allowance was actually \$1,371,399.46. See Nitz, Attachment A, Schedules 12 and 13, Base Allowance Filings, Vol. 2. This was the result of the fact, as noted subsequently in the text of this opinion, that OXY's transportation allowance filings included requests for allowances not related to FERC Order No. 94 reimbursements.

^{4/} We must point out that appellant failed to make this assertion anywhere in the 20-page supplemental SOR which it filed with the Director, MMS. Moreover, some of its contentions therein, viz., that in virtually all jurisdictions royalty owners must bear a proportionate share of the cost of "making the product marketable" (Supplemental SOR at 6-7), are actually at odds with its present contention that it did not admit that the FERC Order No. 94 reimbursements were for the purposes of rendering the gas marketable.

determined pursuant to this subpart." It is clear both from this regulation and from the Court's decision in Mesa that the FERC Order No. 94 reimbursements must be considered to be part of the gross proceeds which OXY received and from which applicable allowances may be deducted, if warranted.

[2] Moreover, appellant's various submissions reveal a fundamental misconception of the nature of allowances permitted under the applicable regulations. Thus, the extensive documentation submitted by OXY with its second supplemental SOR shows that appellant is equating those components in the FERC Order No. 94 reimbursements which, it contends, were related to transportation costs with transportation allowances which may be deducted. There is, however, no necessary congruity between reimbursements which a lessee may receive from a purchaser for performing a service and the actual costs which the lessee has incurred in doing so. It is these latter costs for which an allowance is properly granted, not the total reimbursement received. Cf. Cities Service Oil & Gas Corp., 117 IBLA 17, 32-33, 97 I.D. 243, 252 (1990) (holding that appellant could not subtract the fees which it charged third-party producers for fractionation but must establish its actual costs of fractionation). It may be, of course, that the reimbursement actually does equate with allowable costs of transportation, but these costs are essentially independently established rather than being an outgrowth of the monies received by way of FERC Order No. 94 reimbursements.

Indeed, appellant's second supplemental SOR implicitly recognizes this dichotomy as its attached request for allowances does not merely consist of monies received under FERC Order No. 94, but also clearly includes claimed expenditures for which OXY was not reimbursed. See Nitz Affidavit at 2 ("I have calculated additional costs (over and above FERC 94 reimbursements) incurred by OXY for transporting gas to a processing plant and/or transporting gas to the point of royalty valuation."), Base Allowance Filings, Vol. 2. We must point out, however, that nothing in OXY's previous submissions can fairly be said to have placed the question of these allowances in issue in the matter presently under review. On the contrary, the present assertion of these allowances underscores the fact that appellant's original complaint was directed not towards obtaining recognition of allowances for transportation costs subsumed in FERC Order No. 94 reimbursements but rather to the inclusion of any of these reimbursements in its gross proceeds. The earliest that it can fairly be said that OXY's submissions embraced this alternate approach was in its response to the TRCO Manager's analysis of its supplemental SOR filed with the Director, MMS. It is clear that the Director, MMS, chose to ignore this contention in his decision and, in view of the late nature of its assertion, we cannot say that this was error, particularly since, as we have discussed above, any transportation allowance would not necessarily be coincidental with the FERC Order No. 94 reimbursement received therefor.

Accordingly, we conclude that MMS is correct in its assertion that OXY's request for recognition of transportation allowances may properly be treated as a matter discrete from the issue of the inclusion of FERC Order No. 94 reimbursements in gross proceeds, which was the issue decided below. That being the case, the proper course of action is to affirm the decision below since we have found that the Director, MMS, correctly held that FERC

Order No. 94 reimbursements were properly included in gross proceeds for royalty purposes. Appellant's request that we remand the matter for consideration of its request for transportation allowances is denied on the ground that this question is functionally independent of the matter decided herein and is properly considered in the context of the filings with MMS which OXY made on August 14, 1992, pursuant to the "Dear Payor" letter of June 18, 1992.

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 and appellant's request for remand is denied.

James L. Burski
Administrative Judge

I concur in the result:

Franklin D. Arness
Administrative Judge