

FEDERAL COURT INVALIDATES FEDERAL AND INDIAN GAS LEASING RULE

by

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In the consolidated cases of Independent Petroleum Association of America v. Armstrong, Civ. No. 98-00531, and American Petroleum Institute v. Babbitt, Civ. No. 98-00631 (D.D.C. March 28, 2000) (slip op.), the United States District Court for the District of Columbia recently invalidated a Department of Interior ("DOI") rule that would have imposed a duty on federal and Indian gas lessees to market gas downstream at no cost to the lessor, and that would have disallowed the deduction by the lessee of downstream marketing costs.

Prior to 1992, all costs associated with moving gas produced from federal Indian lands to downstream markets were treated collectively as transportation costs, and were deductible by the lessee from royalty value when the point of sale was downstream from the lease. Slip op. at 6. In 1992, however, the Federal Energy Regulatory Commission issued its Order No. 636, which in part required pipelines to convert their existing bundled sales and transportation service into separate services with independent charges for each element of a pipeline's transportation services. In purported response to the demands of the changes in the gas market brought about by Order No. 636, the Minerals Management Service ("MMS") proposed in 1996 and promulgated in 1997 a rule that, among other things, created for the first time an express duty on the lessee to market gas downstream at no cost to the lessor, and to disallow deductions by the lessee for marketing costs and certain transportation charges. Slip op. 10. MMS is the bureau within DOI in charge of federal and Indian gas royalty collection and distribution.

Two gas industry trade associations whose members hold federal and Indian gas leases challenged the MMS rule's mandate that these downstream costs (labeled by MMS as "marketing costs"), previously deductible from royalty value, were now no longer deductible. Slip op. 12. Specifically, the trade associations attacked the MMS rule under the Administrative Procedures Act ("APA") as arbitrary and capricious. MMS and DOI (collectively "the agencies") maintained that their disallowance of deductions for downstream marketing costs was merely a continuation of longstanding agency policy, and that the MMS rule was entitled to deference because it was a reasonable use of the agencies' authority to define the "value" of gas production for royalty purposes. Slip op. 13.

The United States District Court for the District of Columbia disagreed with the agencies. Preliminarily, the court noted the general rule under the APA that, to sustain its actions, an agency must articulate a satisfactory explanation for its action and a rational connection between the facts found and the choice made. Slip op. 16. Further, the court noted that when an agency changes a settled course of behavior or departs from a prior policy, the agency is obligated to provide in the record a reasoned analysis for the

change. Slip op. 16 Finally, the court noted an agency's interpretation of its own regulations is not entitled to deference when it will affect contracts to which the agency is a party. Slip op. 18.

From these rules, the court held that it was well-recognized that the government's oil and gas royalty interest is limited to the production at the lease or the wellhead, not in value enhancements resulting from downstream activities. Slip op. 20. Thus, the court ruled that the government's royalty interest on the value of production may not include proceeds attributable to matters other than gas production, and that MMS' position that it had the authority to define value to include downstream costs unrelated to production of the gas was therefore untenable. Slip op. 20. Further, the court gave little deference to the agencies' interpretation of its existing rules as support for the new rule, because such interpretations are looked upon skeptically by courts when, as here, the interpretation greatly expands the obligations of a private party to the direct benefit of the government. Slip op. 27. Finally, the court reviewed various existing agency gas lease forms and found that a duty to market gas at no cost to the lessor could not reasonably be implied from those leases. Slip op. 28. The court therefore held that the rule imposing a duty on lessees to market gas downstream at no cost to the lessor and disallowing the deduction of downstream "marketing" costs was invalid. Slip op. 35.

As indicated above, the district court opinion restates a number of legal principles of interest to entities pursuing litigation against the federal government and its agencies.