CITATION OIL AND GAS CORPORATION

179 IBLA 390 Decided August 16, 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

CITATION OIL AND GAS CORPORATION

IBLA 2010-91 Decided August 16, 2010

Appeal from a September 25, 2009, Decision by the Associate Director, Minerals Management Service, affirming in part an Order to Report and Pay Additional Royalties.

Affirmed in part, set aside in part and remanded.

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

Under the royalty valuation regulations promulgated in 1988, MMS cannot attribute a Federal lessee's non-marketing affiliate's sale proceeds, received pursuant to the lessee's buy/sell agreement, to "gross proceeds accruing to the lease" for royalty purposes under 30 C.F.R. § 206.102(b)(1)(ii), unless the affiliate is "any person to whom the United States . . . issues a lease, or any person who has been assigned an obligation to make royalty or other payments required by the lease." 30 C.F.R. § 206.101.

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

Where a payor's royalty in kind obligation exceeds the volume reported on its MMS Form 2014, MMS properly determines and demands the payment of additional royalties based on the difference between what should have been and what was actually paid as royalty in kind. The burden is on the payor to show error in determining the amount of royalty in kind oil that was due and/or that the volume of oil actually received as royalty in kind satisfied its royalty obligation.

APPEARANCES: Jerry E. Rothrock, Esq., Washington, D.C., for appellant.

OPINION BY ADMINISTRATIVE JUDGE KALAVRITINOS

Citation Oil and Gas Corporation (Citation) appeals from a September 25, 2009, Decision by the Associate Director, Minerals Management Service (MMS),[1] affirming in part an Order to Report and Pay Additional Royalties issued on August 8, 2006 (Order to Pay). For reasons discussed herein, we affirm MMS in part and set aside the agency's Decision in part.

I. Background

Citation was the lessee, operator, or working interest holder of producing Federal oil leases in North Dakota during 1996 to 1999. The North Dakota State Auditor's Office, acting under a delegation of authority from MMS, audited Citation's royalty payments from Federal leases located within the State for the period of January 1, 1996, through December 31, 1999.[2] The audit findings are summarized as follows:

A. The State's Determinations and Citation's Responses

1. Underpayments Stemming From Buy/Sell Agreements

The State generally found that Citation was involved in "buy/sell/exchange agreements" between August 1998 and December 1999.[3] Statement of Reasons (SOR) at Exhibit (Ex.) A-77 (State Auditor Letter to Citation, dated Mar. 24, 2003).[4]

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[1] Secretary Salazar issued Secretarial Order 3302 on June 18, 2010, which renamed MMS the Bureau of Ocean Energy Management, Regulation, and Enforcement. For purposes of this appeal, we retain MMS' original name.

[2] MMS may delegate its auditing authority to the host state or an Indian tribe under 30 U.S.C. §§ 1732, 1735.

[3] Although it can take many forms, the typical buy/sell agreement (also known as an exchange agreement) involves a lessee's commitment to sell oil to an unaffiliated purchaser at a specified location, in exchange for the right to purchase oil from the original buyer at another location. The parties may engage in below-market transactions because of the potential to profit from resale or refining. Thus, the contract price in a buy/sell agreement may not represent gross proceeds accruing to the lessee. *See* 65 Fed. Reg. 14022, 14023 (Mar. 15, 2000) (MMS' explanation of buy/sell agreements in its Federal lease oil valuation amended regulations.)

[4] Citation submitted a plethora of paginated exhibits with its SOR, which were also included in the administrative record provided by MMS. For ease of reference, we

(continued...)

This finding was based on Citation's respective arm's-length transactions with Amoco Production Company (Amoco), TransCanada Energy Marketing USA, Inc. (TransCanada), Conoco, Inc. (Conoco), Koch Oil Company (Koch), and EOTT Energy Operating Limited Partnership (EOTT) for the on-lease sale of its Federal crude. Exs. G – K (Citation's contracts with Conoco, Amoco, TransCanada, Koch, and EOTT). Those same buyers, Conoco, Amoco, TransCanada, Koch, and EOTT, contracted with Citation Crude Marketing Inc. (CCMI), Citation's wholly-owned subsidiary, to sell CCMI their oil stored at Cushing, Oklahoma. *See* Exs. M – Q (contracts with CCMI).

The State found that Citation's contracts required each on-lease buyer to pay certain premiums above the publicly-posted prices for crude sold in North Dakota.[5] *See* Ex. A-77. Those same buyers then agreed to sell to CCMI in Cushing, Oklahoma domestic sweet crude oil at posted prices for that product, plus a per-barrel premium for transportation charges. *Id*. Citation sold its North Dakota oil to Conoco, Amoco, TransCanada, Koch, and EOTT in exchange for reciprocal oil deliveries at Cushing. The State believed that these contracts were related. Because the on-lease sale was conditioned on buying back similar quantities of oil (after location and quality differential adjustments) from Conoco, Amoco, TransCanada, Koch, and EOTT in Cushing, the State believed that Citation's on-lease sale prices did not include total consideration received for the oil, that is, that Citation, through its affiliate, was reaping the difference in value between the oil sold on lease and the oil purchased and resold in Cushing. *Id.*

The auditors identified Citation's total on-lease consideration received from Conoco, Amoco, TransCanada, Koch, and EOTT, respectively, to be the price at which Citation sold the North Dakota oil plus any discount CCMI received for purchasing their oil in Cushing (*i.e.*, the difference between its market value, as determined by the New York Mercantile Exchange (NYMEX) price [6] for West Texas Intermediate

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[4] (...continued)
cite to Citation's exhibits (*e.g.*, "Ex. X").

[5] The regulations promulgated in 1988 defined "posted prices" as "the price specified in publicly available posted price bulletins, offshore or onshore terminal postings, or other price notices . . . for oil in marketable condition." 30 C.F.R. § 206.101.

Unless otherwise specified, we cite to the 1988 editions of the U.S. Code and the Code of Federal Regulations. The 1988 rules at 30 C.F.R. Part 206 remained in effect until 2000 and, because the audit period was from 1996 to 1999, those rules therefore apply to this case.

[6] By 1997, MMS understood that posted prices no longer reflected crude oil's actual market value at the lease. The market price at Cushing, Oklahoma had essentially
(continued...)

crude oil (WTI) between August 1, 1998, and December 31, 1999, and the price that CCMI contracted to pay for the oil from each of the original buyers).[7] Adding that discount to Citation's on-lease contract sale price increased Citation's production price by about 50 cents per barrel per month for each producing well named in the buy/sell agreements, amounting to a total of $15,828.16 in unpaid royalties.[8]

2. Underpayments on the Big Stick Unit and Unitized Lease No. 284-032252

The State also determined that, from January 1996 to December 1996, Citation paid royalties on a smaller amount of production than it actually sold. *See* Exs. A-11, A-79. For those leases under audit,[9] the State subtracted from the purchased production volume, as stated in Citation's sales contracts, the volumes Citation reported in MMS Form 2014, Report of Sales and Royalty Remittance. *See* Exs. A-56 – A-65.[10] The State then subtracted the total royalty Citation actually paid to the Federal government from royalty due on the adjusted production

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[6] (...continued)
been tied to the NYMEX since the 1980s, but MMS did not abandon the posted price benchmarks for valuing production until 2000. *Compare* 30 C.F.R. § 206.102(c) *with* 65 Fed. Reg. at 14022-24. Nonetheless, the State and MMS apparently ignored those and other benchmarks in favor of the NYMEX pricing under 30 C.F.R. § 206.102(c)(5). We need not decide, for the reasons stated herein, the propriety of MMS' use of NYMEX pricing implementation in this case.

[7] The following example is a simple formula for this calculation: (Citation's per-barrel sale price for Lease A's production) + (Amoco's per-barrel oil market value as defined by NYMEX pricing – CCMI's per-barrel purchase price of Amoco's oil in Cushing) x (Lease A's number of barrels sold to Amoco) = total consideration.

[8] The Federal leases involved in Citation's buy/sell agreements were Lease Nos. 255-012876, 255-013085, 255-015450, 255-031244, 255-032155, 255-032460, 255-032948, 255-040533, 255-045650, 284-013323, 284-019167, 284-031252, 284-031262, 284-031836, 284-032464, 284-083077, 284-082236. *See* Ex. A-10.

[9] The State found that Citation owed additional royalties for unreported production on the following Federal leases: Federal Lease Nos. 255-015450, 255-031244, 255-032460, 284-013323, 284-019167, 284-031252, 284-031262, 284-031836, 284-032464, 284-082236.

[10] The regulation at 30 C.F.R. § 210.10(c)(1) (1996) explained that MMS Form 2014 was used "monthly to report lease-related transactions essential for royalty management to determine the correct royalty amount due, reconcile or audit data, and distribute payments to appropriate accounts."

volumes. Adjusting for an overpayment of $14,238.31 (from Citation's lease interests within the Bob Creek Unit), the State determined that $22,349.50 was still due in unpaid royalties. *See* Ex. A-11.

The largest underpayment allegedly occurred on the Big Stick Unit, where MMS Federal Lease No. 284-032252, made up of Tracts 8A through 8D, created 3.91631 percent of the Unit production in 1996. *See* Ex. A-61; BLM Serial Register Page for Big Stick Unit (NDN06724X); *see also Citation Oil and Gas Corp.*, IBLA 2005-245, at *5 (Order, Mar. 31, 2008) (discussing those same tracts for gas royalty purposes). To determine actual volume production, the auditors looked to Citation's sales contracts (for the months Citation provided the State with those documents) and the production volumes reported in MMS Form 3160, Monthly Report of Operations, filed monthly by Exxon Corporation (pre-merger with Mobil Corporation), the operator of the Big Stick Unit in 1996 (for the months Citation did not provide the State with its sales contract information).[11] *See* Ex. A-61. The auditors then compared Citation's reported production volumes listed in its MMS Forms 2014 with the actual volume production numbers. Those numbers did not match.

The State specifically found that Citation's royalty-in-kind (RIK) obligation, as determined by Citation's sales contracts or MMS Forms 3160, exceeded what Citation reported on its 1996 MMS Forms 2014 by 1,670.16 barrels. *See* Ex. A-61. Thus, the State asserted that Citation owed additional royalties of $34,064.34 based on the value of the 1670.16 barrels of oil that Citation failed to report during 1996.[12] The auditors then applied Citation's overpayments to offset that debt and royalty liability from other wells. The net result was an underpayment of $22,349.50.

3. Miscellaneous Underpayments

In its audit investigations, the State further discovered that, for certain months and leases, Citation paid royalties on a lower price than reflected in some of its sales contracts, and concluded that the company had underpaid royalties by $500.14. *See* Exs. A-6, A-11, A-66 – A-74. The State considered that Citation had requested a

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[11] MMS Form 3160 was "[u]sed by onshore oil and gas lease operators to report monthly oil and gas production to MMS." 30 C.F.R. § 210.10(c)(2) (1996).

[12] Another way to explain these figures is by the following formula: (monthly production volume reported in contracts on MMS Form 3160 x 3.916431 x .125 = monthly royalties owed) – (monthly production volume reported on MMS Form 2014 x 3.916431 x .125 = monthly royalties paid) = monthly underpaid royalties). Repeat the formula for each month in 1996. Add all monthly underpaid royalties to compute the total amount of unpaid royalties on Lease No. 284-032252.

stripper well royalty rate reduction, which MMS had approved, effective on February 1, 1997. In addition, finding that Citation allegedly underreported royalties for one Federal well (Federal #13-4) because the company relied on inherently flawed average daily production numbers, the State resorted to gauge reports for a true and correct reading of the production days, and found that Citation had underpaid royalties by $192.74 for the period between May 1998 and December 1999.[13] *See* Ex. A-78.

4. Citation's Response to the State's Audit Report

Citation contested the State's royalty underpayment claims by letter dated May 22, 2003. *See* Exs. A-83 – A-86 (Citation's response to State audit). The company asserted that the contracts between Citation and its buyers for the on-lease sale of crude oil in North Dakota were independent of the contracts entered into by CCMI for the purchase of oil in Cushing from the original purchasers. The company maintained that it correctly determined and paid royalties for production from those leases. Ex. A-85.

With regard to the Big Stick Unit, Citation urged the State to rescind its finding that Citation was liable for $34,064.34 in additional royalties during 1996 because "MMS was taking its royalty share of oil in kind and selling it to Sinclair Refining," and certain disputes between them had been "resolved by a settlement agreement."
Ex. A-85. Citation complained that it paid its RIK to Sinclair Oil Company and therefore MMS should discuss those royalty matters with Sinclair, the buyer of RIK oil.[14] *Id.* Citation stated simply, without further explanation, that it had correctly calculated its royalties for all other leases. *Id.*

B. Minerals Revenue Management's Order to Pay Additional Royalties and Citation's Appeal to MMS' Policy and Management Division

In its Order to Pay, Minerals Revenue Management Division (MRM), MMS, directed the company to pay all of the outstanding royalties, as determined by the

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[13] The State also alleged that Citation miscalculated the step-scale royalty rate for the months of September 1997 and November 1997 for the Stearns #14-15H well because the company had rounded the average daily production down rather than up. This caused an underpayment of $229.25. *See* Ex. A-79. This matter, however, was not appealed to the Board and we discuss it no further.

[14] Pursuant to both 30 U.S.C. § 223 (1996) and 43 U.S.C. § 1353 (1996), MMS could take royalties as cash payments based on the value of production (royalties in value) or could accept payments in shares of the production itself (royalties in kind).

State. Specifically, MRM declared that Citation owed $15,828.16 from August 1, 1998, through December 31, 1999, because the

> exchange agreements are conditioned upon the lessee's purchase of crude oil at a subsequent exchange point, the value specified in the exchange agreement does not necessarily reflect either market value or the total consideration received for the crude oil. The value of production must be determined based on the total consideration received for the crude oil[,] including any premiums received for the resale of the crude oil at the subsequent exchange point less any allowable costs or location differentials specified in the exchange agreement.

Ex. A-5. MRM further concurred with the State that Citation was liable for all other miscellaneous royalty miscalculations, including the Big Stick Unit/Lease No. 284-032252 royalty shortage. Exs. A-6 – A-7.

Citation appealed MRM's Order to Pay to the Policy and Management Division, MMS. Ex. B. The company argued that it was not responsible for additional royalties under its sale contracts with Conoco, Amoco, TransCanada, Koch, and EOTT because it had paid royalties on the on-lease sale prices, which, according to Citation, represented the production's fair market value. *See* Exs. B-4 – B-10. Citation provided MMS the affidavit of Charles C. Chesser, the company's Manager of Revenue Accounting, who attested that the company sold all of its Federal lease production in North Dakota for market prices. *See* Ex. E, ¶ 6.[15]

Citation further claimed that any profit CCMI might have received from reselling crude oil it purchased from Conoco, Amoco, TransCanada, Koch, and EOTT could not properly be treated as additional consideration for Citation's sale of its lease production in North Dakota because the alleged profits were solely attributable to CCMI, an affiliate company operating hundreds of miles away from the leases in question. In support of its claim that it had no obligation to include CCMI's profits in its royalty calculations, Citation cited the United States Court of Appeals' ruling in *Fina Oil and Chemical Co. v. Norton*, 332 F.3d 672 (D.C. Cir. 2003) (*Fina*) (*rev'g Fina Oil & Chemical Co.*, 149 IBLA 168 (1999) and *Texaco Exploration & Production, Inc.*,

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[15] Even though he averred that Citation's on-lease production was sold at market value, Chesser did not discuss the bases for his statement or otherwise support his assertion.

MMS-92-0306-O&G (1999) (Assistant Secretarial Order, Secretary of the Interior, concurring)).[16]

In *Fina*, the Court of Appeals held that a Federal lessee operating under the 1988 rules that sold production directly to a non-marketing affiliate (a company that purchases production from other companies in addition to its parent) was required by the regulations to base royalties on its affiliate's resale of Federal production, but was permitted to calculate royalties owed on production valuation benchmarks set forth in those regulations.[17] Citation argued that, under *Fina* and the 1988 regulations, MMS could not attribute to Citation proceeds that were received by CCMI. Citation declined to address differences in the facts at issue in *Fina* and the matter at hand, *e.g.*, Citation's on-lease sales were not to an affiliate, and CCMI did not contract to resell Citation's Federal production. *See* Ex. B-8.

As for the $22,349.50 (after overpayment deductions) in royalties assessed for Lease No. 284-032252, Citation claimed that its royalty obligation was satisfied by RIK, and that failure to provide it with Exxon's MMS Forms 3160, which the State used in calculating production volumes and Citation's royalty obligations, deprived the company of "any meaningful opportunity to respond and defend itself against MMS' claims." Ex. B-12. Citation then requested copies of Exxon's MMS Forms 3160 for the months under scrutiny. Ex. B-14.

Citation then stated that "MMS had entered into settlement agreements with both Sinclair and Exxon that resolve certain disputes between the parties, including disputes involving the Big Stick Unit." *See* Ex. B-12. The company suggested that Sinclair and/or Exxon may have resolved matters relating to Citation's disputed royalty liability, and, if so, the Government is not entitled to double royalties. It requested that MMS provide any settlement agreements between MMS and Exxon or MMS and Sinclair, concerning the Big Stick Unit. *See* Ex. B-14.

Citation also newly asserted an overpayment. *See* Ex. B-13. In the months of October 1997 and November 1999, the company allegedly overpaid $625.01 on

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[16] For a detailed description of *Texaco Exploration & Production, Inc.*, see *Fina*, 332 F.3d at 675. For an in-depth discussion of *Fina* and its relationship to this Board's subsequent holdings, see *Tom Brown, Inc.*, 162 IBLA 227 (2004).

[17] Fina used the so-called "benchmark" valuation methods to calculate its royalties. Under the 1988 regulations, a lessee implemented these benchmarks when it sold production directly to an affiliate or otherwise engaged in a non-arm's length transaction for Federal production. *See* 30 C.F.R. § 206.102(c). The benchmarks generally attempted to establish objective, external production valuation measures, which were primarily based on arm's-length prices (*i.e.* posted prices) for similar oil.

Lease No. 255-031244 and $1,135.25 in royalties on Lease No. 255-015450, respectively. It also claimed to have correctly documented a payment of $773.05 in April 1997 on Lease No. 284-031836, but MMS did not include it in its calculations. The company demanded from MMS a refund of those amounts, plus interest. *Id.*

Citation repeated all other arguments it had made to the State.

C. MMS' Decision

In its September 25, 2009, Decision, MMS declared that, while Citation and its buyers and CCMI and its sellers engaged in arm's-length transactions, Citation's sales contracts were not independent of CCMI's sales contracts. *See* Decision at 4. MMS disregarded Citation's assertion that it sold its crude in North Dakota for market price because "the sale of the oil at market price does not consider the additional consideration attained through transactions remote from the wellhead, but affecting the oil extracted from the [F]ederal lease . . . ." *Id*. at 5. MMS therefore held that the profits CCMI received in Cushing represented undocumented consideration of Citation's agreements in North Dakota. Furthermore, MMS determined that *Fina* was distinguishable from Citation's case because it involved a non-arm's-length contract between affiliates, rather than arm's-length contracts among unaffiliated companies. *Id*. at 6. MMS sustained the demand for $15,828.16 in underpaid royalties owing under Citation's buy/sell agreements.

MMS also rejected Citation's arguments regarding the Big Stick Unit, finding that Citation "failed to adequately respond to the claim of an underpayment of royalties" for Lease No. 284-032252. The agency also found that Citation's request for documents "have no bearing on the outcome of this Order to Pay." MMS upheld MRM's determination that Citation was liable for the additional outstanding royalties owed on that lease—$22,349.50. *Id*.

MMS further observed that Citation was responsible for $421.99, which represented Citation's stripper and step-scale royalty rate miscalculations. Regarding the stripper well royalty rate reduction issue, MMS held that "Citation [] failed to rebut the [State's] charge . . . that the information on [Citation's] submitted forms was inherently flawed. Consequently, the State resorted to the gauge reports for a true and correct reading of the production days. Nothing in the regulations prohibits the use of gauge reports to verify data." Decision at 7. MMS continued, "Citation failed to address the accuracy and reliability of the gauge report on oil production days," and denied that portion of Citation's appeal. *Id*.

The agency noted that the law required a lessee to pay royalties on the "gross proceeds resulting from contract sales," and sustained the $500.14 assessment for underpayments caused when Citation paid royalties on a different price than that reflected in its contracts in force during the audit period. Decision at 7.

Finally, MMS denied Citation's reimbursement demand for overpayments, deeming it "tangential" to the matters before MMS. *Id.*

Citation appealed. MMS declined to file an answer.

II. Discussion

It is well settled that the party challenging a royalty valuation by MMS has the burden of showing that the agency's method of calculation is in error. *Seagull Energy Corp.*, 148 IBLA 300, 309 (1999), *rev'd, Texaco Exploration & Production, Inc.*, MMS-92-0306-O&G (1999), *rev'd, Fina*, 332 F.3d 672. After carefully reviewing this case, we find that Citation has met this burden with respect to (1) the alleged underpayments stemming from buy/sell agreements during the audit period and (2) the April 1997 payment, which MMS apparently overlooked. We affirm MMS' Decision in all other respects for the reasons that follow.

A. The Proceeds of an Affiliate May Not Be Considered Part of a Lessee's Gross Proceeds for Royalty Purposes under the 1988 Rules.

Citation contends, as it did before the State, MRM, and MMS, that the Government cannot attribute CCMI's hypothetical profits to Citation's Federal oil sale price to calculate royalties owed from those Federal leases. Citation offers several theories in support of this portion of its royalty dispute. We focus on the applicability of *Fina* to the present case.[18]

[18] In light of our holding with respect to the applicability of *Fina*, we need not address Citation's arguments relating to market value prices, whether the agreements were actually buy/sell agreements, and the State's use of NYMEX prices. *See* SOR at 12-19.

1. The 1988 Gross Proceeds Rule

During the period at issue in this appeal, the oil and gas leasing statutes and the royalty statute for onshore, non-Indian, Federal lands (the Mineral Leasing Act, 30 U.S.C. §§ 181-287, the Mineral Leasing Act for Acquired Lands, 30 U.S.C. §§ 351-359, and the Federal Oil and Gas Royalty Management Act, 30 U.S.C. §§ 1701-1757) required the Secretary of the Interior, through MMS, to establish for royalty purposes the reasonable value of mineral production removed or sold from the leased land and an appropriate auditing system. Under the applicable regulations implementing those statutes, MMS based oil royalty calculations on the "gross proceeds accruing to the lessee . . . ." 30 C.F.R. § 206.102(b)(1)(i). Gross proceeds were defined as the "total mon[ies] and other consideration accruing to an oil and gas lessee for the disposition of the oil produced." 30 C.F.R. § 206.101. Thus, the rule required a lessee to report its *total consideration* received from the sale, minus certain allowances or deductions not relevant here.

During the audit period, MMS had the authority to examine whether Citation's contracts "reflect[ed] the total consideration actually transferred either directly or indirectly from the buyer to the seller . . . ." 30 C.F.R. § 206.102(b)(1)(ii). Ordinarily, the price of the oil the lessee sold directly to "unaffiliated purchasers with opposing economic interests" under ordinary "arm's-length contracts" represented gross proceeds. 30 C.F.R. § 206.102(b)(1)(i). However, if the arm's-length contract did not incorporate all compensation for the Federal production, then MMS could value production by calculating a lessee's sale price along with whatever other consideration the lessee gained from its sale.[19]

MMS' policy towards buy/sell agreements was clear: "Lessees cannot avoid their royalty obligations by keeping a part of their agreement outside the four corners of the contract." 53 Fed. Reg. 1184, 1194 (Jan. 15, 1988) (Preamble). As an example, the agency observed that,

> in return for Seller's reduced price for oil production from a Federal lease, Buyer may agree to reduce the price of gas it sells to the Seller from a non-Federal lease. This agreement is not reflected in the oil sales contract. In the event that MMS becomes aware of consideration that exists outside the four corners of the contract, MMS could accept

[19] For example, if the lessee sold 1,000 barrels of crude oil for $10.00/barrel from its Federal lease located in Wyoming to XY Oil Company, but then actually received as compensation $10,000 plus a new drill collar, the lessee would pay royalties on the sales contract price plus the drill collar's value.

> the lessee's gross proceeds as value, adjusted to reflect the additional consideration.

53 Fed. Reg. at 1198 (Preamble). Clearly, under the 1988 gross proceeds rule, MMS could attribute to a lessee's initial sale price any profit from the lessee's resale of exchanged oil that it subsequently purchased from its former arm's-length buyer, now seller, in exchange for a lower price in the initial sale.

In upholding Citation's Order to Pay, however, MMS took the 1988 gross proceeds rule a step further. The agency held that the "additional consideration CCMI received . . . must represent consideration received by [Citation] . . . as gross proceeds . . . ." Decision at 6. Under the regulations then in effect, MMS misapplied the definition of "gross proceeds"—the total monies and other consideration accruing to an oil *lessee*—to a non-marketing affiliate.

2. Fina Established that the Gross Proceeds Rule Does Not Apply to Lessee's Non-marketing Affiliates under the 1988 Regulations

Fina sold gas to its affiliate, Fina Natural Gas Company (FNGC), a natural gas marketer that purchased gas from producers for arm's-length resale to downstream end-users. Fina paid royalties on its contract price with FNGC. After MMS audited Fina, it issued an order rejecting Fina's royalty valuation and demanded that Fina base its royalty valuation on the gross proceeds rule. That rule, according to MMS, required Fina to use the higher prices that FNGC received from subsequent downstream arm's-length sales in its royalty calculations because Fina and FNGC were the same entity for royalty purposes. This Board applied the Secretary's *Texaco Exploration & Production, Inc.*, decision in *Fina Oil & Chemical Co.*, 149 IBLA 168 (1999), and affirmed MMS' decision. Fina appealed.

The issue before the Federal Court was whether the gross proceeds rule applied to a lessee's non-marketing affiliate. The Court responded in the negative, determining that, according to the 1988 rules, MMS could apply the gross proceeds rule only to a Federal lessee's sale or resale, not to a lessee's non-marketing affiliate's sale or resale. Therefore, FNGC's resale proceeds from the initial non-arm's-length transaction were not attributable to Fina for royalty purposes because, under the regulations, gross proceeds could only "accru[e] to the lessee." 332 F.3d at 674, 676-77. Under the 1988 regulatory definition, a "lessee" was

> any person to whom the United States . . . issues a lease, or any person who has been assigned an obligation to make royalty or other payments required by the lease. This includes any person who has an interest in a

> lease as well as an operator or payor who has no interest in the lease but who has assumed the royalty payment responsibility.

30 C.F.R. § 206.101. The Court stated that this "definition could hardly be clearer. It defines 'lessees' not as 'persons . . . issued . . . leases *and their affiliates*,' but rather restricts the definition to 'persons . . . issued . . . leases.'" 332 F.3d at 677. The Court therefore reversed both the Board's case, *Fina Oil & Chemical Co.*, 149 IBLA 168, and the Assistant Secretarial Order, *Texaco Exploration & Production, Inc*., MMS-92-0306-O&G, on which the Board's decision was based.

3. Application of Fina and the 1988 Gross Proceeds Rule to this Case

[1] While the facts in *Fina* are distinguishable from the facts of the present case, the applicable law is not. It is of no moment that *Fina* dealt with an initial intra-corporate transfer, whereas Citation initially engaged in arm's-length transactions with non-affiliated companies, because central to the issue before us is the proper interpretation of the regulatory definition of "lessee" under the 1988 gross proceeds rule—a matter squarely addressed by the Court in *Fina*, and critical to its holding. The *Fina* court examined the plain meaning of the regulatory language and held that, under 30 C.F.R. § 206.101, only a "lessee" is subject to the gross proceeds rule, and further, that the scope of the definition of "lessee" as used in 30 C.F.R. § 206.102(b)(1)(i) and (ii) is not so broad as to include Fina's affiliate, an entity that did not hold a Federal lease and was not obligated to pay royalties under a lease. *See* 332 F.3d at 677.[20]

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[20] MMS addressed this royalty loophole in 2000. The regulations now provide that if a lessee

> enter[s] into an arm's length exchange agreement, or multiple sequential arm's-length exchange agreements, and following the exchange(s) you or your affiliate sell(s) the oil received in the exchange(s) under an arm's-length contract, then you may use either § 206.102(a) [gross proceeds rule] or § 206.103 to value your production for royalty purposes.

30 C.F.R. § 206.102(d)(1) (2000). The regulations further provide that if a lessee uses the gross proceeds rule under section 206.102(a), then the "gross proceeds are the gross proceeds under your or your affiliate's arm's-length sales contract after the exchange(s) occur(s). You must adjust your gross proceeds for any location or quality differential, or other adjustments, you received or paid under the arm's-length exchange agreement(s)." *Id.* § 206.102(d)(1)(i).

The use of affiliates to fraudulently circumvent Federal royalties was addressed in several False Claims Act cases brought on behalf of the United States.

(continued...)

Under the royalty valuation regulations promulgated in 1988, MMS cannot attribute a Federal lessee's non-marketing affiliate's sale proceeds, received pursuant to the lessee's buy/sell agreement, to "gross proceeds accruing to the lease" for royalty purposes under 30 C.F.R. § 206.102(b)(1)(ii), unless the affiliate is "any person to whom the United States . . . issues a lease, or any person who has been assigned an obligation to make royalty or other payments required by the lease." 30 C.F.R. § 206.101.

Citation was a lessee under the operative rules; CCMI was not. From the record before us, we glean that CCMI, as a non-marketing affiliate of Citation and a separate corporate entity, was not "any person to whom the United States . . . issue[d] a lease," nor "any person who has been assigned an obligation to make royalty or other payments required by the lease." 30 C.F.R. § 206.101.[21] Consequently, under the 1988 regulations, CCMI was not a lessee whose proceeds accrued for royalty valuation purposes. MMS' determination to the contrary must be set aside and remanded for appropriate revision.

B. Citation Documented a Payment Made to MMS that MMS Overlooked During the Audit Process

Citation claims that it reported $773.05 due on Federal Lease No. 284-031836 for April 1997, and that MMS misread its MMS Form 2014 for that month and year. We agree. Citation's unrefuted evidence shows that it correctly reported the royalty due and that MMS failed to record it in its audit computations. *Compare* Ex. A-63 *with* Ex. E-8. Thus, on remand, Citation's debt to the United States should be reduced by that amount.

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[20] (...continued)
See United States ex rel. Maxwell v. Kerr-McGee Oil & Gas Corp., 2009 WL 3161828, Civil Action No. 04-cv-01224-REB-CBS (D. Colo. Sept. 30, 2009); *United States ex rel. Johnson v. Shell Oil Co.*, 33 F. Supp. 2d 528 (E.D. Tex. 1999). In those cases, however, whether the defendants had an obligation to pay the government some other value beyond what it had already paid was not litigated—that the defendants breached their royalty duties to the United States was simply presumed.

[21] MMS based this portion of its decision on its presumption that there existed no legal distinction between Citation and CCMI for purposes of determining gross proceeds accruing to Citation for the purpose of royalty valuation. It apparently considered the entities one and the same, but its decision provides no reasoned analysis supported by the record to support the validity of such an assumption.

C. Citation is Liable for the Big Stick Unit's Unpaid Royalties

We next deal with Citation's concerns regarding the Big Stick Unit and Lease No. 284-032252. Citation continues to contend that its royalty obligations were satisfied by RIK and that "MMS has no legal right to demand duplicate royalty payments from Citation for the royalty oil that the MMS took in kind and sold under its own contract to Sinclair." SOR at 6. MMS acknowledges that Citation paid RIK, as reported on its MMS Forms 2014, but found that amount insufficient to satisfy its royalty obligation, based on the volume of oil produced and attributed to Citation on the unit to which this lease was committed. *See* Ex. A-61. MMS now seeks royalties on production committed, but not delivered to Sinclair.

[2] The State found from data provided by the unit operator, Exxon, and the MMS Forms 3160 it submitted that 1,316,133.96 barrels of oil were produced from the unit during 1996. Since Citation's share of unit production was 3.916431 percent and its royalty obligation was 12.5 percent, the State calculated Citation's RIK obligation for that unit production at 6,443.19 barrels. Citation reported RIK on its MMS Forms 2014 as totaling only 4,773.02 barrels, a difference of 1,670.17 barrels between what it was obligated to pay as RIK and what it reported as having been paid. Using values reported by Citation on those MMS Forms 2014, MMS determined that additional royalties of $34,064.34 were then due. The burden is on the payor (Citation) to show error in determining the amount of RIK that was due and/or that the volume of oil actually received by MMS' purchaser (Sinclair) satisfied its royalty obligation. *Cf., Texaco, Inc*. 129 IBLA 46, 48 (1994) (a payor is not liable for an underpayment of royalties shown on MMS forms if RIK had, in fact, been delivered). Citation has offered no facts showing any error in determining its RIK obligations or that those obligations were satisfied by Sinclair's receipt of RIK oil. *See generally*, 30 C.F.R. Part 208 (Sale of Federal Royalty Oil). Furthermore, Citation has not demonstrated the relevance of any settlement agreements between the Government, Sinclair, and/or Exxon in determining whether its RIK obligations were satisfied for 1996. Citation has not met its burden to show error.

Citation also claims MMS wrongfully denied its request for information, including Exxon's MMS Forms 3160 for each month in 1996 and that it was "clear error" for MMS "to deny Citation's request for copies of these third party documents . . . ." SOR at 7. We are not persuaded that Citation was in any way prejudiced when MMS did not heed the company's request for documents.

To begin, nothing in the record shows that it ever requested this information from the State Auditor or from Exxon. Second, MMS relied on Exxon's form submissions only because Citation failed to provide the State all sales contracts regarding Lease No. 284-032252. Finally, during the State audit, all of Citation's unit operator's information obtained by MMS pursuant to the agency's production accounting regulations were held in the MMS' Denver, Colorado office and were available for public inspection, during all regular office hours. *See* 30 C.F.R. § 216.25. Citation had this and likely other opportunities to inspect all of Exxon's filed documents. We see no reversible error here.

D. Citation Has Not Shown That It Has Overpaid Royalties and Is Therefore Not Entitled to an Offset of Underpayments

Citation argues that MMS failed to acknowledge several overpayments the company made during the audit period, and that MMS must deduct from those overpayments any royalties due. Under 30 U.S.C. § 1721a(a)(3) (1996), "[i]f an overpayment is identified during an audit, then the Secretary or the applicable delegated State, as appropriate, shall allow a credit or refund in the amount of the overpayment." *See also FMP Operating Co.,* 121 IBLA 328, 333-36 (1992).

With scant explanation, Citation declares that MMS only calculated $11,714.84 in overpayments when, as the company avers, Citation overpaid royalties by $14,248.15 during the audit period.[22] We are mystified as to where Citation derived its $11,714.84 figure. Citation cites the Order to Pay (Ex. A-11) as the source of MMS' erroneous miscalculations. However, a review of this document clearly shows that Citation had made overpayments in the amount $14,238.31, not $11,714.84. *See* Ex. A-11. MMS deducted the $14,238.31 in overpayments from the company's royalty underpayments. *Id*.[23]

Equally confusing is Citation's specific claims to several royalty overpayments MMS allegedly failed to document during the audit process. The record shows Citation paid $1,135.25 in royalties on Federal well C 1 in November 1999, but it now denies any sales upon which a royalty was due that month. *See* SOR at 9; Ex. E-4. However, Citation's MMS Form 2014, dated December 29, 1999, clearly shows that Citation sold oil from this well in November 1999. *See* Ex. E-6. Citation also claims that it paid $625.01 more in October 1997 than it was required to pay for

[22] Citation claims a $2,533.31 offset, the difference between Citation's alleged overpayments, $14,248.15, and what Citation claims as the overpayment amount the government found, $11,714.84. The offset amount is the total of three alleged overpayments of $1,135.25, $625.01, and $773.05. As discussed *supra*, the $773.05 was not an overpayment. It was the actual payment due, which Citation documented. Thus, we discuss that payment no further.

[23] To the extent that Citation meant to reclaim $9.84, the difference between Citation's alleged overpayments and the overpayments MMS credited to the company's underpaid royalties, the record does not support such a royalty reduction.

Federal well 2-14. Citation refers us to another MMS Form 2014 as evidence of its overpayment. That form is mostly illegible and blacked out. Legible numbers do not correspond with those cited in the SOR. Despite ample opportunity throughout this appeals process, Citation has produced no evidence to support its claim of an offsetting error.

E. The Rest of Citation's Arguments are Without Merit

Citation still contests MMS' finding that the company underpaid royalties by $500.14, the difference between royalties paid and owed under the contract prices. It urges this Board to set aside this figure because the "Decision does not specify [] the contract prices that MMS believes Citation should have used to compute its royalty values." SOR at 21. We refer Citation to its own exhibits A-66 through A-74. Those documents present all the contract prices Citation claims MMS never specified.

Finally, Citation posits that MMS erroneously held "Citation responsible for one hundred percent of the royalties alleged due on the [] North Dakota Leases, including but not limited to the Big Stick Unit." SOR at 22. Again, we urge appellant to review its exhibits. MMS factored into its calculations the percentage of Citation's payor responsibility for each lease. MMS did not attribute all royalties due under the Big Stick Unit to Citation; the company was responsible only for 3.91631 percent of all royalties due from that unit.

III. Conclusion

We conclude that, under 30 C.F.R. § 206.102(b)(1)(ii) (1988), the rules in place during the audit period, MMS cannot attribute a Federal lessee's affiliate's sale proceeds, even where accrued pursuant to the lessee's buy/sell agreement, "to gross proceeds accruing to the lease" for royalty valuation purposes. We further find that Citation proved that it correctly documented a $773.05 royalty payment MMS failed to include in its calculations. We therefore set aside those portions of MMS' Decision and remand the case to the agency for proper calculation of royalties due.

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 appealed from is affirmed in part, set aside in part, and remanded for further action consistent with this decision.

/s/
Christina S. Kalavritinos
Administrative Judge

I concur:

/s/
James K. Jackson
Administrative Judge