

INTERIOR BOARD OF LAND APPEALS

Seagull Energy Corp.

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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. As explained more *infra*, the holding here involves two sets of regulations, one applicable to pre-March 1988 production and, the other applicable to post-March 1988 production.

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 054-008131-05 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-arm'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 HCO 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

^{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 BCGGS 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