



PLAINS EXPLORATION & PRODUCTION COMPANY

178 IBLA 327

Decided January 15, 2010



United States Department of the Interior  
Office of Hearings and Appeals  
Interior Board of Land Appeals  
801 N. Quincy St., Suite 300  
Arlington, VA 22203

PLAINS EXPLORATION & PRODUCTION COMPANY

IBLA 2009-271 and 2009-272

Decided January 15, 2010

Appeals from decisions of the Deputy State Director for Energy, Lands, and Minerals, Colorado State Office, Bureau of Land Management, denying beneficial use status to certain natural gas produced from Federal onshore oil and gas leases used as compressor fuel and gas processing plant fuel. CO-09-05 and CO-09-06.

Decision in IBLA 2009-271 (CO-09-05) affirmed in part and reversed in part; decision in IBLA 2009-272 (CO-09-06) affirmed.

1. Oil and Gas Leases: Royalties: Generally

Gas produced from an onshore Federal lease used as fuel in a compressor located off the lease, unit, or communitized tract from which the gas is produced is royalty-bearing under 30 C.F.R. § 202.150(b)(1) and Notice to Lessees and Operators of Onshore Federal and Indian Oil and Gas Leases (NTL-4A).

2. Oil and Gas Leases: Royalties: Generally--Oil and Gas Leases: Royalties: Processing Allowance

Under 30 C.F.R. § 202.151(b), the proportionate share allocable to a particular Federal lease of a reasonable amount of residue gas used for operation of a gas processing plant is royalty-free even if the plant is located off the lease, unit, or communitized tract from which the gas is produced.

APPEARANCES: Laura Lindley, Esq., Denver, Colorado, for appellant; John S. Retrum, Esq., Office of the Regional Solicitor, U.S. Department of the Interior, Lakewood, Colorado, for the Bureau of Land Management.

OPINION BY ADMINISTRATIVE JUDGE HEATH

Plains Exploration & Production Company (PXP) appeals from two decisions of the Deputy State Director, Colorado State Office, Bureau of Land Management (BLM), both dated May 22, 2009 (SD Decisions). The decision in CO-09-05 affirmed

the February 11, 2009, decision letter of BLM's Grand Junction Field Office (GJFO) denying royalty-free beneficial use status to gas produced from Federal oil and gas leases in the East Plateau and Brush Creek Fields that was used as fuel for (1) compressors located off the leases and off the communitized tracts that included parts of some of the leases involved, and (2) a processing plant located outside both fields. The decision in CO-09-06 affirmed the March 17, 2009, decision letter of BLM's Glenwood Springs Energy Office (GSEO) denying royalty-free beneficial use status to gas produced from Federal oil and gas leases in the Hells Gulch Field that was used as fuel for a compressor located off the leases involved. For the reasons explained below, we affirm in part and reverse in part the SD Decision in CO-09-05, and affirm the SD Decision in CO-09-06.

### *Factual and Legal Background*

#### *A. The Fields, Leases, and Communitization Agreements*

##### *1. The East Plateau and Brush Creek Fields (IBLA 2009-271)*

The East Plateau Field is located in eastern Mesa County, Colorado, in parts of Ts. 9 and 10 S., Rs. 94 and 95 W., 6th Principal Meridian (P.M.), near the town of Collbran. The field includes both Federal and private surface and Federal and private mineral estate. The field includes PXP's Federal oil and gas leases COC-23102, 51673, and 65766.<sup>1</sup>

According to PXP, the producing formation in the East Plateau Field is a tight sand formation requiring close well spacing for maximum natural gas recovery. See Statement of Reasons in IBLA 2009-271 (271 SOR) at 1. Numerous wells are producing from both the Federal leases and the private properties. Virtually all have been directionally drilled from surface well pads, each of which serves a number of wells. It appears that there are 18 active surface pads in the East Plateau Field, and that 24 wells have been drilled from 7 of the surface pads to bottom hole locations within the Federal leases. One surface pad located on Lease 23102 (and serving 10 of the wells) is the only surface pad located on any of the Federal leases. The remaining 14 wells drilled into the Federal leases were drilled from pads on private lands. See PXP Planned Development Map for the Brush Creek/East Plateau Fields, dated Jan. 24, 2008, in the Administrative Record (AR) for IBLA 2009-271 (271 AR) and 271 SOR Ex. B.

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<sup>1</sup> Lease 23102 is situated in secs. 5, 6, 8, and 17, T. 10 S., R. 94 W., 6th P.M. Leases COC-51673 and 65766 are both situated in parts of secs. 31 and 32, T. 9 S., R. 94 W., 6th P.M.

According to PXP and BLM records in the AR, portions of Leases 23102 and 51673 are subject to communitized development with adjacent private properties in certain quarter sections under identified communitization agreements (CAs).<sup>2</sup> Lease 65766 is not subject to any CA. 271 SOR at 2.

Lines run from all of the surface pads in the field to the East Plateau compressor, located on private lands in SW $\frac{1}{4}$  sec. 8, T. 10 S., R. 94 W., 6th P.M. The compressor is not on any of the communitized tracts that include portions of Leases 23102 and 51673. Gas moves from the compressor to a junction with the Collbran Valley Gathering System (CVGS) line near Plateau Creek, approximately on the boundary of the NW $\frac{1}{4}$  and the NE $\frac{1}{4}$  sec. 36, T. 9 S., R. 95 W., 6th P.M. The CVGS line carries the gas to the Anderson Gulch gas plant west of Collbran for processing. Residue gas is delivered at the tailgate of the plant to one of two pipelines for sale. PXP Planned Development Map; Laramie Energy, LLC, Gathering Systems Map, 271 AR; PXP Application for Commingling dated Dec. 15, 2008, 271 AR, at unpaginated 4.

The Brush Creek Field is located in Mesa County, Colorado, northeast of the East Plateau Field, in T. 9 S., Rs. 93 and 94 W., 6th P.M. It includes both Federal and private surface and Federal and private mineral estate, and produces from tight sand formations. The field includes PXP's Federal onshore oil and gas leases COC-50131,

<sup>2</sup> Specifically, the areas covered by CAs are as follows:

<u>Lease</u>	<u>CA (COC-)</u>	<u>Federal Acres</u>	<u>Private Acres</u>	<u>Location (6th P.M.)</u>
23102	35824	80.3	84.18	NW $\frac{1}{4}$ sec. 6, T. 10 S., R. 94 W.
	67646	80	80	NE $\frac{1}{4}$ sec. 8, T. 10 S., R. 94 W.
	69946	40	120	NW $\frac{1}{4}$ sec. 8, T. 10 S., R. 94 W.
	69947	40	120	NE $\frac{1}{4}$ sec. 17, T. 10 S., R. 94 W.
51673	50895	40	120	SE $\frac{1}{4}$ sec. 30, T. 9 S., R. 94 W.
	62533	80	80	NW $\frac{1}{4}$ sec. 32, T. 9 S., R. 94 W.

See 271 SOR at 2; BLM Case Recordation Serial Register Pages for CAs COC-35824, 67646, 69946, 69947, and 62533, 271 AR "Communitization Agreement" binder. For unexplained reasons, the Serial Register Page for CA COC-50895 appears to have been omitted. However, it is in the official BLM online land records in BLM's LR 2000 system at <http://www.blm.gov/Hyperion/ihtml/OpenDoc?DocInstanceID=1&DocUUID=000001096eee68e3-0000-11ac-0a780c38&DocVersion=1&isSmartcut=true>. The PXP Planned Development Map shows two inactive surface pads and no wells for the tract covered by this CA.

50945, 60719, 64790, and 64797.<sup>3</sup> Numerous wells are producing from both the Federal leases and the private properties in the Brush Creek Field, virtually all of which have been directionally drilled from 26 active surface well pads, each of which again serves a number of wells. It appears that 28 wells have been drilled from 7 surface pads to bottom hole locations within the Federal leases. None of the surface pads are located on the Federal leases. According to PXP and BLM records, portions of Leases 50131, 50945, and 64790 are subject to communitized development with adjacent private properties in certain quarter sections under identified CAs.<sup>4</sup> Leases 60719 and 64797 are not subject to any CA. 271 SOR at 2-3.

Lines run from all of the surface pads to the Brush Creek compressor located on private lands in NE $\frac{1}{4}$  sec. 14, T. 9 S., R. 94 W. The compressor's location is not part of any communitized tract. 271 SOR at 3; PXP Planned Development Map. Gas moves from the compressor to a junction with the CVGS line, from which the gas is moved to the Anderson Gulch plant and processed and sold in the same manner as the gas from the East Plateau Field. PXP Planned Development Map; Laramie Energy, LLC, Gathering Systems Map; Dec. 15, 2008, Application for Commingling, 271 AR, at unpaginated 5.

<sup>3</sup> Lease 50131 is situated in secs. 11, 12, and 13, T. 9 S., R. 94 W., 6th P.M. Lease 50945 is situated in secs. 11 and 12, T. 9 S., R. 94 W., and sec. 18, T. 9 S., R. 93 W., 6th P.M. Lease 60719 is situated in secs. 1 and 2, T. 8 $\frac{1}{2}$  S., R. 94 W., and sec. 6, T. 8 $\frac{1}{2}$  S., R. 93 W., 6th P.M. Lease 64790 is situated in sec. 2, T. 9 S., R. 94 W., 6th P.M. Lease 64797 is situated in secs. 23 and 24, T. 9 S., R. 94 W., 6th P.M.

<sup>4</sup> Specifically, the areas covered by CAs are as follows:

<u>Lease</u>	<u>CA (COC-)</u>	<u>Federal Acres</u>	<u>Private Acres</u>	<u>Location (6th P.M.)</u>
50131	56624	80	80	SW $\frac{1}{4}$ sec. 12, T. 9 S., R. 94 W.
	72361	80	80	NE $\frac{1}{4}$ sec. 13, T. 9 S., R. 94 W.
	72362	80	80	SW $\frac{1}{4}$ sec. 11, T. 9 S., R. 94 W.
50945	57583	80	80	NE $\frac{1}{4}$ sec. 12, T. 9 S., R. 94 W.
	61262	80	80	SE $\frac{1}{4}$ sec. 12, T. 9 S., R. 94 W.
64790	72360	122.47	40	SW $\frac{1}{4}$ sec. 2, T. 9 S., R. 94 W.

See 271 SOR at 2-3; BLM Case Recordation Serial Register Pages for CAs COC-56624, 57583, 61262, 72360, 72361, and 72362, 271 AR "Communitization Agreement" binder.

PXP acquired the Federal leases in the East Plateau and Brush Creek fields effective June 1, 2007. It operated the fields until December 1, 2008, when it sold all of its interests to OXY USA Inc. 271 SOR at 1-2.

## 2. *The Hells Gulch Field (IBLA 2009-272)*

The Hells Gulch Field is also located in eastern Mesa County, Colorado, east of the Brush Creek Field, in Ts. 8 and 9 S., R. 92 W., 6th P.M. The field includes PXP's Federal leases COC-66918 and 66724.<sup>5</sup> All the wells drilled in this field—some 60 wells drilled from 7 surface pads—have been drilled into the Federal leases.<sup>6</sup> These wells likewise produce gas from tight sand formations and are relatively densely spaced. 272 SOR at 1-2; PXP Planned Development Map, Hells Gulch Field, AR in IBLA 2009-272 (272 AR) and 272 SOR Ex. B. None of the leases are subject to any CAs.

All of the surface pads are connected to the Alkali Creek compressor located on private surface in SE¼ sec. 15, T. 8 S., R. 92 W., 6th P.M. Gas moves from the Alkali Creek compressor through the Hidden Creek Gathering System line to a junction with Questar's pipeline in sec. 1, T. 8 S., R. 92 W, 6th P.M., where the gas is metered. 272 SOR at 2; PXP Planned Development Map; PXP Application for Commingling dated Dec. 23, 2008, 272 SOR, at unpaginated 6.<sup>7</sup>

PXP operated the Hells Gulch Field during the period June 1, 2007 - December 1, 2008, before selling its interests to OXY—the same period in which it operated the East Plateau and Brush Creek Fields. 272 SOR at 1-2.

### B. *Gas Measurement and Use of Produced Gas As Compressor Fuel and Processing Plant Fuel*

In all three fields, during the period relevant to this case, volumes produced from each well were measured at wellhead meters located on the surface pads.

<sup>5</sup> Lease 66918 is situated in secs. 23, 24, 25, and 26, T. 8 S., R. 92 W., 6th P.M. Lease 66724 is situated in sections 1, 2, and 12, T. 9 S., R. 92 W., 6th P.M.

<sup>6</sup> Six of the 7 surface pads, serving 51 of the wells, are located on the Federal leases. One surface pad, serving 9 wells, is located on private surface north of Lease 66918. Statement of Reasons in IBLA 2009-272 (272 SOR) at 2; PXP Planned Development Map.

<sup>7</sup> PXP states that on four occasions during the relevant period, because of operational problems in the Brush Creek Field, a portion of the gas from that field was moved to the Hidden Creek Gathering System. Except for those occasions, gas produced from the Hells Gulch Field was not commingled with gas produced from other fields.

271 SOR at 3; 272 SOR at 2-3. When gas accumulated from the various surface pads entered each of the respective compressors, a portion of the gas was used to fuel the compressor. The volume used as compressor fuel was metered at the compressor. PXP then allocated the compressor fuel volume back to individual wells in each field in the same proportion that the volume of gas produced from each well bore to the total volume delivered to the compressor from all wells. 271 SOR at 3; 272 SOR at 3.<sup>8</sup> *See also* Dec. 15, 2008, Application for Commingling, 271 SOR, at unpaginated 10; Dec. 23, 2008, Application for Commingling, 272 SOR, at unpaginated 7.

In addition, gas produced from the East Plateau and Brush Creek Fields was used as fuel at the Anderson Gulch processing plant. A proportionate share of the plant fuel was allocated to those fields under the plant processing agreement. Dec. 15, 2008, Application for Commingling, 271 SOR, at unpaginated 10.

### C. *Legal Background*

#### 1. *Statutory and Lease Royalty Provisions*

Section 17 of the Mineral Leasing Act prescribes a royalty of a specified percentage of the “value of the production *removed or sold from the lease.*” 30 U.S.C. § 226(b)(1)(A), (c)(1) (emphasis added). The BLM onshore oil and gas leasing regulations contain an identical requirement at 43 C.F.R. § 3103.3-1(a). Standard Federal onshore lease terms repeat the statutory and regulatory provision. Related regulations of the Minerals Management Service (MMS) regarding the production subject to royalty are discussed below.

#### 2. *NTL-4A and Related MMS Regulations*

The United States Geological Survey (USGS) Conservation Division, MMS’ predecessor agency, issued “Notice to Lessees and Operators of Federal Onshore Oil and Gas Leases (NTL-4)” on November 15, 1974. NTL-4 required lessees to pay royalty on all oil and gas produced from a lease or unit, including production used in lease or unit operations or unavoidably lost, reversing the Department’s prior longstanding view.<sup>8</sup> Federal courts rejected the position taken in NTL-4 in two cases, *Marathon Oil Co. v. Andrus*, 452 F. Supp. 548 (D. Wyo. 1978), and *Gulf Oil Corp. v.*

<sup>8</sup> According to PXP, “the same allocation method is used to allocate drip condensate back to individual wells.” *Id.*

<sup>9</sup> The position taken in NTL-4 was approved in an opinion of the Solicitor that was approved by the Secretary and issued on Oct. 4, 1976, M-36888, 84 I.D. 54. *See also* M-36888 (Supp. II), 84 I.D. 171 (Mar. 9, 1977).

*Andrus*, 460 F. Supp. 15 (C.D. Cal. 1978). As the district court explained in *Marathon Oil Co. v. Andrus*:

Prior to the issuance of the NTL-4 Notice, the practice of the United States Department of the Interior had been that, in determining the amount of production to which royalty rates will be applied, no royalty is payable on oil or gas unavoidably lost, *used in lease or producing operations on the leasehold premises, or beneficially used for purposes of production on the leasehold*.

For more than half a century, both the government, as lessor, and all of its lessees have understood and have been governed by the pertinent statutes to the end that all oil and gas *used on the lease for ordinary production purposes* or unavoidably lost were not subject to royalty payments to the government.

452 F. Supp. at 551 (emphasis added). The court then rejected the NTL-4 interpretation as contrary to the Department's long-standing construction of the Mineral Leasing Act. The court held:

A review of the legislative history of the Mineral Leasing Act, together with its many enactments and re-enactments, each leaving intact the wording that a royalty is to be paid on "value of the production removed or sold from the lease", plus the interpretation placed thereon by the Secretary of the Interior for a long period of time holding that royalties are not to be collected on oil and gas that was unavoidably lost *or used in lease operations*, are entitled to great weight.

*Id.* at 552-53 (emphasis added). The District Court in *Gulf Oil Corp. v. Andrus* reached the same conclusion after examining the legislative history of the phrase in section 17(b) of the Mineral Leasing Act, quoted above, imposing royalty as a specified percentage of the value of the production "removed or sold from the lease." 460 F. Supp. at 17-18.<sup>10</sup>

Following the *Marathon* and *Gulf* decisions, USGS issued "Notice to Lessees and Operators of Onshore Federal and Indian Oil and Gas Leases (NTL-4A)" on December 27, 1979, revoking pertinent provisions of NTL-4 retroactively. 44 Fed. Reg. 76600 (Dec. 27, 1979). Section I of NTL-4A provides in relevant part:

<sup>10</sup> Subsequently, two cases involving offshore leases also rejected notices issued to offshore Federal oil and gas lessees that asserted the same position taken in NTL-4. *Placid Oil Co. v. Dep't. of the Interior*, 491 F. Supp. 895 (N.D. Tex. 1980); *Amoco Production Co. v. Andrus*, 527 F. Supp. 790 (E.D. La. 1981).

Gas Production (both gas well gas and oil well gas) subject to royalty shall include that which is produced and sold on a lease basis or for the benefit of a lease under the terms of an approved communitization or unitization agreement. No royalty obligation shall accrue on any produced gas which (1) is used *on the same lease, same communitized tract, or same unitized participating area for beneficial purposes . . . .*

44 Fed. Reg. at 76600 (emphasis added). Section II.B of NTL-4A then defined “beneficial purposes” as follows:

“Beneficial purposes” shall mean that oil or gas which is produced from a lease, communitized tract, or unitized participating area and which is used *on or for the benefit of that same lease, same communitized tract, or same unitized participating area* for operating or producing purposes such as (1) fuel in lifting oil or gas, (2) fuel in the heating of oil or gas for the purpose of placing it in a merchantable condition, (3) fuel in compressing gas for the purpose of placing it in a marketable condition, or (4) fuel for firing steam generators for the enhanced recovery of oil. Gas used for beneficial purpose [sic] shall also include that which is produced from a lease, communitized tract, or unitized participating area and which is consumed on or for the benefit of that same lease, same communitized tract, or same unitized participating area (1) as fuel for drilling rig engines, (2) as the source of actuating automatic valves at the production facilities, or (3) with the prior approval of the Supervisor, as the circulation medium during drilling operations. . . .

*Id.* (emphasis added). NTL-4A remains in effect today. 43 C.F.R. § 3164.2(b).

In addition, MMS regulations promulgated in 1988 at 30 C.F.R. § 202.150(b), applicable to gas produced from Federal onshore and offshore leases, provide:

(1) All gas (except gas unavoidably lost or *used on, or for the benefit of, the lease*, including that gas used off-lease for the benefit of the lease when such off-lease use is permitted by the MMS or BLM, as appropriate) produced from a Federal lease to which this subpart applies is subject to royalty.

(2) When gas is used on, or for the benefit of, the lease at a production facility handling production from more than one lease with the approval of MMS or BLM, as appropriate, or at a production facility handling unitized or communitized production, only that proportionate share of each lease’s production (actual or allocated) necessary to

operate the production facility may be used royalty free. [Emphasis added.]

In the preamble to the final rule, in response to a number of comments on the proposed rule, MMS explained the relationship of this provision to NTL-4A and the respective responsibilities of BLM and MMS:

The determination of whether or not gas has been unavoidably or avoidably lost and whether or not gas used is royalty-free (whether used off-lease or on-lease) are operational matters covered by the appropriate regulations of the Bureau of Land Management (BLM) and MMS for onshore and offshore operations, respectively. The BLM's requirements are governed by the provisions of 43 CFR Part 3160 and Notice of [sic] Lessees and Operators No. 4A. The MMS' requirements are governed by the provisions of 30 CFR Part 250 [*i.e.*, the offshore oil and gas lease operations rules]. . . .

53 Fed. Reg. 1230, 1233 (Jan. 15, 1988).

Proposed section 202.150(b) was identical to the final rule in all relevant respects. See 52 Fed. Reg. 4732, 4742 (Feb. 13, 1987). The preamble to the proposed rule stated: "Gas used for the benefit of a lease, which is royalty free, includes gas used in lease equipment *on communitized areas or unit areas when the lease is committed to a communitization agreement or unitization agreement . . .*" 52 Fed. Reg. at 4733 (emphasis added).

### 3. Marketable Condition Requirements

MMS regulations promulgated under the rulemaking authority granted in the MLA at 30 U.S.C. § 189 (2006), among other statutes, as well as authority reserved to the Secretary in the standard lease terms, establish the value of gas produced from Federal leases for royalty purposes. See 30 C.F.R. § 206.150. The valuation regulations for both unprocessed and processed gas at 30 C.F.R. §§ 206.152(i) and 206.153(i), respectively, require lessees to put gas produced from Federal leases into marketable condition at no cost to the lessor (in other words, with no deduction for the cost of treatment in computing royalty). Putting gas into marketable condition may involve, depending on the circumstances, gathering, compression (to the pressure of the relevant transportation pipeline), dehydration, and "sweetening" (removal of gases such as hydrogen sulfide (H<sub>2</sub>S) and carbon dioxide (CO<sub>2</sub>) that form acid compounds when combined with water vapor).<sup>11</sup> Notwithstanding the

<sup>11</sup> See, e.g., *Devon Energy Corp. v. Kempthorne*, 551 F.3d 1030 (D.C. Cir. 2008);  
(continued...)

requirement that the lessee undertake these functions at its own expense, NTL-4A specifically includes gas used as fuel in compressors to put gas into marketable condition within the definition of gas used for “beneficial purposes,” which therefore is not subject to royalty.

#### 4. Gas Processing

If a lessee or its affiliate processes gas for extraction of heavier liquid hydrocarbons (such as ethane, propane, etc.) or other valuable products, and sells the residue gas (methane) and the extracted products after processing, the value for royalty purposes of the residue gas and the extracted products is determined under the MMS processed gas valuation rule at 30 C.F.R. § 206.153. In that event, value is “the combined value of the residue gas and all gas plant products determined pursuant to this section . . . less applicable transportation allowances and processing allowances determined pursuant to this subpart.” 30 C.F.R. § 206.153(a)(2).<sup>12</sup> MMS rules at 30 C.F.R. § 202.151(b), addressing royalty on processed gas produced from Federal leases, further provide:

*A reasonable amount of residue gas shall be allowed royalty free for operation of the processing plant, but no allowance shall be made for boosting residue gas or other expenses incidental to marketing, except as provided in 30 CFR part 206. In those situations where a processing plant processes gas from more than one lease, only that proportionate*

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<sup>11</sup> (...continued)

*Amoco Production Co. v. Watson*, 410 F.3d 722 (D.C. Cir. 2005); *Amerada Hess Corp. v. Dep’t. of the Interior*, 170 F.3d 1032 (10th Cir. 1999); *Mesa Operating Limited Partnership v. Dep’t. of the Interior*, 931 F.2d 318, 323 (5th Cir. 1991); *Shoshone & Arapaho Tribes v. Hodel*, 903 F.2d 784 (10th Cir. 1990); *California Co. v. Udall*, 296 F.2d 384, 387-88 (D.C. Cir. 1961); *J-W Operating Co.*, 159 IBLA 1, 11-12 (2003); *Nexen Petroleum U.S.A. Inc.*, 157 IBLA 286 (2002), *aff’d*, *Nexen Petroleum U.S.A. Inc. v. Dep’t. of the Interior*, No. 02-3543 (E.D. La. Mar. 31, 2004); *Bailey D. Gothard*, 144 IBLA 17 (1998), *aff’d*, *Gothard v. United States*, No. CV 98-103-BLG (D. Mont. June 29, 1999); *R. E. Yarbrough & Co.*, 122 IBLA 217, 218 (1992).

<sup>12</sup> Under 30 C.F.R. § 206.151, “processing” is “any process designed to remove elements or compounds (hydrocarbon and nonhydrocarbon) from gas,” but it does not include “natural pressure reduction, mechanical separation, heating, cooling, dehydration, and compression.”

In determining the royalty value of processed gas, the lessee may deduct the reasonable, actual costs of processing against the value of the extracted liquid hydrocarbons. 30 C.F.R. § 206.158. Section 206.159 prescribes how the allowance is calculated, both for arm’s-length and non-arm’s-length processing arrangements.

share of each lease's residue gas necessary for the operation of the processing plant shall be allowed royalty free. [Emphasis added.]

The preamble to the final rule noted: "Historically, MMS's policy has been to allow a reasonable amount of residue gas to be royalty-free for operation of the processing plant." 53 Fed. Reg. at 1236. That policy was reflected in NTL-4A. After the language in NTL-4A's definition of "beneficial purposes" quoted previously, that definition further provided: "Where the produced gas is processed through a gasoline plant and royalty settlement is based on the residue gas and other products at the tailgate of the plant, the gas consumed as fuel in the plant operations will be considered as being utilized for beneficial purposes. . . ." 44 Fed. Reg. at 76600-01. The MMS rule in section 202.151(b) continued and codified its established practice.

*D. PXP's Applications, the GJFO and GSEO Decisions, and the Deputy State Director's Decisions*

In November 2008, the GJFO issued one or more notices of incidents of noncompliance (INCs) to PXP because PXP had not obtained BLM approval for off-lease measurement or commingling. In response, PXP filed the December 15, 2008, Application for Commingling with the GJFO, seeking approval to use the custody transfer meters at the tailgate of the Anderson Gulch plant as the royalty settlement point for gas produced from the East Plateau Field and the Brush Creek Field. PXP proposed to allocate the residue gas and liquid hydrocarbons metered at that point to the wells in those fields based on the thermal content of the wet gas measured at the wellheads. 271 SOR at 3-4; Dec. 15, 2008, Application for Commingling, 271 AR, at unpaginated 2-3, 5-6.

Because the Hells Gulch Field is within the jurisdiction of the GSEO, PXP initiated meetings with that office. 272 SOR at 3. PXP ultimately filed the similar December 23, 2008, Application for Commingling<sup>13</sup> with the GSEO, seeking approval to use the custody transfer meters at the Questar pipeline as the royalty settlement point for gas produced from the Hells Gulch Field and that portion of the gas produced from the Brush Creek Field that had been routed through the Hidden Creek Gathering System due to operational problems. 272 SOR at 3; Dec. 23, 2008, Application for Commingling, 272 AR, at unpaginated 2.

Both Applications for Commingling also identified fuel used to power the compressors (and, in the case of the East Plateau and Brush Creek Fields, the proportionate share of the fuel used at the processing plant) as fuel used for the benefit of the leases and accounted for as non-royalty-bearing, relying on NTL-4A. At least implicitly, PXP's applications sought approval of its treatment of that gas as

<sup>13</sup> Apparently actually filed on Jan. 29, 2009. 272 SOR at 3.

royalty-free. Dec. 15, 2008, Application for Commingling, 271 AR, at unpaginated 9-10; Dec. 23, 2008, Application for Commingling, 272 AR, at unpaginated 7.

The February 11, 2009, GJFO decision letter denied the Dec. 15, 2008, Application for Commingling for leases in the East Plateau and Brush Creek Fields on the ground that BLM had no jurisdiction over the meter PXP proposed to use and thus could not ensure that it met established standards. Feb. 11, 2009, Letter, 271 AR, at 3-4. Consequently, the royalty settlement point (or measurement point) was established at “the lease line” for the leases and communitization agreements at issue. The letter then stated that the only allowable beneficial use is for equipment “used and installed prior to the point of measurement.” *Id.* at 4. The GJFO therefore denied royalty-free beneficial use status to the gas used as fuel at the field compressors and at the processing plant “located downstream of the royalty settlement point.” *Id.*

The March 17, 2009, GSEO decision letter denied the request for commingling for the Hells Gulch Field due to concerns about allocation accuracy. Mar. 17, 2009, Letter, attached as Supplement 1 to memorandum dated Apr. 27, 2009, from the GSEO Program Manager to the State Director, 272 AR, at unpaginated 2-3. The letter then denied royalty-free beneficial use status to the gas used as compressor fuel on the ground that the use must occur before the point of measurement. *Id.* at unpaginated 4.

PXP sought review of both letter decisions by the BLM Colorado State Director under 43 C.F.R. § 3165.3(b).<sup>14</sup> In simultaneous letters dated April 20, 2009, PXP withdrew its request for review (for the Hells Gulch Field, declined to seek review) with respect to denial of its off-lease measurement and commingling applications in view of the sale of all of PXP’s interests to OXY. Letters from counsel for PXP to BLM Colorado State Office dated Apr. 20, 2009, 271 AR and 272 AR, at 1; *see also* 271 SOR at 4; 272 SOR at 4. However, PXP maintained that denial of beneficial use status for the gas used as compressor fuel was incorrect and should be reversed under NTL-4A and this Board’s decision in *Wexpro Co.*, 174 IBLA 57 (2008), discussed below. Apr. 20, 2009, Letters at 1, 3-6. PXP also disputed the GJFO’s ruling with respect to gas used as processing plant fuel, stating that PXP “will seek a processing allowance from the MMS that includes a reasonable amount of residue gas to be royalty-free for operation of the plant.” Apr. 20, 2009 Letter, 271 AR, at 6.

The simultaneous SD Decisions dated May 22, 2009, upheld denial of beneficial use status for gas used as compressor fuel on the ground that the compressors were all downstream of the applicable production accountability

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<sup>14</sup> Review of the Feb. 11, 2009, GJFO decision was given the number CO-09-05. Review of the Mar. 17, 2009, GSEO decision was given the number CO-09-06.

measurement point and were off the lease or communitized area. SD Decision CO-09-05 at 5; SD Decision CO-09-06 at 6.<sup>15</sup> In addition, the decision in CO-09-05 upheld denial of beneficial status for gas used as fuel at the processing plant on the ground that the processing occurred past the lease line, and was an issue that should be handled under the MMS processing allowance regulations. SD Decision CO-09-05 at 6.

Both decisions stated: “The royalty free use of produced oil and gas is limited to on-lease operations.” SD Decisions at 6. The decision in CO-09-05 further stated: “Fuel used for field operations such as compression, product conditioning, the measurement of gas, and gas processing past the lease line is not available for beneficial use allowances.” SD Decision CO-09-05 at 6. The decision in CO-09-06 contained a similar statement, except that the reference to gas processing was omitted. SD Decision CO-09-05 at 6.

PXP appealed both decisions. The appeal of CO-09-05 was docketed as IBLA 2009-271. The appeal of CO-09-06 was docketed as IBLA 2009-272. Granting a motion by PXP, the appeals were consolidated by order dated October 16, 2009.

### *Analysis*

#### *I. Gas Used as Fuel in a Compressor Located off the Lease, Unit, or Communitized Tract from Which the Gas Is Produced Is Royalty-Bearing.*

PXP’s principal argument is that the SD Decisions denying royalty-free beneficial use status to gas used as fuel in off-lease compressors are contrary to both NTL-4A and MMS regulations at 30 C.F.R. § 202.150(b)(1). 271 SOR at 5-7; 272 SOR at 5-7. PXP relies heavily on NTL-4A’s definition of “beneficial purposes,” quoted above, as “that oil or gas which is produced from a lease, communitized tract, or unitized participating area and which is used on or for the benefit of that same lease, same communitized tract, or same unitized participating area for operating or producing purposes.” 271 SOR at 6; 272 SOR at 6 (underscored emphasis PXP’s). PXP also relies on the exception from royalty in 30 C.F.R. § 202.150(b)(1), quoted above, for gas “used on, or for the benefit of, the lease, including that gas used off-lease when such off-lease use is permitted by MMS or BLM, as appropriate.” 271 SOR at 7; 272 SOR at 7. PXP argues that the references to gas used “for the benefit of” the lease necessarily imply that beneficial use is not limited to operations

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<sup>15</sup> For directional wells drilled to bottom hole locations on a Federal lease from a surface pad off the lease, the SD Decisions took the position that fuel used for operations on the surface pad or upstream of the approved production accountability measurement point would be regarded as beneficially used. SD Decisions at 6. However, no such operations are at issue in this appeal.

occurring on the lease, and that PXP therefore has a right to use gas royalty-free in compression operations off the lease.

[1] PXP reads too much into both NTL-4A and the MMS rule. As quoted above, section I of NTL-4A provides: “No royalty obligation shall accrue on any produced gas which (1) is used *on the same lease, same communitized tract, or same unitized participating area* for beneficial purposes . . . .” 44 Fed. Reg. at 76600 (emphasis added). The phrase “used on *or for the benefit of* that same lease, same communitized tract, or same unitized participating area for operating or producing purposes” in the definition of “beneficial purposes” in section II.B of NTL-4A (emphasis added) was not intended to expand the coverage of the operative provision in section I. Gas that is used off a particular lease, but on a unitized participating area or a communitized tract that includes that lease, is used for the benefit of that lease as well as for the benefit of other parts of the unitized participating area or communitized tract. But the use must occur on the unitized participating area or communitized tract. There is nothing in the language of NTL-4A that implies, and there is nothing in its history that indicates, that the definition in section II was intended to greatly expand the coverage of section I and grant lessees a general right to use gas royalty-free as fuel for operations off lease or off unit areas or communitized tracts—a right which lessees had never before possessed.

Similarly, the exception from royalty for gas “used on, or for the benefit of, the lease, including that gas used off-lease for the benefit of the lease when such off-lease use is permitted by the MMS or BLM, as appropriate” in the MMS rule at 30 C.F.R. § 202.150(b)(1) does not imply a general right to royalty-free use of production as fuel for operations regardless of where the operations are performed. As explained previously, the preamble to the final rule makes clear that it was intended to operate alongside NTL-4A. 53 Fed. Reg. at 1233. Further, the preamble to the functionally identical proposed rule explained that gas used “on communitized areas or unit areas when the lease is committed to a communitization agreement or unitization agreement” was to be excepted from royalty. 52 Fed. Reg. at 4733. It said nothing regarding gas used off the lease, unitized area, or communitized tract.

Examples of “gas used off-lease for the benefit of the lease when such off-lease use is permitted by the MMS or BLM, as appropriate” include (1) gas used off the lease but within a unitized participating area or communitized tract, and (2) gas used for production purposes (*e.g.*, gas used to power an oil well or to lift gas) at a wellhead location off the lease where the production first surfaces. In the instant case, there are numerous examples of gas surfacing at off-lease wellheads because, as PXP explains, the location of the multi-well surface pads was determined largely by the difficulties of mountainous terrain and environmental considerations. 271 SOR at 12; 272 SOR at 12. BLM approved the off-lease wellhead locations when it approved the applications for permits to drill (APDs), as shown in each of the APDs

included in the two binder volumes in the 271 AR labeled “Leases.” However, production operations at the wellheads apparently are not at issue here.<sup>16</sup>

PXP’s position ignores the origin of the principle that is the basis of NTL-4A and the MMS rule. As the courts in both *Marathon Oil Co. v. Andrus*, 452 F. Supp at 552-53, and *Gulf Oil Corp. v. Andrus*, 460 F. Supp. at 17-18, explained, production used on the lease for lease operations was royalty-free because it was not removed or sold from the lease. Including a lease as part of a unit or a communitization agreement expands that principle to the unit participating area or the communitized tract, as NTL-4A and the MMS rule both specifically provide.<sup>17</sup> But there is not (and never has been) a legal right to use lease production to fuel any and all operations regardless of the location where those operations are performed.<sup>18</sup>

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<sup>16</sup> Had any such operations been involved, the SD Decisions, as noted previously, stated that fuel used for such operations would be regarded as beneficially used. SD Decisions at 6. We note that under the particular circumstances involving off-lease wellheads presented here, the gas was not produced (extracted from the ground) until after it had crossed the lease line. Production and removal from the lease are both requisite to triggering the royalty obligation. (As quoted above, royalty is a percentage of the “value of the *production* removed or sold from the lease.”) Thus, gas used in wellhead production operations would be regarded as used for the benefit of the lease.

<sup>17</sup> Production from all wells in a unit is allocated back to the lease under section 12 of the model unit agreement at 43 C.F.R. § 3186.1. Under section 14, royalty shall be “paid in value . . . as to all unitized substances on the basis of the amounts thereof allocated to unitized Federal land as provided in Section 12 at the rates specified in the respective Federal leases . . . .” In short, production from the unit implies production from the lease, and removal from the unit implies removal from the lease.

Similar principles apply in the case of communitization agreements. For example, under paragraph 5 of CA COC-67646, communitizing 80 acres in Lease 23102 with 80 adjacent private acres in the East Plateau Field, the communitized area is “developed and operated as an entirety” and all communitized substances are “allocated among the leaseholds comprising said area in the proportion that the acreage interest of each leasehold bears to the entire acreage committed to this agreement.” Under paragraph 8, production from a well on the communitized area shall be considered as production from each lease and all lands within the communitized area. CA COC-67646, attached to Dec. 15, 2008, Application for Commingling, 271 AR, at unpaginated 2-3.

<sup>18</sup> PXP also quotes *Marathon Oil Co. v. Andrus, supra*, for the proposition that “the right to use gas produced from a lease on or for the benefit of that lease was a part of the oil and gas lease contract.” 271 SOR and 272 SOR at 5. However, the portion of  
(continued...)

PXP further argues that in *Wexpro*, this Board rejected BLM's position that royalty-free beneficial use must occur on the lease. 271 SOR at 6; 272 SOR at 6 (quoting 174 IBLA 57, 69). PXP misinterprets *Wexpro*. In *Wexpro*, the compressor and dehydrator in which gas produced from the Federal and Indian leases was used as fuel were located on the unit. 174 IBLA at 68. They were downstream of the point of measurement (POM) at the wellheads, but were still on the unit. We rejected BLM's position that use of gas as fuel had to occur before the POM for it to be considered beneficial, and held: "The fact that the gas has passed through the POM does not imply that use of part of the gas within the unit for fuel is not for beneficial purposes." *Id.* The fact that the facilities were located on the unit was a controlling consideration. *Id.* at 68-69. Nothing in the *Wexpro* decision implies that gas used as fuel in a compressor located off the unit would be royalty-free.<sup>19</sup>

Moreover, PXP's position is inconsistent with, and would seriously undermine, the marketable condition rule. If PXP's position were adopted, lessees could force the Federal lessor to share in the costs of compression, dehydration, and sweetening, no matter where these functions are performed, simply by taking care to design the treatment facilities to be powered by gas produced from the Federal leases involved. No law or regulation or precedent supports such a result.

PXP argues that it would be uneconomical and environmentally damaging to locate wellhead compressors on every surface pad to obtain the benefit of royalty-free use of produced gas in compression operations. 271 SOR at 13-14; 272 SOR at 13. The fact that locating a compressor at every surface pad would be uneconomical and would not make sense is undoubtedly broadly true in almost any situation involving production from multiple wells and surface pads in a particular area (and for those

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<sup>18</sup> (...continued)

the *Marathon* opinion which PXP quotes refers to "gas used *on the lease* for ordinary production purposes." 452 F. Supp. at 551 (emphasis added). *Marathon* said nothing about gas used at facilities off the lease.

PXP also argues that its interpretation "is consistent with the interpretation of the royalty clauses in most private oil and gas leases." 271 SOR at 8, 272 SOR at 8 (citing *Bice v. Petro-Hunt, LLC*, 768 N.W.2d 496 (N.D. 2009)). That case is inapposite here because the law applicable to Federal leases controls and is contrary to PXP's interpretation.

<sup>19</sup> PXP acknowledges that *Wexpro* "did not address whether beneficial use may be allowed off-lease when the leases are not unitized," 271 SOR at 6; 272 SOR at 6. With that acknowledgment, it falls back on the argument that such use is authorized under the "plain language" of the phrase "for the benefit of" the lease in NTL-4A and 30 C.F.R. § 202.150(b)(1). 271 SOR at 6-7; 272 SOR at 6-7. For the reasons explained previously, PXP's "plain language" argument is misplaced.

reasons, no lessee is likely to do so). But that fact does not imply that the marketable condition rule is either invalid or unfair. Nor does it imply that denial of royalty-free status to gas used as fuel for compression or other operations off the lease or unit participating area or communitized tract deprives the lessee of a right he otherwise has. The extent of the lessee's right is that he may use lease production to fuel conditioning operations without paying royalty on the fuel as long as he does so before the production leaves the lease or unit or communitized area. He does not have an absolute right to use lease production royalty free to compress gas or to power other conditioning operations regardless of where the operation occurs.<sup>20</sup>

Therefore, we affirm the portion of the SD Decision in IBLA 2009-271 denying royalty-free beneficial use status to the gas used as compressor fuel, and affirm the SD Decision in IBLA 2009-272.

*II. A Lease's Proportionate Share of a Reasonable Amount of Residue Gas Used for Operation of a Gas Processing Plant Is Royalty-Free Even If the Plant Is Off the Lease, Unit, or Communitized Tract from Which the Gas Is Produced.*

As noted previously, the SD Decision in IBLA 2009-271 upheld denial of royalty-free status for gas used as fuel at the processing plant, and took the view that the question should be addressed under the MMS processing allowance regulations. PXP states that it "will seek a processing allowance from the MMS that includes a reasonable amount of residue gas to be royalty-free for operation of the plant," but

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<sup>20</sup> PXP argues that the central field compressors not only compress gas to pipeline pressure (necessary to put production into marketable condition), but also serve production purposes because the suction effect at the compressor inlet lowers pressure at the wells. PXP says that this extends the life of the wells, maximizes the ultimate recoverable reserves, and increases efficiency. 271 SOR at 12; 272 SOR at 11-12. The attached Affidavit of James J. Adkins, the supervising operations engineer for the three fields involved, dated April 15, 2009, details several engineering considerations specific to these fields, wells, and producing formations that result in these effects. 271 SOR Ex. D and 272 SOR Ex. D at 2-4. But the affidavit compares the effects and benefits of centralized field compression to "individual site compressors," Adkins Affidavit at 3, *i.e.*, a compressor at each surface pad. Installing compressors at each surface pad presumably was never seriously considered as an alternative anyway, in view of economic and environmental factors. The fact that centralized compression has more favorable effects on production capacity and efficiency than installing a compressor at each surface pad does not imply that compression is not necessary to put production into marketable condition; nor does it transform the compression performed at the central field compressors into a production operation.

that the processing allowance regulations are not the “appropriate mechanism” to approve royalty-free volumes of gas used as compressor fuel. 271 SOR at 8.

BLM misunderstands the applicable regulations. Title 30 C.F.R. § 202.151(b), as quoted above, provides that “[a] reasonable amount of residue gas shall be allowed royalty free for operation of the processing plant.” This is a different provision from section 202.150(b)(1), and unlike that section is not geographically limited. Further, while the operative provisions of section I of NTL-4A limit use of gas for beneficial purposes to operations conducted on the lease or unit participating area or communitized tract, 30 C.F.R. § 202.151(b) contains no such restriction. Nor has MMS historically limited royalty-free use of residue gas as fuel in processing plants to plants located within those areas.

Some conceptual confusion could arise from including consumption of gas as fuel in processing plants in the definition of “beneficial purposes” in section II.B of NTL-4A, because the royalty-free status of gas used as processing plant fuel is not based on an assumption that such gas is not removed or sold from the lease. As PXP correctly notes, 271 SOR at 8, processing plants are only rarely located on the lease from which the gas was produced. Gas used as plant fuel is commonly removed from the lease or unit or communitized tract. Rather, the royalty-free status of gas used as processing plant fuel originates in the principle that the lessee is not required to process gas to separate and extract valuable royalty-bearing byproducts at no cost to the lessor—the principle that is the basis of the processing allowance. Rather than trying to value the residue gas used as fuel and incorporate that figure into calculation of the processing allowance, it is simpler to treat the fuel gas as royalty-free and then allow any other reasonable actual costs incurred as a processing allowance.

The Deputy State Director’s denial of royalty-free status to the proportionate share of residue gas used as fuel at the Anderson Gulch plant that is allocable back to each of the Federal leases in the East Plateau and Brush Creek Fields was contrary to 30 C.F.R. § 202.151(b). The share of plant fuel residue gas that is properly allocable to each of the Federal leases is not royalty-bearing. It is not necessary for PXP to request a processing allowance for that fuel gas. We therefore reverse that portion of the SD Decision in IBLA 2009-271.

*Conclusion*

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 decision in IBLA 2009-271 is affirmed in part and reversed in part as explained above. The decision in IBLA 2009-272 is affirmed.

\_\_\_\_\_/s/\_\_\_\_\_  
Geoffrey Heath  
Administrative Judge

I concur:

\_\_\_\_\_/s/\_\_\_\_\_  
James F. Roberts  
Administrative Judge