Editor's Note: **appeal filed**, **Fina Oil & Chemical Co. v. Babbitt**, Civ.No. 99-2392-HHK (D.D.C.); Petition for Director's review denied, **Fina Oil & Chemical Co.**, 19 OHA 200 (June 18, 2001), **aff'd** (D. D.C. June 11, 2002); 209 F.Supp.2d 246; **appeal filed**, No. 02-5241 (D.C. Cir.), rev'd (June 27, 2003) 332 F.3d 672.

FINA OIL AND CHEMICAL CO. ET AL.

IBLA 96-534 Decided June 11, 1999

Appeal from a decision of the Associate Director for Policy and Management Improvement, Minerals Management Service, denying appeal and upholding a May 3, 1993, Order requiring lessees to perform a restructured accounting of gas royalties paid on Outer Continental Shelf Leases. MMS-93-0236-OCS.

Affirmed.

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

   Where the Assistant Secretary has issued a decision with the concurrence of the Secretary which affirms an Order by the Minerals Management Service directing a Federal lessee to recalculate and pay additional royalties on lease production sold or transferred to its affiliate under a nonarm's-length contract and which its affiliate then resold at arm's length to a third-party purchaser, that decision is final for the Department.

2. Administrative Authority: Generally--Administrative Procedure: Administrative Review--Rules of Practice: Appeals: Generally--Secretary of the Interior

   When a final decision is issued by the Assistant Secretary with the concurrence of the Secretary of the Interior, the Board, may append the decision and adopt the analysis and rationale contained therein to decide a pending appeal.

APPEARANCES: Charles D. Tetrault, Esq., Virginia N. Brooks, Esq., Washington, D.C., and Richard H. McPike, Esq., Dallas, Texas, for appellants; Barry Crowell, Esq., Howard W. Chalker, Esq., and Geoffrey Heath, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE FRAZIER

Fina Oil and Chemical Company (FOCC) and Petrofina Delaware, Inc. (PDI) (collectively referred to herein as appellants or lessees/appellants) have appealed from a June 7, 1996, decision (Decision) of the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS), denying appellants' appeal and upholding a May 3, 1993, Order requiring lessees/appellants to perform a restructured accounting of gas royalties paid on Outer Continental Shelf leases where unprocessed gas was sold by lessees/appellants to its affiliate Fina Natural Gas Company (FNGC) between October 1, 1990, and May 3, 1993, the date of MMS' Order in MMS-93-0236-OCS.

MMS' Decision stated that MMS had performed an audit on the royalties calculated and paid by FOCC on gas produced on Federal offshore lease 054-002391-0 and offshore unit 754-39002-0 (High Island Block 571) for calendar year 1990, and that

> [t]he audit revealed that FOCC sold gas from High Island Block 571 under several arm's-length gas sale contracts through September 30, 1990. Effective October 1, 1990, FOCC entered into a non-arm's-length gas purchase agreement with FNGC for the sale of High Island Block 571 gas. FNGC then sold the gas under similar contract terms and prices to the same arm's-length purchasers that FOCC used prior to its non-arm's-length contract with FNGC. FOCC then calculated and paid gas royalties based on the lesser non-arm's-length gas sales price it received from FNGC. The MMS determined that there was a significant underpayment of royalties due to the non-arms length pricing and expanded the audit scope to include the entire time covered by the non-arm's-length gas contract with FNGC.

(Decision at 1.) Based on the audit, MMS issued an Order dated September 29, 1992, directing FOCC to calculate and pay royalties based on arm's-length prices received by FNGC. MMS asserted in that Order that it could require FOCC to tender royalty based on the arm's-length prices received by FNGC because FNGC was FOCC's "marketing affiliate as defined in 30 CFR 206.101 (1995)," and therefore MMS under 30 C.F.R. § 206.152(b)(1)(i) properly looked to the price received by the "marketing affiliate," FNGC. Regulation 30 C.F.R. § 206.101 defines "marketing affiliate" as "an affiliate of the lessee whose function is to acquire only the lessee's production and to market that production." In the case of a sale or transfer to a "marketing affiliate," the applicable regulation, 30 C.F.R. § 206.152(b)(1)(i), directs "for purposes of this section, gas which is sold or otherwise transferred to the lessee's marketing affiliate and then sold by the marketing affiliate pursuant to an arm's-length contract shall be valued in accordance with this paragraph based upon the sale by the marketing affiliate."

FOCC appealed the September 29, 1992, Order and as a result of meetings and dialogue with MMS it was agreed that FNGC was not a "marketing affiliate" of FOCC as defined by regulation in 30 C.F.R. § 206.101 (1995), because FNGC does not acquire gas only from its affiliates, FOCC and PDI.

From discussions with FOCC, MMS states it learned that the nonarm's-length gas purchase contract between FOCC and FNGC included other offshore and onshore leases in addition to High Island Block 571 and that FOCC's producing affiliate and Federal lessee, PDI also had a nonarm's-length gas purchase contract with FNGC to sell gas produced from Federal leases.

The Decision states further:

> Additional audit work revealed that the non-arm's-length FNGC contract price used for royalty calculations by FOCC and PDI on other offshore and onshore properties did not represent the actual market value of the gas. The audit scope was expanded to include all FOCC and PDI onshore and offshore properties having non-arm's-length gas sale contracts with FNGC. Based on the additional audit work, MMS withdrew the non-arm's-length pricing issue from the order dated September 29, 1992, because it only covered High Island Block 571 leases. The MMS issued an order dated May 3, 1993, directing FOCC and PDI to identify those leases where either FOCC or PDI sold gas to FNGC and to use the arm's-length sales prices received by FNGC to recalculate and pay royalties for those leases.

(Decision at 2.) The May 3, 1993, Order, like MMS' September 29, 1992, Order, demanded that royalty be tendered based on FNGC's arm's-length sale, rather than the nonarm's-length sales between FOCC or PDI to FNGC. The May 3, 1993, Order, justified MMS' disregard of the FOCC or PDI sales to FNGC, not based on the abandoned "marketing affiliate" rule, but on the "marketable condition rule." The May 3, 1993, Order, found that "unacceptable FNGC non-arm's-length gas contract prices were used by FOCC and PDI in their royalty calculations. The MMS determined that the non-arm's-length gas prices were not equivalent to the arm's-length gas prices because they included FNGC's cost to place the gas in marketable condition." (Decision at 2 (emphasis added).) The Order directed lessees/appellants to perform a restructured accounting for all of their properties between October 1, 1990, and May 3, 1993, the date of the Order, to recalculate royalty value based on the arm's-length sales prices received by FNGC, and to pay any additional royalties due as a result of the recalculation. Id.

On appeal to the Director, the Associate Director concluded that MMS did not "err in requiring [lessees/appellants] to pay royalties on amounts which exceeded [lessees/appellants] sales price from the non-arm's-length sales contract it had with a related marketing company." The Associate Director's Decision citing Santa Fe Energy Products Co. v. McCutcheon, 127 IBLA 265 (1993), aff'd, No. 94-C-535, slip. op. (D. Colo. Mar. 30, 1995), aff'd, 90 F.3d 409 (10th Cir. 1996), and Xeno, Inc., 134 IBLA 172, 179 (1995), begins with the proposition "that it is proper for MMS to look to the first arm's-length sale by the affiliate to ensure that the lessee has complied with the gross proceeds rule in determining royalty value." (Decision at 3.)

The Associate Director rejected appellants' argument that MMS was required to look to the first applicable regulatory benchmark under 30 C.F.R. § 206.152(c) (1995), stating "that when FOCC and PDI derive a gas value under the first benchmark, the non-arm's-length contract prices received by FOCC and PDI are not equivalent to the contract prices received by other producers in the same field." Id. at 4. As for calculated contract prices under the second benchmark, 30 C.F.R. § 206.152(c)(2), "MMS holds that they too, do not represent the full market value of the gas." Id. The Decision, albeit reaching this conclusion, neither contains documentation nor cites to specific documents containing evidence supporting the Associate Director's conclusion.

Looking to FNGC, the Associate Director notes that "FNGC was created to perform essential services including buying gas, aggregating it to form packages, undertaking market risks, arranging for transportation, processing and ultimately reselling the gas," and that in the identical agreements between FNGC and FOCC and FGNC and PDI, "factors such as cost of service, gathering, compression and dehydration fees are included in determining the price used for royalty purposes." The Associate Director, relying on the "gross proceeds rule," 30 C.F.R. § 206.102(h), Shell Oil Co. (On Reconsideration), 132 IBLA 354 (1995), overruling Shell Oil Co., 130 IBLA 93 (1994), Santa Fe Energy Products Co., supra, and the "marketable condition" rule, 30 C.F.R. § 206.152(i) (1995), reasoned:

> The issue is whether or not FOCC and PDI's definition of fair market value represent[s] the correct value for royalty calculations. The IBLA has held that the sales price received by an affiliate of the lessee in the first arm's-length transaction may be considered in determining the value of the gas production under the "gross proceeds rule." See Shell Oil Company (On Reconsideration), 132 IBLA 354 (1995), overruling Shell Oil Co., 130 IBLA 93 (1994); See also Santa Fe Energy Products Co., 127 IBLA 265 (1993).
>
> As stated by IBLA in Shell Oil Company (On Reconsideration) at 356:
>
>> The purpose of 206.102(h) is to make clear that no matter what valuation method is used, the value for royalty purposes cannot be less than the lessee's gross proceeds less applicable allowances. Therefore, if a benchmark derived value less applicable allowances is less than gross proceeds less applicable allowances,

> gross proceeds less applicable allowances is to be used as the value for royalty purposes. 52 F.R. 30,826; 30843-44 (Aug. 17, 1987).
>
> FOCC and PDI maintain that a number of their gas royalty determination points are located at onshore gas plants and that transportation charges and fees are incurred in moving gas from the wellhead to these points. In the Dallas Area Audit field report, the statement is made that a deduction for transportation is allowed for those sales where FNGC performs transportation services. (FOCC and PDI assert that several factual errors were made; review of those assertions indicate they would have no material bearing on the decisions.)
>
> However, there are certain expenses deemed related to the marketing of production that are not deductible for royalty purposes. Nondeductible expenses include, but are not limited to, the gathering and compression of the gas to the pressure required for entry into the buyer's pipeline. Mobil Oil Corp., 108 IBLA 216 (1989); dehydration to meet market specifications for water content. The Texas Company, 64 I.D. 76 (1957).
>
> Section 206.152(i) of 30 CFR (1995) states that:
>
> The lessee is required to place gas in marketable condition at no cost to the Federal Government * * * Where the value * * * is determined by a lessee's gross proceeds, that value shall be increased to the extent that the gross proceeds have been reduced because the purchaser or any other person, is providing certain services the cost of which ordinarily is the responsibility of the lessee to place the gas in marketable condition.
>
> All expenses necessary to market production from a Federal lease must be performed at no cost to the lessor. California v. Udall , 296 F.d. 384, 388 (D.C. Cir. 1961); Walter Oil and Gas Corp., MMS-87-0126-OCS (May 1, 1997. 8 Gower Federal Service, Royalty Valuation and Management, Rocky Mountain Mineral Law Foundation (Gower).

(Decision at 4-6.) Applying the foregoing, the Associate Director concluded:

> FOCC and PDI's gas sales to FNGC include deductions from the sales price to compensate FNGC for the costs of marketing the gas for downstream sales. The gross proceeds received by

FOCC and PDI for the sale of gas are directly diminished by those marketing costs. The cost of removing impurities, measuring, gathering, dehydrating, compression, broker fees, marketing fees , sales commissions, or any combination thereof, for gas produced on a Federal or Indian lease may not be deducted for purposes of computing the royalty value of gas. See The Texas Co., GS-21-0&G (August 30, 1956) * * * Arco Oil Gas Co., 112 IBLA 8 (1989). It makes no difference that any of these marketing functions takes place downstream from the wellhead sales meter and is performed by a third party. This argument was addressed in R.E. Yarbrough & Co., * * * 122 IBLA 217, 221 (1992) as follows:

> Whether a lessee hires a third party to gather, dehydrate and compress the gas, and deducts the payments made to the third party from the value of the gas production, or in the alternative, sells the gas to a third party at a reduced price to reflect the costs of gathering, dehydrating, and compressing the gas, and uses that gas as the value of the gas production, the effect is the same. In either case, the gas is under valued for royalty purposes.
>
> The lessor is not a party to the contract between the sellers and buyer. FOCC and PDI's obligation to the lessor is to pay royalty based on the value of the production, not on sales price of the production. The lessor is not required to share in the risks of the management decisions of the lessee. If FOCC and PDI chose to sell the gas production at less than its value, the gross proceeds forfeited by them is not the burden of the lessor. FOCC and PDI are still obligated to pay the lessor royalties based on the value of the gas produced.
>
> If lease terms were to provide that the lessee pays the lessor royalties based on the sales price of the gas sold, then the lessor would be obligated to accept whenever price is negotiated between the lessee and the purchaser. However, Federal leases, and many private leases, require that the royalty paid by the lessee to the lessor is not a function of the sales price, but, rather is a function of the "value" of the gas production. And as cited above, the controlling statute and regulations likewise require the royalties computed on the basis of the value of the gas production.
>
> For the reasons stated above, I conclude that the difference between the price received by FOCC and PDI and the competitive market value price received

> by FNGC constitutes a deduction for marketing costs. I also find that, when applicable, a calculated FOCC and PDI index price is also net of marketing costs. Whether gross proceeds are based on the non-arm's-length gas prices received from FNGC or a calculated price based on spot index prices, marketing cost must not be deducted from gross proceeds.

(Decision at 5-7.)

Appellants' Arguments

Marketable Condition/Gross Proceeds/Affiliate's Resale Price

Appellants maintain that the "marketable condition" rule has no application here. Noting that the Court in California Co. v. Udall, 296 F.2d at 388, recognized that "a market exists where there is an established demand for an identifiable product," appellants insist that FOCC and PDI sold gas at the wellhead both before and after the creation of FNGC. Appellants contend that gas sold at the wellhead was, and continues to be, sold in "marketable condition."

Appellants deny that there can be any serious doubt that a market for OCS gas existed at the wellhead. They cite to the MMS Field Report: "The MMS audit found that virtually all of FNGC's sales to third parties occurred at the wellhead, which was also the point-of-sale between FOCC and FNGC." (Field Report at 4.) Indeed, appellants submit in the context of High Island Block 571 (which was the focus of the audit), that it is undisputed that FOCC and PDI were selling gas to major interstate pipelines at the wellhead. The gas sold at the wellhead, they submit, was clearly acceptable under gas sales contracts typical for the field or area. The facts present in this case, appellants argue, stand in stark contrast to the facts involved in the marketable condition cases relied on by the Associate Director in her Decision at 5-6. (Appellants' Statement of Reasons (SOR) at 36.)

With respect to the High Island leases covered by the audit expansion in other High Island areas, appellants submit that "there is substantial evidence that the gas is in `marketable condition' when it comes from the wells." Appellants note that gas in the Gulf of Mexico region historically has been sold at or near the wellhead to major interstate pipelines. Id. at n.11.

FNGC, appellants emphasize, is not the "lessee." MMS, appellants note, makes no claim that either FOCC or PDI incurred marketing costs or cost to place the gas in marketable condition. They reason "the only conceivable way the marketable condition rule could apply is for the agency to prove that FNGC's services are necessary to put the gas in marketable condition." This claim, they contend, however, makes no sense because there is no legitimate dispute concerning whether the gas is in marketable condition at the wellhead. "[P]urchasers of all stripes," it is contended, have "bought gas at the High Island Block 571 wellhead and at other offshore platforms in the High Island area." (SOR at 37.)

Appellants dispute "the repeated references in the Order and Field Report to the effect that virtually all of FNGC's sales to third parties occurred at the wellhead." (Field Report at 4.) This, appellants insist, is simply wrong. In support of this assertion, appellants report that "beginning in approximately February 1992, FNGC began transporting significant volumes of High Island gas on the ANR Pipeline system to French Lick, Indiana, for sale to a number of different customers." Again, "beginning on approximately July 1992, FNGC began selling large volumes of High Island gas in Willow Run, Michigan, the location of a large General Motors plant." (SOR at 38.) Observing that the court in Beartooth Oil & Gas Co., slip. op. at 6, concluded that the case law did not support a contention that the market of concern was 50 miles away from the lease, appellants argue that "[t]ransporting gas thousands of miles from the High Islands blocks to Indiana and Michigan -- indeed virtually the breadth of the country, [similarly, can] hardly be called a cost associated with putting natural gas produced from the Outer Continental Shelf off the State of Texas into marketable condition." Id.

Further disputing "MMS's finding that the unit prices received by FNGC are representative of the actual market value of the gas and that royalties should have been calculated and paid based on sales to FNGC's purchasers (Order at 3)," appellants deny there is any support for the conclusion that the prices that FNGC received for the gas in French Lick, Indiana and Willow Run, Michigan are representative of the actual market value of High Island Block 571 gas produced on the OCS.

They argue that the terms of FNGC's contracts themselves, contradicts MMS' conclusory statement regarding marketing costs. Appellants note that the pricing formula found in Article V of the FNGC contracts contains a specific provision providing for an adjustment for "appropriate treating and related costs." Such costs include treatment, dehydration, and compression costs between the delivery point and where the gas is received from FOCC or PDI and the delivery points utilized in the spot index. The parties, appellants reason, have thus provided for situations where there will be adjustments for costs associated with making the gas marketable. Documentation of the various sales under the contract denominated as "supply packages" are attached to the contract as Exhibit A to the FNGC contracts. (Ex. 1 and 2 to SOR.) Appellants maintain that in "virtually all circumstances, the adjustment provided for treatment costs is 0" meaning that "for almost all locations there are no cost associated with putting the gas in marketable condition." (SOR at 39.) This conclusion, appellants aver, is consistent with the fact that gas, historically, has been sold in marketable condition by FOCC and PDI at the wellhead.

Appellants reason that "the adjustment" (which is almost always zero) provided in the sales packages attached to FNGC's contract, also, makes clear that the mechanistic calculation of the arithmetic difference between the FNGC purchase price and FNGC resale price has nothing to do with putting the gas in marketable condition. (SOR at 39.) Appellants criticize MMS' failure to "even attempt to quantify those alleged marketing costs." Id. at 39-40. Instead, they urge that MMS "in a mechanistic fashion subtracts the FNGC purchase price from the FNGC resale price and calls the resulting difference the cost of putting the gas in marketable condition or marketing costs." Appellants reason that to be sustainable, the arithmetic difference must equal the costs incurred by FNGC to put the gas in marketable condition. Appellants deny, however, that there is any support in the record for this sweeping conclusion. Id. at 40.

Appellants explain in their SOR that FERC regulatory initiatives, specifically FERC Order No. 436, and its progeny, have drastically altered the roles played by lessees/producers and pipelines in the natural gas market. Specifically, appellants relate that under FERC Order No. 436, pipelines who traditionally purchased gas from producers and marketed gas to local distribution companies (LDCs) and end-users (residential and industrial customers) moved from gas merchants (buying and reselling gas to end-users) to common carriers (transporting gas for a fee). Because pipelines after FERC Order No. 436 were no longer purchasing gas from lessees/producers at the wellhead and reselling it to LDCs and end-users, producers had to fill the gap. Producers no longer simply marketed the gas by selling the gas to the pipeline at the wellhead but were required to sell to end-users, LDCs and industrial/residential consumers. These developments, appellants relate, resulted in the emergence of marketing affiliates to perform functions previously performed by pipelines and to solve problems associated with tracking production back to the lease for royalty accounting and severance tax purposes. (SOR at 11-19.)

Maintaining that there is clearly a market for the gas at the wellhead, appellants assert that "[a]fter FNGC purchases the gas [from FOCC and PDI], [FNGC] engages in independent marketing functions that are unrelated to the production of gas or to royalty valuation." Id. at 40. FNGC, appellants contend, adds value by arranging for purchasers throughout the country and by arranging for transportation of the gas to those purchasers. Appellants insist that the value that a nonlessee, such as FNGC adds, has nothing to do with the value of production for royalty purposes. Id.

Appellants argue that implicit in MMS' conclusion that the entire difference between the price at which FNGC purchases gas and the FNGC resale price is the cost of putting the gas in "marketable condition" "is an assumption that FNGC does not provide transportation services." Id. at 41. At best, MMS concedes in the Field Report that a deduction for transportation is allowed on those few sales where FNGC did perform transportation services." (Field Report at 6.) The Decision, FNGC argues, essentially ignores the transportation information making only passing reference to the statement in the Field Report, while concluding that any "factual errors would have no material bearing on the decision [sic]." This, appellants contend, cannot be, "because MMS has repeatedly stated that FNGC provides few or no transportation services." See Field Report at 4, 6. MMS' statements, it is contended, find no support in the record. Appellants insist that they have shown in "voluminous submission to the Director" that "approximately 90% of FNGC sales -- whether considered by number or by volume -- occurred downstream of the wellhead and involved transportation services arranged by FNGC." (SOR at 41.) Appellants state that FNGC provides significant transportation services: "It is taking gas produced more than 100 miles offshore in the Gulf of Mexico and transporting it on the ANR system almost to the Canadian border." Moreover, "as made clear by materials supplied to the Director ([appellants'] 4/26/94 Response at 20-31), FNGC transported significant volumes of gas into the State of Indiana to connect with the Texas Eastern and Tennessee Gas systems -- two major interstate pipeline systems that serve New Jersey, New York, and the Northeast." Id. at 42-43.

Appellants reason that "if 90% of FNGC's sales involved transportation services, and if -- as MMS concedes -- a deduction for transportation is allowed where FNGC provided transportation services, then it is not possible for the difference between the FNGC purchase price and FNGC resale price to be `marketing costs.'" (SOR at 41.)

Appellants deny, moreover, that the effect of this transportation, i.e., transporting gas away from the lease by FNGC, is insignificant. MMS, appellants contend, has recognized as much in a November 26, 1996, "General Valuation Guidance For Auditing Affiliate Sales of Natural Gas." Therein, the Associate Director, MMS, stated "if the resale of production from the affiliate to a third party occurs in the same field or area as the sale from the lessee to its affiliate, the proceeds under the arm's-length resale contract may be used in calculating the applicable benchmark value." Id. at 42. Here, appellants emphasize that "the overwhelming majority of the sales by FNGC took place downstream -- often hundreds of miles downstream -- from the wellhead." The sales to third parties, they insist, did not occur in the "same field or area." Id. Thus, appellants urge that even under MMS' own audit policy there is no basis to treat the FNGC sales price as the value for royalty purposes. Id.

Likewise, appellants contend that in the Field Report, "MMS has mistakenly assumed that none of the gas sold under the FNGC contract was processed and that FNGC performed no processing services." (Field Report at 4.) Appellants assert that in its "Response to Report" it demonstrated that FNGC frequently bought gas and had it processed. Employing the same argument advanced in the case of transportation costs, above, appellants insist that if the gas is processed and FNGC is entitled to a processing allowance, the arithmetic difference between the FNGC purchase price and the FNGC resale price cannot be equal to the cost of putting the gas in marketable condition. Alternatively, appellants assert that "even if MMS could treat distant locations as value for royalty purposes, [appellants] would be entitled to deductions for costs of transportation, processing and manufacturing." See 30 C.F.R. § 206.151 (SOR at 42).

Appellants deny that the cases relied upon by MMS stand for the proposition that the price at which FNGC sells gas to unaffiliated third party purchasers must be the value of the lessee's production for royalty purposes. Nor do they, appellants state, stand for the proposition that the difference between the price received by appellants and FNGC's resale price constitutes marketing costs or the cost of putting the gas in marketable condition. (SOR at 44.)

Specifically pointing to Santa Fe Energy Products Co. v. McCutcheon, supra, Shell Oil Co. (On Reconsideration), supra, and Xeno, Inc., supra, appellants deny that any of the cases support the result dictated by the Decision in this case. Appellants note that all three cases permit access to documents of an affiliate under certain circumstances. None, however holds that the "resale price of an affiliate should be -- let alone must be -- the value of a lessee's production for royalty purposes."

Santa Fe, decided under the old oil regulations, appellants urge stands for the proposition that MMS can obtain information from affiliates regarding arm's-length sales in order to determine value for royalty purposes under the pre-1988 regulations, which instructed MMS to look at various factors including "other relevant matters." 30 C.F.R. § 206.137 (1987).

Appellants urge Shell was similar in upholding MMS' right to obtain resale price information from Shell and its affiliates. Therein, the Board also explicitly recognized that "the term lessee * * * is specific and cannot be expanded to include an affiliate of the lessee." 132 IBLA at 357; (SOR at 45). On appeal the district court in Shell Oil Co. v. Babbitt, 945 F. Supp. 792 (D. Del. 1996), upheld the Board's determination that documents involving resale could be obtained from the affiliate. Appellants point out that the court, however, expressly declined to decide whether the lessee's royalty value could be based on the affiliate's resale price especially for the post 1988 period:

> What this Court does not hold is perhaps just as significant as the core holding itself. This Court does not hold the interpretation of the gross proceeds rule posited by the Government in this proceeding is correct; indeed, the factual vacuum in which this Court must proceed cannot sustain the vitality of such a holding.

945 F. Supp. at 811.

Appellants insist that neither the Board nor the court's decision in Shell, supra, requires the result mandated by the decision in this case. They contend a factual vacuum exists in this case as well.

Appellants argue that the final case cited by MMS, Xeno, provides support for appellants position, not MMS'. Appellants state that Xeno also involved a case where the Board concluded that MMS could obtain information concerning the first arms length sale of gas by an affiliate and that MMS could properly consider the first arm's-length transaction in determining the value of gas produced under the gross proceeds rule. 134 IBLA at 178-79. Recognizing that it is one thing to say that MMS may consider the resale price of an affiliate and quite another to say the affiliates resale price controls, the Board in Xeno reversed MMS' decision concluding that the resale price was not necessarily the value for royalty purposes.

Appellants, seeking to draw a parallel between this case and Xeno, argue that here, as in Xeno, there was evidence that the gas was in marketable condition at the wellhead. Finding the gas to have been in marketable condition at the wellhead, the Board in Xeno rejected MMS' argument that the difference between the initial sales price and the affiliate resale price was the cost of placing the gas in marketable condition and declined to hold that the value of lessee's production for royalty purposes was established by the first arm's-length contract between the affiliate entity and the third party purchaser.

Here, as in Xeno, appellants note that the marketable condition of the gas at the wellhead was established by sales to unaffiliated firms at the wellhead. While conceding that cases authorize MMS to scrutinize inter-affiliate sales, appellants argue that such scrutiny requires analysis of all facts and circumstances, analysis not presented here. Appellants maintain "in the face of much evidence about the transportation of gas and its resale at points hundreds of miles from the lease, the Decision simply concludes that the difference between the purchase price and FNGC resale price is the cost of putting the gas in marketable condition." Appellants argue that the Decision, like MMS' initial Order in this case "fails to demonstrate any justifiably basis for choosing the FNGC resale price as the value of lessees' production." (SOR at 47.)

Valuation Based on Regulatory Benchmarks

Appellants criticize MMS for cavalierly dismissing the benchmarks identified in the regulation. Applying 30 C.F.R. § 206.152(c)(1), appellants assert that the FNGC contract price should be the value for royalty purposes. They reason

> when gas is not sold pursuant to an arm's-length contract, under the prioritized benchmark system, the value of gas for royalty purposes is the gross proceeds accruing to the lessee under the non-arm's-length contracts, provided that those proceeds are equivalent to the gross proceeds derived from or paid under comparable arm's-length contracts for sale of like quality gas in the same field.

(SOR at 48.) Appellants argue that the prices they received from FNGC for gas are equivalent to the prices paid under comparable arm's-length contracts for the purchase, sale, or other disposition of like quality gas in the same field or area.

That the prices received are equivalents, appellants contend, is ensured by the methodology used to establish the contract price in the price provision of the various contracts. Under those contracts, if FNGC is purchasing gas from a third party in the same field under similar terms and conditions, the contracts dictate that the FNGC price to FOCC or PDI will be the same as the average of the arm's-length contract prices between FNGC and unrelated third parties. Only in cases where FNGC is not purchasing from a third party in the same field under similar terms and conditions is the contract formula used. Under the contract formula an average of three index prices, less a location differential (which serves the same purpose as a transportation factor), is used. Appellants emphasize that "[n]one of those index prices is within the control of FOCC, PDI or FNGC." This alone, they contend demonstrates that the FNGC contract prices cannot be the result of a sweetheart deal between company executives where the lessor is being "asked to accept whatever price is negotiated between company executives."

Use of market indices, appellants maintain, demonstrates that the formula price is based on prices established by the market consistent with the Board's long held recognition of the importance of market information in determining royalty values. In the case of High Island Block 571, for example, appellants note that they rely on the published indices of Natural Gas Pipe Line Company of America, Tennessee Gas Pipe Line Company, and Transcontinental Gas Pipe Line Corporation. Because these indices are based on actual prices of gas bought and sold by unrelated purchasers and sellers, "they are thought to be accurate and reliable sources of spot market prices." (SOR at 50.)

Appellants reason that while FNGC contracts with PDI and FOCC may not be arm's-length contracts, proceeds accruing thereunder, "are nonetheless based on market prices." Appellants claim that MMS' Decision "makes only a passing reference to the fact that MMS maintains that the FNGC contract price is not equivalent to contract prices received by other producers in the same field, and that sales data assembled by MMS is out of line with published indices that establish a market price based on actual purchases by three major interstate pipeline in that area." Id. at 51. As to High Island Block 571, appellants deny that it can verify the accuracy of sales data relied on by MMS to conclude that prices received by FOCC and PDI are not equivalent to other producers in the same field. Id.

More specifically, appellants note that "[f]or every month for which MMS provided data (October 1990 through May 1991), the median price identified by MMS at the wellhead at High Island Block 571 is higher -- and in some cases, significantly higher -- than the average of the three onshore indices used in the FNGC pricing formula, even before the location differential is applied." Because spot market sales at the wellhead cannot be more valuable than spot market gas onshore (because wellhead gas has to be transported to shore), appellants argue that MMS' conclusions are "counter-intuitive." Id. at 51. MMS' numbers, it is contented, are either wrong or the numbers are not based on comparable sales. Appellants note that

> [d]uring the audit period, * * * it cost as much as 25 [cents] per MMBtu to transfer gas to shore. However,

> according to the [MMS'] numbers in the Order, even if one were able to transport gas to shore without any charge, the median price for the High Island Block 571 gas, as delivered, still would be higher than the onshore spot market price. This clearly suggests that MMS is not comparing apples to apples.

Id. at 51. The contention that FNGC's prices are equivalent to prices under comparable spot contracts, appellants urge, is reinforced by their understanding of the market for gas produced in the Gulf, and by preliminary net-back calculations which confirm the validity of the pricing formula in the FNGC contracts. They note, for example, that in the month of January 1994 it cost FNGC approximately 16.5 cents to transport gas from the High Island Block 571 platform to shore. Appellants relate that the total transportation cost was approximately 16.54 cents per MMBBtu, virtually identical to the 17 cents location differential/transportation factor included in the FNGC contract. Appellants therefore assert that the use of market indices and transportation factors, which are consistent with net-back calculations, demonstrates that the price paid by FNGC at the wellhead is equivalent to the gross proceeds received under any comparable arm's-length contract.

Appellants close their SOR requesting a hearing before an Administrative Law Judge pursuant to 43 C.F.R. § 4.415 "[t]o the extent the Board believes it must address factual issues inherent in any application of the prioritized benchmark system." Id.

MMS' Arguments

Gross Proceeds Rule

MMS' Answer does not address appellants' arguments applying the regulatory benchmarks contained in 30 C.F.R. § 206.152(c). Instead, MMS, citing the same cases cited by the Associate Director in the Decision, insists "the first arm's-length sale of an affiliate's production determines value for royalty purposes under the gross proceeds rule." (Answer at 3.)

MMS, relying on Shell Oil Co. (On Reconsideration), supra, maintains that even if FOCC's and PDI's production should be valued under the first benchmark, "MMS must nonetheless determine gross proceeds accruing to the lessee and compare this gross proceeds value to any other applicable value of production to establish the minimum value for royalty purposes."

MMS argues that the Board in Xeno, Inc., held that in construing the gross proceeds rule "MMS may look to the first arm's-length sale by an affiliate, less transportation costs, to determine the value of production for royalty purposes." The Board, in Xeno, Inc., MMS contends, found it was "reasonable" for MMS to look to the first arm's-length sales by an affiliate where the lessee obtained an economic benefit by selling its production to an affiliate in a nonarm's-length transaction. Id. at 6.

MMS contends, as it did in Xeno, supra, that the lessee obtained an economic benefit by selling its production to an affiliate in a nonarm's-length transaction. Because FOCC and PDI paid royalty on the lower nonarm's-length price received from their affiliate, MMS insists the interaffiliate transfer "created an economic benefit for FOCC and PDI by enabling them to pay royalties based upon the lower non-arm's-length price." Id. at 7. On this basis alone, MMS submits the Board should affirm the Decision.

MMS denies appellants' contention that it erred in attempting to apply the "gross proceeds" rule directly to FNGC, a party not included in the definition of "lessee" under applicable regulation. Asserting that appellants misunderstand the regulation, MMS explains that it "applied the rule to the Federal lessees, FOCC and PDI, not FNGC. By considering the gross proceeds received by FNGC from third-party purchasers," MMS states, "[it] concluded that gross proceeds of FOCC and PDI exceeded their claimed benchmark values of production, upon which they based their royalty calculations." (Answer at 7.)

Alternatively, MMS urges the Board to revisit its decision in Shell Oil Co. (On Reconsideration), supra, and "for purposes of clarity * * * modify" (essentially, reverse) its finding that a lessee does not include a lessee's affiliate. MMS offers proposed language stating, inter alia, "`lessee' may include an `affiliate.'" Id. at 24.

MMS challenges appellants' attempt to distinguish Santa Fe III, 90 F.3d 409 (10th Cir. 1996), contending that as in that case "nothing in the 1993 regulations limits the methods MMS may employ to determine a lessee's gross proceeds." (Answer at 8.)

MMS denies that it impermissibly attempted to reap the benefits of the "marketing affiliate" rule (30 C.F.R. § 206.152(b)(1)(i)), which MMS concedes does not apply because FNGC is not a "marketing affiliate" as defined by regulation. Even though MMS recognizes that this rule does not apply, MMS denies that it is deprived of the remedy afforded by that rule under 30 C.F.R. § 206.152(b)(1), i.e., that it may require a lessee to value production for royalty purposes based upon the gross proceeds accruing to their affiliates in the first arm's-length sale to third parties. MMS denies that "by specifically stating that a `marketing affiliate's' proceeds establish the value of production for royalty purposes under § 206.152(b)(1)(i), [MMS] precluded itself from determining that an affiliate's proceeds establish the value of production under § 206.152(c), the gross proceeds rule." (Answer at 9.)

MMS denies that it so restricted itself in promulgating the marketing affiliate rule in § 206.152(b)(1)(i), maintaining that it adopted the marketing affiliate rule in response to requests from the oil and gas industry during the rulemaking process. MMS states: "Industry objected to MMS's use of benchmarks to value production in instances where a producer transfers production to its marketing affiliate who then sells to an independent third party in an arm's-length transaction. See [53 Fed. Reg. 1184, 1196 (1988);] see also 52 Fed. Reg. 30826, 30841 (1987)." "Industry," MMS states, "was concerned that applying the benchmarks could lead to a higher value of production than the actual sale price in a subsequent arms-length transaction. 52 Fed. Reg. 30841." (Answer at 9.) MMS states that it "added the marketing affiliate clause to establish that, in cases where a producer sells to its marketing affiliate, the subsequent transaction between the marketing affiliate and independent third party would establish as the royalty value the gross proceeds accruing to the lessee and the benchmark system would not apply." Id.

Consequently, MMS concludes that the marketing affiliate clause was not intended to limit the methods by which MMS could determine gross proceeds under § 206.152(h). MMS claims that even where the marketing affiliate rule does not apply, MMS is not required to accept the affiliates proceeds as the value for royalty purposes and to exclude consideration of the benchmarks. MMS argues, citing 30 C.F.R. § 206.152(c),(h) and Xeno, 134 IBLA at 178-79 that "[in] such a case, therefore, the value of production would be the greater of: (1) the benchmark value under 30 C.F.R. § 206.152(c); or (2) the lessee's gross proceeds, which MMS may determine by considering the affiliate's gross proceeds under its arm's-length sales." (Answer at 10.)

MMS emphasizes that no statement in the rulemaking history or in the rules prevents MMS from looking to an affiliate's arm's-length sales to establish the lessee's gross proceeds. Such a limit MMS contends would "conflict with [MMS'] obligation in 30 C.F.R. § 206.152(h) to value production, at a minimum, as the lessee's gross proceeds." Based on the foregoing application of the gross proceeds rule, MMS insists, the Board should affirm the holding in the decision "that FNGC's arm's-length sale of FOCC and PDI's production, less allowable transportation costs, establish the lessees' gross proceeds for royalty purposes." Id. at 11.

Marketable Condition/Marketing Costs

Secondly, MMS denies that FOCC and PDI can deduct marketing costs from the value of their production for royalty purposes. MMS notes that the Decision states that "FOCC and PDI's gas sales to FNGC include deductions from the sales price to compensate FNGC for the cost of marketing the gas for downstream sales."

MMS notes that appellants "interpret this ruling as an application of the `marketable condition' rule found at 30 C.F.R. § 206.152(i)" and contend "because a market for their production existed at the wellhead, the gas was in marketable condition when FNGC purchased it."

MMS asserts that FOCC and PDI's argument relying on the "marketable condition rule," "misconstrue[s] the regulations." Relying on Amoco Production Co., 112 IBLA 77, 87 (1989); Arco Oil & Gas Co., 112 IBLA 8, 11

(1989), MMS notes that the Federal lessee has a duty to market production, and must bear the expenses incurred in discharging that obligation. Noting that the Board recognized in Amoco that

> [t]he creation and development of markets for production is the very essence of the lessee's implied obligation to prudently market production from the lease at the highest price obtainable for the mutual benefit of the lessee and lessor * * *. [The producer] has cited no authority, nor do we find any which supports an allowance for the creation and development of markets for the royalty share of production.

Arco, supra at 11; see also Walter Oil and Gas Corp., supra. Based on these authorities, MMS insists that the cost of the "marketing services" provided by FNGC cannot be deducted from the value of production for purposes of royalty calculation. (Answer at 12.)

MMS emphasizes that the Board explicitly rejected the argument that a lessee may deduct the cost of marketing services from its gross proceeds because the services had nothing to do with placing gas in "marketable condition." Walter Oil and Gas Corp., supra. Acknowledging that the regulations disallowed deductions for "marketing costs," Walter Oil argued that because the services provided by the marketing agent had nothing to do with placing the gas in marketable condition, a deduction for such marketing costs should be allowed. Id. at 261.

Likewise, MMS contends that in the instant case FOCC and PDI point to no affirmative regulation entitling them to a deduction of the costs of FNGC's "downstream marketing services." MMS insists "that in the absence of such authority, MMS properly applied the gross proceeds rule to disallow the deduction of such marketing costs from the value of production for royalty purposes." Id. at 13.

MMS notes that the "marketable condition rule" in 1997 was amended to read "the lessee must place gas in marketable condition and market the gas for the mutual benefit of the lessee and lessor at no cost to the Federal Government." Id. at 13, n.9. MMS concludes, "[t]herefore, even if such a market existed and the gas was in marketable condition when it left the wellhead, marketing costs associated with the creation or development of a market are nonetheless not deductible." Id. at 14.

Defending the claim that MMS mechanically concluded that the difference between the FOCC, PDI, and FNGC price were marketing costs, MMS argues that

> [g]iven that FNGC marketed most of the production of FOCC and PDI, MMS reasonably concluded that the price FOCC and PDI accepted from FNGC reflected a reduction intended to compensate FNGC for the cost of the marketing services it provided. Because

> of this reduction for marketing cost, FOCC, and PDI violated the gross proceeds rule by basing their royalty payments upon the price they received from FNGC without adding the cost of FNGC's marketing services.

(Answer at 16 (footnotes omitted).) MMS insists that "[l]ogically, it follows" that FNGC's marketing costs are equivalent to the difference between the higher arm's-length price FNGC received when it marketed the gas and the price FNGC paid FOCC and PDI (less any applicable transportation allowances).

Acknowledging FOCC and PDI's claim that the price differential between the nonarm's-length price received from FNGC and the arm's-length prices FNGC received from third party sales reflects transportation and processing costs, MMS concedes in a footnote "if true, and if FOCC and PDI can substantiate these costs, they may properly deduct these costs from their gross proceeds in accordance with 30 C.F.R. §§ 206.156-206.159 (1993)." (Answer at 16, n.13.)

Pierce the Corporate Veil

Thirdly and finally, MMS argues that the Board should refuse to recognize a corporate distinction between FOCC, PDI, and FNGC for the purpose of determining the gross proceeds accruing to FOCC and PDI. MMS urges that under applicable law, the Board should treat FOCC, PDI, and FNGC as one entity. To disregard the corporate form, MMS contends, is an equitable exception to the recognition of separate corporate entities. In earlier submissions MMS characterized the sales between FOCC, PDI, and FNGC as "paper transactions." Here, MMS urges the Board to pierce the corporate veil of affiliated companies maintaining that the sales to affiliates qualify as "a manifestation that affiliated companies are using their corporate relationship to defeat royalty collection efforts" within the purview of the Board's decision in Shell Western Exploration & Production, 112 IBLA 394, 400 (1990). (Answer at 17-25.)

Appellants' Reply

In their reply, appellants deny the FNGC sales price is equal to the value of production for royalty purposes. Appellants deny that marketing costs are paid for by FNGC; rather, appellants argue that FNGC enhances the value of the already-marketable gas by further marketing it downstream of the lease. This downstream marketing, appellants contend, is above and beyond the ordinary costs of marketing the production at no cost to the lessor.

[1, 2] Recently, the Board issued a decision in Seagull Energy Corp., 148 IBLA 300 (1999), which reversed a decision by the Associate Director, MMS, where the circumstances, facts, issues, and arguments by the parties were similar to those in this appeal. However, subsequently, the Acting Assistant Secretary, Land and Minerals Management, with the concurrence of

the Secretary of the Interior, issued a May 18, 1999, decision in Texaco Exploration and Production, Inc., which negates the precedential value of Seagull on the issues extant herein. 1/

In her decision, the Acting Assistant Secretary rejected the Board's rational in Seagull which she refused to follow, and affirmed an MMS Order dated July 29, 1992, which directed Texaco Exploration and Production, Inc., and Texaco, Inc., to recalculate and pay additional royalties on crude oil it sold or transferred to its affiliate under a nonarm's-length contract and which its affiliate then resold at arm's length to a third-party purchaser.

With respect to the arguments considered in this appeal, the decision of the Acting Assistant Secretary has examined and ruled on the ultimate issues highlighted in this appeal. The arguments raised by appellants with respect to value of production for royalty purposes have all been addressed in Texaco. Therein the Acting Assistant Secretary examined the nature of a sale between affiliates including application of the benchmark system to determine value of production in accordance with the gross proceeds rule, the marketable condition requirement, a lessee's duty to market lease production, the authority of MMS to require a Federal oil and gas lessee to perform restructured accounting and affirmed MMS in all respects. Under Texaco, supra, we find that MMS properly applied the gross proceeds rule to disallow the deduction of such marketing costs from the value of production for royalty purposes. With the Secretary's concurrence, the Texaco decision constitutes a final decision for the Department. See 43 C.F.R. § 4.5(a). We therefore append the Texaco decision, and adopt the analysis and rational contained therein to affirm MMS.

1/ On June 3, 1999, as this Order was in final preparation, MMS filed a motion to dismiss this appeal "due to statutory final decision." MMS seems to argue that since several extensions were either granted prior to the passage of RSFA, or the fact that MMS has no record of an Order granting extensions in its files that there was no "agreement in writing to extend the 33-month time limit of RSFA." We disagree because the record and the conduct of the parties belie the motion. Both parties to this appeal requested, in writing, and received extensions of time in which to file various briefing papers with the Board. At no time did the parties allege any procedural defect and took full advantage of the extensions in which to file with the Board. In fact, extensions were granted to MMS totaling 18 months and FINA 6 months. Having taken advantage of the extensions of time, neither party can now be heard to argue, using a strained reading of the statutory language, that the extensions are defective in some technical sense. That is not the purpose of this provision of RSFA and to now allege such is disingenuous. In any event, our disposition of this appeal puts it in essentially the same position as if the statutory deadline had expired. The issue is therefore moot for the purposes of this appeal. We do, however, emphasize that we find that the statutory time limit has not expired and so rule.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the June 7, 1996, Decision of the Associate Director, MMS, appealed from is affirmed.

Gail M. Frazier
Administrative Judge

I concur:

James P. Terry
Administrative Judge