

INTERIOR BOARD OF LAND APPEALS

Apache Corp.

127 IBLA 125 (August 24, 1993)

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APACHE CORP.

IBLA 89-649, 90-179

Decided August 24, 1993

Appeals from decisions of the Director, Minerals Management Service, requiring payment of additional royalties on wet gas produced from Federal oil and gas leases. MMS 86-0429-O&G, etc.

Affirmed in part, set aside in part, and remanded.

1. Oil and Gas Leases: Royalties: Generally--Oil and Gas Leases: Royalties: Natural Gas Liquid Products

Under 30 CFR 206.105(c), wet gas is properly valued using the aggregate value of all commodities, including residue gas. That is, MMS may properly determine the value to be the aggregate of the value of residue gas, NGLP, and sulfur, all of which were commodities obtained from the gas.

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

Under 30 CFR 206.106, a manufacturing allowance of up to two-thirds the value of entrained hydrocarbon liquids may be taken as a deduction from the royalty basis of those liquids. Thus, a deduction is allowable for costs of manufacture of such substances extracted from the gas produced from the leasehold, but there is a regulatory limit of two-thirds of the value of those substances.

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

A Federal oil and gas lessee has the duty to put gas produced from the lease in a marketable condition.

That duty includes treating the gas to remove hydrogen sulfide, so that costs of such treatment are not deductible. It is irrelevant who performs the treatment or the activities necessary to place the gas in marketable condition, or that title may have passed from the Federal lessee prior to undertaking the activity necessary to place the gas in marketable condition.

4. Oil and Gas Leases: Royalties: Generally

Where wet gas was processed into residue gas and liquid hydrocarbons, but only a portion of residue gas was immediately sold, with the remainder being stored because there was not sufficient market demand, the unsold gas is properly valued as of the time it was removed from the leases, as there was a demand for gas and available supply at that time sufficient to accord the gas a fair market value upon which royalty could be calculated. Where MMS valued all of the residue gas, including the portion not immediately sold, at the price of that sold immediately, its valuation will be affirmed in the absence of a showing that MMS did not value the gas giving "due consideration \* \* \* to the highest price paid for a part or for a majority of production of like quality in the same field, \* \* \* to posted prices, and to other relevant matters," as required by 30 CFR 206.105(c).

5. Oil and Gas Leases: Royalties: Generally--Regulations: Applicability

Where an audit of a Federal oil and gas lease extends through September 1988, a decision by MMS calculating royalty based on regulations that were effective only through Mar. 1, 1988, is properly set aside and the matter remanded for consideration of whether the audit pertaining to this lease should have been terminated on Mar. 1, 1988, or whether amended regulations should have been applied to the balance of the period through September 1988.

6. Oil and Gas Leases: Royalties: Generally

Where a lessee strongly suggests that the high percentage of hydrogen sulfide made transportation of the gas unduly expensive, MMS should allow the lessee the opportunity to justify a request that costs of removal of hydrogen sulfide may be deductible as a transportation allowance.

APPEARANCES: Marla J. Williams, Esq., Denver, Colorado, for appellant; Peter J. Schaumberg, Esq., Howard W. Chalker, Esq., Geoffrey Heath, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE HUGHES

Apache Corporation (Apache) appeals from two decisions of the Director, Minerals Management Service (MMS), dated June 15 and October 26, 1989, concerning royalty on liquid hydrocarbons and elemental sulfur separated

from gas produced from 11 Federal leases located in Billings County, North Dakota. 1/ The two appeals, which concern virtually identical questions of fact and law relating to valuation, are hereby consolidated.

In three separate audits initiated under authority granted by section 205 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. § 1735 (1988), the North Dakota State Auditor (State Auditor) reviewed the royalty computations of Apache pertaining to the above-referenced leases and determined that royalties for the leases had been underpaid. 2/ MMS concurred with the State Auditor's findings and issued a series of orders directing Apache to pay additional royalties in the amounts of \$184,079.82 and \$17,197.46. Apache appealed the assessments to the Director, MMS, who affirmed the assessments in the two decisions noted above.

The appeal involves casinghead gas sold under contracts between Apache and Koch Hydrocarbon Company (Koch), which processes the gas obtained from Apache's leases. There appears to be no dispute that the casinghead gas is "wet gas." 3/ Under those agreements, Apache sells its working share of raw gas to Koch, with title passing at Koch's meter at or near the wellhead. 4/ Koch transports the gas "some distance" to its Grasslands processing plant, where it is processed, yielding residue gas (containing methane and ethane), natural gas liquid products (NGLP), and sulfur. Koch sells the residue gas, NGLP, and sulfur to third parties. Apache receives from Koch either 75 or 80 percent (depending upon the contract) of the sum of amounts

1/ The following cases were resolved by the June 15, 1989, decision of the Director, MMS, and are included in the appeal styled Apache Corp., IBLA 89-649: MMS 86-0429-O&G, MMS 86-0526-O&G, MMS 87-0084-O&G, MMS 87-0143-O&G, MMS 87-0238-O&G, MMS 87-0239-O&G, and MMS 87-0489-O&G.

The Director's decision of Oct. 26, 1989, resolved one case, MMS 89-0192-O&G, and the appeal of that decision is styled Apache Corp., IBLA 90-179.

The leases in question are Nos. 255-012876, 255-045650, 284-017031, 255-040533, 284-031254, 284-031836, 284-031262, 255-031244, 255-032948, 284-014394, 284-051628, and 255-017667.

2/ Apache's royalty computations for lease Nos. 255-012876, 255-045650, 284-017031, 255-040533, 284-031254, 284-031836, 284-031262, 255-031244, and 255-032948 were audited for the period from June 1980 through December 1986. Royalty computations for production from Federal lease Nos. 284-014394 and 284-051628 were audited by the State for the period April through November 1983. Federal lease No. 255-017667 was audited for the period from March 1984 through September 1988.

3/ "Wet gas" is natural gas containing liquid hydrocarbons in solution, which may be removed by a reduction of temperature and pressure or by a relatively simple extraction process. "Dry gas" is natural gas which does not contain dissolved liquid hydrocarbons. 8 Williams and Meyers, Oil & Gas Law, Vol. 8, 363 (1992).

4/ In some cases, Apache is a successor-in-interest to another party's contract with Koch.

received by Koch from those sales, minus three categories of fees: (1) a proportionate share (based on total volumes of unprocessed gas delivered by Apache); (2) a proportionate share (based on the liquefiable hydrocarbon content of the unprocessed gas delivered); and (3) an additional fee based upon the relative hydrogen sulfide (H<sub>2</sub>S) content of the unprocessed gas delivered by Apache.

In effect, MMS used the "net-back" or "net-realization" method of valuation, using as value for royalty purposes the proceeds received by Koch from sales of the residue gas, NGLP, and sulfur. Compare, 30 CFR 206.151 (1989) (definition of "net-back method"). MMS approved no deduction for the residue gas, valuing it at 100 percent of the proceeds received by Koch. MMS did allow an allowance of two-thirds of the value of the NGLP as a manufacturing allowance. 5/ The Director affirmed, citing 30 CFR 206.105 and 30 CFR 206.106, 6/ the Notice to Lessees and Operators of Federal and Indian Onshore Oil and Gas Leases (NTL-5) (43 FR 22610 (May 4, 1977)), the Notice to Lessees Numbered 5 Gas Royalty Act (NTL-5 Act), P.L. 100-234, 101 Stat. 1719 (1988), and this Board's decision in Kerr-McGee Corp., 106 IBLA 72 (1988), and holding that royalty should have been paid on 100 percent of the value of the residue gas plus not less than one-third of the value of the NGLP and sulfur:

In calculating royalties on natural gas that is processed through a natural gas processing plant, it has been a longstanding Federal policy that the royalty percentage is to be applied to the full value of the residue gas. The royalty value of any manufactured liquid products may reflect a maximum of two-thirds allowance for processing costs. Under no circumstances shall the amount of royalty on the residue gas and extracted liquids be less than the gross proceeds accruing to the lessee. [sic]

\* \* \* \* \*

In the instant case, MMS compared the royalty value reported by the Appellant with the value of 100 percent of the residue gas and one-third of the value of the natural gas liquids and sulfur

5/ MMS also apparently allowed a manufacturing allowance of two-thirds of the price received from sales of sulfur. We note that 30 CFR 206.106 (quoted below) allows manufacturing allowances for "all casinghead or natural gasoline, butane, propane, or other liquid hydrocarbon substances extracted from the gas produced from the leasehold." Sulfur is not a hydrocarbon. However, in the absence of an appeal directly challenging the propriety of MMS' allowing a manufacturing allowance for sulfur under that regulation, we offer no opinion as to the propriety of that practice.

6/ Effective Mar. 1, 1988, the Department revised the regulations in 30 CFR relating to gas valuation for royalty purposes. 53 FR 1230 (Jan. 15, 1988). References in this decision to gas valuation regulations are to the regulations in effect during the relevant periods in dispute.

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and found that the Appellant's valuation methodology effectively exceeded the two-thirds limitation on processing cost deductions. As a result, MMS refused to accept the Appellant's net proceeds for royalty valuation purposes. [Emphasis supplied.]

(Director's Decisions at 3-4). The Director rejected Apache's arguments that the value of the unprocessed gas at the wellhead should be established by the processing agreements under which it was sold, allowing full deduction of processing costs. Finally, the Director rejected Apache's argument that no royalties should be charged to it for a portion of the residue gas that Koch was unable to sell under the processing agreements and which was subsequently sold to Western Natural Gas at lesser prices. Apache contended that royalties

should accrue to the United States based upon the sales price actually received by Apache for that portion when it was subsequently sold. The Director, citing 30 CFR 206.105, held that royalties were due when the gas was removed, processed, and stored by Koch, and that the amount of the royalty was properly based "on the highest price received for the majority of the residue gas, natural gas liquids[,] and sulfur" (Director's Decisions at 8). The Director also rejected its arguments that 30 CFR 206.105 and 30 CFR 206.106 are invalid, and that MMS was estopped from assessing higher royalties because Koch had previously accepted Apache's royalty payments and had failed to provide monthly statements showing the higher amounts due.

On appeal to this Board, Apache argues that the Director's decision "fails to address the unique facts of this case and the \* \* \* arbitrary, capricious, and artificially inflated value that results from the valuation formula employed \* \* \* by the MMS" (Statement of Reasons (SOR) at 6). It stresses, inter alia, that its contracts with Koch were at arm's length, and that the gas contains a very high percentage (up to 27 percent) of H<sub>2</sub>S so that it is more expensive to produce, transport, and process, and so that it is unsafe and illegal to flare the gas (SOR at 5-6). Apache states:

In particular, application of the formula in this instance is an arbitrary and capricious method of valuing the gas in issue because (i) it operates as an unreasonable net-back computation that ignores the actual wellhead sale, (ii) it misinterprets the historic intent of the "2/3 of liquids" allowance by converting it into an arbitrary cap on otherwise reasonable processing costs, (iii) it disregards transportation costs and the processing costs for separating the dry gas and hydrogen sulfide gas components of the raw gas stream, (iv) it creates a non-rebuttable presumption that is inconsistent with the Secretary's duties and (v) it has the net effect of increasing the Government's royalty above the rate prescribed under the \* \* \* [Mineral Leasing Act].

(SOR at 7). Finally, Apache argues that it should not be required to pay royalty on a certain portion of the residue gas that was rejected by Koch's buyer, Montana-Dakota Utilities (MDU) at the tailgate of Koch's processing plant.

In its answer, MMS delineates the primary issue in the case as "whether MMS is required to accept Apache's gross proceeds as royalty value for the wet gas produced from the federal leases" (Answer at 3). MMS argues that it correctly applied its regulations in valuing Apache's gas, and that "MMS properly disregarded the costs of processing residue gas when computing the royalty since a lessee has a duty to put gas into a marketable condition" (Answer at 9). In response to Apache's assertion that it not be required to pay royalty upon gas rejected by MDU, MMS states that "royalty is due MMS at the time gas is removed from the lease, not when it is sold at a later date" (Answer at 12).

[1] The determination of the royalty payable to the United States for production from Federal onshore oil and gas leases is governed by provisions of the applicable statute and Departmental regulations. Section 17 of the Mineral Leasing Act, as amended, 30 U.S.C. § 226 (1988), requires that royalty be a certain percentage of the "amount or value of the production removed or sold from the lease." That statute does not set forth any particular method for valuing production removed or sold from a Federal oil and gas lease. However, it is well settled that the Department has "considerable latitude" in determining the value of oil and gas production as a basis for computing royalties. Hoover & Bracken Energies, Inc., 52 IBLA 27, 33 (1981), aff'd, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984).

At most times relevant to this dispute, the regulations applicable to the valuation of wet gas were 30 CFR 206.103, 206.105, and 206.106. Under 30 CFR 206.103,

[t]he 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. 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. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

Apache argues in effect that its "gross proceeds" were the prices paid to it by Koch, that is, either 20 or 25 percent of the price received by Koch from the sale of the residue gas, NGLP, and sulfur, less other costs. Examination of other controlling regulations demonstrates that this interpretation is not correct.

Valuation of "wet gas" is specifically governed by 30 CFR 206.105(c):

§ 206.105 Royalty on gas.

The royalty of gas shall be the percentage established by the terms of the lease of the value or amount of the gas produced.

\* \* \* \* \*

(c) For the purpose of computing royalty, the value of wet gas shall be either the gross proceeds accruing to the lessee from the sale thereof or the aggregate value determined by the Secretary of all commodities, including residue gas obtained therefrom, whichever is greater.

It is thus clear that "wet gas" is properly valued using the aggregate value of all commodities, including residue gas. That is, MMS may properly determine the value to be the aggregate of the value of the residue gas, the NGLP, and the sulfur, all of which were "commodities" obtained from the gas.

[2] A special regulatory provision (30 CFR 206.106) allows for a manufacturing allowance of up to two-thirds the value of entrained hydrocarbon liquids:

A royalty as provided in the lease shall be paid on the value of one-third (or the lessee's portion if greater than one-third) of all casinghead or natural gasoline, butane, propane, or other liquid hydrocarbon substances extracted from the gas produced from the leasehold. The value of the remainder is an allowance for the cost of manufacture, and no royalty thereon is required.

Thus, a deduction is allowable for costs of manufacture of substances extracted from the gas produced from the leasehold, but there is a regulatory limit of two-thirds of the value of those substances. Accordingly, MMS properly limited the deductions of costs associated with manufacture of substances extracted from the wet gas. See 30 CFR 206.106. MMS apparently accepted that Apache's costs of manufacturing these components under its contracts with Koch reached or surpassed the two-thirds limit, as it evidently made no effort to require Apache to itemize expenses of manufacture.

Apache argues that the "proportionate share (based on total volumes of unprocessed gas delivered by Apache) of Koch's electrical costs to power the transportation facility" are deductible as part of the manufacturing allowance. As Apache has characterized these costs as processing costs, we are constrained to hold that these costs fall under 30 CFR 206.106, which limits the lessee to a deduction of two-thirds of the value of the liquid hydrocarbons as a manufacturing allowance for such costs. MMS has evidently already allowed the maximum deduction for manufacturing here.

It is now well established by case law that MMS properly establishes the "aggregate value" of the commodities obtained from the wet gas by reference to the contract price charge for sale to a third party, and that any

deduction from that value is limited to the manufacturing allowance referenced above as well as a transportation allowance. In Kerr-McGee Corp., *supra*, we considered a similar case involving contracts between Kerr-McGee and Koch that were nearly identical to those in this case between Apache and Koch. *Id.* at 74. Although that case was remanded to MMS for an initial determination of how the NTL-5 Act would affect the MMS valuation, we set forth the history of the Secretary's valuation of casing-head gas and, applying 30 CFR 206.105 and 30 CFR 206.106, ruled that MMS is not bound to accept the contract price as the value of the wet gas. <sup>7/</sup> *Id.* at 82. We reaffirmed that interpretation when the remanded case was appealed to the Board in Kerr-McGee Corp., 125 IBLA 279 (1993). See also Walter Van Norman, Jr., 126 IBLA 375 (1993).

Apache argues in effect that its gas should be valued in accordance with 30 CFR 206.103 without regard to the specific provisions of 30 CFR 206.105 pertaining to valuation of wet gas and 30 CFR 206.106 limiting deductions for processing costs. In Wexpro Co., 106 IBLA 57 (1988), this Board rejected a similar argument made by MMS. In that case, MMS relied upon 30 CFR 206.103 (1986) for "authority to calculate royalty based on the value at the wellhead of the wet gas adjusted for its Btu content," even when the gas was not sold as such but was instead processed and its constituent components sold. *Id.* at 67. Noting that 30 CFR 206.103 is a general regulation and that specific regulations containing mandatory language relating to valuation of wet gas for royalty purposes are found at 30 CFR 206.105 and 30 CFR 206.106, we held that the specific regulations take precedence:

In accordance with the applicable Departmental regulations and longstanding Departmental practice, during [the period in question] the wet gas, which was not sold at the wellhead, but was processed by an independent third party pursuant to an arm's-length contract, was properly valued for royalty purposes on the value of the dry gas at the tailgate of the processing plant and the lessee's share of the extracted liquids.

*Id.* at 71.

Apache relies on Piney Woods School v. Shell Oil Co., 726 F.2d 225 (1984), *cert. denied*, 471 U.S. 1005 (1985), in support of its argument that MMS must base its royalty value upon the contract price that it received from Koch. That case involved a private lease not governed by

<sup>7/</sup> We find no basis to conclude in the present case that MMS' method of valuation is inconsistent with the NTL-5 Act. Although sec. 3(b) of that Act extensively quotes 30 CFR 206.103, it also states that value shall be "determined consistent with the lease terms and the regulations codified at part 206 of title 30, Code of Federal Regulations, in effect at the time of production." 101 Stat. at 1720. Thus, we must look not only to 30 CFR 206.103, but also to 30 CFR 206.105 and 206.106. See Wexpro Co., 106 IBLA 57, 66 (1988). Those regulations amply support MMS' decision here.

Federal regulations, so that the consequences of the Court's holding are of limited moment, arising as they did from construction of private lease royalty provisions different from those at issue here. See Exxon Co., U.S.A., 121 IBLA 234, 249 n.8, 98 I.D. 409, 417 (1991). In any event, in that case, the value upon which royalty amounts were to be based was controlled by contractual language which stated that the value of casinghead gas was to be controlled by the "market value at the well." Piney Woods School v. Shell Oil Co., *supra* at 228. That is not the measure upon which value of wet gas has been based where gas is produced from Federal lands. Kerr-McGee Corp., *supra*.

We are unpersuaded by Apache's arguments that MMS' "net-back" computation is "unreasonable and ignores actual wellhead sales"; that "it misinterprets the historic intent of the '2/3 of liquids' allowance by converting it into an arbitrary cap on otherwise reasonable processing costs"; and that it has the "net effect of increasing the Government's royalty above the rate prescribed under the \* \* \* [Mineral Leasing Act]" (SOR at 7). As we stated in BWAB, Inc., 108 IBLA 250, 260-61 (1989),

[w]e recognize that there are situations, as is apparently the case herein, where the two-thirds manufacturing cost allowance may significantly differ from the percentages of liquid hydrocarbons and residue gas actually allocated to the processor as the cost of manufacturing pursuant to an arm's length contract. In 1926, the Department (in one of its earliest codification[s] of the two-thirds manufacturing cost allowance) stated that the value of the liquid hydrocarbons so computed was "assumed" to be the actual value on which royalty could be computed. 52 L.D. at 11; see also 56 I.D. 462, 464 (1937). The Department then continued to operate under that assumption during the relevant time period where the manufacturing cost allowance provided for in 30 CFR 206.106 (1986) was never rescinded and no Departmental regulation ever expressly provided for taking any portion of the value of residue gas or any portion greater than two-thirds of the value of liquid hydrocarbons as the "cost of manufacture." Thus, we must recognize two-thirds of the value of liquid hydrocarbons as the ceiling on the manufacturing cost allowance where neither MMS nor the Board is empowered to disregard a duly promulgated regulation. Conoco, Inc., 103 IBLA 108, 109 (1988); Joseph J. C. Paine, 83 IBLA 145, 147 (1984).

In any event, MMS and this Board are bound to follow duly promulgated regulations of the Department of the Interior, which have the force and effect of law. Conoco, Inc. (On Reconsideration), 113 IBLA 243, 249 (1990), and cases cited. As MMS' valuation was in accord with Departmental regulations in most respects, it is properly affirmed, except as noted below.

Apache argues that an interpretation "revealed by the MMS in [a] 1983 letter to Phillips Petroleum Co. and in \* \* \* 1984 telephone conversations between Apache and MMS personnel is an eminently reasonable interpretation." To the extent that Apache may be arguing that MMS is bound to accept the proceeds from the contracts with Koch as value, we are unpersuaded. It

is established that royalty payments are accepted subject to post audit, and that, in the absence of acceptance of a lessee's statement of value as conclusive, the Department is not barred from determining value by another acceptable method and demanding royalty based on this method. Supron Energy Corp., 46 IBLA 181, 189 (1980). The communications cited by Apache (Apache SOR to the Director, MMS, Exhs. 1 and 2) are very general statements falling short of those standards. Further, to the extent that they can be read as a commitment to "accept gross proceeds received under a properly negotiated arm's-length contract as the basis for calculating royalties on gas produced on Federal leases," that commitment must be seen as a commitment to do so only in concert with other regulations in effect during the period. The fact that MMS may have agreed to accept as "value" proceeds received under an arm's-length contract does not make an otherwise nondeductible cost deductible. Exxon Co., U.S.A., 121 IBLA at 251-52, 98 I.D. at 418-19. Thus, although the contract prices may be used to establish value, terms of the contract providing deductions not allowable under the regulations may properly be disregarded.

[3] MMS' position that Apache, as lessee, must bear the full cost of removing H<sub>2</sub>S, and that those costs are not deductible from the royalty basis, is correct. It is established that the lessee has the duty to put the gas in a marketable condition. See Mobil Oil Corp., 108 IBLA 216 (1989). That duty includes treating the gas to remove H<sub>2</sub>S, and costs of that treatment are not deductible. Exxon Co., U.S.A., 121 IBLA at 247-48, 98 I.D. at 416; BWAB, Inc., *supra* at 260 n.6; see also The Texas Co., 64 I.D. 76, 79-80 (1957). Reducing the royalty value by allowing a deduction for those costs would amount to a subsidy by the Government equal to the royalty rate times those costs. See California Co. v. Udall, 296 F.2d 384, 388 (D.C. Cir. 1961). It is irrelevant who performs the treatment or the activities necessary to place the gas in marketable condition, or that title may have passed from the Federal lessee prior to undertaking the activity necessary to place the gas in marketable condition. Exxon Co., U.S.A., 121 IBLA at 247, 98 I.D. at 416. Thus, MMS properly declined to reduce the royalty basis of the residue gas by the amount expended in sweetening the gas. 8/

[4] Apache argues that MMS erroneously valued a certain portion of the residue gas that it was not able to sell immediately, but had to store. MMS valued that gas at the price paid to Koch by MDU, and Apache argues that it should have been valued at the price eventually obtained for the gas, as 30 CFR 206.103 requires consideration of what it actually received or the highest spot market price. A similar argument was rejected in BWAB, Inc., *supra* at 256:

8/ As discussed above at n.5, MMS apparently allowed a deduction for a portion of the costs of sweetening the gas as a manufacturing allowance for the production of sulfur. That deduction would presumably be for only a small portion of the costs of sweetening, as it would be limited to two-thirds the value (sale price) of the sulfur produced from the gas stream. We offer no comment on the validity of that deduction, as it has not been challenged on appeal.

In the present case, wet gas was removed from the subject leases and processed into residue gas and liquid hydrocarbons. A portion of residue gas was then sold, and the remainder was stored because there was not sufficient market demand. This does not mean that the unsold gas did not have a fair market value when

it was removed from the leases. At that time there clearly was a demand for gas and an available supply. That was sufficient to accord the gas a fair market value upon which royalty is properly computed.

In determining the value of the residue gas at the time of removal from the subject leases, MMS properly relied on 30 CFR 206.105(c) (1986). See Wexpro Co., 106 IBLA 57, 67-69 (1988). That regulation was specifically applicable to the calculation

of royalty with respect to wet gas, including the residue gas and liquid hydrocarbon components of that gas, removed from a lease. Under the regulation, the value of the residue gas was to be either as a part of the gross proceeds received by the lessee from the sale of the wet gas or the separate value of the residue gas. When the wet gas was not sold, MMS properly valued the residue gas as a distinct commodity.

Apache has not provided this Board with information showing that MMS' valuation did not give "due consideration \* \* \* to the highest price paid for a part or for a majority of production of like quality in the same field, \* \* \* to posted prices, and to other relevant matters," as required by 30 CFR 206.105(c). Accordingly, we affirm that valuation.

[5] We remain concerned about two issues. First, we note that production from Federal lease No. 255-017667, which was audited for the period from March 1984 through September 1988, might not be covered entirely by the regulations cited by MMS, but instead by the regulation as amended in 1988. <sup>9/</sup> Accordingly, we set aside the Director's decision and remand it for consideration of whether the audit pertaining to this lease should have been terminated on March 1, 1988, or whether the amended regulations should have been applied to the balance of the period through September 1988, and, if so, whether the amount of royalties due and owing MMS from this lease would be affected.

[6] Second, although Apache does not expressly argue that the costs of removing the H<sub>2</sub>S gas from the raw gas stream should have been recognized as a transportation allowance for these costs, it strongly suggests that the high percentage of H<sub>2</sub>S made transportation of the gas unduly expensive. MMS, in its answer, states that it would allow a proper transportation allowance if it receives a request that meets its criteria. On remand, MMS should allow Apache the opportunity to justify such request. Compare, Exxon Corp., 118 IBLA 221, 243-44 (1991).

<sup>9/</sup> See n.6, above.

Other arguments not specifically addressed herein have been considered and rejected.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed in part, set aside in part, and remanded.

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David L. Hughes  
Administrative Judge

I concur:

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James L. Byrnes  
Chief Administrative Judge