IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

FINA OIL & CHEMICAL COMPANY, *et al.*	)	
Plaintiffs,	)	
v.	)	**Case No. 99-2392 (HHK)**
BRUCE BABBITT, Secretary of the Interior,	)	
Defendant.	)	

DEFENDANT'S REPLY TO PLAINTIFFS' OPPOSITION TO
DEFENDANT'S CROSS-MOTION FOR SUMMARY JUDGMENT

In their July 18, 2000 brief opposing Defendant's motion for summary judgment ("Opp. Br."), Plaintiffs Fina Oil and Chemical Company ("FOCC") and Petrofina Delaware, Inc. ("PDI") (collectively "Fina") have abandoned all but two of the myriad allegations of their complaint. 1/ Fina's remaining theories are: 1) that the agency's interpretation of the "gross proceeds" rule allegedly is not entitled to deference because MMS has a proprietary interest in the leases, and because the interpretation allegedly is inconsistent with the statutory and regulatory definition of "lessee;" and 2) that lessees are not required to market their production at no cost to the United States. As we now explain, these two surviving claims are likewise unsustainable.

1/ Defendant addressed these allegations in its summary judgment memorandum, and established that the orders under review do not violate the notice and comment requirements of 5 U.S.C. § 553, do not constitute retroactive rulemaking, do not effect an uncompensated "taking," and are not barred by equitable estoppel (see Def. Mem. 32-39). In its opposition brief, Fina makes no effort to oppose Defendant's motion for summary judgment seeking dismissal of the complaint allegations concerning the 5 U.S.C. § 553, retroactive rulemaking, uncompensated "takings," and equitable estoppel allegations. Because Fina does not oppose Defendant's cross motion for summary judgment on these issues, and because Fina's own cross motion for summary judgment makes no attempt to sustain these allegations, the Court should treat these claims as abandoned. The Court should likewise treat as abandoned Fina's "self-audit" claim (See Comp. at ¶¶ 105-108) and its statute of limitations claim (Comp. at ¶¶ 109-110). For although Fina raised a tepid opposition to Defendant's motion for summary judgment on these latter two claims, it ultimately disowned them by expressly stating that the "Court need not reach those issues." Opp. Br. 19. Accordingly, Defendant is entitled to summary judgment (and dismissal with prejudice) of these claims as well.

I. MMS' INTERPRETATION OF THE "GROSS PROCEEDS" RULE IS ENTITLED TO DEFERENCE

Fina asserts that MMS' interpretation of the "gross proceeds" rule is "entitled to no deference because it has a proprietary interest in the lease." Opp. Br. 3. This claim flatly contradicts a long line of precedent establishing that MMS' interpretations of that rule are entitled to "substantial deference." Moreover, Fina's argument is based on the erroneous assumption that the agency's decision was based on interpretation of lease language instead of its royalty valuation regulations.

Under the mineral leasing laws, the Secretary retains the authority and discretion to establish value for royalty purposes. 1/ These statutes grant the Secretary the authority to prescribe rules and regulations necessary to carry out the purposes of the statutes. 1/ These regulations have the force and effect of law when not in conflict with those statutes. Chevron U.S.A., Inc. v. Natural Resources Defense Council, 467 U.S. 837 (1984). The leases by their express terms are "subject . . . to all reasonable regulations of the Secretary of the Interior now or hereafter in force" unless inconsistent with the leases themselves.

In Udall v. Tallman, 380 U.S. 1, 17 (1965) (emphasis added), the Supreme Court held:

> When the construction of an administrative regulation rather than a statute is in issue, deference is even more clearly in order. Since this involves an interpretation of an administrative regulation, a court must necessarily look to the administrative construction of the regulation if the meaning of the words used is in doubt. . . . The ultimate criterion is the administrative interpretation, which becomes of controlling weight unless it is plainly erroneous or inconsistent with the regulation. Bowles v. Seminole Rock Co., 325 U.S. 410, 413-414.

Similarly, in upholding the Secretary's exercise of his discretion to establish royalty value

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2/ See, e.g., Marathon Oil Co. v. U.S., 604 F. Supp. 1375 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 480 U.S. 940 (1987); California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961); Continental Oil Co. v. U.S., 184 F.2d 802, 821 (9th Cir. 1950); U.S. v. Ohio Oil Co., 163 F.2d 633, 640 (10th Cir. 1947), cert. denied, 333 U.S. 833 (1948).

3/ 43 U.S.C. 1334 (offshore leases); 30 U.S.C. 189 (Mineral Leasing Act ("MLA"), onshore leases); 25 U.S.C. 396 (Indian allotted leases); 25 U.S.C. 396d (Indian tribal leases).

under the Department's regulations, this Circuit deferred to the Secretary's regulatory interpretation of the MLA because "his definition was a reasonable one and the court should not reject it." California Co. v. Udall, 296 F.2d at 388. This Circuit also restated in two recent cases that in addressing DOI's interpretation of its royalty value regulations, courts must defer to the Department's interpretation if that interpretation is a reasonable one. Amax Land Co. v. Quarterman, 181 F.3d 1356, 1365 (D.C. Cir. 1999); IPAA v. Babbitt, 92 F.3d 1248, 1257 (D.C. Cir. 1996).

Other courts have also uniformly applied this established deference principle in examining Departmental decisions interpreting royalty value regulations. 1/ Indeed, it appears that every court -- with the exception of Judge Lamberth in IPAA v. Armstrong, 91 F. Supp. 2d 117 (D.D.C. 2000) ("Armstrong") -- that has reviewed Departmental decisions under MMS regulations has applied this deference standard. Fina cannot distinguish this case from any of the foregoing cases on the ground that MMS has a "proprietary" interest in the FOCC and PDI leases, because MMS had the same alleged "proprietary" interest in the leases in IPAA v. Babbitt, Amoco, Marathon, and Hoover and Bracken, as it does here.

Fina argues that this Court should withhold deference to the agency's interpretation under Mesa Air Group, Inc. v. USDOT, 87 F.3d 498 (D.C. Cir. 1996), and Meadow Green-Wildcat Corp. v. Hathaway, 936 F.2d 601 (1st Cir. 1991). In Mesa, the Court found that the Department of Transportation was not entitled to Chevron deference to its interpretation of the provisions of certain "subsidy agreements" to which it was a party. Similarly, in Meadow Green, the First Circuit ruled

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4/ E.g., Mesa Operating Limited Partnership v. DOI, 931 F.2d 318, 322, 327 (5th Cir. 1991), cert. denied, 502 U.S. 1058 (1992); Marathon Oil Co. v. U.S., supra; Hoover & Bracken Energies, Inc. v. DOI, 723 F.2d 1488, 1489 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984); Enron Oil & Gas Co. v. Lujan, 778 F. Supp. 348 (S.D. Tex. 1991), aff'd, 978 F.2d 212 (5th Cir. 1992), cert. denied, 510 U.S. 813 (1993); Pennzoil Exploration and Production Co. v. Lujan, 751 F. Supp. 602, 605 (E.D. La 1990), aff'd, 928 F.2d 1139 (TECA 1991); Amoco Production Co. v. Lujan, 877 F.2d 1243, 1248 (5th Cir.1989).

that a special use permit issued by the Forest Service for a ski area was "like a contract," not a regulation and, therefore, the Forest Service was owed no deference in its interpretation of the "contract" provisions. 936 F.2d at 604-05.

Mesa and Meadow Green are not on point. They involve agency interpretation of contract language in agreements to which the agencies were parties. They did not involve agency interpretation of its own regulations. 1/ Indeed, in Meadow Green, the First Circuit distinguished Mountain States Tel. & Telegraph Co. v. U.S., 499 F.2d 611 (Ct.Cl. 1974), which held that substantial deference is owed to agency regulations, even regulations affecting how much fee money a special use permit holder owes the United States.

Thus, Fina's reliance on these "contract interpretation" cases is wholly misplaced. Fina nowhere identifies any lease language that MMS purports to interpret, much less abrogate. MMS did not rely on lease language in determining that the value of Fina's production should be established by the wholly-owned affiliate's arm's-length resale price. Rather, it relied on the gross proceeds rule.

Fina's reliance on Transohio Savings Bank v. OTS, 967 F.2d 598, 614 (D.C. Cir. 1992) is similarly off the mark. While the D.C. Circuit in Transohio noted in dicta that it had expressed "concern" in the past about deferring to an agency's interpretation of agreements to which it is a party, it did not establish or cite to an absolute rule — much less a rule regarding an agency's interpretation of its regulations. *Id.* at 614. Moreover, that decision raised the question of whether to accord deference to an agency's interpretation of newly-enacted statutory language that affected agreements to which the agency was a party. Id. at 614-15. The court did not answer that question

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5/ Fina also relies on a snippet from National Fuel Gas Corp. v. FERC, 811 F.2d 1563, 1571 (D.C. Cir. 1987). *See* Opp. Br. 4-5. There, the Court hypothesized about possible scenarios in which deference to an agency's interpretation of a contract (as opposed to a regulation) "may" or "might" be inappropriate. This case is distinguishable because this matter involves interpretation of a regulation, not a contract or lease. In any event, National Fuel's ruminations were dicta.

because it found that the first step of Chevron -- whether Congress spoke directly to the issue in the statutory language -- had been satisfied. Id. Indeed, the court found that the agency was "merely carrying out specific orders from Congress." Id. Transohio therefore is neither applicable nor analogous to this case.

Even if Transohio stood for the generic proposition which Fina attributes to it, that proposition would not apply in the Federal mineral lease context. Under Federal or Indian mineral leases, one party to the contract has the authority to determine the basis on which the other party must pay. This may be unusual authority when viewed from a general contract perspective, but the Secretary possesses that authority nonetheless. It does not make sense to say that the agency's interpretation of its rules is not entitled to deference where it affects contracts to which the agency is a party when the authority to "affect" the contract has been reserved to the agency by Congress and the lease terms from the beginning. 1/

II. MMS' INTERPRETATION ACCORDS WITH THE STATUTORY AND REGULATORY DEFINITIONS OF "LESSEE"

Fina also claims MMS' interpretation is at odds with the definition of "lessee" in the statutes and regulations. See Opp. Br. 5-10. Contrary to Fina's assertions, MMS has the inherent authority under 30 U.S.C. § 226, 43 U.S.C. § 1337(a)(1), and the gross proceeds rule, 30 C.F.R. §§ 206.152(h) and 206.153(h), to look through transactions between a lessee and its affiliate to the substance and economic reality of the ultimate disposition of production, when necessary, to avoid frustration of statutory and regulatory purposes. See, e.g., General Telephone Co. v. U.S., 449 F.2d 846 (5th Cir. 1971) (federal licensing requirements of Section 214 of the Communications Act, which apply only

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6/ For these same reasons, Defendant believes that IPAA v. Armstrong is demonstrably incorrect in this regard, and should be accorded no weight. This Court should not embrace ambiguous language from Armstrong that, if applied in the context of interpreting regulatory provisions themselves, would run contrary to decades of judicial precedent in this and other Circuits.

to "common carriers" as defined in that Act, could be extended to affiliates of "carriers" offering cable TV services, even though they did not meet the definition of "carrier," where necessary to enforce licensing requirements of the Act); Kavanaugh v. Ford Motor Co., 353 F.2d 710, 716-17 (7th Cir. 1965) (individual deemed an "automotive dealer" within meaning of Dealers Day In Court Act, notwithstanding that he did not meet statutory definition of same, because upholding corporate fiction would subvert purposes of that Act); see also Schenley Distillers Corp. v. U.S., 326 U.S. 432, 347 (1946) (recognizing that "corporate entities may be disregarded where they are made the implement for avoiding a clear legislative purpose."). 1/

In this case, the agency correctly ruled that Fina's position would "allow [] any lessee to avoid the gross proceeds requirement by the simple and facile device of creating a wholly-owned subsidiary and then first transferring the production to an affiliate, for a price the lessee determines unilaterally, before selling the production at arm's-length at a higher price." AR 19, adopting AR 20 G. Moreover, contrary to Fina's unsupported assertion (Opp. Br. 8), the statutory definition of "lessee" in the Federal Oil and Gas Royalty Management Act, 30 U.S.C. § 1702 (7), does not speak to the "precise question" at issue. Nowhere does that definition address its application to wholly-owned or wholly-commonly-owned affiliates. Thus, in light of the abundant case law recognizing the agency's authority to look through corporate formalities when necessary to avoid circumvention of statutory purpose, the agency's interpretation of its regulations in this regard was eminently reasonable.

III. THE AGENCY PROPERLY CONCLUDED THAT FINA HAD SHIFTED THE EXPENSES OF MARKETING ITS PRODUCTION TO ITS AFFILIATE

7/ To like effect, see Cities Service Gas Co. v. FPC, 155 F.2d 694, 703 (10th Cir. 1946) (agency may attribute as revenues to a regulated natural gas company the profits generated by an unregulated affiliate in performing an activity that was essential to the transportation and resale of natural gas); Hope Natural Gas Co. v. FPC, 134 F.2d 287, 307 (4th Cir. 1943), rev'd on other grounds, 320 U.S. 591 (1944) (same); Transcontinental Gas Pipe Line Corp. v. FERC, 998 F.3d 1313, 1321 (5th Cir. 1998) (natural gas company required to make refunds where it set up affiliate to sell gas at prices the company itself could not legally sell).

Fina next argues that the "arithmetic difference" between the price at which FOCC and PDI sold production to their wholly-commonly-owned affiliate (FNGC), and the higher price at which FNGC resold the production to third parties, does not constitute the lessees' marketing costs. According to Fina, "the sales revenues obtained by FNGC are determined by market forces in the midstream and downstream markets" and are "unrelated to the market price at the lease, and hence to the value of production saved, removed, or sold at the lease." Opp. Br. 15-16.

Under MMS' methodology, when a lessee's gas is sold at the lease, the value of the gas sold at arm's-length is determined by the arm's-length price. 30 C.F.R. §§ 206.1152(b)(1)(i); 206.153(b)(1)(i). When gas is sold at arm's length away from the lease, the value of gas at the lease is computed as the arm's-length sale price at the remote location minus an applicable transportation allowance. 30 C.F.R. §§ 206.152(b)(1)(i); 206.153(b)(1)(i); 206.156(a). This is how the agency has always valued production for royalty purposes. 1/ Marketing costs only become an issue when a producer or lessee attempts to deduct those costs from its gross proceeds. In those instances, the

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8/ Fina is wrong to suggest that there is no relationship between the revenues that FNGC receives in arm's-length sales of the lessee's production away from the lease, and the value of Fina's production at the lease. The direct link between the two is the transportation allowance authorized by MMS' regulations. 30 C.F.R. § 206.156. That is, the value at the lease is always at least the gross proceeds received for production sold away from the lease minus the allowable cost of transporting the gas to the downstream market. E.g., Marathon Oil Co. v. U.S., supra. Moreover, Fina twice admits that it "derived" the inter-affiliate transfer price between FOCC/PDI and FNGC from "public indices." Opp. Br. 16, 19 n.7. Those "public indices" are onshore index prices "downstream" from the lease. There are no index prices at the lease. Fina is simply admitting that, in "deriving" the inter-affiliate price, it subtracted considerably more than the costs of transportation-- i.e., it subtracted marketing costs and possibly additional amounts. Indeed, Fina's brief says as much. Opp. Br. 16. Thus, by Fina's own admissions, the inter-affiliate transfer price is related to downstream value.

Fina asserts the "vast majority" of FNGC's sales transactions were downstream of the lease, and that FNGC provided transportation services with respect to those transactions. Opp. Br. 14-15. Assuming arguendo that those assertions are true, MMS has already acknowledged that Fina is eligible for a transportation allowance. See AR 769; see also 30 C.F.R. § 206.156.

agency has routinely denied such a deduction from royalty value. E.g., U.S. v. General Petroleum, 73 F. Supp. 225, 256-57 (S.D. Cal. 1946); Walter Oil and Gas Corp., 111 IBLA 260 (1989); Arco Oil and Gas Co., 112 IBLA 8 (1989); Taylor Energy Corp., 143 IBLA 80 (1998)(petition for reconsideration pending); Amerac Energy Corp., 148 IBLA 82 (1999) (petition for reconsideration pending). 1

In like fashion, marketing costs became an issue in this case only because Fina sought to justify a value for its production that was less than FNGC's resale price (minus applicable transportation allowances) on the ground that FNGC now performs the marketing functions that FOCC and PDI would otherwise have performed. See AR 1024 (Fina expressly concedes that "nominations, management of gas imbalances with pipelines, handling, dispatching, and invoicing, and preparation of pricing forecasts and statistical information . . . . are functions that FNGC now performs that otherwise would have to be performed by PDI and FOCC."); see also AR 807. Thus, MMS' determination that the "difference between the price received by FOCC and PDI and the competitive market value price received by FNGC constitutes a deduction for marketing costs" is substantially correct because it was based on Fina's own admissions that FNGC performed these marketing services on its behalf. 1/ Thus, in line with Amerac and Taylor Energy, the agency properly ruled that Fina may not deduct the cost of these services from its royalty obligation. 1/

9/ The possibility that the "arithmetic difference" between the FOCC/PDI-FNGC price and the FNGC resale price may reflect more than actual costs of marketing does not affect or negate the underlying principle. To the extent that part of that difference reflects transportation costs, Fina is entitled to a deduction, as explained above. To the extent that it may also reflect gain derived from marketing efforts, that gain is part of what Fina realizes for sale of the production and, thus, is part of its gross proceeds.

10/ Fina's argument (Opp. Br. 16) that FNGC commingles FOCC's and PDI's production with gas purchased from unaffiliated producers is entirely irrelevant to the holdings in Amerac and Taylor — that a lessee may not take a deduction for marketing expenses. That FNGC may incur the expense of marketing production bought from unaffiliated parties does not allow Fina to deduct expenses related to marketing its production in determining royalty value.

Finally, Fina again seeks refuge in the IPAA v. Armstrong decision by reprising many of the Armstrong-related arguments it previously made in its initial summary judgment memorandum. (See Opp. Br. 17-19). Defendant has already addressed the many infirmities of the IPAA v. Armstrong decision, upon which Fina relies, in its previous briefs. (See Def. S.J. Mem. 31-32; Def. S.J. Opp. Br. 23-25. Those arguments need not be repeated here. 1/

1/ Some of Fina's arguments in this regard do warrant a response. First, Fina argues that IPAA v. Armstrong rejected the agency's position that "it has authority to define value to include downstream costs unrelated to the cost of production." Opp. Br. 18. But that is not what the agency did in this case. It instead valued production based on the "gross proceeds" received by the lessee -- wherever it sells the production -- minus the actual cost of getting the production to the place of sale. Moreover, the IPAA v. Armstrong court's reliance on Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159 (5th Cir. 1988) is misplaced. That case dealt only with a timing issue -- when proceeds received by a lessee are ascribable to production. It had nothing to do with either costs or downstream gain. As the Fifth Circuit noted in a subsequent decision, Diamond Shamrock did not address questions regarding how to assess "fair market value" of production. Mesa Operating Ltd. Partnership v. DOI, 931 F.2d 318, 326 (5th Cir. 1991), cert. denied, 502 U.S. 1058 (1992).

Moreover, Fina distorts IPAA v. Armstrong by creating the misimpression that Armstrong ruled that revenue attributable to marketing efforts must be excluded from the royalty obligation. (Opp. Br. 16.) That is simply not the case. In Armstrong, the court invalidated regulations disallowing a deduction for marketing costs. But it did so on a different (and less comprehensive) record, because the Armstrong court did not consider the "gross proceeds" rule, and the longstanding administrative precedents applying that rule (see Walter, Arco, Taylor, and Amerac, supra) disallowing a deduction from royalties for marketing costs. Thus, nothing in Armstrong purported to address whether the revenue received from those marketing efforts is properly part of a lessee's "gross proceeds."

Finally, Fina makes essentially the same mistake that the Armstrong court made when Fina characterizes the agency position as imposing a duty on lessees to market their production "downstream." Opp. Br. 19. As Defendant has stated, federal lessees have a duty to market lease production, and that duty can be satisfied by selling arm's-length at the lease or away from the lease. If production is sold away from the lease, legal precedent and agency regulations have long held that the actual costs of transportation (not marketing costs) are deducted from the "gross proceeds" received by the lessee to arrive at the "value at the lease." See Marathon Oil Co. v. U.S., 604 F. Supp. 1375 (D. Alaska 1985), aff'd, 807 F.2d 759, 766 (9th Cir. 1986), cert. denied, 480 U.S. 940 (1987), citing U.S. v. General Petroleum Corp., 73 F. Supp. 225 (S.D. Cal. 1946), aff'd sub nom, Continental Oil Co. v. U.S., 184 F.2d 802, 820-21 (9th Cir. 1950). Thus, Fina's assertion (Opp. Br. 19 n.7) that Defendant has created a "misimpression" by citation to this longstanding precedent is patently wrong.

CONCLUSION

For the foregoing reasons, and the reasons set forth in Defendant's Cross Motion for Summary Judgment, And Defendant's Memorandum In Opposition To Plaintiffs' Cross Motion For Summary Judgment, Defendant's motion for summary judgment must be granted and Plaintiffs' motion for summary judgment must be denied, and the complaint should be dismissed with prejudice.

Dated: August 4, 2000

Respectfully submitted,

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