<u>Editor's note</u>: Reconsideration granted; decision <u>reversed</u> by 132 IBLA 354 (May 11, 1995)

SHELL OIL CO.

IBLA 91-266 Decided August 1, 1994

Appeal from a decision of the Director, Minerals Management Service, requiring production of sales contracts and other documents concerning crude oil produced from Federal leases. MMS-90-0217-O&G.

Reversed.

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

Valuation standards established for crude oil not transferred by a Federal lessee under an arm's-length contract were governed by Departmental regulation 30 CFR 206.102(c), which required a producer who did not have arm's-length sales or post prices to use an arithmetic average of third-party posted prices for like quality oil in the same field to calculate royalty.

APPEARANCES: William G. Riddoch, Esq., Houston, Texas, for Shell Oil Company; 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 ARNESS

Shell Oil Company (Shell) has appealed from a March 1, 1991, decision of the Director, Minerals Management Service (MMS), denying Shell's appeal of an April 3, 1990, Royalty Compliance Division (RCD), MMS, order that required Shell to produce documents concerning crude oil produced from 32 Federal onshore oil and gas leases in California between January 1, 1985, and December 31, 1988.

Shell Western Exploration and Production Inc. (SWEPI), a wholly owned operating subsidiary of Shell, is the operator and designated royalty payor for the identified Federal leases. During the time in question, SWEPI sold all crude production from the leases to Shell pursuant to an agreement that established the price for crude oil purchases as either Shell's then applicable posted price as adjusted for quality and transportation costs or, if Shell had no posted price for the area or production type, the market price as reasonably determined by Shell. Shell posted no crude oil prices in

California during the audit period; therefore Shell relied on third party crude oil price posting to determine the market value of the oil it purchased from SWEPI and others during this period.

During a review of SWEPI's 32 Federal onshore leases in California conducted in accordance with section 205 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. § 1735 (1988), the California State Controller's Office (State) sought access to records concerning Shell's disposition of crude oil purchased from SWEPI. Shell denied the request, contending that the transaction between SWEPI and Shell constituted the point of royalty computation and that the agreement between SWEPI and Shell should be accepted as the measure of value. RCD thereupon issued the April 3, 1990, order, requiring records production.

RCD explained that when oil was transferred between affiliated companies, MMS policy required looking beyond transactions between affiliated companies to arm's-length sales so that values could be compared to determine value of production for royalty calculation. Because of the corporate relationship between SWEPI and Shell, RCD concluded that the transfers between SWEPI and Shell were not arm's-length transactions. Shell was therefore directed to produce documents showing the disposition of Federal lease crude oil production from the point where Shell took title to the oil, including pertinent sales contracts, exchange agreements, ledger entries, crude oil settlement statements, and pipeline schematics.

Shell appealed to the Director, MMS, arguing that while SWEPI's sale of the oil to Shell was a sale between affiliated companies, it nevertheless was a valid transaction resulting in a fair market price for the crude oil and that the State was not entitled to review records relating to Shell's disposition of the oil. Shell acknowledged that contracts between affiliated companies were not arm's-length contracts, but concluded that such contracts may nevertheless result in a fair market price. Shell asserted that since its prices were based on posted prices, which applicable regulations in effect both prior to March 1, 1988 (30 CFR 206.103 (1987)), and afterwards (30 CFR 206.102(c) (1988)) identified as appropriate values for royalty purposes, MMS needed to look no further than its own regulations to determine whether the prices paid by Shell accurately reflected the value of oil produced and sold by SWEPI. Shell contended that MMS should comply with the royalty valuation regulations rather than seek the records of Shell's disposition of crude oil purchased from SWEPI.

Both RCD and the State filed field reports addressing the issues raised by Shell. RCD contended that MMS had the authority to examine the documents sought from Shell, citing section 103(a) of FOGRMA, 30 U.S.C. § 1713(a) (1988), and 30 CFR 212.51, and that MMS needed to examine those records since without them it would be unable to determine gross proceeds accruing to the lessee, the minimum value for royalty purposes. RCD maintained that a lessee could not avoid the regulatory requirement that value for royalty purposes be no less than gross proceeds by transferring production to an affiliate who then sold the production to third parties, for in such situations the latter sale by the affiliate was a factor in establishing royalty computation value. RCD observed that, effective March 1, 1988, 30 CFR 206.102(b)(1)(i) (1988) provided that oil transferred to the lessee's marketing affiliate and later sold by that affiliate pursuant to an arm's-length contract would be valued at the price paid the marketing affiliate, and characterized this regulation as restating longstanding MMS policy that the point of royalty computation in such situations was the point of sale by the marketing affiliate. The State report also argued that the concept of gross proceeds was the basis for the document request, adding that since SWEPI and Shell were the same entity, gross proceeds needed to be measured at the point of sale to the first unaffiliated purchaser.

In reply, Shell argued that 30 CFR 206.102(b)(1)(i) did not apply because it dealt with arm's-length contracts and the contract with SWEPI was not such a contract. Shell also stated that it was not SWEPI's marketing affiliate, but rather an integrated producer, refiner, and marketer, distinguishing the instant case from another appeal to the Director, MMS, that was cited in support of the MMS and State position (and later decided as Santa Fe Energy Products Co., 127 IBLA 265 (1993)).

The Director, MMS, found that MMS had both the authority and the need to examine the information requested from Shell. In so doing, he found that gross proceeds accruing to the lessee constituted the minimum value for royalty purposes and concluded that a lessee could not avoid this requirement by transferring production to an affiliate who then sold the production to third parties, observing that in such cases the later sale by the affiliate established gross proceeds accruing to the lessee. The Director relied on his earlier decision involving Santa Fe Energy Products Company to buttress his finding that the transfer between SWEPI and Shell was not the proper point of royalty computation. According to the Director, the issue to be decided was whether the transfer between SWEPI and Shell, which was not made at arm's length, represented fair market value. He determined that this question could not be resolved without the information sought from Shell because without it MMS and the State were unable to make a reasonable determination of crude oil values for royalty purposes since the lessee's gross proceeds, the minimum value for royalty purposes, had not been established. The Director cited the Board's decision in Transco Exploration Co. & TXP Operating Co., 110 IBLA 282 (1989), appeal filed, No. 90-191-L (Cl. Ct. Mar. 1, 1990) (Transco), for his conclusion that the information sought from Shell was necessary to determine reasonable value. The Director did not rule on Shell's contention that it was not SWEPI's marketing affiliate, but found instead that 30 CFR 206.102(b), which pertained only to arm's-length contracts, did not apply to the transaction between SWEPI and Shell, and he thereupon denied Shell's appeal.

Shell frames the issue here on appeal as whether the price received by SWEPI from Shell, which is based on third-party posted prices for crude oil of like quality in the same field, represents the fair market value of such crude for royalty purposes under Departmental regulations. Resisting this approach, MMS relies upon the decision in Santa Fe Energy Products Co., supra, to support the Director's decision, contending that this case is not factually or legally distinguishable from Santa Fe, a case where production of sales documentation was required.

[1] Under section 103(a) of FOGRMA, 30 U.S.C. § 1713(a) (1988), purchasers of oil produced from Federal leases "through the point of first sale or the point of royalty computation, whichever is later," must establish, maintain, and provide any records, reports, or information reasonably required by the Secretary. Shell does not dispute that it is covered by these provisions; rather, it is contended that the point of royalty computation with respect to its crude oil purchases from SWEPI coincides with the point of the first sale of the oil from SWEPI to Shell, and not, as MMS contends, at the point where Shell disposes of the crude oil to third parties. The royalty valuation regulation in effect between January 1, 1985, and February 28, 1988, 30 CFR 206.103 (1987), authorized the Associate Director, MMS, to determine the reasonable value of production for royalty purposes giving due consideration "to the highest price paid for a part or for the majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters," and established that royalty value may never be less than gross proceeds accruing to the lessee from the sale of such production. In applying this regulation to situations where production has been sold pursuant to a non-arm's-length contract between affiliates, the Department will not assume the contract price represents fair market value of the production unless there are independent indicia that the contract price is fairly derived from the marketplace. Transco, 110 IBLA at 286 n.2, 322, 96 I.D. at 370 n.2, 389; Getty Oil Co., 51 IBLA 47, 51 (1980).

Regulations effective after March 1, 1988, while adopting gross proceeds as the floor value for royalty valuation purposes (30 CFR 206.102(h)), contain separate provisions for valuing production sold under arm's-length contracts (30 CFR 206.102(b)), and for production not sold under arm's-length contracts (30 CFR 206.103(c)). Transfers from a lessee to its marketing affiliate fall under 30 CFR 206.102(b)(1)(i) if the production is sold by the marketing affiliate pursuant to an arm's-length contract; the nature of the contract between the marketing affiliate and its purchaser determines whether 30 CFR 206.102(b)(1)(i) governs the valuation of production subject to that transaction. This rule does not apply here because the record does not show that Shell is "an affiliate of the lessee whose function is to acquire only the lessee's production and to market that production." 30 CFR 206.101. The preamble to revised royalty valuation regulations effective March 1, 1988, explains that application of the rule is limited to affiliates that purchase oil only from the lessee, observing that

> [i]f the affiliate of the lessee also purchases oil from other sources, then that affiliate's posted price or oil sales contract prices could be used in determining value if they satisfy the first benchmark [of 30 CFR 206.102(c)]. Also deleting the term "only" from the definition may require the lessee to track production much farther downstream than the point at which it can be valued under the benchmarks."

53 FR 1184, 1196 (Jan. 15, 1988). Because Shell is an integrated producer, refiner, and marketer of petroleum products who purchases crude oil to meet

refining needs, and not specifically for resale, Shell is not SWEPI's marketing affiliate, and the production sold by SWEPI to Shell pursuant to their non-arm's-length contract after March 1, 1988, must be valued in accordance with 30 CFR 206.102(c), which applies to oil production "not sold pursuant to an arms-length contract."

Third-party posted prices reflect a price that independent buyers in arm's-length transactions are willing to pay for production. See Getty Oil Co., 51 IBLA at 51, and cases cited. The royalty valuation regulations recognize the use of posted prices to determine royalty value in transactions that are not at arm's length by listing such posted prices as the second standard to be used in establishing such value. 30 CFR 206.102(c)(2). Since SWEPI, the lessee, does not post contemporaneous prices or have arm's-length sales contracts for like quality oil (see 30 CFR 206.102(c)(1)), the arithmetic average of contemporaneous third party posted prices for like quality oil in the same field establishes reasonable value for royalty calculation in this case under 30 CFR 206.102(c)(2).

MMS does not deny that third party posted prices represent reasonable value for royalty valuation purposes under the valuation regulations in effect either before or after March 1988. Rather, MMS contends that information concerning Shell's disposition of the production from the leases is necessary in order for MMS to determine gross proceeds accruing to SWEPI from lease production. Such information may be sought from a lessee's marketing affiliate in order to establish gross proceeds in accordance with both 30 CFR 206.103 (1987) and 30 CFR 206.102(b)(1)(i). See Santa Fe Energy Products Co., 127 IBLA at 265. Shell, however, is not SWEPI's marketing affiliate, and, contrary to the contention by MMS, this case is distinguishable from Santa Fe Products Co. for that reason, since in that case there was a transfer to a marketing affiliate. Under the regulations promulgated by MMS, royalty computation should be made using the applicable rule for transfers of production not made under an arms-length contract, 30 CFR 206.102(c).

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 reversed.

Franklin D. Arness
Administrative Judge

I concur:

Gail M. Frazier
Administrative Judge