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DEPARTMENT OF ENERGY
OFFICE OF HEARINGS AND APPEALS

Interlocutory Order

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This decision concerns an appeal filed by Chevron USA Inc. (Chevron) with the Office of Hearings and Appeals. The appeal concerns equity interests in the production from the Elk Hills oil field, also referred to as Naval Petroleum Reserve No. 1 (the Reserve). In 2002, the Assistant Secretary for Fossil Energy (AFSE) issued a determination concerning the Stevens Zone, the largest producing zone in the Unit. Chevron filed an appeal, challenging the ASFE methodology for converting gas volumes to barrel-of-oil equivalents (BOEs), the unit by which the parties measure their equity interests. In a 2005 decision, we granted the appeal in part and remanded the matter to the ASFE. *Chevron USA Inc.*, Case No. TEA-0001 (2005).¹ In 2007, the ASFE issued a revised determination, and Chevron filed the instant appeal. In this interlocutory order, we address issues raised in the appeal, and we provide for further briefing related to the appropriate conversion methodology.

I. Background

A detailed history of the Reserve is set forth in *United States v. Standard Oil of Cal.*, 545 F.2d 624 (9th Cir. 1976). Discussions are also set forth in our decisions in *Chevron USA, Inc.*, Case No. TEA-0001 (2005), and *Chevron USA Production Co.*, Case No. VEA-0010 (2000). For purposes of this decision, a brief discussion will suffice.

¹ Decisions issued by the Office of Hearings and Appeals (OHA) are available on the OHA website located at <http://www.oha.doe.gov>. The text of a cited decision may be accessed by entering the case number of the decision in the search engine at <http://www.oha.doe.gov/search.htm>.

Congress established the Reserve in 1912 to conserve oil for the national defense. The Reserve was comprised of parcels of land - some owned by the federal government and others owned by Standard Oil of California (Standard), now Chevron. Initially, the Department of the Navy (Navy) had jurisdiction over the federal government's interest in the Reserve. In 1977, Congress transferred that jurisdiction to the newly-established DOE.

In 1942, Standard and Navy (also referred to as "the parties") entered into a unit plan contract for limited production of the Reserve. In 1944, after concerns were raised about the legality of the contract, the parties terminated it. That same year, the parties entered into a congressionally-approved Unit Plan Contract (the UPC) covering a portion of the Reserve (the Unit). Under the UPC, the parties' "participating percentages" in production, also referred to as "equity interests," were based on estimates of the volume of hydrocarbons underlying their respective lands. The UPC established initial participating percentages and provided for subsequent redeterminations, retroactive to 1942, as the parties learned about the geological structure of the field.

In 1995, Congress enacted legislation directing that the government sell its interest in the Reserve. National Defense Authorization Act for Fiscal Year 1996, §§ 3412-16, 10 U.S.C. § 7420 note. In conjunction with the sale, the parties entered into an agreement to determine their final equity interests. The parties' agreement is entitled "Agreement Regarding Equity Redetermination Process," Chevron Ex. 5, and is also referred to as the "Equity Process Agreement" or the "EPA."

Under the Equity Process Agreement, the ASFE makes final equity determinations for each geological zone. Chevron Ex. 5, at 3-7. The parties first make presentations to an Independent Petroleum Engineer (IPE), who then makes a preliminary recommendation. *Id.* at 3 (EPA ¶ B.1). After the parties comment on the preliminary recommendation, the IPE makes a final recommendation, and the parties have an opportunity to comment. *Id.* (EPA ¶ B.2). The ASFE issues a preliminary determination, the parties have an opportunity to comment, and the ASFE issues a final determination. *Id.* (EPA ¶¶ 3-6). If the ASFE accepts the IPE recommendation, the matter is final and not appealable. *Id.* (EPA ¶ 7). If

the ASFE rejects the IPE recommendation on a given issue, Chevron may appeal that issue to OHA. *Id.* Similarly, if an Independent Legal Advisor (ILA) and the ASFE reject Chevron's position on a legal issue, Chevron may appeal that issue to OHA. *Id.* (EPA ¶ 11.)

In 2002, after receiving the IPE recommendation and the parties' comments, the Principal Deputy ASFE (hereinafter also referred to as the ASFE) issued a determination on the Stevens Zone - the Unit's largest producing zone. Chevron Ex. 13 (2002 ASFE determination). Chevron appealed, challenging the ASFE's "conversion" methodology, *i.e.*, the methodology for converting the parties' respective volumes of gas (in million cubic feet or "mcf") to barrel-of-oil equivalents (BOEs), the measure of "hydrocarbons" underlying the parties' respective lands. The ASFE used the average of two conversion factors: one based on relative 1996-1998 prices ("current prices"), and one based on relative thermal value (expressed in British Thermal Units or BTUs). 2002 ASFE Determination at 15-22. Chevron appealed the determination to OHA, arguing that the conversion factor should be based on relative 1942 prices.

In 2005, we granted the Chevron appeal in part. *Chevron*, Case No. TEA-0001 (2005) (the 2005 OHA Decision). We rejected the ASFE and Chevron methodologies. We reasoned that the methodology for calculating participating percentages must be consistent with the UPC's provision for each party's eventual receipt of its 1942 volume of hydrocarbons. *Id.* at 5. We further reasoned that, to accomplish that result, the conversion factor must be based on the prices received for the Unit's production." *Id.* at 6. We provided an example showing that if the conversion factor were not based on weight-averaged prices over the life of the Unit, the parties would not receive revenues consistent with their 1942 share of hydrocarbons. *Id.* at 6-7.

Based on the foregoing, the 2005 OHA Decision remanded the matter to the ASFE for a revised determination. *Id.* at 11. The 2005 OHA Decision stated:

As part of the remand, the [ASFE] should prepare a schedule with the following information:

- (a) the Unit's revenues in each month,
- (b) the Unit's revenues in each month as

- a percentage of total revenues,
- (c) the per barrel price of oil in each month,
- (d) the per thousand cubic feet price of gas in each month,
- (e) the ratio of the price of gas to oil in each month,
- (f) the result of multiplying (b) by (e), and
- (g) the sum of the entries in column (f).

Item (g) is a conversion factor based on the weight-averaged monthly relative price of gas and oil. If the [ASFЕ] determines that for technical reasons Item (g) is not the most accurate weight-averaged conversion factor, the [ASFЕ] should explain why. In any event, [Chevron] may appeal to this Office any determination reached by the [AFSE].

Id. at 11-12. As the foregoing indicates, the 2005 OHA Decision required that the ASFЕ prepare a schedule showing the calculation of a conversion factor based on revenue-weighted monthly price ratios (hereinafter the 2005 formula) and explain the basis for any ASFЕ objection to the use of the resulting conversion factor. Finally, the 2005 OHA Decision provided that "[i]n any event," Chevron could appeal the resulting ASFЕ determination. *Id.* at 12.

In 2006, the ASFЕ issued a preliminary determination concerning the OHA remand (the 2006 ASFЕ Preliminary Determination). Chevron Ex. 17. The ASFЕ discussed the process leading to that preliminary determination. After the issuance of the 2005 OHA Decision, the parties engaged in a process to consider how the ASFЕ should implement the 2005 decision. *Id.* at 2-4. Each party had an "equity team" that provided its views to an ASFЕ "headquarters equity advisory team" (the ASFЕ advisory team). *Id.* The matter was not referred to the IPE, who had resigned his position in 2005. See Chevron Mot. for Stay, Case No. TES-0010, at 7.

In 2006, the ASFЕ advisory team prepared a report, setting forth its technical analysis (the 2006 ASFЕ Advisory Team Report). Chevron Ex. 19. The ASFЕ advisory team stated that the 2005 formula was "imprecise" for various technical reasons related to the formula's use of revenue-weighted monthly price ratios. 2006 ASFЕ Advisory Team Report at 2.

The ASFE advisory team cited as "a more accurate approach" the formula proposed by the DOE equity team, using weighted average prices. *Id.* at 3. Nonetheless, the ASFE advisory team recommended the 2005 formula, viewing it as a "requirement" of the 2005 OHA Decision. *Id.* at 16.

The ASFE advisory team then discussed its view of the technical issues associated with using the 2005 formula, two of which are relevant to the instant appeal. First, for months in which a hydrocarbon was not sold, the ASFE advisory team declined to impute a sale price, which precluded a price ratio and resulted in the exclusion of the month from the calculation (the excluded months issue). 2006 ASFE Advisory Team Report at 4. Second, for the determination of gas prices, the ASFE advisory team calculated a composite "wet" gas price, *i.e.*, a price that consisted of two components - a dry gas price and a value for natural gas liquids (NGLs) (the NGL issue).

Shortly after the ASFE advisory team issued its report, the ASFE issued the 2006 Preliminary Determination. The ASFE stated that the 2005 OHA decision required the use of revenue-weighted monthly price ratios. 2006 Preliminary Determination at 2. The ASFE addressed various technical issues concerning the implementation of that approach. The ASFE agreed with the ASFE advisory team on the excluded months issue, stating that he did not "see a technically defensible methodology for creating a monthly price ratio" where sales of both oil and gas did not occur. *Id.* at 7-8. The ASFE also agreed with the ASFE advisory team on the NGL issue, stating that the inclusion of NGLs in gas prices was a settled issue. *Id.* at 6, 8.

Both parties filed comments and, in 2007, the ASFE issued his final determination. Chevron Ex. 18 (the ASFE 2007 Final Determination). The ASFE reiterated his view that the 2005 OHA Decision required a calculation based on revenue-weighted monthly sale price ratios. *Id.* at 2. He then addressed various technical issues, adopting his preliminary determination on the excluded months and NGL issues. *Id.* at 2-5. The result was to raise Chevron's equity interest from 19.4575 percent to 19.6460 percent. Compare 2002 Determination at 31, with 2007 Determination at 5.

Following the 2007 ASFE Determination, Chevron filed a Notice of Appeal, which included the following issue:

Whether there are technical reasons that the conversion factor established by the formula in OHA's 2005 decision is not the most accurate weight-averaged conversion factor.

Notice of Appeal at 3. After DOE filed a Partial Motion to Dismiss, Chevron redefined that issue. Chevron argued that the 2005 formula was accurate and that the ASFE erred in implementing the formula with respect to the excluded months and NGL issues. Chevron Resp. (Mot. to Dismiss) at 17. In the alternative, Chevron argued that if the ASFE accurately implemented the 2005 formula, then the formula was not consistent with the logic of the 2005 OHA decision. *Id.* at 19.

In a 2008 interlocutory decision, we noted that Chevron was free to challenge the 2005 formula. We stated:

In the 2005 OHA decision, we recognized that there may be technical reasons why the decision's formula may not produce the most accurate weight-averaged conversion factor. If Chevron does argue that there is a more accurate formula, Chevron should include a discussion of the alternative formula proposed by the DOE in proceedings before the ASFE.

Chevron USA Inc., Case No. TEZ-0010, at 5 (2008). As explained below, Chevron argues that consideration of any alternative formula is foreclosed by the 2005 OHA Decision and the 2007 ASFE Determination.

In its opening brief, Chevron argued that the ASFE erred in his implementation of the 2005 formula with respect to the excluded months and NGL issues. In response, DOE argued that there is a more accurate formula - based on weighted average prices - that would not give rise to those issues, and DOE requests that we adopt that formula. In the alternative, DOE argued that the ASFE determination represents a reasonable, technical judgment of how to implement the 2005 formula that should be upheld. In reply, Chevron argued that the 2005 formula is a settled issue and, therefore, the issues properly considered in this appeal are Chevron's challenges to the ASFE's implementation of the formula with respect to the excluded months and NGL issues. Oral argument on these issues was held on March 5, 2009.

II. The Applicable Standard

The parties agree that the Equity Process Agreement governs Chevron's appeal of the 2007 ASFE Determination. Paragraph B.8 of the Agreement provides that if OHA remands "a specific issue back to the ASFE for further determinations in accordance with OHA's instructions," Chevron "shall have the right to challenge any further determination of the ASFE on such remand" pursuant to Paragraph 7 of the Agreement. See Chevron Ex. 5 at 5 (Equity Process Agreement ¶ B.8). Paragraph 7 refers to appeals from ASFE determinations in the first instance and provides that the standard of review is that set forth in the Administrative Procedures Act, 5 U.S.C. §706, and the Wunderlich Act, 41 U.S.C. §§ 321, 322. Chevron Ex. 5 at 4.

III. Analysis

In this interlocutory decision, we discuss the issues raised by the parties. In light of that discussion, we require additional briefing.

A. The 2005 Formula

As mentioned above, the 2005 formula is based on revenue-weighted monthly sale price ratios. Chevron's objections, discussed below, illustrate that the 2005 formula is not fully aligned with the analysis in the 2005 OHA Decision and the IPE's treatment of NGLs.

As noted above, Chevron objects to the ASFE's refusal to impute sale prices in months in which sales did not occur. One of Chevron's objections is that this is "illogical," given the 2005 formula's inclusion of months in which only small sales occurred. Chevron Br. at 22. This argument illustrates a fundamental characteristic of the 2005 formula, i.e., that it weights the monthly price ratios based on revenues, regardless of the relative contribution of oil and gas to those revenues. Thus, two months with the same price ratios and the same revenues will have the same revenue-weighted monthly sale price ratios, even if one month's revenues are attributable mostly to gas and the other month's revenues are attributable mostly to oil. In this respect, the 2005 formula is not completely aligned with the 2005 OHA decision's discussion of the use of weighted average prices. 2005 OHA Decision at 6-7.

Similarly, Chevron's challenge to the ASFE's inclusion of NGLs in the gas prices illustrates that the formula is not completely aligned with the IPE treatment of NGLs. It is undisputed that in the proceedings leading to the 2002 ASFE Determination, the IPE recommended the inclusion of certain NGLs (associated with gas cap and solution gas) in gas prices. It is also undisputed that the ASFE accepted that recommendation. See, e.g., Chevron Br. at 13, DOE Resp. Br. at 2. Finally, it is undisputed that the 2005 formula does not permit the IPE's treatment of NGLs, instead requiring an all-or-nothing treatment, i.e., that the gas price includes a value reflecting all NGLs or the gas price does not include a value for NGLs. See, e.g., Chevron Br. at 13; DOE Resp. Br. at 2.

Given the foregoing, we question whether the 2005 formula produces the most accurate conversion factor. DOE argues for a formula based on weighted average prices. Chevron previously asked for such a formula as an alternative form of relief.² As explained above, however, Chevron now argues that, for a variety of reasons, consideration of an alternative conversion formula is foreclosed and we are limited to upholding the ASFE implementation of the formula on the excluded months and NGL issues.

B. Whether Consideration of an Alternative Formula is Foreclosed

Chevron argues that the 2005 OHA Decision requires use of the 2005 formula. In support of that argument, Chevron cites the ordering paragraph stating that gas reserves shall be converted based on revenue-weighted monthly price ratios.

This argument ignores the decision's context and language. In the prior appeal proceeding, the parties did not brief the issue of whether the conversion factor should be based on prices over the life of the Unit, let alone the implementing formula. Chevron, Case No. TEA-0001, at 6. Although the 2005 OHA Decision required that the ASFE prepare a schedule utilizing a particular formula, the

² In its appeal of the 2002 ASFE Determination, Chevron stated that if OHA rejected its position on 1942 prices, OHA "should order that there be no conversion, or it should apply a conversion factor based on the actual historical values of gas and oil, weighted according the quantities produced over the life of the contract." Chevron Reply Br. at 29, Case No. TEA-0001.

decision specifically stated that if the ASFE determined that the resulting conversion factor was not the most accurate conversion factor, he should explain why. The decision allowed that "in any event" Chevron could appeal the resulting determination to OHA. *Id.* at 12. It would be illogical to require the ASFE to utilize the 2005 formula yet give Chevron the right to appeal the formula.

Chevron next argues that, even if the 2005 OHA decision did not require the use of the 2005 formula, the 2007 ASFE determination reflects his independent assessment that the 2005 formula produces the most accurate conversion factor. This argument lacks merit. As an initial matter, we note that the ASFE advisory team advised the ASFE that, in its view, the 2005 formula was not the most accurate conversion formula. Chevron Ex. 19 at 2-3. More importantly, the ASFE stated, in both the preliminary and final decisions, that he viewed, as a "central holding" of the 2005 OHA decision, a requirement that he use the formula's methodology of revenue-weighted price sale ratios. Chevron Ex. 17 at 2; Chevron Ex. 18 at 2. There is nothing in the determination to indicate that the ASFE made an independent assessment that the 2005 formula produced the most accurate conversion factor.

Finally, Chevron argues that, regardless of the ASFE's view of the formula, the formula is a settled issue under the Equity Process Agreement. Chevron states that issues not appealed are final and that Chevron did not appeal the formula. This argument too lacks merit. As an initial matter, we note that Chevron's Notice of the Appeal raised the issue whether the formula produced the most accurate conversion factor. Notice of Appeal at 3.³ Chevron later argued that if the ASFE correctly implemented the formula then the formula did not implement the logic of the decision. See, e.g., Chevron Resp. to DOE Motion to

³ Chevron identified the following issue:

Whether there are technical reasons that the conversion factor established by the formula in OHA's 2005 decision is not the most accurate weight-averaged conversion factor.

Notice of Appeal at 3, *quoted in Chevron*, Case No. TEZ-0010, at 4.

Dismiss, *cited in Chevron*, Case No. TEZ-0010, at 4-5. More importantly, Chevron's objections to the ASFE's implementation of the formula illustrate that the formula is not fully aligned with the logic of our decision and prior proceedings, and the ASFE's use of the formula resulted from his misunderstanding of the 2005 OHA Decision and resulting failure to render a determination "in accordance with OHA's remand instructions." *Chevron Ex. 5* at 5 (EPA ¶ B.8). Given these circumstances, the Equity Process Agreement does not preclude our consideration of whether the 2005 formula produces the most accurate conversion factor.

C. Further Briefing

The parties have not fully briefed issues on the proper methodology for calculating the conversion factor. Chevron has not done so, because it took the position that the consideration of an alternative formula was foreclosed. DOE, while arguing for the use of weighted average prices based on production, has not fully briefed why the use of production volumes, rather than sales volumes, produces the more accurate conversion factor. Accordingly, Chevron should file a brief setting forth its views on the merits of the respective approaches to using prices over the life of the Unit: (i) weighted monthly price ratios and (ii) weighted average prices. DOE will have a chance to respond, and Chevron to reply. Both parties should include a discussion of (i) whether the Unit's termination prior to the production of all recoverable hydrocarbons affects the operation of the formulas and (ii) which formula is best aligned with the UPC and the logic of the 2005 OHA Decision.

The parties should also brief the impact of the absence of the IPE from the remand proceeding. With respect to the treatment of NGLs, the parties strenuously dispute the percentage of NGL revenues attributable to gas versus oil, citing various IPE analyses leading to the 2002 ASFE Determination. Despite the obvious relevance of the IPE's views on this issue, we have no IPE recommendation concerning how to treat NGLs under the 2005 formula or whether the 2005 formula produces the most accurate conversion factor. It appears to us that the Equity Process Agreement does not contemplate OHA consideration of technical issues, except in the instances where the ASFE has rejected an IPE recommendation. See *Chevron Ex. 5* at 4 (EPA ¶ 7). The parties should brief whether the choice of the most accurate formula is a technical determination that

requires IPE participation and, if so, the appropriate action from this office concerning the appeal.

IT IS THEREFORE ORDERED THAT:

(1) The parties shall brief the issues identified in Part III.C. of this Interlocutory Order.

(2) The parties shall file a proposed briefing schedule within 21 days of this Interlocutory Order.

Poli A. Marmolejos
Director
Office of Hearings and Appeals

Date: September 2, 2009