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October 7, 1971

Honorable Robert S. Calvert
Comptroller of Public Accounts
Austin, Texas

Opinion No. M- 968

Re: Calculation of production tax under Ch. 3, Title 122A, Taxation-General, V.C.S., on State owned leases.

Dear Mr. Calvert:

We have received your request for our official opinion reading as follows:

"Reference is made to your Opinion No. M-943, dated August 23, 1971, which opinion was requested by Honorable Bob Armstrong, Commissioner of the General Land Office.

"Based on the same facts presented to you by the Commissioner of the General Land Office, your opinion is requested as to the application of the tax on producers of natural gas, specifically Article 3.01 and 3.02, Title 122A, Taxation-General Revised Civil Statutes of Texas.

"In arriving at the taxable market value, is the producer or operator of the lease entitled to deduct from the sales price of the gas at the platform a proportionate part of the amortization of the costs of the facilities referred to and the costs of operating the facilities:

"If your answer to this question is to the effect that the producer or lease operator is entitled to deduct a proportionate part of the costs, should such costs be limited to only the compression and/or dehydration facilities, plus operating costs and maintenance, or should the costs include some part of the cost of the platform on which the compression and dehydration facilities are located?

> "If the producer or lease operator is entitled to deduct from the sales price of the gas at the platform a proportionate part of the amortization of the costs of the facilities referred to and the costs of operating the facilities, your opinion is requested as to the application of the Texas Supreme Court's decision, Item No. 1, Mobil Oil Corporation vs. Robert S. Calvert, et al., No. B-170.[1] In other words, since there is no production tax due on the state's royalty interest, is the producer or lease operator entitled to deduct 5/6ths of the costs, or is he entitled to deduct 6/6ths of the costs from the sales price of the 5/6ths taxable portion of the gas?"

The pertinent facts referred to in the foregoing request, as taken from our Opinion No. M-943, are as follows:

> ". . . The lease operator holds several State oil and gas leases in the Gulf of Mexico upon each of which it has drilled several wells that produce natural gas. On each lease one of the wells is a platform well or production deck well upon which are heaters, gas production separators, dehydrators, and metering devices for gas, condensate, and water. Each lease also contains one or more satellite wells upon which are a heater, meter regulator, valves, and flow lines running from the satellite well to the platform well. After the gas has been processed through the above mentioned facilities, it is sold by the operator to the gas gatherer-purchaser at the platform well."

Our answer to your first question is that the costs of readying the gas for market after it has been produced, such as processing and transportation, are deductible from the gross sale price of the gas in order to ascertain its taxable market values. If the producer is required to provide other equipment and machinery for the purpose of making the gas ready for market, such as compressors, then it would be proper to allow all these

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1. Reported at 451 S.W.2d 889.

costs of processing, transportation and compression to be amortized in arriving at the cost of readying the gas for market. These costs preparatory to marketing are properly deductible from the gross proceeds received from the sale of the gas in order to arrive at the taxable market value of the gas sold as contemplated by Article 3.02, Title 122A, Taxation-General, Vernon's Civil Statutes. Mobil Oil Corp. v. Calvert, 451 S.W.2d 889 (Tex.Sup. 1970).

Our answer to your second question is that only such facilities as are necessary for processing or making the gas ready for marketing after it is produced, and which facilities would not be needed were it not necessary to process the gas for this purpose, would be deductible as a part of the costs of marketing the gas. No expense attributable to the platform should be deducted.

Our answer to your third question is that the rule laid down in Mobil Oil Corp. v. Calvert, supra, is controlling. In construing that case, our opinion is that the method for determining the amount of tax due under the facts you present to us is as follows: multiply the gross sale price of the gas for a given length of time (less the allowed cost of processing and transportation) times the tax rate of 7½%. The total tax due is then allocated between the various interest owners in proportion to the interest owned. For instance: if the gross sale price of the gas is $60,000 and the cost of processing and transportation is $6,000 then the taxable market value is $54,000. The taxable market value of $54,000 is then multiplied by the tax rate of 7½% to get the total tax due of $4,050. The total tax of $4,050 is then multiplied by the fractional interest of the taxpayer, which is given by you as 5/6ths, to determine how much of the tax is owed by the producer. That sum is $3,375. If the royalty owner were a non-exempt taxpayer owning a 1/6th interest in the proceeds, then his tax would be computed by multiplying the total tax due of $4,050 by 1/6th to arrive at the sum of $675.

The case of Mobil Oil Corporation v. Calvert, 451 S.W.2d 889 (Tex.Sup. 1970), referred to in your opinion request, announces principles of law particularly pertaining to and controlling the questions here involved. In that case the court in defining the provisions of Chapter 3, Taxation-General, Vernon's Civil Statutes, relating to the calculation of the tax on producers of natural gas, held, at page 892 of the opinion, as follows:

"We find no sound basis in the quoted statutes for holding that the tax imposed thereby must be computed on each ownership interest separately. We hold that the market value of gas at the mouth of the well in cases such as this is measured, as to all ownership interests, by the total proceeds of the sale of the component parts of the gas after processing, less transportation and processing costs; and that each taxable ownership interest is liable to the State for its proportionate part of the tax computed on market value as thus ascertained. Our holding is predicated upon our conclusion that the descriptive noun, 'producer,' as used in the statutes, defines two classes or persons, to wit: (1) all owners of interests in the gas as defined in Art. 3.04(1), including royalty owners, and (2) only those owners of working interests who actually produce the gas; and by our further conclusion that the provisions of Art. 3.01(1) directing that the tax be computed by each producer on the amount of gas produced and saved, refers to the second class of producers. Considered in connection with the provisions of Art. 3.04(11), Art. 3.01(1) would seem to bear no other reasonable interpretation. When the statute is interpreted as indicated, the tax to be paid was not affected by Mobil's agreement to assume payment of the processing costs theretofore paid by the royalty owners." (underscoring added)

Thus, according to the Mobil Oil case, the total tax due under Article 3.01 is calculated upon the basis of the total proceeds of the sale of all component parts of the gas produced, less allowable transportation and processing costs. The tax so calculated is then borne ratably by the various interested parties. The formula for calculating the tax due is: sale price, less allowable transportation and processing, times tax rate, times taxpayer's ratable interest.

S U M M A R Y

In calculating the amount of natural gas production tax due from a producer owning the working interest in a lease in which the State

of Texas, as a royalty owner, is an exempt producer, the gross sale price of the gas produced for a given length of time, less the allowed cost of processing and transportation, is to be multiplied by the fractional interest of the taxpayer and the tax rate applied to the resulting figure. This method of tax calculation under Chapter 3, Title 122A, Taxation-General, V.C.S., effects an allowance of a deduction of costs from the proceeds of sale to the producer owning the working interest in an amount proportionate to his interest in the lease.

All facilities necessary and pertaining solely to the processing of the gas for market after it is produced, plus reasonable operating and maintenance costs thereof, may be deducted from the proceeds of sale as part of the costs of marketing such gas. If such facilities and equipment are necessary for the purpose of making the gas ready for market, it is proper to allow the costs thereof to be amortized in arriving at the cost of readying the gas for market.

Yours very truly,

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