ENCANA OIL & GAS (USA), INC.

185 IBLA 133 September 30, 2014

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

ENCANA OIL & GAS (USA), INC.

IBLA 2013-220 September 30, 2014

Appeal from a decision of the Director, Office of Natural Resources Revenue, denying in part and affirming in part an order to report and pay additional royalties. MMS-10-0134-O&G.

Affirmed.

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

   A "*sales contract typical for the field or area*" reasonably refers to the contracts that are typical in the field or area into which the gas is actually sold, which may or may not be the field or area where the gas was produced.

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

   Gas used as fuel off-lease is not royalty-free because section 17 of the Mineral Leasing Act, 30 U.S.C. § 226(b)(1)(A) (2006), specifies that royalty is due "in amount or value of the production removed or sold from the lease."

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

   A reasonable amount of residue gas shall be allowed for operation of the processing plant free of royalty, but no allowance shall be made for boosting residue gas or other expenses incidental to marketing, except as provided in 30 C.F.R. Part 206 (2006).

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

Processing means any process designed to remove elements or compounds (hydrocarbon and nonhydrocarbon) from gas, including absorption, adsorption, or refrigeration. Field processes that normally take place on or near the lease, such as natural pressure reduction, mechanical separation, heating, cooling, dehydration, and compression, are not considered processing. Further compression at the plant tailgate is not a process that removes hydrocarbon and nonhydrocarbon elements or compounds from gas. The costs of further compressing the gas were incurred to satisfy pipeline specifications to market the gas to purchasers in the market into which appellant sold its gas.

APPEARANCES: John F. Shepherd, Esq., and Tina R. Van Bockern, Esq., Denver, Colorado, for appellant; DeAnn L. Owen, Esq., Office of the Regional Solicitor, U.S. Department of the Interior, Lakewood, Colorado, for the Office of Natural Resources Revenue.

OPINION BY ADMINISTRATIVE JUDGE PRICE

Encana Oil & Gas (USA), Inc. (Encana), has appealed from the August 9, 2013, decision of the Director, Office of Natural Resources Revenue (ONRR)[1/] denying in part and affirming in part an October 5, 2010, Order to Report and Pay Additional Royalties (Decision) in the amount of $7,858,995 for production from January 1, 2004, through December 31, 2006 (Order).[2/]

[1/] The Order was issued by the Bureau of Ocean Energy Management, Regulation, and Enforcement (BOEMRE). On May 19, 2010, the Secretary of the Interior separated the responsibilities performed by the former Minerals Management Service (MMS) and reassigned those responsibilities to three successor organizations: BOEMRE, Bureau of Safety and Environmental Enforcement, and ONRR. On Oct. 1, 2010, the Secretary transferred MMS' royalty and revenue functions to ONRR. *See* 75 Fed. Reg. 61051, 61052 (Oct. 4, 2010). For convenience, references to ONRR include MMS, as may be appropriate.

[2/] On Feb. 7, 2014, ONRR submitted a public and confidential copy of the Administrative Record (AR) on two compact disks accompanied by an unopposed

(continued...)

Background

The facts are not in dispute. According to Encana, most of the gas volumes in this appeal was produced from Encana's Federal leases in the Mamm Creek field. Statement of Reasons (SOR) at 3. In 2001, Encana acquired Ballard Petroleum (Ballard) through a predecessor. Ballard had an arm's length contract to sell Mamm Creek gas at the wellhead to Enserco Energy, Inc. *Id.*, Ex. 2 (Ballard gas sales contract dated June 1, 1999, as amended July 1, 2000). The price for the first 10,000 MMBtu (1 million BTUs) per day delivered at the wellhead was the first of the month price quoted in the Federal Energy Regulatory Commission's Gas Market Report for Natural Gas Pipeline of America, Mid-Continent Zone, plus $0.055, less transportation costs. *Id.* at 4. Encana states it determined it could "obtain a better net price by transporting the gas itself to downstream markets," terminated that contract, and "began marketing the gas downstream." *Id.* Encana acknowledges it "could have sold the gas at or near the wellhead by continuing the contract in place." *Id.* Encana moved Mamm Creek gas to the Pumba, Hunter Mesa, and East Mamm compressor stations to increase the pressure to 1,000 pounds per square inch (psi) and dehydrated the gas down to 2 pounds per MMcf (1,000,000 cubic feet). The gas then entered the 24-inch Rifle Pipeline, was transported to Encana's Rifle Plant, a Joule-Thompson (JT) gas processing facility 12 miles northwest of the leases, and entered the plant at 950 psi. *Id.* After processing, the pressure declined to 600 psi.

2/ (...continued)
Request for Confidential Treatment of Certain Documents. At the Board's request, on July 7, 2014, ONRR submitted indices to the two bates-stamped versions of the AR, neither of which is in chronological order or included all of the parties' agreements to extend the 33-month statutory deadline for deciding appeals of ONRR Orders. *See* 30 U.S.C. § 1724(h) (2006); 43 C.F.R. § 4.904. On Mar. 5, 2014, ONRR supplemented the AR by submitting a copy of an agreement dated Feb. 26, 2014, that extended the deadline through Aug. 26, 2014. In response to the Board's request for a status of the deadline, on July 7, 2014, ONRR submitted a copy of an agreement that extended the deadline for the period Jan. 2, 2014, through June 2, 2015. The overlap between the periods identified in the two agreements, like the apparent absence in the confidential AR of agreements covering the period between July 6, 2011, and Feb. 25, 2014, was not explained. That circumstance casts doubt on the completeness of the record, and in a different case we would insist upon an explanation. We decline to do so in this appeal, however, given our view of the issues presented in this appeal and the absence of a challenge to the sufficiency of the record, but omissions of this nature are not acceptable compliance with the regulation requiring prompt submission of the "complete administrative record compiled during the officer's consideration of the matter leading to the decision being appealed." 43 C.F.R. § 4.411(d)(3).

In April 2005, Encana converted the Rifle Plant to a refrigeration plant, following which the pressure after processing was 800 psi. *Id.* at 4-5.

Questar Pipeline Company (Questar) has a mainline pipeline connected to the Rifle Plant, as does Xcel Energy (Xcel). The operating pressure of the former is 850-950 psi, and the operating pressure of the latter is 920-970 psi. Encana had to boost the pressure of its gas to enter both of those pipelines. After the Rifle Plant was converted, it had to be boosted from 800 to 850-950 psi. *Id.* at 5. Colorado Interstate Gas (CIG) operates a mainline pipeline roughly 15 miles from the Rifle Plant, which Encana initially accessed by its 12-inch Great Divide I pipeline at less than 700 psi. When the gas reached the CIG pipeline, which operated at 850-950 psi, it had to be boosted by the Roan Cliffs compressor prior to entering that pipeline. The TransColorado pipeline is a pipeline to New Mexico, but it is roughly 30 miles from the Rifle Plant. Encana initially accessed the TransColorado pipeline by the Great Divide I pipeline and a pipeline operated by the Williams Companies (Williams), which had an entrance near the CIG pipeline and the Roan Cliffs compressor. In 2003, Encana built the 24-inch Great Divide II pipeline to transport gas from the Rifle Plant to the CIG and TransColorado pipelines. It began compressing gas to 1,300 psi at the tailgate of the Rifle Plant and discontinued using the Williams pipeline and Roan Cliffs compressor in 2004 because the gas lost less pressure and could enter either the CIG or TransColorado pipeline without additional compression.

Encana further states that the Questar, Xcel, and CIG pipelines accepted gas containing less than 3 percent carbon dioxide (CO_2), and Mamm Creek gas contains 2.6 percent carbon dioxide, whereas the TransColorado pipeline allows a maximum of 2 percent. *Id.* at 7. To sell its gas in New Mexico via the TransColorado pipeline, from January through September 2004, Encana removed carbon dioxide at an amine facility at the Rifle Plant. In October 2004, Encana installed the Logan Wash carbon dioxide removal facility at the entry to that pipeline, and dismantled its amine facility because carbon dioxide removal was not necessary to transport gas on the Questar, Xcel, and CIG pipelines.

Encana acknowledges it sold all of the Mamm Creek gas on the Questar, Xcel, and CIG pipelines before it began using the TransColorado pipeline for sales in New Mexico. In 2004, it transported and sold 44 percent of its gas on the TransColorado pipeline, while the remainder was sold on the Questar, Xcel, and CIG pipelines. *Id.* In 2005-2006, Encana transported and sold 65 percent of the Mamm Creek and Orchard field gas on the TransColorado pipeline, and 35 percent was transported and sold on the Questar, Xcel, and CIG pipelines, which are closer to the field. *Id.* at 7-8.

Based on the results of an audit initiated by the State of Colorado on April 16, 2007,[3] in the Order, ONRR determined Encana had (1) improperly deducted transportation costs for gas produced from properties identified as Mamm Creek; (2) improperly deducted transportation costs for gas produced from properties identified as Orchard; (3) failed to include residue gas used as fuel at the Hunter Mesa, Pumba, and East Mamm Creek compressor stations for purposes of royalty valuation; (4) failed to include residue gas used as fuel to compress residue gas at Encana's Rifle Plant; (5) failed to include gas used as fuel to further compress residue gas at its cryogenic Dragon Trail Plant; (6) improperly included third-party gas to calculate Encana's transportation allowance; (7) deducted unallowable transportation costs from Tom Brown, Inc. (TBI) fields; and (8) failed to use Encana's actual costs to determine its processing allowance for the Dragon Trail Plant. Encana timely appealed to the Director, ONRR, pursuant to the provisions of 30 C.F.R. Part 1290, Subpart B.[4]

In his August 9, 2013, Decision, the Director sustained the appeal in part and denied it in part. The Decision upheld the Order to the extent it concluded Encana claimed costs to place its gas in marketable condition in its transportation allowance for production from the Mamm Creek and Orchard leases; failed to pay royalty on gas used as compressor fuel, for boosting residue gas, and for fuel to compress residue gas at the Dragon Trail Plant; and claimed a transportation allowance for third-party gas. The Decision reversed the Order to the extent it demanded additional royalty for excessive processing allowances for gas processed at the Dragon Trail Plant based on production periods that are barred by the statute of limitations contained in 30 U.S.C. § 1724 (2006); determined 6 instead of 12 years of depreciation remained in calculating the processing allowance; and erroneously applied the rate of return to the capital balance that existed at the end of the year instead of the capital balance that existed at the beginning of the year. The Director modified the Order accordingly.

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[3] The audit was conducted under the authority delegated to the State by 30 U.S.C. § 1735 (2006). Four agreements were audited: C 56608A Grass Mesa 14th Rev, C 55972E Hunter Mesa 29th Rev, 891006098A Lower Horse Draw Unit, and 891006892B Dragon Trail Unit. Order at 1. The audit was expanded to include other properties that presented "similar accounting calculations for value, similar processing allowance percentages, and similar transportation allowance percentages," and these were then grouped (Mamm Creek, Orchard, Clough Rulison, and Dragon Trail) according to how Encana calculated its royalty obligations. *Id.*

[4] Formerly codified as 30 C.F.R. Part 290, Subpart B. With the creation of ONRR, these regulations were redesignated as 30 C.F.R. Part 1290, without substantive change. 75 Fed. Reg. 61051, 61093 (Oct. 4, 2010).

Encana timely appealed to this Board, where only issues 1 through 5, as set out above, are before us. SOR at 2-3.

On appeal, Encana maintains the Decision is contrary to the regulation defining *marketable condition* at 30 C.F.R. § 206.151 (2006)[5/] and the regulation governing the computation of royalty on processed gas at 30 C.F.R. § 206.154(b) (2006).[6/] It further argues the Decision is contrary to the Board's decision in *Exxon Corp.*, 118 IBLA 221 (1991), because it improperly "ignores the purpose of many of the costs at issue," which "were incurred for transportation of the gas – to enable Encana to market gas via the TransColorado pipeline, a mainline transmission pipeline 30 miles away, for higher prices in New Mexico." SOR at 1.

ONRR argues Encana's position must be rejected because Board and judicial precedent have repeatedly confirmed the principle that the costs of compressing and removing carbon dioxide are costs of placing the gas in marketable condition, which the lessee must bear. It further argues that Encana has ignored regulatory provisions establishing that gas used as fuel to compress gas off-lease is royalty-bearing and the costs of boosting residue gas are not deductible. Answer at 6.

[5/] The Decision cited the 2006 regulations found at 30 C.F.R. Part 206. The regulations were redesignated as 30 C.F.R. Part 1206 without substantive change. 75 Fed. Reg. at 61069. The parties have cited both the 2006 and current versions, but in general, we will cite the 2006 regulations cited in the Decision.

[6/] The regulation states in material part:

> (b)(1) For residue gas and gas plant products, the quantity basis for computing royalties due is the monthly net output of the plant even though residue gas and/or gas plant products may be in temporary storage.
>
> (2) If the value of residue gas and/or gas plant products determined pursuant to § 206.153 of this subpart is based upon a quantity and/or quality of residue gas and/or gas plant products that is different from that which is attributable to a lease, determined in accordance with paragraph (c) of this section, that value shall be adjusted for the differences in quantity and/or quality.

30 C.F.R. § 206.154(b) (2006).

Analysis

1, 2. Mamm Creek and the Orchard Leases:
Encana Was Required to Place the Gas in Marketable Condition

Encana argues that the dehydration and compression costs it incurred to meet the requirements of the TransColorado pipeline are not costs to place its gas in marketable condition, which are borne by the lessee, but instead are properly deducted from value for royalty purposes as a transportation allowance. SOR at 1. Encana apparently distinguishes the facts of this appeal from the facts of Board and judicial decisions considering marketable condition based on the following logic: If Encana could market its processed gas on the mainline pipelines near the Mamm Creek field, the gas was in marketable condition; therefore the additional costs of boosting compression and removing carbon dioxide for its processed gas to enter the TransColorado pipeline for sale in a more distant market must be deemed transportation costs. *Id.* at 8-9.

This line of argument has been considered and rejected by this Board and by courts. *Amoco Prod. Co. v. Watson*, 410 F.3d 722, 729 (D.C. Cir. 2005), *aff'd sub nom. BP Am. Prod. Co. v. Burton*, 549 U.S. 84 (2006) ("We are not persuaded . . . that the regulations require [ONRR] to understand typical sales – and thus marketable condition – as relating to transactions at the leasehold or immediately nearby. As an initial matter, it is not even clear that 'field or area' . . . refers only to leasehold land."); *Devon Energy Corp. v. Kempthorne*, 551 F.3d 1030, 1037 (D.C. Cir. 2008) ("DOI's interpretation of the marketable condition rule to require lessees to compress and dehydrate gas to meet the requirements of the pipelines that serve its typical purchasers is not 'plainly erroneous or inconsistent with the regulation'" (citation omitted)); *Indep. Petroleum Ass'n of Am.*, 279 F.3d 1036, 1040 (D.C. Cir. 2002) ("We find nothing unreasonable in Interior's refusal to allow deductions for so-called 'downstream' marketing costs.").

Encana's reliance on the Board's ruling in *Exxon Corp.*, 118 IBLA 221, does not overcome the weight of these and other precedent rejecting the assertion that the costs of downstream marketing should be deemed transportation costs. Citing *U.S. v. General Petroleum Corp.*, 73 F. Supp. 225, 263 (S.D. Cal. 1946), *aff'd sub nom. Continental Oil Co. v. U.S.*, 184 F.2d 802 (9th Cir. 1950), in *Exxon Corp.*, the Board stated: "Case law makes clear that if there is no open market in the place where an article would ordinarily be sold, then the market value of such article in the nearest open market, less cost of transportation to such open market, becomes the market value of the article in question." The Board concluded a transportation allowance was warranted, and did so because there was no market for Exxon's sour gas stream in the field, "and only after transportation and manufacture [did] a market exist for products of the gas stream." 118 IBLA at 240.

The Board reasoned that dehydration at the central dehydration facility "was not performed to satisfy market specifications. Indeed the record is plain that *no market existed* for the dried LaBarge gas stream, even at [the] Shute Creek [processing plant]. Nor did dehydration at the central [dehydration] facility remove the need for further dehydration during the manufacturing process or lessen the costs of the Shute Creek gas processing plant." *Id.* at 242 (emphasis added). The Board held that in the circumstances presented, ONRR should have allowed a deduction of Exxon's dehydration costs at that central facility. *Id.* at 244. *Exxon* clearly is distinguishable, because the costs incurred in this case do not involve processing to manufacture constituent products, and because there are markets for Encana's gas both near the Mamm Creek field and in New Mexico.

Encana cites the definition of *marketable condition* under 30 C.F.R. § 1206.151: "*Marketable condition* means lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser *under a sales contract typical for the field or area*." (Encana's emphasis.) In Encana's view, the emphasized language must mean that marketable condition is defined by the requirements of sales contracts in or near the Mamm Creek field, SOR at 9, and not, as ONRR contends, sales contracts typical for the field or area into which the gas was ultimately sold, Answer at 10. According to Encana, ONRR errs by "now interpreting 'marketable condition' to mean meeting the pressure and other specifications for transmission on the mainline pipelines 'into which Encana markets its gas.'" SOR at 10 (citing Decision at 7 n.3). Encana further argues the agency's reliance on the decisions in *Amoco Prod. Co.*, 410 F.3d at 722, and *Devon Energy Corp.*, 551 F.3d at 1030, is misplaced, because both involved coalbed methane gas rather than conventional gas,[7/] and both cases turned on the lack of evidence regarding typical sales contracts. SOR at 11.[8/]

[7/] Encana does not explain why the fact that coalbed methane was involved in *Amoco Prod. Co.* and *Devon Energy Corp.* should change our analysis and we perceive no reason why it would.

[8/] Encana submitted a wellhead contract for the sale of Mamm Creek gas, as well as a contract for gas "in the fields connected to the Dragon Trail Plant, also in the Piceance Basin and not far from the Mamm Creek field." SOR at 10, Exs. 2 (1999 contract between Ballard, an Encana predecessor, and Enserco Energy, Inc.), 7 (unexecuted copy of 1995 contract between TBI Production Co. and Conoco, Inc.). ONRR objects to the evidentiary value of the two contracts. It first notes that neither is a contract that was executed and performed during the audit period. Second, it argues a wellhead contract for gas produced from other fields does not establish Mamm Creek gas was in marketable condition. Third, ONRR argues a single contract for the sale of wellhead gas in no event establishes a market for Mamm Creek gas at the wellhead. Lastly, the terms of the Enserco-Ballard contract, as amended (SOR,

(continued...)

Nor do we agree that the phrase "under a sales contract typical for the field or area" is properly confined to sales in or near the Mamm Creek and Orchard fields for purposes of satisfying the duty to make gas marketable. 30 C.F.R. § 1206.151; *Amoco Prod. Co.*, 410 F.3d at 729; *see Devon Energy Corp.*, 551 F.3d at 1037. "*Field* means a geographic region situated over one or more subsurface oil and gas reservoirs encompassing at least the outermost boundaries of all oil and gas accumulations known to be within those reservoirs vertically projected to the land surface." 30 C.F.R. § 1206.151. "*Area* means a geographic region at least as large as the defined limits of an oil and gas field, in which oil and gas have similar quality, economic, and legal characteristics." *Id.* Those definitions pertain to comparing oil and gas volumes because they share the same characteristics. They do not state or imply that a lessee discharges its obligation to place oil and gas in marketable condition upon showing that third party purchasers in or near the Mamm Creek field would purchase the gas without requiring compression and/or dehydration. In any event, this Board and the courts have considered and rejected that argument, holding that the question in each case is whether typical third party purchasers would accept the gas without the added compression, carbon dioxide removal, and/or dehydration required by the pipelines delivering it.

The Board most recently addressed this issue in *Burlington Resources Oil & Gas Co.*, 183 IBLA 333 (2013). There, the Board held as follows:

> While dehydration and sweetening may be useful for transportation or processing, once it is properly determined that they are principally necessary to place the gas at issue in a marketable condition, they cannot also be the subject of a processing or transportation allowance. *See Devon Energy Corp. v. Kempthorne*, 551 F.3d at 1037 ("[Although] the costs of dehydration and compression can reasonably be interpreted to fall within the compass of 'transportation costs[,]'" ONRR properly held that they "are not deductible if the[] primary function [of compression and dehydration] is to prepare the gas to move through the pipelines to the point where gas is purchased" (emphasis added)); *Amoco Production Co. v. Watson*, 410 F.3d at 731 ("The logic of the regulations bars an expenditure to place gas in marketable condition from also being an expenditure deductible from gross proceeds as a transportation cost"); *Amoco Production Co. v. Baca*, 300 F. Supp. 2d [at 13 ("[Unlike dehydration in *Exxon*, which did not place the produced gas in a marketable

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Ex. 2), provided that purchasers were not obligated to accept and market gas that did not meet the requirements of the pipelines. Answer at 11-12, 15 n.4. ONRR's objections are well taken. *See California Co.*, 296 F.2d 384, 388-89 (D.C. Cir. 1961).

> condition,] CO2 removal is essential in the instant case to place gas in marketable condition. *That there exists a corollary benefit in [transporting and] reducing the level of CO2 [at the treatment facility] does not transform what is a marketing cost into a transportation cost*." (emphasis added)).

Burlington, 183 IBLA at 354.

[1] A "*sales contract typical for the field or area*" therefore reasonably refers to the contracts that are typical in the field or area into which the gas is actually sold, which may or may not be the field or area where the gas is produced. *Id.* at 352. As Encana's factual recitation makes abundantly plain, to enter the Questar, Xcel, and CIG pipelines from the Rifle Plant, Encana still had to boost the pressure of its gas, although not to the extent required by the TransColorado pipeline. SOR at 5. Considerably more compression and the removal of carbon dioxide was required to enter the TransColorado pipeline to reach purchasers in the market Encana elected to reach. *Id.* at 6, 7; *see Beartooth Oil and Gas Co.*, 122 IBLA 267, 272 (1992) (citing *California Co. v. Udall*, 296 F.2d at 387-88, and *The Texas Co.*, 64 I.D. 76, 79 (1957)). It is the New Mexico market that determines the primary purpose of the CO_2 removal, dehydration, and compression costs Encana incurred.

A substantial portion of processed gas from the Rifle Plant was sold and marketed through the Questar, Xcel, and CIG pipelines, ranging from 35 to 56 percent between 2004 and 2006. In *Amoco Prod. Co.*, the Department took the position that under 30 C.F.R. § 206.151, "because the 'dominant market for gas from the area is for gas that is utilized in distant markets with a much lower CO_2 content,' sales contracts for *treated* gas were typical for the area, while those for untreated gas were not." 410 F.3d at 729. The producers argued the "'dominant end-use' rationale is irreconcilable with the text of section 206.151 . . . , which frames typicality in terms of a given 'field or area.'" The Court rejected those arguments, and tacitly endorsed the "dominant market rationale," stating:

> We are not persuaded, however, that the regulation requires MMS to understand typical sales contracts–and thus marketable condition–as relating to transactions at the leasehold or immediately nearby. As an initial matter, it is not even clear that "field or area" . . . refers only to the leasehold land. . . . Because these terms do not foreclose the possibility of defining a region beyond the geographical limits of a leasehold, we are hesitant to conclude the Assistant Secretary's

> interpretation failed to "sensibly conform[ ] to the purpose and wording of the regulations" (citation omitted).

Id.

Encana's added costs to boost compression and remove carbon dioxide are properly royalty-bearing because they were incurred to place the Mamm Creek and Orchard leases gas volumes in marketable condition for sale in New Mexico. We accordingly will not address this contention in this appeal again.[9/]

3. Gas Used to Fuel Off-lease Compressors is Royalty-Bearing

ONRR seeks additional royalty on gas used as fuel to operate the Mamm Creek compressor stations. Encana advances three contentions in support of its argument that gas used to fuel the Mamm Creek compressor is not royalty-bearing. It maintains Mamm Creek gas is in marketable condition at the wellhead, and so the gas consumed to run the compressors is not to make the gas marketable. SOR at 17. Next, it argues that the gas is compressed in the field to transport it for processing at the Rifle Plant, and therefore it is a deductible transportation allowance. *Id.* Third, the gas was processed into residue gas and gas plant products, which comprise the net output of the plant and the quantity basis for computing royalty. Since gas used as compressor fuel does not reach the plant tailgate, it is not part of the net output of the plant and therefore it is not royalty-bearing under 30 C.F.R. § 206.154(b)(1) or the Board's decision in *Wexpro Co.*, 174 IBLA 57, 71 (2008). *Id.*

In addition to disputing the assertion that the gas is in marketable condition at the wellhead, ONRR argues lessees may use gas free of royalty obligations, provided their gas is used on the same lease or area subject to a unit or communization agreement. Answer at 23-24. As to a transportation allowance, ONRR acknowledges that "all but a small percentage of the compression costs are for transportation," and agrees that "Encana may convert the percentage of fuel allocable to that small percentage of transportation to a dollar amount and include that cost in its

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[9/] Encana's arguments are not without a certain logic. That observation is not a basis for invalidating ONRR's decision, however. As Encana implicitly admits, nothing in those rules expressly provides that a lessee's duty to place gas in marketable condition is met by showing that nearby markets would accept Encana's gas with less compression and dehydration, and without removing the carbon dioxide, when the lessee must incur such costs to prepare the gas to move through the pipelines to the point where it is actually purchased.

transportation allowance." *Id.* at 24.[10/] As to that small remaining percentage, citing the preamble to the final rule and its responses to comments on the proposed rule, ONRR argues it has clearly announced that "royalty is due on 'the volume of gas leaving the lease.'" *Id.* at 25.

[2] Encana's interpretation of 30 C.F.R. § 1206.154(b)(1) cannot be upheld. As discussed above, we do not agree that Encana has shown that there is a market for Mamm Creek gas at the wellhead, or that any such contracts in general or the two contracts it submitted on appeal are relevant to the marketable condition determination when Encana markets the gas to New Mexico.[11/] Encana correctly maintains the fuel is not residue gas or a marketable product derived from processing gas; we therefore agree that gas consumed as fuel is not part of the net output of the plant. *See* 30 C.F.R. § 206.154 (2006). However, it does not follow that such gas is royalty-free, because under section 17 of the Mineral Leasing Act, 30 U.S.C. § 226(b)(1)(A) (2006), royalty is due "in amount or value of the production removed or sold from the lease." *See* 30 C.F.R. § 206.154(a)(1) (2006) (Royalty is due "on the basis of the quantity and quality of unprocessed gas at the point of royalty settlement approved by BLM or [ONRR].").

In the preamble to the adoption of 30 C.F.R. § 206.154 as the final rule, ONRR explained that "[h]istorically, MMS has required that royalties be computed on the basis of the quantity and quality of unprocessed gas in marketable condition as measured on the lease unless prior approval to measure off-lease is obtained." 53 Fed. Reg. 1230, 1255 (Jan. 15, 1988) ("[T]his provision simply recognizes that it is the measured production that must be valued for royalty purposes."). Similarly, 30 C.F.R. § 206.154(c) (2006) "establishes the procedure to allocate the net output of a processing plant back to the leases." *Id.*

[10/] As ONRR concedes the applicability of the transportation allowance, we properly address this issue no further.

[11/] In its Reply, Encana continues to argue it could have sold all the residue gas volumes into the Questar, Xcel, and CIG pipelines without incurring any additional compression and CO_2 costs, and that those additional costs to reach the New Mexico market on the TransColorado pipeline therefore are properly deemed transportation costs. Reply at 1-2. It complains that ONRR is in possession of the contracts that would demonstrate what is typical in the field or area, and that it has failed to provide a reasoned explanation supported by facts, contrary to the requirements of the Administrative Procedure Act, 5 U.S.C. §§ 552-559 (2006). *Id.* at 5. Again, because we do not agree with Encana's construction of the regulations, these arguments lack merit.

In response to comments questioning whether the method of computing gross proceeds is consistent with the method for valuing net output, particularly with respect to an output product that is temporarily stored, ONRR stated it perceived no conflict, because

> it is the volume of gas leaving the lease which must be valued, for royalty purposes, and the use of the cumulative value of any condensate recovered downstream of the point of royalty settlement without resorting to a manufacturing process, plus the residue gas and gas plant products, less applicable allowances, is the method by which this is done when gas is processed. Therefore, all such condensate, residue gas, and gas plant products attributable to this production must be used in determining value. . . .
>
> Paragraph 206.154(c) establishes the procedure to allocate the net output of a processing plant back to the leases.

Id.[12/]

The rules provide for beneficial uses of gas free of royalty only on the lease or on a unitized or communitized area from which the consumed gas was produced. As stated in *Plains Exploration & Prod. Co.*, 178 IBLA 327, 343 (2010):

> 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 power other conditioning operations regardless of where the operation occurs.

Accord Wexpro Co., 174 IBLA at 61-65 (examining the unit agreement, Notice to Lessees and Operators of Federal Onshore Oil and Gas Leases (NTL)-4 and -4A, relevant judicial decisions, and rulemaking confirming beneficial use is royalty-free, but such use must occur on the lease or unitized or communitized tract from which

[12/] Encana would dismiss the preamble discussion because the comment to which the agency was responding concerned the valuation of stored plant production. Regardless of the comment that prompted it, MMS correctly stated that royalties must be based on the volume of gas leaving the lease, and when gas is processed, valuation for royalty purposes must include condensate, residue gas, and gas plant products attributable to lease production, less applicable allowances that do not include the costs of placing the gas in marketable condition.

the gas was produced).[13/] ONRR avers the three compressors are not located on the leases and units from which the gas they consumed was produced, and Encana does not challenge that assertion.[14/] ONRR properly demanded additional royalty on the portion on gas used as fuel for the compressors that was not otherwise allowed as a transportation cost. *Plains Exploration & Prod. Co.*, 178 IBLA at 344 ("[P]roduction used on the lease for lease operations was royalty-free because it was not removed or sold from the lease. . . . 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.").

4. The Costs to Boost Residue Gas Are Not Allowable Transportation Costs

Encana contends the costs of boosting gas at the tailgate of the Rifle Plant and Roan Cliffs booster stations should be allowed as transportation costs. SOR at 13-14, 19. Seizing on the Decision at 17 where it states the "primary function of the recompressor at a cryogenic plant is to boost the gas up to the pressure requirements of the *pipeline leaving the gas plant*" (Encana's emphasis), Encana argues that "[v]ery little residue boosting" would have been necessary to enter the two mainline pipelines connected to the plant, and that the recompression was necessary in order to transport the gas 30 miles to enter the TransColorado pipeline. *Id.* at 13. It further notes that additional compression at the Roan Cliffs Booster Station was necessary to restore pressure lost on the Great Divide I pipeline to market gas on the CIG Pipeline. *Id.* In its Reply, Encana points to ONRR's concession that its gas was in marketable condition (citing Decision at 12) to conclude the costs therefore were not incurred to make the gas marketable, and therefore the additional compression is a transportation cost. Reply at 4-5.

ONRR acknowledges the rule that a lessee is not required to place gas in marketable condition more than once, but characterizes the prohibition against deducting the cost of boosting residue gas as an exception to that rule. Answer at 26.

[13/] Encana cites *Wexpro Co.*, 174 IBLA at 71, as support for its contrary assertion. However, that citation furnishes no support to Encana. The Board reversed the State Director's decision, not because there was a question about the basic principle that the beneficial use of gas must occur on the lease from which that gas was produced, but because it could not determine from the record before it the extent to which gas used in the compressors, dehydrator, and JT facility on the unit was to make the gas marketable or for a beneficial use under NTL-4A, the regulations, or the unit agreement.

[14/] ONRR notes that the gas from the leases and units on which the compressors are located was free of royalty and the Order did not assert otherwise. Answer at 24, n.6.

To be accurate, in the Decision, the ONRR Director stated: "Here, Encana's gas is in marketable condition at the Questar and Xcel pipelines for that particular market. However, that fact does not convert all gas sold into marketable condition. Encana is still required to meet the CO_2 specifications of the TransColorado pipeline for gas volumes transported through that pipeline to meet marketable condition." Decision at 12. The Decision explained that the requirements of the pipeline actually used that properly determine the relevant market and what constitutes marketable condition. *Id.* We agree. *See* 30 C.F.R. § 206.158(d)(1) (2006) ("[N]o processing allowance shall be allowed for the costs of placing lease production in marketable condition, including dehydration, separation, compression, or storage, even if those functions are performed off the lease or at a processing plant."); *cf. Amoco Prod. Co.*, 410 F.3d at 728 ("The producers read the statute as if it referred to 'gas sold at the lease,' but that is not the case. They direct us to no precedent limiting marketable condition to their narrowing construction."); *Devon Energy Corp.*, 551 F.3d at 1037 ("The producers' construction also does not square with the regulatory scheme as a whole. The regulation stipulating that producers are to place gas in marketable condition at no cost to the government does not contain a geographic limit."); *Indep. Petroleum Ass'n of Am. v. DeWitt*, 279 F.3d 1036, 1041 (D.C. Cir. 2002) ("[A]t no point do [the producer groups] offer a persuasive reason for introducing a distinction between marketing for leasehold sales and for 'downstream' sales . . . . [P]roducers are under no duty to market 'downstream' and may opt to sell at [or near] the leasehold.").

[3] The additional difficulty Encana overlooks lies in the regulation at 30 C.F.R. § 202.151(b) (2006),[15/] which authorizes a processing allowance for the reasonable, actual costs of processing gas, but also unambiguously provides: "(b) 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." (Emphasis added.) Encana has not shown that its recompression costs are allowable as a cost of operating the Rifle Plant, or identified a provision in 30 C.F.R. Part 206 that would otherwise authorize an allowance.

5. Fuel Used for Boosting Residue Gas at the Dragon Trail Plant is Royalty-Bearing

The Decision directed Encana to pay additional royalties due on gas used as fuel to boost the residue gas at the Dragon Trail Plant. Decision at 16. In addition to the points considered and rejected above, Encana explains that this gas must be recompressed "in large part because of the sophisticated cryogenic process, which

[15/] The Decision cited the regulation as "30 C.F.R. § 202.151(b)(1) (2006), but the 2006 version of that rule did not have a paragraph designated (b)(1). *See* Decision at 10, 17.

creates a substantial pressure drop (along with extremely low temperatures) to extract liquids than the refrigeration process. The greater liquid recovery, which is shared with ONRR, comes at the cost of needing to recompress gas to enter the adjacent pipelines," though it also acknowledges that "further compression would have been necessary, but not to the extent required after cryogenic processing." *Id.* at 20, n.7. Encana thus appears to argue, as it did before the ONRR Director, that the fuel used to boost the residue gas is properly subject to a processing allowance.

[4] As noted in the Decision, the regulation at 30 C.F.R. § 202.151(b) (2006), quoted above, does not distinguish between types of processing plants. The Decision rejected inclusion of the fuel as a processing cost because the recompression occurred after gas had been processed into plant products, and not during processing to extract them. It did so on the basis of the guidance provided in Form MMS-4109 and the Payor Handbook, and section 647.73D of the U.S. Geological Survey's Conservation Division Manual describing the activities that constitute processing, which are consistent with the rules governing processing allowances:

> *Processing* means any process designed to remove elements or compounds (hydrocarbon and nonhydrocarbon) from gas, including absorption, adsorption, or refrigeration. Field processes which normally take place on or near the lease, such as natural pressure reduction, mechanical separation, heating, cooling, dehydration, and compression, are not considered processing. The changing of pressures in a reservoir is not considered processing.

30 C.F.R. § 206.151 (2006). Further compression at the plant tailgate to meet mainline pipeline specifications is not a "process designed to *remove* elements or compounds (hydrocarbon and nonhydrocarbon) from gas." 30 C.F.R. § 206.151 (definition of *processing*, emphasis added). Instead, further compression was necessary in order to render the gas marketable by satisfying TransColorado's pipeline specifications.

The regulation clearly considers boosting residue gas to be in the category of "other expenses incidental to marketing," for which an allowance is expressly prohibited. The preamble to the final rules removes all doubt. In response to comments urging an allowance for boosting residue gas under section 202.151(b), *Royalty on processed gas*, on the theory that such costs result from processing and should not be regarded as a cost of placing gas in marketable condition, MMS stated: "The cost for boosting residue gas is considered as a cost necessary to place the gas in marketable condition, and will not be an allowable deduction." 53 Fed. Reg. 1230, 1236 (Jan. 15, 1988); *see also* comments on proposed section 206.152(i), *id.* at 1252 ("Several . . . commenters agree with the MMS' proposed provision that costs such as those for compression to meet pipeline pressure specifications to place gas in marketable condition should be borne by the lessee.”). ONRR properly concluded Encana could not deduct these costs as a processing allowance. We find no basis for disturbing ONRR’s Decision.

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.

/s/
T. Britt Price
Administrative Judge

I concur:

/s/
James K. Jackson
Administrative Judge