ESCO OIL AND GAS, INC. P.O. Box 27823 Houston, TX 77228,	' '	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	'	DOCKET NO. MISC. 00-310
v.	'	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	'	

FINAL ORDER DENYING DEPARTMENT=S
APPLICATION FOR REHEARING

This appeal involves a disputed final assessment of oil and gas privilege and production tax entered against Esco Oil and Gas, Inc. (AEsco@) for April 1994 through March 1997. A Final Order was entered on May 8, 2001 voiding the final assessment. The Department timely applied for a rehearing.

The issue in dispute is how should Esco compute the taxable value of its gas severed during the subject period under the work back method. The Department contends that such value must be determined pursuant to Dept. Reg. 810-8-6-.01, which is entitled ADetermining Gross Value or Market Price of Oil or Gas at the Point of Production.@ The Department asserts that a Department regulation properly promulgated has the force and effect of law, and that the Administrative Law Division failed to follow Reg. 810-8-6-.01 when it entered the Final Order in this case.

I agree that a Department regulation should be given sufficient weight, and should be followed if it is consistent with the statute or rule of law it attempts to interpret. But if the regulation is contrary to the statute or rule of law to which it relates, the regulation must be rejected. *Ex parte Uniroyal Tire Co.*, 779 So.2d 227 (Ala. 2000). Otherwise, the Department

could ignore the Legislature and enact by regulation whatever tax laws it deemed appropriate.[1]

In any case, Reg. 810-8-6-.01 does not apply in this case for two reasons. First, the regulation=s effective date was April 1, 1997. The period in issue ended in March 1997. Consequently, the regulation was not in effect during the assessment period. The Department has consistently ignored this point.

Second, even if the regulation had been in effect during the audit period, by its specific language it applies only to non-market transactions. Reg. 810-8-6-.01(1) reads as follows:

> PURPOSE: Oil and gas severed from the soil or waters or from beneath the soil or waters of Alabama are taxed on their gross value at the point of production. This regulation establishes a regime for determining that value in non-market transactions. ' 40-20-2(a)(1), Code of Ala. 1975.

The processing contract between Esco and Rockbridge clearly was an arm=s-length market transaction. The only connection between Esco and Rockbridge was that the owner of

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[1]The Department may, of course, establish by regulation a method by which taxpayers are required to maintain proper records. Such a regulation will be affirmed if reasonable. For example, in *Ex parte White*, 477 So.2d 422 (Ala. 1985), the Alabama Supreme Court affirmed as reasonable a Department regulation that required separate metering of taxable and exempt uses of gas and electricity for purposes of the utility gross receipts tax. But as indicated, if a regulation attempts to interpret a statute or rule of law, it should be followed only if it is consistent with the statute or rule of law.

a company that owned a 50 percent interest in Rockbridge also owned a 13 percent interest in Esco. That percentage is well below the 40 percent control needed for the companies to be Aaffiliated companies,@ as defined at Reg. 810-8-6-.01(2)(p), and certainly is insufficient to make the processing contract a non-market transaction.

Esco and Rockbridge clearly had opposing economic interests, as required for the contract to be at arm=s-length. They were on opposing sides in a lawsuit involving the Flomaton Plant. (T. at 43.) Esco also had a backup processing contract with Pennzoil at the Flomaton Plant, which contained basically the same terms as the Esco/Rockbridge contract. That further shows the arm=s-length nature of the Esco/Rockbridge contract. Because the Esco/Rockbridge contract was a market transaction, Reg. 810-8-6-.01, which relates only to non-market transactions, does not apply.

Valuation under the workback method is a simple concept. If there is no sale at the wellhead, the taxable value of the raw gas is determined by taking the sale price of the refined gas at the plant tailgate, and then backing out all processing costs.

If a non-market transaction is involved, the gas owner/plant owner is allowed certain plant investment costs and plant operating expenses in computing value under the workback method. See, Reg. 810-8-6-.01(6).

If the gas owner and the processor are unrelated parties with opposing economic interests, as in this case, the workback method allows the gas owner to deduct all post-production costs it is required to pay to have the gas processed into marketable form. If the gas owner is required to pay a lump-sum processing fee, the full fee is what it actually costs the owner to have the gas processed, and thus must be allowed. It is improper in such cases to look behind the arm=s-length processing contract to determine how the unrelated plant owner used the money, or which expenses incurred by the plant owner would have been non-deductible if a non-market transaction had been involved.

The fallacy of the Department=s position is explained on pages 5 and 6 of the Taxpayer=s reply brief:

> Taken to its logical conclusion, the theory now urged by the Department would yield illogical results because arm=s length processing agreements would have to be dissected by the Department to determine what the non-taxpayer party did with the processing fees that it had received from the taxpayer. For example, it an arm=s length processing agreement called for payment of a flat processing fee of 75 cents per MCF by the gas owner to the plant owner, the gas owner would deduct the full 75 cents paid in calculating the wellhead value of its production, and this would be fully consistent with the regulations= definition of Aallowed costs.@ Yet the Department=s present theory would require a determination as to what the plant owner did with the 75 cents after receiving it from the gas owner. If the plant owner used any portion of the 75 cents to offset expenses that are nondeductible by the plant owner, the Department would disallow that same portion to the gas owner on the ground that the gas owner was paying for those nondeductible items rather than for processing. Nowhere, however, do the Department=s regulations attempt to disallow actual processing costs incurred in a market transaction depending on what the non-taxpayer party does with the money, nor do the regulations ever purport to tell parties how they have to negotiate their processing contracts.

The Department cites *Clay Calhoun v. Dept. of Revenue*, Misc. 89-115 (Admin. Law

Div. 10/31/95) for its position that salt water disposal is not an allowable cost under the workback method. *Calhoun* does not apply, however, because it involved a non-market transaction in which the same party, Calhoun, both produced and processed its own gas. Certainly, allowable costs in a non-market transaction are different from allowable costs in a market transaction.

The other costs disallowed by the Department were those costs delineated as Aproduction overhead@ and Astorage and separation costs@ on the Exxon billings to Rockbridge. Even if Reg. 810-8-6-.01 applied, the only costs not allowed are wellhead separation and other production costs, see &(2)(a). AProduction costs@ are those costs relating to acquiring, developing, maintaining, and abandoning a well, see &(2)(b). Consequently, because the Flomaton Plant is approximately 12 miles from where Esco=s gas was severed, Exxon could not have incurred any non-deductible wellhead or other production-related costs relating to the Esco gas at the Flomaton Plant.

Concerning the fuel gas issue, the Department cites Reg. 810-8-6-.01(6)(b)5 for its argument that Esco owes tax on the gas retained by Exxon at the Flomaton Plant. But again, that regulation did not become effective until after the period in issue, and in any case, it relates only to non-market transactions where the plant owner burns its own gas to operate the plant. Esco did not operate or have an interest in the Flomaton Plant, and obviously did not use its own gas to operate the Plant.

There is no substantive difference between the Esco NGLs retained by Exxon at the Jay Plant, which the Department allowed as a processing cost, and the Esco gas retained at Flomaton. Contrary to the Department=s claim, the evidence also shows that Exxon did not

use Esco=s gas as plant fuel at Flomaton. Rather, Exxon drew its Flomaton plant fuel from a separate, dedicated low pressure line at the facility. (T. at 90.)

One final point. The Department argues that the burden is on Esco to Asubstantiate the claimed deductions.@ Department=s Application for Rehearing, at 15. However, the statute in issue, Code of Ala. 1975, '40-20-2(a)(1), is a tax levy, not a deduction. Consequently, the applicable rule of statutory construction is that a tax levy statute must be strictly construed against the Department and for the taxpayer. *City of Arab v. Cherokee Elec. Co-op.*, 673 So.2d 751 (Ala. 1995).

Any reviewing court is also referred to the Taxpayer=s brief in opposition to the Department=s application for rehearing, which further rebuts the assertions and arguments raised by the Department. The Department=s application for rehearing is denied. The Final Order previously entered is affirmed.

This Final Order Denying Department=s Application for Rehearing may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, '40-2A-9(g).

Entered August 16, 2001.