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The activity in the area of production and disposition of oil from federally leased lands has been on the increase for a number of years. The regulations that control the supervision of oil and gas leases and the collection of royalties from the leased lands are both complex and nebulous. Mr. Boyd, in the article which follows, discusses the problems and possible solutions to these regulations as well as an evaluation of the new regulations which create some interesting changes.

THE PURCHASE OF CRUDE OIL FROM FEDERALLY LEASED LANDS

*Walter K. Boyd, Jr.**

INTRODUCTION

THE Mineral Leasing Act of February 25, 1920,[1] authorizes the granting of mineral leases on the public domain. The United States leases oil and gas producing lands to members of the public to develop in exchange for a return of a royalty to the lessor. The Secretary of the Interior, through the United States Geological Survey (U.S.G.S.), administers the Mineral Leasing Act. Many of the duties relating to the supervision of oil and gas leases and the collection of royalties from leased lands are performed by the Oil and Gas Operations Branch of the Conservation Division of the U.S.G.S.[2]

The purposes of the Mineral Leasing Act were stated by Judge Prettyman of the District of Columbia Court of Appeals in *California v. Udall* as follows:

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1. Ch. 85, 41 Stat. 437 (codified in scattered sections of 30 U.S.C.).
2. Schwabrow, *Supervision of Operations under Federal and Indian Oil and Gas Leases by the United States Geological Survey*, 8 ROCKY MTN. MIN. L. INST. 24, 242-4, *passim* (1963).

> The purpose of the Mineral Leasing Act was not to obtain sales for the gas from these reserves on Government land at any price. The Act was intended to promote wise development of these natural resources and to obtain for the public a reasonable financial return on assets that 'belong' to the public. The Secretary of the Interior is the statutory guardian of this public interest. He has a responsibility to insure that these resources are not physically wasted and that their extraction accords with prudent principles of conservation. To protect the public's royalty interest he may determine that minerals are being sold at less than reasonable value. . . . Of course his duties have another aspect. The public does not benefit from resources that remain undeveloped, and the Secretary must administer the Act so as to provide some incentive for development.[3]

The Secretary of the Interior may make rules and regulations to accomplish the purposes of the Mineral Leasing Act.[4] The regulations of the Secretary of the Interior have the force and effect of statutes when not inconsistent with or repugnant to any statutes.[5] For example, the Oil and Gas Operating Regulations[6] were promulgated pursuant to this authority.

The functions of the Oil and Gas Operations Branch of the Conservation Division of the U.S.G.S. are described in the *Branch Operations Manual* as follows:

> The Branch has regulatory and engineering supervision of operations for the prospecting, development, and production of, and the determination of royalties due on, oil and gas from Federal and Indian lands and oil, gas and certain other minerals from Outer Continental Shelf Lands under its jurisdiction pursuant to the applicable mineral leasing acts and regulations and the provisions of this Branch Operations Manual.[7]

The policies of the Oil and Gas Operations Branch are described in the *Branch Operations Manual* in this manner:

3. 296 F.2d 384, 388 (D.C. Cir. 1961).
4. 30 U.S.C. § 189 (1964).
5. Hodgson v. Midwest Oil Co., 297 F. 273, 276 (D. Wyo. 1924).
6. Codified at 30 C.F.R. ch. 30, pt. 221 (1969).
7. BRANCH PROGRAM SERIES, pt. 640.3.1.

> The supervisory functions of the Branch shall be conducted in accordance with the policies of the Geological Survey and in cooperation with appropriate Federal and State agencies and with the petroleum and the OCS mineral industries to encourage and promote the economic maximum recovery of oil, gas, and OCS minerals without waste.[8]

The Oil and Gas Supervisor oversees oil and gas operations and performs other duties prescribed in the Oil and Gas Operating Regulations. The Supervisor has the power to require compliance with lease terms and with the Oil and Gas Operating Regulations so that all operations conform to established practices. The Supervisor has the responsibility to protect the deposits of the leased lands and to foster the maximum ultimate recovery of oil, gas, and other products with a minimum of waste.[9]

It is in this setting, then, that crude oil is purchased from federally leased lands, and it is in this setting that this article considers the problems of federally owned oil after it has been discovered and put into production.

DIVISION ORDERS

The Oil and Gas Operating Regulations provide that the Oil and Gas supervisor may approve division orders granting purchasers authority to receive products from leased lands.[10] The Supreme Court of Kansas defined a division order in the case of *Wagner v. Sunray Mid-Continent Oil Co.,* in this manner:

> A division order is an instrument required by the purchaser of oil or gas in order that it may have a record showing to whom and in what proportions the purchase price is to be paid. Its execution is procured primarily to protect the purchaser in the matter of payment for the oil or gas, and may be considered a contract between sellers on the one hand and the purchaser on the other.[11]

An elaboration upon this definition is found in Williams, *Oil and Gas Law*:

8. *Id.*
9. 30 C.F.R. § 221.4 (1969).
10. 30 C.F.R. § 221.13 (1969).
11. 182 Kan. 81, 318 P.2d 1039, 1047 (1957) (Court's citations omitted).

> [The] division or transfer order does not amount to a conveyance of interest in the land, minerals or royalty. It is merely a direction for payment by the purchaser until some different direction is given.... Although a division order is not itself effective as a conveyance as between or among the parties thereto, the division order may be incorporated by reference in an instrument which is effective as a conveyance. In such event, the latter instrument may effect a conveyance as between or among the signatory parties so as to leave them with the interests recited by the order.... Normally, then, a division or transfer order does not amount to a conveyance of an interest in the land, minerals, or royalties.[12]

A brief outline of a Division Order is found in Appendix A to this Article.

The Oil and Gas Operating Regulations require the lessee to file with the Oil and Gas Supervisor executed copies of all contracts for the disposition of all oil of the leased land. These regulations provide that the lessee may not sell any oil except in accordance with a sales contract, division order, or other arrangement first approved by the Oil and Gas supervisor.[13] Nevertheless, a contract may be made without obtaining the approval of the Supervisor if it is made pursuant to a lease containing provisions under which the lessee agrees that nothing in any contract made for the sale or disposal of oil, gas, natural gasoline and other products of the leased land shall be construed as modifying any of the provisions of the lease, including, provisions relating to gas waste, taking royalty in kind, and the method of computing royalties due.[14]

Although the Department of Interior approves division orders, it does not thereby execute division orders. In the case of *Sinclair Oil & Gas,* [15] the Regional Oil and Gas Supervisor notified Sinclair Oil & Gas Company that he had been instructed to recompute the royalties on production from two leases for the period April 1, 1948, to September 30, 1961 at higher rates. The recomputation resulted in a determination that Sinclair owed the sum of $3,209,763.30 in additional

12. 4 WILLIAMS, OIL AND GAS LAW, § 707, at 693 (1964).
13. 30 C.F.R. § 221.13, .38 (1969).
14. 30 C.F.R. § 223.3 (1969).
15. 1968 GOWER FED. SERV. [Solicitor's Op. A-30709] SO-1968-14 (June 20, 1968).

royalty payments. Upon appeal to the Secretary of the Interior, Sinclair contended that the oil and gas supervisor's approval of division orders filed by the appellant covering production from the leases constituted an approval of the flat twelve and a half percent royalty rate provided for in the division orders. But the Secretary held that these division orders were not executed by the U.S.G.S. They were approved by the U.S.G.S. "subject to the condition that nothing herein shall be construed as affecting any of the relations between the lessee and the Secretary of the Interior." The conditional approval could not be regarded as sanctioning a royalty rate inconsistent with the terms of the leases, and could not change the royalty rate of the applicable law required a higher rate that that provided for in the division orders.

This power of the Oil and Gas Supervisor to approve division orders and sales agreements and contracts includes the power to refuse to approve a contract for the sale of oil if, in his discretion, the price is not adequate. In the case of *Wilbur v. Texas*,[16] the Secretary of the Interior refused to approve a sale of oil produced on the public domain in the Oregon Basin field at a price of less than $.85 a barrel. The Secretary warned that he would shut down the production of the lease lands to prevent delivering oil at that price in compliance with the contract. The Court held that the Secretary may restrict a lessee's production to an amount commensurate with the market demand. The Court indicated the rationale of this decision when it stated:

> It enables the government to prevent a 'chilling' of the market price of oil produced . . . such as might reduce the amount of the royalties received by the government when taken "in value," and might also tend to discourage the development of the field by prospectors and operators. These considerations are not foreign to the legislative purposes expressed by Section 32 of the act (30 U.S.C.A. § 189), granting the Secretary of the Interior authority 'to prescribe necessary and proper rules and regulations and to do any and all things necessary to carry out and accomplish the purposes of this Act."[17]

16. 40 F.2d 787 (D.C. Cir. 1930), *cert. denied* 282 U.S. 843 (1930).
17. *Id.* at 789.

ROYALTIES ON PRODUCTION

VALUE BASIS FOR COMPUTING ROYALTIES

Lessees who develop production of oil resources on public lands are required to return to the government a percentage of the estimated reasonable value of the oil produced. Lessees are required to pay all rentals and royalties on producing oil and gas leases to the Regional Oil and Gas Supervisor of the United States Geological Survey.[18] The Oil and Gas Operating Regulations require the Oil and Gas Supervisor to compile and maintain records of production and prices and to determine royalties accrued.[19] Each lessee is required to submit a report of the operations for each lease, including a report of days each well produced and the quantity of oil produced.[20] The lessee must file signed run tickets with the Supervisor within five days after the oil has been run.[21] The functions of the Oil and Gas Supervisor include determination of royalty liability.[22] The Oil and Gas Supervisor submits monthly statements to the lessee showing the amount of oil produced and the value of production accruing to the lessor as royalty from each lease.[23]

The Oil and Gas Regulations of Title 43 provide that the Secretary of the Interior may establish reasonable values for purposes of computing royalty on any or all oil, due consideration being given to the highest price paid for a part of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters.[24]

The Secretary of the Interior receives the advice of the Oil and Gas Supervisor in doing so. The Oil and Gas Operating Regulations provide that the value of production for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the Supervisor, due consideration being given to the highest price paid for a part of production of like quality in the same field, to the price received by the lessee, to posted prices and to other relevant mat-

18. 43 C.F.R. § 3102.2(b) (1969).
19. 30 C.F.R. § 221.12 (1969).
20. 30 C.F.R. § 221.60, 221.60(c), (d) (1969).
21. 30 C.F.R. § 221.43(d) (1969).
22. 30 C.F.R. § 221.3 (1969).
23. 30 C.F.R. § 221.12 (1969).
24. 43 C.F.R. § 3125.3(d) (1969).

ters. These regulations provide that, in the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, offered at the time of production in a fair and open market for the major portion of like-quality oil will be considered to be a reasonable value.[25]

Federal Lease Forms have similar provisions. A typical lease provision follows:

> It is expressly agreed that the Secretary of the Interior may establish reasonable minimum values for purposes of computing royalty on any or all oil, gas, natural gasoline, and other products obtained from gas, 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 and, whenever appropriate, after notice and opportunity to be heard.[26]

The Secretary of the Interior has a broad power to interpret the lease provisions administratively, in a manner which, in his discretion, will best serve the public interest. A trilogy of cases interpreting royalty provisions in Department of Interior leases have established this broad discretion. In the case of *United States v. Ohio Oil Co.*,[27] by the provisions of the lease, the Secretary was authorized "to determine the reasonable minimum value of royalty oil" based upon "the highest price per barrel offered... at the time of production in a fair and open market for a like quality of oil... produced and sold from the field where the lease lands are situated." The lessee sold the oil under an approved contract with a pipeline company for \$.77 a barrel. The Secretary determined that the minimum value which he would accept for payment of royalty was the posted price of \$1.02 a barrel. The price had been set at \$.77 a barrel to induce the pipeline company to construct a pipeline to the field to provide a market for the oil. The record showed that oil of a poorer grade and quality produced in the same field and transported to the same market under similar conditions sold for \$1.02 a barrel.

25. 30 C.F.R. § 221.47 (1969).
26. U.S. Dep't. Int. Lease Form 3120-3, § 2(d)(2), at 2, II GOWER FED. SERV. pt. 1, § 1 *Leases* [GFS Form 1] (1969).
27. 163 F.2d 633 (10th Cir. 1947), *cert. denied*, 333 U.S. 833 (1948), *reh. denied* 333 U.S. 865 (1948).

Nothing justified the price differential except the sales price of the oil established in the contract which had been approved by the Department. The Court of Appeals held that the Secretary's determination of reasonable minimum value of royalty oil was neither unlawful, inequitable, arbitrary, nor unreasonable.

In *Continental Oil Co. v. United States*,[28] the lease contained terms that authorized the Secretary to determine the minimum values of royalty oil. The Secretary determined that the posted price of crude oil in the particular field was "unreasonably low, and not in accord with true value," when compared with evidence of the true market value of the oil. The Secretary established minimum values for the royalty oil, and the Court of Appeals sustained the power of the Secretary to do so.

The case of *California Co. v. Udall*,[29] also involved the royalty provisions of a Department of the Interior Oil and Gas lease in which the Secretary, exercising discretion vested in him, defined "value of production" in the lease to mean "marketable production". In this case the producer of the product had to condition the product for market. The lessee sought to deduct the cost of conditioning from the sale price. The Court pointed to the Secretary's responsibility for administering the Mineral Leasing Act and his authority to determine, as an administrative matter, the meaning of terms in the Act. The Court concluded that the Secretary had not abused his discretion in defining, as an administrative determination, the word "production" in the statute. The value upon which royalties were computed thus included the costs of making the product suitable for transmission.

The central theme running through these three decisions is that the Secretary of the Interior has a very broad discretion to determine the value basis for computing royalties in a manner which best serves the public interest.

A sequel to the *Ohio Oil* and the *Continental Oil* cases was the Department of Interior's decision in *Husky Oil*.[30] In the *Husky* case the lease did not contain a provision reserving

28. 184 F.2d 802 (9th Cir. 1950).
29. 296 F.2d 384 (D.C. Cir. 1961).
30. 1957 GOWER FED. SERV. [Solicitor's Op. A-27168] SO-1957-4 (Nov. 26, 1956).

the power of the Secretary to establish minimum value for royalty purposes. Husky contended that the prices they offered for determining royalty were at least the reasonable market value of the oil, since they based that upon the cost to it of oil delivered to its refinery at Cody, Wyoming, from the Oregon Basin. From this price it made adjustments for differences in gravity, marketable constituent elements, and transportation costs to arrive at what Husky considered to be the reasonable market value of the oil. The Secretary indicated that these factors were relevant, but not all-inclusive for purposes of determining reasonable value. The Oil and Gas Supervisor and the Secretary held that these values were founded upon a too restrictive basis. The Secretary found that owing to the relatively short distance over which the oil was transported, the oil was priced low in comparison to the delivered prices of oil at other refineries.

In this case Husky purchased and refined all of the oil produced on the leases in question, and it paid for the oil on the basis of what it paid for other oil delivered to its Cody, Wyoming, refinery. The price paid by Husky was lower than prices paid by other refineries in the area. Husky asserted that the Department did not have authority to set minimum values for royalty from computation of royalty from these leases because the leases did not expressly reserve that right. Husky contended that the price they offered for the oil was at least the reasonable market value of the oil.

In deciding the appeal, the Secretary sustained the authority of the Department to set reasonable prices. The Secretary found that competing refineries in the area paid more than Husky did at their refinery, and that the prices paid by competing refineries constituted the reasonable market value of the oil for royalty purposes.

A broad reading of the *Husky* case is that the Department will set the reasonable market value at the highest price paid in the area. It is submitted that the decision was profoundly misdirected. Husky was at a disadvantage in this situation, since it not only produced and transported, but also purchased its own oil. If Husky had been selling to a competing refinery, not owned by Husky, at this lower price, the Department would have accepted that price as the market value. The Department should have accepted that price as the market value in this case.

The Department of the Interior has great latitude in making its determination of value. Presumably the Department investigates other prices in the area, computes a weighted average of them in some manner, and establishes a fair market value. Although this procedure appears to be fair and equitable, it is deficient in its lack of standards by which one can predict the determination of fair market price. It therefore creates uncertainty as to what factors the Department will consider in determining the true market value.

It should be noted that the Department of the Interior is not required to afford the lessee notice or opportunity to be heard concerning the prices because the United States is not acting in a governmental capacity, but in a proprietary capacity pursuant to its power to make contracts.[31]

The Oil and Gas Operating Regulations require the lessee to put into marketable condition, if commercially feasible, all products produced from the leased land and to pay a royalty on those products without recourse to the lessor for deductions on account of costs of treatment or of costs of shipment.[32] This principle has been established in litigation involving the Department of the Interior.

In the case of *California Co. v. Udall*,[33] the court held that the Secretary's inclusion of costs of making the gas suitable for pipeline transmission was proper for determining reasonable market value. In the appeal of *Big Piney Oil and Gas Co.*,[34] the Secretary declared that the Department's inclusion of the costs of compression of gas was an element of value for royalty purposes even though the costs of compressing the gas were sustained *after* the gas had entered the buyer's line, instead of *before*. That title to the gas had passed to the purchaser before it was compressed was immaterial so long as the sales contract required the seller to compress the gas. Thus, the expenses required to put the product

31. United States v. General Petroleum Corp., 73 F. Supp. 225 (S.D. Cal. 1946).
32. 30 C.F.R. § 221.31 (1969).
33. *Supra* note 28.
34. 1964 GOWER FED. SERV. [Solicitor's Op. A-29895] SO-1964-73 (July 27, 1964).

into marketable condition were appropriate expenses to be considered in determining value for purposes of computing royalties.

It has become the policy of the Department to rely more on the Oil and Gas Supervisor in each region to determine fair and equitable royalty values based on firsthand knowledge of all the conditions and factors concerned. The Department's policy on determining value basis for computing royalties is set out in the *Oil and Gas Branch Operations Manual* as follows:

> There has been less tendency, however, in the last several years for the Department to establish minimum royalty values and more tendency to rely on the Supervisor's judgment to determine fair and reasonable values pursuant to the authority granted by the current Operating Regulations. In the absence of discrimination against non-integrated producers, self-serving price setting by producer-purchasers and instances of severe over-supply, the sale price available to the producer generally represents the fair market value and is acceptable for royalty purposes. Except where unreasonably low prices may be conducive to waste, the establishment of minimum prices does not serve the prime objective of encouraging conservation, that is, increasing the economic maximum recovery.[35]

The *Branch Operations Manual* discusses the role of costs of putting the product in a marketable condition and transportation costs in determining fair market value.

> Many of the problems concerning royalty values are closely related to the cost of transportation to the nearest available market and to the requirement placed on the producer to put all products in marketable condition, if commercially feasible, without deductions for the costs of treatment or shipping. So-called trucking, or other transportation allowances for crude oil are actually nothing more than a means of determining a fair royalty value for the product at an isolated lease, pool, or field where no actual market value exists. In other words an extrapolation of some near or far firm market value to the lease with

35. BRANCH PROGRAM SERIES, 642.3.1A (S47).

> due regard to transportation costs in arriving at such extrapolated value.[36]

Indeed the Regional Oil and Gas Supervisor have recognized that many small operators can sell only at prices below posted prices. Since posted prices are only one of the factors to be considered in determining royalty values, the Supervisor has the authority to assess royalties on prices that are lower than posted prices when good reasons exist to do so.[37]

ROYALTIES ON PRODUCTION

APPLICATHON OF ROYALTY RATES

The royalty rates that are applied to the value of production, determined by the Secretary, may be a fixed rate, a sliding scale royalty rate, or a step scale royalty rate. The sliding scale royalty varies in amount, depending on the amount of production; the step scale royalty grows by increments as the production increases.[38]

The Mineral Leasing Act was amended August 8, 1946,[39] to provide:

> If the lands to be leased are within any known geological structure of a producing oil or gas field, they shall be leased to the highest responsible qualified bidder by competitive bidding. . . upon the payment by the lessee of such bonus as may be accepted by the Secretary and of such royalty as may be fixed in the lease, which shall not be less than 12½ per centum in amount or value of the production removed or sold from the lease.
>
> If the lands to be leased are not within any geological structure of a producing oil or gas field, the person first making application for the lease. . . shall be entitled to a lease of such lands without competitive bidding. Such leases shall be conditioned upon the payment by the lessee of a royalty of 12½ per centum in amount or value of the production removed or sold from the lease.[40]

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36. *Id.*
37. *Id.*
38. WILLIAMS & MEYERS, OIL AND GAS LAW, "Manual of Terms" (1964).
39. Ch. 916, § 3, 60 Stat. 950, 30 U.S.C. § 226(b), (c) (1964).
40. *Id.*

So a fixed royalty rate of twelve and a half percent governs noncompetitive leases,[41] and a minimum twelve and a half percent royalty rate applies to competitive leases. For competitive leases the notice of sale sets forth the royalty rates.[42]

For some leases, instead of a flat royalty rate, the rate is determined by a step scale. Tables for computing royalty on the step scale may be obtained from the Oil and Gas Supervisor.[43] A step scale royalty rate set out in the regulations is as follows:

> When the average production of oil for the calendar month in barrels per well per day is:
>
> Not over 110, the royalty shall be 12½%.
>
> Over 110 but not over 130 the royalty shall be 18% of all production.
>
> Over 130 but not over 150 the royalty shall be 19% of all production.
>
> Over 150 but not over 200 the royalty shall be 20% of all production.
>
> Over 200 but not over 250 the royalty shall be 21%of all production.
>
> Over 250 but not over 300 the royalty shall be 22% of all production.
>
> Over 300 but not over 350 the royalty shall be 23% of all production.
>
> Over 350 but not over 400 the royalty shall be 24% of all production.
>
> Over 400 the royalty shall be 25% of all production.[44]

Today the only leases upon which royalty is determined on a sliding scale rate are those issued competitively before August 8, 1946, or those which have been exchanged for or renewed for those issued before August 8, 1946.

The sliding scale royalty rate requires payment of royalty for oil of over 30° Baume gravity, as follows:

> 12½ per cent (⅛) was paid on the first 20 barrels,
> 16⅔ per cent (1/6) on the next 30 barrels,

41. Lease Form 3120-3, *supra* note 26, § 2(d)(1), at 2, provides as follows:
    > (L)essee agrees . . . to pay Lessor 12½ percent royalty on the production removed or sold from the leased lands computed in accordance with the Oil and Gas Operating Regulations [Citation ommitted].
42. 43 C.F.R. § 3125.3(a)(2) (1969).
43. 30 C.F.R. § 221.49 (1969).
44. 43 C.F.R. § 3125.3(a)(4)(i) (1969).

20 per cent (1/5) on the next 50 barrels,
25 per cent (¼) on the next 100 barrels,
and on all production over 200 barrels, the rate was
33⅓ per cent (⅓).[45]

The chief virtue of the flat rate of royalty is that it is easily applied. The sliding scale and step scale royalty provisions in Federal leases create a problem of mechanics with which most purchasing companies are not able to cope. Some purchasing companies employ computers in recording payments made. The computer is programmed in advance, and records of payments are entered into the computer. The fixed rate of royalty is easily adapted to the computer program, but sliding scale and step scale royalty rates are not. The purchasing company is unable to establish a program for the sliding scale or step scale rates. The purchasing company's information is limited to what it has purchased from the lease. The purchaser does not know what the well produced. Experience has abundantly demonstrated that it is impossible for the purchaser to program a computer for a sliding scale or step scale royalty rate.

Although several solutions to the problem have been suggested, none is really satisfactory. One solution would be to obtain the acquiescence of the U.S.G.S. and the other owners as to what the current fractional royalty interest is on the step scale or sliding scale, credit this percentage to the U.S.G.-S., and make payments on this basis until notified by the parties that the percentage based on production has changed. Adjustments could later be made after the production is determined. The U.S.G.S. has been reluctant to agree to such a procedure.

An alternative suggested solution is for the purchasing company to pay the operator-lessee one hundred percent of the production, so that the operator-lessee then has the burden of settling with the U.S.G.S. on the basis of the royalty interest in effect. In this instance the operator-lessee is aware of the actual production from the lease, and in most instances can readily determine the government's royalties. This method

45. Schwabrow, *Supervision of Operations Under Federal and Indian Oil and Gas Leases by the United States Geological Survey*, 8 ROCKY MTN. MIN. L. INST. 241, 258-9 (1963).

also has its shortcomings. Many operator-lessees are unequipped with either office staff or machines to handle the payments. If the lessee has a great number of leases, his costs in employing such a procedure would be prohibitive.

Although the minimum royalty payable to the United States under oil leases issued today is 12½ percent of the production removed from the lease, this is subject to reduction. The statute provides that the Secretary of the Interior may waive, suspend, or reduce the minimum royalty if he determines that it is necessary to promote development or if he determines that the leases cannot be sucessfully operated under the terms provided in the lease.[46]

DISPOSAL OF GOVERNMENT ROYALTY OIL UNDER THE NEW REGULATIONS

On January 17, 1969, the Department of the Interior substantially revised the regulations for the disposal of government royalty oil.[47] These differ in many important respects from the former regulations, which were promulgated pursuant to the statute.[48] The statute authorizes the Secretary of the Interior to sell royalty oil that the government is entitled to receive in kind, when he determines that sufficient supplies of crude oil are not available on the open market to refineries not having their own source of supply for crude oil. To assist small business enterprise, the Secretary may grant a preference to refineries, not having their own source of supply of crude oil, in the sale of royalty oil for processing or use in such refineries and not for resale in kind. When the Secretary decides to sell royalty oil in any region, he specifies the manner in which the sale is to be effected.[49]

These regulations define the term "eligible refiners" as owners of existing refineries who qualify as a small business enterprise under the rules of the Small Business Administrations and who are unable to purchase in the open market an adequate supply of crude oil to meet the needs of their existing refinery capacity. The definition of "eligible refin-

46. 30 U.S.C. § 209 (1964).
47. 34 Fed. Reg. 1019 (1969). These will be found in Chapter II, Part 225, Title 30, *Code of Federal Regulations*, when the 1970 revision becomes available.
48. Act of July 13, 1946, ch. 574, 60 Stat. 533, 30 U.S.C. § 192 (1964).
49. 34 Fed Reg. § 225.7, at 1020 (1969).

er" explicitly states that the refineries need not be in operation.[50] The regulations define "preference eligible refiners" as eligible refiners located within a given region.[51]

An eligible refiner interested in purchasing government royalty oil files an application with the Oil and Gas Supervisor of the region in which the oil is produced. [52] The Supervisor considers each application filed. The Supervisor may notify lessees or operators of the Federal oil and gas leases involved and the then purchasers of the oil of his receipt of an application and allow lessees and operators thirty days within which to submit comments.[53]

The Supervisor is required to inquire of other small refiners having refineries in his region as to their interest in purchasing royalty oil. He may also go outside his region when he has reasons to believe that other interested, qualified refiners are outside his region. The Supervisor then makes appropriate recommendations to the Director of the Geological Survey and to the Secretary of the Interior. [54]

As a matter of policy, government oil is sold only to "eligible refiners." The Secretary gives "preference eligible rerefiners" a preference over other "eligible refiners" in the purchase of government oil. When two or more "preference eligible refiners" apply for the oil, the Supervisor allocates the oil among those applicants by a drawing or on a prorated basis. When two or more "eligible refiners" apply for the same oil and no "preference eligible refiners" apply, the Supervisor allocates the oil among the "eligible refiners" in a similar manner.[55]

The new regulations commit important decisions to the discretion of the Supervisor and the Secretary, particularly in the area of determining market price. The definition of "market price" set out in the new regulation is notable. Market price may be established in any one of three ways. Market price may the highest price per barrel regularly posted, published, or generally paid or offered by any principal pur-

50. *Id.*, § 225.2(a), at 1019.
51. *Id.*, § 225.2(e), at 1019.
52. *Id.*, § 225.5, at 1019.
53. *Id.*, § 225.6, at 1020.
54. *Id.*
55. *Id.*, § 225.3, at 1019.

chaser of crude oil of equal A.P.I. gravity in the field where produced. If no prices are posted in the field, market price is the highest price posted in the nearest field where a comparable grade of crude oil is produced and sold. In the alternative market price is the true value as determined by the Supervisor when, in his judgment, such highest price regularly posted, published, or generally paid or offered in the same field or the nearest field is found by him to be less than the true value of the royalty oil, thereby vesting the Supervisor with the sole right to establish the price of the oil.[56]

No guidelines are available in the new regulations to indicate the procedures or the evidence or any factors which the Supervisor investigates in formulating his determination of the true value. It is submitted that a preferable definition of market value would set forth guidelines for determining true value to afford all parties standards by which to determine market value. Indeed the lessee and the present purchasers ought to be afforded an opportunity to be heard and to present evidence in the determination of the true market value.

An obvious change brought about by these regulations is the removal of any requirement that the Secretary advertise for bids. The Secretary may sell the oil at private sale without advertising for bids or receiving sealed bids, as was required under the former regulations. Sales are made at the "market price" without premium or bonus.[57]

Another change from the former regulations is the requirement that applications for royalty oil be filed with the Regional Oil and Gas Supervisor of the region in which the oil is produced, instead of with the Director of the Geologic Survey in Washington, D.C.[58]

These regulations provide for notice to the lessee of any change in the disposition of royalty oil. If the Secretary sells government royalty oil, he is required to give the lessee or operator thirty days notice of the proposed change in disposition of the oil.[59] This policy is eminently sound. Fairness demands that the purchaser of the oil be given advance warn-

56. *Id.*, § 225.2(f), at 1019.
57. *Id.*, § 225.3, at 1019.
58. *Id.*, § 225.5, at 1019-20.
59. *Id.*, § 225.8, at 1020.

ing that he may lose the oil to which he was entitled. The thirty days notice of redisposition of royalty oil gives the lessee and the operator at least some time in which to arrange to accommodate the change.

This authority of the Secretary to dispose of government royalty oil, paid in kind, although avowedly affecting only the royalty, in application, has a palpable effect on the working interest. By the very nature of the transaction, it includes the working interest and thus affects more than government royalty oil. The working interest owners will follow the switch of the purchase of the oil from the original purchaser to the new small refinery. This is so because it is difficult for the operator to segregate the government's portion of the oil. The operator would have to set a separate tank battery and collect one-eighth of the monthly production in this tank battery, and then deliver it to the eligible refinery. This imposes a burden on the operator not only by requiring greater expense, but also by requiring more onerous operations of the lessee. If the Secretary grants small refineries government royalty oil, the lessee will most likely turn the entire lease over to the small refinery for purchase and distribution to all of the owners. The original purchaser then loses the connection and the purchase.

CONCLUSION

This, then, is the process by which oil is purchased from federally leased lands. The sale of crude oil is governed by the policy established by the Mineral Leasing Act. The function of selling the oil from federally leased lands is carried out by the Oil and Gas Operations Branch of the Conservation Division of the U.S.G.S.

As currently administered, the Mineral Leasing Act encourages the development of the mineral resources on the public lands of this nation, while guaranteeing a return to the public in the form of royalties. The United States Geologic Survey seems to be achieving these policies as it sells crude oil from federally leased lands.

APPENDIX A

The division order is directed to the purchaser. The signing interest owners guarantee and warrant their title to their respective interest set out in the division order. The division order contains a legal description of the property from which the oil is being purchased. The effective date of the commencement of purchases is set out. The term of the division order is set out generally as "until further written notice from either the purchaser or the signing interest owner." This, until further written notice, is generally construed as 30 day notice from either party for termination of the division order. However, there is no hard and fast rule as to the time; although no court case seems to have construed this provision, it can be confidently asserted that notice given within a reasonable time is sufficient.

Into the covenants and agreements contained in the usual division order—the first covenant provides that title to the oil shall pass on as soon as the same is received into the purchaser's custody, and the interest owner agrees to look solely to the oil purchaser for payment.

The second covenant usually provides for the price to be paid, and might read something like this: "The oil received and purchased hereunder shall be delivered F.O.B. to any pipeline or carrier designated by the purchaser, which gathers and receives said oil, and you shall pay for such oil to the respective owners according to the division of interest above set forth at the same price per barrel received by the operator of the lease covered by this division order. The word 'oil' used herein shall mean crude oil and condensate (or distillate) delivered hereunder," or the pricing clause may read like this: "The oil purchased and received . . . shall be paid for . . . at the market price paid by the .... Company for the same kind and quality of oil on the same day that said oil, purchased in pursuance of this division order, is delivered as aforesaid."

The third covenant usually defines quality and quantity, and may read something like this: "Qualities and quantities of oil received hereunder shall be determined by the practice prevailing in the area in which oil is produced, and in accordance with rules and regulations of the governmental agency or commission having recognized jurisdiction or control of the production and handling of crude in such area, you or your nominee will receive only oil, which, in the exclusive opinion of you, or your nominee, is merchantable and may require well owners to treat or steam any unmerchantable oil at well owner's expense, before acceptance hereunder."

The fourth covenant provides for settlement and payment, and may read like this: "Settlements and payments shall be made monthly by check mailed from your office to the respective parties at the addresses above given, for the amount of such purchase price due said parties, respectively, less any taxes required by the law to be deducted and paid by you as purchaser."

The fifth covenant concerns the interest owners developing their title and interest in the oil as providing for furnishing abstracts of title or other evidence of title, provides for suspending the interest in the event of conflicting claims and what will happen in the event of litigation. This covenant may read as follows: "Abstracts and other evidence of title satisfactory to you will be furnished to you at any time on demand. In the event of failure to so furnish such evidence of title, or in the event of any dispute of question at any time concerning title to the above lands, or the oil produced therefrom, you may hold the proceeds of all oil received and run, without interest, until indemnity satisfactory to you has been furnished or until such dispute or question of title is corrected or removed to your satisfaction. And in the event any action or suit is filed in any court affecting title either to the real property above described or to the oil produced therefrom in which any of the undersigned are parties, written notice of filing of such action shall immediately be furnished you by the undersigned, stating the court in which the same is filed and the title of such action or suit, and you or any carrier transporting oil for your account shall be held harmless from any judgment rendered in such suit and all reasonable costs and expenses incurred in defending against said claim, whether in your defense or in the defense of the carrier transporting oil for your account, and the undersigned shall pay said judgment and said costs and expenses."

The sixth covenant generally concerns subsequent transfers of interest and the procedure to be followed as interests are conveyed from time to time, and may read as follows: "The undersigned severally shall notify you of any change of ownership, and no transfer of interest shall be binding upon you until a transfer order and the recorded instrument evidencing such transfer, or a certified copy thereof, shall be furnished to you. Transfers of interest shall be made effective not earlier than the first day of the calendar month in which notice is received by you. You are relieved hereby of any responsibility for determining if and when any of the interests hereinabove set forth shall or should revert to or be owned by other parties as a result of the completion or discharge of money or other payments from said interest and the signers hereof whose interests are affected by such money or other payments, if any, assume said responsibility and shall give you notice in writing by registered letter addressed to you at the above address, when any such money or other payments have been completed or discharged or when any other division of interest that that set forth above shall, for any reason, become effective and to furnish transfer orders accordingly, and that in the event such notice shall not be received, you shall be held harmless in the event of, and are hereby released from any and all damage or loss which might arise out of any overpayment."

The seventh covenant provides for severability of the division order and consent to the removal of the purchaser's personal property when the lease is disconnected, and may read as follows: "This division order shall become valid and binding on each and every owner above named as soon as signed by him or her regardless of whether any of the other above named owners have so signed; and in consideration of the purchase of oil hereunder, consent is given hereby to you and any pipe line company which you may cause to connect with the wells or tanks on said land, to disconnect and remove such pipe lines, in case of termination by either you or us of purchases under this division order."

The eighth covenant contains a representation from the owners that their oil has been produced and sold in accordance with all applicable federal, state and municipal laws, rules and regulations.

As heretofore stated, the above analysis is a representation of a division order in general terms. The covenants and agreements can be anything the parties want. I have seen division orders that contained ratifications of the base oil and gas lease. There are division orders that contain words of grant. Sometimes the division order is used as a curative instrument to cure prior title defects. Most purchasing companies refuse to allow their division orders to contain special clauses designed to clear title defects. I have consistently advised my employer to never include in its division order any curative clauses on the premise that it is a third party purchase not a party to the lease and could destroy its position as a stakeholder by such action.