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<tr><td>BP AMERICA PRODUCTION CO.
f/k/a Amoco Production Company
P.O. Box 591
Tulsa, OK 74102,

Taxpayer,

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.</td><td>§

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§</td><td>STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. MISC. 02-595</td></tr>
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OPINION AND PRELIMINARY ORDER

This is an oil and gas severance tax case. Amoco Production Company ("Amoco"), now known as BP America Production Company, was the working interest owner in numerous coal bed methane gas wells in the Oak Grove field in Tuscaloosa County and Jefferson County, Alabama from March 1994 until it sold the wells in July 1997. Amoco also operated approximately half of the wells during that period. Taurus Exploration, Inc. ("Taurus") operated the other half for Amoco. Amoco was responsible for reporting and paying the Alabama severance tax due on the raw gas produced in the field.

In December 1997, Amoco petitioned the Revenue Department for a refund of severance tax for March 1994 through July 1997. The petition requested a refund of $115,699.

The Department responded to the petition by auditing the Taxpayer's records for the subject period beginning in January 1998. The Department calculated Amoco's liability pursuant to the audit using the workback method. The specifics of the workback method are discussed below. Before the audit was completed, Amoco filed a second refund petition for the same period in December 1999. That petition was prepared for Amoco by J.T. and Ketan Thakker, d/b/a Shiv Om Consultants ("Shiv Om"), and requested a refund of

$2,280,422.91.

The Department issued its audit report in June 2001. The audit established Amoco's total liability for the period, and concluded that Amoco was due a refund of $231,128.29, which the Department paid. The Department denied the balance of the claimed refund. Amoco appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(c)(5)a. In its notice of appeal, Amoco reduced its refund claim to $1,302,525.54, plus interest.

A hearing was conducted from April 28 through 30, 2004. Chief Counsel Henry Chappell and Assistant Counsel John Breckenridge represented the Department. Duane Graham represented Amoco. The Department submitted a revised audit report at the hearing indicating that Amoco is due an additional refund of $52,634.85, including interest through April 28, 2004.

ISSUES

Alabama's severance tax is measured by the "gross value" of unrefined oil and gas at the point of production, i.e. the wellhead. Code of Ala. 1975, §§40-20-2(a)(1) and 9-17-25. "Value" is defined as the "sale price or market value at the mouth of the well." Code of Ala. 1975, §40-20-1(3). If oil or gas is not sold at the wellhead, as in this case, the Department may estimate the taxable value of the oil or gas using the workback method. Value is computed under the workback method by taking the first arm's-length sales price of the refined product, and then working back to the taxable wellhead value by deducting all transportation, treatment, and other post-production costs incurred in processing the product into marketable form. See generally, *Ex parte State of Alabama*, (*In re State of Alabama v. Phillips Petroleum Co.)*, 638 So.2d 886 (Ala. 1992). Deductible costs under the

workback method generally include all processing and treatment costs, i.e. water separation, gas gathering, compression, dehydration, etc., incurred from the wellhead to the point of sale. Deductions for depreciation and a percentage return on investment concerning the producer's processing-related capital assets are also allowed.

The ultimate issue in this case is whether Amoco is entitled to an additional refund over that amount agreed to by the Department. The parties disagree, however, as to how the ultimate issue should be decided.

The Department contends that the burden was on Amoco to prove it is entitled to an additional refund. It argues that the refund petition prepared by Shiv Om is exaggerated, fraudulent, unsupported by the evidence, and should be rejected outright – end of case.

Amoco argues that even if the revised Shiv Om calculations are not accepted, it is still entitled to an additional refund because the Department erroneously computed the taxable value of the Oak Grove gas pursuant to its workback audit. Specifically, Amoco disputes the Department's computations concerning six workback deductions. Those six disputed deductions are identified and discussed below.

The Department is correct that Amoco has the burden of proving that it is entitled to an additional refund. I also agree that the Shiv Om refund petition was over-reaching and exaggerated. Amoco concedes as much because it has greatly reduced its refund claim. I also agree, however, that Amoco could prove that it is entitled to an additional refund by showing that various computations in the Department's workback audit are incorrect.

Because Amoco's refund petitions were complicated and involved numerous workback issues, the Department quite reasonably elected to audit Amoco's records. The Department concedes that Amoco's records were sufficient to do a full and complete audit.

"The records presented directly by Amoco to the Department during the audit were found to be in good order . . ." Department's Brief at 58. Thus, while the Department reviewed the Shiv Om refund petition during its audit, it determined the amount of the refund due Amoco based on its own audit findings, not on an item-by-item analysis of the Shiv Om petition.

Amoco now disputes various aspects of the Department audit, and specifically the six workback deductions discussed below. It is entitled to do so. The Alabama Supreme Court stated in *Phillips Petroleum* that when the Department computes value under the workback method, as in this case, the computations "may be challenged by the taxpayer on the ground that the assessment overestimates, or underestimates, the 'value' or 'market value.' Value is a question of fact, and value may be shown by expert testimony or by evidence of other sales of like-quality gas. Also, when the Department resorts to the work-back method, which is disfavored as a method of calculating value, the assessment can be attacked by showing that the calculations improperly included or excluded items in such a manner that the end result does not fairly indicate value." *Phillips Petroleum*, 638 So.2d at 889 – 890. While this case involves a disputed refund, not an assessment, the same principle applies. Amoco could thus prove that it is entitled to an additional refund by presenting testimony and other evidence showing that the Department's workback method calculations are incorrect. That is what Amoco attempted to do at the April 2004 hearing. Whether the evidence submitted by Amoco is sufficient is addressed in the below analysis of the six disputed workback deductions.[1]

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[1] The Department has spent much time and energy attacking the Shiv Om refund calculations, and also Ketan Thakker, personally. The Department's attacks on Thakker and his work product are laced throughout the transcript of the hearing and its 78 page

(continued)

The Department also argues that Amoco should not have been allowed to submit additional evidence at the April 2004 hearing that had not been previously provided to the Department. It contends that the sole function of the Administrative Law Division is to decide if the Department correctly denied Amoco's refund claim based on the information the Department had at the time, and that any evidence subsequently offered by Amoco cannot be considered:

> Aside from substantive deficiencies of that evidence (submitted by Amoco at the hearing) addressed in following sections of this brief, it was untimely and should not therefore be considered at all by the Court. To conclude otherwise would mean that there could never be finality with respect to a Department decision on a refund petition. The Taxpayer could, as here, engage in an endless series of "audit-by-trial" forays. The Administrative Law Court is not empowered to serve as a *de novo* reviewing court of a refund petition denial by the Department. Its lawful function is, rather, to review on appeal and determine whether the Department made a correct decision based on what the Taxpayer had provided for substantiation at the time of the denial decision.

Department's Brief at 27.

I disagree. First, the Department's position is contrary to its longstanding practice and procedure. In most of the over 9,000 appeals decided by the Administrative Law Division since 1983, taxpayers presented additional records or other evidence during the appeal. The Department has always reviewed any new evidence submitted by a taxpayer

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brief. The Department claims, for example, that the Shiv Om petition is tainted because Shiv Om had a contingency fee contract with Amoco, and also that Ketan Thakker "willfully testified falsely as to material facts." Department's Brief at 25. However, contingency fee contracts are not per se improper, and I find no evidence to support the latter claim. In any case, the case does not turn on the accuracy of the Shiv Om calculations or the veracity of Thakker. Rather, as indicated, the issue is whether the Department correctly computed Amoco's liability pursuant to its workback method audit. Consequently, the Department's arguments concerning the specifics of the Shiv Om petition and its personal attacks on Thakker are irrelevant and will not be addressed further in this Order.

on appeal, and if the evidence was relevant and affected the taxpayer's liability for the period in issue, the Department adjusted the liability accordingly. The Department has sometimes objected to a taxpayer's evidence because it was not admissible under the applicable rules of evidence, but it has never before objected to otherwise admissible evidence only because it was not previously submitted before the Department entered the final assessment or denied the refund in issue.

The Department's position is also contrary to its stated mission, which is to efficiently and effectively administer the revenue laws of Alabama.[2] The Department is required to administratively determine a taxpayer's correct liability after reviewing all relevant records and other evidence. An appeal to the Department's Administrative Law Division, although quasi-judicial in nature, is a continuation of that administrative process. If it is determined from all admissible evidence submitted on appeal that a taxpayer has overpaid tax, a refund should be issued, assuming that the refund was timely claimed. Likewise, if a taxpayer has underpaid tax, the taxpayer should be required to pay the tax due, again assuming that the tax was timely assessed. The taxpayer thus would be required to pay the correct amount due. Alabama's citizens expect nothing more and nothing less.

If the Department's position in this case is accepted, however, a taxpayer's correct liability could not be accurately determined in many cases because the taxpayer would be prohibited from presenting additional evidence on appeal, even if the evidence was admissible and affected the taxpayer's liability for the subject period. That is contrary to both the intent and language of the Alabama Taxpayers' Bill of Rights and Uniform

[2] See, Department's Mission Statement dated September 5, 1996.

Revenue Procedures Act, Code of Ala. 1975, §40-2A-1 et seq., which specifies that the Act "shall be liberally construed to allow substantial justice." Section 40-2A-1(a).

The Department's position also conflicts with the statutory duties and responsibilities of the Administrative Law Division and the Department's administrative law judge. The purpose and function of the Administrative Law Division and the administrative law judge is "to provide for the fair, efficient, and complete resolution of all matters in dispute." Code of Ala. 1975, §40-2A-9(a). Prohibiting a taxpayer from presenting relevant evidence in an appeal certainly does not further that purpose. The administrative law judge is authorized to receive testimony and exhibits in a hearing. Section 40-2A-9(d). The admissibility of such evidence is limited only by the same rules of evidence applicable in civil, non-jury cases in circuit court. Section 40-2A-9(j). The final order issued by the administrative law judge shall be based on all evidence that is relevant, competent, and material. Section 40-2A-9(j). There is nothing in the Uniform Revenue Procedures Act ("URPA"), Code of Ala. 1975, §40-2A-7, et seq., that prohibits a taxpayer (or the Department) from submitting relevant, admissible evidence at a hearing before the Administrative Law Division; nor does URPA limit the administrative law judge's function to only an on-the-record review of the Department's actions. Rather, the appeal before the Administrative Law Division is a de novo proceeding in which all admissible testimony and exhibits can be submitted and should be considered.

Allowing additional evidence in an appeal does not "mean that there could never be finality with respect to a Department decision on a refund petition"; nor does it allow a taxpayer to "engage in an endless series of 'audit by trial' forays," as argued by the Department in its Brief, at 27. Amoco has not engaged in an endless series of forays. It

has only appealed to the Administrative Law Division as allowed by §40-2A-7(c)(5)a. And finality will be provided by the Final Order entered by the Administrative Law Division, and any appeal therefrom.

In summary, the ultimate issue is whether Amoco is entitled to an additional refund, and if so, in what amount. That issue turns on whether the Department correctly computed the taxable wellhead value of the Oak Grove gas pursuant to its workback method audit. The burden was on Amoco to prove its claim, but it certainly could do so by presenting relevant, admissible evidence on appeal.

An Overview of the Workback Method in Alabama.

Alabama's oil and gas severance tax statutes, Code of Ala. 1975, §40-20-1 et seq., do not authorize or even mention the workback method for valuing oil and gas. The Department began using the workback method in the 1980's.

The Administrative Law Division decided several appeals in the late 1980's concerning the Department's use of the workback method. Two of those cases were appealed to Alabama's appellate courts. The courts ultimately decided both cases on procedural or jurisdictional grounds, and did not address the specifics of the workback method. See, *State Department of Revenue v. Clay J. Calhoun*, 792 So.2d 373 (Ala. Civ. App. 1998), and *State v. Petro-Lewis Corp.*, 534 So.2d 302 (Ala. Civ. App. 1988).

The Alabama Supreme Court first approved the Department's use of the workback method in 1992 in *Phillips Petroleum, supra*. In that case, the Court generally defined the workback method as a method for calculating taxable value at the wellhead by taking the first arm's-length sale price of the refined product and then deducting all "costs of transportation, processing, and treatment" of the oil or gas. *Phillips Petroleum*, 638 So.2d

at 888. But other than the Supreme Court approving the use of the workback method and providing the broad definition stated above, neither that Court nor the Alabama Court of Civil Appeals has ever addressed the specifics of the workback method, i.e. exactly what transportation, processing, and treatment costs should be allowed, and how should those costs be computed. The parties also have not cited any cases or authority from other states explaining the mechanics of the workback method.

The Tuscaloosa County Circuit Court applied the workback method in *Black Warrior Methane Corp. v. State of Alabama*, Civ. Action CV-92-1423, decided December 30, 1993. Apparently relying on *Phillips Petroleum*, that Court found that under the workback method, the taxpayer could deduct all actual expenses associated with the transportation, processing, and treatment of the gas. The Court elaborated that deductible expenses included all gathering costs, including the actual cost of producing the compressor gas used to process the gas[3], which it found to be $.68 per mcf, all operating expenses, all administrative expenses directly related to the processing, treatment, and transportation of the gas, and a 10 percent return on investment, which the Court found to be reasonable. The Department had apparently attempted to limit deductible administrative expenses to

[3] Compressor gas is otherwise known as fuel gas or plant gas, which is the gas used to operate the post-production processing equipment. As discussed below, fuel gas may be purchased from a third party, or it may be gas produced in the field.

15 percent of total administrative expenses. The Court rejected that argument, finding that "there is no rational basis for putting a 15 percent limitation on administrative expenses. If any administrative expense is directly related to the processing, treatment, or transportation of the gas, it should be fully allowed." *Black Warrior Methane* at 8.

The Circuit Court noted in *Black Warrior Methane* that the Department had failed to promulgate regulations concerning the workback method. The Department shortly thereafter began drafting a workback method regulation. After receiving input from industry representatives, the Department promulgated Reg. 810-8-6-.01, effective April 1997. That regulation is still in effect, and is discussed below.

The Administrative Law Division has also decided two severance tax appeals that involved workback deductions relevant to this case, *Torch Operating Co. v. State of Alabama*, Misc. 02-590 (Admin. Law Div. 7/31/03), and *Smacko Operating v. State of Alabama*, Misc. 02-787 (Admin. Law Div. 5/23/03). *Torch Operating* involved how deductible "field labor" and "overhead" should be calculated. *Smacko Operating* involved depreciation, and specifically, what evidence must a producer provide to establish its depreciable capital asset base. The holdings in both *Torch Operating* and *Smacko Operating* are discussed below.

The Six Disputed Workback Deductions.

Amoco contends that the Department failed to properly compute six workback deductions in its audit. Those deductions involve:

(1) Additional Taurus gathering costs;

(2) Additional Amoco capital expenditures;

(3) Additional Amoco operating (field labor) expenses;

(4) Operating expenses for Taurus-operated wells;

(5) Overhead; and,

(6) Fuel gas.

ANALYSIS

I. Additional Taurus Gathering Costs.

As indicated, Taurus operated approximately half of the Oak Grove field wells for Amoco. The Department allowed only 40 percent of the Taurus gathering system costs in its initial audit. It subsequently allowed 100 percent of those costs in its revised audit. Consequently, this is no longer a disputed issue, except the Department conceded at the April 2004 hearing that a previously disallowed authority for expenditure ("AFE") relating to Taurus gathering system number 5 should be allowed.[4] The amount of the capital expenditure was $416,196.72. See, Amoco's Exhibit 3, tab 20. The appropriate additional depreciation and return on investment should be allowed concerning that capital expenditure.

II. Additional Amoco Capital Costs.

Capital expenditures are relevant in the workback method because they constitute the investment base on which allowable depreciation and return on investment are computed. This issue turns on whether Amoco sufficiently documented that additional capital assets should be included in its Oak Grove investment base, and if so, in what amount.

Amoco's capital expenditures were evidenced by two source documents, an AFE

[4] An AFE is an internal company document commonly used in the industry for pre-approval

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Amoco issued internally before it purchased a capital asset, and also a vendor invoice Amoco received when it purchased the asset. Amoco subsequently entered the invoice information, and all other financial data, on its computerized accounting system. The system is coded, and capital costs are entered under the appropriate code. The system is routinely audited by outside auditors, and is used by Amoco to prepare its federal tax returns, SEC reports, and other required filings.

The initial Department auditor requested a sampling of Amoco's capital asset invoices, which Amoco provided. Shiv Om also provided the Department with Amoco's computerized accounting data that had been downloaded onto spreadsheets. However, the Department elected not to perform a random sampling using the capital invoices provided by Amoco. It also rejected the Shiv Om spreadsheets because, according to the Department, there was no guarantee that the downloading of the Amoco data was proper.[5] Rather, a subsequent Department auditor requested that Amoco provide the various documents specified in Dept. Reg. 810-8-6-.01(6)(a)2. That regulation provides as follows:

> All claims for the inclusion of an item of cost in the investment basis shall be supported by verifiable data such as state or federal tax returns, ad valorem tax filings, reports to the Securities and Exchange Commission, audited financial statements or reports to stock-holders, authority for expenditures (AFE) and other similar data.

Amoco provided the Department with all of the AFEs that it could locate. Many could not be located due to the passage of time and because Amoco had sold the Oak Grove

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of a major expenditure.

[5] The Department also claims that "the evidence establishes that the BP/Amoco data has been transformed, augmented, strategically altered, and manipulated to yield a desired result . . ." Department's Brief at 32. No evidence was presented, however, showing that the Shiv Om spreadsheets did not accurately reflect the source data on Amoco's computerized accounting system.

field in 1997. The Department allowed most of the AFEs provided by Amoco. Amoco did not provide the other documents listed in the regulation, other than a 1997 Tuscaloosa County property tax return, because it deemed that the information in the documents was at too high a level to identify or verify the capital assets at the Oak Grove field. Because Amoco failed to provide the documents specified in the regulation, the Department did not allow any capital expenditures other than those verified by the AFEs.

What is the effect of Amoco's failure to provide the documents specified in Reg. 810-8-6-.01(6)(a)2? A Department regulation that requires a specific method of recordkeeping must be followed unless it is contrary to a statute or is unreasonable. *Uniroyal Tire Co. v. State, Dept. of Revenue*, 779 So.2d 221 (Ala. Civ. App. 1999); *White v. Shellcast Corp.*, 477 So.2d 422 (Ala. 1985). Reg. 810-8-6-.01(6)(a)2. is not contrary to a statute because there is no Alabama statute defining or governing the workback method. The regulation is, however, unreasonable under the circumstances because even if Amoco had provided the documents listed in the regulation, they would not have identified Amoco's capital asset base at Oak Grove. The Department conceded that point at the April 2004 hearing. A Department severance tax manager testified as follows:

> Administrative Law Judge: Concerning the verification of the capital asset amount, I've heard considerable testimony about you needed additional records. Could the Department determine that from Amoco's Alabama income tax returns?
>
> The Witness: Probably not. The summary schedules that are filed, we needed the backup data that was used in calculating the returns, but the taxpayer could give us schedules and breakdowns of that amount. And we've got to have totals. We've got a 24, I think, billion dollar number for their assets that were shown. And if it says that in Alabama – six billion of that was in Alabama, then they probably had a further breakdown that says X amount was Oak Grove, X amount was whatever other properties they have.

> Administrative Law Judge: So the items requested by the Department, whether it be the tax returns, the – all the other public filings, that really wouldn't be sufficient. You need the underlying data.
>
> The Witness: Right. We couldn't just go get the tax return and have the information. We'd need the taxpayer to give us the return plus the backup data to go with the return.
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> Administrative Law Judge: Okay. I just wanted to clarify that. Thank you.

(T. 853, 854.)

The severance tax manager speculated that Amoco "probably had a further breakdown that says X amount was Oak Grove . . ." The Department also claims that "BP/Amoco and its counsel knew perfectly well that the Department wanted the underlying detail of workpapers" used to compile the documents listed in the regulation. Department's Brief at 39. However, the Department never identified and requested any such breakdown or workpapers during its audit, nor is there evidence that Amoco ever compiled a written breakdown showing its capital assets at Oak Grove. Rather, the evidence indicates that the "backup data" that Amoco used to compile its tax returns, financial statements, etc. was Amoco's computerized accounting information that the Department rejected. (T. 144.) The Department also conceded that the underlying data from which Amoco's federal tax returns were compiled could have been Amoco's computerized accounting records. (T. 740.) Because the documents listed in the regulation, even if provided, would not have established Amoco's Oak Grove capital asset base, Amoco is not barred from establishing its capital asset base by other competent evidence.[6]

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[6] I do not understand why Amoco refused to provide the documents specified in Reg. 810-8-6-.01(6)(a)2. Nor do I understand why the Department, if it deemed the documents essential to its audit, did not independently obtain the documents. Amoco's Alabama

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The Administrative Law Division also found in *Smacko Operating* that requiring the documents listed in Reg. 810-8-6-.01(6)(a)2. was unreasonable under the circumstances, and that Smacko Operating could verify its capital expenditures by other competent evidence.

> I appreciate the Department's concern that a taxpayer may improperly claim that certain operating expenses are capital in nature. But the language of the regulation is sufficiently broad to allow a taxpayer to provide any "verifiable data" to prove that an expenditure was capital in nature. Tax returns, financial statements, etc. are only examples of what may be used to establish a capital item. The list is not exclusive.

Smacko Operating at 5 – 6.

The Administrative Law Division ultimately ruled for the Department in *Smacko Operating* because the evidence presented by Smacko was not sufficient to establish its capital asset base. The case nonetheless affirms that a producer's capital asset base may be established from competent evidence other than the documents specified in Reg. 810-8-6-.01(6)(a)2.

The Department argues that it should not be required to rely on the Shiv Om spreadsheets to verify Amoco's capital assets. I agree. While there is no evidence that the spreadsheets did not accurately reflect Amoco's computerized data, the Department could

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income tax returns are on file with the Department, and can be used for "the proper administration of any matter administered by the department," which obviously includes determining Amoco's severance tax liability. See, Code of Ala. 1975, §40-2A-10(a). Likewise, Amoco's audited financial statements and SEC filings are matters of public record and can be easily accessed on the Internet. One of the Department's expert witnesses testified that he accessed Amoco's audited financials and its SEC filings on Amoco's web site. However, he used the information in the documents only for debunking Shiv Om's calculations. (T. 1068.) The fact that the Department did not independently obtain and use the documents further affirms that the information in the documents would not have been useful.

have requested and audited Amoco's actual computerized data system and the source invoices maintained by Amoco. The invoices were coded into the system, and Amoco provided the Department with the codes. The evidence shows, however, that the Department never actively sought to audit or otherwise review Amoco's computerized records or the source invoices after it requested and received the sample capital invoices early in the audit. Department auditors visited Amoco's facility in Tulsa, Oklahoma where Amoco's records were maintained, but they only asked to review Amoco's operating expenses, not the capital invoices.

Instead of reviewing Amoco's computerized data and the source invoices, or performing a random sampling of the invoices provided by Amoco, the Department decided to rely solely on the documents listed in the regulation. A Department severance tax manager, when asked whether the invoices, if provided, would have been sufficient, testified as follows – ". . . I did not want to go out there (to Amoco's Tulsa facility) and recalculate a whole new number for asset capitalization (using Amoco's computerized system and the invoices). I was wanting someone at Shiv Om or Amoco to provide me – show me where you capitalized the assets" on the documents listed in the regulation. (T. 736.) If those documents had identified Amoco's capital assets at Oak Grove, then the Department's reliance on those documents would have been reasonable. But as discussed, even the Department concedes that the information in the documents was at too high a level to be of use. The information in the Tuscaloosa County ad valorem return provided by Amoco also did not accurately reflect Amoco's capital asset base at Oak Grove. See generally, Amoco's Reply Brief at 29 – 31.

The Department could by regulation require all oil and gas producers to maintain a

separate document or spreadsheet listing their capital assets in Alabama, and their cost basis in those assets. Such a regulation would be upheld unless found to be unreasonable. *Shellcast*, *supra*. But the current regulation only requires that producers provide their income tax returns, audited financial statements, etc., which would have been useless in this case. Producers are otherwise generally required to keep records from which value can be determined. Code of Ala. 1975, §§40-2A-7(a)(1) and 40-20-4(b). Amoco did so concerning its capital assets by maintaining the invoices and its coded accounting data. The Department elected not to review that information.

The best evidence from which Amoco's capital base can be established are the invoices Amoco received from its vendors. Amoco submitted approximately 250 of its capital invoices at the April 2004 hearing.[7] See, Amoco Exhibits 17A through 17H. Amoco's field supervisor, Douglas Buchanan, testified in detail concerning the invoices, and identified with specificity which entries on the invoices represented capital assets. (T. 215 – 253.)

The Department claims that the invoices should not be allowed because they were not previously submitted by Amoco. But as discussed, the Department never sought to obtain and review the invoices during its audit. In any case, the invoices are the best evidence and were clearly admissible.

The Department also contends that it should not be required to rely on the field

[7] Amoco's representative explained that Amoco only submitted invoices over $5,000 at the hearing because it was cost prohibitive to retrieve and submit all of the over 17,000 capital invoices for which AFEs were not provided. There was testimony that the capital invoices

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supervisor's testimony concerning the Exhibit 17 invoices, citing *State v. Ludlum*, 384 So.2d 1089 (Ala. Civ. App.) *cert.* denied 384 So.2d 1094 (Ala. 1980). The Court of Civil Appeal stated in *Ludlum* that the Department is not required to rely on the verbal assertions of a taxpayer. *Ludlum*, 384 So.2d at 1091, citing *State v. T.R. Miller Mill Co.*, 130 So.2d 185, 190 (1961). The Court ultimately held in *Ludlum*, however, that the taxpayer's available invoices and other records, as supplemented and explained by the testimony of the taxpayer's CPA, were sufficient to establish the taxpayer's liability. The Court thus affirmed the circuit court, which found in part as follows:

> That the records as kept by (Ludlum) allowed a determination of what sales were and were not taxable, and the best method used by any of the parties in determining the amount of tax due was the method first used by Robert McCullar, a C.P.A. employed by (Ludlum). Mr. McCullar went through every invoice, and every deposit, and categorized each between taxable and non-taxable sales and substantiated this by the records kept by the Appellant and records which were readily obtainable by the taxpayer from third parties, and, therefore, subject to scrutiny by the Department of Revenue.

Ludlum, 384 So.2d at 1090.

Ludlum supports Amoco's position, not the Department's. The field supervisor testified concerning the Exhibit 17 invoices and categorized them as to capital and non-capital assets. The invoices were "subject to scrutiny by the Department of Revenue" because the Department could have reviewed the invoices during its audit. Under the circumstances, the Exhibit 17 invoices, as identified and explained by the field supervisor's testimony, are sufficient to establish the various invoice items as capital assets.[8]

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that were not submitted totaled approximately $6 million. (T. 386.)

[8] The Department states in its Brief, at 36, that "BP/Amoco argues that Thakker . . . was somehow able to divine without any visit to the Oak Grove Field, or any communication with Amoco personnel at the Oak Grove Field, what the (Exhibit 17) capital cost invoices were

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The Exhibit 17A through 17H invoices are grouped by category. The invoices relating to gas gathering (17A), compressors (17B), separators (17D)[9], meter runs (17F), and flowline connections (17H) are 100 percent processing-related, and thus should be included in Amoco's capital asset base.

The Exhibit 17C invoices relate to pipe and other capital expenses incurred for both gas gathering and water gathering. Gas gathering is a deductible processing-related cost. Water gathering is not deductible.[10] Amoco's field supervisor estimated that gas gathering represented approximately 75 to 80 percent of the invoiced amounts, with 20 to 25 percent

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used for. . ." But the field supervisor, not Thakker, identified the invoices at the April 2004 hearing. The supervisor was knowledgeable concerning the Oak Grove field, and had personal knowledge concerning the capital assets in the field.

[9] The Department concedes that separators at coal bed methane wells are allowed costs under the workback regulation. But it then also argues that the regulation was only in effect for four of the months in issue, and that until Amoco "comes forward with the appropriate documentation . . . none of the asserted capital costs related to the coal seam separators should be allowed." Department's Brief at 46. However, for the reasons explained in more detail below, at pages 31 and 32, concerning deductible overhead, the workback regulation should be applied to the entire period in issue. Separator costs are thus deductible, and should be allowed to the extent verified by the Exhibit 17D invoices.

[10] The Administrative Law Division held in *Calhoun v. State of Alabama*, Misc. 89-115 (Admin. Law Div. 10/31/95) at 9, that the cost of gathering and disposing of salt water separated from the gas at the wellhead was not an allowed deduction under the workback method because it was not a "necessary and direct" cost incurred in processing the gas. However, gas processing requires that the water mixed with the raw gas must be separated, gathered, and disposed of. Consequently, as discussed in more detail below at 39 – 40, it can reasonably be argued that the cost of gathering and disposing of water is a required and necessary cost incurred in or resulting from the processing of the gas, and thus deductible. That position is supported by the fact that other "indirect" costs, i.e. depreciation and return on investment, are allowed under the workback method. If water gathering was allowed, all costs included in Exhibit 17C would be included in Amoco's capital asset base. However, Amoco has acquiesced in this case that water gathering is non-deductible. Hopefully, on appeal, Alabama's appellate courts will clarify exactly what direct and/or indirect processing and treatment costs are deductible under the workback

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relating to water gathering. The supervisor's estimate is based on the fact that gas pipe is larger and more expensive than water pipe, and also requires more labor to install.

The cost of the pipe used by Amoco to gather and transport its gas must be allowed in determining the value of the gas at the wellhead. Although Amoco claims that 75 to 80 percent should be allowed, under the circumstances, allowing 50 percent of the Exhibit 17C invoices as gas gathering-related is reasonable.

The Exhibit 17E invoices relate to Amoco's automation system. The automation system monitored the wells and also the gathering lines, compressor stations, and the other post-production equipment. The Department initially disallowed all automation costs, but subsequently allowed 5 percent after discussing the issue with Amoco's field supervisor. Amoco claims that 80 percent should be allowed based on the field supervisor's testimony.

A part of the automation system clearly related to the processing of the gas, and must be allowed. But a significant portion was also production-related because the wells were monitored. The Department's 5 percent estimate is too low, and Amoco's 80 percent is too high. A reasonable allowance under the circumstances would be 42.5 percent. That percentage of the Exhibit 17E invoices should be allowed.

The Exhibit 17G invoices represent Amoco's capital road construction costs. The roads allowed access to both the wells and also the gathering lines, compressor stations, and the other processing-related equipment in the field. Amoco argues that 50 percent of the capital costs should be allowed because the roads provided access to both the wells

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method.

and its post-production equipment. The Department contends that none of the road costs should be allowed because they "were not incurred in the actual treating, processing, marketing or transportation of the gas anywhere from the point of production to the point of first arm's-length sale . . . it is emphatically clear that expenditures for land and capital improvements to land (such as roadways) do not serve to increase the value of the natural gas produced between the point of severance and the point of sale." Department's Brief at 48.

The roads in the Oak Grove field were necessary to operate, monitor, and repair Amoco's processing equipment, and thus some portion of the capital costs associated with the roads should be allowed. The fact that Amoco drilled the wells before it constructed its gathering and processing facilities does not mean that the capital cost of the roads should be allocated 100 percent to the wells. Under the circumstances, it is reasonable that 50 percent of the road costs should be attributed to processing the gas, and thus includable in Amoco's capital asset base.

III. Additional Amoco Operating Expenses.

This issue involves Amoco's field employee costs. Amoco had nine field employees at the Oak Grove field during the period in issue, including the field supervisor. The employees performed both production-related work involving the wells, and also processing-related work involving the gathering system, compressors, dehydrators, etc. The Department concedes that Amoco's processing-related field labor costs are deductible. It also does not dispute the total field labor expense documented by Amoco. The disagreement concerns what part of total field labor constituted deductible processing-related labor.

The Department refused to allow any field labor because Amoco did not provide records establishing what percentage of its total field labor was processing-related. The Department argues that the burden was on Amoco to maintain records showing deductible field labor, and that no deduction can be allowed without such records.

Amoco contends that there was no practical method of recording the time its field employees spent on deductible versus nondeductible activities. It thus argues that the testimony of its field supervisor should be relied on in establishing deductible labor. The specifics of the supervisor's testimony are discussed below. The Department objects that the supervisor's testimony is insufficient without documentation.

The Administrative Law Division has consistently held that the burden is on a taxpayer to keep adequate records establishing the amount of a statutory deduction or exemption. For example, if a taxpayer fails to keep receipts or a travel log for business-related expenses, an income tax deduction for the expenses cannot be allowed. *Nall v. State of Alabama*, Inc. 03-557 (Admin. Law Div. 1/22/04). But as discussed in *Torch Operating*, Opinion and Preliminary Order at 6, and despite the Department's arguments to the contrary, allowed expenses under the workback method are by their nature different than statutorily-allowed income tax deductions. Income tax deductions are allowed only as a matter of legislative grace and serve to reduce an otherwise established taxable amount. Processing-related expenses under the workback method, which are for convenience referred to as "deductions," are different in that they must be allowed in establishing the tax base, i.e. value, for severance tax purposes. They are a required component in determining the severance tax base, not an exception or deduction from an otherwise taxable amount, as are income tax deductions.

The Department argues that it would be unfair to "require the Department to prove taxpayer's deductions (as was done in the *Torch Operating* case) when the taxpayer has not provided" adequate records. Department's Brief at 57. At the same time, the Department also recognizes that when using the workback method, it is under an affirmative duty to accurately determine value. "In *Phillips Petroleum*, the Alabama Supreme Court confirmed that the Department has an affirmative duty to determine the value of the taxpayer's natural gas . . . when the operator fails to perform its statutory duty as to recordkeeping." Department's Brief at 57. Processing-related expenses are a required component and must be allowed in determining value. Thus, unlike income tax deductions, which should generally by disallowed if not verified by adequate records, the Department is under an affirmative duty to estimate and allow a workback deduction in the absence of records. Otherwise, the end result will not fairly indicate value, as mandated by the Alabama Supreme Court in *Phillips Petroleum*, 638 So.2d at 890. Even concerning income tax deductions, if the right to a deduction is established but the taxpayer cannot verify the amount by adequate records, the *Cohan* rule allows a reasonable estimated amount based on the best information available. *Cohan v. Commissioner*, 39 F.2d 540 (2nd Cir. 1930).[11]

In determining value, the Department may use the "most accurate and complete information obtainable by the department." Code of Ala. 1975, §40-2A-7(b)(1)a. Such accurate and complete information may be in the form of believable, admissible testimony.

[11] Pursuant to IRC Reg. §1.274-5T(a)(1), the *Cohan* rule may not be used to verify business-related travel, entertainment, and other similar expenses covered by 26 U.S.C. §274. However, it may still be used to substantiate other type deductions in lieu of records.

In *Phillips Petroleum*, the Supreme Court opined that expert testimony may be considered in determining value. Amoco's field supervisor certainly qualifies as an expert concerning the Oak Grove field, and specifically concerning the activities of the field employees. The Supreme Court further held in *Phillips Petroleum* that "[v]alue is a question of fact," and that the Department's determination of value under the workback method "can be attacked by showing that the (Department's) calculations improperly included or excluded items in such a manner that the end result does not fairly indicate value." *Phillips Petroleum*, 638 So.2d at 889, 890. Such a "showing" can be by tangible evidence or by the undisputed testimony of a competent fact witness such as Amoco's field supervisor.

The Department's mantra that Amoco's processing-related field labor costs cannot be allowed without adequate records is further belied by the fact that there is no reasonable method by which processing-related field labor can be recorded. It cannot be separately metered or otherwise mechanically recorded, nor can it be verified by receipts, invoices, or other third party documents. The field supervisor or the field employees could have after the fact recorded the time they spent on deductible versus nondeductible

activities, but that also would have necessarily involved estimates by Amoco employees.

The allocation of deductible field labor was in issue in *Torch Operating*. The Department had allowed up to 100 percent of Torch's total field labor in prior audits. Torch deducted 70 percent of its field labor during the period in issue. The Department rejected the 70 percent because Torch had failed to keep records identifying deductible field labor. It instead allowed 15 percent based on a formula suggested by one of its auditors. The Administrative Law Division held that approximately 65 percent of total field labor should be allowed based on the detailed and credible testimony of Torch's field supervisor.

> The Department also argues that (Torch) was required to maintain records identifying the deductible field labor, and that because it failed to maintain such records, "then the Department need not accept the approximations of Torch." Department's Brief at 3.
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> * * *
>
> The Department argues that it is not obligated to rely on the field supervisor's verbal assertions in lieu of records. It claims that (Torch) could have maintained either employee time sheets or written job descriptions identifying the time spent on the various field activities.
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> The field employees certainly could have kept daily time sheets, but requiring such meticulous minute-by-minute recordkeeping would be impractical and unreasonable. The Department also had never requested or required (Torch) to maintain such records in prior audits. (Torch) also could have provided written job descriptions, but again, (Torch) was not on notice that such records were necessary because the Department had previously estimated deductible field labor without requiring or requesting such records. In any case, written job descriptions would have included the same information provided through the credible testimony of the field supervisor. Arguably, the supervisor's testimony is better evidence because he was subject to cross-examination by the Department. While the Department argues that some of the field labor was not deductible, it failed to present evidence disputing the supervisor's testimony concerning the time spent on those activities. As the best information available, the supervisor's testimony must be used to estimate deductible field labor. "Value is a question of fact, and value may be shown by expert testimony. . . ." *Phillips*, 638 So.2d at 689.

Torch Operating, Opinion and Preliminary Order at 5 – 8.

The Department does not argue in this case, as it did in *Torch Operating*, that Amoco should have maintained employee time sheets or written job descriptions concerning field labor. Rather, it contends that Amoco could have maintained daily logs showing problems at the wells and also automation system computer printouts documenting problems in the system. But those records would not have established the time spent by the field employees in fixing the problems, and certainly would not have reflected the time spent monitoring the wells versus the post-production equipment.[12]

The Department also asserts that Amoco could have developed "a trustworthy allocation estimate" of deductible field labor by using a qualified engineer to conduct a field site inspection, and then apply his experience to develop a table of data showing the proper allocation. It concedes that Amoco's field supervisor had on-the-job experience, but that "he just grabbed out of the sky an across the board estimate of 'probably 60 to 65%' which has no reasoned analysis to support it." Department's Brief at 62.

I disagree that the field supervisor "just grabbed out of the sky" his estimate of processing-related field labor. He has worked for Amoco for 25 years, first as a roustabout, then as a gas plant operator, a maintenance man, an equipment analyst, and a

[12] The Department could by regulation either allow a fixed percentage or other amount of total field labor as a deduction, the same as it has done concerning deductible administrative overhead pursuant to Reg. 810-8-6-.01(6)(b)7., see below at 30 – 34; or it could by regulation identify the type of document an operator must maintain concerning deductible field labor. Again, such a regulation would be upheld unless found to be unreasonable. However, the Department denied in *Torch Operating* that it had ever demanded detailed minute-by-minute records concerning field labor. *Torch Operating*, Final Order on Rehearing at 4. Consequently, other than an Amoco employee recording an estimate of deductible field labor, I know of no reasonable method by which deductible field labor could be documented.

maintenance foreman. At Oak Grove he was responsible "for the installation of pipelines, gathering systems, compressors, all aspects of the project." (T. 198.) He became the Oak Grove field supervisor in 1993, and thereafter oversaw the day-to-day operations of the field throughout the audit period. His testimony was thus based on his in-depth knowledge of the field, and specifically the duties of the field employees.

The best and only evidence concerning deductible field labor is the testimony of the field supervisor. His testimony constituted "a trustworthy allocation estimate" of the time the field employees spent on processing-related activities. And while the supervisor's testimony should perhaps be subject to extra scrutiny because he is an Amoco employee, that fact does not make his believable testimony inadmissible. He could have developed a table of data showing the proper allocation or otherwise reduced his testimony to writing, but as discussed, any job description or other written record prepared by the field supervisor would include the same facts and estimates as provided by his testimony.[13] In any case, the field supervisor's testimony "is better evidence because (the field supervisor) was subject to cross-examination by the Department." *Torch Operating*, Opinion and Preliminary Order at 7. The Department cross-examined the field supervisor, but did not question him in depth concerning his estimates of deductible field labor. (T. 280 – 319.)

The Department argues that it "has an affirmative duty to challenge the taxpayer's value determinations made using the workback method where the taxpayer's value

[13] Concerning field labor, the Department argues that "the Thakkers certainly did not possess the requisite expertise nor did they perform the appropriate study to develop a reliable estimate of deductible field labor." Department's Brief at 62. The Department's argument is again misdirected because Amoco is relying on the expertise and first-hand knowledge of its field supervisor, not the Thakkers, in support of its argument concerning

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computations are shown to produce a patently unreasonable result." Department's Brief at 58. I agree. However, the Department failed to present any evidence contradicting or otherwise showing that the field supervisor's testimony concerning deductible field labor was exaggerated or otherwise "patently unreasonable." Rather, the Department simply disallowed field labor in toto, even though it is uncontested that a substantial portion of Amoco's field labor costs was processing-related, and thus must be allowed.

The field supervisor testified that two of the nine field employees worked as pumpers. They spent 60 to 65 percent of their time on the gathering system and the rest at the well sites. Three other of the field employees spent 65 to 70 percent of their time on the gathering system, compressors, dehydration facilities, etc. The field supervisor did not testify concerning the other three field employees that he supervised, or the time he personally spent on each activity.

Together the 2 pumpers and the 3 field employees that primarily monitored the gathering system spent on average 63 percent of their time on deductible activities, which represents approximately 35 percent of total field labor. Assuming that the field supervisor spent a similar amount of his time on deductible activities, which is reasonable, the evidence supports a finding that 39 percent of Amoco's total field labor costs were processing-related, and thus deductible.[14] That amount of total field labor should be

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field labor.

[14] The 39 percent amount was determined as follows: Each of the nine employees represented 11.11 percent of the total field labor workforce. The 2 pumpers thus represented 22.22 percent. Sixty percent of that amount is 13.332 percent. The 3 employees that worked primarily on the gathering system represented 33.33 percent of the workforce. Sixty-five percent of that amount is 21.665 percent. Together the deductible activities of the 5 employees represented 34.997 (13.332 plus 21.665) percent or

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allowed in determining the wellhead value of Amoco's gas.

IV. Operating Expenses for Taurus Operated Wells.

Taurus operated approximately half of the Oak Grove field wells for Amoco. Taurus billed Amoco for its operating expenses by issuing joint interest billing ("JIB") statements. Amoco also paid operating expenses to two other companies, Basin Pipeline and First Chicago Leasing, relating to the Taurus-operated post-production equipment.

The Department initially allowed the amounts paid to Basin Pipeline and First Chicago and also 36.743 percent of the Taurus JIB expenses. The 36.743 percent amount was based on a random sampling the Department performed using operating expense records Amoco provided at the beginning of the audit. In its final audit, however, the Department disallowed all of the Taurus operating expenses other than $29,286.30 charged to Taurus compressor facilities and the amounts paid to Basin Pipeline and First Chicago.

Amoco's field supervisor testified that the wells, gathering systems, compressor stations, etc. operated by Taurus were substantially the same as those operated by

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approximately 35 percent of total field labor. The field supervisor represented 11.11 percent of the workforce. Thirty-five percent of his labor represents 3.889 or 3.9 percent of total labor, which when added to the 35 percent totals approximately 39 percent. I suspect that the other 3 field employees also performed some processing-related functions. However, no deductible labor was attributed to those employees because there is no evidence confirming that they performed any processing-related labor. The above calculation is also based on the assumption that all of the field employees were paid the same.

Amoco. Clearly, some of the Taurus operating expenses related to the gathering and processing of the produced gas. The 36.743 percent initially allowed by the Department was based on a random sampling of Amoco's operating expense records, which is an accepted and oft-used audit method. That amount is reasonable and should be allowed.

V. Overhead.

Amoco's administrative and other direct overhead expenses relating to a specific facility were booked or attributed for accounting purposes to the specific facility. Amoco also incurred general administrative, accounting, marketing, and other indirect expenses that could not be directly booked to a specific project or activity. For example, Amoco's personnel at its headquarters in Texas performed centralized administrative, accounting, and marketing functions that related to both the wells and the processing facilities at the Oak Grove field, and also the numerous other fields operated by Amoco throughout the United States. Those indirect administrative costs are generally referred to as "overhead" or "administrative overhead." The Department concedes that a portion of a producer's indirect overhead costs are processing and marketing related, and thus can be deducted.

Amoco incurred indirect processing and marketing-related overhead concerning the gas it processed at the Oak Grove facility. Taurus also billed Amoco for indirect overhead costs relating to the Taurus-operated facilities. The Department concedes that Amoco incurred some indirect overhead. It argues, however, that no overhead deduction should be allowed because Amoco failed to keep records identifying the deductible overhead.

Indirect administrative overhead is similar to field labor in that like processing-related field labor, the amount of processing-related overhead cannot be mechanically recorded or otherwise precisely measured. Recognizing that fact, the Department generally allowed

producers to deduct 10 percent of total administrative overhead before Reg. 810-8-6-.01 was promulgated in 1997. For example, in *Torch Operating*, the Department allowed Torch to deduct 10 percent of total overhead in each month before the regulation was promulgated. *Torch Operating*, Opinion and Preliminary Order at 11. Since 1997, allowable overhead has been governed by Reg. 810-8-6-.01(6)(b)7., which specifies the amount of administrative overhead that can be deducted. The regulation reads as follow:

> <u>ADMINISTRATIVE AND OVERHEAD COSTS</u>. Administrative and overhead costs related to the supervision of facility operations, expense accounting, secretarial expense and the expense of marketing a product, shall be limited to ten percent of allowed depreciation, direct labor, contract services, materials, supplies, equipment rentals, fuel and power costs.

Although Reg. 810-8-6-.01 became effective April 1, 1997, after most of the period in issue, it can still "be viewed as a guideline in understanding how the workback method should be applied." *Esco Oil & Gas, Inc. v. State of Alabama*, Misc. 00-310 (Admin. Law Div. 5/8/01) at 4.

The Department agrees that the regulation "may be relied upon by both the Department and the taxpayer as a guideline in understanding how the workback method should be applied in reporting periods before the effective date of the regulation." Department's Brief at 64. Curiously, however, the Department then asserts that the regulation cannot be retroactively applied, and that instead the parties "must look to pre-effective date statutory and regulatory provisions and to case precedents in order to properly determine" value before the effective date of the regulation. Department's Brief at 64. But there were no statutory or regulatory provisions governing the workback method before 1997, nor were there any appellate court precedents. *Phillips Petroleum* generally defined and authorized the use of the workback method, but did not discuss how the

various workback deductions should be computed, and certainly did not address the overhead deduction. Consequently, Reg. 810-8-6-.01, and specifically subparagraph (6)(b)7 concerning overhead, will be applied to the entire period in issue.

The first part of the regulation identifies those activities that constitute total administrative overhead, i.e. “the supervision of facility operations, expense accounting, secretarial expense and the expense of marketing a product.” The second part attempts to identify the amount of total administrative overhead that is processing-related and thus deductible, i.e. that part of total overhead that may be deducted “shall be limited to ten percent” of various direct costs.

The Department argues that the regulation does not specify the amount of allowable overhead, but only limits otherwise deductible overhead to 10 percent of the various direct costs listed in the second part of the regulation. The Department contends that a three-step process is involved. First, total administrative overhead must be determined. Second, that part of total overhead that constitutes deductible processing-related overhead must be determined using the taxpayer’s books and records. Third, after determining that portion of total overhead that is deductible, the taxpayer must then compute the 10 percent limitation in the regulation. The taxpayer may then deduct the lesser of actual deductible overhead (Step 2) or the10 percent limitation amount in the regulation (Step 3). “Of course, the actual amount of the taxpayer’s marketing related overhead costs must first be properly documented and substantiated by the taxpayer in order to be included in the overhead allowance amount. Once the actual marketing related overhead amount is determined, it is mathematically limited to 10% of the various direct costs listed in the regulation.” Department’s Brief at 67, 68.

The Department's argument is flawed for two obvious reasons. First, the Department's position requires that deductible overhead must first be independently computed. But as discussed, and as recognized by the Department in prior cases, that part of total administrative overhead that relates to deductible processing and marketing-related activities cannot be measured or recorded, and thus cannot be independently computed. If it could, there would be no need for a regulation that specifies an arbitrary amount that should be allowed.[15]

Second, a Department regulation cannot limit the amount of an otherwise allowable workback deduction.[16] *Phillips Petroleum* requires that all post-production transportation, treatment, and processing costs must be allowed. In *Black Warrior Methane*, the Department attempted to limit deductible administrative expenses to 15 percent of total administrative expenses. The Circuit Court correctly rejected the Department's position – ". . . there is no rational basis for putting a 15 percent limitation on administrative expenses. If any administrative expense is directly related to the processing, treatment, or transportation of the gas, it should be fully allowed." *Black Warrior Methane* at 8. Likewise,

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[15] The amount allowed by the regulation appears to be arbitrary because there is no evidence that the amount of deductible indirect overhead incurred by a producer is generally equal to 10 percent of the various direct costs listed in the last part of the regulation. I suspect that the 10 percent amount was the result of a compromise between the Department and the oil and gas industry representatives that helped draft the regulation. But while the 10 percent amount may be arbitrary, the regulation should be followed unless evidence is submitted showing that the amount allowed does not accurately approximate a producer's processing and marketing-related indirect overhead costs.

[16] Code of Ala. 1975, §40-20-4(d) authorizes the Department to promulgate severance tax regulations. But the statute also specifies that no regulation "shall alter, limit, extend or be out of harmony with any of the provisions of this chapter." Consequently, a Department regulation cannot limit or cap the amount of a processing-related workback deduction that

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there is no rational basis for arbitrarily limiting otherwise deductible overhead, which may be the same type of expense as the administrative expenses in issue in *Black Warrior Methane*. If Amoco's indirect marketing and processing-related administrative overhead attributable to Oak Grove could be independently calculated (which it cannot), then all such overhead must be allowed. Because the Department's interpretation of Reg. 810-8-6-.01(6)(b)7. would improperly limit otherwise allowable overhead, it must be rejected as unreasonable and contrary to the workback requirement that all processing, treatment, and transportation costs must be allowed in full.

Reg. 810-8-6-.01(6)(b)7 is poorly worded. The intent of the regulation was not to cap or limit the amount of otherwise deductible overhead, which is improper. Rather, it was to standardize the amount of indirect overhead that could be deducted. The only viable interpretation is that the amount of total overhead that can be deducted is the 10 percent amount specified in the regulation. Obviously, if total indirect overhead was less than the 10 percent amount, the full 10 percent "limit" would not be allowed. But in this case, as in *Torch Operating*, the amount of total indirect overhead greatly exceeded the allowable 10 percent amount specified in the regulation. Amoco thus should be allowed an overhead deduction equal to 10 percent of the various direct costs listed in Reg. 810-8-6-.01(6)(b)7.

VI. Fuel Gas

Fuel gas is an allowable deduction under the workback method. Department Reg. 810-8-6-.01(6)(b)5. specifies the amount of the fuel gas deduction, as follows:

(i) The cost of fuel and power used to operate the facility shall be allowed.

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must be allowed in full in determining gross value.

> (ii) For purchased fuel and power, the allowable cost shall be the amount actually paid to a third party.
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> (iii) If the source of the fuel used in a facility is the hydrocarbons derived from the facility, the fuel is taxable at gross value as determined herein. A fuel cost deduction of the $.68 per MCF or actual cost shall be allowable, up to gross value, for the cost of producing the fuel.

Amoco sold all of the gas processed at the Oak Grove field during the audit period to take advantage of a federal tax credit on the production and sale of coal bed methane. It sold the gas to various unrelated parties, including Sonat. It also purchased fuel gas from Sonat that it used in operating the Oak Grove field.

The Department argues that the fuel gas purchased by Amoco was produced in the Oak Grove field. It thus contends that Amoco should be allowed a fuel gas deduction of $.68 per mcf pursuant to subparagraph (iii) of Reg. 810-8-6-.01(6)(b)5.

Amoco makes three alternative arguments concerning fuel gas. First, it concedes that any gas produced in the field that is subsequently used as fuel gas is taxable at its wellhead value. It then argues that it should also be allowed to deduct that same value. "Fuel gas should simply be a 'wash.' Amoco's deduction for fuel gas should equal the wellhead taxable value plus post-production expenses allocable to the fuel gas." Amoco's Post-Hearing Brief at 31.

Amoco argues in the alternative that pursuant to subparagraph (ii) of the regulation, it should be allowed to deduct the amount it paid to Sonat for the fuel gas because it purchased the gas from Sonat at arm's-length and for fair market value.

Finally, Amoco contends that if its first two positions are rejected, it should at least be allowed to deduct the actual cost of producing the fuel gas, not the $.68 per mcf amount

specified in subparagraph (iii) of the regulation.[17]

This is a difficult issue for several reasons. First, there is conflicting evidence as to whether the fuel gas Amoco purchased from Sonat came from the Oak Grove field. Amoco submitted evidence that the Oak Grove gas was commingled with other gas in the Sonat pipeline before the fuel gas was taken from the line. The Department submitted evidence that the Oak Grove gas was diverted back as fuel gas before it entered the Sonat pipeline.

It is undisputed that Amoco purchased the fuel gas from an unrelated party, Sonat, at arm's-length. In that case, subparagraph (ii) of the fuel gas regulation provides that the amount actually paid to Sonat should be allowed. It could then be argued, however, that in determining Amoco's true cost of the fuel gas, the amounts Amoco paid for the gas should perhaps be offset by all or part of the federal tax credit Amoco received for selling its own gas and then buying the fuel gas from Sonat.

Also, at least some of the fuel gas was derived from the Oak Grove field, in which case subparagraph (iii) of the regulation comes into play. As indicated, that subparagraph provides that if the fuel gas is derived from the facility, a deduction of $.68 per mcf, or the actual cost of producing the gas, shall be allowed, up to gross value. Consequently, because the fuel gas in issue was both purchased from a third party and also at least partly derived from the Oak Grove facility, subparagraphs (ii) and (iii) of the fuel gas regulation

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[17] The fuel gas regulation is misleading in that it only allows a deduction for the cost of producing the gas, but not for processing the gas into usable form, which obviously should also be an allowed cost. However, the cost of processing the fuel gas is otherwise included as part of a producer's overall processing-related costs. Consequently, that cost need not be identified and allowed as part of a separate fuel gas deduction. My prior confusion on this issue is shown in the discussion of the fuel gas issue in *Torch Operating*, Opinion and Preliminary Order, at 14 – 18

both apply. The drafters of the regulation certainly did not foresee such a situation.

Amoco's argument that fuel gas should be a "wash" is attractive from a theoretical and practical standpoint. If a producer uses its own fuel gas, it costs the producer the value of the raw gas at the wellhead plus the cost of processing the gas into usable form. The value of the gas at the wellhead is included in the tax base, and that same value should be deducted as a cost incurred by the producer. But the regulation does not have a "wash" option. Under the circumstances, the better position is that the fuel gas in issue should be treated as "buy-back" gas produced in the Oak Grove field.

The Department allowed Amoco the $.68 per mcf specified in subparagraph (iii) of the regulation. That was the amount the Tuscaloosa County Circuit Court found to be the actual cost of producing the gas in *Black Warrior Methane*. There is no evidence, however, that it cost Amoco $.68 per mcf to produce the fuel gas in issue. The workback method requires, and the Department concedes, that Amoco "is entitled to its actual costs of producing (the fuel gas)." Department's Brief at 75. That actual cost should be allowed.

Subparagraph (iii) of Reg. 810-8-6-.01(6)(b)5. also limits or caps the actual cost of producing the gas to the gross value of the gas at the wellhead. But as with Amoco's overhead deduction (and the administrative expenses in *Black Warrior Methane*), the actual cost of producing the fuel gas must be allowed in full and cannot be limited by Department regulation.

Finally, the Department argues that the cost of producing the fuel gas should not include a return on investment because return on investment "is a profit allowance, not an actual out-of-pocket cost." Department's Brief at 75. I disagree for the reasons explained in detail in *Torch Operating*, Opinion and Preliminary Order at 14 – 18. Return on

investment is an allowed cost under the workback method and must be allowed the same as depreciation, which the Department concedes is an allowed cost in determining the cost of producing fuel gas. See again, *Torch Operating*, Opinion and Preliminary Order at 16.

CONCLUSION

This case illustrates why the workback method "is disfavored as a method of calculating value. . ." *Phillips Petroleum*, 638 So.2d at 889, 890. The method provides only an estimate of value, and certain deductible costs, administrative overhead and field labor, for example, by their nature cannot be accurately recorded and thus must also be estimated. But even if a workback expense could be easily documented and a producer failed to do so, the Department still cannot disallow the expense in full. Rather, the expense must be reasonably estimated and allowed based on the best evidence available. Otherwise, the end result will not approximate the fair market value of the unrefined oil or gas at the wellhead.

This Order attempts to fairly determine the taxable value of the gas produced in the Oak Grove field. Amoco established that it is entitled to include additional capital assets in its investment base through the Exhibit 17 invoices and the testimony of its field supervisor. Amoco was entitled to deduct some field labor, not the zero amount allowed by the Department. Because deductible field labor cannot be accurately recorded and thus must be estimated (which the Department has recognized in prior cases), Amoco reasonably estimated the allowable amount through the undisputed testimony of its field supervisor. Taurus-related operating expenses were allowed based on the Department's own random sampling. Overhead was allowed per the Department's workback regulation, as was the fuel gas deduction, except that the actual cost of producing the fuel gas cannot be capped

or limited to the value of the gas at the wellhead.

Amoco was not a good corporate taxpayer when it submitted the Shiv Om refund petition. The petition was improperly based on exaggerated and factually unsupported assumptions as to Amoco's deductible costs. However, the workback deductions allowed by this Order are not based on Shiv Om's calculations or claims. Rather, they are based solely on the admissible evidence submitted at the April 2004 hearing.

I appreciate the difficult task the Department has in determining wellhead value using the workback method. The task is made more difficult because (1) large oil and gas producers maintain voluminous, detailed records that must be reviewed, and (2) there is no statutory or case law guidance explaining what costs should be allowed, and how those costs should be computed.[18]

The Department contends that only "direct" costs incurred in transporting, processing, and treating oil and gas should be allowed. As discussed in n. 11, at 19 – 20, the Administrative Law Division has also held that salt water disposal costs could not be deducted because they were not a "necessary and direct processing cost." It is unclear, however, what constitutes a necessary and direct cost.

The Department concedes that depreciation and return on investment are allowed

[18] Research reveals that at least some of the other states that use the workback or "netback" method for valuing oil and gas have statutes that govern the method. See generally, *Williams Production RMT Co. v. State of Wyoming Dept. of Revenue*, 2005 WY 28 (Wyo. 3/2/05), and *Washington County Bd. Of Equalization v. Petron Development Co.*, 2005 WL 697018 (Colo. 2005). Unfortunately, as indicated, Alabama has no such statute.

costs.[19] But those costs are not directly incurred in the actual processing of the gas, nor do they "serve to increase the value of the natural gas produced between the point of severance and the point of sale," which the Department contends is required for a cost to be deductible. Department's Brief at 48.

The workback method should "result in an amount *approximating* market value." *Phillips Petroleum*, 638 So.2d at 889. Market value is determined by what a willing buyer would pay a willing seller. A Department expert testified that if a prospective buyer was determining what to pay for raw gas at the wellhead, the buyer would consider all costs necessarily incurred in bringing the processed gas to the point of sale. (T. 995 – 999.) It thus follows that for workback purposes, all costs necessarily incurred from the wellhead to the point of sale should be allowed. Those costs would include all direct processing costs, and also all "indirect" costs such as water gathering and disposal that a producer necessarily incurs and must pay as a direct result of processing the gas. As previously stated, hopefully Alabama's appellate courts will clarify on appeal exactly what costs should be allowed and how those costs should be computed. The best long-term solution would be to change from a value-based tax to a volume-based tax, but that is for the Alabama Legislature to decide.

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[19] Presumably, the Department allows a return on investment based on the Circuit Court's Order in *Black Warrior Methane*, in which the Court concluded that "[r]eturn on investment is found to be an element of the workback method, according to case law." *Black Warrior Methane* at 5. Unfortunately, the Court did not cite the case law referred to.

When a taxpayer's liability changes after an appeal to the Administrative Law Division, the Department is normally directed to recompute the taxpayer's liability and notify the Administrative Law Division of the additional tax or refund due. In this case, however, the Department repeatedly states that even if Amoco's claims concerning each of the disputed workback deductions is accepted, the amount of each deduction, and the resulting additional refund due, "can only be determined if BP/Amoco provides details of its calculations, which has not been done at this time." Department's Brief at 34, 35, 46, 47, 48, and 63. Amoco, on the other hand, asserts that the proper deductions, and the correct refund due, can be computed based on the evidence submitted in the case.

Amoco is directed to compute the amount of its refund due based on the findings in this Order. In addition to a narrative explaining how each deduction was computed, Amoco should also provide detailed schedules or attachments identifying the evidence used in computing the deductions. The methods and evidence used by Amoco in its computations should be transparent. The Administrative Law Division will take appropriate action after Amoco responds.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days from the date of the Final Order pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered May 12, 2005.

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BILL THOMPSON
Chief Administrative Law Judge