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INTRODUCTION

Two oil and gas issues generate continuous debate: the calculation of royalties paid on oil and gas produced on federal land,[1] and the scope of federal preemption of state oil and gas regulations.[2] The Tenth Circuit addressed both issues during the survey period.[3] *Santa Fe Energy Products Co. v. McCutcheon*[4] considered calculation of federal royalties when oil or gas is sold by a producer in a non-arm's length transaction.[5] *Panhandle Eastern Pipeline Co. v. Oklahoma*[6] discussed the relative authority of federal and state regulations governing oil and gas activities.[7]

I. GENERAL BACKGROUND

Domestic natural gas production continues to rise and reached 19 trillion cubic feet in 1996.[8] Crude oil production, although at a forty-two year low, forged ahead at 6.4 million barrels a day in 1996.[9] Revenues to the federal treasury generated by rent and royalties from oil and gas activities on federal land are measured in the billions of dollars annually; only federal income tax revenue exceeds the revenue generated by the nation's natural resources.[10]

Federal regulation of this vast enterprise has expanded over the past sixty years. State and local governments regulated natural gas sales prior to 1938.[11] However, Supreme Court decisions in 1918 and 1924 restricted the state regu-

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1. *See, e.g.*, Owen L. Anderson, *Calculating Royalty: "Costs" Subsequent to Production—"Figures Don't Lie, But . . . ."*, 33 WASHBURN L.J. 591, 591 (1994). "Royalty payment disputes, particularly those involving gas, will continue to be a chief source of litigation in the future." *Id.*

2. *See, e.g.*, David E. Pierce, *Reconciling State Oil and Gas Conservation Regulation with the Natural Gas Act: New Statutory Revelations*, 1989 BYU L. REV. 9, 10 (1989). "After fifty years of experience under the Natural Gas Act (NGA), allocation of federal and state authority to regulate oil and gas production remains unclear." *Id.*

3. In addition, the Tenth Circuit decided two other oil and gas cases between September, 1995 and August 1996. First, the court considered a private contract dispute with respect to drilling company leases in *Slawson Exploration Co. v. Vintage Petroleum, Inc.*, 78 F.3d 1479 (10th Cir. 1996). Second, the court examined the jurisdiction of the Federal Energy Regulatory Commission in the context of interstate transportation of gas in *Colorado Interstate Gas Co. v. FERC*, 83 F.3d 1298 (10th Cir. 1996).

4. 90 F.3d 409 (10th Cir. 1996).

5. *Santa Fe Energy Prods.*, 90 F.3d at 411-15.

6. 83 F.3d 1219 (10th Cir. 1996).

7. *Panhandle*, 83 F.3d at 1225-29.

8. American Gas Association, *Preliminary Findings Concerning 1996 Natural Gas Reserves* (visited June 11, 1997) <http://www.aga.com/gio/96gas.html>.

9. Telephone Interview with Joe Lastelic, Spokesman, American Petroleum Institute (June 11, 1997).

10. Michael E. Shapiro, *Sagebrush and Seaweed Robbery: State Revenue Losses from Onshore and Offshore Federal Lands*, 12 ECOLOGY L.Q. 481, 481 (1985).

11. WILLIAM A. MOGEL, TRANSPORTATION AND MARKETING OF NATURAL GAS 19 (1985).

lation of oil and gas within interstate commerce.[12] Congress reacted to the interstate regulatory gap by enacting the Natural Gas Act (NGA) in 1938.[13] The stated purpose of the NGA is to protect the public interest by regulating the transportation and sale of natural gas in interstate commerce.[14] Congress vested NGA oversight in the Federal Power Commission (FPC) (subsequently renamed the Federal Energy Regulatory Commission (FERC)).[15] Oil shortages and rising oil prices led Congress to amend the NGA regulatory scheme by enacting the Natural Gas Policy Act of 1978 (NGPA).[16] The NGPA altered the method for computing natural gas pricing by abandoning a cost-based formula requiring complex calculations of producer costs.[17] The act instituted a new method that categorized gas based on the circumstances of its production and sale.[18] The categories are defined by various circumstances of the "first sale" of the gas.[19]

Problems computing oil and gas royalties[20] led Congress to enact the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA).[21] Congress hoped to mitigate a number of ills affecting federal oil and gas management, including royalty procedures overwhelmed by the growing volume and complexity of accounting systems, drilling field thefts of equipment and oil,

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12. *Id.* at 19-20 (citing Missouri v. Kansas Natural Gas Co., 265 U.S. 298 (1924) and Public Util. Comm'n v. Landon, 249 U.S. 236 (1918)).
13. MOGEL, *supra* note 11; Natural Gas Act, 15 U.S.C. §§ 717, 717a-717w (1994).
14. 15 U.S.C. § 717(a)-(b) (1994).
15. 42 U.S.C. § 7172(a)(1)(C) (1994).
16. MOGEL, *supra* note 11, at 59. *See also* Natural Gas Policy Act of 1978, Pub. L. No. 95-621, 92 Stat. 3350 (codified in scattered sections of 12 U.S.C.).
17. MOGEL, *supra* note 11, at 63.
18. *Id.*
19. *Id.* at 64 (citing 15 U.S.C. § 3301(21) (1994)). The statute defines "first sale":

> (A) General rule.—The term "first sale" means any sale of any volume of natural gas—
> (i) to any interstate pipeline or intrastate pipeline;
> (ii) to any local distribution company;
> (iii) to any person for use by such person;
> (iv) which precedes any sale described in clauses (i), (ii), or (iii); and
> (v) which precedes or follows any sale described in clauses (i), (ii), (iii), or (iv) and is defined by [FERC] as a first sale in order to prevent circumvention of any maximum lawful price not established under this chapter.
> (B) Certain sales not included.—Clauses (i), (ii), (iii), or (iv) of subparagraph (A) shall not include the sale of any volume of natural gas by any interstate pipeline, intrastate pipeline, or local distribution company, or any affiliate thereof, unless such sale is attributable to volumes of natural gas produced by such interstate pipeline, intrastate pipeline, or local distribution company, or any affiliate thereof.

15 U.S.C. § 3301(21).

20. Criticisms of federal oil and gas royalty management led Secretary of the Interior James Watt to appoint a panel to study the Department of Interior's royalty accounting systems. The panel issued its report in January of 1982. U.S. COMM'N ON FISCAL ACCOUNTABILITY, U.S. DEP'T OF INTERIOR, FISCAL ACCOUNTABILITY OF THE NATION'S ENERGY RESOURCES: REPORT OF THE COMMISSION 13-39 (1982). The Commission was popularly named for its chair, David E. Linowes, and this publication is thus known as the "Linowes Report." The report contained sixty recommendations for royalty reform, after listing many problems with the current regulatory framework. Its recommendations drove Congress to swift action; the President signed FOGRMA on January 12, 1983. Laura Lindley, *Of Teapot Dome, Wind River and Fort Chaffee: Federal Oil and Gas Resources*, NAT. RESOURCES & ENV'T, Summer 1995, at 25.
21. Federal Oil and Gas Royalty Management Act of 1982, 30 U.S.C. §§ 188, 191, 1701-57 (1994).

and federal government reluctance to take advantage of state and Indian tribe offers to assist in royalty management.[22] Furthermore, Congress determined that companies underpaid royalty obligations by as much as 10 percent, resulting in an estimated loss of $500 million annually.[23] These problems led Congress to the reforms embodied in FOGRMA.[24] The Tenth Circuit considered regulations promulgated under FOGRMA targeting royalty management in *Santa Fe Energy Products Co. v. McCutcheon.*[25]

II. AFFILIATE SALES AND ROYALTY CALCULATIONS

A. *Background*

To address serious defects in royalty management and the methodologies used to compute the lessor's royalties under federal oil and gas leases, Congress enacted FOGRMA in 1982.[26] Among the reforms instituted by FOGRMA is a framework for federal royalty management and enforcement. This scheme directs the Mineral Management Service (MMS) to solicit the assistance of states and Indian tribes to enforce its provisions.[27] The statute defines the rights and responsibilities of lessees, operators, and other persons involved in oil and gas transportation and the sale of oil and gas produced from federal leases.[28] It also specifies record-keeping duties for operators, audit authority for federal, state and Indian agencies, royalty payment methodologies, inspection rights, and civil and criminal penalties.[29]

Heightened audit requirements are among FOGRMA's reforms. Section 103(a) of FOGRMA requires federal oil and gas producers, transporters, lessees, and others to maintain royalty records.[30] The act requires these parties to produce royalty records upon request by the Secretary of the Interior, a state, or any Indian tribe.[31] The Secretary delegated authority to the MMS to audit royalty payments.[32] As a result of these reforms, Congress hoped to remedy serious defects in the royalty management system by conducting more

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22. H.R. REP. NO. 97-859, at 15 (1982), *reprinted in* 1982 U.S.C.C.A.N. 4268-69.
23. *Id.* at 16 (citing General Accounting Office reports).
24. *Id.* at 15-16.
25. 90 F.3d 409, 413 (10th Cir. 1996).
26. *See supra* notes 20-24 and accompanying text.
27. 30 U.S.C. § 1701(b)(5) (1994).
28. 30 U.S.C. § 1701(b)(1) (1994).
29. 30 U.S.C. §§ 1713-1715, 1718-1720 (1994).
30. Federal Oil and Gas Royalty Management Act § 103(a), 30 U.S.C. § 1713 (1994). The statute states:

> A lessee, operator, or other person directly involved in developing, producing, transporting, purchasing, or selling oil or gas subject to this chapter through the point of first sale or the point of royalty computation, whichever is later, shall establish and maintain any records . . . and provide any information that the Secretary may, by rule, reasonably require . . . . Upon the request of any officer or employee duly designated by the Secretary or any State or Indian tribe conducting an audit or investigation pursuant to this chapter, the appropriate records, reports or information . . . shall be made available for inspection and duplication by such officer or employee . . . .

Id.

31. *Id.*
32. 30 C.F.R. § 201.100 (1996).

audits, thus collecting more royalty underpayments.[33]

Regulations promulgated under FOGRMA have been revised frequently.[34] In 1988, the MMS established new oil valuation standards and procedures,[35] and revised the regulations that govern the value of oil and gas for royalty purposes.[36] Prior to 1988, they had used the "gross proceeds rule:"[37] the value of oil and gas production for royalty purposes included the total value of money and other consideration derived by a lessee when making an oil or gas disposition.[38] The rule included a caveat: oil values could be determined by reference to "other relevant matters."[39]

The 1988 revision of the gross proceeds rule provided greater detail to make royalty calculations.[40] The agency confirmed its commitment to the rule by stating that they would generally "assess royalty on the value to which the lessee is legally entitled under its arm's length contract. The MMS maintain[ed] that gross proceeds to which a lessee is legally entitled under arm's length contracts are determined by market forces and thus represent the best measure of market value."[41]

While reaffirming the 1988 revision of the gross proceeds, the MMS added a process to value oil production not sold in an arm's length transaction.[42] Non-arm's length transactions, according to the MMS, include such situations as intracompany use of oil, or a transaction lacking a sales contract.[43]

The 1988 regulations provide the method for assessing the value of oil for royalty purposes within non-arm's length transactions.[44] Specified criteria in a prescribed order are applied.[45] If the first criterion reasonably applies to

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33. H.R. REP. NO. 97-859, at 15 (1982), *reprinted in* 1982 U.S.C.C.A.N. 4268.

34. Mary Gilliam Zuchegno, *How New Rules Affect Existing Oil and Gas Leases*, 19 COLO. LAW. 2073, 2073 (1990).

35. Revision of Oil Product Valuation Regulations and Related Topics, 53 Fed. Reg. 1184 (1988) (codified at 30 C.F.R. pts. 202, 203, 206, 207, 210, 241, and 43 C.F.R. pts. 3100, 3160). Through the revision, the MMS sought to clarify existing regulations promulgated under the NGA, including "that royalty is to be paid on all consideration received by lessees, less applicable allowances, for lease production." *Id.*

36. *Id.* at 1186.

37. 30 C.F.R. § 206.103 (1987), *amended by* 53 Fed. Reg. 1184 (1988). The regulation contains the gross proceeds rule:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, *and to other relevant matters.*

Id. (emphasis added).

38. Independent Petroleum Ass'n of Am. v. Babbitt, 92 F.3d 1248, 1252 (D.C. Cir. 1996) (citing 30 C.F.R. § 206.151 (1995)).

39. 30 C.F.R. § 206.103.

40. Revision of Oil Product Valuation Regulations and Related Topics, 53 Fed. Reg. at 1186.

41. *Id.*

42. Revision of Oil Product Valuation Regulations and Related Topics, 52 Fed. Reg. 1858, 1861 (1987) (to be codified at 30 C.F.R. pts. 202, 203, 206, 207, 210, 241) (proposed Jan. 15, 1987).

43. *Id.*

44. *Id.*

45. 30 C.F.R. § 206.102(c) (1988).

the circumstance of the sale, it is used; otherwise the next applicable criterion is used.[46] The criteria are: (1) The lessee can use its own current posted prices used in arm's length transactions for similar oil sold in significant quantities in the same field; (2) if the lessee has no posted prices, then an arithmetic average of the posted prices, given the same circumstances of the first method, is used; (3) if no posted price exists in the same field, then prices used in a similar field; (4) if no contemporaneous arm's length transactions, then spot sales postings and other relevant information; and (5) a net-back procedure that works backward from the sales price to determine the value to the lessee.[47] In addition, the fifth criterion allows for any other reasonable means to calculate value where all of the previous means are inapplicable.[48]

Thus, the 1988 revision served to substantially clarify the "other relevant matters"[49] language of the pre-1988 regulation, especially in the area of non-arm's length transactions. It was under these regulations that the Tenth Circuit decided the following case.

B. *Santa Fe Energy Products Co. v. McCutcheon*[50]

1. Facts

Santa Fe Energy Resources Company (Producer) and one of its affiliates were the targets of a California State Controller's Office's audit covering royalty payments from 1984 through 1987.[51] The California agency wanted to determine if Producer had mistakenly valued oil for royalty purposes.[52] In the transaction at issue, Producer produced oil under federal leases in California and sold most of its oil to its affiliate, Santa Fe Energy Products Company (Marketing Affiliate).[53] Producer had calculated royalties based on the value of the sale by Producer to its Marketing Affiliate.[54] Although Producer was the lessee of record, the California agency requested documents from Marketing Affiliate to determine if Producer chose the proper values when computing the royalties paid on the oil sold to Marketing Affiliate.[55]

Following Marketing Affiliate's refusal to produce documents, the MMS issued a compliance order to Producer.[56] Marketing Affiliate appealed the MMS' order to its director, who affirmed the agency's order.[57] Thereafter,

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46. *Id.*
47. 30 C.F.R. § 206.102(c)(1)-(6) (1988).
48. 30 C.F.R. § 206.102(c)(5) (1988).
49. 30 C.F.R. § 206.103 (1987).
50. 90 F.3d 409 (10th Cir. 1996).
51. *Santa Fe Energy Prods.*, 90 F.3d at 411.
52. *Id.* at 411-12.
53. *Id.*
54. *Id.* at 412.
55. *Id.* at 411-12.
56. *Id.* at 412.
57. *Id.* The Tenth Circuit quoted the MMS' director's finding that

> [t]he issue in this case is whether the transfer [between Producer and Marketing Affiliate], admittedly not at arm's length, represents fair market value. The request for information from [Marketing Affiliate] was meant to ascertain that fact . . . . Without the

Marketing Affiliate appealed to the Interior Board of Land Appeals (IBLA).[58] The IBLA affirmed the director's order, stating that the MMS could examine the records of an "affected person"[59] and was not limited to examining the records of the federal lessee.[60] Marketing Affiliate's petition for reconsideration was denied by the IBLA.[61]

Marketing Affiliate subsequently filed a complaint in federal district court asking for a review of the IBLA decision.[62] The MMS countered by filing a motion for summary judgment.[63] The district court granted the motion, stating that the MMS has the "broad discretion to require disclosure of information."[64]

2. Decision

The Tenth Circuit affirmed the district court's grant of summary judgment in favor of the MMS.[65] The court rejected Marketing Affiliate's two arguments.[66] First, Marketing Affiliate contended that the district court erred by not applying the 1988 revisions to the regulations governing royalty management.[67] In dismissing this argument, the court noted that the revised regulations were prospective and did not affect the oil produced during the audit period.[68] An earlier IBLA decision, *Exxon Co., U.S.A.*,[69] had established that the MMS specifically intended the 1988 regulations to apply to gas production on or after March 1, 1988.[70] The court noted that agency interpretations of their own rules must be given great deference.[71] Thus, the court declined to apply the 1988 revisions to the regulations governing royalty management.[72]

Second, Marketing Affiliate asserted that the MMS erred when choosing

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> information requested from [Marketing Affiliate], the State and MMS cannot make a reasonable determination as to the value of the crude oil for royalty purposes, since the lessee's gross proceeds always is the minimum value.

Id. (citing 30 C.F.R. § 206.103 (1987)).

58. *Id.*

59. Under section 103(a) of FOGRMA, a "person directly involved in . . . purchasing or selling oil or gas [is] subject to [the Act]." Federal Oil and Gas Royalty Management Act of 1982 § 103(a), 30 U.S.C. § 1713 (1994). The Act defines "person" as "any individual, firm, corporation, association, partnership, consortium, or joint venture." Federal Oil and Gas Royalty Management Act § 3(12), 30 U.S.C. § 1702(12) (1994).

60. *Santa Fe Energy Prods.*, 90 F.3d at 412.

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.* at 413.

65. *Id.* at 415.

66. *Id.* at 413-15.

67. *Id.* at 413.

68. *Id.* Marketing Affiliates' royalty audit covered the period from January 1, 1984, to June 30, 1987, and the revised royalty management regulations were expressly applied to oil production on or after March 1, 1988. *Id.* at 413 (citing 53 Fed. Reg. 1184, 1230 (1988)).

69. Exxon Co., U.S.A., 128 I.B.L.A. 22 (1993).

70. *Id.* at 24 (referring to the intent of the MMS, as represented in the Revision of Oil Product Valuation Regulations and Related Topics, 53 Fed. Reg. at 1230 (1988)).

71. Santa Fe Energy Prods. v. McCutcheon, 90 F.3d 409, 413 (10th Cir. 1996) (citing Thomas Jefferson Univ. v. Shalala, 512 U.S. 504, 512 (1994)).

72. *Id.*

the point at which royalties were computed, the proper point being the sale between Producer, the federal lessee, and Marketing Affiliate, rather than the sale between Marketing Affiliate and a third party, as the MMS asserted.[73] Consequently, Marketing Affiliate argued that the records of its sales to third parties were not available to the MMS under FOGRMA's record-keeping and audit requirements.

The court looked to the text of FOGRMA to determine the extent of the statute's record-keeping requirements.[74] Section 103(a) of FOGRMA requires a lessee, "or other person," involved in producing, transporting, and marketing oil or gas through the first sale, or royalty calculation point, to maintain those records required for compliance with royalty regulations.[75] A "person" is defined as "any individual, firm, corporation, association, partnership, consortium, or joint venture."[76] Since Marketing Affiliate is a "person" as defined by FOGRMA, and Marketing Affiliate was the first purchaser of oil produced by Producer under a federal lease, the court concluded that section 103(a) applied. Thus, Marketing Affiliate must allow access to its records.[77]

Next, the court applied the pre-1988 gross proceeds rule, discussed above.[78] The "other relevant matters" language, which concededly provided very little guidance to the MMS, allowed the agency to inquire about Marketing Affiliates' sales in order to determine fair market value.[79] Their sale of oil would be a "relevant matter" under the pre-1988 regulation, as it could help the MMS ascertain the fair market value of the oil at the time of its transfer between Producer and Marketing Affiliate.[80]

Finally, the court concluded that the MMS' determination that Marketing Affiliate must produce documents relating to the arm's length sale of oil received from Producer "was not arbitrary, capricious, or contrary to law."[81] The court affirmed the district court's order of summary judgment in favor of the government.[82]

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73. *Id.*
74. *Id.* at 413-14.
75. *See supra* note 30.
76. 30 U.S.C. § 1702(12) (1994).
77. *Santa Fe Energy Prods.*, 90 F.3d at 414-15.
78. *Id.* at 414. The court cited the following regulation:

> The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to *other relevant matters*.

Id. (citing 30 C.F.R. § 206.103 (1987)) (emphasis added).

79. *Santa Fe Energy Prods.*, 90 F.3d at 414-15.
80. *Id.* at 414.
81. *Id.* at 414-15.
82. *Id.* at 415.

C. *Analysis*

Santa Fe Energy Products turns on the scope of FOGRMA's royalty calculation methodologies, and the requisite audit authority to determine oil and gas values for royalty purposes. Section 103(a) of FOGRMA requires records to be kept through the "point of first sale or the point of royalty computation, whichever is later."[83] The Tenth Circuit determined that Marketing Affiliate's sale to a third party was the point of first sale, thus records could be examined by the MMS with regard to that sale, in order to determine the value of royalties owed by Producer.[84]

The point of contention between Producer, Marketing Affiliate, and the MMS was the period at which the agency should make royalty calculations. To reframe the issue: At what point, from the oil's first gush up the wellhead to the first arm's length sale downstream, is the value of the oil fixed for purposes of royalty computations? The court determined that the "first sale" was the sale by Marketing Affiliate to a third party, not the intracorporate transfer of oil from Producer to Marketing Affiliate.[85]

Assume that the MMS audit, completed in the wake of this Tenth Circuit decision, resulted in Producer paying higher federal royalties since the royalty was now based on the higher market prices obtained by Marketing Affiliate. The higher royalty charged to the producer calls into question the fairness of this outcome. Commentators have noted that traditionally the lessee—in this case Producer—is viewed as holding a greater risk vis-a-vis the lessor because the lessor's royalty expectation has few upfront risks while the lessee risks the working interest and capital investment needed to explore, develop and produce the oil or gas.[86] While the lessor's risk is low, however, the lessor still has an interest in obtaining a fair value for its oil and gas.[87] The lessor bears the risk that the lessee will not diligently develop the oil or gas and obtain a fair price for it.[88]

This risk from reliance on the lessee to obtain a fair price upon which the royalty is based was heightened by the advent of the use of marketing affiliates to conduct the lessee's marketing efforts.[89] Following FERC's restructuring of producer/pipeline/consumer relationships in the mid-1980s, oil and gas producers were allowed to market what they produced, but were reluctant to do so because of the attendant responsibilities of measuring, billing, and controlling the flow of its oil and gas, responsibilities traditionally held by pipeline purchasers.[90] Thus, producers developed the concept of marketing affiliate.[91]

83. 30 U.S.C. § 1713(a) (1994).
84. Santa Fe Energy Prods. v. McCutcheon, 90 F.3d 409, 414 (10th Cir. 1996).
85. *Id.*
86. Anderson, *supra* note 1, at 59f.
87. *Id.*
88. *Id.*
89. Arthur J. Wright & Carla J. Sharpe, *Direct Gas Sales: Royalty Problems for the Producer*, 46 OKLA. L. REV. 235, 236 (1993).
90. *Id.* at 235-36.
91. *Id.* at 236.

The marketing affiliate relationship, according to one commentator, served to mitigate producers' increased responsibility by (1) the producer holding a larger share of gross proceeds by not sharing a portion of the sale proceeds with royalty owners, and (2) capturing the cost of marketing efforts through the affiliate.[92] *Santa Fe Energy Products* militates against the first of these reasons for using marketing affiliates by interpreting federal royalty regulations in a way which captures the value of the sale by the marketing affiliate to a third party.[93]

Whether the outcome of *Santa Fe Energy Products* is fair thus seems tied to whether, and to what extent, the marketing affiliate may be used to fulfill the lessee's obligation to obtain a fair price for the oil and gas. To the extent that the sale by the marketing affiliate is the fair price contemplated by the lessor for the return on its royalty interest, and that fair price is not the price upon which the royalty is based, the outcome of *Santa Fe Energy Products* is fair; viewed in this light the MMS' regulations are only attempting to capture the fair value for the royalty holder.

However, to the extent that an oil or gas producer does seek to obtain a fair price in the non-arm's length sale to its marketing affiliate, the capture of the sale price to the marketing affiliate's customer unfairly burdens the producer with excessive royalty obligations. The FOGRMA statute requiring royalty computation at the first arm's length sale,[94] interpreted as encompassing the sale from a marketing affiliate to a third party,[95] clearly favors the lessor/royalty interest, since it captures a portion of the sales price which may exceed the fair price upon which the oil or gas was transferred between affiliates.

Practitioners should note that a recently enacted statute may change the royalty management scheme yet again. On August 13, 1996, President Clinton signed legislation intended to improve royalty management.[96] The Federal Oil and Gas Royalty Simplification and Fairness Act of 1996[97] (FOGRSFA) revises procedures for collecting royalty payments, including the statute of limitations for audit exposure, interest payments on returns of overpayments, and the delegation of royalty collection activities to the states.[98]

The practical effect of the legislation is unknown—regulations have not been promulgated[99]—but the MMS believes it will simplify royalty manage-

92. *Id.*

93. *Santa Fe Energy Prods.*, 90 F.3d at 414.

94. 30 U.S.C. § 1713(a) (1994).

95. *Santa Fe Energy Prods.*, 90 F.3d at 414.

96. Federal Oil and Gas Royalty Simplification and Fairness Act of 1996, Pub. L. No. 104-185, 110 Stat. 1700 (1996) (codified in scattered sections of 30 U.S.C.).

97. *Id.*

98. *Id.* §§ 3-5.

99. The MMS intends a phased approach to implementing the royalty management modifications mandated by FOGRSFA. Meeting on Federal Oil and Gas Royalty Simplification and Fairness Act of 1996, 61 Fed. Reg. 55,941 (1996). The MMS expects that FOGRSFA will require numerous changes to royalty management programs, including increased delegation of royalty collection and enforcement activities to the states. Statement of Regulatory Priorities, 61 Fed.

ment.[100] Typical commentary to date describes the oil and gas industry's "delight" at the prospect of royalty management reform.[101] While the act is designed to streamline royalty computations, collections, and audits,[102] it does not modify FOGRMA's description of the point at which royalty computations are made in arm's length transactions.[103] As a consequence, the outcome of *Santa Fe Energy Products* in a post-FOGRSFA setting would vary to the extent of the types of records audited, the identity of the enforcement agency, and the statute of limitations for audits. On the other hand, the timing of royalty computations, such as the point of first sale in an arm's length transaction, would not likely change.

III. PREEMPTION OF STATE LAW BY THE NATURAL GAS ACT

A. *Background*

As discussed above, the NGA and NGPA created a scheme of federal regulation for the oil and gas industry.[104] The preemption doctrine guides analysis of the effect of these statutes.[105] Under the Supremacy Clause, Congress can enact federal statutes that preempt state law.[106] The Supreme Court recognizes three circumstances in which a federal statute preempts a state statute.[107] First, Congress can provide for preemption expressly in the statute.[108] Second, a state law is preempted if there is an actual conflict with a federal law.[109] Finally, a body of federal law may occupy a field, leaving no room for state regulation.[110]

As early as 1947, and regularly since then, the Supreme Court has described the NGA as a statute that occupies an entire area, within which the states may not act.[111] Section 1(b) of the NGA describes the scope of federal authority as extending to the transportation and sale of natural gas, and to

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Reg. 62,071, 62,073 (1996).

100. *Industry Execs Applaud Clinton's Signing of Royalty Fairness Bill*, INSIDE ENERGY/WITH FED. LANDS, Aug. 19, 1996, at 14, *available in* 1996 WL 8697208 (quoting the MMS' Director Cynthia Quarterman as saying that the new law would "provide additional certainty, equity and simplicity in royalty management").

101. *See, e.g.*, Kimberley Music, *Clinton Signs Bill Writing New Book on Collection of Oil, Gas Royalties*, OIL DAILY, August 14, 1996, at 1.

102. S. REP. NO. 104-260, at 13 (1996).

103. 30 U.S.C. § 1713(a) (1994). FOGRSFA does not modify FOGRMA's section addressing the point of royalty computation.

104. *See supra* notes 11-20 and accompanying text.

105. *See infra* note 147 and accompanying text for examples of the preemption doctrine as applied to NGA and NGPA cases.

106. U.S. CONST. art. VI, cl. 2.

107. Cipollone v. Liggett Group, Inc., 505 U.S. 504, 516 (1992). For a discussion of preemption and federal energy statutes, see Note, *Preemption and Regulatory Efficiency in Federal Energy Statutes*, 103 HARV. L. REV. 1306 (1990).

108. *Cipollone*, 505 U.S. at 516.

109. *Id.*

110. *Id.*

111. Interstate Natural Gas Co. v. Federal Power Comm'n, 331 U.S. 682, 690 (1947) ("As was stated in the House Committee report, the 'basic purpose' of Congress in passing the Natural Gas Act was 'to occupy this field in which the Supreme Court has held that the States may not act.'") (citation omitted).

companies engaging in such activity, but authority "shall not apply to . . . the production or gathering of natural gas."[112] The Supreme Court interpreted "production or gathering" narrowly to ensure broad federal control over the industry.[113]

Although the NGPA ostensibly served as a partial deregulation of the gas market by removing certain price restrictions, the Supreme Court addressed its true effect on the exclusive jurisdiction created by the NGA in *Transcontinental Gas Pipe Line Corp. v. Mississippi Oil & Gas Board.*[114] The Court held that the NGPA did not in fact alter the comprehensive regulatory scheme created by the NGA, thus the "deep federal concern" over gas pricing continued to provide a rationale for federal preemption of state regulation.[115]

B. *Panhandle Eastern Pipeline Co. v. Oklahoma*[116]

1. Facts

Natural gas producers and purchasers (plaintiffs) challenged the constitutionality of an Oklahoma statute affecting royalty payments.[117] The Oklahoma legislature enacted Senate Bill 160 (SB 160) in 1984.[118] The law had two principal effects.[119] First, the bill amended the procedure for determining the royalties paid to owners of drilling units.[120] Second, the bill forced the first purchaser of the oil or gas to pay the required royalties.[121] In addition, the first purchaser could not contract out the responsibility to pay the royalties.[122]

The plaintiffs filed suit in district court against the Oklahoma Commissioners of the Land Office.[123] The owners of the mineral interests intervened

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112. 15 U.S.C. § 717(b) (1994). Section 1(b) of the Act states:

> The provisions of this [Act] shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

Id.

113. *Interstate Natural Gas Co.*, 331 U.S. at 693.
114. 474 U.S. 409, 417-21 (1986).
115. *Transcontinental*, 474 U.S. at 421-22.
116. 83 F.3d 1219 (10th Cir. 1996).
117. *Panhandle*, 83 F.3d at 1221.
118. *Id.* at 1222. For purposes of convenience, the Tenth Circuit and this Survey refer to the two revisions by the name of Oklahoma Senate Bill, SB 160.
119. *Id.* SB 160 amended two existing statutes: OKLA. STAT. tit. 52, § 87.1(e) (Supp. 1984) and OKLA. STAT. tit. 52, § 540 (Supp. 1984).
120. *Panhandle*, 83 F.3d at 1223.
121. *Id.* Prior to SB 160, where two or more royalty owners had separate tracts within a drilling unit, the lessee of the tract that included a producing well must have paid to the royalty owners of the nonproducing tracts a one-eighth royalty in all production generated within the unit. *Id.* at 1222 (citing OKLA. STAT. tit. 52, § 87.1(e) (Supp. 1984)). SB 160 altered royalty owner's rights by adding to the one-eighth share an amount commensurate with the royalty owner's interest in the unit. *Id.* at 1222-23 (citing 20 Op. Okla. Att'y Gen. 181 (1989)).
122. *Panhandle*, 83 F.3d at 1223.
123. *Id.* at 1224.

as defendants in the case.[124] The plaintiffs agreed that the repeal of SB 160 in 1992 remedied the constitutional issues, but the repeal arguably did not apply to royalty payments during the period between 1985 and 1993.[125] The amended complaint included a claim that federal law preempted SB 160.[126] The district court entered judgment in favor of the plaintiffs, finding that federal law preempted SB 160.[127]

2. Decision

The Tenth Circuit affirmed the district court's decision.[128] The court considered two issues: the preemption of SB 160 by the NGA and NGPA,[129] and whether those portions of SB 160 that were constitutional could be severed from the remainder of the statute.[130]

The court began by determining Congress' intent with respect to the preemption of state law.[131] An inference of federal preemption occurs when "Congress has legislated comprehensively to occupy an entire field of regulation, leaving no room for the states to supplement federal law."[132] The relevant federal law in this case was the NGA and NGPA.[133] The court noted that Congress enacted the NGA, in part, in response to a series of Supreme Court decisions invalidating state regulation of interstate oil and gas activities.[134] To fill this gap, the NGA created the Federal Power Commission (now FERC) to regulate those activities from which the state was prohibited.[135] The NGPA did not alter this comprehensive regulatory scheme.[136]

Next, the court turned to the question of the scope of FERC's authority, in relation to that of the state, to regulate oil and gas. Pursuant to the NGA, FERC regulates the transportation and sale of oil and gas in interstate commerce, as well as those companies engaged in such activity.[137] The court

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124. *Id.*

125. *Id.* The court stated:

> [Plaintiffs] have no dispute with SB 168 [which repealed SB 160], as it allows producers disadvantaged by its royalty payment provisions to offset any loss by producing a correspondingly greater volume of gas than they would otherwise be entitled to produce. [Appellee-intervenors] agree that SB 168 remedied the constitutional defects of SB 160, because SB 168 explicitly provides that a purchaser who pays its contracted producer for gas taken is thereafter liable to no other parties. Thus, the determination whether SB 160 was constitutional affects the rights and liabilities of these parties for the period 1985 to 1993 only.

Id.

126. *Id.* at 1225.

127. *Id.*

128. *Id.* at 1223.

129. *Id.* at 1225.

130. *Id.* at 1229.

131. *Id.* at 1225.

132. *Id.* (quoting Northwest Central Pipeline Corp. v. State Corp. Comm'n of Kansas, 489 U.S. 493, 509 (1989)).

133. *Id.* at 1225-29.

134. *Id.*; *see supra* notes 11-13 and accompanying text.

135. *Panhandle*, 83 F.3d at 1225 (quoting Corporation Comm'n v. FPC, 415 U.S. 961, 962 (1974)).

136. *Id.* at 1226-27 (quoting Transcontinental Gas Pipe Line Corp. v. Mississippi Oil & Gas Board, 474 U.S. 409, 421 (1986)).

137. *Id.* at 1225-26 (quoting Cascade Natural Gas Corp. v. FERC, 955 F.2d 1412, 1416

found that the powers reserved to the states—those powers outside of FERC's jurisdiction— include the regulation of the physical production and gathering of oil and gas "in the interests of conservation or any other consideration of legitimate local concern."[138]

Thus, the issue of preemption turned on whether SB 160 fell within physical production or gathering, the only allowable purview of state regulation.[139] The court concluded that SB 160 did not regulate physical production or gathering.[140] Instead, the court found that SB 160 directly regulated interstate gas purchasers by making them liable to all royalty owners of a particular drilling unit.[141] By regulating interstate purchasers, and not just producers, SB 160 imposed obligations on them that would "substantially and materially influence their purchasing decisions."[142] Because SB 160 overstepped the state's authority, the court found it preempted by the NGA and NGPA to the extent of its effect on the purchase of natural gas from interstate pipelines.[143]

Finally, the court had to decide whether the preempted portions of SB 160 could be severed from those provisions which were constitutional.[144] The court held that under Oklahoma law, the whole of SB 160 was preempted since the valid portions of the statute were "so essentially and inseparably connected with and so dependent upon the void provisions" that the state legislature would not have enacted the statute with only the valid provisions.[145]

C. *Analysis*

NGA and NGPA effectively reserve to the states a very specific and limited area of regulation—states may regulate only the physical production and gathering of oil and gas when they have legitimate local concerns.[146] Beyond this reservation, courts' holdings usually specify that the NGA and NGPA preempt state law. In the past thirty years, the Supreme Court decided six cases involving state law and its relation to the NGA, and found that state law was preempted in all but one.[147] Likewise, the Tenth Circuit has held

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(10th Cir. 1992)).

138. *Id.* at 1225-26 (quoting Interstate Natural Gas Co. v. FPC, 331 U.S. 682, 690 (1947)).

139. *Id.* at 1227-28.

140. *Id.* at 1228.

141. *Id.* at 1229.

142. *Id.* at 1228.

143. *Id.* at 1229.

144. *Id.* at 1229-31.

145. *Id.* at 1229-30 (quoting OKLA. STAT. tit. 75, § 11a (1995)). The issue of severability is governed by state law. *Id.* at 1229.

146. *Interstate Natural Gas*, 331 U.S. at 690.

147. *See Northwest Central Pipeline Corp.*, 489 U.S. at 518-19 (1989) (holding that the NGA does not preempt a state regulation of production despite possible effect on interstate purchasers; regulation was plausibly related to a legitimate state concern to protect correlative rights of Kansas producers); Schneidewind v. ANR Pipeline Co., 485 U.S. 293, 301-04 (1988) (holding that the NGA preempted a state requirement that a public utility must obtain state approval to transport natural gas and state statute impermissibly regulated rates of companies involved in the interstate transportation of natural gas); Transcontinental Gas Pipe Line Corp. v. Mississippi Oil & Gas Board, 474 U.S. 409, 424-25 (1986) (holding that the NGA preempted the order of a state

that states may not encroach upon federal regulation of the transportation, sales, and distribution of oil and gas.[148]

While case law appears well settled, commentators' assessment of the effect of the NGA and its preemptive consequences fuels debate over the statute's reach into intrastate activities. One commentator believes that the jurisdictional distinction between federal and state governments created by the NGA adequately protects consumers, in addition to being relatively simple for the courts and agencies to apply.[149] Others believe that the once useful, narrow construction by the Supreme Court of state powers over production and gathering have increasingly become an impediment to the types of regulations states need to effectively manage the growing complexity of oil and gas operations.[150]

Recent FERC orders have obscured the once clear distinction between state control of production and gathering and federal control of pricing and transportation.[151] FERC Orders 436[152] and 636[153] deregulated many aspects of transportation and sales functions.[154] FERC issued Order 436 in 1985 to create "equal access" in the gas pipeline market; pipeline owners must transport gas owned by third parties under the same terms as it transports its own gas.[155]

FERC Order 636, issued in 1992, continued the process of deregulation by requiring interstate pipelines to separately sell their transportation, storage, and gas marketing services.[156] It has been argued that the post-Order 636

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oil and gas board requiring a pipeline company to purchase ratably from a gas pool because the order undermined congressional intent to regulate prices); Exxon Corp. v. Eagerton, 462 U.S. 176, 184 (1983) (holding that the NGA preempted state regulation prohibiting producers from passing an increase in severance taxes through to consumers and that the regulation was preempted to the extent that the statute applied to sales of gas in interstate, as opposed to intrastate, commerce); Maryland v. Louisiana, 451 U.S. 725, 748-51 (1981) (holding that the NGA preempted state regulation providing for a state tax to be added to oil and gas owners' costs associated with marketing the gas; this provision of the tax statute usurped FERC's authority to determine pipeline and producer costs); Northern Natural Gas Co. v. State Corp. Comm'n, 372 U.S. 84, 95-96 (1963) (holding that the NGA preempted state regulation requiring pipeline to take ratably from all connected users and that the regulation violated FERC's authority over sale and transportation of natural gas in interstate commerce).

148. *See* Backus v. Panhandle Eastern Pipe Line Co., 558 F.2d 1373, 1375 (10th Cir. 1977); Saturn Oil & Gas Co. v. Federal Power Comm'n, 250 F.2d 61, 67 (10th Cir. 1957). After citing Interstate Natural Gas Co. v. Federal Power Comm'n, 331 U.S. 682, 690-91, the court remarked that "[t]his would seem to dispose of the point. The jurisdiction of the Commission is not defeated by state regulatory action." *Saturn Oil & Gas*, 250 F.2d at 67.

149. Frank R. Lindh, *Federal Preemption of State Regulation in the Field of Electricity and Natural Gas: A Supreme Court Chronicle*, 10 ENERGY L.J. 277, 314 (1989).

150. Paula A. Sinozich et al., Project, *The Role of Preemption in Administrative Law*, 45 ADMIN. L. REV. 107, 128, 145-46 (1993); Cody L. Graves & Maria Mercedes Seidler, *The Regulation of Gathering in a Federal System*, 15 ENERGY L.J. 405 (1994).

151. Graves & Seidler, *supra* note 150, at 408.

152. Regulation of Natural Gas Pipelines after Partial Wellhead Decontrol, 50 Fed. Reg. 42,408 (1985) (codified at 18 C.F.R. pts. 2, 157, 250, 284, 375, 381).

153. Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 57 Fed. Reg. 13,267 (1992) (codified at 18 C.F.R. pt. 284).

154. Graves & Seidler, *supra* note 150, at 405.

155. Regulation of Natural Gas Pipelines after Partial Wellhead Decontrol, 50 Fed. Reg. at 42,408.

156. Pipeline Service Obligations and Revisions to Regulations Governing Self-Implement-

environment effectively allows market forces to regulate gas gathering and distribution functions, and as a result there is no compelling need for federal preemption of these activities.[157]

D. *Other Circuits*

The District of Columbia Circuit delivered a cautionary note during the survey period, in *United Distribution Co. v. Federal Energy Regulatory Commission.*[158] There the court stated: "[C]onflict preemption analysis must be applied with particular care in those instances in which the Commission seeks to preempt state regulation merely because it has some effect on the interstate transportation of natural gas."[159] While the court conceded that a state statute is not preempted merely because it might indirectly affect gas rates, a statute will be preempted if it infringes upon one of the enumerated federal responsibilities.[160]

The state regulation at issue targeted "buy/sell" transactions involving "agreements by which firm shippers allocate space on an interstate pipeline to customers who negotiate their own wellhead transactions."[161] The court found that interstate transportation of the gas is a key element of the buy/sell agreement.[162] While the regulation indirectly affects rates, and thus may not be preempted on that basis alone, the direct effect on interstate transportation of gas does provide sufficient ground for preemption.[163]

Thus, like the Tenth Circuit in *Panhandle Eastern Pipeline Co.*, the District of Columbia Circuit has affirmed the jurisdictional boundaries between federal and state regulation of the oil and gas industry. The construction followed by the District of Columbia and Tenth Circuits provides strict adherence to the exclusive domains of state regulation of physical production and gathering, and federal regulation of interstate transportation and sale of natural gas.

CONCLUSION

Tenth Circuit case law on oil and gas follows well-established rules of law. Nearly sixty years have passed since the NGA's enactment; this aged pedigree certainly contributes to the harmony of these decisions. Additionally, the pervasive regulation of the industry, which has been conferred by the

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ing Transportation and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 57 Fed. Reg. at 13,267.

157. Graves & Seidler, *supra* note 150, at 422-23.

158. 88 F.3d 1105 (D.C. Cir. 1996).

159. *United Distrib. Co.*, 88 F.3d at 1157.

160. *Id.* at 1156-57 (citing Schneidewind v. ANR Pipeline Co., 485 U.S. 293, 308 (1988)).

161. *Id.* at 1157.

162. *Id.*

163. *Id.*

NGA, amended by NGPA, and refined by FOGRMA, make this area a creature of regulatory law, where remarkably specific language establishing standards and procedures leaves little room for judicial discretion. The Tenth Circuit has chosen to stay within the well-worn furrows of oil and gas precedent.

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