

ALABAMA DEPARTMENT OF REVENUE

OIL AND GAS SEVERANCE TAX

810-8-6-.01 Determining Gross Value or Market Price of Oil or Gas at the Point of Production.

(1) **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 Alabama 1975.

(2) **DEFINITIONS:** The following terms shall have the meaning ascribed to them for purposes of this regulation:

(a) **Allowed costs.** The costs incurred to bring the oil or gas to the point of delivery or first market transaction including, but not limited to, gathering (including gathering prior to separation), transporting, dehydrating, compressing, treating, conditioning, cleansing, stabilizing, processing and delivering. Allowed costs do not include wellhead separation of hydrocarbons, nor any other production costs.

(b) **Production costs.** All costs incurred for acquisition, exploration, development, maintenance, and abandonment of a well.

(c) **Market transaction.** An agreement or contract for the sale, treating, conditioning, cleansing, processing, transporting, and/or compressing of oil or gas that has been arrived at between a producer or his agent and a person or entity with opposing economic interests. Transactions between the parent company and its subsidiaries; subsidiaries of a common parent; a company and its principal owners, management, or members of their immediate families or affiliated companies are not market transactions unless the net proceeds received by the producer are equal to or exceed the value determined by comparison to publicly available indices or information published and used for a particular Alabama area or other publicly available indices or information, adjusted by location differential as appropriate, in which case the transaction in question shall be deemed a market transaction.

(d) **Non-market transaction.** A transaction between a producer or his agent and another person or entity which is not a market transaction as defined in these regulations.

(e) **Gross value.** The sale price or market value at the point of production.

(f) **Market value.** The proceeds received by the producer for oil or gas at the point of production under a market transaction, or the sale price for cash received by a producer for like quality oil or gas at the point of production under a market transaction.

(g) **Point of production.** The mouth of the well as defined in (2)(h).

(h) **Mouth of the well.** The point of production where the well production is severed from the soil or the waters, or from beneath the soil or the waters. Such point includes the wellhead separator or its functional equivalent, heater/treater and/or storage tanks. Such point does not include a wellhead separator which is used exclusively for separating water from a coalbed methane gas stream.

(i) **Plant.** A facility for treating, conditioning, cleansing or processing hydrocarbons, to extract, stabilize or fractionate well production into its separate components or gaseous sulphur compounds or sulphur from natural gas.

(j) **Facility.** An installation serving one or more wells, providing one or more functions such as extraction, stabilization, fractionation, compression, dehydration, treating, conditioning, cleansing, gathering, transportation or delivery.

(k) **Investment basis.** The capitalized cost on which depreciation is allowed. A return on this investment

is also permitted after deducting the allowable depreciation.

(l) **Condensate.** The liquid hydrocarbons recovered or recoverable at the surface which result from condensation.

(m) **Natural gas liquids (NGLs).** Liquefiable hydrocarbon components of natural gas and natural gasoline which can be extracted and are usually saved in liquid form. Such components include: Ethane, propane, iso and normal butanes, and natural gasoline sometimes referred to as pentane and heavier products.

(n) **Treating, conditioning, cleansing, or processing.** The removal of hydrocarbons and nonhydrocarbons from a well stream.

(o) **Workback price.** The price from which allowed costs are deducted in order to establish gross value.

(p) **Affiliated companies.** Companies owning or controlling more than 40% of a given company, or being owned or controlled more than 40% by another company.

(3) **DETERMINING GROSS VALUE IN A MARKET TRANSACTION.** The gross value of oil or gas shall be the proceeds received by the producer for the oil or gas at the point of production under terms of a market transaction.

(4) **DETERMINING GROSS VALUE OR MARKET PRICE IN A NON-MARKET TRANSACTION.** The gross value of oil or gas shall be determined in a non-market transaction in the following manner:

(a) By establishing the net proceeds received by a producer at the point of production by the use of contracts as provided in paragraph (5); however, if gross value is not established by the use of contracts as provided in paragraph 5, then;

(b) By utilizing the workback method , as provided in paragraph (6).

(5) **THE USE OF CONTRACTS TO ESTABLISH GROSS VALUE IN NON-MARKET TRANSACTIONS.** In order to establish gross value, for purposes of paragraph (4) of this regulation, a taxpayer shall offer contract(s) at the time of audit by the Department.

(a) The requirements for contract(s) involving gas not processed in the same plant as the gas in question are:

1. Involving oil or gas that is severed from beneath the soil or waters of the State of Alabama, and having a hydrogen sulfide content that is within seven percentage points of the hydrogen sulfide content of the oil or gas to which it is being compared;

2. Involving a market transaction; and

3. Involving a volume which is at least fifteen percent (15%) of the volume of gas being valued.

(b) The requirements for contract(s) involving gas processed in the same plant as the gas in question are:

1. Involving a market transaction; and

2. Involving in the aggregate at least ten percent (10%) of the total volume of gas processed in the plant.

(c) When offering a contract for purposes of establishing market value, the taxpayer shall acknowledge that to the best of its belief the contract is complete, including any and all amendments.

(d) The taxpayer shall provide a statement at the time of submission of a contract as to why and in what manner it is representative of market value, or in the case of past periods covered by an audit, the relevant time period.

(e) The Taxpayer may submit a contract which is not directly applicable in the determination of market value but which could be applicable with modifications or adjustments. Such submissions shall be accompanied by an explanation of the proposed modification to the tendered contract together with a full explanation of why such modifications would be appropriate for the determination of market value.

(6) USE OF THE WORKBACK METHOD TO ESTABLISH GROSS VALUE IN NON-MARKET TRANSACTIONS.

(a) The initial step in utilizing the workback method will be to establish the investment basis as defined at 2(k) of this regulation.

1. The investment basis shall be limited to the costs actually incurred by the taxpayer in acquiring or constructing a facility.

2. 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.

3. All claimed investment items shall be broken down to the fullest extent possible as to function within a facility.

4. A facility or a portion of a facility which is used to convert hydrogen sulfide gas to elemental sulphur will not be included in the investment basis for purposes of the workback method. Additionally, a facility or a portion of a facility which is used to produce or extract carbon dioxide or nitrogen for sale or use or to handle and dispose of produced water, whether salt water or otherwise, will not be included in the investment basis for purposes of the workback method.

5. The investment basis of a facility shall be reduced each year by an amount equal to the depreciation allowable that year and increased by the amount of investment added that year.

6. The investment basis shall be reduced each year by an amount equal to the undepreciated basis of any assets or portions thereof that are retired from service. No depreciation or return shall be allowed on retired assets after retirement from service.

7. The investment basis shall be reduced by any investment tax credits or similar investment based allowances received by the taxpayer.

(b) **ALLOWED COSTS.** The allowed costs to be deducted from the workback price in arriving at gross value or market price are:

1. DEPRECIATION

(i) The anticipated useful life of the facility shall be determined and the net salvage value estimated. If useful life cannot be determined, then 20 years shall be utilized.

(ii) Each year the Taxpayer shall take as depreciation an amount equal to the difference between the investment basis and net salvage value divided by the number of years of the anticipated life of the facility. Costs added to the investment basis after the first year's depreciation shall be amortized over the then remaining life of the facility.

(iii) A taxpayer may calculate depreciation in the same manner as depreciation is calculated

for the facility in the taxpayer's financial statements prepared in accordance with Generally Accepted Accounting Principles.

(iv) In the event of a sale or other transfer, the acquiring entity, if an affiliate, shall succeed to the then undepreciated investment basis of the transferring taxpayer.

2. RETURN ON INVESTMENT. Each year the taxpayer shall be allowed a return of eleven percent on its average investment basis as depreciated. Due to a final and unappealed from court order, entered in favor of UNOCAL and against the State of Alabama by the Circuit Court of Mobile County, the return on investment provision of this regulation shall not apply to UNOCAL's Chunchula Gas Plant. The return for the Chunchula plant shall be 24.65%, as stated in the above referenced court order.

3. LABOR EXPENSE

(i) All direct labor costs of operation and maintenance personnel assigned on site at the facility through the first level supervisor, including contract services, shall be allowed. The actual cost of engineering and support personnel located on or off the site shall be allowed to the extent such costs can be documented.

(ii) Indirect labor burden, including FICA, vacation, retirement, medical, thrift and savings plans and other similar indirect costs shall be allowed.

(iii) Indirect labor burden shall be limited to 50% of allowed direct labor costs.

4. MATERIALS, SUPPLIES AND EQUIPMENT RENTALS. Materials, supplies and equipment rentals necessary for operations and maintenance of the facility shall be allowed.

5. FUEL AND POWER COSTS

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

(ii) For purchased fuel and power, the allowable cost shall be the amount actually paid to a third party.

(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 \$.68 per MCF or actual cost shall be allowable, up to said gross value, for the cost of producing the fuel.

6. AD VALOREM TAXES. Ad valorem taxes on the facility shall be allowed.

7. ADMINISTRATIVE AND OVERHEAD COSTS. 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.

8. INSURANCE. The taxpayer may deduct the expense of insurance actually carried with respect to the facility, including:

(i) Workers compensation coverage for persons employed in the activities represented by the investment basis.

(ii) Public liability.

(iii) Property damage.

(iv) No deduction shall be allowed for self-insured taxpayers.

9. **TRANSPORTATION CHARGES.** Transportation charges actually paid by a producer to a third party for delivery of oil or gas to the point of delivery or first market transaction shall be allowed.

10. **SOUR GAS COSTS**

(i) If the raw gas processed through a facility contains hydrogen sulfide gas, investment and operational costs attributable to the processing of such gas to recover sulfur must be allocated to the hydrogen sulfide.

(ii) If the market value of the recovered sulfur is less than these costs, the excess of said costs over the sulfur value, shall be included in the allowable hydrocarbon costs.

(c) **ESTABLISHING THE WORKBACK PRICE.** For purposes of establishing a price from which to workback to the point of production, the following shall be applied:

1. The total price received for the oil or gas in the first market transaction, without any deductions, or;

2. In the event of a non-market transaction, a taxpayer shall rely upon certain indexes of value commonly employed for the determination of the price of certain hydrocarbon products. These indexes include, but are not limited to the quotations of the Oil Price Information Service (OPIS) for products sold at Mt. Belvieu, Texas and any index published by industry publications showing the price offered on certain pipelines for gas delivered to their main line facilities. These pipelines include, but are not limited to, Florida Gas Transmission Company, Zone 3; Koch Gateway Pipeline Company, Louisiana; and Transcontinental Gas Pipeline Corporation, Mississippi, Alabama, as published in Inside F.E.R.C.'s Gas Market Report. For gas delivered to a particular pipeline for which an index is published, a taxpayer may rely on said index price. Alternatively, a taxpayer may rely on the average of the prices published for the three pipelines specified above, or any one of these three prices, if consistently applied for a consecutive twelve-month period. Reliance on any such pricing information shall include the following, as appropriate, in each such election:

(i) For OPIS, the location differential between the point of delivery and Mt. Belvieu and how such differential was determined.

(ii) For any pipeline index the amount higher or lower than the index and why such adjustment is appropriate, such as any gathering or transportation charge.

3. In the event of a non-market transaction involving crude oil or condensate, the taxpayer shall provide a representation as to why the prices used are appropriate for value. Such representation shall take into consideration publicly available pricing information for comparable products.

(Sections 40-20-4(d), 9-17-26(d) and 40-2A-7(a)(5), Code of Alabama 1975, effective April 1, 1997)