STATE OF ALABAMA DEPARTMENT OF REVENUE,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. MISC. 94-207
LONGHORN PRODUCTION CO. 4600 Greenville Avenue Dallas, Texas 75206-5038,	§	
Taxpayer.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed oil and gas severance tax against Longhorn Production Company ("Taxpayer") for the period April 1992 through April 1993. The Taxpayer appealed to the Administrative Law Division and a hearing was conducted on September 12, 1994. J. Patrick Courtney, III, represented the Taxpayer. Assistant counsel Claude Patton represented the Department.

The primary issue in this case is whether gas produced by the Taxpayer during the period in issue should be taxed at a reduced 6% rate (from 8%) pursuant to Code of Ala. 1975, §40-20-2(a)(4). That section levies a reduced rate for gas produced from certain qualifying discovery and development wells. The reduced rate is allowed "for a period of five years from the date production begins" at a qualifying well. The specific issue in dispute is whether "production" begins when gas and oil condensate is taken from a well for testing purposes, as argued by the Department, or when the well goes on-line and gas is first severed and delivered to the refinery for processing, as argued by the Taxpayer. A second issue is whether $1500 monthly compression payments allegedly made by the Taxpayer to the refinery operator should be allowed as a marketing deduction in computing the taxable value of the gas.

Two gas wells are involved, the Middleton well and the Dees well, both located in the Crosby's Creek Field in Washington County, Alabama. Both wells were drilled in 1986. Because the wells are sour gas wells that have a high sulphur content, the Taxpayer (actually, the Taxpayer's predecessor, Hughes Eastern Corporation) was required by Alabama Oil and Gas Board regulations to test the gas at both wells.

Samples were drawn from the Middleton well in October and November 1986, and from the Dees well in April 1987. The samples were tested and the results were reported to the Oil and Gas Board. The tests confirmed that the two wells contained gas with a high sulphur content. The excess gas not used in testing was flared into the atmosphere. The excess oil condensate was captured and sold.[1]

[1] The Taxpayer reported and paid tax on 3,374 barrels of oil

Shortly after testing, the Taxpayer petitioned the Oil and Gas Board requesting a reservoir wide unit. The Oil and Gas Board denied the request by order dated August 7, 1987.

The Oil and Gas Board established the Crosby's Creek Gas Field and approved operating field rules for the Field on January 29, 1988. The Middleton and Dees wells were the only wells in the Field.

The Taxpayer subsequently petitioned the Oil and Gas Board for permission to lay gathering lines to connect the two wells, and also a pipeline to connect the wells to a processing plant seven miles away. Permission was granted in April 1988. Construction began immediately, and the lines were completed in about three months. A steady stream of gas began flowing from the wells to the processing plant in July 1988. The Taxpayer thereafter reported

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condensate in October 1987 and 77 barrels in November 1987, both from the Middleton well. The Taxpayer reported and paid tax on 3,957 barrels from the Dees well in April 1987. No additional gas or oil condensate was taken after testing, and thus no severance tax was paid, until the wells came on-line in July 1988.

and paid Alabama severance tax on the gas at the reduced 6% rate as provided at §40-20-2(a)(4).

The Taxpayer claims that "production" began when the wells came on line and started delivering gas in a continuous flow to the processing plant in July 1988. Consequently, the Taxpayer argues that the reduced 6% rate should apply for five years from that date, or through June 1993.

The Department argues that "production" began when the wells were tested in October 1986 and April 1987 concerning the Middleton and Dees wells, respectively. If the Department is correct, the five-year reduced rate period expired in September 1991 for the Middleton well, and in March 1992 for the Dees well. The final assessment in issue is based on the difference between the 8% rate claimed by the Department for the period April 1992 through April 1993 versus the reduced 6% rate actually paid by the Taxpayer during that period.

There is no Alabama court case directly on point. Nor is the term "production" defined for oil and gas purposes by Alabama statute. Other states' courts have, however, attempted to define the term.

In Riley v. Merriweather, 780 SW.2d 919, at 923 (Tex. 1989), the court held that "production of a well involves actually taking oil or gas from the well in a captive state for either storing or marketing the product for sale." Other courts have held that "production" means "producing in paying quantities". Diamond

Shamrock Exploration Corporation v. Hodel, 853 F.2d 1159, 1168 (5th. Cir. 1988); Exxon v. Oil Company v. Dalco Oil Company, 609 SW.2d 281, 285 (Tex. Civ. App. 1980); Fischer v. Grace Petroleum Corporation, 830 P.2d 1380, 1382, (Ok. Civ. App. 1990); See also, Sheffield v. Exxon Corporation, 424 So.2d 1297 (Ala. 1982).

The Department in its letter brief makes three arguments why "production" begins when a well is tested. Those three arguments are as follows:

> (1) The Legislature did not specify commercial production in Act No. 83-328 (sic) as it did the following year in Act No. 84-372 (sic);
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> (2) Act No. 83-328 (sic) does not allow a new five year period for a replacement well but only allows the remaining time of the initial five year period;
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> (3) The purpose of the reduced rate was to generate tax revenue quickly by enticing companies to drill and produce <u>now</u>, not drill and wait to produce whenever they so desired. (underline in original)

Concerning argument (1), the statute in issue, §40-20-2(a)(4), was enacted as part of Act No. 84-328, passed by the Legislature on May 17, 1984.

The Legislature subsequently passed Act No. 84-672 on June 7, 1984. Act 84-672 is codified at §40-20-2(a)(6) and reads as follows:

> (6) Any well which begins commercial production of occluded natural gas from coal seams after June 7, 1984 shall be taxed at the rate of two percent of the gross value of said occluded natural gas from coal seams at the point of production for a period of five years after such well begins production.

The Department argues that the word "production" as used in

Act 84-328 must refer to something other than "commercial production" because otherwise the Legislature would have used "commercial production" in Act 84-328 as it did in subsequent Act 84-672. The term "commercial production" also is not defined by Alabama statute. I assume the term means producing or taking oil and gas for processing and sale.

I agree that use of both terms "production" and "commercial production" does raise a question as to what the Legislature intended. However, while Act 84-672 does include the term "commercial production", it also uses the term "production" to refer to the same activity or event. Act 84-672 states that "[A]ny well which begins commercial production . . . shall be taxed . . . (at 2%) . . . for a period of five years after such well begins production". The two terms are used interchangeably in the Act to refer to the same event. Consequently, a good argument could be made that the two terms mean the same thing. Concerning argument (2), the fact that a replacement well is allowed the reduced rate for only the balance of time it would have been allowed to the prior discovery or development well has no bearing or relevancy as to when "production" begins.

Concerning argument (3), the Department argues that the intent of the reduced rate was to induce companies to drill and produce immediately. However, a development well qualifies for the reduced rate if drilling of the well is commenced within a certain time, not if production begins within a certain time. If drilling begins within the required period, the reduced rate applies to oil and gas subsequently produced from the well regardless of when production begins. Apparently, the Legislature was not concerned that a well might be drilled and capped, but rather assumed that if a company drilled a well, production would begin in due course, as did the wells in this case.

The Legislature clearly intended to allow the reduced rate for a full five years for oil and gas produced from certain qualifying wells. If the Department's position is correct, the reduced rate would be lost for that period from when the wells in issue were tested (October 1986 and April 1987), until the wells went on line and began delivering gas for processing (July 1988). After the wells were tested, the Taxpayer was required by Oil and Gas Board regulations to petition to have field rules granted, and then apply for permission and actually build a gathering system and pipeline to take the gas to the processing plant. Gas from the wells could not be severed, refined and sold until the pipeline was completed. The Legislature certainly did not intend for the five year reduced rate period to run during a period when gas could not be taken from the wells and taxed for severance tax purposes.

In my opinion, "production" as used in §40-20-2(a)(4) begins when gas is severed from an operating well for either storage or delivery to a refinery for processing. That holding is in line with the cases cited above, specifically Riley v. Merriweather, supra.

Production began at the two wells in issue when the gas began flowing to the refinery in July 1988. Accordingly, the Taxpayer should be allowed the reduced 6% tax rate until June 1993, which includes the period in question.

Concerning the second issue, the Department does not dispute that compression charges or expenses can be deducted in arriving at taxable value under the "workback" method. However, the Department denied the $1500 per month compression charges deducted by the Taxpayer because the Department could not verify that the charges were actually paid.

It is undisputed that the Taxpayer was obligated to pay the refinery operator $1500 a month in compression charges (Taxpayer Ex. 7). But instead of issuing a check for the charges, the Taxpayer claims that the charges were withheld or subtracted from the monthly disbursement made by the operator to the Taxpayer.

In my opinion, money withheld is the same as money paid. However, the burden is on the Taxpayer to prove that the compression charges were actually withheld by the operator.

James O. Stevens of Hughes Eastern, the Taxpayer's predecessor in interest, testified that the operator, Collet Ventures, had always issued an itemized monthly statement to Hughes Eastern showing the deducted compression charges. However, no such itemized statements relating to the Taxpayer were submitted into evidence, nor were any other records showing specifically that the compression charges had been withheld. Consequently, I must uphold the Department's disallowance of the compression charges because the Taxpayer failed to verify that the charges were actually paid or withheld.

The Department is directed to recompute the final assessment in issue to reflect the denied compression charges only. A Final Order will then be entered from which either party may appeal under Code of Ala. 1975, §40-2A-9(g).

Entered on March 2, 1995.

BILL THOMPSON
Chief Administrative Law Judge