

ACTION ON DECISION

Subject: Pacific Enterprises and Subsidiaries v. Commissioner
101 T.C. 1 (1993)
T.C. Dkt. No. 5295-91

Issue:

Whether the cost of recoverable cushion gas and recoverable line pack gas, the gas used to maintain adequate pressure in a gas storage facility and a pipeline, respectively, is properly treated as (i) merchandise and thus included in inventory; (ii) a depreciable capital asset; or (iii) a nondepreciable capital asset.

Discussion:

The petitioner operated underground storage reservoirs and an extensive gas pipeline transmission and distribution system in order to provide natural gas service to residential, commercial, and industrial customers in central and southern California. Underground storage reservoirs for natural gas are rock formations. Reservoirs have varying degrees of density, consistency, size, and depth, yet all have permeability and porousness.

Natural gas stored in storage reservoirs is divided into working gas and cushion gas. Working gas is the volume of natural gas in the reservoir above the designed level of cushion gas. The petitioner and the government agree that working gas is inventory. Cushion gas is the minimum volume of gas required in an underground storage reservoir to provide the pressure necessary to deliver working gas volumes to customers. Cushion gas is subdivided into recoverable cushion gas, the volume of cushion gas which will be recovered upon abandonment of the reservoir, and nonrecoverable cushion gas, the volume of cushion gas which will remain in the reservoir upon abandonment.¹ Pipelines have similar divisions: working gas/inventory is called "pack the line" gas and the gas to maintain pressure is called line pack gas.

The taxpayer considered recoverable cushion gas and recoverable line pack gas as depreciable capital assets. The government argued that recoverable gas was inventory.

Relying on Rev. Rul. 68-620, 1968-2 C.B. 199, a ruling applicable only to line pack gas, the Service argued that recoverable cushion gas and recoverable line pack gas are merchandise and thus includible in inventory. The government argued that the fungibility of the gas and the physical similarity

¹ Nonrecoverable cushion gas is capitalized to the reservoir and depreciated over the life of the reservoir. Rev. Rul. 75-233, 1975-1 C.B. 95.

of molecules means that recoverable gas is sold to customers as merchandise. Also, by definition, recoverable cushion gas or recoverable line pack gas is retrieved at some point in operations and can be sold as merchandise. However, the recoverability of such gas usually occurs only upon abandonment of a reservoir or pipeline, which is often 20 years after injection.

Noting that physical similarity does not necessarily control classification as inventory, the Tax Court concluded that the recoverable gas was not held for sale in the ordinary course of business, and hence not "merchandise." The eventual sale of the recoverable gas upon abandonment was viewed as a salvageable portion of total cushion and linepack gas, akin to sales of capital assets upon liquidation. The court further held that recoverable gas is nondepreciable because it is not subject to exhaustion, wear and tear or obsolescence, agreeing with the Fifth Circuit's decision on this issue. See Arkla, Inc. v. United States, 765 F.2d 487 (5th Cir. 1985), rev'g 592 F. Supp. 502 (W.D. La. 1984) [involving only recoverable cushion gas]. Accordingly, the court found that recoverable cushion gas and recoverable line pack gas were nondepreciable capital assets and not inventory.

In accord with the Tax Court and the Fifth Circuit, the Federal Circuit has likewise held that recoverable gas is not inventory but is properly characterized as a nondepreciable capital asset. Washington Energy Co. v. United States, 94 F.3d 1557 (Fed. Cir. 1996) [involving only recoverable cushion gas]; Arkla, Inc. v. United States, 37 F.3d 621 (Fed. Cir. 1994), cert. denied, 115 S. Ct. 1339 (1995) [involving both recoverable cushion gas and recoverable line pack gas]. The Service now agrees that the recoverable portion of cushion gas or line pack gas is not merchandise held for sale as inventory. Instead, recoverable cushion gas and recoverable line pack gas are appropriately treated as nondepreciable capital assets.

Recommendation:

Acquiescence. Revocation of Rev. Rul. 68-620.

Reviewers:

GMH

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