1991

Enron Oil and Gas Company v. State of Utah, Department of Natural Resources, Division of State Lands and Forestry and the Director of the Division of State Lands and Forestry : Amicus Brief

Utah Supreme Court

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IN THE UTAH SUPREME COURT

ENRON OIL & GAS COMPANY (Successor to Belco Petroleum Corporation)	)	
Appellant,	)	
v.	)	Case No. 910057
STATE OF UTAH, DEPARTMENT OF NATURAL RESOURCES, DIVISION OF STATE LANDS AND FORESTRY AND THE DIRECTOR OF THE DIVISION OF STATE LANDS AND FORESTRY	)	Priority 16
Appellees,	)	

BRIEF OF *AMICUS CURIAE* ANR PRODUCTION COMPANY, CIG EXPLORATION, INC. and COASTAL OIL & GAS CORPORATION

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INTEREST OF *AMICI CURIAE*

ANR Production Company, CIG Exploration, Inc. and Coastal Oil & Gas Corporation are each Delaware corporations qualified to do business in the State of Utah. Each of *Amici* hold oil and gas leases issued by the Division of Lands and Forestry of the Department of Natural Resources of the State of Utah (the "Division") covering and affecting public lands owned by the State. CIG Exploration, Inc. and Coastal Oil & Gas Corporation are currently parties to a proceeding pending before the Division concerning the precise issue presented in this case, that is, whether royalties are owed to the State of Utah under applicable law for reimbursed ad valorem and severance taxes[1]. In addition, one or more of *Amici* have similar issues pending before the Division. Further, *Amici*, as some of the largest producers of natural gas in the State of Utah, are vitally interested in the orderly and consistent development of oil and gas law in the states in which they do business.

DETERMINATIVE STATUTES

(i) Utah Code Ann. §65-1-18(2)(a) (1953), repealed and reenacted in part at §65A-6-4, (1988).

(ii) The Natural Gas Policy Act of 1978, 15 U.S.C. §§3301-3432, specifically, 15 U.S.C. §3320; and

(iii) Utah Property Tax Act, Utah Code Ann. §§59-2-101 to —1372 (1987 & Supp. 1991).

STATEMENT OF ISSUES

(i) Did the District Court err in finding that reference to "gross value" in Utah Code Ann. §65-1-18 (1953) (repealed, 1988) includes ad valorem tax reimbursements which Appellant

[1]*See* Notice of Agency Action 91-0213-COASTAL AUDIT dated March 11, 1991. The amounts alleged to be owed have been paid under protest. In addition, that administrative proceeding has been stayed by agreement of the parties pending disposition of the instant case by the Utah Supreme Court.

receives for the sale of its own production and in finding that such tax reimbursements are therefore subject to royalty?

(ii) Did the District Court err in finding that reference to "market value" in the royalty clauses contained in the oil and gas leases subject to this dispute included ad valorem tax reimbursements which Appellant receives for its own production and in finding that such tax reimbursements were therefore subject to royalty?

(iii) Did the District Court err in finding that its ruling as described in paragraphs (i) and (ii) above was not consistent with federal or state law?

STATEMENT OF THE CASE AND PROCEEDINGS BELOW

The facts in this case and the synopsis of the proceedings below have been ably set forth in the Brief of Appellant Enron Oil & Gas Company and, for the sake of brevity, will not be repeated here. By Corrected Minute Entry dated January 24, 1992, the Motion to File Brief of *Amici Curiae* was granted. The brief is to be filed by March 2, 1992. In addition, *Amici* were granted the opportunity to participate in oral argument for a total of ten minutes.

SUMMARY OF ARGUMENT

At issue in this case is whether the State of Utah may claim royalties under applicable law and the terms of oil and gas leases covering public domain properties owned by the State with respect to tax reimbursements received by its lessees for taxes which were only assessed against the lessee's non-exempt, taxable share of production.

It is the position of *Amici* that, because the State's reserved royalty share of production is not subject to taxation, any reimbursements from taxes borne by the lessee with respect to its share of production do not constitute any part of the gross value of the State's royalty share, and that, accordingly, royalties may not be permissibly charged against reimbursements received by the lessee. The inclusion of such reimbursements in the royalty value of the State's share of production causes the State's royalty share of production to impermissibly exceed the statutorily mandated maximum of 12½ percent. Further, any such construction causes the price received for the sale of the State's share of production to exceed the federally imposed maximum lawful price. Finally, any construction of the so-called "federal-floor" provision of the State's lease form which is essence adopts by reference the complex web of statutes, regulations, interpretations, and policies applicable to valuation of production from federal lands exceeds legislative authorization and can only lead to confusion, conflict, and litigation.

ARGUMENT

A. The Inclusion Of Tax Reimbursements In The Value Of The Tax Exempt Royalty Share Of Production Impermissibly Causes The State Of Utah's Reserved Royalty Share Of Production To Exceed The Statutory Maximum Of 12½ Percent.

As more particularly set forth in Appellant's Brief (*See* Brief of Appellant at pp. 13-16), the royalty share of production reserved by the Division of State Lands and Forestry is a separate and distinct interest in real property and in the oil and gas production appurtenant thereto. The inclusion of ad valorem tax reimbursements in the royalty value of such production contravenes the express language of Utah Code Ann. §65-1-18 that ". . . royalty <u>shall</u> <u>not</u> <u>exceed</u> 12½ percent of the gross value of the product at the point of shipment from the leased premises." Utah Code Ann. §65-1-18 (1953), (repealed, 1988) (emphasis supplied). By including in the value of the tax exempt royalty share of production the reimbursements for taxes attributable to the non-exempt, working interest share of production, the Division of Lands and Forestry impermissibly causes the State's reserved royalty share of production to exceed the statutorily established maximum of 12½ percent.

By way of example, assume that a well located on lands covered by an oil and gas lease from the State of Utah produced 1000 units of natural gas which are sold at $4.00 per unit. Assume further that there are assessments of ad valorem and severance taxes totalling 10 percent. Only the non-exempt working interest share of production is subject to taxation. The purchaser agrees to reimburse the producer for the taxes assessed against the working interest.

Under these facts, the State of Utah's royalty share of production should not exceed a maximum of 12½ percent of the production, or 125 units. Since each unit is sold for $4.00 per unit, the State would thus be entitled to a maximum royalty of $4.00/unit x 125 units, or $500.00.

But if the value of the reimbursed taxes attributable to the non-exempt working interest is allocated in part to the tax exempt royalty share of production, the State's royalty share impermissibly exceeds 12½ percent. Assume the same facts as above. 1000 units are sold at $4.00, or for a total of $4,000.00. The purchaser also reimburses the producer who actually bore the taxes in question an amount sufficient to pay such taxes, i.e., 10 percent of 7/8 of $4.00/unit x 1000 units, or $350.00. (The 7/8 share is the non-exempt working interest portion of production.)

In the State's view, it is thus entitled to 12.5 percent of $4,350.00, or $543.75. But as seen above, the State's share of production, i.e., 125 units, could only be sold for $500.00.

Thus, the State, through this legerdemain, has increased its royalty share from the maximum permissible statutory rate of 12.5 percent to, in this example, 13.59 percent (i.e., the $543.75 alleged "value" of the State's royalty share as a percentage of the total sum of $4000.00 realized upon the sale of the production in question.) It is clear that in the event the State took its royalty share of production in kind and marketed that production for its own account, it would not be allowed to receive the proceeds from the sale of any volume of production in excess of 12½ percent, or 125 units. But because the producer markets the State's share of production, even where that production is sold under arrangements in which both the royalty share and the working interest share realize the same per unit sums, the producer finds itself bearing an additional royalty burden in excess of that for which it contracted and in excess of the statutory maximum.

B. The Decision Below Is Contrary To Law Because It Requires The Payment Of Royalties On A Value That Exceeds The Maximum Lawful Price For Which The State's Royalty Share of Gas Could Have Been Sold.

Prior to enactment of the Natural Gas Policy Act ("NGPA") in 1978, federal price controls were imposed only on sales of gas in interstate commerce. As a result, prices for gas sold in that market were kept relatively low, while prices for gas sold in the intrastate market continued to rise as the demand for gas increased. This, in turn, led to sharp pipeline delivery curtailments in the lower-priced interstate market during the natural gas shortages of the early 1970's. *See generally*, Mobil Oil Exploration and Producing Southeast, Inc. v. United Distribution Companies, 112 L. Ed 2d 636, 111 S.Ct. 615 (U.S. 1991).

In the NGPA, Congress sought to correct this imbalance (1) by subjecting all wellhead sales of gas to federal price controls, regardless of whether the gas was sold in the interstate or intrastate market, and (2) by replacing the cost-based ceiling prices that were established by the Federal Power Commission with incentive-based price ceilings imposed by Congress. With regard to the incentive pricing structure of the NGPA, the Fifth Circuit recently explained:

> [T]he NGPA set price ceilings on gas depending on when or how the gas was produced. Newer, harder to produce gas commanded higher price ceilings while older gas already under production was pegged with lower price ceilings. Congress had, through the pricing provisions of the NGPA, sought to balance the interests of the consumer by keeping old gas prices low while at the same time encouraging the development of new reserves through incentive pricing.

Mobil Oil Exploration and Producing Southeast, Inc. v. FERC, 885 F.2d 209 (5th Cir.1989), at 214 (emphasis added).

As part of this incentive-based statutory scheme, Congress allowed first sellers of natural gas to recover, in addition to the price ceilings imposed by the NGPA, certain reimbursements of post-production costs and expenses. Among the reimbursements allowed were reimbursements for state severance and ad valorem taxes (referred to in the statute and hereinafter collectively as "severance taxes"). This allowance, however, was strictly limited to the amount "necessary to recover" severance taxes actually "borne by the seller." Under Section 110 of the NGPA:

> [A] price for the first sale of natural gas shall not be considered to exceed the maximum lawful price applicable to the first sale of such natural gas under this part if such first sale price exceeds the maximum lawful price to the extent necessary to recover. —
>
> (1) State severance taxes attributable to the production of such natural gas and borne by the seller, but only to the extent the amount of such taxes does not exceed the limitation of subsection (b) of this section; . . .

15 U.S.C. §3320 (emphasis added).

By allowing the recovery of these cost reimbursements, Congress accomplished two things. First, it made marginal properties more economic to produce. Thus, an incentive was provided for the production of natural gas that otherwise might not have been produced. Additionally, however, the interests of the consumer were protected since only those costs that were actually incurred could be reimbursed.

In the royalty context, this means that private lessors who pay severance taxes could receive reimbursements for their out-of-pocket costs. Lessees likewise could receive reimbursements since they too pay severance taxes with respect to their working interest share of the gas. Since severance taxes are neither assessed nor paid with respect to the State's royalty share, however, no reimbursements are allowed — only the federally-mandated ceiling price can be collected for the sale of the government's royalty gas.

First, under the statutory scheme of the NGPA, severance tax reimbursements have nothing to do with the value of gas. The reimbursements are allowed, not as part of the price for the sale of gas, but as a special incentive to encourage the production of gas that might not otherwise be produced. The Department's decision is therefore contrary to law because it requires the payment of royalties on something other than the value of "production" and because it undermines the incentive purposes of the NGPA.

Second, the Department's decision is contrary to law because it requires the payment of royalties on a value that exceeds the maximum lawful price for which the government's royalty share of the gas could have been sold. As previously noted, the government is entitled to a <u>percentage share of the production</u>. This percentage share of the production can be taken either in amount or in value; however, when the government elects to take its royalty in value, the government is entitled only to <u>the value of its royalty share</u> of the production. Here, the value of its royalty gas could only have been the ceiling price since no tax reimbursements were received or could have been received with respect to the government's royalty gas.

Finally, even if the Department could lawfully claim a royalty based on the value of tax reimbursements collected by others, it must also take into consideration the costs that these others incurred in order to obtain those tax reimbursements. This is because the value of production for royalty purposes is determined at the well, and because the payment of severance taxes is a post-production cost that is properly deducted in determining the wellhead value of production.

It should be remembered that the reimbursements received by the producer are in fact just that; i.e., reimbursements for costs actually incurred. The producer realizes the same $4.00 per unit that the State receives for its share of production. While it may receive the reimbursement, it must also pay the identical amount for taxes to the State's taxing authorities. Severance tax reimbursements were allowed by Congress in Section 110 of the NGPA, not as a part of the price that could be paid for the sale of gas, but as an incentive to encourage the production of gas that might not otherwise have been produced. While the ceiling price categories of the NGPA are also incentive-based, a clear distinction is drawn in the act between cost reimbursements and ceiling prices. The ceiling prices are generally applicable to all gas within a particular category. But the allowance of cost reimbursements is strictly limited to amounts necessary to allow the seller to recover certain identified costs, and even these costs must actually be "borne by the seller." Thus, as is evidenced by the statutory scheme, Congress clearly contemplated that the payments allowed by Section 110 of the NGPA would be reimbursements for out-of-pocket expenses, not payments for gas.

By structuring the statutory scheme in this way, Congress intended to ensure that the incentive ceiling prices allowed by the act would not be diminished by post-production costs and expenses that might make marginal properties uneconomic to produce. At the same time, Congress protected the interests of the consumer by ensuring that only those costs that are actually "borne by the seller" can be reimbursed. This balance between the incentive purposes of the act and the interests of the consumers is now being undermined by the DOI. As Chief Judge Seth pointed out in his dissenting opinion in Hoover & Bracken Energies, Inc. v. DOI, 723 F.2d 1488, 1493 (10th Cir. 1983) *cert. denied*, 469 U.S. 821, 105 S.Ct. 93 (1984):

> It was understood that under the Act the Severance taxes would be passed on to the consumers. Congress thus balanced the considerations among the lessors,

lessees, purchasers and the public. This fixed the public policy considerations beyond changes by administrative agencies . . . . Congress also set price ceilings and classifications beyond the authority of administrative agencies. The Act thus made fundamental changes in the theory of pricing, the method of pricing, the handling of severance taxes, and the allocation of authority. The Act thereby impacted Interior's formula for royalty calculations.

In sum, under the statutory scheme of the NGPA, severance tax reimbursements are not payments for the sale of gas — they are reimbursements for out-of-pocket costs. Thus, they are not royalty-bearing. Moreover, for the Department to require the payment of royalties on costs reimbursements would undermine the underlying intent of the NGPA, which was to allow the reimbursement of certain costs, in addition to the ceiling price, as an incentive for the production of gas that might not otherwise be produced.

Even if the Department could lawfully claim a royalty based on the value of either total unit production or total lease production, if the Department is allowed to claim a portion of the reimbursement of taxes paid by others, it must also take into consideration the costs that these others incurred in order to obtain those tax reimbursements. This is because production for royalty purposes is determined at the well, and because the payment of severance taxes is a post-production cost that must be deducted from the proceeds received to determine a wellhead value. Again, using the example from above:

> the private lessor receives the \$4.00 ceiling price + a \$.40 tax reimbursement, but it pays \$.40 in taxes — therefore, the value of the private lessor's royalty share of the gas at the well would be \$4.00 + \$.40 − \$.40 = per unit;
>
> the lessee likewise receives the \$4.00 ceiling price + a \$.40 tax reimbursement, but it also pays \$.40 in taxes — therefore, the value of the lessee's working interest share of the gas at the well would also be \$4.00 per unit.

Thus, a percentage of the value of total production at the well is the same as the value of the government's 1/8 royalty share of the production:

1/8 of the proceeds attributable to the State of Utah lease ($4.00 per unit for the 1000 units produced, i.e., $4000.00) = $500.00;

the proceeds received for the government's 1/8 share of the production (12.5 units x $4.00) = $500.00.

Under either theory, the royalty payments in this case were correct — the reimbursements that they received for the taxes paid on their working interest share of the gas produced from their leases were not subject to royalty.

C. The Inclusion Of A So-Called "Federal Floor" Provision In The State's Lease Form Does Not Thereby Incorporate Federal Statutes, Regulations, Interpretations, and Policies Concerning Valuation of Federal Royalties.

Utah Code Ann. §65-1-18 is the statute which governed the issuance of the oil and gas leases in question. The statute provided, in relevant part, as follows:

> All mineral leases issued by the Board shall contain such terms and provisions as the Board deems to be in the best interest of the State and shall provide for such annual rental and for such royalties as the Land Board shall deem fair and in the best interest of the State of Utah, but the annual rental shall not be less than 50¢ per acre per annum nor more than $1 per acre per annum and the royalty shall not exceed 12½% of the gross value of the product at the point of shipment from the leased premises.

While the statute provided that "[A]ll mineral leases issued by the Board shall contain such terms and provisions as the Board deems to be in the best interest of the State" and "shall provide for . . . such royalties as the Land Board shall deem fair and in the best interest of the State of Utah . . .", the statutory delegation is not without limitation. The Board may not provide for a royalty in excess of "12½% of the gross value of the product . . . ."

Nowhere does the statute suggest that the Board may, in essence, by a single reference in the State's lease form to the "price" received by the United States for its production in the field thereby cause the statutes, regulations, rules, and policies of another jurisdiction to be read into the State of Utah's oil and gas leases. Yet this is precisely the result that the State urges in its reliance upon the so-called "federal floor" provision of its oil and gas leases.

The leases in question provided, in relevant part, "that in no event shall the price for gas be less than that received by the United States of America for its royalties from gas of like grade and quantity from the same field." *See* Exhibit "C", Section 4(c), to Brief of Appellant Enron Oil & Gas Company (emphasis supplied).

There are numerous statutes governing the determination of federal royalty value. *See generally*, the Mineral Lands Leasing Act of 1920, 30 U.S.C. §§181-263, the Mineral Leasing Act for Acquired Lands, 30 U.S.C. §§351-359, the 1938 Omnibus Leasing Act, 25 U.S.C. §§396(a) — 396(g), the Outer Continental Shelf Lands Act, 43 U.S.C. §§1331, *et seq.*, and the Federal Oil and Gas Royalty Management Act, 30 U.S.C. §§1701, *et seq.*

In addition to this complex statutory scheme, there exists a complex web of federal regulations governing federal royalty valuation. *See generally*, Subparts C and D of Part 206 of Title 30 of the Code of Federal Regulations. Further, these statutes and regulations are subject to a myriad of interpretations, both by the Director of the Minerals Management Service, the federal bureau within the Department of the Interior charged with overseeing product valuation and royalty collections from federal lands, and by the Interior Board of Land Appeals, an adjudicatory tribunal within the Department of the Interior that hears, *inter alia*, appeals of decisions of the Director of the MMS. So extensive is the present jurisprudence governing federal royalty valuation that the above-referenced statutory, regulatory and administrative authorities are published in a 15 volume loose-leaf service compiled and edited by the Rocky Mountain Mineral Law Foundation. *See* Gower Federal Service, "Royalty Valuation and Management", Volume 1-15.

It is inconceivable that the legislature, in delegating certain powers to the Board to establish "fair" royalties, contemplated that the Board would, in essence, purport to adopt by reference in a single phrase in the State's oil and gas lease form the complex statutory and regulatory regime applicable to federal lands. Nor could it have envisioned that a lessee of State lands, in ascertaining its royalty obligation to the State, would be required to look not to Utah's statutes, not to regulations promulgated by the Board, nor even to the terms of its contract with the State, but that it would be required to look to the statutes, regulations, and interpretations of a federal agency without jurisdiction of any sort over the State lands of the State of Utah.

The issues raised by any such construction are almost endless. For example, if the "federal floor" provision causes federal law to be incorporated into the lease terms, are the statutes, regulations, interpretations, and policies of the Interior Department in existence at the time of lease issuance to govern, or do evolving federal statutory, regulatory and interpretative policies cause the meaning of Utah's leases to vary over time? Conversely, can the Department disavow any federal policy or interpretation it does not approve and, if so, under what circumstances? As the court can see from these two examples, and from the countless others that come easily to mind, any such construction of the language of this lease provision will do nothing other than cause uncertainty, engender endless and useless controversy, and foster needless litigation.

Amici therefore strongly urge this court that the implications of this case are both far reaching and significant. The Board's attempt to bootstrap itself into a sort of quasi-federal agency, despite the lack of legislative authorization, should not be countenanced. No lessee of State lands should be expected to anticipate that the voluminous and complex regulatory scheme governing federal lands is subsumed within a single phrase buried in the boilerplate of the State's lease form. A more reasoned interpretation of this provision, and, most significantly, one that does not result in such obviously unintended consequences, is found in Appellant's Brief at page 22, paragraph B.3.

CONCLUSION

The tax reimbursements at issue in this case were not payments for gas. Rather, they were allowed as an incentive, under strictly limited circumstances, by Section 110 of the NGPA. Therefore, to subject the reimbursements to royalty would be contrary to the incentive purposes of the NGPA. Moreover, even if the reimbursements could be considered to be payment for the sale of the Appellant's working interest share of the gas, the Appellants were prohibited by law from collecting reimbursements with respect to the State of Utah's royalty share of the gas. Therefore, reimbursements can form no part of the value of the government's royalty gas. Even if the Department could lawfully consider the value of the tax reimbursements received by others in determining its lessee's royalty obligations, it must also consider the corresponding costs incurred by those others in paying the taxes. Finally, the "federal floor" provision of the State's lease form should not be construed as incorporating the complex web of statutes, regulations, interpretations, and policies attendant to federal royalty valuations. Therefore, even under the government's numerous and varied theories, royalties cannot be collected on the tax reimbursements at issue in this case.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that, pursuant to Rule 26 of the Utah Rules of Appellate Procedure, four (4) copies of the above and foregoing Brief of *Amicus Curiae* ANR Production Company, CIG Exploration, Inc. and Coastal Oil & Gas Corporation have been served on counsel of record for the Appellees and counsel of record for Appellant, respectively, on this the 2nd day of March, 1992, by depositing same into the United States mail, postage prepaid, and addressed as follows:

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