STATE OF ALABAMA DEPARTMENT OF REVENUE, § STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION

v. § DOCKET NO. MISC. 89-154

FMP OPERATING COMPANY §
1615 Poydras Street
New Orleans, Louisiana 70112, §

Taxpayer. §

FINAL ORDER

The Revenue Department assessed oil and gas severance tax against FMP Operating Company ("Taxpayer") for the period January 1986 through September 1988. The Taxpayer appealed to the Administrative Law Division and a hearing was conducted on September 13, 1994. Ed Dean and Thomas Smith represented the Taxpayer. Assistant Counsel John Breckenridge represented the Department.

The Alabama severance tax is measured by the value of oil or gas at the wellhead. Code of Ala. 1975, §40-20-2(a). "Value" is defined at Code of Ala. 1975, §40-20-1(3).

The primary issue in this case is whether the taxable "value" of certain gas severed from the Womack Hill oil and gas field ("Womack Hill field") and surrounding fields during the period in issue should be computed (1) using the "work-back" method, as argued by the Department, or (2) using the sales price as specified in certain casinghead gas contracts, as contended by the Taxpayer. If the work-back method is allowed, a second issue is how the work-back method should be computed.

The parties agreed at the administrative hearing on September 13, 1994 that the case should be bifurcated, and that the primary issue should be decided first. Consequently, this Final Order addresses only the issue of whether the work-back method or the casinghead contracts should be used to determine the taxable value of the gas in issue.

The Womack Hill field is located primarily in Choctaw County, Alabama and was discovered in the late 1960s. The field contains "sour" gas which was initially flared into the atmosphere because it could not be economically gathered and processed.

In the early 1970s, a group of well owners in the area agreed to jointly build a gas gathering system and processing facility. The Womack Hill Processing Plant ("Womack Hill Plant" or "Plant") was completed in 1974.

Prior to building the Plant, the Plant owners (hereafter "associated working interest owners" or "associated owners") entered into numerous casinghead gas contracts to purchase gas from most of the well owners in the area that did not have an ownership interest in the Plant (hereafter "non-associated working interest owners" or "non-associated owners").[1] Most of the contracts were executed in approximately 1974, although other casinghead contracts

[1]Casinghead gas is gas produced from an oil well.

were executed in later years.

The casinghead contracts provided that title to the gas passed from the well owners to the Plant upon severance at the wellhead. The gas from the various wells was commingled in the gathering system and routed to the Plant for processing. The Plant processed the gas and then separately sold the liquid hydrocarbons ("NGLs") and the residue gas at the plant tailgate at the prevailing market price. Pursuant to the casinghead contracts, the well owners received 50% of the sales price of the processed NGLs at the tailgate, and 60% of the sales price of the residue gas at the tailgate.[2] The remainder, after operating expenses and taxes, was divided among the associated owners based on their percentage ownership in the Plant.

The associated owners also owned working interests in various wells in the Womack Hill and surrounding fields. The associated owners entered into a Plant operating agreement in 1974 under which they were obligated to sell their gas to the Plant under the same terms and for the same sale price as the non-associated owners.

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[2] In some cases, the casinghead contracts also took into account that extraordinary treatment costs might be incurred by the Plant, or that extra transportation costs might be incurred if the sale occurred downstream from the Plant tailgate.

Title to the gas passed from the individual associated well owners to the Plant at the wellhead.

The Taxpayer in this case was one of five or six associated owners during the audit period. The Taxpayer also operated the Plant, which obligated the Taxpayer to report and pay all severance taxes to the Department. As Plant operator, the Taxpayer also calculated and paid both the associated and non-associated well owners for their gas pursuant to the 50%/60% formula set out in the casinghead contracts.[3] As stated, the balance, after expenses and taxes, was disbursed pro-rata to the Plant owners.

The Taxpayer reported and paid Alabama severance tax on behalf of both the associated and non-associated owners during the period in issue based on the sales price set out in the casinghead contracts. The Department accepted the casinghead contracts as the correct wellhead value of the gas sold by the non-associated owners. However, the Department rejected the casinghead contracts as not reflecting the true market value of the gas sold by the associated owners. Rather, the Department used the work-back method to compute the taxable value of the gas sold by the associated owners.[4] The final assessment in issue is based on

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[3]There was at least one contract (the Midroc contract) that had a different sales price formula based on the remoteness of the well. As stated in footnote 1, some contracts also included special treatment and transportation cost provisions.

[4]The work-back method was defined by the Alabama Supreme Court in State v. Phillips Petroleum Co., 638 So.2d 886, 888 (Ala. 1992)

those computations. As stated, the primary issue is whether the value of the gas in issue should be determined pursuant to the casinghead contracts or pursuant to the work-back method.

The oil and gas severance tax is measured by the "gross value of said oil and gas at the point of production . . .". Code of Ala. 1975, §40-20-2. "Value" is defined at Code of Ala. 1975, §40-20-1(3) as follows:

> "The sale price or market value at the mouth of the well. If the oil or gas is exchanged for something other than cash, if there is no sales at the time of severance or if the relation between the buyer and the seller is such that the consideration paid, if any, is not indicative of the true value or market price, then the department shall determine the value of the oil or gas subject to the tax hereinafter provided for, considering the sale price for cash of oil or gas of like quality."

The first sentence of §40-20-1(3) is controlling. The taxable measure is the sale price or market value of the unprocessed gas at

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as follows: "A method for calculating market value of oil or gas at the well-head . . . Under this method costs of transportation, processing and treatment are deducted from the ultimate proceeds of the sale of the oil or gas and any extracted or processed product to ascertain well-head value."

the wellhead.

Section 40-20-1(3) also provides that if any one of three "if" situations are present, then "the department shall determine the value of the oil or gas . . ., considering the sales price for cash of oil and gas of like quality". Each of the three "if" situations is discussed separately below:

(a) "<u>If the oil or gas is exchanged for something other than cash, . . .</u>" - Clearly this clause does not apply in this case. Both the associated and non-associated owners were paid by check after the sale of the gas at the tailgate in accordance with the 50%/60% formula set out in the casinghead contracts.

(b) "<u>. . . if there is no sale at the time of severance . . .</u>" - This clause also does not apply in this case. The casinghead contracts clearly provide that title to the gas passed to the Plant at the wellhead. (R. 47). A sale occurs with the passing of title from the seller to the buyer. Code of Ala. 1975, §7-2-106(1). The sale of the gas was thus complete at the wellhead. The formula under which the sale price at the wellhead was computed was also fixed at the time of sale, although the actual amount to be paid depended on a later event, the sale price received by the Plant for the processed gas at the tailgate. However, because the amount of the sale price was calculated on a later event does not alter the fact that the sale was completed upon severance at the wellhead.

(c) " . . . or if the relation between the buyer and the seller is such that the consideration paid, if any, is not indicative of the true value or market price, . . . " - The Department argues that the sales by the associated owners to the Plant were not arm's-length transactions, and thus were not indicative of the true market value of the gas. I disagree.

This same issue was decided in a prior Administrative Law Division case, State v. Petro-Lewis Corp., Docket No. Misc. 86-228, decided July 22, 1987. I held in Petro-Lewis that the sales by the associated owners were at arms-length, as follow:

> "The Department does not dispute that the sales price as fixed by the casinghead gas contracts is the proper value to be applied for tax purposes to that gas sold by the non-associated owners. However, as to the associated owners (Taxpayer), the Department argues in effect that they cannot sell their gas to themselves and consequently, that the sales price paid under such circumstances is not the result of an arm's-length transaction, and thus is not indicative of the true market value of their gas.
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> To begin, the Department's contention that the associated well owners are not selling their gas at arm's-length to the plant is incorrect. The associated owners operate in two separate capacities, each independent of the other. As well owners, they sell their production to the plant as required by an arm's-length agreement under the same terms and for the same prevailing market price as the non-associated owners. They profit accordingly. On the other hand, as plant owners, they gather and process the gas and sell the refined products at the plant tailgate. Fifty percent of the NGL sales proceeds and 60% of the residue gas proceeds are then paid to the well owners, both associated and non-associated alike, per the casinghead gas contracts. The remainder is retained by the plant to cover processing and other operating expenses, with any excess over expenses, if any, divided among the plant owners as profit. There is no collusion between the

> associated owners in their capacity as well owners and their separate capacity as plant owners, as evidenced by the fact that the amounts received by the associated owners for their gas is tied to that sales price as established for all well owners under the casinghead contracts."

The above quote from Petro-Lewis is still valid. The fact that an associated working interest owner that sells gas to the Plant is also one of five or six otherwise unrelated Plant owners does not cause the transaction to be at less than arm's-length. To the contrary, the Plant operating agreement requires the associated owners to deal at arm's-length by selling their gas to the Plant under the same casinghead contract terms and for the same price as the non-associated owners. There is no collusion by the associated owners. They are required to sell their gas to the Plant at arm's-length.

In any case, regardless of the relationship between the parties, this third "if" clause applies only if the consideration paid to the associated owners was not indicative of the true value of the gas at the wellhead. The Department has accepted the sale price paid to the non-associated owners as the true value of the gas. Clearly that same price received by the associated owners is also "indicative of the true value or market price" of their gas at the wellhead.

None of the three "if" clauses of §40-2-1(3) apply in this case. Consequently, the taxable value of the gas was the sale price paid to the associated owners as established by the arm's-length casinghead contracts.

But even assuming that the sales by the associated owners to the Plant were not at arm's-length, the taxable value should still be determined considering the sale of like-kind gas by the non-associated owners and the Plant.

The Alabama Supreme Court has approved use of the work-back method of valuing gas under certain circumstances. State v. Phillips Petroleum Co., 638 So.2d 886 (Ala. 1992). However, the Court also held that the method is "disfavored as a method of calculating value", Phillips, at p. 889, and should only be "used when there are no factually comparable sales contracts". Phillips, footnote 2, at p. 890. The Court further stated that any determination of value by the Department "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." Phillips, at p. 889.

The Supreme Court remanded the case back to the Court of Civil Appeals, which issued a subsequent opinion in July 1993. See, State v. Phillips Petroleum Co., 638 So.2d 890 (Ala.Civ.App. 1993). That opinion was also appealed to the Supreme Court. See, State v. Phillips Petroleum Company, 638 So.2d 893 (Ala. 1994). In that second opinion, the Supreme Court stated as follows, at p. 894:

> "In our original opinion, we held that the Revenue

> Department was not limited in the method that it could use in arriving at the "value" of the gas; however, we specifically held that any determination of value, other than the actual sale price for cash at the wellhead, could be challenged by the taxpayer on the ground that the assessment overestimates or underestimates, the value or market value. We noted that the work-back method, although not favored, could be used in determining value. So long as the Revenue Department considers like-quality gas sales prices by reasonably regarding them, the Revenue Department is not constrained to determine value on the basis of like-quality sales prices and may conclude that gas should be valued by the work-back method. See our opinion in State v. Phillips Petroleum Co., 638 So.2d at 886."

The Supreme Court then upheld the Department's use of the work-back method because "we cannot find that Phillips Petroleum pointed to any like-kind sales of like-quality gas or any contracts as being determinative of the value of its gas". Phillips, supra, at p. 895.

This case can be factually distinguished from Phillips. Unlike Phillips, in this case the Taxpayer reported and paid severance tax based on the casinghead contracts in effect during the audit period. The Taxpayer emphasized the casinghead contracts to the auditor during the audit. (R. 275). The auditor reviewed and rejected several of the contracts, and was aware of but did not consider the remaining contracts. (See generally, R. 272-278). The Department in all cases rejected like-kind sales when valuing the gas sold by associated owners. (R. 279).

The Department explained that it rejected the casinghead contracts because (1) the contracts were remote in time, and (2) they contained quality control provisions and also provisions that allowed the Plant not to take gas under certain circumstances. (R. 299, 309).

Concerning reason (1), some of the contracts were executed in 1974, while others were executed later. But it is irrelevant when they were executed because they were all in effect and viable during the audit period.

Concerning reason (2), it is also irrelevant that the Plant had the option of when or if to take gas from a well, or that some gas could be rejected for low quality. What is relevant is that if gas was severed, the associated owners received the same arm's-length sales price as the non-associated owners. In any case, the same terms were included in the contracts with the non-associated owners.

The gas sold by the non-associated and associated owners was clearly of like-quality. In some cases it came from the same well. Ken Hanby, a petroleum engineer with extensive experience and knowledge concerning the Womack Hill and surrounding fields, testified that all of the gas going to the Womack Hill Plant was of like-kind. (R. 186). The Department concedes that the gas produced by the associated and non-associated owners was identical. (R. 277, Department's brief at p. 9).

If the statutory language requiring the Department to "consider the sales price for cash of oil or gas of like-quality", and the Supreme Court's mandate that like-kind sales must be "reasonably regarded" means anything, then the sales price set out in the arm's-length casinghead contracts between the non-associated owners and the Plant for the identical gas must govern in this case.

The Department makes the following argument on page 9 of its brief - "It is true that the physical makeup of the gas severed by both the associated owners and the non-associated owners is identical. However, the value to each of the parties of the gas is not the same!" That last statement is wrong. The associated and non-associated owners clearly received the same sale price for the unprocessed gas at the wellhead. It is true that the associated owners also received an additional amount based on their ownership interest in the Plant. But the profit received by the associated owners for processing and selling the gas is irrelevant for purposes of determining taxable value at the wellhead. Only the sale price received by the associated owners for the unprocessed gas at the wellhead is subject to severance tax.

In the Department's hypothetical on pages 9 and 10 of its brief, gas is sold for $1.00 at the tailgate and the non-associated owners get $.40 (should be $.60) per the casinghead contracts. The remaining $.60 (should be $.40) goes to the associated Plant owners to cover expenses, taxes and profit from the operation of the Plant. The Department argues that if the gas purchased from the associated owners is sold for the same $1.00 at the tailgate, the amount realized by the associated owners would be $.90 after deducting $.10 actual processing cost. The Department thus concludes that the associated owners received more value than the non-associated owners (90% versus 40%), and thus owe more tax.

What the Department fails to recognize is that the total "amount realized" by the associated owners was from two sources, one taxable and the other not. First, as well interest owners, the associated owners received $.40 from the sale of their gas at the wellhead, the same as the non-associated owners. They then realized an additional $.50 ($1.00 less $.40 cost of gas less $.10 processing cost) in their capacity as Plant owners. But only the $.40 received from the sale of the unprocessed gas at the wellhead is subject to severance tax. The $.50 profit (before taxes) realized from their ownership interest in the Plant is not taxable. The associated owners also realized the same $.50 operating profit from the Plant on the gas purchased from the non-associated owners ($1.00 less $.40 paid to non-associated owners for the gas less $.10 processing cost).[5]

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[5]All gas purchased by the Plant is commingled in the gathering system and processed together. It costs the Plant the same to process the gas purchased from the associated owners as it does the

gas from the non-associated owners.

In summary, the work-back method can be used, but only if there is no arm's-length sale at the wellhead. The associated owners sold their gas at arm's-length at the wellhead in this case as evidenced by the Plant operating agreement and the casinghead contracts. If the associated owners had conspired and purchased their own gas for less than the amount paid to the non-associated owners, the Department would have cause to disregard those sales as not at arm's-length. But there was no collusion by the associated owners. They were required to sell their gas at the wellhead for the same fair market price as the non-associated owners. That identical sale price was accepted by the Department as the fair market value at the wellhead of the unprocessed gas sold by the non-associated owners. It should also be accepted for the associated owners. The fact that the associated owners also received additional value or profit from their ownership interest in the Plant is not relevant for severance tax purposes.

Even it the sale price paid to the associated owners is ignored, the Department must still "reasonably regard" sales of like-quality gas. The work-back method can only be used "when there are no factually comparable sales contracts". Phillips, footnote 2, at p. 890. The casinghead contracts between the non-associated owners and the Plant clearly established the sale price at the wellhead for like-quality gas. There is no reasonable reason why those arm's-length like-kind sales by the non-associated owners should be rejected.

The above considered, the second issue concerning how the work-back method should be calculated is moot. The Taxpayer properly reported and paid severance tax during the subject period using the sale price in the casinghead contracts. The final assessment in issue is accordingly dismissed.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered May 4, 1995.

BILL THOMPSON
Chief Administrative Law Judge