Oil Valuation Issues
(1988 Regulations)

1. Sales: What do we consider a sale? What do we not consider a sale?
   Are the following necessary conditions for a sale to occur under the 88 rules:

   Seller unconditionally transfers title to the oil to the buyer and does not retain any related rights such as the right to buy back similar quantities of oil from the buyer elsewhere;

   Buyer pays money or other consideration for the oil;

   Parties intent is for a sale to occur.

   (These are the conditions for a sale to occur under the 3/15/2000 oil rules) Bottom line: Are conditions for a sale under the 1988 rules any less stringent?

2. Gross Proceeds:

   Can there be gross proceeds in a sale/transfer between lessee and affiliate?
   Can there be gross proceeds between two parties in an A/L Buy/sell exchange?
   What about a non A/L buy/sell?

3. Significant Quantity:

   Should we specify any % of a lessee's total field production as "significant" for purposes of the benchmarks in valuing oil not sold at arm's length?

4. Sales to Affiliates:

   Do our auditors trace production to first A/L sale or apply benchmarks?

   If proceeds between lessee and affiliates is greater than 1st A/L sale or benchmark then what?

   If no A/L sale do we take higher of lessee's proceeds and benchmark value?

5. Gathering and Handling (?)

   What do we consider gathering?
   Can either gathering or handling ever be deducted?
   What if it is between two separate parties?
   What if it is between parent company and affiliate?

6. Exchange Agreements:

How do we treat exchange agreements? A/L (?), non- A/L (?), no sale.

Trace production to first A/L sale at subsequent exchange point (?)
If buy/sell exchange is A/L and comparable to A/L sales contract, can we use it for benchmarking?

If the proceeds from the initial buy/sell exchange is higher than proceeds from the subsequent sale of production received (less differential) how do we value?

7. Differential (Quality, Locality):

Can we accept differential mentioned in the contract between lessee and affiliate? That is—a non A/L exchange differential.

8. Joint Ventures:

How do we treat Joint Ventures? As though sales between affiliates (?)

9. Hedging

Under what contract conditions do we participate in sharing the risk (?)

10. 4th Benchmark

For Raj's example valuing oil from Elk Hills area, where value falls to the fourth benchmark to a CA spot price, should we use ANS or Line 63 (Raj will elaborate during the meeting)?

United States Department of the Interior

OFFICE OF HEARINGS AND APPEALS
Interior Board of Land Appeals
4015 Wilson Boulevard
Arlington, Virginia 22203

IN REPLY REFER TO:

SEAGULL ENERGY CORP.

IBLA 98-25 Decided May 6, 1999

Appeal from a decision of the Associate Director, Minerals Management Service, denying in part and modifying an order requiring a Federal lessee to perform a restructured accounting for all its Outer Continental Shelf leases between April 1986 and September 1992, and to pay any additional royalties. MMS-92-0497-OCS.

Reversed.

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

   Under the Outer Continental Shelf Lands Act, the Secretary of the Interior has authority to lease lands on the OCS and to obtain payment of specified royalty from leases issued pursuant thereto. It is within the Secretary's discretion to determine the value of production for royalty purposes, and a party challenging that valuation has the burden of showing the valuation is in error.

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

   Pursuant to 30 C.F.R. § 206.150 (1987), the benchmark provisions of 30 C.F.R. § 206.152(c)(1) and the "gross proceeds rule," 30 C.F.R. § 206.152(h), the minimum value of lease production for royalty purposes shall never be less than the gross proceeds accruing to the lessee for the sale thereof.

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

   A Federal lessee is required to place gas in marketable condition at no cost to the Federal Government unless otherwise provided in the lease agreement. Where the value is determined by a lessee's gross proceeds that value may not per se be increased to the purchase price received by a nonmarketing affiliate in a downstream arm's-length sale.

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

A lessee selling lease production to an affiliate that is not a "marketing affiliate" as defined at 30 C.F.R. § 206.151 is not per se required to include the difference between the affiliate's purchase price at the wellhead and the affiliate's sale price in a down stream arm's-length sale of lease production absent a determination that the sale at the wellhead was not the reasonable equivalent of an arm's-length sale at the wellhead. 30 C.F.R. § 206.152(b)(1)(i); 30 C.F.R. § 206.152(c).

APPEARANCES: Thomas J. Eastman, Esq., Washington, D.C., and James D. Harris, Esq., Houston, Texas, for appellant; Howard W. Chalker, Esq., Geoffrey Heath, Esq., and Sarah L. Inderbitzin, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE FRAZIER

Seagull Energy Corporation (Seagull or appellant) has appealed a July 31, 1996, decision of the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS), denying in part and modifying a Letter Order issued September 3, 1992, by the Area Manager, Houston Compliance Office (HCO), MMS, directing Seagull to perform a restructured accounting on all of its Federal Outer Continental Shelf (OCS) leases because it had "incorrectly deducted unapproved expenses in calculating the value of production for royalty purposes" between April 1986 and September 1992.

Seagull is the lessee of producing OCS Federal oil and gas leases off the coast of Louisiana and Texas. The record establishes that Seagull's first sales of gas were wellhead sales to its affiliate, Seagull Marketing Services, Inc. (SMS). SMS then sold the gas to various third-party purchasers under arm's-length contracts, transported the gas to the purchasers under arm's-length transportation arrangements, and received a higher price than it paid to Seagull and other producers at the wellhead. Seagull based its royalty payments on the purchase price it received from SMS. The HCO Letter Order stated that "Seagull deducted transportation charges, fuel use charges and marketing margin charges from the third party purchase price." Id. at 1.

As a result of an audit of Seagull's royalty payments for OCS leases for the period April 1, 1986, through March 31, 1991, HCO determined that, under the gross proceeds rule, 30 C.F.R. § 206.150 (1987), 30 C.F.R. § 206.152(h), 1/ Seagull should have paid royalties based on

1/ 30 C.F.R. § 206.150 (1987), applies to production through March 1988, and 30 C.F.R. § 206.152(h), applies to production subsequent to March 1988.

SMS' arm's-length sales price. Specifically, HCO determined that Seagull had underpaid royalties on production from Lease Nos. 054-006004-0 and 054-003043-0 by $42,892.74 in December 1987, February 1988, and March 1988, and underpaid royalties on production from Lease Nos. 054-004069-0 and 054-008131-0 by $403.23 for December 1987.

HCO's September 3, 1992, order required Seagull to pay royalty based on the proceeds received by SMS, its affiliate, from the third party sales, rather than on the proceeds Seagull received from SMS. Seagull appealed the HCO Letter Order to the Director, MMS, pursuant to 30 C.F.R. Part 290, arguing that HCO's claim for additional royalties was premised on a misapplication of MMS' regulations. Seagull asserted that SMS was not a "marketing affiliate" as that term is defined at 30 C.F.R. § 206.151 and applied in 30 C.F.R. § 206.152(b)(1)(i), and that the value of gas for royalty purposes should be determined by the benchmark system for nonarm's-length contracts found at 30 C.F.R. § 206.152(c). Seagull further argued that if it were found to have incorrectly paid royalties pursuant to the Letter Order, it was entitled to retroactive transportation allowances.

In her July 31, 1996, decision on appeal herein, the Associate Director conceded that SMS was not Seagull's "marketing affiliate," within the meaning of 30 C.F.R. § 206.152(b)(1). Nonetheless, she concluded that royalty value was properly calculated based on the proceeds received by Seagull's affiliate. The Associate Director reached this conclusion relying on the "gross proceeds" rule, 30 C.F.R. § 206.152(h), and on Santa Fe Energy Products Co., 127 IBLA 265 (1993), aff'd, Santa Fe Energy Products Co. v. McCutcheon, No. 94-C-535, slip. op. (D. Colo. Mar. 30, 1995), aff'd, 90 F.3d 409 (10th Cir. 1996).

The Associate Director states in part:

> I do not agree that the Appellant's gross proceeds from its non-arm's-length sale(s) at the well head is, per se, conclusive with respect to value for royalty purposes. MMS rules at 30 C.F.R. 206.152 (h) specify that in no event may value be less than a lessee's gross proceeds. In Santa Fe Energy Products Co., 127 IBLA 265 (1993), the IBLA concluded, based upon this rule, that a lessee could not shield proceeds from consideration in the value calculation by establishing an affiliated transfer. On this basis, the IBLA ordered Santa Fe to produce records of its affiliated sale.
>
> * * * * * * *
>
> It follows that MMS may properly look to the arms-length third party sales by SMS, Seagull's affiliate, to determine royalty value and whether the benchmark value established by operation of 30 C.F.R. 206.152(a) is consistent with subpart (h) of that rule. In fact, Seagull claims that MMS' order amounted to requiring payment of royalties on the basis of the affiliate's price.

This is the flip side of the well-settled rule . . . that selling expenses necessary to market production from a Federal lease must be performed at no cost to the lessor. California v. Udall, 296 F.2d 384, 388 (D.C. Cir. 1961).

The fact that a lessee, by accepting a reduction in the sales price, may "pay" a third party, in this case Seagull's affiliate, to perform marketing functions, does not alter the rule that when computing royalty the lessee cannot reduce the value of the lease production by deducting the cost incurred in marketing that production.

* * * * * * *

The Interior Board of Land Appeals (IBLA) addressed the issue of marketing costs in Amoco Production Co., 112 IBLA 77, 84 (1989), stating that although MMS will normally accept a non-arms's-length contract price for royalty purposes where the contract has characteristics similar to arm's-length contracts which represent fair market value, where the contract price reflects deductions that cannot be made in determining value for Federal royalty purposes, such deductions may be added back into the contract price for purposes of computing royalty.

Here, the MMS concluded that SMS was incurring some combination of transportation, *fuel use marketing and/or other* costs. Since not all of these costs, or potential costs, are allowable deductions from value for royalty purposes, it was proper for MMS to inquire as to the nature and extent of those costs, and to require Appellant to net back into its gross proceeds for royalty purposes those costs which are the responsibility of the lessee.

When Seagull claimed that MMS' order amounted to requiring payment of royalties on the basis of the affiliate's price; it conceded that the SMS sales price, in essence, is the confluence of these two principles, namely (1. The requirement that a lessee must place production in marketable condition at no cost to the lessor and (2. The gross proceeds requirement embodied in *30 C.F.R. 206.152(h))*. Thus, *I conclude that the subject MMS* order should be modified to require the Appellant to identify the costs incurred by SMS in the execution of its contract with the Appellant and to recalculate the royalties due for the subject leases, adding back into its gross proceeds those cost which are not properly deducted for royalty purposes.

(Decision at 3-4.)

In conclusion, the Associate Director directed Seagull to pay any additional royalties found to be due, based on its recalculations, and modified the HQ Letter Order to permit Seagull to apply for and obtain retroactive approval of transportation allowances for the lease production at issue. (Decision at 4.)

Arguments on Appeal

On appeal to the Board, Seagull argues that MMS erroneously relied on the gross proceeds provision because gross proceeds applies to the gross proceeds of the "lessee" and the term, "lessee" as defined in 30 C.F.R. § 206.151, does not include lessee's affiliated entities. Seagull asserts that MMS' reliance on Santa Fe to support its position is misplaced because that case deals with the oil regulations rather than the gas regulations and focuses on the production of documents which is not an issue in this case.

Seagull contends that MMS has properly determined that SMS is not a "marketing affiliate," which is defined at 30 C.F.R. § 206.151 as "an affiliate of the lessee whose function is to acquire only the lessee's production and to market that production," because SMS is an affiliated marketer which purchases and markets gas from both affiliated and nonaffiliated lessees/sellers. Seagull argues that, for royalty purposes, the prices paid by SMS to the nonaffiliated sellers should be used as the acceptable value for gas produced by affiliated sellers. Seagull cites MMS' explanation provided in the preamble to its royalty valuation regulations:

> The MMS is retaining the term "only". If the affiliate of the lessee also purchases gas from other sources, then that affiliate presumably will have comparable arm's-length contracts with other parties which should demonstrate the acceptability of the gross proceeds accruing to the lessee from its affiliate. 53 Fed. Reg. 1230, 1243 (Jan. 15, 1988).

(SOR at 5.)

Appellant insists that since SMS is not a "marketing affiliate," its royalty value must be based on the benchmark expressly established for nonarm's-length transactions. Id.

Further, Seagull argues that the discussion in the preamble quoted above,

> confirms that the valuation rules applicable to sales to "marketing affiliates" would not apply to sales to other affiliates, because in sales to other affiliates there will be comparable transactions on which to demonstrate the reasonableness "of the gross proceeds accruing to the lessee from its affiliate." 53 Fed. Reg. 1230, 1243 (January 15, 1988).

(SOR at 6.) Seagull asserts the Associate Director cannot disavow or ignore either the plain terms of the regulations or the express guidance set forth in the preamble to the regulations.

Citing Bahramizadeh v. United States, I.N.S., 717 F.2d 1170, 1173 (7th Cir. 1983), appellant argues that MMS cannot interpret its regulation in a manner to nullify the effective intent or wording of the regulation.

The Associate Director's interpretation of the gross proceeds rule, it contends, serves to negate the detailed benchmark system established for gas royalty valuation when gas is sold in a nonarm's-length transaction. Appellant reasons that "under the express term of the regulations, the benchmark system applies to all such transactions with the sole exception of when gas was sold to a 'marketing affiliate.'" Id. Because the decision "effectively renders the non-arm's-length benchmark regulation inoperative" Seagull insists "it is unreasonable and cannot be sustained." Id.

A regulation, like a statute, Seagull avers, must be read "so that no part will be inoperative or superfluous, void or insignificant, and so that one section will not destroy another unless the provision is the result of obvious mistake or error." Silverman v. Eastrich Multiple Investor Fund, L.P., 51 F.3d 28, 31 (3rd Cir. 1995). Here, Seagull maintains that "the plain terms of the regulations are not the result of 'mistake or error', but the result of a reasoned distinction between marketing affiliates and other affiliates." (SOR at 6.)

According to Seagull, the first benchmark, 30 C.F.R. § 206.152(c), is applicable to this case and is the method by which Seagull valued its gas production. That benchmark provides that gas is valued according to the

> gross proceeds accruing to the lessee pursuant to a sale under its non arm's-length contract (or other disposition other than by an arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under, comparable arm's-length contracts for purchases, sales or other dispositions of like-quality gas in the same field (or, if necessary to obtain a reasonable sample, from the area.).

Id. To evaluate comparability, the regulation states MMS will consider the following factors: "price, duration of the contract, market or markets served, term, quality of gas, volume and such other appropriate factors." Id.

Seagull maintains that it provided evidence to establish that the gross proceeds accruing to Seagull under its nonarm's-length contracts are equivalent to gross proceeds derived under comparable arm's-length sales in the same field or area, as set forth in the first benchmark standard. Specifically, Seagull points to a chart found in Ex. F. of Ex. B attached to its SOR, which it claims demonstrates that the "price paid by SMS to Seagull - and the price on which Seagull based its royalties to the MMS - was equal to the price for gas paid by SMS to non-affiliated lessee/producers for gas from the same or nearby leases." (SOR at 9.) Appellant states "the gas purchase contracts covering Mustang Island 828 and Mustang Island 831 * * * are executed by Seagull and all other lessee/producers selling production from the blocks. All sellers under those contracts, including those not affiliated with SMS, agreed to identical prices." Id. Appellant notes that "these particular contracts are not only contracts between affiliates, but are also comparable arm's-length contracts between SMS and non-affiliated third parties that demonstrate the acceptability of the gross proceeds accruing to Seagull from SMS." Id.

Recognizing that the audit period at issue in this case includes a time period covered by the pre-1988 regulations, Seagull applies the earlier regulation and maintains that its "valuation method also conforms to the MMS regulations in effect prior to March 1988." (SOR at 10.) Citing Mobil Oil Corp., 112 IBLA 56 (1989), appellant notes the Board held that a nonarm's-length contract price will be accepted as the basis for royalty so long as it falls within the range of prices received in the same field or area under arm's-length contracts. It also notes that the Board in Getty Oil Co., 51 IBLA 47, 51 (1980), "upheld the use of non-arm's-length sale prices for royalty valuation, where evidence established that the price is comparable to the price 'independent buyers in arm's-length transactions would be willing to pay.'" (SOR at 10.) Further it states that the Board held in *Shell Western E & P, Inc.*, *112 IBLA 394 (1990)*, that the MMS may not apply its royalty valuation rules in a manner that unfairly discriminates against lessees who are affiliates of other parties to a transaction. (SOR at 10.) Applying the foregoing cases, appellant reasons that under Getty, the evidence that appellant paid royalty on the same price that other nonaffiliated lessees received from SMS demonstrates that appellant paid royalty on fair market value. Seagull insists that MMS cannot demand a higher royalty value from Seagull than it does from the other lessees receiving the identical price from SMS. Id. To do so, appellant contends, "would unfairly discriminate against Seagull because it sold gas to its affiliate, as prohibited under Shell Western." Id.

In light of facts presented here, appellant insists that the precedents demonstrate that MMS' order cannot be sustained under the pre-March 1988 regulation because appellant paid royalty based on the same sales price other unaffiliated lessees received from SMS. MMS' attempt, moreover, to redefine the nature of Seagull's nonarm's-length sale by an expansive reading of the "gross proceeds" provision, Seagull argues, cannot be sustained. Citing Diamond Shamrock Exploration v. Hodel, 853 F.2d 1159 (5th Cir. 1988), Seagull concludes that MMS' reading of the "gross proceeds" provision is an "unreasonable interpretation of the MMS regulations, and represents an abuse of discretion and an unlawful retroactive substantive rulemaking." (SOR at 10-11.)

In its answer, MMS disputes Seagull's claim that it erroneously relied on the "gross proceeds" provision, 30 C.F.R. § 206.152(h), as a basis for its decision. MMS argues that, because Seagull and SMS are an *integrated enterprise engaged in the production and marketing of gas*, it is more than reasonable for MMS to determine that the proceeds that the enterprise receives when selling gas on the open market is the true measure of the gross proceeds from the disposition of Seagull's production. MMS maintains that its position is supported by the Board's holding in Xeno, Inc., 134 IBLA 172, 179-80 (1995), citing Shell Oil Co. (On Reconsideration), 132 IBLA 354 (1995) (overruling Shell Oil Co., 130 IBLA 93 (1994), aff'd, Shell Oil Co. v. Babbitt, 945 F. Supp. 792 (D. Del. 1996), aff'd, 125 F.3d 172 (3rd Cir. 1994)); Santa Fe Energy Products Co., supra. MMS notes that, in Xeno, the Board concluded that "MMS may properly look to the first arm's-length sale by an affiliate, less transportation costs, to determine the value of production for royalty purpose." (Answer at 2.) Consistent with Xeno, MMS determined that it was "'reasonable' for MMS to look at the first arm's-length sale by an affiliate where the price received by the affiliate 'purchaser' for that sale is higher than the price the purchaser paid its affiliate producer." 134 IBLA at 179. This, MMS contends, "is exactly what occurred in this appeal." (Answer at 3.)

MMS asserts that Seagull cannot avoid application of the "gross proceeds" rule under (1) former 30 C.F.R. § 206.150 (1987), for gas produced prior to MMS' promulgation of its 1988 valuation regulations, and under (2) the "benchmark" system under 30 C.F.R. § 206.152(c), for production occurring after promulgation of the March 1, 1988, regulations. MMS denies that it is ignoring the regulations, and responds that, "[e]ven if Seagull's production is valued under 30 C.F.R. § 206.150 (1987), or 30 C.F.R. § 206.152(c) (1996), MMS still must determine the gross proceeds accruing to the lessee and compare the gross proceeds value to any other applicable value in order to establish the minimum value for royalty purposes." (Answer at 5.) Citing Board and court precedent, MMS characterizes "gross proceeds" as the minimum value of production. MMS contends that it is required to determine gross proceeds and compare that value to any other value that may be applicable under the regulations contained in 30 C.F.R. Part 206. (Answer at 6-7.) MMS asserts that, having "determined that the gross proceeds accruing to SMS were higher than the 1988 benchmark and pre-1988 Section 206.150 values, MMS properly followed its regulations when it ordered Seagull to recalculate royalties based on the higher value." Id. at 7.

MMS denies that 30 C.F.R. § 206.152(b)(1)(i) precludes it from requiring Seagull to establish value based on its affiliate's proceeds when its affiliate, SMS, is not a "marketing affiliate" as defined at 30 C.F.R. § 206.150. MMS maintains that Seagull's argument rests

> on the faulty assumption that by specifically stating that a "marketing affiliate's" proceeds would establish the value of production for royalty purposes under Section 206.152(b)(1)(i), MMS meant to preclude itself from determining that an affiliate's proceeds establish the value of production under the gross proceeds rule of Section 206.152(h) in any other case.

(Answer at 8.) For support, MMS points to a related discussion at 53 Fed. Reg. 1189, 1196 (Jan. 15, 1988). MMS insists that Seagull is wrong because MMS added the marketing affiliate rule in response to industry's request during the rulemaking process, and their concern "that applying the benchmarks could lead to a higher value than what the production actually was sold for in a subsequent arm's-length sale." (Answer at 9.)

MMS reasons that the only difference between cases involving a marketing affiliate and a nonmarketing affiliate is that, in the case of a nonmarketing affiliate, "MMS is not obligated to exclude consideration of the benchmarks and conclusively accept the affiliate's proceeds as royalty value." (Answer at 9.) In the case of a nonmarketing affiliate, MMS argues that "value would be the greater of the benchmark value under 30 C.F.R. § 206.152(c) or the affiliate's gross proceeds under its arm's-length sale." Id.

Thirdly, MMS reiterates that Seagull cannot deduct marketing costs from the value of its production, arguing that, under Amoco Production Co., 112 IBLA at 87, "the lessee has the duty to market its production and must bear the expenses incurred in discharging that obligation." (Answer at 10.) Citing Arco Oil & Gas Co., 112 IBLA 8, 11 (1989) and Mobil Oil Corp., 112 IBLA 198, 209 (1989), MMS states that the Board recognized that "[t]he creation and development of markets for production is the very essence of the lessee's implied obligation to prudently market the production from the lease at the highest price obtainable for the benefit of the lessee and the lessor." (Answer at 10.) Therefore, MMS argues that Seagull cannot deduct any cost incurred in marketing the production from its Federal leases or from its gross proceeds prior to royalty valuation. Acknowledging that SMS markets gas from both affiliated and nonaffiliated sellers, MMS asserts that Seagull has attempted to circumvent its obligation to market the gas by enlisting its wholly-owned affiliate, SMS, to market its gas.

MMS maintains that here where a Federal lessee pays an affiliate to perform marketing functions, or accepts a reduction in price for gas, the lessee may not deduct the costs of such services from the royalty value. Id. at 11. Alternatively, MMS reasons the market value of Seagull's production was either the price SMS paid plus marketing costs or SMS' arm's-length sale, less allowable transportation costs. Id. at 12.

On March 5, 1998, MMS filed a "Notice of Supplemental Authority," arguing that Taylor Energy Co., 143 IBLA 80 (1998), requires that the Board affirm its decision, herein. MMS submits that Seagull, like Taylor, circumvented its obligation by enlisting third parties to market its gas resulting in the Board finding Taylor to have improperly deducted the costs from royalty value.

Alternatively, MMS argues that there is no corporate distinction between Seagull and SMS for purposes of determining gross proceeds accruing to Seagull. 2/ Thus, MMS avers that SMS is the "alter ego" of Seagull

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2/ In light of its alternative argument, MMS urges the Board to modify its prior statement in Shell Oil Co. (On Reconsideration), 132 IBLA at 356-58, to recognize that, in some circumstances, the term "lessee" does include its affiliate, and that, under established legal principles, it would be correct to state the following:

"The term 'lessee' may include an affiliate under certain circumstances. When a lessee and the affiliate to whom it initially sells production operate as an integrated or single enterprise for production and marketing of federal oil or gas, the affiliate's arm's-length resale proceeds represents the gross proceeds accruing to the lessee from the disposition of production. This is true regardless of whether the term 'lessee' includes the affiliate under the particular circumstances or whether the corporate form is disregarded."

Shell Oil Co. (On Reconsideration), 132 IBLA at 357. The lessee definition set forth in the regulation, 30 C.F.R. § 206.151, is clear. If MMS wants to include the lessee's affiliate in that definition, it should amend the regulation.

and urges the Board to exercise its authority to pierce the corporate veil of the affiliated entities where to recognize the corporate form would defeat public policy recognized in Shell Western E&P, Inc., 112 IBLA 394, 400 (1990). MMS opines that applying the rule to this case is appropriate because there exists some manifestation that affiliated companies "are using their corporate relationship to defeat MMS royalty collection efforts." Id. at 17.

Discussion

The question presented in this appeal is whether a Federal lessee who sells lease production to an affiliate at the wellhead under contract which is for all practical purposes identical to the contract under which the affiliate purchases gas from other unaffiliated producers from the same field is per se required to use the affiliate's resale price as a basis for determining value for royalty purposes. Consideration of this question requires an examination of the traditional obligation of the lessee to market the production at no cost to the lessor and to place the gas in "marketable condition" under 30 C.F.R. § 206.152(i) (1997), 30 C.F.R. § 206.151 and an examination of what constitutes gross proceeds accruing to the lessee under 30 C.F.R. § 206.150 (1987) and 30 C.F.R. § 206.152(h).

[1] The Secretary of the Interior is authorized to lease land on the OCS under the Outer Continental Shelf Lands Act (OCSLA), as amended, 43 U.S.C. § 1337 (1994), for the exploration and development of mineral resources, including oil and gas. The provisions of OCSLA, 43 U.S.C. §§ 1331-1356 (1994), and leases issued pursuant to that Act, require payment of royalties equal to a specified percentage of the amount or value of the oil and gas produced. When it passed this Act, Congress committed the Government to the goal of obtaining fair market value for offshore oil and gas resources. Watt v. Energy Action Educational Foundation, 454 U.S. 151, 162 (1981); Conoco Inc., 110 IBLA 232, 239 (1989); Sun Exploration & Production Co., 104 IBLA 178, 184 (1988); Amoco Production Co., 78 IBLA 93 (1983), aff'd, Amoco Production Co. v. Hodel, 627 F. Supp. 1375 (W.D. La. 1986), vacated and remanded, 815 F.2d 352 (5th Cir. 1987), cert. denied, 487 U.S. 1234 (1988).

The Secretary has considerable discretion in determining the value of production for royalty purposes. Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1382 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 480 U.S. 940 (1987); Conoco Inc., supra at 240; Texaco, Inc., 104 IBLA 304, 308 (1988); Amoco Production Co., 78 IBLA at 96. That discretion is tempered only by the standard of reasonableness. Conoco Inc., supra; Texaco Inc., supra at 310. The party challenging a royalty valuation by MMS has the burden of showing that the method of valuation is in error. TXP Operating Co., 115 IBLA 195, 204 (1990); Walter Oil & Gas Corp., 111 IBLA 260, 266 (1989); Mobil Oil Corp., 108 IBLA 216 (1989); Amoco Production Co., 85 IBLA 121 (1985); Amoco Production Co., 78 IBLA at 95.

[2] The relevant time period at issue in this appeal is April 1986 through September 1992. During part of that time period involving production through March 1988, the governing provision of the royalty valuation

regulation was found at 30 C.F.R. § 206.150 (1987). That regulation provided:

> The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary.

For that part of the relevant time period at issue involving post-March 1998 production, 30 C.F.R. § 206.150 (1987), quoted above, was superseded by the amended royalty product valuation regulations found 30 C.F.R. Part 206 Subpart D. 53 Fed. Reg. 1272-1284 (Jan. 15, 1988). Pursuant to 30 C.F.R. § 206.152, effective March 1, 1988, gas not sold pursuant to an arm's-length contract is required to be valued in accordance with a series of benchmarks. 53 Fed. Reg. 1248 (Jan. 15, 1988). MMS explained the valuation procedure in the preamble:

> Under the benchmark system, value will be determined through application of criteria in a prescribed order. In other words, the second criterion would not be considered unless the first criterion could not be reasonably applied. Therefore, if the proceeds under the comparable arm's length contracts in the field are not "equivalent" to the proceeds under the non arm's-length contract, then the first benchmark does not apply and the lessee should try to apply the second benchmark. If that one also does not apply, then the lessee must apply the third benchmark.

53 Fed. Reg. 1249 (Jan. 15, 1988).

With respect to gross proceeds, MMS explained:

> Gross proceeds under arm's-length contracts are a principal determinant of value. The MMS cannot adopt a standard and then not require lessees to pay royalties in accordance with the express terms of those contracts. It is MMS's intent that the definition be expansive to include all consideration flowing from the buyer to the seller for the gas, whether that consideration is in the form of money or any other form of value. Lessees cannot avoid their royalty obligation by keeping a part of their agreement outside of the four corners of the contract. * * * Therefore, MMS has purposefully drafted the gross proceeds definition to be expansive and thus include all types of consideration flowing from the buyer to the seller. Toward that end, MMS has replaced the word "paid" used in the first draft final rule

> with the term "accruing." There may be certain types of consideration which are not actually paid by the buyer to the seller, but from which the seller benefits. The term "accruing" ensures that all such consideration is considered gross proceeds.

53 Fed. Reg. 1241 (Jan. 15, 1988.)

The "gross proceeds" regulation, 30 C.F.R. § 206.152(h), effective March 1, 1988, thus provides: "Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances determined pursuant to this subpart." Gross proceeds encompass the actual consideration received for the gas produced from the Federal lease. Pennzoil Oil & Gas, Inc., 109 IBLA 147, 159 (1989); Wheless Drilling Co., 13 IBLA 21, 31, 80 I.D. 599, 604 (1973). The Board has interpreted the term "gross proceeds" broadly. See Pennzoil Oil & Gas, Inc., supra (gross proceeds include tertiary incentive revenue); Enron Corp., 106 IBLA 394 (1989) (gross proceeds include state severance tax reimbursements made by a buyer of gas produced from a Federal lease); Hoover & Bracken Energies, Inc., 52 IBLA 27, 88 I.D. 7 (1981), aff'd, Hoover & Bracken Energies, Inc. v. U.S. Department of the Interior, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984) (gross proceeds include state severance taxes paid by a buyer directly to the state in addition to the ceiling price set for the gas and paid to the lessee); see also Amoco Production Co., 29 IBLA 234 (1977) and Wheless Drilling Co., supra. In short, the value of the gas for royalty purposes is what a buyer is willing to pay for it. Enron Corp., supra at 397.

[3] For that part of the relevant time period involving post-March 1988 production, applicable regulation 30 C.F.R. § 206.152(i) (1997) defined a Federal lessee's responsibility as follows:

> The lessee is required to place gas in marketable condition at no cost to the Federal Government * * * unless otherwise provided in the lease agreement. Where the value established pursuant to this section is determined by a lessee's gross proceeds, that value shall be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services the cost of which ordinarily is the responsibility of the lessee to place the gas in marketable condition. [3/]

See California Co. v. Udall, 296 F.2d 384, 388 (D.C. Cir. 1961); Amoco Production Co., 112 IBLA at 87; The Texas Co., 64 I.D. 76, 79 (1957).

3/ Although not relevant to the time period at issue in this case the last sentence of the regulation was amended effective Feb. 1, 1998, to read "in marketable condition or to market the gas." 62 Fed. Reg. 65753, 65762 (Dec. 16, 1997).

"Marketable condition" means the "lease products 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." 30 C.F.R. § 206.151.

Finding purchasers, negotiating sales contracts, and monitoring sales are also the lessee's responsibility. Hoover & Bracken Energies, Inc., supra. Marketing costs includes the costs of storage, stock loss, inventory, receivables, and equipment. Amoco Production Co., 112 IBLA at 87. As we said in R.E. Yarbrough & Co., 122 IBLA 217, 221 (1993), the costs of placing the gas in marketable condition include tax reimbursements, measuring, field gathering, compressing the gas, sweetening, and dehydration.

However, whether production is in "marketable condition" at or near the wellhead turns on the nature of the gas itself and not on whether the gas is sold to an affiliated vis-a-vis a nonaffiliated purchaser. We recognize that the concept of "gross proceeds accruing to the lessee" was intended to be expansive and all inclusive.

The record establishes that SMS purchased all of Seagull's production from the OCS leases at or near the wellhead, and that SMS also purchased like quality OCS gas from nonaffiliated lessees/producers producing gas from the same field, at or near the Seagull wellhead. All of the sales were pursuant to the terms of a contract signed by the lessees/producers and covered production from Blocks 828 and 831 Mustang Island area. MMS does not claim that the nonaffiliated sales resulted in less than fair market value.

While there is no dispute that SMS is not a "marketing affiliate" as defined under 30 C.F.R. § 206.151 (post-March 1988 regulations), which would require Seagull to use the sale price SMS receives in an arm's-length sale to determine value for royalty purposes (30 C.F.R. § 206.152(b)(1)(i)), MMS argues that the same result is reasonable in this instance:

> the sales price to SMS must be increased by the amount of such reductions. In other words, as an alternative to valuing Seagull's production based on SMS' arm's-length sale, less allowable transportation costs, the market value of Seagull's production was the price SMS paid Seagull plus SMS' cost of marketing the production.

(Answer at 12.)

[4] MMS describes Seagull and SMS as "an integrated enterprise engaged in the production and marketing of gas" that should be treated "as one and the same entity for purposes of the transactions at issue," and considered a single entity for royalty purposes. (Answer at 4, 12.) We are not persuaded that MMS' conclusion that they must be considered a single entity is supported by the facts or the regulations. On the

contrary, it appears that the regulations and Departmental policy acknowledge the existence and contemplate the interaction between affiliates in transactions like the one between Seagull and SMS. In a Memorandum dated December 12, 1988, from the Deputy Assistant Secretary - Land and Minerals Management concerning "Policy Interpretation of Valuation Regulations," the Deputy Assistant Secretary referenced his Memorandum of October 14, 1988, establishing the Department's policy for the enforcement of the benchmark system contained in the 1988 gas valuation regulations. Noting that the benchmark system can only be applied if there are comparable arms-length contracts in the field or area between parties not affiliated with the lessee, the Deputy Assistant Secretary supplemented the policy enforcing the benchmark system contained in those gas valuation regulations, stating that the supplement was specifically intended:

> to cover situations where there are no comparable arm's-length contracts in the field or area between parties not affiliated with the lessee. In those situation, the lessee's gross proceeds will determine the value of the production if they are within the range of the gross proceeds derived from comparable arm's-length contracts between sellers who are not affiliated with the lessee and purchasers who are affiliated with the lessee for sales or other disposition of like-quality production in the same field or, if necessary to obtain a reasonable sample, from the same areas.

We decline to find that the Federal lessee's duty to market lease production or to place leasehold products in "marketable condition" at no cost to the lessor (30 C.F.R. § 206.152(i)(1997); 30 C.F.R. § 206.151), can be fairly construed to require per se valuation at the purchase price paid to an affiliate in a subsequent arms-length sale of lease production.

In Shell Oil Co. (On Reconsideration), we said:

> Departmental regulations establish that parties are affiliated if one controls, or is controlled by, or is under common control with another. 30 CFR 206.151 (arm's-length contract). The term lessee, however, is specific and cannot be expanded to include an affiliate of the lessee. 30 CFR 206.101 (lessee). In support of the argument by Shell that it is an affiliate, but not the lessee, and therefore need not produce sales records demanded by MMS, Shell has furnished a copy of an MMS policy paper, Valuation of Sales to Affiliates, dated October 14, 1993. Shell contends that this document is consistent with the valuation regulations and provides support for our prior Shell decision that excused Shell from reporting to MMS because Shell was not a marketing affiliate (as that term is defined by 30 CFR 206.101). Pertinently, the policy paper states that:
>
> > The gross proceeds accruing to the lessee are considered the minimum value for royalty purposes. The gross proceeds standard is applicable to both arm's-length and non-arm's-length sales. Gross proceeds may

> be reduced by appropriate processing and transportation allowances, but may not be reduced by costs associated with marketing the production, whether the contract is arm's-length or non-arm's-length.

(Policy Paper at 2). With respect to sales of oil after March 1, 1988, from a lessee to an affiliate (other than a marketing affiliate), the paper states:

> The value for both oil and gas is to be determined by the first applicable benchmark [in 30 C.F.R. § 206.102(c)] * * *.
>
> When applying the benchmarks, it is necessary to consider the gross proceeds requirement discussed previously. Gross proceeds may not be reduced by costs to place the product in marketable condition or marketing costs. If the resale from the affiliate to a third party occurs in the same field as the first sale from the lessee to the affiliate and if the affiliate is performing services other than transportation or processing (i.e., marketing services), the resale price would represent the minimum value for royalty purposes under the gross proceeds requirement.

(Policy Paper at 3-4).

> Contrary to the argument advanced by Shell, therefore, the policy paper also indicates that there is an obligation and an expectation that MMS will look beyond any inter-affiliate transfer to determine whether other factors affect production value. As suggested in Santa Fe, supra, affiliates participating in a transfer of Federal lease production in contemplation of sales to a third party should expect MMS to scrutinize any inter-affiliate transfer and all subsequent affiliate sales. As a result, SWEPI and Shell should have anticipated that MMS would review their handling of Federal production in order to properly determine royalty in accordance with statutory and regulatory requirements.

Shell Oil Co. (On Reconsideration), supra at 356-58.

The Board has routinely recognized MMS' authority to require a Federal lessee's affiliate to produce records and other information related to the disposal and transfer of lease production, recognizing that transactions between affiliates should be examined and when appropriate considered to determine the benefits obtained by a lessee as a result of its affiliate transaction that may not be apparent. See Shell Oil Co. (On Reconsideration), supra. Where the inquiry revealed that the lessee obtained some benefits other than those contained in the contract, the value of the benefit to the lessee should be determined and included in the lessee's gross proceeds.

Nothing in the record suggests that MMS has required the nonaffiliates to recalculate royalties due on their leases as it has required Seagull. Thus, SMS' contract with the nonaffiliate producers is evidence that gas from the field is in marketable condition at the wellhead. The decision in Taylor Energy Co., supra, relied on by MMS, is not controlling. In that case, no market existed at or near the wellhead.

MMS has urged the Board to find that the affiliate relationship between Seagull and SMS is a sham created to avoid paying royalties. However it has offered no facts to support its theory, except that Seagull and SMS are affiliated entities. That is not sufficient. MMS' failure to distinguish between a "marketing affiliate" defined at 30 C.F.R. § 206.151, and an affiliate, has resulted in an interpretation which the regulations do not support.

The arm's-length sale by producers not affiliated with SMS establishes that there was a market at the wellhead and the gas was in marketable condition. Thus, Seagull was not required to bear the costs attributable to downstream sales, and appellant was not required to include them in their "gross proceeds" for purposes of computing royalties. MMS, erred to the extent it held otherwise under either the "marketable condition" rule (30 C.F.R. § 206.152(i) (1997); 30 C.F.R. § 206.151), the duty to market leasehold production at no cost to the lessor, or the "gross proceeds" rule codified in the pre-March 1988 regulation, 30 C.F.R. § 206.150 (1987), or post-March 1988 regulations, 30 C.F.R. § 206.152(h); 30 C.F.R. § 206.151.

In determining value for royalty purposes for the post-March 1988 production, MMS is properly guided by the first applicable benchmark identified in 30 C.F.R. § 206.152(c), dealing with nonarm's-length sales, to which it must superimpose consideration of the gross proceeds rule under 30 C.F.R. § 206.152(h) to arrive at the minimum value of the lease production for royalty purposes. That minimum value may be the affiliate purchase price at the wellhead; it may not. We hold only that it is not per se the price received by an affiliate in a downstream arm's-length transaction.

The record indicates that the gross proceeds received by SMS in its nonarm's-length contracts with Seagull is equivalent to the gross proceeds received under comparable arm's-length sales of like quality production. 30 C.F.R. § 206.152(c)(1). Neither the record on appeal, the Associate Director's decision, nor MMS' submissions on appeal provide sufficient data to dispute this.

Xeno Inc., supra, is a case in which the record established that the gas was in marketable condition when sold and there was a market for the gas when sold to affiliated or unaffiliated entities at or near the wellhead, which is distinguishable from Branch Oil & Gas Co., 144 IBLA 304 (1998), Branch Oil & Gas Co., 143 IBLA 204 (1998), and Taylor Energy Co., supra, where no market existed at or near the wellhead and costs were incurred by lessee to place the gas in a "marketable condition." However, in Xeno Inc., we found that Xeno received an economic benefit from the formation of the Battle Creek Gas Gathering System (BCGGS) when it received a higher wellhead price from BOGGS than it had received from Montana Power in past sales. 134 IBLA at 179.

MMS does not contend here that Seagull's gas was not in "marketable condition" when sold to SMS or that no market existed at the wellhead. Rather, MMS contends that Seagull has improperly deducted marketing costs, costs incurred by SMS to market the gas downstream only because those two entities are affiliates.

We conclude that it was not necessary for Seagull to bear the costs of downstream marketing where the gas sold at the wellhead was in marketable condition and where a market existed there. Thus, absent some allegation that the sale is determined not to be the reasoned equivalent of an arm's-length sale at the wellhead, Seagull is not required to include the costs incurred by SMS in its "gross proceeds" for purposes of computing royalty. MMS erred to the extent it held otherwise under either the "marketable condition" rule (30 C.F.R. § 206.152(i) (1997); 30 C.F.R. § 206.151), the duty to market leasehold production at no cost to the lessor, or the "gross proceeds" rule codified in the pre-March 1988 regulation, 30 C.F.R. § 206.150 (1987), or post-March 1988 regulations, 30 C.F.R. § 206.152(h); 30 C.F.R. § 206.151.

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 reversed.

Gail M. Frazier
Administrative Judge

I concur:

R.W. Mullen
Administrative Judge

United States Department of the Interior

OFFICE OF THE SECRETARY
Washington, D.C. 20240

MAY 1 8 1999

TEXACO EXPLORATION AND PRODUCTION INC., and TEXACO INC.,	)	**No. MMS-92-0306-O&G**
Appellants.	)	**Appeal Denied**

Texaco Exploration and Production Inc. ("Texaco E & P") and Texaco Inc. (collectively "Texaco") (*see* Notice of Appeal at 2) appealed from a Minerals Management Service ("MMS") Order dated July 29, 1992 (the "Order"), directing Texaco to recalculate and pay additional royalties on crude oil it sold or transferred to its affiliate under a non-arm's-length contract and which its affiliate then resold at arm's length to a third-party purchaser.

FACTUAL BACKGROUND

Texaco Inc. is the parent of Texaco E & P. Notice of Appeal at 1. Texaco Refining and Marketing Inc. ("Texaco Marketing") was a wholly owned subsidiary of Texaco Inc. Statement of Reasons at 2. Texaco E & P is the lessee of certain onshore Federal oil and gas leases in California.[1] Texaco E & P sold its oil production from these leases to its affiliate, Texaco Marketing, in non-arm's-length transactions at posted prices.[2] Texaco Marketing and TTTI undertook the marketing functions for Texaco E & P's oil by moving the oil to a downstream sales location and reselling the oil at arm's-length to third party purchasers at a higher price. (*E.g.*, Texaco's Response to Field Report, dated Jan. 7, 1998, at 10-11.) Texaco paid royalties based on the posted prices used in the non-arm's-length "sales" to Texaco Marketing at the leases. Texaco Marketing also purchased oil from other producers in the fields at the same posted prices that it used in the transfers from Texaco E & P. (*Id.*, attached affidavit of Zachary Brown dated Jan. 6, 1998.)

The California State Controller's Office ("State") audited Texaco's royalty payments for its Federal onshore leases in California for the period February 1, 1983, through December 31, 1989, under a delegation of authority from MMS under section 205 of the Federal Oil and Gas Royalty

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[1] Lease no. 080-019414-A is in the Belgian Anticline field; nos. 080-037494, 080-019927, and 080-019453-A are in the Kern Front field; and no. 080-019349 is in the Midway Sunset field. Texaco obtained these leases from Getty Oil Co. when Texaco and Getty merged effective January 1985. (California State Controller's Office Field Report dated Oct. 9, 1997, at 2.)

[2] From May 1988 through the end of 1989, Texaco E & P sold the oil produced from each of the leases to Texaco Trading and Transportation Inc. ("TTTI"), which was a wholly-owned subsidiary of Texaco Marketing. Statement of Reasons at 3. Hereinafter, TTTI and Texaco Marketing are referred to collectively as Texaco Marketing.

Management Act of 1982 ("FOGRMA"), 30 U.S.C. § 1735. The State and MMS determined that under the "gross proceeds" rule (*see* the former 30 C.F.R. § 206.103 (1983-1987), and 30 C.F.R. § 206.102(h) (1988-present)), Texaco should have paid royalties based on Texaco Marketing's arm's-length sales price.

Specifically, the State found that Texaco underpaid royalties on all of the five leases by a total of $20,375.59 for the period January 1, 1986, through June 30, 1987. However Texaco would not provide to the State records of Texaco Marketing's arm's-length sales price for the period July 1, 1987, through December 31, 1989. Accordingly, by Order dated July 29, 1992, MMS ordered Texaco to pay additional royalties of $20,375.59 on crude oil produced from the five leases for the period January 1, 1986, through June 30, 1987, and to recalculate and pay additional royalties due on all California onshore Federal leases from which oil was sold to Texaco's affiliates based on the affiliate's arm's-length sales price (if greater than the non-arm's-length transfer price) for the period July 1, 1987, through December 31, 1989.

Texaco appealed the Order to the MMS Director under 30 C.F.R. Part 290.

ISSUES PRESENTED

1. Are Texaco Marketing's arm's-length sales proceeds the correct measure of the "gross proceeds accruing to the lessee" under the former 30 C.F.R. § 206.103 (1987) and the current 30 C.F.R. 206.102(h)?

2. May a lessee deduct the expenses of, or exclude from royalty value proceeds resulting from, its marketing efforts by using a wholly-owned affiliate or wholly-commonly-owned affiliate to perform marketing functions?

3. May Texaco deduct the costs of blending?

4. May MMS require Texaco to conduct a restructured accounting?

5. Do other pending MMS orders regarding Texaco's California crude oil production bar the instant order?

6. Are any claims for underpaid royalties time-barred under the statute of limitations at 28 U.S.C. § 2415(a)?

ANALYSIS

I. TEXACO MARKETING'S ARM'S-LENGTH SALES PROCEEDS ARE THE CORRECT MEASURE OF THE GROSS PROCEEDS ACCRUING TO THE LESSEE.

A. The Gross Proceeds Rule

For many decades, regulations promulgated under the authority of the Mineral Leasing Act (*see* 30 U.S.C. § 189) and in force during the period relevant to this case provided:

> Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary.

30 C.F.R. § 206.103 (1983-1987), formerly 30 C.F.R. § 221.47 (1942-1982) (emphasis added).[3] New product value regulations effective March 1, 1988 (53 Fed. Reg. 1184, 1221), continue this requirement. Title 30 C.F.R. § 206.102(h) (1988-present), applicable to both onshore and offshore leases, provides:

> Notwithstanding any other provision of this section, under no circumstances shall the value of production, for royalty purposes, be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances determined pursuant to this subpart.[4]

The lessee's gross proceeds are specifically defined as "the total moneys and other consideration accruing to an oil and gas lessee for the disposition of the oil produced." 30 C.F.R. § 206.101. (Section 206.151 contains similar language for natural gas.) This accords with the meaning

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[3] This language was codified as 30 C.F.R. § 221.47 in 1942, 7 Fed. Reg. 4132, 4137 (June 2, 1942). Essentially identical language was first promulgated in 1936 as part of section 3(e) of the oil and gas operating regulations, 1 Fed. Reg. 1996, 2000 (Nov. 20, 1936). Since the beginning of offshore leasing in 1954, the offshore royalty valuation rules contained a provision essentially identical to section 206.103. *See* the former 30 C.F.R. § 206.150 (1983-1987), formerly 30 C.F.R. § 250.64 (19 Fed. Reg. 2659 (May 8, 1954)).

[4] Identical provisions apply to natural gas produced from both onshore and offshore leases. 30 C.F.R. §§ 206.152(h) (unprocessed gas) and 206.153(h) (processed gas). (*See* 53 Fed. Reg. 1272 (Jan. 15, 1988)).

of the term "gross proceeds" established in prior judicial and administrative decisions. Those decisions consistently have upheld the gross proceeds rule and that definition.[5]

The gross proceeds rule provides the "absolute minimum value for computation of royalties." *Pennzoil*, 751 F. Supp at 605, quoting *Marathon Oil Co. v. United States, supra*, 604 F. Supp. at 1384. As a result, "there is no authority to allow the DOI to assess royalties on a lower basis than gross proceeds." *Id.*

B. The Valuation Scheme under the pre-March 1, 1988 Rules

For oil produced during periods before March 1, 1988, the former 30 C.F.R. § 206.103 provided:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. [The gross proceeds provision quoted above from this section then followed.]

Under this rule, the agency had considerable discretion in establishing the reasonable value of production. The specific factors listed were not given any priority. But in every case, value established by any measure other than the lessee's gross proceeds had to be compared to the gross proceeds minimum.

C. The Valuation Scheme of the 1988 Rules

In the 1988 rules, MMS adopted a two-pronged scheme for determining the value of oil and gas production. The rules differentiate between production sold at arm's-length and production not sold at arm's-length.

Under the rules, if the lessee sells production under an arm's-length contract, the arm's-length gross proceeds (the total consideration received for the production) is the royalty value. 30 C.F.R.

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[5] *E.g.*, *Wheless Drilling Co.*, 80 I.D. 599, 13 IBLA 21 (1973); *Hoover & Bracken Energies, Inc. v. Department of the Interior*, 723 F.2d 1488 (10th Cir. 1983), *cert. denied*, 469 U.S. 821 (1984) (accepting the *Wheless* definition of gross proceeds); *Pennzoil Exploration and Production Co. v. Lujan*, 751 F. Supp. 602, 605 (E.D. La 1990), *aff'd*, 928 F.2d 1139 (TECA 1991); *Marathon Oil Co. v. United States*, 604 F. Supp. 1375 (D. Alaska 1985); *aff'd*, 807 F.2d 759 (9th Cir. 1986), *cert. denied*, 480 U.S. 940 (1987); *Enron Oil & Gas Co. v. Lujan*, 778 F. Supp. 348 (S.D. Tex. 1991), *aff'd*, 978 F.2d 212 (5th Cir. 1992), *cert. denied*, 510 U.S. 813 (1993); *United States v. Century Offshore Management Corp.*, 111 F.3d 443 (6th Cir. 1997), *cert denied*, 118 S. Ct. 880 (1998).

§ 206.102(b)(1). If, on the other hand, the lessee does not sell production under an arm's-length contract, the royalty value of the oil is the first applicable of a series of so-called "benchmarks" — external indicia of value to be used when there is no arm's-length sale. 30 C.F.R. § 206.102(c)(1)-(5). (Similar provisions for gas are contained in 30 C.F.R. §§ 206.152 (unprocessed gas) and 206.153 (processed gas).)[6]

The rules further provide that notwithstanding the benchmarks or any other provisions of section 206.102, value may not be less than the "gross proceeds accruing to the lessee for lease production," less applicable allowances (*i.e.*, transportation allowances under sections 206.104 and 206.105), as quoted above. Section 206.102(h).[7] Because "gross proceeds" is the minimum value of production — notwithstanding any other provision of section 206.102 — MMS must determine

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[6] For crude oil not sold under an arm's-length contract, the benchmarks may be summarized briefly as follows (further technical descriptions or explanations are not necessary here):

1. The lessee's own contemporaneous posted prices or sales contract prices actually used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field or area, provided that those prices meet certain factors of comparability to other contemporaneous arm's-length prices. Section 206.102(c)(1).

2. The arithmetic average of contemporaneous posted prices used in arm's-length transactions by persons other than the lessee for purchases or sales of like-quality oil in the same field or area. Section 206.102(c)(2).

3. The arithmetic average of contemporaneous arm's-length contract prices for purchases or sales of like-quality oil in the same area or nearby areas. Section 206.102(c)(3).

4. Prices received for arm's-length spot sales of significant quantities of like-quality oil from the same field or area, and other relevant matters. Section 206.102(c)(4).

5. A net-back method or any other reasonable method to determine value. Section 206.102(c)(5).

[7] In the preamble to the Further Notice of Proposed Rulemaking, MMS said with respect to the section 206.102(h) (52 Fed. Reg. 30826, 30843-44 (1987)):

> The purpose of § 206.102(h) is to make it clear that no matter what valuation method is used, the value for royalty purposes cannot be less than the lessee's gross proceeds less applicable allowances. Therefore, if a benchmark derived value less applicable allowances is less than gross proceeds less applicable allowances, gross proceeds less applicable allowances is to be used as the value for royalty purposes.

the gross proceeds and compare that value to any other value that may be applicable under section 206.102. Unless the non-arm's-length transfer between Texaco E & P and Texaco Marketing were simply disregarded, the benchmarks of section 206.102(c) apply to that transaction. (Texaco claims that the first benchmark — which would use Texaco's posted price — applies.) But the value established under whatever benchmark is first applicable must be compared to the "gross proceeds accruing to the lessee for lease production."

The benchmarks cover a variety of possible situations. First, the lessee may refine the crude oil, with no sale occurring until refined products (such as gasoline or lubricants) are sold. Second, the lessee may "sell" or transfer the oil to a corporate affiliate, who then refines it and disposes of the refined products. Third, the lessee may use the production internally (such as for manufacture of asphalt or of petrochemicals that the lessee then uses in other processes).

What the rule and the preamble do not expressly address, however, is how the rule applies when there is both a non-arm's-length transaction and an arm's-length sale in the course of disposition of the same production. (The rules in effect before March 1, 1988, did not expressly address this situation either.) That is precisely the situation in the instant case. In this case, the production arm (Texaco E & P) transferred to the marketing arm (Texaco Marketing), who then sold the oil at arm's length. Both Texaco E & P and Texaco Marketing are wholly-owned subsidiaries of Texaco Inc. (In this discussion, affiliates who are both wholly owned by the same corporate parent are referred to as "wholly-commonly-owned" affiliates.)

The Interior Board of Land Appeals ("IBLA" or "the Board") recently addressed a similar situation involving natural gas produced from Federal offshore leases in *Seagull Energy Corp.*, 148 IBLA 300 (1999) ("*Seagull*"). In that case, the producing entity, Seagull Energy Corp., sold gas at the lease to its wholly-owned subsidiary, Seagull Marketing Services, Inc. ("Seagull Marketing"). Seagull Marketing then transported the gas and sold it to third-party purchasers for a price which, net of transportation costs, was higher than it paid to Seagull Energy. Seagull Marketing also had purchased gas from other producers at arm's length at the wellhead, and had paid them the same price it paid to Seagull Energy. The IBLA reversed the MMS Director's decision determining royalty value based on the arm's-length resale price, and held that the royalty value was the price Seagull Marketing paid to its parent entity in the non-arm's-length transaction. Because I believe the holding and reasoning of *Seagull* is incorrect, and decline to follow it, this case will be discussed in detail below.

D. The Measure of Gross Proceeds Used in the Comparison with Other Valuation Criteria Is the Marketing Entity's Arm's-Length Sales Price.

Texaco believes that the proper measure of royalty value, under both the pre-March 1, 1988 rule and the benchmarks in the current rule, is the particular posted price or combination of posted prices it asserts are applicable to the particular field. Texaco's marketing subsidiaries used their posted prices (or an average of their postings and other companies' postings) in the non-arm's-length purchases from Texaco E & P. As explained above, MMS must determine the gross proceeds both for the pre-March 1, 1988 period (to be compared with the applicable posted price or average posted price) and for the period beginning March 1, 1988 (to be compared with the first benchmark). The question then is: What is the correct measure of gross proceeds? Is it the non-arm's-length transfer price or is it the marketing entity's arm's-length sale price?

Texaco further argues that under both rules, the proper measure of "gross proceeds" is the non-arm's-length transfer price between Texaco E & P and Texaco Marketing (which, of course, is the posted price used.) Texaco's argument is based on two theories, namely (1) the term "lessee" in the gross proceeds rule means Texaco E & P only, and cannot include an affiliate, and (2) Texaco Marketing is not a "marketing affiliate," as that term is defined in 30 C.F.R. § 206.101 and used in section 206.102(b)(1)(i). I will address both of these arguments below. But beyond those arguments, Texaco overlooks a consideration that controls the interpretation of the gross proceeds rule in these circumstances.

1. Texaco's Theory Would Effectively Vitiate the Gross Proceeds Rule.

The fundamental flaw in Texaco's position is that it allows any lessee to avoid the gross proceeds requirement by the simple and facile device of creating a wholly-owned subsidiary and then first transferring the production to the affiliate, for a price the lessee determines unilaterally, before selling the production at arm's length at a higher price. Texaco's theory would confine gross proceeds to the intra-corporate transfer price, even if the lessee's convenient device ultimately realizes more money from the sale of the production.

There is nothing in law that requires that one corporate entity conduct production operations while another entity of identical ownership conducts sales and marketing. There is nothing preventing one entity from doing both. The producing entity could sell the production itself to the same purchaser at the point and at the price the marketing entity does without using a corporate subsidiary or affiliate arrangement. Were it to do so, its gross proceeds unquestionably would be the price realized on the sale — the same price the marketing entity receives. Whether a lessee conducts its business through one entity or two is entirely up to the lessee. (Indeed, the widespread bifurcation of these functions between two affiliated entities is of relatively recent origin.) But the number of entities of identical ownership used to perform these functions makes no difference as to the nature of the functions performed.

The effect of Texaco's view is readily apparent if it were applied to one of the foundational gross proceeds cases, *Marathon Oil Co. v. United States*, 604 F. Supp. 1375 (D. Alaska 1985), *aff'd* 807 F.2d 759 (9th Cir. 1986), *cert. denied*, 480 U.S. 940 (1987) (cited in the discussion of the gross proceeds rule above). In that case, Marathon produced natural gas from Federal leases in Alaska, liquefied it in a specialized plant, and transported the liquefied gas to Japan by cryogenic tanker. There, the gas was then evaporated back into gaseous form and the first sale occurred. The court upheld MMS' assessment of royalty on Marathon's gross proceeds, as determined by the sales price in Japan less the costs of transporting it there (liquefaction and tankering).

In Texaco's view, Marathon should have created a wholly-owned subsidiary and transferred the gas to the subsidiary at a price at which other gas produced in the field was sold. Then the subsidiary would have liquefied the gas, shipped it to Japan, and sold it for the higher price. Under Texaco's theory, Marathon's problem would have been solved — its gross proceeds would have been the price at which it transferred to its subsidiary, rather than the much higher landed price in Japan less the costs of liquefaction and tankering.

The potential for abuse here is obvious. I do not believe that the gross proceeds rule must be read to mean that its requirements can be so easily avoided. Nor do I believe that its authors (and those who have recodified it over the years) intended for lessees to be able to use their internal structuring arrangements to escape the rule. There is no legal principle that compels MMS to interpret its regulation in a manner that allows lessees to rely on readily-changeable formalities of corporate structure to avoid its application. Texaco's theory would create an exception to the gross proceeds rule that in practice would swallow it, and completely nullify its underlying intent.

The Board in *Seagull* overlooked this problem entirely. I believe that oversight to be a central flaw in the Board's reasoning in that case.

Moreover, the result under *Seagull* appears inconsistent with recent statements by the Board in other cases. In *Xeno, Inc.*, 134 IBLA 172, 179-180 (1995), the IBLA stated that "the sale price received by an affiliate of the lessee in the first arm's-length transaction is properly considered in determining the value of gas produced under the gross proceeds rule" (citing *Shell Oil Co. (On Reconsideration)*, 132 IBLA 354 (1995) (overruling *Shell Oil Co.*, 130 IBLA 93 (1994)), *aff'd, Shell Oil Co. v. Babbitt*, 945 F. Supp 792 (D. Del. 1996), *aff'd*, 125 F.3d 172 (3d Cir. 1997); *Santa Fe Energy Products Co.*, 127 IBLA 265 (1993), *aff'd, Santa Fe Energy Products Co. v. McCutcheon*, No. 94-C-535, slip op. (D. Colo. Mar. 30, 1995), *aff'd*, 90 F.3d 409 (10th Cir. 1996).) The Board recently reiterated this view (in a case that involved a somewhat different argument) in *Blue Dolphin Exploration Co.*, 148 IBLA 72, 76 (1999) (citing *Xeno* and the other authorities *Xeno* cited).

The *Santa Fe* and *Shell* cases involved lessees' attempts to avoid producing documents regarding their affiliates' arm's-length resales following inter-affiliate transfers. The IBLA and the courts uniformly rejected those attempts. Though acknowledging that the cases before them concerned document production and not orders to pay that might result from the audits, the courts in both circuits recognized the potential implications. The Tenth Circuit in *Santa Fe Energy Products Co. v. McCutcheon* acknowledged that the gross proceeds rule justified MMS' collection of "information relating to [the affiliate's] sales in order to ascertain the oil's fair market value <u>and to determine the gross proceeds accruing to [the lessee]</u>." 90 F.3d at 414. Likewise, in *Shell Oil Co. v. Babbitt*, the Third Circuit stated:

> It is undisputed that Shell paid Shell Ex [Shell Western Exploration & Production, Inc., the producing arm] a "market price" for the federally derived oil it purchased. The gross proceeds rule requires that the federal royalties be based, at a minimum, on what the lessee receives

> for the oil, not the "market price" of the oil. If [the affiliate] sold the oil at a premium above the market price, federal royalties would be based on that premium price. Shell appears to be arguing that it can avoid this result by purchasing the oil from Shell Ex at the market price and then reselling it at a premium itself. MMS is entitled to documents which will allow it to determine if Shell Ex is undervaluing oil for royalty purposes by first transferring it to Shell.

125 F.3d at 177. Moreover, while the Third Circuit said that it did not find "that MMS can impute the proceeds received by Shell to Shell Ex," *Id.*, because that case involved document production, it is clear from the above-quoted language that the Third Circuit would not condone facile devices to avoid the agency's rules. Both Texaco's position and the Board's decision in *Seagull* contradict the sound principles that these prior statements of the Board and the Third and Tenth Circuits recognize.

What the Third Circuit anticipated is exactly what occurred in the instant case. The sale from Texaco E & P to Texaco Marketing was a sale between affiliates who were both wholly owned by the same corporate parent, and Texaco Marketing received a higher price from its third party purchasers than the price it paid Texaco E & P. Texaco E & P and Texaco Marketing cannot dispute that they are an integrated enterprise under the same overall ownership that is engaged in the production and marketing of oil. I believe MMS was correct in interpreting the term "gross proceeds accruing to the lessee" to *mean that the true measure of the gross proceeds* derived from the disposition of the production is the proceeds which that enterprise receives in selling oil at arm's length on the open market. I believe that to do otherwise would, in practical application, essentially vitiate the gross proceeds rule.

This analysis addresses only situations in which the producing entity transfers to a wholly-owned subsidiary or to a wholly-commonly-owned affiliate before an arm's-length sale occurs. The foregoing analysis does not address the effect of the gross proceeds rule in situations where a marketing entity is owned by multiple unrelated owners.

2. Texaco Misinterprets the "Marketing Affiliate" Exception.

Texaco argues that MMS may value production based on an affiliate's arm's-length resale only if the affiliate is the lessee's "marketing affiliate," as that term is defined in 30 C.F.R. § 206.101. There, a "marketing affiliate" is defined as "an affiliate of the lessee whose only function is to acquire only the lessee's production and to market that production." Title 30 C.F.R. § 206.102(b)(1)(i) then provides:

> The value of oil which is sold pursuant to an arm's-length contract shall be the gross proceeds accruing to the lessee, except as provided in paragraphs (b)(1)(ii) and (iii) of this section. The lessee shall have the burden of demonstrating that its contract is arm's-length. The

> value which the lessee reports, for royalty purposes, is subject to monitoring, review, and audit. <u>For purposes of this section oil which is sold or otherwise transferred to the lessee's marketing affiliate and then sold by the marketing affiliate pursuant to an arm's-length contract shall be valued in accordance with this paragraph based upon the sale by the marketing affiliate</u>. (Emphasis added.)

Texaco infers from this that because Texaco Marketing is not a "marketing affiliate" under 30 C.F.R. § 206.101 (because it buys oil from unrelated sellers and not just from Texaco E & P), MMS may not require Texaco to value the production at Texaco Marketing's arm's-length resale price.

Texaco wrongly assumes that by specifically stating that a "marketing affiliate's" proceeds would conclusively establish the value of production for royalty purposes under section 206.102(b)(1)(i), without any reference to the benchmarks, MMS meant to preclude itself from determining that an affiliate's proceeds may represent the "gross proceeds" under section 206.102(h) *in* any other case. That assumption and the conclusion Texaco draws from it are incorrect.

MMS added the last clause in Section 206.102(b)(1)(i) in response to industry's request during the rulemaking process. *See* 53 Fed. Reg. 1189, 1196 (1988). Industry objected to MMS' use of benchmarks to value production in instances where a producer transfers its production to an affiliate who did not buy from anyone else, who then sells to an independent third parties in arm's-length transactions. *Id. See also* 52 Fed. Reg. 30826, 30841 (1987). The basis of the industry's concern was that applying the benchmarks could lead to a higher value than what the production actually was sold for in the subsequent arm's-length sale. 52 Fed. Reg. 30826, 30841; 53 Fed. Reg. 1189, 1202. The lessees wanted the "protection" that other arm's-length transactions had, namely, that value would equal the gross proceeds in the arm's-length transaction. *See* 52 Fed. Reg. 30826, 30839; 53 Fed. Reg. 1189, 1200. Thus, MMS added the "marketing affiliate" clause to establish that in cases where a producer sells to its marketing affiliate (as narrowly defined), the gross proceeds in the subsequent transaction between the marketing affiliate and the independent third party would establish the royalty value. 53 Fed. Reg. 1189, 1198-99.

However, nothing in the rule or the preamble implies that MMS intended to prevent itself from looking to the subsequent arm's-length sale as establishing the lessee's gross proceeds if an affiliate is not a "marketing affiliate," as defined in section 206.101. *See* 52 Fed. Reg. 30826, 38843-44. The difference is that if an affiliate is not a "marketing affiliate" as defined in the rules, then MMS is not obligated to exclude consideration of the benchmarks and conclusively accept the affiliate's proceeds as royalty value. If the benchmark value under 30 C.F.R. § 206.102(c) is higher than the arm's-length resale proceeds, then the benchmark value is higher than the gross proceeds minimum and is a proper royalty value.

In a perfunctory sentence in *Seagull*, the Board appears to adopt the same argument Texaco asserts: "MMS' failure to distinguish between a 'marketing affiliate' defined at 30 C.F.R. § 206.151, and an affiliate, has resulted in an interpretation which the regulations do not support." 148 IBLA at 315. For the reasons just discussed, I do not believe the Board's interpretation is correct, and I decline to adopt it.

3. The Term "Lessee" in the Gross Proceeds Rule May Include a Wholly-Owned or Wholly-Commonly-Owned Affiliate.

Texaco further argues that the term "lessee" in the phrase "gross proceeds accruing to the lessee" is limited to the particular corporate entity that holds an ownership interest in the lease or has been assigned royalty payment responsibility. Texaco relies on the Board's dictum in *Shell Oil Co. (On Reconsideration)*, 132 IBLA 354, 357 (1995) that "[t]he term lessee, however, is specific and cannot be expanded to include an affiliate of the lessee." In *Seagull* (decided long after briefing in the instant case was complete), the Board elevated this dictum to a holding, rejecting MMS' contention that it should be reexamined. 148 at 308 n. 2.[8] I disagree.

In circumstances where the producing entity sells or transfers to a wholly-owned or wholly-commonly-owned affiliated marketing entity — such as the circumstances in this case — I believe the plain intent of the gross proceeds rule is to encompass the total consideration the production and marketing enterprise receives from selling the oil on the open market that it does not either refine before an arm's-length sale or use internally. The gross proceeds rule existed for decades before the development of current marketing methods, and the agency's task is to apply the intent and purpose of the rule in the current context. In circumstances such as those presented here, common sense, reasonableness, and the underlying logic and purpose of the rule itself support interpreting the term "lessee" to encompass both entities. Therefore, I believe that the Board's interpretation in *Seagull* and its dictum in *Shell (On Reconsideration)* are incorrect. It is therefore correct for this reason, in addition to the reasons explained previously, to measure the gross proceeds as the marketing entity's arm's-length sale proceeds.

I emphasize that this decision does not seek to simply disregard the corporate form or to "pierce the corporate veil." The question in this case is the meaning and application, in the context of the facts presented, of a term in MMS' rules governing establishment of royalty value, not whether one corporation is the "alter ego" of the other. This does not mean that MMS may not seek to

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[8] The Board based its refusal to reexamine its statement in *Shell* in part on two memoranda which the then-Deputy Assistant Secretary for Land and Minerals Management issued on October 14, 1988, and December 12, 1988, respectively. 148 IBLA at 313. These documents addressed the application of the gas value benchmarks in situations where there are no comparable arm's-length contracts in the field or area between parties not affiliated with the lessee. While those memoranda address the interpretation of the benchmarks, because they do not address the gross proceeds rule, they do not logically support the Board's holding that the term "lessee" in the gross proceeds rule can never include an affiliate.

"pierce the corporate veil" in an appropriate case as an additional ground for how it determines value in that case, if the facts warrant, but this decision does not seek to do so here.[9]

II. TEXACO MAY NOT DEDUCT THE EXPENSES OF, OR DISREGARD THE ADDITIONAL VALUE ACCRUING FROM, ITS MARKETING EFFORTS BY USING A WHOLLY-OWNED AFFILIATE OR WHOLLY-COMMONLY-OWNED AFFILIATE TO PERFORM MARKETING FUNCTIONS.

A. Federal Lessees Have an Implied Duty to Market Production at No Cost to the Lessor.

In several decisions, IBLA has addressed disputes involving marketing costs and their relation to royalty value. The Board consistently has held that the lessee has an implied duty to market production at no cost to the government.[10] In *Walter Oil and Gas Corp.*, 111 IBLA 260 (1989), and *Arco Oil and Gas Co.*, 112 IBLA 8 (1989), lessees of Federal leases on the offshore Louisiana Outer Continental Shelf contracted with independent marketers to locate buyers for the lessees' gas, negotiate sales contracts, and monitor gas sales. In *Walter*, the Board upheld MMS' denial of Walter's request to deduct the amounts it paid to its marketer from royalty value. The IBLA held:

> The only allowances recognized as proper deductions in determining royalty value are transportation allowances for the cost of transporting production from the leasehold to the first available market, which has been considered a relevant factor pursuant to 30 C.F.R. § 206.150(e) . . . and processing allowances for processed gas authorized by 30 C.F.R. § 206.152(a)(2) (1987). . . . Walter's unsupported assumption that it is somehow entitled to deduct its marketing costs from royalty value fails in the face of contrary regulatory requirements . . . .

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[9] MMS did seek to disregard the corporate form in *Seagull* as an additional ground for its position in that case. The Board rejected the argument without analyzing the factors on which MMS relied. 148 IBLA at 312. It is not necessary to address here whether the Board in *Seagull* was correct under the facts of that case because the facts in the instant matter are not identical to those in *Seagull*.

[10] In the context of Federal leases, the D.C. Circuit referred to this implied lease covenant many years ago in *California Co. v. Udall*, 296 F.2d 384, 387 (D.C. Cir. 1961), stating that "the lessee was obliged to market the product." Nor is it unique to Federal leases. *See, e.g.*, Merrill, *Covenants Implied in Oil and Gas Leases* (2d Ed. 1940), §§ 84-86 (Noting "[n]o part of the costs of marketing or of preparation for sale is chargeable to the lessor"); "Direct Gas Sales: Royalty Problems for the Producer," 46 Okla. L. Rev. 235 (1993); *Amoco Production Co. v. First Baptist Church of Pyote*, 579 S.W.2d 280 (Tex. Civ. App. 1979), *writ ref'd n.r.e.*, 611 S.W.2d 610 (Tex. 1981), and cases cited in these authorities.

> The lessee has a duty to market the gas. *See California Co. v. Udall*, 296 F.2d 384, 387 (D.C. Cir. 1961). A lessee may choose to employ its own personnel to find markets for its gas, or it may decide to hire an independent marketer to perform these functions. The lessee's business decision as to which method it prefers does not affect the value of gas for royalty purposes. A lessee performing these duties with its own employees may not deduct the costs of finding markets for the gas; neither may a lessee that contracts out these functions deduct those costs.

111 IBLA at 265 (footnotes omitted) (emphasis added). In *Arco Oil and Gas Co.*, decided shortly after *Walter*, the IBLA held:

> The creation and development of markets for production is the very essence of the lessee's implied obligation to prudently market production from the lease at the highest price obtainable for the mutual benefit of the lessee and lessor. Traditionally, Federal gas lessees have borne 100 percent of the costs of developing a market for gas. Appellant has cited no authority, nor do we find any, which supports an allowance for creation and development of markets for the royalty share of production.

112 IBLA at 11.

Recently, in *Taylor Energy Co.*, 143 IBLA 80 (1998), the Board considered a case in which the lessee, Taylor Energy, arranged with PSI Gas Marketing, Inc., to sell Taylor's gas. PSI paid Taylor 97 percent of the price PSI obtained when it sold the gas. In other words, PSI sold Taylor's production for a 3 percent commission. PSI's only function was to market the gas. The Board reiterated its holding in *Arco*, and added:

> It is the lessee's duty to perform that service [marketing] at no cost to the lessor. That means that the lessor's royalty is not reduced by the cost of finding a market for the gas, in this case the 3-percent payment to PSI.
>
> Nor can Taylor avoid paying royalty on the cost of selling the gas because a third party (PSI) performed that duty. It is established that it is irrelevant who performs the necessary obligations of a lessee, or that title may have passed from the Federal lessee prior to undertaking an activity the lessee is obligated to perform. *See Apache Corp.*, 127 IBLA 125, 134 (1993).

143 IBLA at 81.[11]

Several weeks ago, in *Yates Petroleum Corp.*, 148 IBLA 33 (March 9, 1999), IBLA affirmed MMS' finding that a 2-percent deduction from the net proceeds received by a processor from sale of the plant products and drip liquids derived from the producer's gas constituted a marketing cost that was not deductible from royalty value. The Board reiterated its holdings in *Taylor Energy* and *Arco*. 148 IBLA at 34.

On March 24, 1999, the IBLA issued its decision in *Amerac Energy Corp.*, 148 IBLA 82. In addition to again reiterating its prior holdings, the IBLA found that, "despite Amerac's characterization of the underlying agreement as an 'indefinite price escalation clause,' the contract as a whole appears to be and declares itself to be a marketing agreement pursuant to which [the agent] was to market [the lessee's] oil to the ultimate purchasers for the best possible price." *Id.* at 88. Moreover, the IBLA held that the marketing agent was "merely a conduit to the ultimate purchasers, and that its share of the marketing net profits constituted a marketing fee." *Id.*

The IBLA also reiterated that the duty to market at no cost to the lessor exists "without regard to whether the lessee chooses to market its production using its own staff and efforts, or engages an affiliate or a third party to perform such services." *Id.* Notably, the IBLA held that "any fees paid to a third party for marketing services are properly regarded as gross proceeds accruing to [the lessee]." *Id.* at 89.

Several principles are apparent from these decisions. First, the lessee has an implied duty to prudently market the production at the highest price obtainable for the mutual benefit of both the

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[11] Taylor has filed with the Board a motion for reconsideration of this decision. The parties and an *amicus* have filed additional briefs. One month after the *Taylor* decision, in *Amoco Production Co.*, 143 IBLA 189 (1998), the Board considered a situation in which Amoco Production Co., the Federal offshore lessee, sold its gas to an affiliated marketing entity, Amoco Gas Co., in a non-arm's-length transaction, for a price equal to 90 percent of the price Amoco Gas Co. received in its arm's-length resale of the gas. The Board initially upheld MMS' order to add the ten percent difference to the value on which Amoco paid royalties (the non-arms'-length price) on the basis that Amoco had improperly deducted marketing costs. However, on reconsideration, 148 IBLA 255 (1999), the Board reversed the MMS order on the ground that under the facts of that case, MMS had not provided evidence that the difference between the non-arm's-length price and the arm's-length resale price constituted a marketing fee. 148 IBLA at 261-262. The reason for this finding was the rather unique circumstances involved. Amoco Gas Co. was a regulated utility that sold to end users at an "end user" or "burner tip" price that was regulated by the State of Texas, and that Amoco Gas Co. was entitled by law to a certain rate of return on its investment. These circumstances are not present in any of the other cases discussed here, and they are irrelevant to Texaco's situation in the instant case.

lessee and the lessor.[12] The creation and development of markets is the essence of that obligation. Second, lessees have always borne all of the marketing costs, and the Department has never permitted an allowance or deduction from royalty value for marketing costs.[13]

Further, marketing costs are not deductible, regardless of whether the lessee bears them directly or transfers the marketing function or costs to a contractor, affiliate, or any other entity. If marketing costs are borne by a purchaser, affiliate, or contractor, they may be added back to gross proceeds (or other measure of value, if appropriate) to arrive at the value of production. Moreover, the fact that marketing arrangements enhance the lessee's ability to obtain a higher price does not imply that costs are deductible. It also follows that a lessee may not deduct or disregard for royalty purposes the additional benefits it gains or value it receives through obtaining a higher price through its marketing skill or expertise. If the lessee manages to obtain a higher price for its oil through skillful marketing efforts, that higher price is the minimum royalty value under the gross proceeds rule.

Finally, the location of the market at which the lessee chooses to sell its production does not change the marketing obligation. For sales at distant markets, the lessee is entitled to an allowance for transportation costs, but not for marketing costs.

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[12] This does not imply that lessees must market production "downstream" of the lease. Lessees may market at the lease without breaching the duty to market. However, if a lessee chooses to market downstream, the choice to do so is for the mutual benefit of itself and the lessor, and does not affect the lessee's relationship to the lessor. The choice to market downstream does not make marketing costs deductible.

[13] Lessees may deduct from value only those costs allowed by the regulations, especially in light of the gross proceeds minimum value requirement. The only deductible costs are transportation costs and, in the case of "wet" gas with heavier entrained liquid hydrocarbons, processing costs. Transportation allowances are permitted because the government is entitled to a royalty on the value of production in marketable condition at or near the lease. Sales away from (or "downstream" from) the lease often are the starting point for determining royalty value, and the costs of transportation always have been allowed in order to ascertain value at or near the lease. An excellent example is *Marathon Oil Co. v. United States*, *supra*, in which the lessee deducted the costs of transportation (tankering and liquefaction) from the sales price in Japan to determine the gross proceeds value at the lease. A lessee who transports production to sell it at a market remote from the lease or field is entitled to an allowance for the costs of transportation. *See* 30 C.F.R. 206.104, 206.105 (crude oil), 206.156 and 206.157 (gas) (1988-1997). Before the 1988 regulations, transportation costs were allowed under judicial and administrative cases. *See, e.g., United States v. General Petroleum Corp.*, 73 F. Supp 225 (S.D. Cal. 1946), *aff'd, Continental Oil Co. v. United States*, 184 F.2d 802 (9th Cir. 1950); *Arco Oil and Gas Co.*, 109 IBLA 34 (1989); *Shell Oil Co.*, 52 IBLA 15 (1981); *Shell Oil Co.*, 70 I.D. 393, 396 (1963).

B. The Lessee's Duty to Market at No Cost to the Lessor and Its Duty to Put Production into Marketable Condition Are Related but Are Not Identical.

Notwithstanding the clarity of the holdings discussed above, there is another line of statements in IBLA cases regarding the lessee's duty to market that results in considerable confusion. These statements confuse the lessee's duty to market discussed above with its duty to put production into "marketable condition" discussed below. That confusion appears in *Seagull* (decided on May 6, 1999), as discussed further below. It is necessary to address these other Board statements to correctly apply the relevant law.

Before doing so, some background is necessary. Rules in place since at least 1942 for Federal onshore leases and 1954 for offshore leases require Federal lessees to put production into marketable condition without deduction from royalty value for the costs of treatment.[14] For oil, those functions include removal of basic sediment and water, etc. (For gas, those functions include gathering, compression, dehydration, and desulphurization). The current oil regulation provides:

> The lessee is required to place oil in marketable condition at no cost to the Federal Government or Indian lessor unless otherwise provided in the lease agreement or *this section*. Where the value established under this section is determined by a lessee's gross proceeds, that value shall be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services the cost of which ordinarily is the responsibility of the lessee to place the oil in marketable condition.

30 C.F.R. § 206.102(i) (1997). The gas rules (30 C.F.R. §§ 206.152(i) and 206.153(i)) contain essentially identical language.

The Fifth Circuit upheld the "marketable condition" rule in *Mesa Operating Limited Partnership v. Department of the Interior*, 931 F.2d 318 (5th Cir. 1991), *cert. denied*, 502 U.S. 1058 (1992), and held that reimbursements paid to a lessee for the costs of putting production into marketable condition are part of the lessee's gross proceeds. The Tenth Circuit adopted and followed *Mesa* in *Amerada Hess Corp. v. Department of the Interior*, 170 F.3d 1032 (10th Cir. 1999). *California Co. v. Udall*, 296 F.2d 384 (D.C. Cir. 1961) likewise held that the Secretary could require value on production in marketable condition.

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[14] *See*, 30 C.F.R. §§ 206.102(i) (crude oil), 206.152(i) (unprocessed gas), and 206.153(i) (processed gas) (1988-present), and predecessor regulations at 30 C.F.R. §§ 250.42 (1987), 250.42(b) (1969), and 250.41(b) (1956) (promulgated at 19 Fed. Reg. 2655, 2658 (1954)) (offshore leases), and 43 C.F.R. § 3162.7-1(a) (1987), formerly 30 C.F.R. § 221.31 (promulgated at 7 Fed. Reg. 4132, 4136 (1942)), and Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases No. 5 (NTL-5), 42 Fed. Reg. 2261, 22611 (1977) (onshore leases).

Against this background, we may now address the Board's other line of statements. The first one occurs in *Viersen & Cochran*, 134 IBLA 155 (1995). In that case, the lessee attempted to continue taking a transportation allowance although it was no longer transporting production away from the lease. The IBLA properly upheld MMS's determination that such costs could no longer be deducted. In arriving at its conclusion with regard to the transportation allowances, the IBLA stated that "the Department has long permitted an allowance for certain costs which have been deemed not to be directly related either to the costs of production or to the fulfillment of the lessee's contractual obligation to market production from the lease." 134 IBLA at 164. In a footnote, the IBLA further stated:

> In this regard, it is important to emphasize that the Department has consistently held that the obligation to market the product "is not a covenant read into the lease by implication" but rather is an affirmative duty expressly imposed under the terms of the lease via the incorporation of the Department's regulations into the lease. *See The Texas Co.*, 64 I.D. 76, 79-80 (1957). . . . Thus, as the decision in *The Texas Co.* noted, judicial interpretations of the scope of the "implied" covenant to market are of limited utility since a Federal lessee's obligations in computing royalty are a matter of contractual interpretation and regulatory construction.

134 IBLA at 164 n.8. This statement is largely misplaced. First, *Viersen & Cochran* did not involve either the duty to market or the obligation to put production into marketable condition. Second, the IBLA holdings cited above uniformly rely on the lessee's implied covenant to market which the *Viersen & Cochran* dictum appears to dismiss. Moreover, the 1957 decision on which this dictum relies, *The Texas Co.*, is a marketable condition case. (Specifically, the appellant sought to deduct from royalty value the costs of compression and of gathering gas from two wells to a central delivery point in the field.[15]) The obligation to put production into marketable condition is an express lease covenant imposed by longstanding regulations. The obligation to market is implied under the lease, and still would be implied even in the absence of an express marketable condition rule.

In *AnSon Co.*, AnSon had sold its gas produced from Federal and Indian leases to its affiliate, AnSon Gas Marketing, at a price equal to 98 percent of AnSon Gas Marketing's resale price — *i.e.*, for a two-percent marketing fee. In upholding MMS' order to add the two-percent difference into the gross proceeds and pay royalty on it, the Board quoted the marketable condition rule, briefly explained what constitutes "marketable condition," and said:

> The concept of "marketable condition" entails not only the physical conditioning of the gas but marketing services as well. Thus, for royalty purposes a lessee is responsible for arranging transportation

[15] The decision in *The Texas Co.* correctly held that those costs were not deductible, but, ironically, did not mention the marketable condition rule in its discussion.

> downstream of the delivery point, dealing with local distribution companies, and aggregating nominations of customers on the same pipeline. *Arco Oil & Gas Co.*, 112 IBLA 8, 10 (1989).

145 IBLA at 225. The source of the Board's notion, expressed in the first sentence quoted, that the putting production into marketable condition includes the functions identified in the second sentence (as well as finding purchasers, developing markets, etc.) is unclear. The fact that marketing functions are not the same functions as the processes necessary to put production into marketable condition does not imply that marketing costs are deductible — for the reasons discussed above, they are not, and the Board's result in *AnSon* was correct. But its reasoning relies on incorrectly combining two obligations that are not identical.

In *Amerac Energy Corp.*, 148 IBLA 82 (1999), as discussed above, the IBLA reaffirmed its prior holdings in *Arco*, *Taylor*, and *Walter* regarding the lessee's implied duty to market. However, the Board also cited the marketable condition rule and said that "[a]n element of this so-called marketable condition rule is the duty to market production. *The Texas Co.*, 64 I.D. 76, 79 (1957)." 148 IBLA at 88. This dictum suffers from the same defects as the statements in *Viersen & Cochran* and *AnSon*.

Lastly, in *Amoco Production Co. (On Reconsideration)*, 148 IBLA 255 (1999), though it reversed the MMS order because of the unusual facts involved, the Board summarized its decisions in *Walter*, *Arco*, and *Taylor*. However, the Board also again cited the marketable condition rule and said that "the concept of marketable condition embraces not only the physical conditioning of the gas (*e.g.*, separation of impurities, compression, etc.), but marketing services as well. *AnSon Co.*, 145 IBLA 221, 225 (1998)." 148 IBLA at 261. This dictum is misplaced for the same reasons discussed above with respect to *AnSon*.

The Board's various statements in these cases appear to incorrectly perceive the relationship between the marketable condition rule and the implied covenant and duty to market the production. The marketable condition rule is related to marketing in the sense that production must be conditioned before it can be marketed.[16] Indeed, in *California Co. v. Udall, supra* (D.C. Cir. 1961), the court specifically noted near the outset of its analysis that "[a]ppellant admits that it has a duty to market gas removed from these leaseholds." 296 F.2d at 387. In addressing whether the Secretary had authority to require the lessee to put the production into marketable condition, the Court viewed the conditioning obligation as additional to and in furtherance of the lessee's already existing duty to market.

Marketing production is an expected condition of the lease as much as other implied covenants, such as the lessee's duty to drill wells, protect against drainage, and act as a diligent

[16] Some state law cases recognize the obligation to place production into marketable condition as a subset of the implied duty to market. *See, e.g., Garman v. Conoco*, 886 P.2d 652, 659 (Colo., 1994), *Martin v. Glass*, 571 F. Supp. 1406, 1415-1416 (N.D. Tex., 1983).

operator. Indeed, if the lessee had no duty to market, production would be futile. The marketable condition rule supplements the implied covenant to market the production. It would make no sense for a lessee to be required to put production into marketable condition without cost to the lessor — which is a higher obligation of the lessee than under many private leases — if the lessee were not also obligated to actually do the marketing without cost to the lessor.

C. The Board's Decision in *Seagull* Regarding Marketing Costs Is Incorrect.

The Board's decision in *Seagull* compounds the difficulties with its statements in *Viersen & Cochran*, *AnSon*, etc. In *Seagull*, as discussed above, the producing entity, Seagull Energy, sold gas at the lease to its wholly-owned marketing subsidiary, Seagull Marketing. Seagull Marketing transported the gas and sold it to third-party purchasers for a price which, net of transportation costs, was higher than it paid to Seagull Energy. Seagull Marketing also bought gas at arm's length from other producers at the wellhead, and paid them the same price it paid Seagull Energy.

In *Seagull*, the Board found:

> The arm's-length sale by producers not affiliated with SMS [Seagull Marketing] establishes that there was a market at the wellhead and the gas was in marketable condition. Thus, Seagull was not required to bear the costs attributable to downstream sales, and appellant was not required to include them in their [sic] "gross proceeds" for purposes of computing royalties. MMS erred to the extent it held otherwise under either the "marketable condition" rule (30 C.F.R. § 206.152(i) (1997); 30 C.F.R. § 206.151), the duty to market leasehold production at no cost to the lessor, or the "gross proceeds" rule codified in the pre-march 1988 regulation, 30 C.F.R. § 206.150 (1987), or post-March 1988 regulations, 30 C.F.R. § 206.152(h); 30 C.F.R. § 206.151.
>
> * * *
>
> MMS does not contend here that Seagull's gas was not in "marketable condition" when sold to SMS or that no market existed at the wellhead. Rather, MMS contends that Seagull has improperly deducted marketing costs, costs incurred by SMS to market the gas downstream only because those two entities are affiliates.
>
> We conclude that it was not necessary for Seagull to bear the costs of downstream marketing where the gas sold at the wellhead was in marketable condition and where a market existed there.

148 IBLA at 315-316.

I believe this analysis is incorrect, and decline to follow it, for several reasons. First, the fact that production is in marketable condition does not imply that the lessee's duty to market has no relevance beyond the point where production physically is in marketable condition. Nor does it imply that the lessee may deduct marketing costs incurred — or exclude from royalty value additional proceeds received for the production — "downstream" of the point where production physically is in marketable condition.

Yet the *Seagull* rationale effectively allows lessees to deduct marketing costs, and avoid paying royalty on additional proceeds resulting from marketing — at least in circumstances where some production is sold at arm's length at the point where production is first physically in marketable condition. Under *Seagull*, a lessee may incorporate a wholly-owned affiliate, transfer the production to the affiliate for a lower price (at which some production is sold) at the point where the production physically is in marketable condition, and have the affiliate resell "downstream" at a higher price. Under *Seagull*, the lessee would owe royalties only on the inter-affiliate transfer price; any proceeds for the production realized above that price would be excluded, and downstream marketing costs incurred would not be added to the royalty value.

This contradicts the long line of prior holdings that lessees may not deduct their costs of marketing by transferring the function to other entities and accepting a lower price. Indeed, the *Walter*, *Arco*, *Taylor*, *Yates*, and *Amerac* cases make clear that a lessee may not avoid the requirement to market at its own expense, and cannot exclude from royalty value part of the proceeds it realizes from marketing, even by hiring a marketer at arm's length. It follows, *a fortiori*, that a lessee may not do so when it hires a wholly-owned (or wholly-commonly-owned) affiliated marketer, as Seagull did. The *Seagull* decision again creates an exception big enough to swallow the established rule.

Moreover, the result and reasoning with respect to the lessee's duty to market at no cost to the lessor do not change simply because there is a "market" at the lease, or because the wholly-owned or wholly-commonly-owned affiliated marketing entity buys other production at arm's length from other working interest holders in the field at the same price it pays to its affiliated producer. The Board's incorrect inference from, and incorrect application of, the marketable condition rule in *Seagull* effectively adopts a "lowest common denominator" theory of valuation — *i.e.*, the price at which any production is sold at arm's length will be the value of production initially transferred non-arm's-length, even if a the latter production nets a higher price in the open market. That position is incorrect in a number of respects.

First, for the reasons discussed above, it enables a lessee whose enterprise realizes more proceeds or greater value for its production than some other producers in the field to avoid paying royalty on part of those proceeds. The producing entity could have sold its production at the point and at the price its affiliate did, instead of using the wholly-owned affiliate arrangement. Had it done so, its gross proceeds unquestionably would have been the higher price realized on the sale downstream, minus the lessee's transportation costs, regardless of the fact that other producers sold for less. It is perfectly proper to value the production of a producer who markets through a wholly-owned affiliate at a higher level than the production that other producers sell at arm's length in the first instance, when the gas marketed through the wholly-owned affiliate commands a higher price. Indeed, this is the very situation which the Third Circuit correctly anticipated in *Shell Oil Co. v. Babbitt*, as quoted above.[17]

Further, the *Seagull* view creates an incentive for a lessee to sell some small percentage of its production at the lease at arm's-length for a lower price so that it can pay royalty on the rest of its production at that price. This is not the intent or meaning of the marketable condition rule or the gross proceeds rule.

The Board in *Seagull* attempts to bolster its position by claiming that "[n]othing in the record suggests that MMS has required the nonaffiliates to recalculate royalties due on their leases as it has required Seagull." 148 IBLA at 315. In other words, the Board says that the record gives no indication that MMS added marketing costs to the royalty value of production sold at arm's length to Seagull Marketing by other producers. This argument has at least three major problems.

First, the lack of specific reference in this record to any orders issued to other producers is irrelevant. The absence of such a reference does not imply that MMS did not issue orders to other producers, or will not do so in an appropriate case, if MMS finds that an arm's-length contract between a particular producer and Seagull Marketing is a marketing contract and not an ordinary arm's-length sale. However, there is nothing that compels MMS to ensure that the record in this case refers to assessments against others.

Second, assuming *arguendo* that the Board's supposition that there are no orders to other producers is correct, and further assuming *arguendo* that the facts would warrant issuing such orders, the failure on MMS' part to enforce the other producer's obligations does not change Seagull's obligations or the royalty value of its production under the rules and established legal principles.

Finally, while Seagull Marketing performed marketing for Seagull Energy, it does not follow that Seagull Marketing's contracts with other producers at arm's length were marketing contracts, as opposed to ordinary arm's-length sales contracts whose gross proceeds establish royalty value. The other producers may well have sought the best deal for their gas, with the result that Seagull Marketing offered them the best price or best overall terms. Whether any of those contracts constituted marketing contracts (with the producer hiring Seagull as its marketing agent) as opposed to outright arm's-length sales, is unknown. It cannot be assumed that MMS either can or should increase the royalty value paid by those producers without a much more thorough knowledge of the facts in each case — facts which are not in the *Seagull* record and have no reason to be in the *Seagull* record.

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[17] The Board apparently has a perception that lessees in Seagull's position unfairly are being treated differently from those who sell at arm's length at the lease. I believe that such a perception is not well-founded when the production transferred to the wholly-owned affiliate brings a higher price when it is sold at arm's length.

D. Texaco Cannot Avoid the Marketable Condition Requirement or Exclude Proceeds Derived from Marketing by Working through Its Affiliate.

For the reasons discussed above, I believe that the Board's holdings in *Walter*, *Arco*, *Taylor*, *Yates*, and *Amerac* (except for the dictum noted previously) are correct, and I adopt and follow them here. I believe the Board's ruling in *Seagull* is incorrect and I decline to follow it here. As noted previously, the several Board cases followed here establish that a lessee may not avoid the requirement to market at its own expense, and may not exclude from royalty value part of the proceeds resulting from marketing, even by hiring a marketer at arm's length. The principles of those cases apply with even greater force if a lessee uses a wholly-commonly-owned affiliated marketer, as Texaco did here.

In this case, it is undisputed that Texaco Marketing performs marketing for Texaco E & P's production.[18] Texaco E & P therefore may not effectively deduct marketing expenses, or exclude from royalty value proceeds derived from the production, by first transferring to Texaco Marketing before selling at arm's length on the open market.

It follows that Texaco must value the production, at a minimum, at the price Texaco Marketing received in its arm's-length sale (less allowable transportation costs). The MMS order therefore is correct.

III. TEXACO MAY NOT DEDUCT THE COSTS OF BLENDING.

In support of its position that royalty is due only on the basis of the posted prices used in the non-arm's-length transfers, Texaco argues that Texaco Marketing "added substantial non-royalty-bearing value" to some of the crude oil produced from the subject leases by blending it with higher-quality crude before reselling it. Texaco asserts that this changed the physical composition of the crude oil and increased its value downstream of the field from which it was produced. Texaco argues that blending facilitates more efficient movement of a wide variety of crudes to refineries through a limited number of pipelines, and that some crudes are blended to deliver a stream with particular specifications to a refiner. Texaco asserts that blending requires substantial investment and operational costs. (Response to Field Report at 10-11.)

As explained above, longstanding regulations and applicable cases require Texaco to put production into marketable condition at its own expense, without deduction from royalty value. 43 C.F.R. 3162.7-1(a)(1986); 30 C.F.R. § 206.102(i) (1988-present). In *Davis Exploration*, 112 IBLA 254 (1989), *aff'd*, *Davis v. Lujan*, No. 90-CV-0071-B, 1991 U.S. Dist. LEXIS 21678 (D. Wyo. 1991), *aff'd*, No. 91-8030, 1992 U.S. App. LEXIS 7251, notice of unpublished decision at 961 F.2d 219 (10th Cir. 1992), IBLA addressed the blending and marketable condition issue. The Board held:

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[18] Texaco summarizes the various specific functions Texaco Marketing performs at pp. 10-11 of its January 7, 1998 response to the State's field report. They include location exchange, storage, and terminaling and handling services.

> Although Davis argues that its blending constitutes manufacturing, we agree with BLM [the Bureau of Land Management] that it is not manufacturing because the blending does not transform the crude oil it produces. Although Davis might have been able to sell its crude oil unblended, that would not meet its obligation to render the product marketable, *see California Co. v. Udall, supra* [296 F.2d] at 387-88, and Davis acknowledges that until water and basic sediment are removed its product is not marketable. We therefore conclude that Davis has not met its burden of demonstrating that the basis for BLM's royalty determination — the price received for the blended product less the cost of the offlease condensate [that was blended with Davis' crude], *i.e.*, the gross proceeds from the sale of the product — was in error.

112 IBLA at 259.

On judicial review, the District Court then explained that the method the Secretary employed

> involves first determining the sales price of the blended crude as established by the arm's-length sale. That factor is established without contradiction in this case. Considering that the sales price reflects the value of low and high grade crude in a blended state, the next step in this valuation method is to subtract from this established sales price the cost (reflecting quality) of the particular quantity of high grade crude blended in with the low grade crude. The cost of the high grade crude which plaintiff utilized is also established without contradiction. The resulting figure reflects the contribution of low grade crude to the contract sales price of the blended product, thus establishing a value of the low grade crude as adjusted by the quality and quantity of the high grade crude blended in, pursuant to 30 C.F.R. § 206.103(a)(2).

Slip Op., *Davis v. Lujan*, No. 90-CV-0071-B (D. Wyo. Apr. 29, 1991), at 9-10, 1991 U.S. Dist. LEXIS 21678. The Tenth Circuit affirmed this holding.

Thus, the costs of blending are costs incurred to put crude oil into marketable condition and are not deductible from royalty value. Likewise, royalty is due on the value of the oil after blending (less the cost of the higher-grade crude blended in with the lower-grade crude). Texaco may not avoid this principle through the device of an initial transfer to a wholly-commonly-owned affiliate, just as it may not avoid the requirements of the gross proceeds rule or the duty to market at no cost to the lessor through that device. MMS' methodology of valuing Texaco's oil is in accordance with its regulations and therefore is not erroneous.

IV. MMS PROPERLY REQUIRED TEXACO TO PERFORM A RESTRUCTURED ACCOUNTING.

Texaco argues that the MMS order's requirement that Texaco recalculate and pay the royalties due for the period July 1, 1987, through December 31, 1989, is improper because it supposedly requires Texaco to conduct a "self-audit." Texaco's theory is based on a mischaracterization of what an audit is and what function it serves.

When MMS issues an order to a lessee such as the order in this case, it has conducted an audit with respect to the issues identified and is directing the lessee to correct specific types of noncompliance. It is not ordering the lessee to perform an audit. *At the time an order is issued,* MMS already has performed an audit and, finding patterns of noncompliance, is ordering the lessee to take corrective action — *i.e.*, a revised or restructured accounting — to remedy the irregularities already found. The order requires the lessee to locate accounting transactions meeting specifically identified conditions and then make certain directed corrections. Rather than calling for first-instance investigation and testing to assess the adequacy of compliance, it simply requires correction of a class of mistakes or errors already identified.

There is ample authority to require accounting revisions of this nature. FOGRMA section 107(a), 30 U.S.C. § 1717(a), provides:

> In carrying out his duties under this Act the Secretary may conduct any investigation or other inquiry necessary and appropriate and may conduct, after notice, any hearing or audit, necessary and appropriate to carrying out his duties under this Act. In connection with any such hearings, inquiry, investigation, or audit, the Secretary is also authorized where reasonably necessary —
>
> > (1) to require by special or general order, any person to submit in writing such affidavits and answers to questions as the Secretary may reasonably prescribe . . . .

When an audit has identified a systemic error, such as failure to pay royalty on the correct measure of gross proceeds on all five of the subject Federal leases for the period January 1, 1986, through June 30, 1987 (Statement of Reasons at 3), it is reasonable and appropriate to require the lessee to answer the inquiry as to where else the error has occurred, which is what a restructured accounting does. If additional royalty is due, the lessee is obligated by law to pay it to correct existing underpayments.

When MMS orders a lessee to perform a restructured or revised accounting, the MMS audit already has demonstrated noncompliance with the lease terms, related laws, and regulations which resulted in the lessee paying less royalty than required. Since the order directs actions to correct royalties for demonstrated deficiencies, it is not a requirement to "self-audit," but instead is a *requirement for the lessee to comply with its obligations to properly determine and pay royalty.* Specific corrections required by such orders are simply part of the remedy.

The Board has upheld this principle on several occasions. *E.g., Amoco Production Co.*, 123 IBLA 278 (1992). Indeed, the Board has rejected Texaco's "self audit" argument in three of Texaco's own cases. *Texaco Exploration & Production Inc.*, 140 IBLA 287 (1997); *Texaco Inc.*, 138 IBLA 26 (1997); *Texaco Exploration & Production Inc.*, 134 IBLA 267 (1995).

In this case, Texaco does not seriously dispute that a systemic deficiency exists if royalty is due on Texaco Marketing's arm's-length sale proceeds. Texaco does not contend that it paid royalty on that basis, and, indeed, admits that it did not. Statement of Reasons at 3. The MMS order's restructured accounting requirement therefore is proper.

V. OTHER PENDING ORDERS REGARDING CRUDE OIL PRODUCED FROM TEXACO'S FEDERAL LEASES IN CALIFORNIA DO NOT BAR THE INSTANT *ORDER.*

Texaco argues that the MMS order in this case is inconsistent with three later MMS orders issued in 1996 relating to Texaco's crude oil production from Federal leases in California. All of these orders resulted from MMS' examination of the overall question of the proper royalty value of crude oil produced from leases in California. That examination included a report by a special interagency task force. The larger controversy involving oil produced in California is beyond the scope of this decision and need not be addressed here for reasons including those explained below. It suffices here to note that MMS has issued the following orders:

1. On September 5, 1996, the MMS Houston Compliance Division issued an order to Texaco to pay approximately $4.49 million in additional royalties and interest on crude oil produced from Texaco's Federal leases in California during the period March 1, 1988, through May 31, 1996. For crude oil not sold at arm's length, this order prescribes a value based on weighted average premiums over posted prices obtained in arm's-length sales. The period involved overlaps that part of the order in the present case from March 1, 1988, through December 31, 1989. Texaco appealed this order to the MMS Director under 30 C.F.R. Part 290. Docket No. MMS-96-0424-O&G. That appeal is pending.

2. On October 18, 1996, and December 20, 1996, the Houston Compliance Division issued orders to Texaco which, taken together, assess additional royalties and interest of more than $13.9 million on crude oil produced from Texaco's Federal leases in California during the period from January 1, 1980, through February 29, 1988. These orders require that value be based on prices for Alaska North Slope oil sold in California, adjusted for location and quality. The period involved

overlaps that part of the order in this case from January 1, 1986, through February 29, 1988.[19] Texaco has appealed both of these orders to the MMS Director under 30 C.F.R. Part 290. Docket Nos. MMS-96-0412-O&G (Oct. 18, 1996 order) and MMS-97-0018 (Dec. 20, 1996 order). Both of these appeals are pending. In addition, Texaco has filed suit alleging that MMS is time-barred under the statute of limitations at 28 U.S.C. § 2415(a) from collecting additional royalties. *Texaco Inc. and Texaco E&P Inc. v. Babbitt*, No. 99-CV-058 BU (N.D. Okl., filed Jan. 21, 1999).[20]

Whether additional royalties are owed under these orders does not affect the outcome of this appeal. The royalties assessed under the July 29, 1992 order at issue here are due under the gross proceeds rule. The lessee's gross proceeds constitute the minimum value of production for royalty purposes. Royalty value may be higher than gross proceeds in certain circumstances. If the later orders identified above are upheld on administrative appeal or judicial review, then Texaco owes additional amounts over and above the gross proceeds value at issue in the instant case. But those orders do not nullify Texaco's obligation to pay on a minimum value of the gross proceeds accruing for disposition of lease production.

Any royalty paid as a consequence of the instant appeal that duplicates or overlaps any amounts that may be due under the later orders would not have to be paid again. MMS may not, and is not attempting to, make lessees pay twice.[21]

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[19] MMS' July 29, 1992 order in the instant case states that the "State will be unable to complete its determination of the product (crude oil) value for royalty purposes until California product value determination issues have been finalized." Order at 3. This refers to the controversy regarding royalty value on oil produced from leases in California.

[20] Two other lawsuits challenging, on statute of limitations grounds, similar orders to other lessees for the 1980-1988 period are the subject of District Court decisions adverse to the United States in which appeals are pending. *Oxy USA, Inc. v. Babbitt*, No. 96-CV-1067 K (N. D. Okl. Sept. 8, 1998), *appeal pending*, No. 98-5222 (10th Cir.); *Shell Oil Co. v. Babbitt*, No. 96-CV-1078 K (N.D. Okl. Oct. 7, 1998), *appeal pending*, No. 98-5252 (10th Cir.)

[21] Texaco also has asserted that "all of the MMS' claims based on leases Texaco E&P acquired from Texaco Inc." are barred by a U.S. Bankruptcy Court order in Texaco Inc.'s Chapter 11 bankruptcy reorganization proceeding filed in 1987, *Texaco Inc., Debtor*, No. 87 B 20142 (Bkcy. S.D.N.Y.) Response to Field Report at 1-2 n. 3. Texaco says that in that proceeding, "all pre-confirmation claims against Texaco were discharged." *Id.* Texaco neglects to point out that under a Bankruptcy Court order dated August 18, 1987, Texaco assumed all of its Federal oil and gas leases under 11 U.S.C. § 365. Texaco thereby became obligated to cure all defaults under all of its leases and pay MMS all amounts owed under its leases. Texaco also retained all of its leases when it emerged from the reorganization proceeding. Its argument therefore has no merit.

VI. THE STATUTE OF LIMITATIONS AT 28 U.S.C. § 2415(a) DOES NOT APPLY TO THIS ADMINISTRATIVE PROCEEDING.

Finally, Texaco argues that under the statute of limitations at 28 U.S.C. § 2415(a), MMS is time-barred from collecting the royalties due under the MMS order in this case. The IBLA has consistently and repeatedly held that section 2415(a) is a judicial defense and is not applicable to administrative proceedings. *E.g., Foote Mineral Co.*, 34 IBLA 285, 306 (1978); *Anadarko Petroleum Co.*, 122 IBLA 141 (1992); *BHP Petroleum (Americas) Inc.*, 124 IBLA 185 (1992). For this reason, the Department has declined to rule on asserted limitations defenses in administrative proceedings.

Texaco has petitioned for oral argument in connection with this appeal. Inasmuch as the issues involved were adequately briefed, oral argument would serve no useful purpose. Accordingly, Texaco's request for oral argument is denied.

CONCLUSION

For all of the foregoing reasons, MMS' July 29, 1992 order is affirmed in all respects, and Texaco's appeal is denied. Texaco must comply with this decision not later than 30 days after receiving this decision, unless the MMS Associate Director for Royalty Management grants a written extension of time.

Because this decision is issued by an Assistant Secretary of the Department of the Interior, it is not subject to appeal to the Interior Board of Land Appeals and is the final action of the Department. *Blue Star, Inc.*, 41 IBLA 333 (1979); *Marathon Oil Co.*, 108 IBLA 177 (1989).

Sylvia V. Baca

Acting Assistant Secretary
Land and Minerals Management

I concur:

Bruce Babbitt

Secretary of the Interior

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Washington, DC 20240

AUG 21

MMS/RMP
Mail Stop 3000

Memorandum

To: Deputy Associate Director for Royalty Management
Chief, Royalty Valuation Division
Chief, Lakewood Compliance Division
Chief, Houston Compliance Division
Chief, State and Indian Compliance Division

From: Associate Director for Royalty Management Lucy Querques Denett

Subject: Guidance for Determining Control for Ownership Between 10-50 Percent in Light of the National Mining Association (NMA) Decision

The attached paper provides guidance for determining control in situations where a lessee sells its production to a purchaser in which the lessee has between 10 and 50 percent ownership. This guidance is based on the *National Mining Association, Appellant v. United States Department of the Interior, et al., Appellees decision, dated May 28, 1999.* This guidance should be used when auditing or giving guidance for oil, gas, coal, or geothermal leases under existing regulations. Address any questions about the policy to the Chief, Royalty Valuation Division.

Guidance for Determining Control for Ownership Between 10 and 50 Percent in Light of the National Mining Association Decision

Arm's-length Contract

The definition of arm's-length-contract contained in existing regulations is generally consistent for all minerals:[1]

> *Arm's-length contract* means a contract or agreement that has been arrived at in the marketplace between independent, nonaffiliated persons with opposing economic interests regarding that contract. For purposes of this subpart, two persons are affiliated if one person controls, is controlled by, or is under common control with another person. For purposes of this subpart, based on the instruments of ownership of the voting securities of an entity, or based on other forms of ownership:
>
> (a) Ownership in excess of 50 percent constitutes control;
>
> (b) Ownership of 10 through 50 percent creates a presumption of control; and
>
> (c) Ownership of less than 10 percent creates a presumption of noncontrol which MMS may rebut if it demonstrates actual or legal control, including the existence of interlocking directorates. [Underscore added.]

The May 28, 1999, United States Court of Appeals Decision

In *National Mining Association, Appellant v. United States Department of the Interior, et al., 177 F.3d 1 (D.C. Cir., 1999)* the court concluded that four of the six (factors 1, 3, 4, and 5) Office of Surface Mining's presumptions of ownership and control were impermissible. The Office of Surface Mining Reclamation and Enforcement (OSM) regulations at 30 CFR § 773.5(b) (1999) state:

> The following relationships are presumed to constitute ownership or control unless a person can demonstrate that the person subject to the presumption does not in fact have the authority directly or indirectly to determine the manner in which the relevant surface coal mining operation is conducted:
>
> (1) Being an officer or director of an entity;
>
> (2) Being the operator of a surface coal mining operation;

[1]The new Federal oil regulations that are effective for production after June 1, 2000 contain separate definitions for the terms arm's-length contract and affiliate. The definition of affiliate was also modified in light of the NMA decision consistent with this guidance.

(3) Having the ability to commit the financial or real property assets or working resources of an entity;

(4) Being a general partner in a partnership;

(5) Based on the instruments of ownership or the voting securities of a corporate entity, owning of record 10 through 50 percent of the entity;

(6) Owning or controlling coal to be mined by another person under a lease, sublease or other contract and having the right to receive such coal after mining or having authority to determine the manner in which that person or another person conducts a surface coal mining operation.

The court found that OSM had not offered any basis to support the rule's presumption "that an owner of as little as ten percent of a company's stock controls it." 177 F.3d at 5. The court continued, "While ten percent ownership may, under specific circumstances, confer control, OSM has cited no authority for the proposition that it is ordinarily likely to do so." *Id.* (Emphasis added.) In a footnote, the court referred to the existing MMS rule:

> In its brief OSM referred the court to several regulations promulgated by other agencies but none of them presumes control based simply on a ten percent ownership stake, although another Department of Interior regulation does so. *See* 30 C.F.R. § 206.101(b) [sic] ("based on the instruments of ownership of the voting securities of an entity, or based on other forms of ownership: . . . (b) Ownership of 10 through 50 percent creates a presumption of control"). We do not consider the validity of section 206.101 here. *Id.*

The United States did not file a petition for rehearing, nor did the United States seek Supreme Court review.

Guidance

If there is ownership or common ownership of between 10 and 50 percent of the voting securities or instruments of ownership, or other forms of ownership, of another person, you must consider the following factors in determining whether there is control under the circumstances of a particular case:

- The extent to which there are common officers or directors;
- With respect to the voting securities, or instruments of ownership, or other forms of ownership:
  - the percentage of ownership or common ownership,
  - the relative percentage of ownership or common ownership compared to the percentage(s) of ownership by other persons,

- whether a person is the greatest single owner, or
- whether there is an opposing voting bloc of greater ownership;

- Operation of a lease, plant, or other facility;

- The extent of participation by other owners in operations and day-to-day management of a lease, plant, or other facility; and

- Other evidence of power to exercise control over or common control with another person.

Regardless of any percentage of ownership or common ownership, relatives, either by blood or marriage, are affiliates.

All the factors listed above must be considered in determining whether there is control under the circumstances of each particular case. However, just because one entity is found not to control another on the basis of stock ownership and other factors, and therefore that the entities are not affiliates, that does not always mean that the relationship between the two entities is at arm's length. The determination of whether a contract is arm's length or not is a two-part test. The contract must also be between parties with opposing economic interest in order to be arm's-length.

The determination of whether parties to a contract have opposing economic interest must be made on a case-by-case basis. You must be able to show that the companies to the contract have a tight relationship including shared employees or facilities or that the individuals or firms have identical or substantially identical business or economic interests (e.g., shared profit or loss risks). *See Crème Manufacturing Co., Inc. v. United States, 492 F.2d 515 (5th Cir. 1974)*

In the case of a contract between a producer and a joint venture in which the producer owns 10-50 percent of the joint venture purchaser, you must determine whether the producer is willing to accept a lower-than-market price knowing that he/she could "make-up" the difference on the resale by the joint venture. Information you should obtain to make that determination includes, but is not limited to, (1) the arm's-length sales contract of the joint venture and (2) the arm's-length purchase contracts of the joint venture for production from the same field or area. You should also obtain information to determine whether: (1) there is additional consideration paid by the purchaser to the producer and (2) the purchaser is performing services that are the responsibility of the producer at no cost to the Federal Government. Such additional consideration and/or services are royalty bearing.

This guidance does not affect the existing provisions that ownership of more than 50 percent constitutes control or that ownership of less than 10 percent constitutes a presumption of noncontrol. The Circuit Court decision does not affect these provisions.

However, while a lessee might sell its production to an entity that owns less than 10 percent and therefore is presumed noncontrolling, the relationship may not be one of "opposing economic interests" and therefore would not be at arm's length. An illustrative example would be a number of working interest owners in a large field forming a cooperative venture that purchases all of the working interest owners' production and resells the combined volumes to a purchaser at arm's length. *Xeno, Inc.*, 134 IBLA 172 (1995) involved a similar situation for a gas field. If no single working interest owner owned 10 percent or more of the new entity, the new entity would not be an "affiliate" of any of them. Nevertheless, the relationship between the new entity and the respective working interest owners would not be at arm's length.