TEXACO INC.

IBLA 91-283 Decided October 12, 1995

Appeal from a decision of the Director, Minerals Management Service, affirming an order of the Royalty Compliance Division assessing additional royalties on production from Federal onshore leases. MMS-89-0121-O&G.

Affirmed.

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

A Federal oil and gas lessee's duty to put gas produced from the lease into a marketable condition includes sweetening sour gas by removing hydrogen sulfide, and the costs of such treatment are not deductible from the value of the production for royalty computation purposes no matter who performs the treatment or whether title to the gas passes before the sweetening occurs. Where a contract for the purchase of natural gas produced from Federal leases provides that when sour gas is delivered the price paid will be equal to the price for sweet gas minus a fee for sweetening the sour gas, MMS properly disallows a deduction for the costs of sweetening the gas and values the gas production for royalty purposes at the price for sweet gas.

2. Administrative Authority: Generally--Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Generally--Statute of Limitations

A MMS demand for additional royalty on production from Federal onshore oil and gas leases is an administrative action not covered by 28 U.S.C. § 2415(a) (1988), which establishes a 6-year time limitation for the commencement of judicial actions for damages by the United States.

APPEARANCES: Nannette J. Crawford, Esq., Denver, Colorado, for Texaco Inc.; 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 BURSKI

Texaco Inc. has appealed from a decision of the Director, Minerals Management Service (MMS), dated March 1, 1991, denying Texaco's appeal of an August 21, 1987, Royalty Compliance Division (RCD), MMS, order assessing $1,184,937.04 in additional royalties on gas produced from nine Federal onshore oil and gas leases in the Table Rock Unit, Sweetwater County, Wyoming, during the period January 1980 through December 1984.

The gas produced by Texaco from the wells on its Federal leases in the Table Rock Unit is sour gas containing high levels of hydrogen sulfide which render it unsafe for consumer use until sweetened by treatment removing the hydrogen sulfide. Texaco sells the gas to Colorado Interstate Gas Company (CIG) pursuant to a gas purchase agreement dated April 6, 1967, as modified by an agreement dated September 15, 1980, and a settlement agreement and gas purchase agreement amendment both dated April 29, 1983. Insofar as the instant appeal is concerned, the relevant paragraph is No. 4 of the September 15, 1980, agreement which provides:

> 4. The price under both said Agreements [1/] for deregulated natural gas which is sour (hereinafter referred to as "sour deregulated natural gas") shall be adjusted downward to reflect CIG's cost of service to sweeten such gas at CIG's Table Rock Processing Plant (hereinafter referred to as the "plant"), which cost, exclusive of plant fuel gas costs, from November 1, 1979 through October 31, 1982 is agreed to be 80 cents per Mcf.

Paragraph 2 of the April 29, 1983, settlement agreement, which covered sales in the period commencing November 1, 1982, through October 31, 1983, provided that the established price during that period "shall be reduced by $.998 per Mcf for sweetening Texaco's deregulated sour as that is processed in CIG's Table Rock Gas Sweetening Plant." The gas purchase agreement amendment, executed contemporaneously with the settlement agreement, provided that the deregulated natural gas price would be subject to redetermination annually, but the record contains no indication that the price for Texaco's gas was modified during the remainder of the period at issue in this appeal.

The Wyoming State Auditor's Office, in accordance with section 205 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA),

1/ The "Agreements" referenced in paragraph 4 involved not only production from the Table Rock Unit Area (Gas Purchase Agreement # 332), but also production from the Higgins Unit Area (Gas Purchase Agreement # 728). Only the Table Rock production is involved in the instant case.

30 U.S.C. § 1735 (1988), conducted an audit of Texaco's Federal leases in the Table Rock Unit for the period January 1980 through December 1984. By letter dated April 15, 1987, the State Auditor informed Texaco of its preliminary determination that Texaco had underpaid the royalties due on the gas production because it had improperly computed and paid royalties on the value of the gas less the sweetening fee charged by CIG to remove the hydrogen sulfide from the sour gas stream. Although Texaco objected to the State Auditor's conclusion, RCD agreed with the State Auditor and prepared a demand letter and bill for collection (FBIL 22744048) on August 21, 1987. 2/ In its order, RCD concluded that the fees which CIG charged Texaco for CIG's costs to sweeten the sour gas production constituted costs incurred by Texaco to make the gas marketable and, thus, were not deductible from the value of the gas for royalty purposes. Accordingly, RCD directed Texaco to pay additional royalties in the amount of $1,184,937.04.

Texaco appealed RCD's order to the Director, MMS. Texaco characterized its contract with CIG as an arm's-length transaction whereby Texaco received the highest price possible for the gas, explaining that since CIG owned and operated the treating facility, CIG essentially bought untreated sour gas for a quoted net price. Texaco acknowledged that its agreement with CIG established the base price for deregulated natural gas and stipulated that the price for deregulated sour gas would be reduced by CIG's sweetening fee, and that the contract price was "predicated on the idea that the sales gas [would] be sweet, and a deduction [was] made for the treating fee." Texaco insisted, however, that, because the gas sales contract could have been structured so that the untreated gas was sold for a price equal to the contract's net price, the net price represented the actual market value of like quality (i.e., untreated) gas in the same field, thus satisfying MMS royalty valuation requirements. Texaco further contended that sweetening the gas enhanced the value of the sour gas and was not the type of production cost normally absorbed solely by the lessee since market value meant such value at the wellhead or lease and the market value of sweet gas differed from the market value of sour gas.

In his decision, the Director, MMS, rejected Texaco's contention that royalty payments were properly based on the gross proceeds less CIG's sweetening fee. He determined that the applicable regulations, 30 CFR 221.31 (1982) and 43 CFR 3162.7-1(a), as well as section V of Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases Number Five (NTL-5), 42 FR 22610, 22611 (May 4, 1977), required the lessee to place lease production into marketable condition and that, therefore, the value of production for royalty purposes was the

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2/ Although these documents were dated Aug. 21, 1987, MMS apparently did not transmit them to Texaco until Nov. 28, 1988, after resolution of the bankruptcy proceedings filed by Texaco on Apr. 12, 1987. See Letter of Dec. 20, 1988, from Texaco to RCD.

value of the product in marketable condition, with the lessee bearing the entire cost of placing the gas into such condition. The fact that the lessee paid a third party to sweeten the gas by accepting a reduction in the sales price did not alter the rule that the lessee could not reduce the value of the gas for royalty purposes by the costs incurred in rendering the gas marketable.

The Director also rejected Texaco's assertion that the sour gas produced from its leases was marketable without sweetening and that CIG's sweetening costs were, in essence, value-enhancement costs, not marketing costs. Defining marketable condition, in the context of Texaco's appeal, as requiring that the gas be placed in a condition which would allow it to be accepted by a high-pressure gas pipeline so that it could be transported to the normal commercial market for methane gas, the Director concluded that the untreated gas was not in a marketable condition since CIG would clearly not use the gas purchased from Texaco or other producers in the area until that gas had been sweetened. Thus, the Director continued, the untreated gas was not in marketable condition and the costs of the treatment necessary to render the gas marketable were not deductible from the sales price for royalty computation purposes, regardless of whether the buyer or the seller actually performed the requisite treatment. Accordingly, he denied Texaco's appeal.

On appeal to this Board, Texaco challenges the MMS assessment of additional royalties, insisting that the sour gas produced from its leases and sold to CIG was marketable as sour gas since CIG was willing to purchase the gas in its untreated form in conformity with industry custom. Texaco asserts that, while sweetening the gas may enhance its value by expanding the customer base, sweetening is not a prerequisite to placing the gas into marketable condition and, thus, the cost of sweetening the gas is not the type of normal production cost that must be borne solely by the lessee. Texaco contends that the price it received from CIG reflected the market price for gas of like-quality, i.e., the actual market value of untreated sour gas, and computing royalty payments based on that value fully satisfied Texaco's royalty obligations. It further maintains that the insistence by MMS that production be valued only after it has been placed in marketable condition directly conflicts with Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159 (5th Cir. 1988), which Texaco interprets as holding that royalty is due only on the value of the minerals as actually produced. Finally, Texaco argues that, in any event, the royalty assessment is partially precluded by 28 U.S.C. § 2415(a) (1988), which bars the United States from filing actions for money damages based on any contract more than 6 years after the right of action accrues, citing FOGRMA's 6-year statute of limitation for actions to recover penalties, 30 U.S.C. § 1755 (1988), as implicit proof that Congress intended to include royalties as contractual obligations within the purview of 28 U.S.C. § 2415(a) (1988).

In its answer, MMS maintains that it properly valued Texaco's gas because Texaco is not entitled to deduct from royalty value the costs required to place the gas into marketable condition which include the costs of sweetening sour gas. 3/ MMS avers that the applicable regulations, including NTL-5, and relevant court and Board precedent clearly establish the lessee's obligation to place production from Federal leases into marketable condition at no cost to the lessor, regardless of who performs the services necessary to put the production into such condition. MMS defines marketable condition in the context of this appeal as requiring that the gas be placed in a condition which allows it to be accepted by a gas pipeline so that it can be transported to the normal commercial market for methane gas and disputes Texaco's contention that the untreated sour gas is marketable as it comes from the well, noting that CIG cannot sell the sour gas until it has been sweetened. MMS also disputes the applicability of the 6-year statute of limitations in 28 U.S.C. § 2415 (1988) to this proceeding, asserting that the statute of limitations does not bar the Board from upholding the MMS order to pay additional royalties.

In a brief response, Texaco contends that MMS has mischaracterized its contract with CIG which, Texaco insists, provides two different prices for gas sold to CIG, one for sweet gas and one for gas sold in its natural sour state, thus establishing not only that there was a market for the unsweetened gas but also that CIG was willing to pay market value for such gas. Texaco does not dispute that the regulations require that the lessee place production into marketable condition; rather, it claims that it fully complied with those provisions since its gas was marketable pursuant to the terms of its contract with CIG, distinguishing factually the authorities cited by MMS and challenging MMS' expansive construction of the term "marketable."

[1] Resolution of this appeal turns on whether the costs of sweetening the sour gas produced from Texaco's Federal onshore oil and gas leases are costs necessary to place the gas into marketable condition and, therefore, not deductible from the value of production for royalty purposes. The Board recently addressed this issue in Apache Corp.,

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3/ Texaco has objected to consideration of the MMS answer on the ground that such answer was not timely filed. We note that the failure to file an answer will not result in a default under 43 CFR 4.414. Although the Board has the discretion under 43 CFR 4.414 to disregard an untimely filed answer, we generally will do so only where the appellant has been adversely affected by the delay in the filing of the answer. See Animal Protection Institute of America, 118 IBLA 345, 347 (1991); Catlow Steens Corp., 63 IBLA 85, 87 n.3 (1982); California Portland Cement Co., 40 IBLA 339, 342 (1979), reversed on other grounds, California Portland Cement Co. v. Andrus, 667 F.2d 953 (10th Cir. 1982); cf. James C. Mackey, 114 IBLA 308, 312-13 (1990) (the Board will not dismiss an appeal for failure to file a timely statement of reasons absent prejudice caused by the belated filing). Since Texaco has not alleged that it has been adversely affected by the late filing of the MMS answer, its objection is denied.

127 IBLA 125 (1993), upholding an MMS determination that the lessee must bear the full cost of removing hydrogen sulfide from sour gas production and that those costs are not deductible from the royalty basis. Therein, we noted:

> It is established that the lessee has the duty to put the gas in a marketable condition. See Mobil Oil Corp., 108 IBLA 216 (1989). That duty includes treating the gas to remove [hydrogen sulfide], and costs of that treatment are not deductible. Exxon Co., U.S.A., 121 IBLA [234, 247-48], 98 I.D. [409, 416 (1991)]; BWAB, Inc., [108 IBLA 250, 260 n.6 (1989)]; see also The Texas Co., 64 I.D. 76, 79-80 (1957). Reducing the royalty value by allowing a deduction for those costs would amount to a subsidy by the Government equal to the royalty rate times those costs. See California Co. v. Udall, 296 F.2d 384, 388 (D.C. Cir. 1961). [4/] It is irrelevant who performs the treatment or the activities necessary to place the gas in marketable condition, or that title may have passed from the Federal lessee prior to undertaking the activity necessary to place the gas in marketable condition. Exxon Co., U.S.A., 121 IBLA at 247, 98 I.D. at 416. Thus, MMS properly declined to reduce the royalty basis of the * * * gas by the amount expended in sweetening the gas. [Footnote omitted].

Id. at 134.

Although Texaco contends that its gas is marketable in its unsweetened state because CIG is willing to purchase the sour gas, the record amply demonstrates that CIG performs the sweetening solely to enable it to market the gas and that the price for the sour gas paid by CIG incorporates a reduction for CIG's sweetening fees. In this regard, we also note that Texaco's belated attempt to characterize the contract as establishing two different prices for its production, one for sweet gas and another for sour gas, is not borne out by the terms of its contract. On the contrary, paragraph 4 of the September 15, 1980, agreement clearly established a single price for natural gas, which price would be discounted if Texaco delivered sour gas to CIG. Indeed, in his March 31, 1989, letter to MMS, the Senior Coordinator - Regulatory Compliance for Texaco clearly confirmed this fact

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4/ Although Texaco contends that the validity of California Co. v. Udall has been undercut by the decision in Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159 (5th Cir. 1988), the Fifth Circuit itself has rejected the contention that Diamond Shamrock affects the legitimacy of the marketable condition rule and has reaffirmed the vitality of the requirement that the lessee value production for royalty purposes without any deduction for the costs of marketing the production. Mesa Operating Limited Partnership v. U.S. Department of the Interior, 931 F.2d 318, 325, 327 (5th Cir. 1991).

when he noted that "[t]he contract price is predicated on the idea that the sales gas will be sweet, and a deduction is made for the treating fee." 5/

Even if Texaco were successful in its belated attempt to characterize its contractual arrangement as one establishing a dual pricing system for natural gas, the ultimate result would not change. It is clear that there is no market for the sour gas; rather, CIG is willing to accept such gas and remove the hydrogen sulfide, itself, provided that Texaco pay for the costs incurred in sweetening the gas.

It is well established that, in the context of Federal leases, the removal of impurities such as hydrogen sulfide from the natural gas stream in order to render the natural gas marketable is the sole obligation of the lessee as part of its duties to market the production and the royalty interest cannot be burdened with any of the costs attendant thereto. See, e.g., Mesa Operating Ltd. v. United States Department of the Interior, 931 F.2d 318, 323-25 (5th Cir. 1991); R. E. Yarbrough & Co., 122 IBLA 217, 221 (1992). This obligation may not be defeated merely by "selling" untreated gas to another party, which then treats the gas to remove the hydrogen sulfide so as to make it marketable. On the contrary, as the Court of Appeals for the District of Columbia noted in California Co. v. Udall, supra, "there is a clear difference between 'marketing' and merely selling." Id. at 388. Until the gas is made marketable, the lessee has not discharged its responsibilities and the transfer or "sale" of untreated gas to a party which will treat the production does not serve to discharge this obligation. See Exxon Co., U.S.A., supra at 247, 98 I.D. at 416; Hoover & Bracken Energies, Inc., 52 IBLA 27, 88 I.D. 7 (1982), aff'd, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984).

These principles apply to the costs associated with sweetening the sour gas herein. Thus, CIG's willingness to purchase Texaco's sour gas for a price which includes a reduction for CIG's costs of removing the hydrogen sulfide from the gas does not establish that the sour gas was in marketable condition when it was sold to CIG or that the reduced price constitutes the reasonable market value of the production. 6/ Accordingly,

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5/ We would also point out that paragraph 4(e) of the April 29, 1983, settlement agreement between Texaco and CIG, which provides for a limited waiver of various operating specifications, including sulphur content, for two of the producing formations, authorizes the waiver only to the extent that CIG's sweetening plant remains capable of treating the sour gas so that the quality of the treated gas equals CIG's systemwide gas quality, thus implicitly acknowledging that the sour gas is not marketable until it has been sweetened.

6/ Although Texaco cites the definition of marketable condition currently found at 30 CFR 206.151, which provides that "lease products which are sufficiently free from impurities and otherwise in a condition that they will we find that MMS properly declined to allow Texaco to base its royalty computations on a value for the gas which included a deduction for sweetening costs.

[2] We further reject Texaco's contention that the 6-year statute of limitations at 28 U.S.C. § 2415(a) (1988) precludes part of MMS' demand for additional royalties. That section, which governs the time for commencing judicial actions brought by the United States, provides in part:

> Subject to the provisions of section 2416 of this title, and except as otherwise provided by Congress, every action for money damages brought by the United States or an officer or agency thereof which is founded upon any contract express or implied in law or fact, shall be barred unless the complaint is filed within six years after the right of action accrues or within one year after final decisions have been rendered in applicable administrative proceedings required by contract or law, whichever is later * * *.

28 U.S.C. § 2415(a) (1988).

This Board has held on numerous occasions that statutes establishing time limits for the commencement of judicial actions for damages on behalf of the United States do not limit administrative actions within the Department of the Interior which, in essence, seek to quantify those damages. See Chevron U.S.A., Inc., 129 IBLA 151, 154 (1994), and cases cited. We have further specifically refused to find that demands by MMS for additional royalties are precluded by that provision. Chevron U.S.A., Inc., supra at 154; Anadarko Petroleum Corp., 122 IBLA 141, 147-48 (1992), appeal filed Civ. No. 3-92-CV0885-T (N.D. Tex. May 1, 1992); Marathon Oil Co., 119 IBLA 345, 352 (1991); Forest Oil Corp., 111 IBLA 284, 286-87 (1989).

A demand for the payment of additional royalty is not a judicial action for money damages brought by the United States, but rather is

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fn. 6 (continued)
be accepted by a purchaser under a sales contract typical for the field or area" are in marketable condition, that regulation did not become effective until Mar. 1, 1988. In any event, 30 CFR 206.158(d)(1) expressly disallows a processing allowance for the costs of sweetening gas unless the removed acids are further processed into gas plant products. As MMS makes clear in the preamble to that regulation, "[p]ost-production costs for the services of gathering, separation, measurement, dehydration, compression, and sweetening are considered to be a requirement to place lease production into marketable condition, at no cost to the lessor." 53 FR 1230, 1267 (Jan. 15, 1988). The obligation to sweeten the gas is thus the result of regulatory direction and contractual assent and is not dependent upon the existence of any implied covenant to market the gas. See The Texas Co., supra.

an administrative action not subject to the statute of limitations. See S.E.R., Jobs for Progress, Inc. v. United States, 759 F.2d 1, 5 (Fed. Cir. 1985); Chevron U.S.A., Inc., supra at 154; Alaska Statebank, 111 IBLA 300, 311-12 (1989). We are without authority to decide whether the statute of limitations would bar a judicial suit to collect royalty deemed owing on a lease; such determination would be made by the court before which any collection proceeding is brought, assuming that the statute were pled. Marathon Oil Co., supra at 352; Alaska Statebank, supra at 312; see Phillips Petroleum Co. v. Lujan, 951 F.2d 257, 259-60 (10th Cir. 1991). None of Texaco's arguments persuades us that the 6-year limitation period in 28 U.S.C. § 2415(a) (1988) is properly applicable to administrative proceedings. 7/ We, therefore, hold that 28 U.S.C. § 2415(a) (1988) does not bar MMS from demanding that Texaco pay the entire amount of additional royalties found to be due for gas produced from its Federal leases in the Table Rock Unit for the period January 1980 through December 1984.

To the extent Texaco has raised issues not specifically addressed herein, we have considered and rejected them.

Accordingly, 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:

C. Randall Grant, Jr.
Administrative Judge

7/ Nor does the 6-year statute of limitations found at 30 U.S.C. § 1755 (1988), which, by its express terms, applies to actions to recover penalties under FOGRMA, affect this proceeding to assess royalties due and owing the Government. See Forest Oil Corp., supra at 286.