INTERIOR BOARD OF LAND APPEALS

Tom Brown, Inc.

162 IBLA 227 (July 27, 2004)

Title page added by:
ibiadecisions.com

TOM BROWN, INC.

IBLA 98-426 Decided July 27, 2004

Appeal from a decision of the Deputy Commissioner of Indian Affairs, Bureau of Indian Affairs, affirming an order to pay additional royalties for production of gas from certain Indian gas leases during a specified period and to audit and recalculate royalties for other months of lease production from the same leases. MMS-97-0138-IND.

Decision vacated; motion to remand granted.

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

A lessee's marketing affiliate which exclusively sells gas produced by its lessee affiliate is properly distinguished from an affiliated firm which sells gas produced by several non-affiliated producers purchased under arm's-length contracts as well as gas produced by the lessee purchased under a non-arm's-length contract. Under the regulation at 30 CFR 206.152(c) (1991), gas sold to an affiliated firm which is not a marketing affiliate, pursuant to a non-arm's-length contract, is properly valued on the basis of the first applicable bench mark under the regulation.

APPEARANCES: Charles D. Tetrault, Esq., and Virginia N. Brooks, Washington, D.C., for appellant Tom Brown, Inc.; and Howard W. Chalker, Esq., Office of the Solicitor, Department of the Interior, Washington, D.C., for Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE GRANT

At issue here is a June 16, 1998, decision of the Deputy Commissioner for Indian Affairs, Bureau of Indian Affairs, denying an appeal by Tom Brown, Inc. (TBI)

of an order issued by Minerals Management Service (MMS). [1] Consideration of this appeal was previously stayed by Order of the Board dated December 21, 2000, finding it was probable that the pending appeal of a judicial decision [2] would have a significant impact on resolution of the present case. After that litigation was concluded, MMS notified the Board of a more recent decision on judicial review, Fina Oil and Chemical Co. v. Norton (Fina), 332 F.3d 672 (D.C. Cir. 2003), rev'g Fina v. Norton, 209 F. Supp. 2d 246 (D.D.C. 2002), aff'g Fina Oil & Chemical Co., 149 IBLA 168 (1999), asserted to be controlling in this case. MMS now moves the Board to rescind our stay of consideration and remand this matter for resolution in accordance with the decision in Fina. TBI opposes the Motion for Remand, asserting that the information necessary for resolving this case is before the Board. TBI further suggests that, if the matter is to be remanded, the decision under appeal should first be vacated in accordance with the Fina decision.

This case concerns a dispute over the proper method of valuing produced gas for the purpose of determining royalty payments. By way of factual background, TBI, an oil and gas producer, is the lease operator and royalty payor for Shoshone and Arapaho Indian Oil and Gas Leases 535-003568-0 and 535-006300-0, located in the Muddy Range and Pavillion Fields of the Wind River Reservation, Wyoming. There are other lessees producing natural gas from these fields. During the period from February 1, 1991, through December 31, 1995, RETEX Gathering Company, Inc. (RETEX), a wholly-owned subsidiary of TBI, purchased all of TBI's production from these leases and resold it to unaffiliated purchasers for a higher price. After scrutinizing this arrangement and auditing the relevant time period, MMS issued an order on May 30, 1997, directing TBI to (1) pay $237,982.14 in additional royalties for production from these leases, (2) calculate and pay additional royalties for production months not listed in the order, and (3) calculate and pay additional royalties for other similarly affected leases. MMS grounded its order to pay on a failure by TBI to value royalties based on the "gross proceeds" RETEX received on resale of the production, concluding that gross proceeds accruing to TBI included the prices received by RETEX when it sold the gas to third parties in arm's-length transactions.

TBI appealed the order pursuant to 30 CFR Subpart 290. In response, the Dallas Compliance Division, MMS, prepared a field report containing conclusions and

---

[1] Where an MMS order involves Indian leases, the Deputy Commissioner of Indian Affairs will exercise the review function normally vested in the MMS Director. 30 CFR 290.6 (1997); see also 30 CFR 290.105(g) (1999).

[2] Independent Petroleum Association of America (IPAA) v. Armstrong, 91 F. Supp. 2d 117 (D.D.C. 2000), aff'd in part and reversed in part, IPAA v. DeWitt, 279 F.3d 1036 (D.C. Cir. 2002).

recommendations in this matter. Two reasons in particular for reevaluating TBI's royalty obligation were asserted: It is proper to look to the arm's-length sales price of a non-lessee affiliate when applying the regulations establishing "gross proceeds" and TBI's sales price to RETEX did not properly account for marketing costs. The Deputy Commissioner declined to apply the bench mark standard applicable to gas sold under a non-arm's length contract pursuant to the regulation at 30 CFR 206.152(c) (1991).[3/] Rather, she held that valuation for royalty purposes is governed by the regulatory mandate that "under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee." 30 CFR 206.152(h). Thus, she found:

> It is evident from the facts of this case that [TBI] and RETEX are an integrated enterprise engaged in the production and marketing of gas. Insofar as this is so, it was reasonable for MMS to conclude that the proceeds that enterprise receives in selling gas on the open market is the true measure of the gross proceeds from the disposition of production.
>
> Therefore, for the reasons stated above, I conclude that MMS did not err in finding that the difference between the price(s) received by [TBI] from RETEX and the price(s) RETEX received from nonaffiliated third parties reflected a deduction for costs incurred by RETEX in marketing the lease production, and that such costs must be added to [TBI's] gross proceeds for royalty purposes.

(June 16, 1998, Decision at 4-5.)

On appeal to the Board, TBI contends that the value of production in this case is properly determined by the competitive market price RETEX pays TBI. It explains that RETEX was created to gather, transport, and market gas purchased from various producers. Beginning in November 1992, RETEX began to purchase gas from various other unaffiliated companies producing in the same field as the subject leases. TBI alleges that RETEX followed a set pattern, negotiating with unaffiliated producers for gas sales from the same field and then offering the same contract price and terms to TBI. Thus, according to TBI, RETEX paid it a price that was identical to the price paid to numerous unaffiliated producers in the same field for like-quality gas. Referencing 30 CFR 206.152(c)(1), TBI argues that under MMS' regulations valuation of production for royalty purposes must follow a prioritized bench mark system in this case as gas is not sold pursuant to an arm's-length agreement. TBI

[3/] Unless otherwise indicated herein, citations are to the regulations in effect in 1991 at the beginning of the audit period.

contends that the first bench mark is applicable here, i.e., the gross proceeds accruing to the lessee are equivalent to the gross proceeds derived from comparable arm's-length contracts for sales of like-quality gas in the same field.

In its answer, MMS argues that the "gross proceeds" rule in 30 CFR 206.152(h) required it to look beyond the inter-affiliate transaction to determine the value of production. Noting that RETEX received higher prices than the price it paid TBI and asserting that TBI could have obtained the same price without going through RETEX, MMS argues that the proceeds received by the wholly-owned "marketer" on the open market is the true measure of the gross proceeds from the disposition of the production from these leases. MMS contends that it was proper to ignore the first bench mark observed by TBI because MMS is bound by the gross proceeds rule to value production at the higher first arm's-length transaction. MMS further asserts that TBI's other arguments go against established Departmental precedent.

Thus, the question presented in this appeal is whether the lessee under an Indian oil and gas lease who sells lease production to an affiliate under a contract which is for all practical purposes identical to the contract under which the affiliate purchases gas produced in the same field from other unaffiliated producers is per se required to use the affiliate's downstream resale price as a basis for determining value for royalty purposes. As MMS now recognizes in its motion for a remand, the Fina litigation is controlling in the context of this appeal.

In Fina, the district court noted:

> The regulations provide several methods for calculating the value of natural gas depending on the nature of the sale from the lessee to the purchaser. Under the first valuation method, if a lessee produces gas which it then sells to a purchaser pursuant to an arm's-length transaction, the "value of gas sold under an arm's-length contract is the gross proceeds accruing to a lessee * * *." [30 CFR 206.152(b)(1)(i).] The term "gross proceeds" is defined as "the total monies and other consideration accruing to an oil and gas lessee for the disposition of the gas * * *." [30 CFR 206.151.] This method is known as the "gross proceeds rule."
>
> While the regulations rely primarily on the marketplace to establish the value of production, Interior recognized that not all gas sales are made pursuant to arm's-length transactions. Many natural gas producers have wholly-owned or partially-owned affiliates to which they sell gas. According to the regulations, arm's-length contracts are limited to contracts between non-affiliated parties. See [30 CFR

> 206.151] (defining "arm's-length contract" as a contract "between independent, non-affiliated persons with opposing economic interests regarding the contract"). Thus, by definition, transactions between two affiliated companies, such as a parent and its wholly-owned subsidiary, are non-arm's-length transactions. Because non-arm's-length contract prices may not represent true market value, the regulations provide an alternative method for calculating value when gas is not sold at arm's length. See [30 CFR 206.152(c).] For non-arm's-length sales, value is determined according to the first applicable of three prioritized valuation methods, or benchmarks. The benchmarks are prioritized in the sense that if the first benchmark is found applicable it is used to calculate value without considering the other two benchmarks. If the first benchmark is not applicable then the second benchmark is used, unless it is also inapplicable, in which case the third benchmark is used.

Fina Oil and Chemical Co. v. Norton, 209 F. Supp. 2d at 248.

In the Fina case MMS determined that the lessee, Fina Oil and Chemical Co., was selling gas produced from a Federal lease to an affiliate, Fina Natural Gas Company (FNGC), at a non-arm's-length price and that the affiliate was reselling the gas at a higher price. In reviewing the record on appeal, the circuit court noted:

> [FNGC] is a natural gas marketer that purchases gas from producers for resale to downstream end users. Though controlled by Fina, FNGC is not a "marketing affiliate" because it purchases gas from both Fina and other gas producers.[4/] Fina therefore paid royalties based on its contract price with FNGC–a price which, according to Fina, complies with the first benchmark or, if the first benchmark is inapplicable, with the second.
>
> In 1993, the MMS issued an order rejecting Fina's use of the benchmarks, requiring Fina instead to base its royalty valuation on the higher prices that FNGC receives from subsequent downstream arm's-length sales. Fina appealed [the Associate Director's affirmation of the order] to the Interior Board of Land Appeals but while that appeal was pending, the Board decided Seagull Energy Corp., [148 IBLA 300 (1999)], which reversed an MMS order substantially similar to the order in Fina's case and squarely rejected MMS's position that gas sold

---

4/ As noted by the court, 332 F.3d at 674, the term marketing affiliate is restricted by regulation to affiliates that purchase gas exclusively from their affiliated producer. 30 CFR 206.151.

to non-marketing affiliates and later resold to end-users must be valued based upon the resale price.

Seagull proved short-lived. Two weeks after it was issued, the Acting Assistant Secretary for Land and Minerals Management, with the Secretary of the Interior's concurrence, expressly overruled Seagull in a decision called Texaco Exploration & Production , Inc., Docket No. MMS-92-306-O7G (May 18, 1999). * * * Holding the benchmarks inapplicable in valuing oil production resold at a profit by a non-marketing affiliate, Texaco expressly rejected Seagull's reasoning on two grounds. First, Texaco noted that the gross proceeds provision requires all valuations to equal at a minimum the "gross proceeds accruing to the lessee," a term the decision interpreted as referring to the total consideration received by the corporate family to which the producer and non-marketing affiliate belong. Because the benchmarks measure only what the producer receives through intra-corporate transfers, not the total consideration the corporate family receives from resale, Texaco reasoned that the benchmarks yield valuations less than "gross proceeds accruing to the lessee" whenever a non-marketing affiliate resells gas for more than it originally paid its controlling producer. Thus, Texaco found that in such instances the gross proceeds provision supercedes the benchmarks, requiring the producer to calculate value based on its non-marketing affiliate's resale proceeds. Second, finding that oil and gas lessees have an implied duty to include in production valuations any increase to value resulting from marketing activities, Texaco concluded, alternatively, that a lessee may not base valuations on sales to a non-marketing affiliate that later turns around and performs marketing activities. Texaco at 12-22.

Because the Assistant Secretary issued Texaco under her discretionary authority to step into the MMS director's shoes and directly hear appeals from MMS orders, Texaco binds the Board. See Texaco at 27; [citations omitted]. Accordingly, the Board summarily denied Fina's appeal, concluding that "[t]he arguments raised by appellants with respect to the value of production for royalty purposes have all been addressed in Texaco * * *."[5/]

Fina Oil and Chemical Co. v. Norton, 332 F.3d at 674-75.

5/ Fina Oil & Chemical Co., 149 IBLA at 168.

The district court in Fina focused on the implied duty of the lessee to market the gas it produces and concluded that the difference in the contract price at which it sold to its affiliate and the price at which the affiliate resold the gas downstream was attributable to marketing. 209 F. Supp. 2d at 256. The appeals court made a different analysis.

[1] After outlining the different valuation methodologies based on the lessee-buyer relationship and defining "lessee" in accordance with relevant statutes and regulations, the appellate court in Fina decided that an affiliate should not be included within the meaning of the term "lessee." See 332 F.3d at 674, 676-77. Hence, according to the court, the regulations clearly delineate which valuation method should be applied:

> In sum, the overall import of the regulation's tripartite structure * * * is crystal clear. Gas sold directly to unaffiliated entities is valued at the contract price, since that price reliably indicates objective value. In contrast, gas sold to marketing affiliates is valued not on the basis of the initial sale–obviously an unreliable indicator of objective value–but rather on the basis of the price at which it ultimately leaves the corporate family. But the agency expressly restricted non-recognition of intra-corporate sales to situations where no directly comparable arm's-length sales exist. Accordingly, gas sold to non-marketing affiliates–where objective value can be reliably approximated through comparable arm's-length sales–is valued through the benchmarks at the initial sale price and not the subsequent resale price.

Id. at 677-78. Thus, the circuit court rejected the reasoning in Texaco upon which both the district court decision and the Board decision in Fina were based and concluded: "Though we express no opinion on whether the Secretary might have statutory authority to value production based on the resale price, the Secretary may not do so by interpreting a regulation to mean the opposite of its plain language." Id. at 673. The court succinctly ruled that "the applicable regulation unambiguously requires valuation based on the initial sale" to the non-marketing affiliate. Id. The court also rejected the marketing argument posed by MMS because it also "conflicts with the regulation's plain language." Id. at 678-79.

We are bound by the decision of the Court of Appeals for the D.C. Circuit in deciding this appeal. Accordingly, it is clear that royalty in this case on gas sold under a non-arm's-length contract must be determined on the basis of the applicable bench mark under the regulation at 30 CFR 206.152(c) and we must vacate the decision of MMS calculating royalty on the basis of the resale price obtained by RETEX.

A remand has been requested by MMS to allow it to apply the appropriate bench mark, noting that determining the comparability of appellant's gross proceeds under its non-arm's-length sale to the gross proceeds under arm's-length contracts for sale of production requires consideration of such factors as price, time of execution, duration, market served, terms, quality, and volume of gas. 30 CFR 206.152(c)(1). Appellant opposes the motion for remand, asserting that there is adequate information in the record to show that it paid royalty in accordance with the requirements of the first bench mark under this regulation. Thus, it points to arm's-length sales negotiated by appellant with several unaffiliated producers including Texaco and Anadarko which were used to set the sales price for appellant, noting that royalties were paid on these market prices. From the record before us, it appears that we lack the information required to make the initial decision regarding comparability of the arm's-length sales required to apply the bench marks under 30 CFR 206.152(c) to the sale of production in this case. [6/] As a general rule, consistent with the appellate nature of this Board's review authority, we decline to issue the initial decision on issues which have not been addressed by MMS. See Gabriel Energy Corp. v. OSM, 122 IBLA 316, 323 (1992); Frontier Exploration, Inc., 114 IBLA 280, 282 (1990).

Therefore, 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 vacated and MMS' motion to remand the case for further adjudication is granted.

____
C. Randall Grant, Jr.
Administrative Judge

I concur:

____
Bruce R. Harris
Deputy Chief Administrative Judge

[6/] In its remand motion, MMS points out that relevant regulation factors other than price alone are properly considered in determining comparability including time of execution, the market served, duration, and other factors. 30 CFR 206.152(c)(1).