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LOUISIANA SEVERANCE TAX ISSUES FOR OIL AND GAS PROPERTIES

ROBERT S. ANGELICO, JD, CPA
Telephone 504-556-4112
E-mail rsangelico@liskow.com

LISKOW&LEWIS
New Orleans | Lafayette | Houston

One Shell Square
701 Poydras Street, Suite 5000
New Orleans, LA 70139
www.liskow.com

I. Crude Oil Valuation

A. Constitution

Article 7, Section 4(B) of The Louisiana Constitution of 1974 states that the severance tax is based "upon either the quantity or value of the products **at the time and place of severance**."

B. Statute

The severance tax on oil and condensate ("oil") is based on the value of the oil at the time and place of severance. La. R.S. 47:633(7)(a).

The value at the time and place of severance is defined by statute as "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**." La. R.S. 47:633(7)(a).

In the absence of an arms-length transaction or a posted field price, the statute provides that the value "**shall be the severer's gross income from the property as determined by R.S. 47:158(C)**," an income tax statute relating to determination of the percentage depletion deduction for oil and gas wells for income tax purposes. La. R.S. 47:633(7)(a).

C. Posted Field Price

Historically, oil companies posted a price at which they were willing to purchase oil from a particular well or lease.

D. Louisiana Oil Market

Today in Louisiana there are two markets for purchasers of domestic crude oil – (1) at the well, lease, or field; and (2) at market centers.

Well, lease or field pricing is characterized by purchases of relatively small quantities ranging from 5-20 B/D to 1000-2000 B/D. There is an active and competitive market for crude oil and condensate at the lease, well, or field that is served by numerous crude oil marketing companies.

In Louisiana, the two large market center terminals are St. James and Empire.

A fundamental characteristic of these market center locations is the opportunity for a buyer and a seller to consummate sales of large quantities of crude oil on any given work day. The buyers of the mixed crude stream available at market centers traditionally are refineries or their affiliated companies, and the sellers are large oil companies or aggregators of crude and not individual lease or well owners.

There are minimum amounts of oil that must be batched or delivered to participate in sales at market centers. For example, at St. James Louisiana, the minimum contract delivery is approximately 75,000 barrels.

There are two general price categories that describe crude oil transactions at market center; spot prices and contract prices.

Spot prices mean and refer to the day-to-day pricing that takes place with respect to sales from the market centers. The term "spot" means that parties can go to the market today and conclude a transaction on the "spot."

In contrast to spot prices, contract prices refer to the pricing of crude oil in contracts covering varying time periods. Terms of crude oil contracts range from thirty (30) day "evergreen contracts" (renew every 30 days) to six (6) month contracts and one (1) year or more contracts.

E. Market Center

"Market center" (large oil terminals) developed, in part, to provide large quantities of needed oil to operators of refineries. Oil marketing and gathering companies perform the functions of gathering, transporting, combining, storing and aggregating oil primarily at market centers, where it is sold to refiners and other buyers.

Various publications publish oil prices or indices, representing average prices paid at the *market centers* for specific grades of commingled oil and do not indicate posted prices at the lease or field.

Industry maintains that the concept of a "posted field price" no longer exists in today's oil market, and the concept should be removed from the law.

F. Arms-Length/Non Arms-Length

All will agree that there are different economic factors involved when the purchaser and the buyer are not dealing at arms-length. The current law recognizes this principle; but, the application of the law is inconsistent.

Existing statute does not define arms-length.

For arms-length transactions, the best evidence of value is the actual gross receipts that the producer obtains at the point of sale at or near the lease from the first purchaser, less applicable adjustments for transportation costs borne by the producer to get the oil from the wellhead to the point of the first sale.

G. Non Arms-Length Integrated

Integrated oil companies typically do business at market centers and derive economic benefits from the efficiencies of a market center. Integrated oil companies will generally agree that a "relevant market center" approach can be a useful starting point for the best evidence of value to them, for non arms-length transactions.

However, the value or gross price can be set by reference to a relevant market center price if the market center is not a "one-size-fits-all" and does not look to spot prices. From the market center gross prices, the value at the time and place of severance can be determined by taking into account adjustments, such as risk of recovery, gravity, and differences between the quality of crude produced at a wellhead and the blended quality at a market center. Then, the transportation costs from the place of severance to the place of delivery of the crude oil should be deducted.

Independent oil companies do not derive the same economic benefits from the operations of market centers and the "market center approach" leads to overvaluing oil at the wellhead. Since the economic benefits of a market center do not necessarily enure to the benefit of independent oil companies and their affiliates, the taxable value set by the income tax provisions for calculating percentage depletion in R.S. 47:158(C) provides an objective mechanism for determining value.

II. The Transportation Deduction – Crude Oil Valuation

A. Transportation Deduction

Typically oil produced at a wellhead is transported by truck, barge, or pipeline to a central accumulation point at or near the lease or field called a Lease Automatic Custody Transfer facility ("LACT Unit"). If a producer must incur costs to move oil from the wellhead to the point of sale, the costs must be deducted from the gross receipt at the point of sale to arrive at the value at the wellhead.

The existing statutes and regulations recognize this principle by providing for a transportation deduction, also called a location differential. The regulations allow the producer to deduct from the gross receipts from the first purchaser the higher of the transportation fees actually charged the producer or $0.25/bbl in the event the producer transports the oil by his own facilities. The $0.25/bbl rate was set decades ago as a mechanism convenient to both producers and the Department.

The Department has disallowed the $0.25/bbl deduction for on-lease transportation initially by field audit authority and then pursuant to RIB No. 08-015 (June 30, 2008). Industry believes that any transportation costs borne by the producer to bring the oil from the wellhead to the point of sale should be allowed as a deduction from value.

Industry believes the law needs to be revisited to resolve the ongoing differences between the Constitution, existing statutes/regulations, and the state's recent audit practices.

III. "Payout" for Incentives

A. Payout Calculations

La. R.S. 47:633(7)(c)(iii) and 633(9)(d)(v) provide for the suspension of severance taxes on production of oil and gas from horizontal and deep wells for a period of twenty four months or until the producer has recovered the "Payout" of well costs, whichever occurs first. Payout occurs when the costs allowed by the Office of Conservation as drilling and completion costs equal the gross revenue from the well, less royalties and operating expenses directly attributable to the well.

The Department's regulation on Payout recognizes that the point of valuation is at the well. "Gross revenues at the well" refers to the fact that all revenues at the well count against all drilling and completion costs. That is to say, the Department cumulates monthly revenue, after deducting the costs incurred to get the product from the well to the point of sale, from each producer and subtracts that from total approved drilling and completion costs to determine when a well has paid out.

The Departments does not allow expenses incurred by the producer to get the oil and gas from the wellhead to the point of sale as deductions from the revenue side of the "Payout" calculation. Industry is proposing that the law be modified to make it clear that "gross revenues at the well" are the gross receipts less expenses incurred for gathering, transportation, processing, and manufacturing expenses.

IV. Severance Tax Incentives

A. Horizontal Wells (La. R.S. 47:633(7)(c)(iii))

There is an exemption of severance tax for horizontally drilled wells or horizontal recompletion wells from which production begins after July 31, 1994. The exemption is for a period of 24 months or until payout of well cost, whichever occurs first. La. R.S. 47:633(7)(c)(iii).

For purposes of this incentive, a horizontal well is one with the wellbore drilled laterally at an angle of at least 80 degrees to the vertical and with a horizontal displacement of at least 50 feet in the producing reservoir. La. R.S. 47:633(7)(c)(iii)(aa); DNR Form STRP-HW; La. Office of Conservation, Severance Tax Relief Program, http://dnr.louisiana.gov/cons/conseren/permits/severancetax.ssi. A horizontal recompletion is horizontal drilling in an existing wellbore; (La. R.S. 47:633(7)(c)(iii)(aa) however, extensions of existing horizontal wellbores, in the same sand, are not considered horizontal recompletions. Louisiana Office of Conservation, Severance Tax Relief Program, http://dnr.louisiana.gov/cons/conseren/permits/severancetax.ssi.

To qualify for this incentive, application must be made to the DNR Office of Conservation. Note that if severance tax is paid before the DNR certifies the well's horizontal drilling or recompletion status, the applicant may be allowed a refund of any severance taxes paid since the date of first production on a qualifying well. *See* Louisiana Office of Conservation, Severance Tax Relief Program, http://dnr.louisiana.gov/cons/conseren/permits/severancetax.ssi.

Application consists of the following forms:

- Form STRP-HW. This form consists of a notarized affidavit of a company representative stating that the well is a horizontal well, the date the well commenced production, and the cost of completing the well to the commencement of production (i.e., the payout of the well).

- Well cost statement. The well cost statement is a detailed, itemized listing of the actual costs to drill, complete, and equip the well for production. No AFE or estimated costs are allowed. Costs allowed on the cost statement include, but are not limited to, building a board road, preparing the location, logging, cement, drill bits, pipe, labor, and 3-D seismic cost. The cost to build a flowline to a facility and any new equipment needed to hook the well up to the facility can also be included, but, the cost of an existing facility is not eligible and a newly constructed facility's cost must be prorated to the number of wells it is designed to serve. Costs that are not allowed on the cost statement include, but are not limited to, lease-related costs, legal fees, hearing costs, saltwater disposal wells, and title searches. (Note that horizontal recompletion costs are limited to those costs associated with the horizontal portion of the wellbore.) The well cost statement must be organized and each line item must be identified by actual service or material and not only the vendor/provider. The DNR prefers that expenditures for the same service or material be grouped together in one line item, rather than listed by vendor/provider each time the service or material is charged. The DNR also desires that any accounting or in-house codes be defined.

- Form STRP-3D. 3-D seismic costs must be allocated first to the producing areas (fields) covered by the 3-D project. Then, within each such area, the cost is further allocated to the locations to be drilled on a pro rata basis. Once an application is filed for the first well in an area, the method of allocation of such costs is fixed upon approval of that application and cannot be revised for any reason. In order to qualify, the well must be drilled to a target identified by the full scale 3-D seismic evaluation. 3-D simulation and/or reevaluation utilizing old seismic data will not be considered by the DNR. Memorandum of George L. Carmouche, Commission of the Department of Natural Resources, September 18, 1996. This form requires information related to these requirements and must be completed if the applicant wishes to include 3-D seismic costs in the well cost statement and the total cost shown on Form STRP-HW.

- Directional survey and stratigraphic lateral wellbore projection.

- Form WH-1, Well History and Work Resume Report.

B. Deep Wells (La. R.S. 47:633(9)(d)(v))

Wells drilled to true vertical depths of more than 15,000 feet, and production of which commences after July 31, 1994, are exempt from severance tax from the date production begins for 24 months or until payout of the well cost, whichever occurs first. La. R.S. 47:633(9)(d)(v). The exemption includes wells sidetracked below 15,000 feet true vertical depth from which production commenced after July 31, 1994 in the sidetrack hole. Memorandum of George L. Carmouche, Commission of the Department of Natural Resources, September 18, 1996. All production from such well is exempt, regardless of whether made from above or below 15,000 feet. *See* Memorandum of Ernest A. Burguieres, III, Commissioner, Department of Natural Resources, January 5, 1995.

Like the other exemptions, this one requires a company to apply to the DNR for certification. If the DNR does not certify the well's deep well status before the applicant must pay severance taxes, the applicant may be allowed a refund of any severance taxes paid since the date of first production on a qualifying well. *See* Louisiana Office of Conservation, Severance Tax Relieft Program, http://dnr.louisiana.gov/cons/conseren/permits/severancetax.ssi.

The DNR application consists of the following:

- Form STRP-DW. This form consists of a notarized affidavit of a company representative stating that the well qualifies as a deep well and to the cost of completing the well to the commencement of production (i.e., the payout of the well cost).

- Well cost statement. See the description of well cost statement in the section on the Horizontal Drilling exemption above. Note that if applying for a well that is sidetracked below 15,000 feet, the cost is limited to expenditures related to drilling the sidetrack. Memorandum of George L. Carmouche, Commission of the Department of Natural Resources, September 18, 1996.

- Form STRP-3D. See the description of Form STRP-3D and the requirements for including 3-D seismic costs in well costs in the section on Horizontal Drilling exemption above. This form is necessary if the applicant wishes to include 3-D seismic cost in the well cost statement and in the total cost shown on Form STRP-DW.

- Directional survey (if applicable).

- Form WH-1, Well History and Work Resume Report.

- Form COMP, Well Completion or Recompletion Report.

C. Incapable Wells (La. R.S. 47:633(7)(b))

Wells classified by the Commissioner of Conservation and determined by the Secretary of the Department of Revenue to be incapable of producing an average of more than 25 barrels of oil per producing day during the entire taxable month, and which also produce at least 50% saltwater per day, shall receive an incentive such that the severance tax rate will be 1/2 of the normal rate, or 6.25%. In order to receive this incentive the well must be certified by the Department of Revenue as incapable of such production on or before the 25th day of the second month following the month of production. Oil that is severed from a multiple well lease or property is not subject to this reduced tax rate unless **all** such wells are certified as incapable.

D. Stripper Wells (La. R.S. 47:633(7)(c)(i))

Stripper wells are those classified by the Commissioner of Conservation as an oil well and certified by the Department of Revenue as being incapable of producing an average of more than 10 barrels of oil per producing day during the entire taxable month. The severance tax rate for stripper wells is 1/4 of the normal rate, or 3.125%. However, oil produced from a certified stripper well is exempt from any severance tax in any month in which the average value is less than $20.00 per barrel. In order to receive this incentive, the well must be certified by the Department of Revenue as a stripper well on or before the 25th 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 10 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 10 barrels per day during the entire calendar month.

E. Stripper Fields (La. R.S. 47:633(7)(c)(ii))

This incentive applies to oil produced from a well in a stripper field (defined as those geological formations as designated by rules and regulations of the Department of Revenue that have been historically recognized as being "stripper fields" and is utilizing stripper wells for oil production) and which are classified by the Commissioner of Conservation as a mining and horizontal drilling project that utilizes gravity drainage to a collection point in a down hole operations room. The incentive here is that the severance tax rate on the working interest portion is equal to 3.125% until the cumulative value of hydrocarbon production from the project equals 2-1/3 times the private investment, that which is invested by the working interest owners, in the project. "Private Investment" is defined as those costs associated with project design, fabrication, installation of equipment, drilling and completion costs of wells, and any other costs directly associated with said project. A "working interest owner" is defined as the owner of a mineral right who is under an obligation to share in the cost of drilling and completing a mining and horizontal drilling project and excludes a person who does not invest and does not take a financial or economic risk in the drilling for and the actual production of the oil.

F. Reclaimed Oil (La. R.S. 47:648.21)

"Reclaimed oil" is defined as meaning the reclamation of waste oil or slop crude oil and condensate from open pits, tanks, or other collectors at the lease production site. Reclaimed oil does not include any oil upon which any severance tax has previously been paid. The incentive here is that the tax rate applicable to reclaimed oil which is reclaimed by class 1 salvage crude reclamation facilities that are permitted by the Office of Conservation shall be 3-1/8% of the value received by the first purchase. However, any person, or affiliate of a person, actually engaged in severing oil, gas, or other natural resources from the soil or water, or actually operating oil or gas property, or other property from which natural resources are severed, shall not be eligible for the tax rate applicable to reclaimed oil.

G. Produced Water Injection (La. R.S. 47:633.5)

This incentive exists in order to help accomplish the objective of reducing the discharge of produced water, to help ease the tremendous financial burden placed upon the oil and gas industry with regard to produced water. The purpose of this provision is to provide an economic incentive to producers of oil and gas by allowing them to realize a severance tax savings if they inject produced water into an oil and gas reservoir, from the same reservoir and field, for the purpose of increasing the recovery of hydrocarbons therefrom. The incentive here is that on the recovery of oil, when produced water is injected into an oil reservoir for the purpose of increasing recovery, the severance tax on one barrel of oil incrementally produced therefrom shall be reduced by 20% of the tax that would otherwise be due.

V. New Legislation

A. Act 658(H.B. 712) Regular Session, 2014, Limitation of Interest Paid on Refunds Due to Severance Incentives.

This legislation will limit the amount of interest that the Department of Revenue will pay on severance tax refunds that are related to the severance tax incentives for horizontal wells and deep wells. If the refund is paid within 180 days of the filing of the claim for refund or an amended return that includes all supporting documentation, the interest on the refund shall be paid at the U.S. Treasury Yield Curve Constant Maturity 6-Month Treasury rate on the first business day of October of the preceding year, such rate to be published on or before January 1st of the following year. If the refund is paid after 180 days from the filing of the claim, interest shall be paid at the U.S. Treasury based rate for the first 180 days, and the Louisiana judicial rate of interest for any period of time after the 180 days in accordance with the new legislation.

The fiscal note for this bill indicated that over the last few years the Department of Revenue has seen a spike in the amount of severance tax refunds paid. During the year 2012 severance tax refunds were averaging about $7.8 million per month. The Department indicated that 81% of this monthly average was associated with the horizontal and deep well severance tax incentives.

Based on those amounts, the Department projected that it was paying an annual average amount of interest of $4.5 million per year.

The interest rate provided in the legislation, the U.S. Treasury Yield Curve Constant Maturity 6-Month Treasury Bill rate, is currently about 0.05% and has averaged 0.10% since 2011. Currently the Louisiana judicial interest rate is 4%.

The legislation was signed by the Governor on June 18, 2014. However, the fiscal note indicates that the first establishment of the 6-month U.S. Treasury rate will occur at the beginning of October 2014 for first application to refunds paid after January 1, 2015.

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