INTERIOR BOARD OF LAND APPEALS

Vastar Resources

148 IBLA 107 (March 30, 1999)

Title page added by:
ibiadecisions.com

VASTAR RESOURCES

IBLA 98-398 Decided March 30, 1999

Appeal from a decision of the Acting Associate Director for Policy and Management Improvement, Minerals Management Service, denying specified transportation allowances for royalty valuation purposes. MMS-89-377-OCS.

Affirmed in part, reversed in part, and remanded.

1. Oil and Gas Leases: Royalties: Generally--Outer Continental Shelf Lands Act: Oil and Gas Leases

   When computing the royalties for offshore oil and gas, the Minerals Management Service allows a transportation allowance for costs reasonably incurred in moving oil and gas from the point of offshore production to the first available market onshore. A transportation allowance may be taken for the costs of construction of a pipeline, to include related sandbagging operations and the cost of unattributed marker buoy spare parts, to allow for delivery to a marketing point.

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

   The Federal lessee was properly required to recalculate and pay additional royalties on other pipelines where there was evidence on one pipeline that Appellant's predecessor ARCO improperly included lease equipment as an investment cost for the purpose of a deduction, and (2) where ARCO changed the life of the pipeline but failed to adjust depreciation accordingly.

APPEARANCES: Norma J. Rosner, Esq., Vastar Resources, Inc., Houston, Texas, for Appellant; Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE TERRY

Vastar Resources, Inc. (Vastar or Appellant), has appealed from a July 7, 1997, Decision (1997 Decision) 1/ of the Acting Associate Director for Policy and Management Improvement, Minerals Management Service (MMS or Respondent), granting in part, modifying, and denying in part ARCO Oil and Gas Company's (ARCO's) (Vastar's predecessor-in-interest) challenge to a September 27, 1989, Order of the Royalty Management Program (RMP), MMS. In the underlying 1989 Order, the RMP had directed ARCO to recalculate, file amended reports, and pay additional royalties claimed due on transportation issues on lease numbers 054-002636-0, 054-002637-0, 054-002640-0, and 054-004501-0 for the period 1983 through the present, and to self-audit all other ARCO producer-owned pipeline deductions taken from off-shore leases for the same time period.

As a brief background to this appeal, ARCO contracted to have Santa Fe Construction build a 6-5/8 inch outside diameter pipeline from ARCO's MC 148 platform approximately 53,000 feet in length to a pipeline connection located at Chevron's South Pass 55 platform "A," offshore Louisiana in the Gulf of Mexico. (ARCO Contract No. DE-81-001, February 1, 1981 (Contract).) The construction contract required that the pipeline work "shall be substantially completed by April 15, 1981," (Contract at 2) at a fixed cost of $1,360,000. (Contract at 1-4.) The contract also contained a provision for extra work, including but not limited to "[a]ll weather related standby time offshore." (Contract at 3-4.) Subsequently, Santa Fe charged and ARCO paid $1,156,418.51 as "extra work" due to weather delays. Of this amount, MMS disallowed $828,048.47 in its 1989 Order, largely because the charges arose within the period for contract completion.

As noted above, the July 7, 1997, Decision appealed from granted in part, modified, and denied in part ARCO's challenge to the 1989 Decision. The 1997 Decision specifically held:

> Based upon the record, the appeal of ARCO Oil and Gas Company is granted to the extent that the RMP order of September 27, 1989, is modified as follows.
>
> * Costs associated with Invoice Nos. 87203, 37239, and 86218 totaling $36,530.85 and previously disallowed by MMS are allowed:
>
> * Costs associated with the weather-delay charges totaling $1,156,418.51 in costs previously disallowed by MMS are allowed;

1/ Briefing in this appeal was not concluded until Sept. 4, 1998.

* Costs associated with post-start-up of the pipeline totaling $6,375.84 and previously disallowed by MMS are allowed; and

* The six cents per barrel terminaling charge is allowed as a permissible transportation charge.

In all other respects the appeal of ARCO Oil and Gas Company hereby is denied–specifically:

* $20,594.17 in costs related to the LACT unit–that is, costs related to measurement, not construction or transportation;

* $52,162.86 in platform costs and supplies related to the LACT unit–that is, costs related to production and/or measurement, not construction or transportation;

* Costs related to production:

* –$25,758 in contract costs;

* –$5,593.55 in platform maintenance costs;

* –$8,877.21 disallowed by MMS as "obvious accounting or allocation errors"; and

* The order to perform a restructured accounting.

(1997 Decision at 10-11.)

On appeal to the Board, three issues remain for adjudication. The first is whether Appellant may capitalize the full cost of its contractor's charge for 3 days of sandbagging the pipeline, despite the fact that some portion of 2 days constituted "down-time" as the crews waited for delivery of additional sandbags. The second issue is whether Appellant may capitalize and depreciate the cost of replacement parts for pipeline marker buoys. The third issue is whether MMS may properly require Vastar to review the support for all other ARCO owned pipeline deductions taken from off-shore leases, and to restructure its accounts.

In its Statement of Reasons (SOR) for appeal, Vastar challenges MMS' refusal to allow ARCO the opportunity to capitalize and depreciate the full amount of sandbagging services necessary to stabilize the pipeline. MMS found that a portion of 2 of the 3 days of sandbagging were idle periods when crews were waiting for delivery of additional sandbags. During this downtime, crews sometimes made necessary equipment repairs. These periods, representing $25,748 in claimed deductions, were excluded by MMS from the amount authorized for capitalization and depreciation. Appellant argues that incidental repairs performed at the same time as the

sandbagging operations, or periodic downtime throughout the operation, do not change the fundamental character of these invoices. As such, Appellant claims, the full $25,748 disallowed should be capitalized and depreciated. (SOR at 4-5.)

With respect to the $6,210.59 in marker buoy parts denied as a capital depreciation by MMS, Vastar states that while the contractor was obligated to supply pipeline marker buoys as part of the fixed cost of the pipeline installation, it was not responsible for providing replacement parts. Appellant urges that ARCO purchased extra battery packs and other replacement parts for the buoys, so that the buoys could be maintained in good repair, and that these expenses should also have been allowed. (SOR at 4-5.)

Appellant also argues that MMS has failed to establish the necessity for a restructured accounting and claims that it is arbitrary, capricious, an abuse of discretion, and contrary to law to require a restructured accounting in the absence of systemic errors. (SOR at 5.) Appellant notes that, in the 1997 Decision, MMS has required ARCO to review the support for all other ARCO owned pipeline deductions taken from offshore leases, and to restructure its accounts. Id. Appellant claims, however, that MMS has reviewed only one pipeline and has not asserted or provided any basis for concluding that the alleged errors exist beyond this particular pipeline. (SOR at 6.) To the contrary, Vastar argues, MMS has conducted numerous other lease audits where the production is transported through ARCO/Vastar owned pipelines and it (MMS) has not taken exception to any portion of the transportation allowance claimed on any of these lines. Id. As no audit exceptions have been issued on any of the pipelines that have been reviewed, Appellant argues that MMS has no reasonable basis for believing systemic errors exist in the accounting for these other pipelines. Id.

In its Answer, MMS responds first that Appellant does not affirmatively point to any errors in its (MMS') determination that the sandbagging costs and buoy replacement costs should not be depreciated and therefore, this part of Appellant's appeal should be dismissed. MMS claims the Acting Associate Director denied ARCO's appeal regarding these costs because "ARCO did not dispute them or failed to adequately support these issues." (Answer at 2, citing 1997 Decision at 3-4.) MMS states that Appellant's SOR does not address the rationale of the Acting Associate Director's decision but, rather, discusses the merits of its own claims. Id. MMS urges that the Board must therefore dismiss ARCO's appeal in regard to any challenge of MMS' assessment concerning this issue. (Answer at 3.)

MMS further claims that it properly required ARCO to conduct a restructured accounting. MMS states that Appellant is incorrect to say that there is no basis for concluding that the alleged errors exist beyond this particular pipeline. (Answer at 3.) Respondent states that while it may be true that audits of Appellant's pipelines after 1989 have not shown accounting errors, "MMS' order required ARCO to conduct the restructured

accounting to the date of MMS' September 27, 1989 order, a period entirely before the audits referenced in ARCO's Statement." (Answer at 3.) MMS claims that because the audits cited by Appellant addressed a later period, their findings are not relevant to the period at issue in this appeal. (Answer at 3-4.) Furthermore, MMS claims, "[b]ased on MMS' audit of the four offshore leases for a three year period and ARCO's admissions, it is unquestionable that ARCO made certain accounting errors." (Answer at 4.) For this reason, MMS argues, it was proper for the Acting Associate Director to place the burden on ARCO to uncover all other instances of a systemic error. Id.

Before addressing the substantive issues posed by this appeal, we find Respondent's claim that Appellant has failed to specifically object to MMS' determination concerning the transportation costs disallowed in the 1997 Decision to be without merit. In expressing its (Vastar's) own view concerning the nature of these charges it incurred to ensure the pipeline was safe to transport hydrocarbons, Vastar has specifically objected to the MMS determination and explained its rationale for including these charges within those costs that should be capitalized and depreciated. This explanation by Appellant with regard to these charges is a direct repudiation of the rationale propounded by MMS in the 1997 Decision. The motion to dismiss is therefore denied.

[1] The Secretary of the Interior is authorized to lease land on the outer continental shelf 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, 108 S. Ct. 2898 (1988). 2/

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, 107 S. Ct. 1593 (1987); Conoco Inc., supra at 240; Texaco, Inc., 104 IBLA 304, 308 (1988); Amoco Production Co., supra at 96. That discretion is tempered only by the standard of reasonableness. Conoco Inc., supra; Texaco Inc., supra at 310. The exercise of Secretarial discretion was governed by the provisions of the royalty valuation regulation

---

2/ The district court decision was vacated for lack of jurisdiction and the case was remanded for transfer to the Claims Court. 815 F.2d at 368.

at 30 C.F.R. § 206.150 (1987), during the time period relevant to this decision. 3/ 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 a majority of like-quality products produced in the area or field; (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.

The cost of transportation of gas to an onshore market has long been recognized to be one of the "relevant matters" taken into consideration when there is no market at the offshore point of production. In the absence of a market for the gas at the wellhead, where production is ordinarily sold and valued, the Board and the courts have upheld a transportation allowance (a deduction from the market value of the gas) for transportation costs from the leasehold to the nearest market. United States v. General Petroleum Corp., 73 F. Supp. 225, 263 (S.D. Cal.), aff'd, Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); TXP Operating Co., 115 IBLA 195, 202 (1990); Conoco, Inc., 109 IBLA 89, 94 (1989); ARCO Oil & Gas Co., 109 IBLA 34, 38 (1989); Shell Oil Co., 52 IBLA 15, 88 I.D. 1 (1981); C & K Petroleum, Inc., 27 IBLA 15 (1976); Kerr-McGee Corp., 22 IBLA 124 (1975); Superior Oil Co., 12 IBLA 212 (1973); Shell Oil Co., 70 I.D. 393 (1963).

The first issue before us is whether the complete charge for 3 days of sandbagging levied against ARCO is a transportation cost incurred by Vastar's predecessor which can reasonably be capitalized and depreciated. We find that it is. These sandbagging expenses were incurred because it was necessary for ARCO to secure the pipeline against water and storm turbulence. From the case file, it is evident that ARCO contracted for this sandbagging operation and there is no evidence ARCO was in a position to control when or how frequently the contractor delivered sandbags nor how quickly the divers placed them over the pipeline. Nor has there been any showing that the schedule carried out was other than reasonable compared

---

3/ This regulation has been superseded. The royalty product valuation regulations at 30 C.F.R. Part 206 Subpart D were extensively amended, effective Mar. 1, 1988. 53 Fed. Reg. 1272-1284 (Jan. 15, 1988). The current regulations specifically provide for transportation allowances and establish procedures for determining those allowances. See 30 C.F.R. §§ 206.156 and 206.157. The current regulations are prospective in effect. 53 Fed. Reg. 1230.

to other instances of sandbagging for other pipeline construction projects. MMS does not dispute the deduction except for the limited periods in which the diving crews were waiting on sandbags. There is no showing by MMS that these were unreasonable delays, and Appellant's predecessor, with no demonstrated ability to control the sandbag delivery schedule, cannot be denied the reasonable cost of the operation, which was not subject to ARCO's control.

Vastar, the party challenging MMS' royalty valuation, has the burden of showing that MMS' determination is erroneous through a showing that these costs were reasonably incurred. It has met that burden. See Mobil Oil Corp., supra; Walter Oil & Gas Corp., supra; Amoco Production Co., 85 IBLA 121 (1985); Amoco Production Co., supra. Thus, the requested transportation allowance for sandbagging must be authorized.

With respect to the $6,210.59 in marker buoy parts denied as a capital depreciation by MMS, this is ultimately a question of fact as to whether these costs were reasonable transportation costs. There can be no doubt that these costs were incurred by Appellant to ensure the security of the pipeline, and not the platforms from which the oil was transported. Thus, if reasonable, they would clearly fall within the category of transportation costs subject to capital depreciation. The parties agree that costs are allowable if they are attributable to an integral part of a transportation system.

Vastar states, and the record supports, that while the contractor was obligated to supply pipeline marker buoys as part of the fixed cost of the pipeline installation, it was not responsible for providing replacement parts. Appellant urges that ARCO purchased extra battery packs and other replacement parts for the buoys as a reasonable transportation expense in order that the buoys could be maintained in good repair.

In this case, the marker buoy system is conceded to be part of the transportation system, as are the pipeline and associated equipment for which a deduction has already been allowed. It is accepted as fact that the marker buoy replacement parts will be required over time. The effect of the equipment on the system has been identified in terms of the security and safety of the pipeline it marks and identifies, and the only question is one of reasonableness. While MMS may not have allocated marker buoy spare parts to a transportation allowance in the past, there is no showing that these are not necessary items integral to, and designed specifically to support an associated transport facility.

The word "integral," used by the MMS rule defining allowable capital costs, is an adjective modifying the phrase "part of the transportation system." "Integral" is defined by The American Heritage Dictionary of the English Language, Houghton Mifflin Company (1976), to mean, "Essential for

completion; necessary to the whole; constituent." Given the facts of this case, it is an inescapable conclusion that the cost of a reasonable number of spare parts was a reasonable expense incurred by ARCO for transportation purposes, and that the marker buoy system is an integral part of the transportation system, the other parts of which have already been approved for allowance by MMS. Under the cited rules and consistent with prior cases cited by both parties, Vastar is entitled to include the cost expended on the marker buoy spare parts as a reasonable actual transportation cost under 30 C.F.R. § 206.157(b)(2) (1988).

Finally, we address the issue of whether MMS may properly require Vastar to review the support for all other ARCO/Vastar-owned pipeline deductions taken from off-shore leases from 1983 to 1989, and to restructure its accounts for the same period. As noted above, Appellant argues that MMS audits of ARCO/Vastar pipeline operations after 1989 have shown no discrepancies.

Vastar's argument asserts that MMS improperly required Appellant to conduct a restructured accounting. Appellant argues that MMS has failed to demonstrate a "pattern" of error in royalty calculation and payment, and is therefore not entitled under the Federal Oil and Gas Royalty Management Act (FOGRMA), 30 U.S.C. § 1713(b) (1994), to require Appellant to conduct a restructured accounting of its records in this matter.

Vastar characterizes the required audit report as unauthorized because "MMS has conducted numerous other lease audits where the production is transported through ARCO/Vastar-owned pipelines and has not taken exception to any portion of the transportation allowance being taken on any of these lines." (SOR at 6.) Appellant cites eight other audits conducted between 1989 and 1992 in support of its contention. Vastar claims that "[a]s no audit exceptions have been issued on any of the pipelines that have been reviewed, MMS has no reasonable basis for believing systemic errors exist in the accounting for these other pipelines." Id.

[2] These arguments lack merit. The authority of the Secretary is broad in discharging his obligation to ensure that lessees comply with their obligation to properly remit revenues to lessors under the terms of leases, regulations, and statutes. See, e.g., 30 U.S.C. § 1701(b) (1994); 30 U.S.C. § 1711(a) and (c) (1994); 30 U.S.C. § 189 (1994); and 25 U.S.C. §§ 396, 396a-396g, and 2101-2108 (1994). More importantly, Vastar's claim misunderstands the nature of the report required: the report is to answer the question (1) whether ARCO, as it did on this pipeline, improperly included lease equipment as an investment cost for the purpose of a deduction, and (2) whether ARCO, as here, changed the life of the pipeline but failed to adjust depreciation accordingly. See 1997 Decision at 2. The investigation to be made is limited to a review of these issues with respect to other ARCO/Vastar pipelines for the period January 1983 through September 1989 based upon discrepancies observed in audits conducted for the period January 1983 through December 1985 on this pipeline, and includes the requirement to pay calculated royalty deficiencies based on this review. (1989 Decision at 4-5.)

The MMS placed the burden of taking corrective action on Appellant only after an audit revealed a systemic pattern of noncompliance by ARCO between 1983 and 1985 on the subject pipeline. See Phillips Petroleum Company v. Lujan, 963 F.2d 1380, 1386 (10th Cir. 1992); Amoco Production Co., supra at 291-92. The MMS, in its 1997 Decision, affirmed the September 1989 MMS letter that directed ARCO to recalculate the transportation authorization on the ARCO/Vastar pipelines during the period in question (1983-89), and to calculate and pay additional royalties owing on account of any unauthorized deductions. This directive is entirely consistent with the "audit and reconciliation" requirements within section 101(c)(1) of FOGRMA.

Section 101(c)(1) of FOGRMA requires the Secretary of the Interior and his delegates to "audit and reconcile, to the extent practicable, all current and past lease accounts for leases of oil or gas." Id. The September 1989 Order issued by MMS and affirmed by the 1997 Decision will require expenditure of some effort by Vastar employees. Vastar must first review ARCO's transportation allowance claims, determine their propriety based upon corrected figures for initial investment costs and claimed useful life of the pipelines in question and then determine whether its royalty payments reflect an accurate assessment based on those corrected transportation allowances. There is nothing, however, in section 101(c)(1) to preclude such an order. Congress, in enacting FOGRMA, sought to incorporate a verification system since the previous honor concept had led to under-reporting of production and sales. See H.R. Rep. No. 859, 97th Cong., 2d. Sess. 15, 16 (1982), reprinted in 1982 U.S.C.C.A.N. 4268-4270. Moreover, the statute does not restrain the Secretary from directing a royalty payor to review royalty accounts in order to uncover underpayments traceable to an identified defect in the payor's original calculation of royalties due. See BHP Petroleum (Americas) Inc., supra at 187.

In two similar cases involving Texaco (Texaco, Inc., 138 IBLA 26 (1997); Texaco, Inc., 138 IBLA 202 (1997)), we previously addressed the issues presented in Vastar's appeal. In Texaco, Inc., 138 IBLA at 26, we approved a review and recalculation ordered by MMS for the period 1981 through 1990, the date of the letter order from MMS. In that case, the audit period extended from 1981 through 1986, and sampling had revealed understatements in the volume of natural gas produced between September 1984 and December 1986. Id. We find the language in that case equally applicable here:

> We further find that FOGRMA does not limit MMS' authority to require Texaco to submit workpapers and schedules demonstrating compliance with the recalculation order. That statute provides that MMS may, in conducting "any investigation * * * require by special * * * order, any person to submit in writing such * * * answers to questions as [MMS] may reasonably prescribe." 30 U.S.C. § 1717(a)(1) (1994). As we noted in Amoco Production Co., 123 IBLA at 285, the purpose of FOGRMA

> was to enhance and expand the investigatory powers of the Secretary and MMS. We conclude that MMS is authorized to require the preparation and submission of the requested documents under 30 U.S.C. § 1717(a)(1) (1994). See Phillips Petroleum Co. v. Lujan, 951 F.2d 257, 260 (10th Cir. 1991); BHP Petroleum (Americas) Inc., 124 IBLA at 189.

Id. at 29.

The evidence discovered by MMS in its 1983-1985 review concerning the four leases related to this pipeline and to errors found in initial investment costs and changes in the estimated useful life of the pipeline, disclosed irregularities that were capable of repetition. See Texaco, Inc., 139 IBLA at 29; Texaco Exploration & Production, Inc., 134 IBLA at 270; Amoco Production Co., 123 IBLA at 294. Thus, ample justification exists for the MMS demand.

To the extent not specifically addressed herein, Vastar's arguments have been considered and rejected.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the decision appealed from is affirmed in part as it relates to the MMS order to conduct a restructured accounting of transportation allowances on other ARCO/Vastar pipelines between January 1983 and September 1989, reversed in part as it relates to disallowance of deductions for sandbagging and spare parts for marker buoys, and remanded to MMS for a recalculation of transportation allowances consistent with this decision.

____
James P. Terry
Administrative Judge

I concur:

____
James L. Byrnes
Chief Administrative Judge