

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-114540-02/CC:PSI:B7

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

LEGEND:

Taxpayer =

Location: =

Plant: =

X =

Y =

ISSUE:

Are natural gas liquids that are removed from a gas stream in a gas plant before the gas is first sold eligible for the credit provided in section 29 of the Internal Revenue Code as "gas produced from a tight formation?"

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CONCLUSION:

Natural gas liquids that are removed from a gas stream in a gas plant before the gas is first sold, are not eligible for the section 29 credit as "gas produced from a tight formation."

FACTS:

Taxpayer holds interests in a number of gas wells in Location that produce mostly from two formations, one of which is a designated "tight formation." The gas from these wells is transported to Taxpayer's Plant near Location. At the Plant, condensate is removed from the gas stream before the inlet meter of the Plant. From the remaining gas stream, the natural gas liquids (NGLs) also are removed and sold in liquid form through an intrastate liquid pipeline. The remaining dry gas stream is sold in gaseous form at the tailgate of the Plant to various purchasers in the interstate gas market.

On its federal income tax returns for its x through y tax years, Taxpayer claimed the section 29 credit for the entire gas stream produced from its wells. The entire gas stream included those hydrocarbons which were sold as dry gas at the tailgate of the plant (mostly methane) and the NGLs sold in liquid form (mostly ethane and propane).

LAW AND ANALYSIS:

Section 29(a) provides a credit for the taxable year for qualified fuel sold by the taxpayer to an unrelated person during the taxable year, the production of which is attributable to the taxpayer.

Section 29(c)(1)(B)(i) defines the term "qualified fuels" to include gas produced from a tight formation.

Section 29(c)(2)(A) provides that, except as provided in section 29(c)(2)(B), the determination of whether any gas is produced from geopressured brine, Devonian shale, coal seams, or a tight formation shall be made in accordance with section 503 of the Natural Gas Policy Act of 1978.

Section 29(c)(2)(B) provides that the term "gas produced from a tight formation" only includes gas from a tight formation --

- (i) which, as of April 20, 1977, was committed or dedicated to interstate commerce (as defined in section 2(18) of the Natural Gas Policy Act of 1978, as in effect on the date of the enactment of this clause), or
- (ii) which is produced from a well drilled after such date of enactment.

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The legislative history underlying section 29 and its statutory language show that the credit for gas produced from a tight formation is closely tied to the intent and policies of the Natural Gas Policy Act of 1978 (NGPA). Prior to 1990, section 29(c)(2)(B) provided that gas produced from a tight formation included only: (i) gas the price of which was regulated by the United States, and (ii) gas for which the maximum lawful price applicable under the NGPA was at least 150 percent of the then applicable price under section 103 of the NGPA. Thus, only gas that was regulated under the NGPA was eligible for the section 29 credit as gas from a tight formation.

The NGPA, which was passed on November 9, 1978, gave the Federal Energy Regulatory Commission (FERC) the authority to regulate ceiling prices of first sales of various types of gas. One such type of gas was "high-cost" gas, which was defined in section 107 of the NGPA as: (1) gas below 15,000 feet; (2) gas from geopressured brine; (3) gas from Devonian shale; and (4) gas produced under such other conditions as the Commission determined to present extraordinary risks or costs. It was under this last category that FERC defined the term "tight formation," and promulgated regulations allowing gas from a "tight formation" to receive the higher ceiling prices of "high-cost" gas.

The NGPA provided for the phased deregulation of natural gas. Various categories of gas were deregulated over a period of time. Only section 103 wells committed or dedicated to interstate commerce remained regulated throughout the life of the NGPA. The Wellhead Decontrol Act of 1989, Pub. L. No. 101-60, 103 Stat. 157, provided for the permanent decontrol of all first-sales gas prices, effective January 1, 1993. Thus, under the Wellhead Decontrol Act all previously regulated gas was deregulated as of January 1, 1993.

In 1990, FERC issued Order No. 519, which provided that regulated tight formation gas produced from wells drilled after May 12, 1990, would no longer qualify for an incentive price under the NGPA. As a result of this order, tight formation gas produced from wells drilled after May 12, 1990, was not eligible for the section 29 credit because it was no longer regulated gas. The cumulative effect of the legislation and the FERC order was that as of January 1, 1993, the section 29 credit was no longer available to gas produced from tight formations.

In response, Congress amended section 29(c)(2)(B) as part of the Omnibus Budget Reconciliation Act of 1990, Pub .L. No. 101-508, 104 Stat. 1388. Congress noted in the legislative history underlying section 29(c)(2)(B) that "[a]s a cumulative result of various legislative and regulatory actions that have occurred since section 29 credit was enacted, the credit presently is not and no longer will be available for any such gas as of January 1, 1993." H.R. Rep. No. 964, 101st Cong., 2d Sess. 134 (1990). The Senate Report underlying section 29(c)(2)(B) states as follows:

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Specifically, the bill treats as qualifying tight formation gas any gas produced from a tight formation (1) which is produced from a well drilled after December 31, 1990, or (2) which, as of April 20, 1977, was committed or dedicated to interstate commerce (within the meaning of section 2(18) of the Natural Gas Policy Act of 1978 as in effect on the date of enactment of this bill). Wells producing gas that was not committed or dedicated to interstate commerce as of April 20, 1977, and thus was subject to decontrol under provisions of the Natural Gas Policy Act of 1978, will not qualify for the credit under the bill.

101 Cong. Rec. S15674 (October 18, 1990). See also H.R. Rep. No. 964, 101st Cong., 2d Sess. 134-135 (1990) (Conference Report).

The legislative history under the 1990 amendment to section 29(c)(2)(B) indicates that the purpose of the amendment was to reinstate the credit for gas that was eligible for the credit prior to deregulation. The Senate Report described the reasons for the new provisions as follows:

The committee does not believe that under the current economic environment, provision of the credit to tight formation gas should be linked to a requirement that the price for such gas be subject to Federal regulation... The committee believes that “**reinstatement**” of the production credit for tight formation gas is desirable in order to accelerate increase in natural gas production... (emphasis added).

Under the bill, gas produced from certain tight formations is **reinstated** as qualifying for the section 29 credit, and any requirement that such gas be regulated for price incentives is repealed... (emphasis added).

101 Cong. Rec. S15674 (October 18, 1990).

The legislative history does not indicate any intention to expand the scope of the credit to cover additional fuels or broaden the definition of existing ones. Therefore, only gas that qualified as gas from a tight formation under former section 29(c)(2)(B), qualifies as gas from a tight formation under current section 29(c)(2)(B). Accordingly, whether the NGLs in this case are eligible for the credit as gas produced from a tight formation depends on whether they were subject to regulation under the NGPA.

The NGPA provided for the regulation of ceiling prices of first sales of various types of natural gas. The NGPA, however, did not provide a detailed definition of the term “natural gas. Section 2(1) of the NGPA simply provided that “the term natural gas means either natural gas unmixed or any mixture of natural and artificial gas.” FERC regulatory orders interpreting the NGPA, however, shed light on what commodities were not considered to be gas for purposes of the NGPA.

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FERC Order No. 94, for example, implemented section 110 of the NGPA, which provided that the price for the first sale of natural gas was not considered to have exceeded the maximum lawful price applicable to the first sale of the natural gas if the first sale price exceeded the maximum lawful price to the extent necessary to recover production-related costs. Order No. 94 states as follows:

All of this suggests that costs which attend the production of natural gas can be broken down into three categories: costs necessary to bring the gas out of the ground and to the wellhead (the costs of finding the gas, of drilling and providing facilities and the costs of maintaining production); costs which go to the production and handling (including separation, storage, and transportation) of **nongas commodities like oil and natural gas liquids**;... (emphasis added).

In implementing the Natural Gas Act, we find that oil and liquids are not included in the definition of "natural gas". This was true in pipeline rate cases where the issue is one of jurisdiction, and it was true after the inauguration of producer rate regulation. Given this history, and given the view that, whatever else our jurisdiction under the NGPA may go to, it does not go to setting prices for oil and natural gas liquid production...

45 Fed. Reg. 53099 (1980).

Therefore, under the NGPA, the NGLs were not considered "gas", but rather "non-gas" commodities outside the jurisdiction of the NGPA.

We note as well that the purpose of the NGPA was to regulate prices of first sales of gas. The concept of the NGPA's first sale requires that the section 29 credit be calculated based on the BTU value of the gas at the point of sale, not at the point of production. The first sale of gas in this case was made at the tailgate of the Plant, and included only the dry gas. Although the NGLs were produced as gas at the wellhead, they were subsequently separated and sold as liquids, which were outside the jurisdiction of the NGPA.

Accordingly, we conclude that the NGLs that are removed from a gas stream in a gas plant before the first sale of gas, are not eligible for the section 29 credit as a "gas from tight formation."

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.