

WAGNER & BROWN, LTD.

IBLA 99-327

Decided April 30, 2001

Appeal from a decision of the Associate Director, Minerals Management Service, upholding an order directing lessee to recalculate and pay additional royalties. MMS-98-0089-O&G.

Affirmed as modified.

1. Oil and Gas Leases: Royalties: Generally

A federal lessee has a duty to market production sold at the lease or in the field at no cost to the lessor. Marketing costs cannot be deducted from gross proceeds, equal to the value of production, before royalty is calculated and when a lessee arranges for someone else to conduct the marketing it must add the costs of that service to its gross proceeds.

APPEARANCES: Charles L. Kaiser, Esq., Charles A. Breer, Esq., and Claire E. Douthit, Esq., Denver, Colorado, for Wagner & Brown, Ltd.; Janet H. Lin, Esq., Geoffrey Heath, Esq., Howard Chalker, Esq., and Christopher P. Salotti, Esq., Office of the Solicitor, U.S. Department of the Interior, for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE IRWIN

Wagner & Brown, Ltd., sold crude oil it produced from its leases in Washakie County, Wyoming, to its affiliate, Lantern Petroleum Corporation, at the lease for the Marathon Oil Company posted price for Wyoming asphalt sour crude oil plus \$.25 or \$.50 per barrel bonus. Lantern also purchased oil from the same field from other producers at the same price.

Lantern sold the oil to Farmers Union Central Exchange (Cenex) and other third parties at the lease for the price it had paid Wagner & Brown and other producers plus \$.65/barrel for oil transported by truck or \$1.15/barrel transported by pipeline.

Based on an audit, the Minerals Management Service (MMS) ordered Wagner & Brown to recalculate the royalties Lantern had paid on Wagner & Brown's behalf from September 1990 through August 1996 and pay additional

royalties based on the price Cenex paid Lantern rather than the price Lantern paid Wagner & Brown. Wagner & Brown appealed the MMS order.

In a February 12, 1999, decision, the Associate Director for Policy and Management Improvement, MMS, denied Wagner & Brown's appeal. Based on the sales agreement between Lantern and Cenex, MMS found that under the Lantern and Cenex sales agreement Lantern delivered the oil to Cenex for sale at the lease, i.e., at the same place Lantern bought it. MMS concluded that Lantern did not transport the oil and therefore the difference between the price Lantern paid Wagner & Brown and the price Cenex paid Lantern was not a deductible transportation cost but rather a field marketing cost paid by Wagner & Brown to Lantern that should be added to Wagner & Brown's gross proceeds for purposes of computing royalty because Wagner & Brown had a duty to market the oil at no cost to the lessor. See 30 C.F.R. § 206.102(h) (1990). Wagner & Brown, Ltd., MMS-98-0089-O&G, at 5-6.

On appeal to us, Wagner & Brown argues MMS' claim "that the only function Lantern performed was marketing in the field" (MMS Answer at 6) "is not true. Lantern marketed oil downstream to various locations * * * See, e.g., Exhibit 7 (sales contract showing Lantern marketed downstream to Silver Tip[, Montana])." Reply at 6; see Response at 2, Exh 9. Wagner & Brown also argues that MMS' statement that a lessee's "choice to market downstream does not make marketing costs deductible" (MMS Answer at 9, note 3) was rejected by the court in Independent Petroleum Association of America (IPAA) v. Armstrong, 91 F. Supp.2d 117 (D.D.C. 2000). Id. at 7.

MMS responds that the IPAA decision "invalidated certain portions of MMS' 1997 amendments to gas transportation allowance regulations" (Surreply at 5) and "is expressly limited to the so-called 'downstream' marketing costs at issue in that matter." Id. at 8. "In the instant matter, [MMS] found that the terms of the sales contract to CENEX indicate that delivery of the lease production by Lantern to CENEX occurred at the leases, and neither Lantern nor Wagner & Brown incurred transportation costs." Id. Thus, IPAA "does not stand for the proposition that marketing costs incurred at the lease are deductible and * * * it does not appear that these transactions fall under that decision." Id. (emphasis in original).

[1] A federal lessee's duty to market production sold at the lease or in the field at no cost to the lessor is well established. Mesa Operating Limited Partnership v. U. S. Department of the Interior, 931 F.2d 318, 325 (5th Cir. 1991). "[M]arketing costs cannot be deducted from gross proceeds, equal to the value of production, before royalty is calculated." Id. (emphasis in original). See California Company v. Udall, 296 F.2d 384, 387 (D.C. Cir. 1961). When a lessee arranges for someone else to market production sold at the lease or in the field, MMS properly requires the lessee to add the marketing costs back into the gross proceeds on which federal royalty is calculated. Amerac Energy Corp., 148 IBLA 82, 88-89 (1999); Walter Oil and Gas Corp., 111 IBLA 260, 264 (1989). That is the situation in this case as to the oil Lantern sold at the lease. Therefore, MMS' February 1999 decision upholding the order to recalculate and pay is properly affirmed to that extent.

To the extent that Wagner & Brown's submissions on appeal to us demonstrate that some of its oil was not sold at the lease or in the field during this period, i.e., was sold downstream, the record does not reflect that this information was before the Associate Director. Because this information appears to relate to the audit period involved, Wagner & Brown may document the extent of downstream marketing to MMS in its recalculation. We cannot determine that from the record before us. The costs of downstream marketing during the period involved would appear to have been deductible under the FERC-approved tariff. See IPAA, supra at 123.

Therefore, in accordance with the authority delegated to the Interior Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, MMS' February 19, 1999, decision is affirmed as modified.

Will A. Irwin
Administrative Judge

I concur:

John H. Kelly
Administrative Judge

