

4-2-2009

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### Repository Citation

Angelico, Robert S. (2009) "Current Issues in the Louisiana Severance Tax on Crude Oil and Condensate," *Annual Institute on Mineral Law*: Vol. 56, Article 19.

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# **Current Issues in the Louisiana Severance Tax on Crude Oil and Condensate**

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## **I. Introduction**

This outline will discuss current issues in connection with the Louisiana severance tax on crude oil and condensate. First, the law governing this severance tax area will be presented together with the current regulations as promulgated by the Louisiana Department of Revenue. Second, background information will be provided concerning disputes that have arisen in this area going back to the mid-to-late 1990s. Third, the outline will present proposals put forth by the Louisiana Department of Revenue to amend both the statutes and the regulations concerning various issues involved in the severance tax, among them valuation, the transportation deduction, and payout of well costs.

## **II. Law and Regulations Governing the Louisiana Severance Tax on Crude Oil and Condensate.**

### **A. La. Const. art. VII, Section 4 (B) provides:**

Taxes may be levied on natural resources severed from the soil or water, to be paid proportionately by the owners thereof at the time of severance. Natural resources may be classified for the purpose of taxation. Such taxes may be predicated on either the quantity or the value of the products at the time and place of severance.

No additional tax or license shall be levied or imposed upon oil, gas, or sulphur leases or rights.

### **B. Statutes on Value**

#### **1. La. R.S. 47:633(7)(a) levies the severance tax on oil as follows:**

(7) (a) On oil twelve and one-half percentum of its value at the time and place of severance. Such value shall be the higher of (1) the gross receipts received from the first purchaser, less charges for trucking, barging and pipeline fees, or (2) the posted field price. In the absence of an arms length transaction or a posted field price, the value shall be the severer's gross income from the property as determined by R.S. 47:158(C).

#### **2. La.R.S. 47:158(C) provides as follows:**

**C. Percentage depletion for oil and gas wells.** In the case of oil and gas wells the allowance for depletion under R.S. 47:66 shall be twenty-two percentum of the gross income from the property during the taxable year, excluding from such gross income an amount equal

to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed fifty percent of the net income of the taxpayer, computed without allowance for depletion, from the property except that in no case shall the depletion allowance under R.S. 47:66 be less than it would be if computed without reference to this Subsection.

### **C. Regulations on Value**

#### **1. Definition of "value" in LAC 61:I.2903**

Value —with respect to oil and/or condensate, the value shall be the higher of (1) the gross receipts received from the first purchaser by the producer or (2) the posted field price.

a. Gross Receipts—the total amount of payment:

i. received from the first purchaser in an arm's length transaction; or

ii. received from the first purchaser or transferred from the first purchaser by recognized accounting methodology, in a non-arm's length transaction. Gross receipts shall include bonus or premium payments when made by the purchaser to the owner, all advanced payments, and any other thing of value such as exchanges, barter, or reimbursement of costs. Advanced payments are not taxable until the oil and/or condensate for which such payments are made are actually severed and delivered to the purchaser.

b. Posted Field Price —a statement of crude oil prices circulated among buyers and sellers of crude petroleum and is generally known by buyers and sellers within the field as being the posted price. The posted field price is the actual price of crude petroleum advertised for a field. The area price is a statement of crude oil prices circulated among buyers and sellers of crude petroleum listing prices for different areas of the state, usually listed as north Louisiana and south Louisiana, and generally known among buyers and sellers within the area as the posted price. This area price is the beginning price for crude petroleum of an area before adjustments for kind and quality (including, but not limited to, gravity adjustments) of the crude petroleum. When no actual posted field price is advertised or issued by a purchaser, the area price less adjustments for kind or quality (including, but not limited to, gravity adjustments) becomes the posted field price.

c. Arm's Length Transaction —a contract or agreement that has been arrived at in the open market place between independent and nonaffiliated parties with opposing economic interests.

d. Non-Arm's Length Transaction —a contract or agreement between subsidiaries and/or related parties and/or affiliates.

e. Value in Arm's Length Transaction—in an arm's length transaction, the value shall be the gross receipts of all things of value received directly or indirectly by the producer.

f. Value in Non-Arm's Length Transaction—in a non-arm's length transaction, the value shall be derived by taking the following into consideration:

i. the gross receipts of all things of value received directly or indirectly by the producer;

ii. if the producer or a subsidiary, related party, or an affiliate of the producer, is the purchaser, look to the gross proceeds from contemporaneous arm's length transactions by such purchaser for the purchase of significant quantities of like quality oil or condensate in the same field, or if necessary, the same area;

iii. the prices paid by independent and nonaffiliated parties for significant quantities of like quality oil or condensate produced in the same field or, if necessary, the same area; and

iv. other relevant information, including information submitted by the producer concerning the unique circumstances of producer's operations, product or market.

g. The secretary, in the absence of supporting documentation or arm's length transaction, may adjust a producer's reported value to conform with the above mentioned standards.

#### **D. Reduced Rate Crude Oil Severance Tax Situations**

**1. La. R.S. 47:633(7)(b) provides the rate for incapable wells as follows:**

(7)(b) On oil produced from a well classified by the commissioner of conservation as an oil well, and determined by the collector of revenue that such well is incapable of producing an average of more than twenty-five barrels of oil per producing day during the entire taxable month, and which also produces at least fifty percent salt water per day, the tax rate applicable to the oil severed from such well shall be one-half of the rate set forth in Subparagraph (a) of this Paragraph [6.25%] and such well shall be defined, for severance tax purposes, as an incapable well, provided that such well has been certified by the Department of Revenue as incapable of such production on or before the twenty-fifth day of the second month following the month of production. Oil severed from a multiple well lease or property is not subject to the reduced rate of tax provided for herein, unless all such wells are certified as incapable.

**2. La. R.S. 47:633(7)(c)(i)(aa) levies the reduced severance tax on stripper wells as follows:**

On oil produced from a well classified by the commissioner of conservation as an oil well, and certified by the Department of Revenue that such well is incapable of producing an average of more than ten barrels of oil per producing day during the entire taxable month, the tax rate applicable to the oil severed from such well shall be one-quarter of the rate set forth in Subparagraph (a) of this Paragraph [3.125%] and such well shall be defined, for severance tax purposes, as a stripper well, provided that such well has been certified by the Department of Revenue as a stripper well on or before the twenty-fifth day of the second month following the month of production. Once a well has been certified and determined to be incapable of producing an average of more than ten barrels of oil per producing day during an entire month, such stripper well shall remain certified as a stripper well until the well produces an average of more than ten barrels of oil per day during an entire calendar month.

Additionally, La. R.S. 47:633(7)(c)(i)(bb) states that crude oil produced from certified stripper wells shall be exempt from severance tax in any month in which the average value set forth in Subparagraph (a) of this Paragraph is less than twenty dollars per barrel.

**3. La. R.S. 47:633(7)(c)(ii) provides for a reduced rate for wells in a stripper field that involves a horizontal drilling project as follows:**

On oil produced from a well in a stripper field classified by the commissioner of conservation as a mining and horizontal drilling project which utilizes gravity drainage to a collection point in a downhole operations room, the tax rate applicable to the oil severed from such well shall be one-quarter of the rate set forth in Subparagraph (a) of this Paragraph (7); provided that such well has been classified by the Commissioner as a mining and horizontal drilling project before the lower rate is claimed on a tax return.

For purposes of this rate, a "stripper field" means those geological formations as designated by rules and regulations of the secretary which have been historically recognized as being "stripper fields" and as utilizing stripper wells for oil production.

The tax rate provided for these stripper wells shall be applicable only to the working interest and shall only apply until the cumulative value of hydrocarbon production from the mining and horizontal drilling project is equal to two and one-third times the total private investment, invested by the working interest owners, in the project. For purposes of this rate, "private investment" shall mean those costs associated with project design, fabrication, installation of equipment, drilling and completion cost of wells and any other costs directly associated with said project. A "working interest owner" shall mean the owner of the mineral right who is under an obligation

to share in the costs of drilling and completing a mining and horizontal drilling project. A person who does not invest and take a financial or economic risk in the drilling for an actual production of oil shall not be a working interest owner under the provisions of this section.

**4. La. R.S. 47:633(7)(c)(iii) provides for a suspension of severance tax on horizontal wells follows:**

All severance tax shall be suspended, for a period of twenty-four months or until payout of the well cost is achieved, whichever comes first, on any horizontally drilled well, or, on any horizontally drilled recompletion well, from which production commences after July 31, 1994. For purposes of this section "horizontal drilling" shall mean high angle directional drilling of bore holes with fifty to three thousand plus feet of lateral penetration through productive reservoirs and "horizontal recompletion" shall mean horizontal drilling in an existing well bore. Payout of well cost shall be the cost of completing the well to the commencement of production as determined by the Department of Natural Resources.

**5. La. R.S. 47:633(7)(c)(iv) provides for severance tax exemption for inactive wells as follows:**

Production from oil and gas wells shall be exempt from severance tax for a period of five years when returned to service after being inactive for two or more years or having thirty days or less of production during the past two years. The exemption shall be extended by the length of any inactivity of a well that has commenced production when such an activity is caused by a force majeure.

To qualify for inactive well status, an application for a two-year inactive well certification must be made to the Department of Natural Resources before commencement of production during the period beginning July 1, 2006 and ending June 30, 2010. Upon certification that a well is inactive, all production is exempt from severance tax for a period of five years from the date production begins or ninety days from the date of the application, whichever occurs first. La. R.S. 47:633(7)(cc)(iv)(aa).

If the severance tax is paid at the full rate provided by this section before the Department of Natural Resources approves an application for two-year inactive well status, the operator is entitled to a credit against taxes imposed by this section in an amount equal to the tax paid. To receive a credit, the operator must apply to the Secretary of the Department of Revenue for the credit not later than the first anniversary after the date the Department of Natural Resources certifies that the well is a two-year inactive well. La. R.S. 47:633(7)(c)(iv)(bb).

**6. La. R.S. 47:633(9)(d)(v) provides for a 24-month exemption for severance tax in connection with deep wells as follows:**

Production of natural gas, gas condensate, and oil from any well drilled to a true vertical depth of more than 15,000 feet, where production commences after July 31, 1994, shall be exempt from severance tax, from the date production begins, for 24 months or until payout of the well costs, whichever comes first.

**7. La. R.S. 47:633(8) provides for the severance tax on distillate, condensate, or similar natural resources severed from the soil or water either with oil or gas as follows:**

On distillate, condensate, or similar natural resources severed from the soil or water either with oil or gas, twelve and one-half percentum of gross value at the time and place of severance. For the levy of this tax, gross value shall be as defined by R.S. 47:633(7)(a). However, natural gasoline, casinghead gasoline and other natural gas liquids, including but not limited to ethane, methane, butane or propane, all of which occur naturally or which are recovered through processing gas after separation of oil, distillate, condensate or similar natural resources shall not be subject to the levy of severance tax provided for oil, but shall be subject to the levy provided for natural gas.

**8. La. R.S. 47:648.3 provides for a severance tax suspension of 24 months on production from certified new discovery oil or natural gas wells as follows:**

All severance taxes on production from certified new discovery oil and natural gas wells are hereby suspended from the date of completion for a period of 24 months or until recovery of payout of the well cost, whichever comes first. Payout of the well cost shall be determined by the Department of Natural Resources. La. R.S. 47:648.2 defines a "certified new discovery oil and natural gas well" as a well that was completed between September 30, 1994 and September 30, 2000. Therefore, there may not still be much use of this suspension provision.

**E. Law and regulations on transportation deductions.**

**1. La. R.S. 47:633(7)(a) permits a deduction for transportation costs in arriving at the gross receipts.**

On oil twelve and one-half percentum of its value at the time and place of severance. Such value shall be the higher of one (1) the gross receipts received from the first purchaser, less charges for trucking, barging and pipeline fees, or (2) the posted field price.

**2. The regulations further flesh out the definition of transportation costs in LAC 61:I.2903.**

h. **Transportation Costs** – there shall be deducted from the value determined under the foregoing provisions the charges for trucking, barging and pipeline fees actually charged the producer. In the event the producer transports the oil and/or condensate by his own facilities, \$0.25 per barrel shall be deemed to be a reasonable charge for transportation and may be deducted from the value computed under the foregoing provisions. The producer can deduct either the \$0.25 per barrel or actual transportation charges billed by third parties but not both. Should it become apparent the \$0.25 per barrel charge is inequitable or unreasonable, the Secretary may prospectively re-determine the transportation charge to be allowed when the producer transports the oil and/or condensate in his own facilities.

**3. The Department has issued a private letter ruling and a revenue information bulletin dealing with deducting transportation costs from the taxable value of oil or condensate.**

**Private Letter Ruling 04-003, September 2, 2004.**

The taxpayer in the private letter ruling was engaged in oil and gas exploration and production in an area of the Gulf of Mexico offshore Louisiana. The taxpayer provided a plat that depicted the extensive pipeline transportation system that the taxpayer used to transport oil and gas from wells located in the area to distribution facilities outside of the taxpayer's lease block. The production platforms contained within the boundaries of the taxpayer's lease were connected to gathering pipelines. The intricate gathering line system was contained within the lease boundaries for the taxpayer's areas of production. The taxpayer owned, maintained and operated the gathering pipelines. The gathering system was set up such that all gathering lines for oil were directly or indirectly connected to one of two central accumulation points located on two separate platforms. At each of these central accumulation points the oil was treated or processed, making it pipeline quality. At each of the central accumulation points, the oil then entered a 10" transportation line that is wholly owned, maintained, and operated by the taxpayer. The transportation lines transport the oil to terminals located outside of the taxpayer's lease block. At the two off lease terminals, the oil was then tied in to pipelines, at which point the oil was sold. The taxpayer did not sell the oil until it reached the export tie-in terminals, and the taxpayer did not own or operate the pipelines located at the tie in terminals.

The taxpayer requested a ruling from the Department of Revenue that stated that the gathering and transportation pipeline system utilized by the taxpayer in its lease production area entitled the taxpayer to take the \$0.25 per barrel deduction for all oil produced in the area and transported through that pipeline system. The Department began its analysis by setting forth the regulation that defines transportation costs. The Department then stated that the phrase "own facilities" means that the pipe-

lines, trucks or barges used to transport the oil and/or condensate are owned or operated by the producer. The producer is considered to be the owner or operator of pipelines, trucks or barges used by the producer to transport oil and/or condensate when the producer has direct, immediate and exclusive authority over such pipelines, trucks or barges.

The Department went on to state that the word "transportation" is used in the regulation in its ordinary sense and comprehends a substantial movement of oil, after gathering, by pipelines, trucks or barges. Thus, movement of crude oil by gathering lines or other related equipment primarily used to produce, gather, or transport crude oil from the well to a point where it can be treated or processed to make it pipeline quality is not the "transportation" of oil as contemplated by the regulation. The Department also indicated that the \$0.25 per barrel deduction is deemed to be a reasonable charge for transportation costs when the producer transports oil and/or condensate in his own facilities. Reasonable or equitable costs of transportation are costs that are fair, proper or moderate and are ordinary and necessary expenses incurred by the producer to transport the oil and/or condensate in his own facilities after gathering. The reasonableness or equitableness of the \$0.25 per barrel transportation charge is a question of fact and involves a case-by-case consideration of all the facts and circumstances of the particular case under review.

Based on its analysis, the Department of Revenue in the private letter ruling concluded that the producer was entitled to take the \$0.25 per barrel deduction with regard to the two 10" transportation lines that it used to move the oil to terminals located outside of the lease block where the oil was sold. The Department concluded that the gathering lines neither constituted the taxpayer's own facilities nor do they transport oil as contemplated by the regulation. Therefore, the Department concluded that the taxpayer was not entitled to deduct a \$0.25 per barrel charge for any crude oil gathered and moved by the taxpayer's gathering lines from the well to the two central points of accumulation where such oil was treated and/or processed to make it pipeline quality. Consequently, the producer was only entitled to the deduction because it owned and operated the 10" transportation lines. Had that not been the case, the Department of Revenue would probably have concluded that the producer was not entitled to the transportation deduction with regard to its gathering system.

#### **4. Revenue Information Bulletin No. 08-015, June 30, 2008.**

This revenue information bulletin reinforces the same conclusions reached in the earlier private letter ruling. The revenue information bulletin sets forth again the regulation section that defines transportation costs that are allowed as a deduction from value to reach the taxable value for purposes of the severance tax on crude oil or condensate. The RIB then

provides further definitions of some of the terms set forth in the regulation. The RIB defines a "barge" as meaning a large, usually flatbottom freight boat that is generally unpowered and towed or pushed by other craft. The RIB defines "gathering," "gathering lines," "gathering systems," "gathering stations," and "gathering facilities" as being all excluded from the definition of "transportation" and "transportation costs." The Department states that by their definitions, the excluded terms refer to processes or services associated with collecting or moving the oil or condensate prior to its being moved off the lease and placed into a truck, barge, or pipeline. Thus, costs, charges, fees, or other expenses incurred, attributed to, or otherwise associated with such process, line, system, station, facility, or the like are not entitled to the benefit of the deduction provided for transportation costs and shall not be deducted from the value of the oil or condensate.

The RIB defines "pipeline" as meaning a tube or series of tubes used for transporting crude and natural gas from the field or gathering system to a refinery. The RIB defines "producer" as meaning the severer of the oil or condensate sold and transported, regardless of whether such person is the owner of the oil or condensate or property from which it is severed, or severed the oil or condensate under contracts or agreements requiring payment directly to the owners of any royalty interest, excess royalty, or working interests, either in money or in-kind. The term "producer" is used interchangeably and treated as being synonymous with the terms "severer" and "operator," with no distinction.

The RIB defines transportation as meaning a substantial of movement of oil or condensate by truck, barge, or pipeline to a point of sale or delivery off the lease. The RIB emphasizes again that transportation does not include moving the oil or condensate by means of gathering lines or systems, or by any other means or process associated with collecting or moving the oil or condensate prior to its being moved off the lease and placed in or on a truck, barge or pipeline.

In addressing which transportation costs may be deducted, the RIB states that if a person is both the producer of the oil or condensate and the owner of the truck, barge, or pipeline in which the oil or condensate is transported, that person is allowed to deduct \$0.25 per barrel from the value of the oil or condensate, provided \$0.25 is reasonable and equitable. If a person is the producer of the oil or condensate and the product is transported in a truck, barge or pipeline of which the person is not the owner, then that person is allowed to deduct only the actual, reasonable transportation costs billed by third parties for trucking, barging and pipeline fees. The person cannot deduct the \$0.25 per barrel. The \$0.25 deduction is allowed only if the producer of the oil or condensate is also the owner of the truck, barge or pipeline in which the oil or condensate is transported.

If a purchaser of crude oil or condensate is required to deduct or withhold severance taxes from the amounts due to the producer, than that purchaser must report on the oil severance tax return the gross value received by the producer, and at the same time must pay the amount of the tax deducted or withheld, or the amount of taxes and interest due if not deducted withheld. If a purchaser is paying the severance tax on behalf of the producer, that purchaser may, for purposes of determining and reporting the gross value received by the producer, deduct transportation costs in accordance with the standards set forth in the revenue information bulletin.

#### **F. Calculation of “payout” for exempt wells.**

**1. For various of the reduced severance tax rate situations, there are suspensions or exemptions of the severance tax until “payout of the well cost is achieved.”**

**The regulations define “payout” in LAC 61:I.2903.**

Payout – the payout of the well cost for a horizontal well as referred to in R.S. 47:633(7)(c)(iii), a deep well as referred to in R.S. 47:633(9)(d)(v), and a new discovery well as referred to in R.S. 47:648.3 occurs when gross revenue from the well, less royalties and operating costs directly attributable to the well, equals the well cost as approved by the Office of Conservation. Operating costs are limited to those costs directly attributable to the operation of the exempt well, such as direct materials, supplies, fuel, direct labor, contract labor or services, repairs, maintenance, property taxes, insurance, depreciation, and any other cost that can be directly attributed to the operation of the well. Operating costs do not include any costs that were included in the well costs approved by the Office of Conservation.

### **III. Background Information on the Various Crude Oil Severance Tax Disputes.**

The beginning of increased activity in the crude oil severance tax area was the experience in Louisiana of an expanded use of royalty theories of valuation of crude oil and condensate production in severance tax audits and in lawsuits initiated by the State of Louisiana against several producers in the mid to late 1990s. In these suits, the State was represented by some of the same attorneys who represented various plaintiff interests in MDL 1206, the multi-district litigation that consolidated numerous royalty suits in a royalty/antitrust action in federal court in Corpus Christi, Texas. That suit was eventually settled in 1999, but part of its heritage was the adoption in Louisiana of a royalty theory of market value as a methodology for analyzing the value of production in the context of the assessment of severance taxes, even when the transaction being taxed was an arms-length sale.

As indicated herein, the Louisiana Constitution states that severance taxes can be based on “value”, and the attorneys for the State argued that this predicate allowed them to assert that the state severance tax system was designed to be based essentially on a market value analysis. As had been urged by lessors in MDL 1206, the State argued that producers had collaborated to commit fraud and had subverted or corrupted the concept of “posted price” as it was originally intended when posted price actually represented true value. The focus of the attack on posted price as an arms-length measure of value was the use of buy-sell and overall balance agreements and exchanges to conceal the value of the production at the place and time of production.

Buy-sell agreements and exchanges, at least, were common marketing techniques used in the sale of crude oil and condensate. The State alleged that such arrangements enabled a producer to obtain and camouflage additional value beyond that reflected in the price used in the “buy” side of the transaction. According to this theory, that singular price had been disconnected from the total transaction, and thus reflected only a part of the value that producers had in fact received.

In addition, since the industry set the posted prices, the State viewed the use of that price as an artificial “self assessment” of taxes that devalued crude and condensate. These same allegations were repeated in cookie cutter fashion as to all producers, presumably under the assumed rubric that the use of posted prices and the various marketing arrangements that were the target of the State’s attacks were part of an industry conspiracy. The State concluded that as a result of their distortion of the true price received, the valuation of production must be on the basis of market value. Of course, at least as it affected arms-length sales, in the view of defendant companies, that analysis ran directly contrary to the statutory language and the regulatory framework for the determination of value for Louisiana severance taxes, though the State very creatively strove to incorporate those elements of the legal structure into their arguments.

The market value solution proposed by the State was that the price to be used to value the oil and condensate was the price being obtained in any given month at one of two market centers on the Mississippi River, less transportation. The transportation allowance that was proposed was \$0.25 per barrel, which under Louisiana law was designed to be used only if a producer used its own facilities for transportation. (If that occurred, the use of \$0.25 as a transportation allowance was unchallenged, though a producer could seek a larger transportation deduction rate, if it could prove a greater expense per barrel.) The use of market center pricing was simple, though it was far different from normal market value analysis, which typically compared prices paid for production of like quantity and quality in the field or in the area. That latter, customary

analysis may well not have been available at the time that these lawsuits were filed, or at least as to the target period between 1986 and 1997, inasmuch as during those years the market was still developing and changing and had not yet matured into a generalized pricing system with its various more sophisticated elements.

There were several key weaknesses in the State's position. First, it could not be used at all with outright sales, and in settling, these were the first volumes which were eliminated from negotiations. Second, where there were arms-length sales, it was difficult, if not impossible, to reconcile the State's theories and conclusions with the statutes and the regulations. As a tax mechanism, Louisiana law was designed to look at the price received, *i.e.*, the gross proceeds to the producer-seller. This specific focus of the tax regime is decidedly unlike the accepted analysis in royalty litigation, where a court can examine the prudence of a price or value used to account for royalty. For purposes of tax valuation, it should be immaterial whether the producer made a good deal in selling its product; the sole inquiry is how much it received in the sale. Of course to arrive at that value of the true gross proceeds, it may be necessary to unwind a transaction and view both sides of the exchange or buy-sell and the barrels that the producer received back as those might be considered in light of the location differential specified by the parties.

Third, the use of market center pricing, less transportation, was itself an encumbrance because it seemed highly artificial in the context of actual marketing by producers, especially where the oil did not even go to that market center. Also, the transportation costs to reach the market center were grossly undervalued and made the State's negotiating position untenable. Producers rightly insisted that if the State wanted to value the crude as if it were sold at a market center, it had to allow transportation to that market center, and those costs were substantial. However, as mentioned above, the use of traditional market value analysis may not have been feasible at the time of these suits, especially since the premise of the argument was that posted price was not a valid method of valuation, so the use of a market center pricing may have been the best option for supporting a market price valuation.

Following on the heels of the Resolution of the final of the state's lawsuits concerning the crude oil severance tax, industry and personnel from the Louisiana Department of Revenue began an attempt to work together to try to clarify and improve the law and regulations concerning the severance tax on crude oil and condensate. Meetings progressed on and off for several years. No resolutions were reached. Then, in the early spring of 2007 the Louisiana Department of Revenue unexpectedly released a proposed legislative act and proposed regulations dealing with the crude oil severance tax. However, the proposed legislation stated that it was providing definitions to clarify the legislative intent as to how,

when and where the severance tax levied on oil arises and to clarify and confirm legislative intent of the law as it existed prior to the effective date of the legislation. The proposed act indicated that it was remedial in nature and was intended to clarify and confirm legislative intent of the laws that existed prior to the effective date and that it would be applied retroactively.

The proposed legislation and the proposed regulations took the industry by surprise, and industry was very concerned with some of the features of the proposed new law. As a result, industry asked the Louisiana Department of Revenue to reconsider introducing the law and regulations because it would create significant problems in the administration of the severance tax laws applied to crude oil. The Louisiana Department of Revenue agreed, and took down the proposed legislation and the proposed regulations.

Following that effort, a special task force committee was formed with representatives of the Louisiana Department of Revenue, the Louisiana Mid-Continent Oil & Gas Association, and the Louisiana Oil & Gas Association. This subcommittee was given the task of trying to reach common ground between industry and the Department on the key issues involved with regard to the imposing of severance tax on crude oil and condensate. The committee worked throughout the remainder of 2007 and all of 2008. However, common ground could not be reached, and very recently, the committee was disbanded. As a result, the area remains unresolved and the various issues could very well be the subject of new legislation and/or regulations proposed by either the Louisiana Department of Revenue or industry groups. The discussion in Section IV of this outline is meant to be a potential guidepost to what may be proposed again by the Louisiana Department of Revenue with regard to these issues and the taxation of crude oil and condensate for severance tax purposes.

#### **IV. Louisiana Department of Revenue Proposed Legislation and Proposed Regulations in the 2007 Regular Session of the Legislature.**

##### **A. Proposed Legislation and Regulations on Taxable Value.**

###### **1. Proposed Legislation with regard to crude oil taxable value.**

The proposed legislation by the Department of Revenue indicated that the taxable value of crude oil would be the higher of (1) the gross receipts of any and all things of value received, directly or indirectly, from the first purchaser in an arm's-length transaction or (2) the fair market value of the oil. The proposed statute went on to state that if the oil is exchanged for anything of value other than cash, or if there is no sale at the point of disposition or point of sales volume measurement, or if the relationship between the buyer and the seller is such that the consideration paid, or to be received is not indicative of the true value of the

oil, the Secretary of Revenue must determine the taxable value of the oil. In making that determination of taxable value, the Secretary must consider the sale price for cash at the point of disposition and for oil of like quality in the same vicinity in an arm's-length transaction.

The proposed legislation also went on to provide several definitions relevant in determining taxable value. "Arm's-length transaction" was defined as meaning a transaction or other agreement which represents or results in fair market value arrived at in the marketplace between independent, unrelated, non-affiliated parties with opposing economic interests regarding that transaction, and who are presumed to have roughly equal bargaining power.

"Fair market value" was defined as meaning the price a willing buyer will pay to a willing seller on the open market in an arm's-length transaction. For purposes of the severance tax levy, there is not a distinction among the terms fair market value, market value, market price, and fair market price. "First purchaser" was defined as meaning the first person who purchases oil from the producer or operator. "Operator" was defined as meaning the person who assumes responsibility for the physical operation and control of a well and is the operator of record as shown by a form the person files with the Office of Conservation and the Office of Conservation approves.

"Non Arm's-Length Transaction" was defined as a contract or agreement between subsidiaries, related parties, or affiliates that is not arm's-length. The term "non arm's-length transaction" includes, but is not limited to, transactions such as exchanges, buy/sell agreements, and balancing agreements where the intent is not to sell the product but to move it for the benefit of the parties, even if the parties to the transaction, contract, or agreement are not subsidiaries, related parties, or affiliates. "Time and place of severance" or "time of severance" was defined as meaning the date, point, or place at which the tax levy on the quantity or value of the natural resource can be determined for purposes of payment of the severance tax. Thus, oil or condensate is severed for purposes of payment of the severance tax only when the product is transferred from the producer to the first purchaser at the point of disposition in an arm's-length transaction, since otherwise the legislative intent to levy and collect the severance tax on the value of the product could not be accomplished.

## **2. Proposed regulations by the Louisiana Department of Revenue with regard to taxable value.**

The proposed regulations again for the most part set forth definitions to support the terms in the statute dealing with value. The regulations equated value with fair market value. In the determination of value for oil or condensate the regulation set forth the following. The value of oil or condensate shall be the higher of the gross receipts of all things of

value received directly or indirectly by the producer or fair market value, less allowed cost of transportation. The regulation stated that when oil or condensate is exchanged for something other than cash, or there is no sale at the time of severance, where the relation between the buyer and the seller are such that the consideration paid, if any, is not indicative of fair market value of the oil or condensate, the transaction will be deemed non arm's-length. In such cases the regulations set forth different factors that may provide the basis for determining the value of the oil or condensate. These different factors are (a) the gross receipts received from contemporaneous arm's-length transactions for significant quantities of like quality oil or condensate in the same field or area, if the producer or subsidiary, related party, or affiliate of the producer is the purchaser; (b) the price is paid by independent and non-affiliated parties for significant quantities of like quality oil or condensate produced in the same field or area; and (c) any other information, including information submitted by the producer concerning the unique circumstances of the producer's operations, product or market. The regulations define "gross receipts" as the total amount of payment received by the producer from the first purchaser in an arm's-length transaction or received or transferred from the first purchase in a non arm's-length transaction. Gross receipts shall include bonus or premium payments when made by the purchaser to the owner of the product, all advance payments, and any other thing of value including, but not limited to, exchanges, borrowed or reimbursement of costs. However, advanced payments are not taxable until the oil or condensate for which such payments are made are actually severed and delivered to the purchaser.

**B. Legislation and regulations pertaining to transportation and cost deductions.**

**1. Proposed legislation regarding transportation cost deduction.**

The legislation proposed in 2007 by the Louisiana Department of Revenue intended to add to the statutory language that the reasonable, actual charges incurred and paid by the producer to third parties for trucking, barging and pipeline fees to transport the oil beyond the point where the volume of oil to be sold has been measured to the first place or point of disposition is what could be deducted from the higher of the gross receipts or the fair market value, provided that the actual sales price or fair market value of the oil is determined at a point off the lease premises and that the transportation actually occurs. The legislation would add the sentence indicating that charges, costs, or fees incurred for gathering or handling the oil would not be deducted and could not be deducted. The statute defines "point of disposition" as meaning the point at which a purchaser or transporter assumes custody of liquids. The dis-

position point may be a lease, unit, well, co-mingling facility, common battery, lease battery, a gas well, pipeline, or market center.

**2. Proposed regulations dealing with transportation deduction.**

The proposed regulation would state that only the reasonable, actual charges incurred by the producer for trucking, barging and pipeline fees to transport the oil or condensate from the point where the volume of oil or condensate to be sold has been measured to the first place or point of disposition shall be deducted from the value of oil or condensate. The regulation would state that in no case shall the deduction allowed for cost of transportation include charges, costs, or fees for gathering or handling the oil or condensate. The proposed regulations would state that the deduction allowed for cost of transportation shall only apply in cases where the actual sales price or market price is determined at a point off the lease.

**C. Legislation and regulations regarding the definition of payout of well costs.**

**1. Proposed legislation relating to payout.**

The proposed legislation would indicate that payout of well costs shall be the cost of completing the well to the commencement of production. The legislation would state that payout occurs when gross revenue from the well, less royalties and operating cost directly attributable to the well, equals the well costs as determined by the Commission of Conservation. Transportation costs or charges shall not be included or used in determining payout of well costs.

**2. Proposed regulations relating to payment.**

The proposed regulations would have stated that payout of the well costs for a horizontal well as referred to in R.S. 47:633(7)(c)(iii), a deep well as referred to in R.S. 47:633(9)(d)(v), or a new discovery well as referred to in R.S. 47:648.3 occurs when gross revenue from all products produced from the well, less royalties and operating cost directly attributable to the well, equals the well costs as approved by the Office of Conservation. Operating costs are limited to those costs directly attributable to the operation of the exempt well, such as direct materials, supplies, fuel, direct labor, contract labor or services, repairs, maintenance, property taxes, insurance, depreciation, and any other costs directly attributed to the operation of the well. Operating costs do not include any costs that were included in the well cost approved by the Office of Conservation. Charges or costs for transportation shall not be included or used to determine the payout of the well cost.

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