Kirumakki, Nagaraja

From: Kirumakki, Nagaraja
Sent: Friday, December 19, 2003 8:31 AM
To: Burhop, Shirley
Cc: Fields, Gary; Conway, Karen
Subject: RE: Comparability

I was aware of the policy of using the lowest posted spot market price. When we were doing the audits for valuing NGL's we always used the Low price, not the average or high. Also, if I remember correctly, I did discuss this with Karen about a month ago in connection with most comparable contract price vs. the lowest comparable contract price.
The following is my argument for most comparable contract price.

1. When usually accept a payors A/L contract price, as long as those A/L contract price includes all consideration. And as a test if we see that A/L price is within the range (from lowest to highest) of all A/L contracts that is even better. On the other hand if the payors A/L contract price is higher than the lowest A/L contract price in the field we are not going to reduce the gross proceeds by the difference in price between the lowest A/L price and the payors A/L contract price. This is because the payor is legally obligated under that to obtain that price.

2. When we use the posted spot prices for NGL other than the price [low or average or high] there is nothing else such as market served, quality of the NGLs, quantity of NGLs or type of contracts etc: for comparison. Also all the Propanes have the same Btus, all the Iso-Butanes have the same Btus, all Normal-Butanes have the same Btus. In other words there is no difference in the Btus Propanes coming out of different gas plants. Further no contract to refer to.
Natural gas is different. The Btu of the gas varies with the composition of the gas which includes the mole % of NGLs and the % inert gases. That is why in the regulations the emphasis is on "like quality gas" and other factors which are very important in determining the comparability of the gas.

3. While determining the comparability of the gas, what the regulation wants us to do is to determine the contract that best f its the lessee's situation. That is where all these factors should be considered in determining that best fit, which may not be the lowest priced A/L contract. If we come up with several identical (emphasis added) to the 'T' contracts then I will entertain the thought of using the lowest price. Otherwise I have trouble in going with the lowest price, just like Oil or Gas Index price. Even in gas for example Inside FERC gas price we use the median price [which us more frequently used price].

I think we need to kick this issue further up to the management and discuss it more, before just accepting it.

Raj

-----Original Message-----
From: Burhop, Shirley
Sent: Thursday, December 18, 2003 4:33 PM
To: Brian Johnson; Dana Summers; Ellwood Soderlind; F David Loomis; George Staigle; Glenn Kepler; Karen Conway; Nagaraja Kirumakki; Nancy Rodriguez; Perry Shirley; Robert Davidoff; Sara Teel; Terence Fisher
Subject: Comparability

<< File: 87%2D762.pdf >> I think this decision answers one question about comparability: "the lowest posted spot market price of the month establishes a floor for royalty valuation."

As Debbie just explained to me, if we are willing to accept the low price as market value from arm's length payors, then we should also be willing to accept it from NAL payors.

Thanks to George Staigle for remembering this case.

I will dig up some policy documents and Dear Payor letters that also address this issue.

Barton, Jayne

From: Burhop, Shirley
Sent: Thursday, December 22, 2005 10:51 AM
To: Fay, Tracey
Subject: FW: Comparability

Attachments: 87%2D762.pdf

Here's the other email you were looking for.

From: Burhop, Shirley
Sent: Thursday, December 18, 2003 4:33 PM
To: Brian Johnson; Dana Summers; Ellwood Soderlind; F David Loomis; George Staigle; Glenn Kepler; Karen Conway; Nagaraja Kirumakki; Nancy Rodriguez; Perry Shirley; Robert Davidoff; Sara Teel; Terence Fisher
Subject: Comparability

87%2D762.pdf (55 KB)

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United States Department of the Interior

OFFICE OF HEARINGS AND APPEALS
INTERIOR BOARD OF LAND APPEALS
4015 WILSON BOULEVARD

CONOCO INC.
ARCO OIL AND GAS CO.

IBLA 87-762, 88-56 Decided August 29, 1989

Appeal from a decision of the Director, Minerals Management Service, affirming orders requiring payment of additional royalties on natural gas liquid products produced under Outer Continental Shelf oil and gas leases (MMS 86-0203-OCS), and appeal from a decision of the Acting Director, Minerals Management Service, affirming orders assessing late payment charges (MMS 86-0344-OCS).

Set aside and remanded.

1. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

   The valuation of natural gas liquid products for purposes of computing the royalty due is required by statute and regulation to be not less than the greater of the fair market value or the gross proceeds realized by the lessee. One of the factors to be considered in assessing fair market value under the regulation governing royalty valuation is posted prices. A determination of fair market value based on posted spot market prices will be sustained as consistent with the regulation in the absence of a showing that this is inconsistent with fair market value.

2. Administrative Procedure: Rulemaking--Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

   A policy guideline interpreting the royalty valuation regulation as it applies to natural gas liquid products is properly distinguished from a regulation having the force and effect of law promulgated in accordance with the rulemaking requirements of the Administrative Procedure Act. Although such a policy guideline is not binding on the Board and will not be followed where it is inconsistent with the relevant regulation, it will be upheld by the Board on appeal where it provides a reasonable basis for a decision applying the royalty valuation regulation and is consistent therewith.

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

   In the absence of acceptance of the lessee's royalty valuation as conclusive by an official authorized to bind the Department on this matter, the Department is not barred from rejecting the valuation, valuing production by another acceptable method, and demanding payment of royalty based on this method.

4. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Natural Gas Liquid Products--Outer Continental Shelf Lands Act: Oil and Gas Leases

   Where the low posted spot market price for the month for natural gas liquid products is found by MMS to establish the fair market value floor for royalty valuation, a decision assessing additional royalty charges based on the difference between lessee's reported valuation and the average spot market price will be set aside and remanded.

APPEARANCES: R. Carol Harvey, Esq., Houston, Texas, for Conoco Inc.; Gary H. Hoff, Esq., Dallas, Texas, for ARCO Oil and Gas Company; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., and Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE GRANT

Conoco Inc. (Conoco) and ARCO Oil and Gas Company (ARCO) appeal from a July 7, 1987, decision of the Director, Minerals Management Service (MMS), affirming orders of the Regional Manager, Tulsa Regional Compliance Office, Royalty Management Program (RMP), MMS, dated March 31, 1986, requiring payment of additional royalties for natural gas liquid products (NGLP) produced from certain offshore oil and gas leases. The orders required Conoco to pay $46,491.94 in additional royalties for NGLP produced from January 1980 through April 1983, and assessed ARCO additional royalties in the amount of $16,082.46 for iso-butane and butane produced in the same time period. The NGLP at issue were all separated at the Grand Chenier Gas Processing Plant from gas produced from various Outer Continental Shelf oil and gas leases and were used by appellants rather than marketed. Conoco and ARCO also appeal from the August 28, 1987, decision of the Acting Director, MMS, affirming the Tulsa Regional Manager's June 3, 1986, orders assessing $35,708.57 in late payment charges against Conoco and $15,592.26 in late payment charges against ARCO.

An understanding of the issues raised by these royalty valuation appeals is facilitated by some background in the royalty history of these leases. In 1981, the Office of the Inspector General (OIG), U.S. Department of the Interior, conducted a general audit of Conoco's Federal oil and gas leases for the years 1978 through 1980. The purpose of the audit was to determine if Conoco's settlement procedures adequately provided for the proper computation and payment of royalties for the gas removed from its Federal leases. The OIG concluded that, with certain exceptions, Conoco's settlement system for the payment of royalties did not contain any material weaknesses and adequately provided for the reasonable payment of royalties. The OIG also noted that Conoco used actual net-back values as the basis for its determination of the value of NGLP produced from the leases. Although the OIG found certain problem with the calculation of royalties on NGLP, these problems did not directly relate to the net-back method of valuing NGLP. The OIG recommended that the Geological Survey (GS), the predecessor of MMS, direct Conoco to pay additional royalties based on the audit. As a result of this audit, Conoco has indicated that it paid $572,498 in additional royalties for the years 1978 through 1980.

Subsequently, the OIG conducted a specific audit of the royalties paid on NGLP removed from Federal leases and processed by the Grand Chenier Gas Processing Plant for the years 1977 through 1982. Both Conoco and ARCO are among the owners of the plant, and were subject to this audit to determine if their accounting systems adequately provided for the proper computation and payment of royalties on NGLP extracted at Grand Chenier. The OIG found that ARCO sold sold of its NGLP to outside parties, but used its share of butane and iso-butane internally, and that ARCO took physical possession of the NGLP at Mont Belvieu, Texas, through an exchange with another company for ARCO's share of the Grand Chenier NGLP. Further, the OIG reported that Conoco used its share of the NGLP internally. With respect to internally used NGLP, the OIG compared the prices reported to MMS with the lowest Mont Belvieu spot market price during the production month to evaluate the accuracy of appellants' royalty valuation of NGLP.

After review of the OIG audit report and appellants' comments on that report, the Tulsa Regional Manager, MMS, informed Conoco and ARCO of his preliminary royalty underpayment determinations by letters dated August 20, 1985. The letters provided ARCO and Conoco an opportunity to comment or provide any additional documentation to refute the preliminary findings. Both appellants responded to the preliminary determinations of royalty underpayments.

In a decision letter dated March 31, 1986, addressing only the valuation of NGLP for purposes of royalty computation for certain offshore leases, 1/ the Regional Manager, MMS, found that Conoco underpaid royalties

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1/ The decision expressly noted that "lease production volumes, manufacturing allowances, and natural gas values reported are subject to further review."

for internally used NGLP produced from January 1980 through April 1983 in the amount of $46,491.94. The decision letter explained that:

> During the period January 1980 through April 1983, Conoco used its share of NGLP's internally and valued them at average monthly Mont Belvieu spot prices as determined by its marketing department. Instances in which the value of NGLP's used by Conoco was less than the lowest Mont Belvieu spot price for the production month resulted in additional royalties of $46,491.94.

(Decision letter at 2). A similar letter was issued to Conoco, as paying agent for ARCO, with respect to additional royalties in the amount of $16,082.46 due on valuation of butanes and iso-butanes used internally. Conoco and ARCO appealed these decisions to the Director, MMS.

The decisions of the Regional Manager were based in substantial part on the royalty valuation methodology set forth in the "Procedure Paper on Natural Gas Liquid Products Valuation" (Procedure Paper) issued by the Royalty Valuation and Standards Division of the Royalty Compliance Division of MMS on December 14, 1984, and revised on February 25, 1985. The Procedure Paper was developed in response to the problem encountered by MMS in establishing an appropriate method of valuing NGLP extracted from gas produced from Federal leases, especially where the NGLP had been used internally. Because the regulations require MMS to establish a basis for royalty using a reasonable unit value which should never be less than the fair market value, <u>see</u> 30 CFR 206.150 (1987), the Procedure Paper's stated purpose was to develop a "yardstick" valuation technique for determining the reasonableness of a lessee's NGLP prices (Procedure Paper at 3). In applying this yardstick, MMS distinguished between sales situations in which an arm's-length contract existed and those with non-arm's-length contracts or no contract.

In determining the appropriate yardstick, MMS considered several factors, including NGLP sales contracts, the prices received by lessees, regulated prices, and commercially available NGLP bulletins. Based on an evaluation of these sources, MMS concluded that commercial price bulletins represented the best available price source, and in most instances were indicative of NGLP fair market value (Procedure Paper at 5). The Procedure Paper explained the royalty valuation methodology set forth therein as follows:

> To establish a yardstick to compare to the lessee's reported prices, MMS will take the highest and lowest published prices for the month from the appropriate bulletin. If the reported price falls within this range, the value will normally be accepted by MMS for royalty determination purposes.
>
> *   *   *   *   *   *   *
>
> If the prices used to calculate royalties fall below this range, a minimum value that is acceptable to MMS can be determined

by developing an average value from the lowest and highest prices in the range.

Id. at 6-7. 2/ The Procedure Paper also listed suggested spot price locations for various producing areas and the appropriate bulletins to be used as price sources. For the NGLP at issue in this case, Mont Belvieu, Texas, was the suggested market.

By decision dated July 7, 1987, the Director, MMS, affirmed the assessment of additional royalties based on the methodology set forth in the Procedure Paper. The decision noted that the assessment was based on production used internally by appellants which had been valued for royalty purposes "at less than the lowest Mont Belvieu spot price." The Director found that appellants' calculation of net back for royalty computation purposes includes costs incidental to marketing which are not allowable deductions. Further, the decision held that MMS did allow a fractionation allowance, in addition to a gas plant processing allowance, but that the amount of these allowances was beyond the scope of the present appeal, having been set by prior unappealed decisions. Because RMP had no record of a request for a transportation allowance by either appellant, the Director determined that a deduction for transportation costs was properly disallowed.

The Director further found that the spot prices protested by appellants are a better indicator of value than posted prices which are of long duration involving substantial volumes. The decision concluded that royalty value determinations need not incorporate all of the factors identified in the regulation and that the weight to be afforded each factor is within the discretion of MMS. Further, the Director found that the Procedure Paper is an interpretation of the regulatory requirement to which the notice and rulemaking provisions of the Administrative Procedure Act (APA), 5 U.S.C. § 553 (1982), do not apply. Additionally, the Director ruled that appellants made no overpayments subject to offset during the audit period when they paid on a valuation in excess of the minimum Mont Belvieu spot market price as different values may be considered reasonable as long as they do not fall below the minimum value set. Finally, the Director found that the OIG audit for 1977-1980 did not constitute a ruling on NGLP valuation which would preclude MMS from assessing liability for additional royalty on this basis for 1980. Furthermore, he stated that MMS was required to audit and

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2/ The Procedure Paper also discusses NGLP prices in the context of arm's-length sales contracts. For royalty computation purposes, if an arm's-length contract establishes an NGLP price, MMS will normally accept the greater of that contract price or gross proceeds; if lessees have a non-arm's-length contract and they can establish that the contract has characteristics similar to arm's-length contracts which represent fair market value, MMS will accept the non-arm's-length contract price for royalty valuation purposes. However, under other situations, including where no contract exists, MMS will use the yardstick value as the fair market value. Id. at 8-9.

reconcile all current and past lease accounts by section 101(c) of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. § 1711 (1982), and to take appropriate action to make additional collections and refunds as warranted.

By orders dated June 3, 1986, the Regional Manager assessed Conoco $35,708.57 and ARCO $15,529.26 in late payment charges for the underpaid royalties. Conoco and ARCO appealed these orders to the Director, MMS, who affirmed the imposition of the late payment assessments by decision dated August 28, 1987.

Concco and ARCO have each filed a substantial statement of reasons (SOR) for appeal from the Director's royalty valuation decision. Conoco's brief raises four basic issues: the validity of the royalty valuation methodology developed in the Procedure Paper; the legality of utilizing this method without formal APA rulemaking; the propriety of applying a procedure developed in 1985 to royalty valuation for an earlier period; and the propriety of reauditing Conoco's Federal offshore leases for a period covered in a previous audit. Conoco first describes the royalty valuation procedure it used for the relevant period, noting that it attempts to accurately represent the actual net-back values for each product at the respective plant. If no specific transaction is made in a particular month,

> then the lease settlement valuation is based on Conoco's assessment of the representative market value for each product at each plant location. To test the validity of this assessment, comparisons are made to public pricing information available in various publications such as Platts Oilgram, Oil Buyers Guide, BP News, etc., as an external test. At the end of the month, Conoco's prices, based on an assessment of the NGLs market, are used for calculating netbacks to the production point. This calculation recognizes any exchange differentials, physical transportation, storage, fractionation, etc., between the using facilities and the production source, if applicable. Neither exchange differentials nor storage costs are incurred at Grand Chenier so such charges are NOT deducted from royalties.

(Conoco's SOR at 9-10).

Conoco argues that the spot market prices used by MMS are not consistently reflective of fair market value and that they ignore the effect of the location of the gas plant and transportation costs to market. Conoco further contends that MMS' method is arbitrary in establishing a floor for NGLP "based on a spot price methodology for a set market, e.g., Mt. Belvieu spot price for the entire Gulf of Mexico, absent another determination by MMS, and in unduly penalizing lessees whose prices fall below the floor" by requiring a valuation equal to the average of the highest and lowest prices, not the floor of the lowest price (Conoco's SOR at 17; emphasis in original).

Conoco further argues that the Procedure Paper represents a new and different standard for valuing NGLP that creates a substantial change in pre-existing law. Conoco alleges that the procedure is a mandatory directive, prescribing conduct and accounting standards, and not merely a clarification or explanation of existing law or regulations. Therefore, Conoco contends that the Procedure Paper should have been issued only after compliance with the notice and comment requirements of the APA, and not without any public explanation or input.

Further, Conoco contends that MMS should be estopped from applying the Procedure Paper retroactively. Conoco asserts that the OIG approved its use of actual net-back values as the basis for its royalty valuation in 1981, and that it was without knowledge of the Procedure Paper methodology during the 1980-1983 audit period. Conoco argues that the application of estoppel in this case would not thwart the purpose of the relevant statute because MMS could still value NGLP under the regulations. Conoco further contends that estoppel is necessary to prevent an injustice because Conoco will be damaged by the retroactive valuation procedure. Conoco argues that MMS has not demonstrated that past administrative practices allowing the net-back valuation were improper or that values computed by this method were erroneous.

Finally, Conoco argues that the earlier audit conducted by the OIG in 1981 for the years 1977 through 1980 fully determined its royalty obligations for that period, and that MMS is precluded from assessing any additional royalties for 1980. Conoco states that it relied on the prior audit as conclusive of its obligation to pay additional royalties for that period, and that it paid the deficiencies which surfaced as a result of the audit. Conoco contends that the 1981 audit contained no disclaimers or limitations upon which MMS may rely to reopen that audit. Furthermore, Conoco contends that the OIG tested Conoco's settlement procedures in that audit and found that they provided for the adequate payment of royalties. Under these circumstances, Conoco argues that MMS is precluded from seeking additional royalties for 1980.

Conoco further argues that consideration by MMS of underpayments on the subject leases requires consideration of any overpayments during the audit period. Appellant reasons that this requires reexamination of the 12.4 percent fractionation fee allowed by MMS in view of Conoco's actual expense of 13.1 percent for fractionation. The same argument is made with respect to transportation costs of $.48 per gallon for propane.

ARCO contends in its brief on appeal that the Procedure Paper is inconsistent with the requirements of the regulation at 30 CFR 206.150 which mandates consideration of several relevant factors in determining "reasonable unit value" for royalty purposes. ARCO argues that the spot market at a central storage and distribution point relied upon by MMS is arbitrary in that it does not relate to either the location of manufacture or the royalty settlement point. Further, ARCO asserts that the net-back values it used for valuation of NGLP do not reflect marketing costs of any kind (as the MMS decision asserts), but rather reflects valuation on the basis of significant purchases from third parties at the consuming location less transportation costs between Grand Chenier and the consuming location. Further, ARCO contends it is entitled to a transportation allowance to the Mont Belvieu spot market if the latter price is to be dispositive of royalty valuation. ARCO asserts the lack of a prior transportation allowance request is not relevant in this context.

In answer to the briefs filed by appellants herein, MMS points out that spot market prices are a type of posted price which is recognized by regulation as a factor in valuation of oil and gas for royalty purposes. MMS asserts that it properly determined that spot prices are a reasonable indicator of market value for the NGLP at issue here. Further, MMS contends that appellants failed to meet the burden of establishing error in the valuation of the NGLP.

In answer to appellants' assertion of violation of APA rulemaking requirements, MMS argues that it has not retroactively applied a new regulatory requirement for valuation of NGLP. Rather, it is asserted that the Procedure Paper merely provided guidance in applying the existing regulation. It is strongly contended that MMS has the authority to examine royalty payments for prior periods to determine whether royalties were properly paid and require payment of additional royalties due. MMS points out that FOGRMA provides comprehensive authority to audit royalty payments and that the provisions of 30 U.S.C. § 1711 (1982) direct the Secretary to audit and reconcile all current and past lease accounts and to take any appropriate action to collect additional royalties or make refunds as warranted.

MMS further contends that valuing production at the average spot market price is reasonable where lessee's royalty valuation falls outside the range of fair market value. Further, it is contended that MMS cannot be estopped to apply this method of royalty valuation which is consistent with the requirements of the regulations.

With respect to the fractionation allowance on Conoco's ethane of 12.4 percent, MMS asserts this was set by letter of November 7, 1984, which was not appealed and, hence, must be considered final. Further, MMS contends that transportation costs were properly disallowed because no application for approval of such costs was filed.

Finally, MMS contends that the previous OIG audit of Conoco leases through 1980 does not constitute a bar to further audit of royalty payments for NGLP produced from the leases including the year 1980 in the absence of a final administrative determination of royalties due which did not occur here.

[1] The provisions of the Outer Continental Shelf Lands Act (OCSLA), as amended, 43 U.S.C. §§ 1331-1356 (1982), and appellants' leases issued pursuant thereto, require the payment of a royalty on production of oil and gas based on a specified percentage of the amount or value of the oil and gas produced. In passing 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); Sun Exploration and 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, 56 U.S.L.W. 3891 (U.S. June 28, 1988) (No. 87-372). 3/

The Secretary possesses considerable discretion in determining the value of production for royalty purposes. Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1382 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 107 S. Ct. 1593 (1987); Texaco, Inc., 104 IBLA 304, 308 (1988); Amoco Production Co., supra at 96. That discretion is tempered by the standard of reasonableness. Texaco Inc., supra at 310.

The Secretary's exercise of this discretion during the relevant time period was governed by the provisions of the royalty valuation regulation at 30 CFR 206.150 (1987), formerly 30 CFR 250.64 (1979). 4/ That regulation provides:

> The value of production shall never be less than the fair market value. The value used in the computation of royalty shall be determined by the Director. In establishing the value, the Director shall consider: (a) The highest price paid for a part or a majority of like-quality products produced in the area or field; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters. Under no circumstances shall the value of production be less than the gross

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

4/ Effective Mar. 1, 1988, the Department completely revised the regulations in 30 CFR relating to gas valuation for royalty purposes. 53 FR 1230 (Jan. 15, 1988). The new regulation for processed gas, 30 CFR 206.153, provides that valuation for royalty purposes is to be determined based upon the combined value of the residue gas and all gas plant products, less certain allowances. When the residue gas or any gas plant product is not sold pursuant to an arm's-length contract, the regulation provides that value will be determined in accordance with the first applicable benchmark method listed. These methods include: (1) the gross proceeds accruing from a sale pursuant to a non-arm's-length contract which is comparable to an arm's-length contract; (2) values determined by consideration of other information relevant in valuing like-quality gas or products including proceeds from arm's-length contracts, posted prices, spot prices, and other reliable public sources of price or market information, and other information particular to the individual lease; and (3) a net-back method or any other reasonable method to determine value. 30 CFR 206.153(c), 53 FR at 1276. References in this decision are to gas regulations in effect during the relevant periods in dispute unless otherwise noted.

> 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.

30 CFR 206.150 (1987). 5/

The regulation defines several factors which may be properly used in the valuation of NGLP. One of the relevant factors is "posted prices." 30 CFR 206.150 (1987). The Mont Belvieu spot market price for NGLP as published during the production month clearly qualifies as a posted price. Thus, the issue is whether the other factors relevant to NGLP valuation render the use of the posted spot market price arbitrary and capricious as a measure of fair market value. Examining the relevant factors enumerated by the regulation, we note there is no showing by appellants that the posted price is inconsistent with the highest price paid for a part or a majority of like-quality products produced in the area or field. Further, the price received by the lessee, normally a significant factor in royalty valuation, is by definition not applicable in the case of NGLP which are used internally and not marketed. The factor of regulated prices is not relevant here as it appears from the record that the price of the NGLP involved was deregulated during the timeframe at issue.

The royalty valuation regulation provides a further check on the value obtained by application of the above-referenced factors by requiring that: "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 * * *." 30 CFR 206.150 (1987). This provision of the regulation has led the Department to value production for royalty purposes on the basis of net-back value to the lessee after subtracting the costs of transportation and processing from the sale price of the production to establish the value at the wellhead on occasion where neither the posted price nor the highest price paid for like-quality products produced in the field is reflective of the proceeds realized by the lessee on sale of the production. Marathon Oil Co. v. United States, 604 F. Supp. at 1385. In the context of the present case we find nothing in the regulation which would require use

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5/ Valuation for royalty purposes of natural gas from which NGLP are produced was further guided by the regulation at 30 CFR 206.152 (1987), formerly 30 CFR 250.67 (1979), which provides, in relevant part:

"(a) When gas is processed for the recovery of constituent products, a royalty established by the terms of the lease will accrue on the value or amount of:

"(1) All residue gas remaining after processing, and

"(2) All natural gasoline, butane, propane, or other substances extracted from the gas. * * *

"(b) Under no circumstances shall the amount of royalty on the residue gas and extracted substances be less than the amount which the Director determines would be payable if the gas had been sold without processing."

of the net-back method of royalty valuation in lieu of reference to such regulatory factors as posted prices. 6/

With respect to the question of an allowance for transportation costs, we must recognize that one of the "relevant matters" taken into consideration in applying the royalty valuation regulation for offshore production is the cost of transportation to an onshore market where there is no market at the offshore point of production. In the absence of a market at the wellhead where production would ordinarily be sold and valued, the deduction of a transportation allowance from the market value of the production at the nearest open market has been upheld. United States v. General Petroleum Corp., 73 F. Supp. 225, 263 (S.D. Cal.), aff'd, Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); Shell Oil Co., 52 IBLA 15, 88 I.D. 1 (1981); C & K Petroleum, Inc., 27 IBLA 15 (1976); Kerr-McGee Corp., 22 IBLA 124 (1975); The Superior Oil Co., 12 IBLA 212 (1973). This transportation allowance has been found applicable to gas from which NGLP is extracted. Phillips Petroleum Co., 109 IBLA 4 (1989). On the other hand, transportation costs have been disallowed where the costs claimed were for transportation beyond the point of the nearest potential market. See The Superior Oil Co., supra. Applying these principles to the case at hand, we find no basis has been shown for considering transportation costs from the processing plant at Grand Chenier to Mont Belvieu as ARCO requests (SOR at 6). Similarly, contrary to the contention of ARCO (SOR at 5), transportation costs between Grand Chenier and the "consuming location" would not be allowable. Accordingly, we must conclude that appellants have failed to sustain the burden of showing error in basing royalty valuation on posted Mont Belvieu spot market prices as opposed to use of a net-back method of valuation.

[2] With regard to the challenge to the Procedure Paper based on the rulemaking provisions of the APA, we find that the Procedure Paper was not a substantive rule subject to the notice and comment provisions of the APA. Substantive rules have the force of law while interpretative rules or general statements of policy are merely clarifications or explanations of existing statutes or rules. See Guardian Federal Savings & Loan Association v. Federal Savings and Loan Insurance Corp., 589 F.2d 658, 664 (D.C. Cir. 1978). Substantive rules have the force of law where they constitute a substantive modification of an existing regulation, adoption of a new regulation, or a change in policy. W.C. v. Bowen, 807 F.2d 1502, 1504 (9th Cir. 1987); Venlease I, 99 IBLA 387, 389; Cambridge Mining Co., 74 IBLA 26, 28 (1983). The Procedure Paper merely clarified the existing regulations by setting forth a yardstick by which MMS would measure the reasonableness of royalty values reported by lessees. It did not require lessees to value their production by any specific method, nor did it modify any existing regulation. Rather, it found that, after consideration of the factors listed in the regulations, the best measurement of the reasonable value of

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6/ We note that the newly amended regulations rank the use of spot prices ahead of the net-back method in their valuation benchmark hierarchy. 30 CFR 206.153(c), 53 FR 1276 (Jan. 15, 1988).

NGLP in situations where no arm's-length contract existed was the commercially available spot price bulletins. We find the Procedure Paper to be essentially a policy guideline adopted by MMS to assist in valuing NGLP production for royalty purposes under the provisions of the relevant regulation. As such, it does not have the force and effect of law as a duly promulgated regulation does, and the Board will decline to follow it where it is inconsistent with the terms of the relevant regulations. See Black Butte Coal Co., 109 IBLA 254, 260 (1989) (declining to apply published guidelines for processing logical mining unit applications which were inconsistent with regulations); Charles J. Rydzewski, 55 IBLA 373, 88 I.D. 625 (1981) (declining to apply instruction memorandum which was inconsistent with the relevant regulation).

[3] A further issue has been raised with respect to whether MMS is bound to accept the royalty valuation reached under the net-back method for calendar year 1980 as a consequence of the earlier OIG audit of all of Conoco's Federal oil and gas leases for the years 1978-1980. As a threshold matter, it must be recognized that the authority for valuation of production for royalty purposes within the Department was vested at the time of the audit in the Director, GS, and those officials under his supervision. 30 CFR 250.10(a) and 250.64 (1980). 7/ Thus, the fact that the earlier OIG audit did not find fault with the use of the net-back method of valuing NGLP did not constitute approval by the official with delegated authority to approve valuation of production. In the absence of an acceptance of the lessee's royalty valuation as conclusive by an official authorized to bind the Department on this matter, the Department is not barred from rejecting the valuation, valuing production by another acceptable method, and demanding payment of royalty based on this method. Supron Energy Corp., 46 IBLA 181, 189 (1980), appeal pending sub nom. Conoco v. Andrus, Civ. No. 80-0261-M (D. N.M. filed Apr. 17, 1980; Big Piney Oil & Gas Co., A-29895 (July 27, 1964). Appellants have not presented the Board with any documentation regarding the additional royalty paid as a consequence of the earlier OIG nationwide audit from which it can be concluded that acceptance of the payment constituted a ruling on the issue of valuation of NGLP processed at Grand Chenier in 1980. Indeed, the fact that a subsequent audit was conducted covering royalties paid on NGLP produced from Federal leases and processed at Grand Chenier for the years 1977 through 1982 would indicate this issue had not been settled. Accordingly, we find the Department was not barred from reviewing the valuation of the NGLP for 1980. Similarly, with respect to the question of estoppel, appellants have shown no basis for estopping MMS from reviewing the valuation of NGLP by appellants for royalty purposes to ascertain whether it represents fair market value as required by statute and regulation and requiring appellants to pay royalty accordingly. Supron Energy Corp., supra at 189.

[4] A distinct issue is presented by the manner in which the spot market price is used to value NGLP. The Procedure Paper provides that if

7/ Pursuant to Secretarial Order No. 3071, dated Jan. 19, 1982, the functions of GS relating to oil and gas lease royalty management were subsequently transferred to MMS. 47 FR 4751 (Feb. 2, 1982).

the lessee's reported price falls within the range of the high and low spot market prices for the month, the value will normally be accepted for royalty determination purposes. Thus, in effect, the lowest posted spot market price of the month establishes a floor for royalty valuation. This Board has previously upheld the reasonableness of gas royalty valuations consisting of the higher of either a floor value determination predicated on the market for gas from the leases or the gross proceeds realized by the lessee upon sale of the production. Supron Energy Corp., supra. However, we find the present case to be distinguishable. As appellants point out, in the present case a price falling below the floor value is raised not to the floor value, but to a price computed by averaging the floor value with the high spot market price, in effect making the average the floor value. We find that the acceptance of any settlement price within the range of the low to the high spot market price as constituting fair market value is inconsistent with requiring payment of the average spot market price where lessee's settlement price is less than the floor value. While the obligation of MMS to value production at no less than the gross proceeds realized by the lessee may lead to a valuation in excess of the fair market value/floor value where this is reflective of proceeds received by the lessee, the fair market value is the standard at issue in this case where the NGLP were used internally and not marketed. If the average spot market price rather than the floor price constituted fair market value, then MMS would be without authority under the statute and regulation to accept royalty settlement prices as low as the floor price as the Procedure Paper indicates MMS has done. Accordingly, we are unable to affirm the application of the Procedure Paper to the extent it is used to value NGLP production at a price in excess of the fair market value floor price and, hence, must remand this case for recomputation of any additional royalty due and any applicable late payment charges.

To the extent appellants have raised arguments which we have not specifically addressed herein, they have been considered and rejected.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decisions appealed are set aside and remanded to MMS for further action consistent herewith.

C. Randall Grant, Jr.
C. Randall Grant, Jr.
Administrative Judge

I concur:

Franklin D. Arness
Franklin D. Arness
Administrative Judge

Kirumakki, Nagaraja

From: Burhop, Shirley
Sent: Monday, December 22, 2003 4:38 PM
To: Brian Johnson; Dana Summers; Ellwood Soderlind; F David Loomis; George Staigle; Glenn Kepler; Karen Conway; Nagaraja Kirumakki; Nancy Rodriguez; Perry Shirley; Robert Davidoff; Sara Teel; Terence Fisher
Subject: comparability

Debbie Gibbs Tschudy believes that the Conoco/ARCO decision, IBLA 87-762 and 88-56, is applicable to all products, not just NGLs.

And for anyone who cares, (feel free to ignore this, but I'm trying to reconcile all this guidance in my own mind) more history on this issue:

On October 14, 1988, a policy interpretation was issued which stated that the gross *proceeds accruing* to the lessee under its non-arm's-length contract shall be viewed as meeting the requirements of...(regs)...if they are **within the range of the gross proceeds derived from or paid under comparable arm's-length contracts between parties not affiliated with the lessee for similarly situated production**. ("Cason memo" #1)

On December 12, 1988, another policy interpretation further stated that when there are no comparable arm's-length contracts in the field or area between parties not affiliated with the lessee, then the lessee's gross proceeds will determine value if they are **within the range of gross proceeds paid under comparable arm's-length contracts between sellers who are not affiliated with the lessee and purchasers who are.** ("Cason memo" #2)

These memos were rescinded by memo of Dec. 30., 1996 because "The Minerals Management Service has had nearly a decade of practical experience in applying this policy interpretation and has not found it to be particularly useful in clarifying the valuation benchmarks."

On December 5, 1996 the new policy paper on "Valuation Guidance for Auditing Affiliate Sales of Natural Gas" was issued. This paper did not specify which comparable arm's-length contracts should be looked at, but stated the following regarding comparability:
"Comparability can ultimately only be determined from the unique circumstances uncovered in each audit. Auditor's judgment will prevail. However it may be useful in certain circumstances to utilize some screening criteria to help evaluate which contracts might be more appropriate than others." The guidance then goes on to discuss relevant screening or filtering criteria, and then states: "Based on the particular circumstances unique to each audit, not all criteria are required. Auditor judgment will prevail."

Nevertheless, the principle stated in the Conoco/ARCO decision:
"This Board has previously upheld the reasonableness of gas royalty valuations consisting of the higher of either a floor [read: lowest, not average, comparable price determined under the benchmarks] value determination predicated on the market for gas from the leases or the gross proceeds *realized by the* lessee upon sale of the production."
still makes sense.

Barton, Jayne

From: Kirumakki, Nagaraja
Sent: Tuesday, December 23, 2003 9:03 AM
To: Burhop, Shirley; Johnson, Brian C; Summers, Dana; Soderlind, Ellwood; Loomis, F David; Staigle, George; Kepler, Glenn; Conway, Karen; Rodriguez, Nancy; Shirley, Perry; Davidoff, Robert; Teel, Sara; Fisher, Terence
Subject: RE: comparability

I think we are stuck with the higher of the floor price [lowest] or the gross proceeds when using the Index price.
When we are not using the Index price we have some flexibility because of the filters/screening criteria and significant quantity concept. This is where judgment comes into play.
Raj

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still makes sense.

Barton, Jayne

From: Conway, Karen
Sent: Monday, December 29, 2003 7:39 AM
To: Kirumakki, Nagaraja; Burhop, Shirley; Johnson, Brian C; Summers, Dana; Soderlind, Ellwood; Loomis, F David; Staigle, George; Kepler, Glenn; Conway, Karen; Rodriguez, Nancy; Shirley, Perry; Davidoff, Robert; Teel, Sara; Fisher, Terence
Subject: RE: comparability

Still, these NAL contracts usually hide marketing and marketable condition costs. These would still be added to the value.

-----Original Message-----
From: Kirumakki, Nagaraja [mailto:Nagaraja.Kirumakki@mms.gov]
Sent: Tuesday, December 23, 2003 9:03 AM
To: Burhop, Shirley; Johnson, Brian C; Summers, Dana; Soderlind, Ellwood; Loomis, F David; Staigle, George; Kepler, Glenn; Conway, Karen; Rodriguez, Nancy; Shirley, Perry; Davidoff, Robert; Teel, Sara; Fisher, Terence
Subject: RE: comparability

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Raj

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> George Staigle; Glenn Kepler; Karen Conway; Nagaraja Kirumakki; Nancy
> Rodriguez; Perry Shirley; Robert Davidoff; Sara Teel; Terence Fisher
> Subject: comparability
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> still makes sense.
>
>
>

Barton, Jayne

From: Conway, Karen
Sent: Monday, December 29, 2003 9:20 AM
To: Kirumakki, Nagaraja; Burhop, Shirley
Cc: Fields, Gary; Conway, Karen; Loomis, F David; Summers, Dana
Subject: RE: Comparability

Should be the most comparable contract first. If the differences are just *slight* volume differences, then lowest price would probably be used. As always, auditor judgment (supervisor buy-in) should be used. We probably do need to discuss this more, especially how to train since so much of this is auditor judgment.

-----Original Message-----
From: Kirumakki, Nagaraja [mailto:Nagaraja.Kirumakki@mms.gov]
Sent: Friday, December 19, 2003 8:31 AM
To: Burhop, Shirley
Cc: Fields, Gary; Conway, Karen
Subject: RE: Comparability

I was aware of the policy of using the lowest posted spot market price. When we were doing the audits for valuing NGL's we always used the Low price, not the average or high. Also, if I remember correctly, I did discuss this with Karen about a month ago in connection with most comparable contract price vs. the lowest comparable contract price.
The following is my argument for most comparable contract price.

1. When usually accept a payors A/L contract price, as long as those A/L contract price includes all consideration. And as a test if we see that A/L price is within the range (from lowest to highest) of all A/L contracts that is even better. On the other hand if the payors A/L contract price is higher than the lowest A/L contract price in the field we are not going to reduce the gross proceeds by the difference in price between the lowest A/L price *and* the payors A/L contract price. This is because the payor is legally obligated under that to obtain that price.
2. When we use the posted spot prices for NGL other than the price [low or average or high] there is nothing else such as market served, quality of the NGLs, quantity of NGLs or type of contracts etc: for comparison. Also all the Propanes have the same Btus, all the Iso-Butanes have the same Btus, all Normal-Butanes have the same Btus. In other words there is no difference in the Btus Propanes coming out of different gas plants. Further no contract to refer to.

   Natural gas is different. The Btu of the gas varies with the composition of the gas which includes the mole % of NGLs and the % inert gases. That is why in the regulations the emphasis is on "like quality gas" and other factors which are very important in determining the comparability of the gas.
3. While determining the comparability of the gas, what the regulation wants us to do is to determine the contract that best f its the lessee's situation. That is where all these factors should be considered in determining that best fit, which may not be the lowest priced A/L contract. If we come up with several identical (emphasis added) to the 'T" contracts then I will entertain the thought of using the lowest price. Otherwise I have trouble in going with the lowest price, just like Oil or Gas Index price. Even in gas for example Inside FERC gas price we use the median price [which us more frequently used price].

I think we need to kick this issue further up to the management and discuss it more, before just accepting it.

Raj

> -----Original Message-----
> From: Burhop, Shirley

> Sent: Thursday, December 18, 2003 4:33 PM
> To: Brian Johnson; Dana Summers; Ellwood Soderlind; F David Loomis;
> George Staigle; Glenn Kepler; Karen Conway; Nagaraja Kirumakki; Nancy
> Rodriguez; Perry Shirley; Robert Davidoff; Sara Teel; Terence Fisher
> Subject: Comparability
>
> << File: 87%2D762.pdf >> I think this decision answers one question
> about
> comparability: "the lowest posted spot market price of the month
> establishes a floor for royalty valuation."
>
> As Debbie just explained to me, if we are willing to accept the low
> price as market value from arm's length payors, then we should also be
> willing to accept it from NAL payors.
>
> Thanks to George Staigle for remembering this case.
>
> I will dig up some policy documents and Dear Payor letters that also
> address this issue.