

VIERSEN & COCHRAN

IBLA 91-388

Decided November 9, 1995

Appeal from a decision of the Acting Deputy Commissioner for Indian Affairs, Bureau of Indian Affairs, affirming an order of the Dallas Area Compliance Office, Minerals Management Service, disallowing certain transportation allowances and directing the recalculation and payment of additional royalties due. MMS-90-310-IND.

Affirmed in part; vacated in part; and reversed in part.

1. Federal Oil and Gas Royalty Management Act of 1982: Royalties—Indians: Mineral Resources: Oil and Gas: Tribal Lands—Mineral Leasing Act: Royalties—Oil and Gas Leases: Royalties: Generally

In the absence of a market for gas at the wellhead where production would ordinarily be sold and valued, the Department may authorize the deduction of a transportation allowance from the market value of the gas to reflect the costs incurred in transporting the gas from the leasehold to the first available market.

2. Federal Oil and Gas Royalty Management Act of 1982: Royalties—Mineral Leasing Act: Royalties—Oil and Gas Leases: Royalties: Generally

Absent a determination either that crucial facts were not disclosed or that express regulatory provisions were violated, an order of the U.S. Geological Survey authorizing a transportation allowance is not subject to retroactive reversal.

3. Federal Oil and Gas Royalty Management Act of 1982: Royalties—Indians: Mineral Resources: Oil and Gas: Tribal Lands—Mineral Leasing Act: Royalties—Oil and Gas Leases: Royalties: Generally

No deduction for royalty valuation purposes is allowed for transportation costs incurred in moving production from the wellhead to a selling point within that lease nor are the costs of transporting lease production beyond the point of the nearest potential market deductible from value for royalty purposes.

4. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Mineral Leasing Act: Royalties--Oil and Gas Leases: Royalties: Generally

In order for a lessee to be entitled to deduct off-lease transportation costs for royalty purposes, a lessee must request, and the appropriate Departmental officer must approve, a transportation allowance.

APPEARANCES: Christopher J. Bernard, Esq., Bland Williamson, Esq., and John L. Randolph, Jr., Esq., Tulsa, Oklahoma, 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 Bureau of Indian Affairs.

OPINION BY ADMINISTRATIVE JUDGE BURSKI

Viersen & Cochran (Viersen) has appealed from a decision of the Acting Deputy Commissioner for Indian Affairs, Bureau of Indian Affairs (BIA), dated May 1, 1991, affirming an order of the Dallas Area Compliance Office, Minerals Management Service (MMS), dated July 13, 1990, disallowing certain transportation allowances and directing recalculation and payment of additional royalties on Cheyenne and Arapaho Tribal lease Nos. 518-007509 (lease 7509), 518-007510 (lease 7510), 518-007511 (lease 7511), and 518-007513 (lease 7513).

The four Indian leases, which embrace lands within the E $\frac{1}{2}$ sec. 31 and the W $\frac{1}{2}$ sec. 32, T. 19 N., R. 13 W., Indian Meridian (IM), Blaine County, Oklahoma, were issued to Tesoro Petroleum Corporation (Tesoro) on March 20, 1979. On October 15, 1979, Tesoro designated Viersen as the operator of lease 7511, and, on November 30, 1979, 1/ Tesoro and Viersen entered into a farmout agreement. Under the terms of this agreement, Viersen agreed to commence drilling operations on an obligation well located in the SW $\frac{1}{4}$ SW $\frac{1}{4}$ sec. 32 (within lease 7511) by December 17, 1979, and, upon completion thereof, Viersen would have the option to conduct a continuous drilling program thereafter on certain lands, including inter alia, the lands embraced by the four Indian leases enumerated above. See Appellant's Statement of Reasons for Appeal (SOR), Exh. E, Farmout Agreement at III.

1/ Viersen had accepted Tesoro's proposed farmout agreement on Nov. 19, 1979, subject to various conditions, including recognition of Viersen's right to assign a portion of the rights and obligations under the farmout agreement to Harper Oil Company (Harper). While Viersen had apparently obtained an oral acceptance of these conditions by Nov. 21, 1979, as indicated in its letter of that date to Harper, the conditions were not formally agreed to by Tesoro until Nov. 30, 1979. On Nov. 27, 1979, Harper agreed to assume half of the rights and obligations under the farmout agreement.

The farmout agreement further provided that, upon submission of satisfactory proof that the obligation well had been completed as a well capable of production in paying quantities, Tesoro would execute and deliver to Viersen an assignment of all of its rights, title, and interest in and to the subject lands and leases covering the spacing or proration unit designated and assigned to the obligation well, subject to the reservation of a 5-percent overriding royalty interest in Tesoro. See Farmout Agreement at V.A. After Tesoro was notified that payout had been reached on the obligation well, Tesoro was afforded a 60-day period in which it could elect to convert its 5-percent overriding royalty interest into a 25-percent working interest in the leasehold. See Farmout Agreement at V.D. ^{2/}

In late 1979, Viersen drilled the Tribal 1-32 well on lease 7511 and successfully completed it as a gas well. On April 7, 1980, Viersen entered into a transportation agreement with Tesoro Natural Gas Company (TNGC), a subsidiary of Tesoro. ^{3/} The terms of the agreement provided that TNGC would transport the gas from the lease to the transmission line of the purchaser, Delhi Gas Pipeline Corporation (Delhi), located in the southwest corner of sec. 6, T. 18 N., R. 13 W., IM, Blaine County, Oklahoma, for a charge of \$0.40 per mcf. On April 28, 1980, Viersen requested a \$0.40 per mcf transportation allowance for the gas sold to Delhi from lease 7511 and, by letter dated May 1, 1980, USGS, MMS' predecessor, approved the requested deduction of transportation charges for royalty purposes. The approval letter also informed Viersen that it must "advise this office of any changes in the marketing conditions for production from this well" (SOR, Exh. J).

In accordance with the terms of the farmout agreement, Tesoro assigned 100 percent of its interest in lease 7511 to Viersen and Harper, retaining a 5-percent overriding royalty, and BIA approved the assignment on November 21, 1980. On February 10, 1981, following payout, BIA approved an assignment from Viersen and Harper reflecting the conversion of Tesoro's overriding royalty interest into a 25-percent working interest in lease 7511. See SOR, Exh. O.

^{2/} Insofar as the option wells were concerned, Tesoro was afforded the opportunity to elect to participate in the drilling of any of these wells. If Tesoro so elected, it was liable for 25 percent of the cost of said well. Upon a successful completion of such an option well, Tesoro would retain a 25-percent working interest with respect to any well which it participated in drilling or a 5-percent overriding royalty interest with respect to any well which it elected not to participate in. See Farmout Agreement at III.D. and V.G.

^{3/} Before finalizing the transportation agreement, Viersen requested and obtained the opinion of the accounting department of the U.S. Geological Survey (USGS; Survey) that TNGC was a third-party transporter. See SOR, Exh. K.

Viersen subsequently completed the Tribal 1-31 and Tribal 2-31 wells on lease 7510 as gas wells in late 1980, and Tesoro duly assigned a 75-percent interest in the lease to Viersen and Harper. See SOR, Exh. P. On December 23, 1980, and January 12, 1981, Viersen and TNGC amended the transportation agreement to provide for the conveyance of natural gas by TNGC from all of Viersen's existing and future wells (other than the Tribal 1-32 well) in an area which included secs. 31 and 32, T. 19 N., R. 13 W., IM, Blaine County, Oklahoma, to Delhi's system for an \$0.18 per mcf transportation charge. See SOR, Exhs. Q and R. On January 14, 1981, Viersen submitted copies of the amendments to USGS, together with a request for a transportation allowance of \$0.18 per mcf for gas delivered to Delhi from the Tribal 1-31 and 2-31 wells. By letter dated February 5, 1981, USGS approved the requested \$0.18 per mcf transportation allowance for the two wells on lease 7510, again informing Viersen that it was required to advise USGS of any changes in the marketing conditions for production from the subject wells. See SOR, Exh. T.

Thereafter, in 1981 and 1982, BIA approved the assignment of a 75-percent interest in leases 7513 and 7509 to Viersen and Harper, with Tesoro retaining a 25-percent working interest in each lease. It is undisputed that Viersen consistently deducted \$0.18 per mcf as a transportation allowance when computing royalties for gas produced from wells on both of these leases.

Viersen cancelled its gas purchase contract with Delhi on July 7, 1983, apparently owing to problems which it had been experiencing with Delhi. Viersen entered into a new gas purchase contract with Phillips Petroleum Company (Phillips) on July 8, 1983. Under the Phillips contract, the point of sale for gas produced from all four of the Indian leases shifted from outside the leases on sec. 6, T. 18 N., R. 13 W., IM, to lease 7511. Viersen nevertheless continued to deduct \$0.40 per mcf for gas produced from lease 7511 and \$0.18 per mcf for gas produced from leases 7510, 7509, and 7513 as transportation allowances when computing royalties due for those leases.

On March 30, 1990, MMS notified Viersen of possible royalty underpayments relating to transportation allowance deductions taken on Indian leases 7509, 7510, 7511, and 7513, proposing to disallow all deductions for leases 7509 and 7513 and to require Viersen to recompute the allowances taken for leases 7510 and 7511. After considering Viersen's April 25, 1990, response, ^{4/} MMS issued an order on July 13, 1990,

^{4/} Neither the Mar. 30, 1990, letter from MMS nor Viersen's Apr. 25, 1990, response has been included in the case file forwarded to the Board. We remind MMS that it is obligated to submit "the complete, original administrative record to this Board, including all original documentation involved

directing Viersen to recalculate its transportation deductions and pay the additional royalties due.

In this order, MMS observed that the transportation allowances approved by USGS for gas produced from wells on leases 7510 and 7511 were premised on Viersen's sale of the gas to Delhi at Delhi's off-lease facility and reflected the costs incurred to convey the gas to the off-lease sales point. Although Viersen's contract with Phillips changed the sales point to a location on lease 7511, MMS complained that Viersen had failed to notify MMS ^{5/} of the change in gas purchaser and sales point as required by the allowance approval letters. MMS asserted that the failure to notify MMS of this change in marketing arrangements effectively terminated the previous approval by USGS of a transportation allowance with the effect that no transportation allowance for past sales to Phillips of gas from lease 7510 could be recognized.

While MMS indicated that future transportation allowances for production from lease 7510 might be permitted after proper application was made, it also noted that production from lease 7511 was not eligible for future transportation allowances. Insofar as lease 7511 was concerned, MMS noted that Viersen's previously approved deduction of transportation costs for production from that lease which was sold to Delhi presupposed a delivery point in sec. 6, whereas the sale to Phillips occurred within sec. 32, inside lease 7511. Pointing out that the applicable regulation, 30 CFR 206.156 (1989), preconditioned the allowability of a transportation deduction on the existence of off-lease sales, MMS concluded that Viersen had improperly deducted transportation costs with respect to all sales to Phillips of gas produced from lease 7511 since, under the Phillips contract, the situs of the sale was within lease 7511.

MMS also found that Viersen had never applied for transportation allowances for gas produced from leases 7509 and 7513 even though it had

fn. 4 (continued)

in the matter." Dugan Production Corp., 103 IBLA 362, 364 (1988). Such submission must include "all documents and materials directly or indirectly considered by agency decision-makers, includ[ing] evidence contrary to the agency's position." Great Western Onshore, Inc., 133 IBLA 386, 397 (1995) quoting Exxon Corp. v. Department of Energy, 91 F.R.D. 26, 33 (N.D. Tex. 1981). Other documents relevant to resolution of this appeal, although absent from the administrative record, have been provided by Viersen as exhibits to both its SOR to the Deputy Commissioner, BIA, and its SOR to this Board. Thus, the failure of MMS to provide a complete record has, thanks to Viersen, not hampered our ability to evaluate the issues raised on appeal.

^{5/} The responsibilities of the Conservation Division, Geological Survey, had been transferred to MMS by Secretarial Order No. 3071, 47 FR 4751 (Feb. 2, 1982), effective Jan. 19, 1982.

taken allowances since initial production. MMS held that the failure to obtain approval of a transportation allowance disqualified Viersen from deducting past transportation costs from the gross value of production received from these two leases, citing 30 CFR 206.157 (1989).

Finally, MMS determined that the original transportation agreement submitted by Viersen to USGS in 1980 was not an arm's-length contract. MMS based this conclusion on Tesoro's status as sole lessee of the Indian leases at the time the contract was finalized and, therefore, concluded that, under 30 CFR 206.151 (1989), the contract with TNGC did not qualify as an arm's-length contract. ^{6/}

Based on the foregoing, MMS directed Viersen to recompute and submit additional royalties (1) for all past sales of production from leases 7509 and 7513 with no deduction for transportation costs; (2) for all past sales of production to Phillips from leases 7510 and 7511 with no deduction for transportation costs; and (3) for all sales of production to Delhi from leases 7510 and 7511 using a transportation allowance deduction based upon the actual costs of transportation.

Viersen appealed the MMS order to the Deputy Commissioner for Indian Affairs, BIA, arguing, *inter alia*, that its transportation agreement was an arm's-length contract negotiated between Viersen and TNGC and had been approved by USGS with full knowledge of the surrounding circumstances; that not only had Viersen requested and USGS approved the transportation allowances, but MMS and USGS had always been aware of these allowances for all four leases; that no change had occurred in the marketing conditions regarding the transportation agreement and amendments necessitating notice to MMS; and that, since Viersen remained bound to the transportation agreement, the transportation allowance for lease 7511 should be continued, notwithstanding the fact that delivery of production now occurred on-lease.

In his decision, the Acting Deputy Commissioner affirmed the MMS decision in all respects. He found that the transportation agreement between Tesoro's operator (Viersen) and Tesoro's affiliate (TNGC) was not an arm's-length contract because Tesoro, as sole lessee at the time of the agreement, had a direct financial interest in the agreement which its retention of a 25-percent working interest perpetuated. Accordingly, he upheld MMS' election to reject the contract-based deductions and to require recalculation of the allowances based on actual costs. In so doing, the Acting

^{6/} We note that despite the fact that the transportation contract was clearly entered into by Viersen and TNGC rather than Tesoro and TNGC, the decision of MMS repeatedly characterized the transportation agreement as a contract "on behalf of" Tesoro and TNGC. We find this characterization self-serving at best.

Deputy Commissioner discounted Viersen's contention that MMS should have been bound by the original USGS approvals which had been granted with full knowledge of the relationship among the parties, asserting that past administrative practices did not prevent the United States from performing its audit and collection duties. Thus, the decision concluded that Viersen was properly required to recompute the transportation deduction taken for production sold to Delhi from leases 7510 and 7511 to reflect the actual costs of transporting the gas.

The Acting Deputy Commissioner disallowed a transportation deduction for production from lease 7511 beginning with the first sale of the gas to Phillips in July of 1983 since, from that point in time, no off-lease transportation expenses were incurred with respect to that gas. He further determined that the change in gas purchaser from Delhi to Phillips and the attendant replacement of a site in sec. 32 for the old delivery point in sec. 6 were changes in the marketing conditions which Viersen was required to report to MMS, but which it had not. Thus, all transportation deductions taken for sales to Phillips were unauthorized and all post-1983 transportation deductions for production from lease 7510 were properly disallowed. As to leases 7509 and 7513, the decision rejected Viersen's assertion that, inasmuch as various printed forms provided by MMS had indicated that transportation allowances were applicable to its leases, such transportation allowances must have been requested and approved, finding instead that the lack of any documentation in the record evidencing that allowances for those leases had been requested and approved supported the disallowance of a transportation deduction for all past production from those leases. Accordingly, he denied Viersen's appeal in its totality.

Before this Board, Viersen essentially repeats the arguments it made before the Deputy Commissioner. Viersen asserts that its transportation agreement with TNGC was an arm's-length contract. While Viersen admits that Tesoro was the sole lessee of record at the time the agreement was negotiated, it emphasizes that both the farmout agreement and Viersen's designation as operator of lease 7511 had effectively transferred all control and indicia of ownership of the leases to Viersen prior to the drilling of the first well, *i.e.*, almost 5 months before the transportation agreement was executed. Viersen maintains that the transportation agreement was negotiated between itself, as the lease operator, and TNGC, a wholly unrelated entity with divergent economic interests. Moreover, Viersen points out that it fully divulged the relationship between Tesoro, TNGC, and Viersen to USGS while the negotiations with TNGC were on-going for the very purpose of assuring that the arm's-length nature of the agreement would be recognized, which assurance was provided by USGS. Since USGS approved the transportation allowances based on the transportation agreement after full disclosure, Viersen argues that the agreement should continue to be considered an arm's-length contract as it has been for over 10 years.

Insofar as the denial of post-1983 transportation allowances for production from lease 7511 is concerned, Viersen argues that, since the transportation system which TNGC constructed is still in use and Viersen is still obligated to pay TNGC the \$0.40 per mcf transportation charge agreed to in 1980 regardless of the fact that the ultimate purchaser and situs of sale has changed, it should be permitted to deduct this cost from its royalty valuation. As to lease 7510, Viersen contends that the change in the purchaser and delivery point did not constitute changes in marketing conditions requiring notice to MMS since its obligations under the transportation agreement were unaffected. This being the case, Viersen insists that, even if the changes in purchaser and delivery point might be considered changes in marketing conditions, their lack of any ultimate effect on Viersen's underlying transportation agreement should preclude the Government from relying on Viersen's failure to notify MMS as justification for disallowing transportation deductions for sales to Phillips from lease 7510.

Viersen also disputes the Government's assertion that transportation allowances were never approved for production from leases 7509 and 7513. Viersen contends that the transportation agreement amendments submitted to USGS covered not only existing wells but any wells which might be drilled in secs. 31 and 32. Viersen asserts that various forms MMS sent to Viersen in 1982 indicating that all the leases were subject to a transportation allowance and the printed royalty reports which showed a deduction of transportation charges for all the leases, including leases 7509 and 7513, clearly establish that MMS recognized transportation deductions for all four of the leases since, Viersen suggests, these documents would not contain such entries unless transportation allowances had not been requested and granted. Thus, Viersen seeks a reversal of the decision of the Acting Deputy Commissioner with respect to all of the leases.

In its answer, the Government expands upon some of the theories advanced below. Thus, it argues that Viersen has not demonstrated that its transportation agreement with TNGC was arm's-length. Given Tesoro's affiliation with TNGC, the Government speculates that Tesoro might not have assigned the lease to Viersen absent Viersen's agreement to pay TNGC the fee demanded for transportation, which may have been higher than arm's-length contract charges. The Government further suggests that other factors deriving from Tesoro's and Viersen's status as working interest owners in the same leases might have led Viersen to pay an affiliate of Tesoro an inflated transportation price. Since Viersen has submitted no documentation verifying that the agreement was arm's-length, the Government contends that accepting the contract charges could amount to a breach of the Department's trust responsibility to Indian lessors.

While the Government recognizes that USGS approved the transportation allowance based on the transportation agreement, it also argues that this does not prevent MMS from limiting the transportation allowance to Viersen's actual costs. The Government attempts to justify its attempted

repudiation of past actions approved by USGS on the theory that, if Viersen's actual costs were less than the non-arm's-length contract price, Viersen's royalties would have been calculated on less than its gross proceeds in violation of applicable royalty valuation regulations and, therefore, USGS approval could not estop the Department from correcting the error. The Government concludes that, in the absence of a showing that the transportation agreement was arm's-length, MMS and the Acting Deputy Commissioner properly limited Viersen's transportation allowance to the actual costs of transporting the production. 7/

After reiterating its assertion that transportation allowances are only permissible to recover costs incurred in transporting the production to the first market and, therefore, that no allowance is available with respect to production from lease 7511 which was sold to Phillips on-lease, the Government challenges Viersen's claim that it was not required to notify MMS of the change in purchaser and delivery point when Viersen abrogated its purchase agreement with Delhi and entered into the Phillips contract, asserting that Viersen's failure both to notify the Department of the change in marketing conditions and to demonstrate that it incurred transportation expenses after Phillips became the gas purchaser supports the propriety of disallowing a transportation allowance for lease 7510 for sales to Phillips.

Insofar as leases 7509 and 7513 are concerned, while acknowledging that MMS payor confirmation forms indicated that these leases were subject to transportation allowances, the Government insists that these forms do not establish that Viersen ever requested such allowances or was granted approval to take such deductions, nor has Viersen submitted any other evidence that such a request was made and approved. In the absence of a request for a transportation allowance, the Government argues the previously taken deductions were properly disallowed, though it suggests that,

7/ We must point out, however, that MMS is less than precise in defining what showing Viersen would be required to make. Thus, in its Answer, it first states that "the fact that Survey approved a transportation allowance based on the contract price [does not] prevent MMS from limiting the transportation allowance to Viersen's actual costs." Answer at 8 (emphasis supplied). Subsequently, however, it declares "MMS properly limited Viersen's transportation allowance to the actual costs of transporting the production." Answer at 8-9 (emphasis supplied). These are not the same thing. Indeed, Viersen's costs are not at issue. It is undisputed that Viersen actually paid \$0.40 per mcf for the transportation of gas produced from lease 7511 and \$0.18 per mcf for production from lease 7510. If MMS desired only to limit Viersen's transportation allowance to its out-of-pocket expenditures, there would have been no reason to require recomputation of the transportation allowance with respect to the sales to Delhi from leases 7511 and 7510. Presumably, MMS is attempting to limit Viersen's deduction to the actual costs to TNGC of transporting the gas in issue.

for the period prior to the adoption of the valuation regulations on March 1, 1988, MMS would consider a request for a retroactive transportation allowance. In sum, however, the Government contends that the decision of MMS and the Acting Deputy Commissioner should be affirmed.

[1] We note at the outset that certain well-settled principles govern the construction and interpretation of the royalty provisions applicable to Federal oil and gas lessees. The regulations in effect both when the leases issued and in 1983 when Phillips became the purchaser of the production from them essentially provided that the value of production for the purposes of computing royalty was the estimated reasonable value of the product as determined by the authorized officer giving due consideration to a number of factors. However, this was subject to the caveat that "[u]nder no circumstances shall the value of production of any of 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." 30 CFR 221.47 (1979) and 30 CFR 206.103 (1983). This "gross proceeds" rule finds its genesis in the original regulations adopted to implement the Mineral Leasing Act. See 47 L.D. 552, 555 (1920); Walter Van Norman, 126 IBLA 375, 379-82 (1993). Insofar as the present discussion is concerned, the relevance of the "gross proceeds" rule resides in the realization that the Government's royalty interest is not burdened with any of the costs of production and that, therefore, the "gross proceeds accruing" from the sale of production represents the minimum value acceptable as a basis for the computation of the amount of royalty due to the Government.

This having been said, however, it must also be recognized that the Department has long permitted an allowance for certain costs which have been deemed not to be directly related either to the costs of production or to the fulfillment of the lessee's contractual obligation to market production from the lease. ^{8/} Thus, since gas is normally sold and valued for royalty purposes at the wellhead, where there is an absence of an on-lease market for the gas the Department has consistently authorized the deduction of a transportation allowance from the market value of the gas to reflect the

^{8/} In this regard, it is important to emphasize that the Department has consistently held that the obligation to market the product "is not a covenant read into the lease by implication" but rather is an affirmative duty expressly imposed under the terms of the lease via the incorporation of the Department's regulations into the lease. See The Texas Co., 64 I.D. 76, 79-80 (1957). The leases in issue herein required the lessee "to abide by and conform to any and all regulations of the Secretary of the Interior now or hereafter in force relative to such issues, including 30 CFR 221." See SOR, Exh. A, ¶ 3(g). Thus, as the decision in The Texas Co. noted, judicial interpretations of the scope of the "implied" covenant to market are of limited utility since a Federal lessee's obligations in computing royalty are a matter of contractual interpretation and regulatory construction.

costs incurred in transporting the gas from the leasehold to the first available market, notwithstanding the fact that this could lower the basis for valuing production below the gross proceeds actually received by the lessee. See, e.g., United States v. General Petroleum Corp., 73 F. Supp. 225, 263 (S.D. Cal.), aff'd, Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); TXP Operating Co., 115 IBLA 195, 202 (1990); Conoco, Inc., 109 IBLA 89, 94 (1989); ARCO Oil & Gas Co., 109 IBLA 34, 38 (1989); Shell Oil Co., 52 IBLA 15, 88 I.D. 1 (1981); C & K Petroleum, Inc., 27 IBLA 15 (1976); Kerr-McGee Corp., 22 IBLA 124 (1975) (authorizing a transportation allowance for production from Indian leases). Indeed, the 1988 revision of the regulations codified this practice by providing that "under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances determined pursuant to this subpart." 30 CFR 206.152(h) (emphasis supplied).

But, while the Department has historically allowed a deduction for the costs of transporting production from the leasehold to the first available market, it has been equally consistent in refusing to allow any deduction for costs incurred in moving production to a selling point within the lease. Phillips Petroleum Co., 109 IBLA 4, 13 (1989); The Texas Co., 64 I.D. 76, 80 (1957). Nor has the Department granted an allowance for the costs of transporting lease production beyond the point of the nearest potential market. Conoco Inc., 110 IBLA 232, 242 (1989); ARCO Oil & Gas, Co., supra; The Superior Oil Co., 12 IBLA 212 (1973). In short, the only transportation costs allowed are those necessary to move the production off-lease to the first potential market.

It was in the context of the above framework that Viersen first applied for and received approval of a transportation allowance for the production from lease 7511 which permitted it to deduct from the royalty basis the \$0.40 per mcf charge which TNGC assessed for transporting the gas from the lease in sec. 32 to Delhi's point of purchase in sec. 6. The Government does not deny that Viersen sought and received USGS approval for this allowance and for the subsequent allowance of \$0.18 with respect to production from lease 7510. Rather, it asserts that the USGS approval was in error since the transportation agreement was not an arm's-length contract. Accordingly, it has required Viersen to recompute the transportation allowance for all production from these two leases which was sold to Delhi to reflect actual costs. We think that this part of the decision below is flawed in a number of respects.

[2] First of all, there is a substantial difference between the assertion of a right to reconsider decisions allowing deductions as of the present time and the assertion of a right to retroactively reverse such a decision. The Government does not challenge Viersen's assertion that USGS was fully informed of all aspects of the arrangement which it entered into with TNGC. Nor does it contravene the fact that, having

been fully apprised of the agreement and being totally aware of the relationship of Tesoro, Viersen, and TNGC, USGS accepted the figure of \$0.40 and \$0.18 per mcf, respectively, as representing an allowable transportation deduction. It simply professes that USGS was in error when it did so, citing in support of this conclusion regulations which were adopted 8 years after the transportation agreement was entered into. The problem with the Government's position, however, is that it does not assert that the transportation allowances were, in fact, excessive. It merely proceeds on the assumption that, since a non-arm's-length contract is involved, reliance on the terms thereof as establishing the allowable transportation deduction is not permissible. In point of fact, however, at the time the transportation agreement was entered into, even had USGS determined that a non-arm's-length agreement was involved, it could nevertheless have allowed the same transportation deduction if it were convinced that the contract terms were fairly reflective of terms which could be obtained in an arm's-length negotiation. See, e.g., Shell Offshore Inc., 116 IBLA 246, 254-55 (1990) and cases cited.

As noted above, USGS did accept the transportation agreement as an arm's-length contract. MMS, the successor to USGS in royalty matters, asserts the authority to revisit this question based on the general principle that the Government acceptance of royalties is always made subject to post-audit and specifically relies on this Board's decision in Shell Offshore Inc., 111 IBLA 350 (1989). MMS' reliance both on the general principle of post-audit acceptance of royalty payments and the specific precedential value of the Shell decision is, in both instances, misplaced.

Insofar as the general principle of acceptance of royalties subject to post-audit is concerned, we recognize that this Board has frequently noted that "the silent acceptance of royalty when initially tendered does not constitute an express determination of the proper royalty level." Supron Energy Corp., 55 IBLA 318, 321 (1981); see also Cities Service Oil & Gas Corp., 113 IBLA 255, 260 (1990). The simple fact of the matter, however, is that we are not faced with a "silent acceptance" of the deduction for the transportation costs claimed by Viersen under its contract with TNGC; rather, we have the affirmative recognition of the contract's acceptability as a basis for establishing a transportation allowance by the official authorized at the time to make that determination. See SOR, Exh. J. Under these circumstances, the Government can, in fact, be bound by its former actions. Cf. Exxon Corp., 97 IBLA 330 (1987) (holding formal acceptance of high bid by the authorized officer barred subsequent attempts to reject the bid for inadequacy).

The Government's reliance on our decision in Shell Offshore Inc., 111 IBLA 350 (1989), is also misplaced. In that case, Shell was taking a processing allowance which was greater than the amount which it was actually being assessed for the processing of its gas. Indeed, the decision expressly noted that "Shell does not dispute that the 55-percent allowance used to calculate royalty exceeded its actual cost of processing." 111 IBLA at 355. Since Shell was obtaining a higher payment for

the delivered gas than it was claiming by use of the 55-percent processing allowance, it was not paying its royalties on the gross proceeds accruing to it as required by the applicable regulations. Accordingly, the Board held that a prior Survey approval of the 55-percent allowance would not bar a subsequent reassessment since, under the facts of the case, the grant of the 55-percent allowance violated the regulations and Survey had no authority to authorize such action.

Herein, by contrast, the Government neither alleges that crucial facts were not disclosed to Survey nor contends that Viersen did not pay TNGC \$0.40 and \$0.18 per mcf, respectively, for transportation of the gas. Moreover, as we noted above, transportation allowances are deducted from the "gross proceeds accruing to the lessee," and, thus, as a technical matter, even if the transportation allowance was excessive it would not involve a violation of the "gross proceeds" rule; it would simply be a case of an adjustment to gross proceeds which could not properly be allowed. In other words, even if Survey had made an error in judgment in determining that the transportation contract was an arm's-length contract, it was an error of the type which it had the authority to make and, by doing so, bind the Government thereto.

In addition to the foregoing, we must also record our disagreement with the conclusion of the Acting Deputy Commissioner and MMS that the transportation agreement was not an arm's-length agreement. Although Tesoro and TNGC were clearly affiliated, Viersen and TNGC, the actual parties to the contract, are not now and never have been affiliated. As Viersen points out, the farmout agreement and the designation of operator essentially transferred the indicia of ownership and all control over the leases from Tesoro to Viersen before the first well was drilled. The record contains absolutely no evidence that Tesoro controlled Viersen's position during the contract negotiations or that it influenced the resulting transportation agreement. The Government's unsubstantiated speculation that Tesoro might have exercised undue influence over Viersen by, in effect, extorting a higher price for transportation by refusing to assign the lease to Viersen (SOR at 7) ignores the reality that Tesoro was contractually obligated, under the terms of the farmout agreement, to assign 100 percent of record title upon demand of Viersen once Viersen had successfully completed the obligation well. Regardless of whether or not the same result would ensue under the present regulations, ^{9/} we cannot

^{9/} We note that the present regulations set forth extensive guidelines for determining what is and what is not considered to be an arm's-length arrangement and the procedures to be followed depending upon this determination. See, e.g., 30 CFR 206.101; 30 CFR 206.151; 30 CFR 206.152. While the animating rationale behind these regulations was applied throughout the period in question, specific regulatory strictures were considerably less developed when the transportation agreement was negotiated by the parties and the allowance was approved by USGS.

agree with the Government's assertion that, under the regulations in effect at the time that USGS approved the transportation allowance, the record establishes that the transportation agreement between Viersen and TNGC was not arm's-length in character. We therefore conclude that, to the extent that the Acting Deputy Commissioner held that the original approval of the transportation allowance by USGS was in error, that decision cannot be sustained. Accordingly, we reverse the order of MMS requiring the recomputation of royalties due for leases 7511 and 7510 commencing from the period of first production up to the date of first sale to Phillips.

As noted above, in 1983, after apparently experiencing a number of difficulties with its original gas purchaser, Delhi, Viersen entered into a new sales arrangement with Phillips. Notwithstanding the fact that Viersen had been expressly cautioned by USGS that it "must advise this office of any changes in the marketing conditions for production" from the subject wells (see SOR, Exhs. J and T), Viersen admits that it never informed MMS (USGS' successor) of the new sales arrangement which affected not only the purchaser but the situs of the sales transaction. Viersen's assertion on appeal that it was not required to report this new arrangement because "[a]lthough the ultimate purchaser may have changed, the market conditions respecting the transportation charges did not (SOR at 14)" is palpable nonsense. If changes in the purchaser and point of delivery are not changes in "the marketing conditions" requiring Government notification, it is difficult to fathom what might be. We reject out-of-hand Viersen's attempt to explain away the violation of its obligation to inform MMS of its new arrangement with Phillips.

However, while we agree with the Acting Deputy Commissioner that Viersen was required to notify MMS of these changes, we do not agree that the failure to do so automatically invalidated any transportation allowance with respect to production from lease 7510 sold to Phillips. Thus, if Viersen had entered into a new arrangement with Phillips which merely substituted Phillips for Delhi and left all other provisions intact, a failure to notify MMS of this change would still violate the reporting requirements but it would not be such a violation as would justify a total disallowing of the transportation allowance. Insofar as lease 7510 is concerned, we believe that Viersen is properly required to recalculate the transportation allowance for gas sold to Phillips to reflect the costs of transporting the gas from those wells to the delivery point on lease 7511 and to tender any additional royalties which may be found to be owing.

[3] On the other hand, insofar as production from lease 7511 is concerned, it is clear that the decision disallowing any transportation allowance for sales to Phillips must be affirmed. Viersen does not dispute the fact that the point of sale to Phillips is located within lease 7511. Rather, Viersen argues, in effect, that, notwithstanding the fact that it now passes title to the natural gas to Phillips on-lease, it is still entitled to a deduction for the costs of transportation since it (Viersen) is still liable to TNGC under the original transportation agreement. We do not agree.

The payments which Viersen now makes to TNGC do not represent the cost of transporting the production from lease 7511 to the point of first sale. Rather, they are marketing costs which Viersen must absorb because of contractual arrangements which it freely entered into and which it has apparently continued to honor. But marketing costs, except to the extent that they represent the actual costs of transporting production to the first available market and for which a transportation allowance is provided, are not properly assessed against the Federal royalty interest. To do so would, in essence, allow Viersen to pay royalty on its "net proceeds," rather than on its "gross proceeds" as clearly required by the lease terms and applicable regulations. MMS properly disallowed any deduction for transportation expenses relating to production from lease 7511 which was sold to Phillips.

[4] Turning to the questions surrounding leases 7509 and 7513, we note that it is well-established that, before deducting permissible transportation costs from the royalty basis, a lessee must request, and the appropriate Departmental officer must approve, such a transportation allowance. See Ladd Petroleum Corp., 127 IBLA 163, 173 (1993), and authorities cited therein; see also 30 CFR 206.151, 206.156, 206.157 (effective Mar. 1, 1988); USGS Conservation Division Manual § 647.5.3E (May 10, 1974). The record before us simply contains no affirmative evidence that Viersen sought or USGS granted a transportation allowance for gas produced from leases 7509 and 7513.

Although Viersen submitted copies of its transportation agreement amendments to USGS on January 14, 1981, when Viersen applied for an \$0.18 per mcf transportation allowance for gas sold to Delhi from the Tribal 1-31 and 2-31 wells on lease 7510, the language of both Viersen's application and USGS' February 5, 1981, approval of the requested \$0.18 per mcf transportation allowance limited that allowance to the identified wells on the one specified lease. See SOR, Exhs. S and T. Viersen's contention to the contrary notwithstanding, USGS approval of the deduction of transportation charges for gas produced from lease 7510 was not a general approval of the transportation agreement amendments nor did it constitute a blanket grant of transportation allowances for production from all leases included within those amendments' ambit.

Viersen's attempt to enlarge the scope of the approved allowance to include gas from wells drilled on its other leases on the theory that, since the charges established in transportation agreement amendments were, under the terms of those amendments, to be applied to any future production from those other leases, USGS approval in one instance constituted an across-the-board approval of the allowance in all cases, is simply belied by the record before the Board. The other Government documents on which Viersen attempts to rely (see Exhs. Y and Z) do not purport to approve transportation allowances; rather, they merely reflect the fact that transportation allowances were being claimed for each lease. The record herein

simply provides an inadequate basis for estopping the Government from disallowing the claimed transportation allowances as they relate to these two leases.

We note, however, that in his decision, the Acting Deputy Commissioner noted that MMS has, in some cases, permitted retroactive transportation allowances for the actual costs of transportation and indicated that, if Viersen was to make an application for an allowance for leases 7509 and 7513, MMS would consider the request and issue a decision thereon. Certainly, some recognition of Viersen's actual transportation costs would seem to be appropriate.

There remains one last matter which we wish to briefly address. In its July 13, 1990, decision, MMS had also found that Viersen had commingled production from leases 7510 and 7511 and from leases 7509 and 7513 and had measured the production for royalty purposes at meters located on lease 7511. The Acting Deputy Commissioner, after noting that MMS had raised questions concerning BLM approval of the metering of production from the leases, reminded Viersen that it was obligated to conduct all operations in conformity with BLM requirements. Viersen contended on appeal that its wells are now and always have been separately metered and that, although its sales to Phillips occur through two separate sales meters, the sales are allocated to each well based upon the individual well meters. Since neither MMS nor the Acting Deputy Commissioner has provided any specific information establishing that Viersen has violated 43 CFR 3162.7-3, we vacate the Acting Deputy Commissioner's decision to the extent it implies that Viersen has failed to comply with BLM metering requirements for production from these leases. Viersen is, of course, required to follow all applicable rules and regulations.

In summary, we reverse the determination of the Acting Deputy Commissioner finding the original transportation agreement between Viersen and TNGC to be non-arm's-length as well as his order directing Viersen to recompute royalties paid on production from leases 7511 and 7510 sold to Delhi; while we agree that the 1983 change in purchaser and delivery point was a change in the "marketing conditions" of which Viersen was obligated to inform MMS, we modify the Acting Deputy Director's decision requiring recomputation of royalties for the sale of production from lease 7510 to Phillips on the basis of no deduction for transportation costs to one requiring the recomputation of the allowance on the basis of the actual costs of transportation to the point of sale; insofar as lease 7511 is concerned, we affirm the decision of the Acting Deputy Commissioner disallowing any transportation allowance for the sale of production from that lease to Phillips and requiring the recomputation of royalties for such sales; finally, with respect to leases 7509 and 7513, in the absence of any application for a transportation allowance, we affirm the decision disallowing a deduction and requiring the recomputation of royalties due and owing the Government. To the extent not specifically addressed herein, all other arguments raised on appeal have been considered and rejected.

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 in part, reversed in part, and vacated in part.

James L. Burski
Administrative Judge

I concur.

Will A. Irwin
Administrative Judge

