OPERATIONAL PLANNING WITHIN THE PRICE REGULATORY AND WINDFALL PROFIT TAX FRAMEWORK

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Federal regulation of prices charged by producers of crude oil was based on a "property" concept focusing on the "right to produce" as it existed in 1972, which the Department of Energy (DOE) and its predecessor, the Federal Energy Administration (FEA) attempted to define and clarify through numerous Rulings, Interpretations and Decisions. Producers often faced substantial liabilities in the context of compliance actions by the Economic Regulatory Administration of the Department of Energy by reason of their failure to designate properties in accordance with Department of Energy Regulations and Rulings. By the same token, however, Producers often failed to take advantage of the substantial flexibility inherent in the DOE property definition.

Unfortunately the ambiguities, interpretative problems, uncertainties and risks which have attended property determinations and designations under crude oil pricing regulations did not cease to exist on January 28, 1981, when President Reagan signed an Executive Order removing all federal price controls on crude oil. The Crude Oil Windfall Profit Tax Act of 1980 relies upon and incorporates by reference the Department of Energy regulations as they existed in June, 1979, for purposes of determining the appropriate taxation tier for crude oil--"without regard to decontrol of oil prices or any other termination of the application of such regulations." I.R.C. Section 4996 (b)(8)(C). The term "property" which was the pivotal concept in determining whether crude oil qualified as "new oil," production from a "stripper property" or "newly discovered crude oil" under the June, 1979, regulations has been defined in Section 150.4996-1 of the excise tax regulations under the windfall profit tax as having "the same meaning as that term is given by the energy regulations. See 10C.F.R. Section 212.72(a); FEA Rul. 1977-1, 42 F.R. 3628 (1977)." Just as a failure to understand and properly apply the property definition under price regulations resulted in substantial over or undercharges by producers, such failure could result in taxation at an improper tier under the Crude Oil Windfall Profit Tax Act of 1980, resulting in some instances, in taxation of crude oil production at substantially higher rates under one tier than would apply under another tier for which the production could also properly qualify.

The following discussion is intended only to point out the factors involved in a property analysis and is not intended to serve as a complete guide to property determinations.

THE PROPERTY DEFINITION

Since September 1, 1976, the Department of Energy's definition of property has read as follows:

> "the right to produce domestic crude oil, which arises from a lease or from a fee interest. A producer may treat as a separate property each separate and distinct producing reservoir subject to the same right to produce crude oil, provided that such reservoir is recognized by the appropriate governmental regulatory authority as a producing formation that is separate and distinct from, and not in communication with, any other producing formation." 10 C.F.R. 212.72.

Numerous Rulings and Interpretations of the Department of Energy and its predecessor, the Federal Energy Administration, including 10 C.F.R. Section 212.72, Rulings 1975-15, 1977-1 and 1977-2, Interpretations 1978-5 and 1978-15, have established that it is not just any "right to produce" which establishes a property, but the right to produce (physical tract described in the instrument creating the right to produce) as it existed on January 1, 1972. Pre-1972 subdivisions of a lease dated prior to 1972 establish separate properties, while post 1972 subdivisions, through assignments, farmouts or even new leases are not permitted to alter the DOE property defined with reference to the 1972 right to produce crude oil.

Federal Energy Administration Rulings 1977-1 and 1977-2 set forth limited cases in which the agency has acknowledged that it would appear inequitable to apply the literal 1972 tract basis of the definition of property:

(1) Distinct developmental rights and obligations with respect to tracts under a lease.

If a specific tract or tracts under a single lease is/are identified as subject to rights and obligations of the Lessee different from rights and obligations specified for other tracts subject to the lease, and if the exploration and developmental history reflects separate treatment, separate properties have been recognized.

(2) Very large tracts subject to a single right to produce.

Leases covering an unusually large block of acreage often encompass separate geological structures (e.g., faults, anticlines, monoclines, synclines, and domes). Where such structures were historically accounted for and developed as separate properties, the agency has recognized permissibility of separate property treatment.

(3) Noncontiguous tracts.

A frequently utilized "exception to the rule" in property designations is the separate property treatment permitted for non-contiguous tracts wich are subject to the same base lease. Separate property treatment is permitted for such tracts, including even tracts which are joined at a corner or in a checkerboard pattern, if such treatment is consistent with historic operational and accounting practices for the tracts.

(4) Unitization of less than the total lease.

Where less than the total premises subject to a lease are aggregated or unitized with portions of premises subject to other leases, the Agency has recognized the creation of a distinct and separate right to produce. In Ruling 1977-1, DOE observed that "it is not uncommon for less than the total premises subject to a right to produce to be unitized or otherwise aggregated with all or portions of premises subject to other rights to produce, to form a single "property", leaving the balance of the premises formerly subject to a single right to produce not aggregated with any other such rights. The portion of the premises which is not aggregated is appropriately recognized as a property separate and apart from the portion of the premises which has been aggregated with other rights to produce."

(5) Severance tax or royalty owner accountability.

In very limited circumstances the Department of Energy has recognized separate property treatment for tracts subject to a single lease which are not subject to the same severance tax rate or which are accountable to royalty owners separately, i.e.,

where an obligation to pay royalty on production from one tract will not entail an obligation to pay royalty owners under another tract subject to the same lease.

(6) Unitizations.

The Department of Energy has permitted units created by combining separate leases or fees to be treated as a distinct property, provided that a bona fide operational reason exists for the aggregation and that the unit is approved or recognized by the appropriate state jurisdictional authority. Merely operating multiple leases as a unit without a formal agreement or production allocation formula does not constitute the unit a separate DOE property. Sauder v. DOE 4 Energy Mgt. (CCH) Paragraph 26,157 (D. Kan. 1979).

(7) Designation of separate reservoirs as separate properties.

Since September 1, 1976, the definition of property set forth in 10 C.F.R. 212.72 has included separate reservoirs which a producer may elect to treat as separate properties. Reservoirs so designated must be recognized by the state regulatory agency as distinct and not naturally in communication with other reservoirs underlying the same lease. The separate reservoir election cannot be made if the producer commingles production from multiple reservoirs in the wellbore. Wells producing from more than one reservoir must have separate tubing strings utilized for each reservoir.

OPERATIONAL PLANNING CONSIDERATIONS

The purported rationale for a basic property definition focusing on the 1972 right to produce was discussed in the Federal Energy Administration Interpretation 1977-42 (November 4, 1977)--

> "...it would be wholly irrational, in the context of the definition of 'property' in Section 212.72 to interpret 'lease' as a reference to a particular lessee's rights under a particular lease. If a 'new' property (and thus 'new' crude oil) could be created merely through the execution of new leasehold agreements between the same lessor and lessee, or through the substitution of a new lessee, the purpose of the two tier crude oil pricing system as a production incentive would be quickly circumvented and defeated. The price regulations applicable to producers of crude oil require for their effectiveness a concept of 'property' which provides a constant frame of reference for measurement of crude oil production between the base level and the current level." (Emphasis added).

The consequence of DOE's focus on a fixed point in time (January 1, 1972) as the point of departure for property determinations has established a price regulatory and now windfall tax basic principle--farmouts, assignments and even new leases after 1972 do not establish new properties if the acreage which is the subject to the new farmout, assignment or lease was subject to a 1972 lease or any subsequent lease which was treated as a DOE property.

The focus on the lease as it existed in 1972 caused producers to be denied new oil pricing for production from a new lease which had been part of a prior lease in force in 1972. Interpretation 1978-15, April 14, 1978. The same property definition, however, permitted producers to obtain stripper pricing for farmouts or even new leases where the applicable property (lease as it existed in 1972) had previously qualified as a stripper property by reason of twelve consecutive months of qualifying stripper level production after December 31, 1972. Interpretation 1978-5, February 20, 1978.

Although an early draft of the crude oil decontrol program published in January, 1979, would have defined newly discovered crude oil on a well-by-well eligibility basis along the lines of pricing regulations of the Federal Energy Regulatory Commission under the Natural Gas Policy Act of 1978, the well-by-well format originally proposed was ultimately rejected because of inconsistency with the historic "property" basis of crude oil pricing regulations. Under the regulations finally adopted and effective June 1, 1979, newly discovered crude oil (exempt from price controls) was defined as production from a property from which no crude oil was produced in calendar year 1978. (10 C.F.R. 212.79, amended effective January 1, 1981, to include production from properties from which there was no crude oil produced and sold in commercial quantities during 1978.)

Under the Crude Oil Windfall Profit Tax Act of 1980, oil which would have been classified as other than oil from "stripper well properties" or "newly discovered crude oil" is subject to a seventy percent tax on the windfall profit (50% for independents). For oil from "stripper well properties" the tax is sixty percent of the windfall profit (30% for independents) and for oil qualifying as newly discovered crude oil the tax is thirty percent of the windfall profit. All oil in this most favored tier is taxed at the thirty percent rate and the base price and base price adjustment are higher.

From a planning standpoint, all producers are desirous of maximizing the amount of crude oil taxable as tier 3 oil. For independent producers, stripper properties acquired other than from integrated companies or other disqualified transferors are also subject to relatively favorable windfall tax treatment.

In order to determine the windfall tax tier applicable to a new lease or farmout it is first necessary to determine the appropriate "property" for DOE regulatory purposes. A new previously undeveloped one-section lease may, for example, initially appear promising for newly discovered crude oil and tier 3 treatment. If a title search establishes that in 1972 the new, single section lease was part of a larger lease for which a Base Production Control level was established, then notwithstanding expiration of the prior 1972 lease, the acreage covered by that lease defines the applicable property. Newly discovered crude oil and tier 3 eligibility will depend upon whether the larger block of acreage which was covered by the 1972 lease had production during 1978. If production was obtained during 1978 by the operator of an adjacent one section lease which was subject to the common prior base lease in 1972, the newly discovered crude oil and tier 3 treatment is not available. In determining the windfall tax treatment which will apply to an acreage acquisition, it is desirable to remember that the new property for business purposes may not be the applicable property for regulatory and windfall profit tax purposes.

In considering windfall taxation tiers applicable to acreage obtained by farmout or by new leases, it is important to remember that the constancy of the property definition means that no new lessee or farmoutee can, by reason of the new acquisition alone, establish a new property. In every instance the basic definition of property as the physical tract subject to lease in 1972 and the limited exceptions to that definition must be considered. In determining newly discovered and tier 3 eligibility, two dates must always be kept in mind--January 1, 1972, for purposes of initial delineation of the DOE property, and calendar year 1978, for purposes of determining whether production from the DOE property qualfies as newly discovered.

The elective separate reservoir property designation and the permissibility of treating non-contiguous tracts as separate properties (if consistent with historic practice) represent two possibilities for tier 3 classification of production from a lease from

which production was obtained in 1978. A lessee or farmoutee who obtains production from a reservoir from which there was no 1978 production may receive tier 3 windfall tax treatment even though production from the same lease was obtained during 1978 from a different reservoir. Similarly, farmouts or new leases covering non-contiguous tracts which had no 1978 production but are subject to 1972 base leases which had production from other tracts during 1978 may also qualify for tier 3 classification if historic development and production accounting warrant separate property treatment.

CONCLUSION

There is understandable reluctance on the part of producers acquiring leases and farmouts in 1981 to undertake a detailed review and title search of the status of leasehold rights as they existed in 1972. In view of the fact that the complex and somewhat arbitrary DOE property definition has been incorporated in the Crude Oil Windfall Profit Tax of 1980, however, such a review and search will be necessary until the scheduled expiration of the tax near the end of the present decade or until the pertinent provisions of the Act are amended or repealed.