INTERIOR BOARD OF LAND APPEALS

J-W Operating Company, Inc., et al.

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J-W OPERATING COMPANY INC. ET AL.

IBLA 99-306 Decided April 16, 2003

Appeal from the decision of the Associate Director for Policy and Management Improvement, Minerals Management Service, affirming in part a decision of the Royalty Valuation Division, Minerals Management Service. MMS 97-0210-O&G.

Affirmed.

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

Gas produced from Federal leases that is subject only to dehydration and compression is properly valued under the valuation standards for unprocessed gas at 30 CFR 206.152.

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

Gas produced from a Federal lease is not sold pursuant to an arm's length contract where 92.5 percent of the ownership interest in the buying entity is directly or indirectly owned by the lessee and the remaining 7.5 percent is owned by the lessee's brother.

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

Gas produced from Federal leases that is subject to valuation under the standards at 30 CFR 206.152 is properly valued under 30 CFR 206.152(c) when the gas is not sold pursuant to an arm's-length contract. Under that provision, MMS values production by using the gross proceeds accruing to the lessee pursuant to a sale under

its non-arm's-length contract. MMS' decision not to examine "benchmarks" under that provision, viz., the comparability of arm's-length contracts or samples from the area, is not grounds for reversal of its decision, as MMS is required to look beyond gross proceeds via benchmark tests only where comparison to comparable sales data of like-quality gas might provide a higher value for royalty purposes.

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

Gas produced from Federal leases that is properly valued under the standards at 30 CFR 206.152 is properly valued under 30 CFR 206.152(b) when the gas is sold pursuant to an arm's-length contract. MMS properly finds under that provision the value of gas sold under an arm's-length contract is the gross proceeds accruing to the lessee.

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

Costs of dehydration and compression of gas produced from Federal leases must be included in gross proceeds, which, by regulatory definition include, inter alia, payments to the lessee for certain services such as compression and dehydration. Dehydration of gas to meet market specifications for water content and the compression of gas to the pressure required for entry into the buyer's pipeline are not deductible. The payment of rebates by the lessee and the offering of discounted prices to purchasers who perform compression and dehydration services amount to "payments to the lessee" for those services under the regulations.

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

Nothing in 30 CFR 206.151 or its preamble suggests that MMS intended to prevent itself from looking to the subsequent arm's-length sale in determining the lessee's gross proceeds where the reselling entity was not a "marketing affiliate." Unless the reselling entity is a

> market affiliate, MMS is free to consider benchmarks where doing so would increase royalty value above the amount indicated by gross proceeds.

APPEARANCES: Brian S. Tooley, Esq., Mary V. Laitos, Esq., Denver, Colorado, for Appellants; Janet H. Lin, 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

J-W Operating Company, Inc. (J-W Operating or J-W), H. G. Westerman, Carl A. Westerman, and Loyle P. Miller (appellants) have appealed the March 3, 1999, decision of the Associate Director for Policy and Management Improvement (Associate Director), Minerals Management Service (MMS), affirming in part an order of the Royalty Valuation Division (RVD), MMS. The RVD order, dated August 19, 1997, adopted in part an audit of appellants' royalty payments performed by the State of Colorado Tax Auditing and Compliance Division, Department of Revenue (CDOR).

H. G. Westerman, Carl A. Westerman, Loyle P. Miller, and Thomas J. Jeffrey held Federal oil and gas leases in Yuma County, Colorado. Their leases produced natural gas, the valuation of which is at issue in this appeal. J-W Operating (which is wholly owned by H. G. Westerman) was lease operator and designated payor for them.

CDOR performed an audit of royalty payments made by J-W Operating (Payor Code 3144) between January 1, 1990, and December 31, 1994, in accordance with sec. 205 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. § 1735 (2000). (Field Report at 1.) On September 13, 1996, CDOR notified J-W Operating of its preliminary determination that it had underpaid royalties on unprocessed gas produced from the leases in the amount of $62,017.76. J-W challenged CDOR's findings before the RVD, which issued a letter decision and bill for collection to J-W on August 19, 1997, for the reduced amount of $54,699.18. J-W appealed that decision under 30 CFR Part 290, and the Associate Director issued his decision upholding the RVD to the extent of a reduced assessment of $53,557.85, with the caveat that this amount might be further reduced by an appropriate transportation allowance yet to be determined. Appellants appealed the Associate Director's decision to this Board.

The bulk of the underpayment discovered during CDOR's audit resulted from failure to pay royalty on additional value received for gathering, compression, and dehydration of the gas. The deductibility from royalty value of the costs of compression and dehydration is at issue in the present appeal.

From January 1, 1990, through March 31, 1994, J-W sold gas produced from the leases to Kansas-Nebraska Energy Company (K-N Energy or K-N), an interstate gas company:

> During the entire MMS audit period of January 1, 1990, through December 31, 1994, the Appellants sold gas to [K-N Energy] under contracts numbers P-4176 and P-4201 dated January 25, 1977, and Amended and Restated contract P-4176 dated July 1, 1988. Under these contracts, [K-N Energy] purchased gas from 230 wells. Gas from 179 of those wells was purchased at the wellhead, and gas from the remaining 51 wells was purchased at a delivery point located off the leased acreage. * * * Gas purchased by [K-N Energy] at the wellhead was required to be delivered at a gathering line pressure of 800 PSIG. If the gas did not meet that pressure requirement, the Appellant was required to reimburse [K-N Energy] from 2 to 7 cents per Mcf depending on the pressure. Gas required to be delivered at a central delivery point off the lease was to be delivered at a pressure up to, but not greater than, 850 PSIG. 1/

(Decision at 1-2 (references omitted).) MMS also found that,

> [d]uring the period April 1, 1991, through December 31, 1994, the Appellants sold lease production to Williams Gas Marketing Company (Williams Gas Marketing). For these sales, the Appellants transferred lease production at the wellhead to [Yuma Gathering System (YGS) 2/], which gathered, dehydrated, and compressed that production and delivered it to Williams Gas Marketing. Williams Gas Marketing paid the Appellants the index price posted for Williams Natural Gas Company under “Prices of Spot Gas Delivered to Pipelines in Inside FERC Gas Market Report” * * * less one cent. YGS provided gathering, dehydration, and compression services at a contract rate of $0.69 per MMBTU.

1/ It is not clear whether the gas delivered to the central delivery point was subject to the contractual term that imposed the rebate for uncompressed gas, or whether the lessees instead compressed the gas to the required pressure themselves.

2/ YGS is a joint venture closely held by appellants: J-W Gathering owned 50 percent of YGS, H. G. Westerman owned 42.7 percent of YGS, and Carl A. Westerman owned the remaining 7.5 percent. J-W Gathering Company is a wholly-owned subsidiary of J-W Operating, which was in turn wholly-owned by H. G. Westerman. Thus, H. G. Westerman in effect owned 92.5 percent of YGS, and his brother Carl A. Westerman owned the remaining 7.5 percent.

(Decision at 2 (reference omitted).) Finally, the Associate Director found that,

> [d]uring the period January 1, 1990, through March 31, 1991, the Appellants also sold lease production at the wellhead to YGS and received a price which was essentially the price paid to YGS by Williams Natural Gas less $0.50 per Mcf that was attributable to the gathering, dehydration, and compression performed by YGS.

(Decision at 2.)

The Associate Director addressed whether appellants had erroneously deducted from royalty value costs that are non-deductible, concluding that they should have included in that value the cost of compressing and dehydrating that production. Applying the "marketable condition" analysis, he found that appellants were, in each case cited, required by contract to provide gas that had (either immediately or eventually) to be compressed and dehydrated. Further, he found that, by accepting a deduction in price, appellants had effectively paid YGS $0.50 per Mcf for gas gathering, dehydration, and compression services with respect to gas sold to Williams Natural Gas, and $0.69 per MMBTU with respect to gas sold to Williams Gas Marketing Company; and that, by accepting a penalty of 2 to 7 cents per Mcf (depending on the pressure of the delivered gas), the appellants had effectively reimbursed KN for the cost of compressing the gas that KN purchased from the appellants. (Decision at 6-7).

The Associate Director considered whether, as a result of the requirement that lessees place production from Federal leases into marketable condition at no cost to the Government, royalty was due to the Government on the value of the gas appellants produced, including the cost of gathering, dehydrating, and compressing it for sale. He analyzed the question of whether J-W had undervalued lease production by failing to calculate its royalty payments based on the sales price plus the costs of gathering, dehydration, and compression. Citing Departmental regulation 30 CFR 206.151 and pertinent case law, he held: "It is well settled that activities necessary to place production from a Federal lease in marketable condition must be performed at no cost to the lessor"; and that "[i]t has generally been held that the costs of gathering, dehydration, and compression of gas produced on a federal lease are costs associated with placing the gas in marketable condition and, thus, may not be deducted when computing the royalty value against which the royalty rate is applied." (Decision at 4.) His decision indicated that, although "[e]xceptions to this rule have occasionally been recognized where it is found that such activities are, in a particular case, related to transportation rather than conditioning the production for the market," no exception exists for "accepting a reduction in the sales price" and paying a third party to condition lease production for the market. (Id.)

With regard to J-W's defense that a third party performed the conditioning, the Associate Director held:

> In the instant case, it is not disputed that a related third party, YGS, is performing gathering, compression, and dehydration for the Appellants. However, the Appellants argue that the services performed by YGS should not be treated as costs associated with placing that production in marketable condition because the lease production is in marketable condition at the wellhead; and the services performed by YGS are related to transportation, not marketing.

(Decision at 5.) The Associate Director rejected J-W's assertions that the lease production is marketable at the wellhead and is not required to be conditioned at the wellhead. He found that domestic and agricultural uses for the gas from the wellhead are "nominal"; 3/ that "total wellhead demand is limited by the lack of residential and industrial users in the area in which the field is located, and that the dominant market for the gas is out of state, i.e., in Kansas and Nebraska" (Id.); and that "[t]he purchasers who are reselling the gas in other states (KN, Williams) require that the gas be properly conditioned for sale in these distant markets." (Decision at 6.) He found that gas sold at the wellhead to K-N, YGS, and Williams was required, as a condition of sale, to be dehydrated and compressed. (Id.) He concluded that "the State did not err in finding that, for purposes of sales to [K-N Energy] and Williams, the Appellants' gas required compression and additional dehydration and was not, therefore, in marketable condition at the wellhead." (Decision at 7.)

The Associate Director rejected appellants' argument that, because title passed at the well, royalty must be based on the value at the well, holding that, even though producer and purchaser may have agreed that title passed at the wellhead, this agreement was not conclusive "for purposes of laws extrinsic to the contract." (Id.) Citing Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225, 233 (5th Cir. 1984), cert. denied, 471 U.S. 1005 (1985), he held that "[w]here the seller bears the cost of conditioning that occurs after title passes at the well, the gas is not being 'sold at the well.'" (Id.) Pointing to appellants' assertions that gas is marketed by appellants and not YGS, the Associate Director also rejected the contention that YGS is the primary market (so that sales to Williams and K-N are therefore secondary) and held instead that Williams and K-N, "as major purchasers, provided the primary market for the field/area, and YGS served as a conduit to that market." (Decision at 8.)

3/ CDOR found that only "small portions" of gas was being used by the landowners, and that it came from only 19 wells out of the over 300 producing wells in the area. (Field Report at 4.)

The Associate Director also rejected the argument that, in the case of sales to K-N Energy, the price deduction taken by appellants was not a reimbursement to the purchaser for compression, but was simply the price paid for lower pressure gas:

> [T]he Appellant has offered no explanation as to why, apart from its lack of compatibility with the pressure level of the gathering system, the pressure of the gas should result in a reduction in price. Moreover, the Appellant has provided no supporting evidence that the gas, as it came from the nine wells [where Appellants reimbursed K-N for costs associated with the failure of the gas to meet minimum pressure requirements set forth in the K-N contract], was of sufficient pressure to enter the subject gathering system.

(Decision at 9.)

The Associate Director conceded that a portion of those fees related to movement of production beyond the BLM-approved point of measurement at the lease meter were properly attributable to transportation. (Decision at 10.) He accordingly allowed appellants the opportunity to submit to MMS a proposed apportionment of the $0.69 fee paid to YGS between (1) deductible transportation and (2) non-deductible costs incurred to place the gas in marketable condition. (Decision at 11.) We consider in the present appeal the correctness of the Associate Director's decision declaring certain of the costs non-deductible. 4/

In their statement of reasons before us on appeal (SOR), appellants raise many of the arguments they advanced before the Assistant Director. 5/ They contend that the Assistant Director erred in finding that the gas was not in marketable condition at the wellhead, that compression expenses were not related to placing the gas in marketable condition but to transporting the gas, and that the marketable condition rule does not require the lessee to condition the gas so that it is suitable for secondary markets. (SOR at 14-20.) Appellants continue to challenge the audit to the extent

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4/ Thus, although the Associate Director rejected appellants' argument that "compression and dehydration of the gas was for the express purpose of transporting that gas to the point of sale" (Decision at 9), he determined that "a portion of the fees at issue in this appeal which relate to the movement of production beyond the BLM-approved point of measurement at the lease meter are, consistent with the MMS Payor Handbook, properly attributable to transportation." (Decision at 10.) That portion of his decision is not presently under appeal.

5/ Appellants have not further appealed the Associate Director's ruling on whether they failed to pay royalties on their "proportionate share of production from communitized properties." (Decision at 4.)

that it measures the value of the gas sold by appellants by "the price received in downstream sales by an affiliate" (SOR at 2), instead of by applying the "benchmark regulations [found at 30 CFR 206.152(c)(1)] in determining the value of gas sold by appellants, H.G. Westerman and Carl Westerman, to YGS." (SOR at 23-32.)

[1] Appellants indicate that the gas produced from these leases requires no treatment. 6/ Although the record does shows that the production was subject to dehydration and compression, these functions are expressly excluded from the regulatory definition of "processing." See 30 CFR 206.151. Gas produced from these leases has not been otherwise subjected to "processing" within the meaning of this definition and was therefore "not processed" within the meaning of 30 CFR 206.152(a)(1) (1995). 7/ Accordingly, production from these leases must be valued under the valuation standards for unprocessed gas at 30 CFR 206.152, which apply "to the valuation of all gas that is not processed." 30 CFR 206.152(a)(1) (1995). Under 30 CFR 206.152(a)(2) (1995), "[t]he value of production, for royalty purposes, of gas subject to this subpart shall be the value of gas determined pursuant to this section less applicable allowances determined pursuant to this subpart."

[2] We affirm MMS' implicit finding that gas was sold to YGS under non-arm's-length contracts. Departmental regulations define "arm's-length contact" as follows:

> *Arm's-length contract* means a contract or agreement that has been arrived at in the marketplace between independent, nonaffiliated persons with opposing economic interests regarding that contract. For purposes of this subpart, two persons are affiliated if one person controls, is controlled by, or is under common control with another person. For purposes of this subpart, based on the instruments of ownership of the voting securities of an entity, or based on other forms of ownership:
>
> (a) Ownership in excess of 50 percent constitutes control;

6/ Appellants state:

"The gas at issue is 'dry' sweet gas as it is produced from the mouth of the well. It is not processed. It is not treated. It has been used straight from the mouth of the well by local landowners for domestic, agricultural and commercial use without any processing, treating or conditioning for many years."
(SOR at 2; see SOR at 5-6.)

7/ CDOR's audit was completed in September 1996 and reviewed royalty payments through Dec. 31, 1994. Accordingly, to the extent that its terms have been amended, we will look to the provisions of 30 CFR Part 206 in effect on July 1, 1995.

> (b) Ownership of 10 through 50 percent creates a presumption of control; and
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> (c) Ownership of less than 10 percent creates a presumption of noncontrol which MMS may rebut if it demonstrates actual or legal control, including the existence of interlocking directorates.
>
> Notwithstanding any other provisions of this subpart, contracts between relatives, either by blood or by marriage, are not arm's-length contracts. The MMS may require the lessee to certify ownership control. To be considered arm's-length for any production month, a contract must meet the requirements of this definition for that production month as well as when the contract was executed.

30 CFR 206.151 (1995).

The record shows that 92.5 percent of the interests in YGS was owned by H. G. Westerman, who also owned 100 percent of J-W Operating and J-W Gathering. See 30 CFR 206.151(a). The remaining 7.5 percent of the interests in YGS was owned by Carl Westerman, H. G. Westerman's brother and, hence, "relative" under this definition. See 30 CFR 206.151(c). It is thus clear that any gas sold by lessees H. G. Westerman and Carl Westerman to J-W Operating, J-W Gathering, or YGS was not sold pursuant to "arm's-length contract."

[3] Under 30 CFR 206.152(c) (1995),

> [t]he value of gas subject to this section which is not sold pursuant to an arm's-length contract shall be the reasonable value determined in accordance with the first applicable of the following methods:
>
> (1) 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 same area). In evaluating the comparability of arm's-length contracts for the purposes of these regulations, the following factors shall be considered: price, time of execution, duration, market or markets served, terms, quality of gas, volume, and such other factors as may be appropriate to reflect the value of the gas[.]

Accordingly, MMS properly examined the gross proceeds accruing to lessees H. G. Westerman and Carl Westerman under that provision.

Appellants point to MMS' alleged failure to examine "benchmarks" under that provision, viz., the comparability of arm's-length contracts or samples from the area. It is not immediately clear from the record that CDOR or MMS made an extended survey of the market in the area. Although royalty value may be greater than gross proceeds, it can never be less. The regulations expressly so dictate: "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." 30 CFR 206.152(h) (1995). It is well established that MMS need look beyond the gross proceeds via benchmark tests only where comparison to comparable sales data of like-quality gas might provide a higher value for royalty purposes:

> The purpose of [30 CFR] 206.102(h) is to make clear that no matter what valuation method is used, the value for royalty purposes cannot be less than the lessee's gross proceeds less applicable allowances. Therefore, if a benchmark[-]derived value less applicable allowances is less than gross proceeds less applicable allowances, gross proceeds less applicable allowances is to be used as the value for royalty purposes.

52 FR 30826; 30843-44 (Aug. 17, 1987), cited with approval in Shell Oil Co. (On Reconsideration), 132 IBLA 354, 356 (1995). 8/

[4] The regulation at 30 CFR 206.156(b)(1) (1995), governing sales of production under arm's-length contracts, provided:

> The value of gas sold under an arm's-length contract is the gross proceeds accruing to the lessee except as provided in paragraphs

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8/ Of course, in order to make an informed decision regarding whether using the gross proceeds to establish royalty value would result in too low a royalty, MMS or a State agency must refer to these benchmarks to see if such data indicates that a higher value is appropriate. We do not imply otherwise.

However, it is clear that reference to comparable arm's-length contracts for purchases, sales, or other dispositions of like-quality gas in the same field or obtaining a reasonable sample from the same area could only result in an increase in the value utilized for determining royalty. In the absence of a showing that royalty due the United States is being understated by utilizing gross proceeds as royalty value, we decline to reopen the question at this late date.

> (b)(1)(ii) and (iii) of this section. The lessee shall have the burden of demonstrating that its contract is arm's-length.

Although appellant Loyle P. Miller has made no affirmative showing that his contract was at arm's-length, as apparently required by 30 CFR 206.152(b)(1) (1995), the record indicates that he sold gas, in all relevant transactions, pursuant to arm's-length contracts. 9/ Accordingly, determination of value of that gas for purposes of determining royalty is governed by that provision. Again, the value of gas for royalty purposes shall never be less than the gross proceeds accruing to the lessee. 30 CFR 206.152(h) (1995). Accordingly, MMS properly examined the gross proceeds from all relevant sales here. 10/

In sum, since the controlling question is the amount of the gross proceeds of the lessees' own sales, the only relevant fact in both Miller's and the other appellants' situations is that they, as lessees, excluded or deducted gas dehydration and compression costs in calculating the gross proceeds from which royalty value was determined. Since the gross proceeds from their actual sales determined royalty value here, we need not examine other contracts in the field or region at appellants' request.

[5] MMS correctly required the inclusion of costs of dehydration and compression here: It is well established those costs must be included in gross proceeds. Under the regulations, "*[g]ross proceeds* (for royalty payment purposes) means the total monies and other consideration accruing to an oil and gas lessee for the disposition of the unprocessed gas, residue gas, or gas plant products produced"; "[g]ross proceeds includes, but is not limited to, payments to the lessee for certain services such as compression, dehydration, measurement, and/or field gathering to

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9/ The exceptions provided by the regulation address circumstances where the arm's-length contract does not, in fact, reflect "the total consideration actually transferred either directly or indirectly from the buyer to the seller" (30 CFR 206.152(b)(1)(ii) (1995)) and where "the gross proceeds accruing to the lessee pursuant to an arm's-length contract do not reflect the reasonable value of the production because of misconduct by or between the contracting parties, or because the lessee otherwise has breached its duty to the lessor to market the production for the mutual benefit of the lessee and the lessor." 30 CFR 206.152(b)(1)(iii) (1995). Apart from the question whether it was necessary to compress and dehydrate the gas to place it in marketable condition, these circumstances are not presented herein.

10/ We note that, even assuming arguendo that appellants could avoid the applicability of the non-arm's-length contract valuation provision (30 CFR 206.152(c)(1)), the result herein would be the same, because valuation would still be based on gross proceeds

the extent that the lessee is obligated to perform them at no cost to the Federal Government * * * ." 30 CFR 206.151 (1995). The offering of rebates or deductions to purchasers who perform compression and dehydration services amounts to "payments to the lessee" under the regulation. Further, it has been held repeatedly that the dehydration of gas to meet market specifications for water content and the compression of gas to the pressure required for entry into the buyer's pipeline are not deductible. Anson Co., 145 IBLA 221, 226 (1998); Mobil Oil Corp., 108 IBLA 216 (1989); The California Co., 66 I.D. 54 (1959), aff'd, California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961); The Texas Co., 64 I.D. 76, 79 (1957); see also Mesa Operating Limited Partnership v. USDI, 931 F.2d 318, 320 (5th Cir. 1991), cert. denied, 502 U.S. 1058 (1992).

The basis for these holdings is the underlying principle (dealt with at length in the Associate Director's decision) that a Federal lessee must ordinarily bear the costs of placing produced gas in marketable condition at no cost to the Government and may not deduct those costs from royalty value. 30 CFR 206.152(i) and 206.153(i), 43 CFR 3162.7-1(a); California Co. v. Udall, supra. The costs of placing gas in marketable condition include compressing and dehydrating the gas. 11/ R. E. Yarbrough & Co., 122 IBLA 217, 221 (1993). Where, as here, the royalty value is determined by a lessee's gross proceeds, that value will be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing services the cost of which ordinarily is part of the lessee's responsibility to place the gas in marketable condition or to market the gas. 30 CFR 206.152(i) and 206.152(j); Mesa Operating Limited Partnership v. USDI, 931 F.2d

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11/ In R. E. Yarbrough, supra, we considered a sales arrangement similar to the ones at issue here. Yarbrough sold its gas production to Natural Gas Operations Company (NGO), which maintained a low pressure gas gathering system. NGO gathered the gas and dehydrated and compressed it, which was necessary to permit the gas to be marketed in a standard high pressure gas pipeline, and thereafter sold it to a third party. Like appellants' price, the price NGO paid Yarbrough was the price paid by a third party purchaser, less NGO's gathering, compression and dehydration costs. Yarbrough argued that the gas was in marketable condition when sold to NGO, since Yarbrough was unable to sell its gas directly to a standard high pressure pipeline because there was no connection available. Like appellants here, Yarbrough's price was determined by a further sale after NGO conditioned the gas for market, leading us to conclude that the gas had not been placed in marketable condition until NGO did so on Yarbrough's behalf. The same conclusion must be reached here, as appellants do not dispute that the production involved here was unprocessed gas sold at the wellhead.

318 (5th Cir. 1991), cert. denied, 502 U.S. 1058 (1992); R. E. Yarbrough & Co., supra; see ARCO Oil & Gas Co., 112 IBLA 8 (1989). 12/

Costs of compression and dehydration of gas produced from Federal leases are not deductible from "gross proceeds" under the regulations for royalty payment purposes. Accordingly, we affirm MMS' conclusion that the costs of dehydrating and compressing the gas must be added to the price received by lessees for the sale of the gas under 30 CFR 206.152(i) (1995).

[6] Appellants make a technical argument based on the fact that YGS arguably falls outside the definition of "marketing affiliate" under the regulations. The regulations provide: "*Marketing affiliate* means an affiliate of the lessee whose

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12/ That term is defined as follows in the regulations: "*Marketable condition* means lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area." 30 CFR 206.151 (1995). Appellants assert that the gas produced from these leases is in marketable condition, within this definition, at the wellhead, and that dehydration and compression are not required to place it into marketable condition. They assert that MMS violated that regulation because it "did not consider what sales contracts were typical for the field or area" and "never attempted to determine whether it was typical for producers to sell gas at the well without compression or dehydration." (SOR at 14-15.)

The costs of dehydrating and compressing produced gas are, by regulation, properly included in royalty basis. They can accordingly be seen as having been declared, by regulation, as costs necessary to place gas into marketable condition. Even assuming arguendo that evidence were needed to establish that dehydrating and compressing the gas are required to place gas from these specific leases into marketable condition, we would conclude that the present record contains such evidence. Appellants present only evidence of limited sales of gas straight from the wellhead to local domestic and agricultural users. MMS rightly discounted those sales as "nominal." Further, we hold, it is necessary only to look to the terms of the sales contracts between Carl A. Westerman and H. G. Westerman (sellers) and YGA (buyer) to confirm that compression and dehydration were necessary to place production from their wells in marketable condition, which state: "Whereas, such quantities of gas must be gathered, dehydrated and compressed for redelivery to BUYER or BUYER's agent." (Gas Gathering, Dehydration and Compression Contract By and Between [YGS] "GATHERER" and Carl A. Westerman "SELLER" dated Apr. 1, 1991, at 1; Gas Gathering, Dehydration and Compression Contract By and Between [YGS] "GATHERER" and H. G. Westerman "SELLER" dated Apr. 1, 1991 at 1). The contract between Thomas J. Jeffrey and K-N Energy corroborates the fact that gas had to be dehydrated and compressed before being introduced into K-N's line. (Contract dated July 1, 1988, at Art. V Secs. 1 and 2.)

function is to acquire only the lessee's production and to market that production." 30 CFR 206.151 (1995). YGS is not a marketing affiliate, appellants maintain, because, even though it is an affiliate of some of the lessees here, its function is not limited to acquiring those affiliated lessees' production. The record confirms that YGS' function is not "to acquire only the lessee's production." Thus, we can agree that YGS is apparently not a "marketing affiliate."

However, a party's status as a "marketing affiliate" is relevant only to the provisions of 30 CFR 206.152(b)(1)(i):

> The value of gas sold under an arm's-length contract is the gross proceeds accruing to the lessee except as provided in paragraphs (b)(1)(ii), (iii), and (iv) of this section. * * * For purposes of this section, gas which is sold or otherwise transferred to the lessee's marketing affiliate and then sold by the marketing affiliate pursuant to an arm's-length contract shall be valued in accordance with this paragraph based upon the sale by the marketing affiliate. * * * .

(Emphasis supplied.) Appellants argue that this provision means that MMS may consider the price received by an entity which sells gas on behalf of a lessee only if that entity is a "market affiliate." Since YGS was not a "market affiliate," appellants maintain that MMS was not bound to value production in accordance with the price YGS received when it sold the production.

Appellants misread this provision, which was promulgated to cover a specific circumstance not presented in this matter. Specifically, as the regulation states, where a lessee sells or otherwise transfers production to an entity that is closely and exclusively tied to it (a "market affiliate"), and where that "market affiliate" entity resells the production pursuant to an arm's-length contract, MMS may not consider the benchmarks, but must instead accept the "market affiliate" entity's proceeds as evidence of an arm's length sale and value the production under the terms of that regulation. 13/ Since YGS is not a "market affiliate," this provision simply does not apply to it. Nothing in the rule or preamble suggests that MMS intended to prevent

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13/ MMS added the language in response to industry objections to MMS' use of benchmarks to value oil production in cases where a lessee transferred its production to an affiliate entity that did not buy from any other source and where the affiliate entity then sold the production to third parties pursuant to arm's-length contracts. Industry wished to ensure that lessees who were in these limited circumstances, which approximate[s] an agency relationship between lessee and its affiliate entity, were treated the same as lessees who sold their production themselves pursuant to arm's-length contracts. See 53 FR 1189, 1196, 1198-99 (Jan. 15, 1988), 52 FR 30826, 30841 (Aug. 17, 1987).

itself from looking to the subsequent arm's-length sale in determining the lessee's gross proceeds where the reselling entity was not a "marketing affiliate." Further, unless the reselling entity is a market affiliate, MMS is free to consider benchmarks where doing so would increase royalty value above the amount indicated by gross proceeds. See Texaco Exploration and Production Inc., MMS-92-0306-O&G (May 18, 1999). 14/

On April 5, 2000, appellants submitted to the Board a copy of Independent Petroleum Ass'n of America v. Armstrong et al. (IPAA v. Armstrong), 91 F. Supp. 2d 117 (D.D.C. 2000), in which the Court struck down 1996 amendments to the royalty valuation regulations. Appellants contend that "this decision is relevant and persuasive authority on the issues presently pending before the * * * Board" and request that we take it into account in our ruling. That decision was subsequently appealed to the D.C. Circuit. During the pendency of that appeal, we suspended consideration of the instant matter. On February 8, 2002, the D.C. Circuit reversed the District Court's decision insofar as it concerned "the deductibility of marketing costs." Independent Petroleum Ass'n of America v. deWitt et al., 279 F.3d 1036, 1039 (D.C. Cir. 2002), cert. denied, ___ U.S. ___ (Jan. 13, 2003.) The Circuit Court generally affirmed the well-established and long-standing principle that a Federal lessee is required to market production at no cost to the lessor. Id. at 1041.

Appellants have also recently raised the question whether the Tenth Circuit's ruling in OXY USA, Inc. v. Babbitt, 268 F.3d 1001 (10th Cir. 2001), concerning the applicability of the 6-year statute of limitations set forth in 28 U.S.C. § 2415(a) applies to MMS orders directing oil and gas lessees to pay additional royalties. (Appellant's Supplemental SOR filed Jan. 11, 2002, at 1.) We adhere to the principle set forth in a long line of cases holding that, because appeals to the MMS Directorate and IBLA are administrative appeals, the statutory bar is inapplicable. See, e.g., Anadarko Petroluem Corp., 122 IBLA 141 (1992); BHP Petroleum (Americas) Inc., 124 IBLA 185 (1992).

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

14/ As discussed supra at n.8, we find no basis to reopen this matter to examine benchmarks in order to determine whether appellants, as non-market affiliates of YGS, might be liable for additional royalties.

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.

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David L. Hughes
Administrative Judge

I concur:

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T. Britt Price
Administrative Judge