

## Internal Revenue Service

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Date: November 23, 2004

### LEGEND:

Taxpayer =

Subsidiary =

Field =

Location =

Year 1 =

Date 1 =

Date 2 =

u =

Date 3 =

v =

Year 2 =

Date 4 =

Date 5 =

Date 6 =

Private Letter Ruling =

w =

x =

Year 3 =

y =

z =

Dear

This letter responds to your letter, dated May 18, 2004, requesting a ruling under § 43 of the Internal Revenue Code.

The represented facts are as follows:

Taxpayer is an accrual taxpayer utilizing a calendar taxable year. Subsidiary is an indirect, wholly owned subsidiary of Taxpayer included on Taxpayer's consolidated income tax return. Field is situated in Location. Production from Field began in Year 1. From Date 1 to Date 2, the average production rate from Field was u thousand barrels of oil per day (MBOPD). Subsidiary acquired its operating mineral interest in Field, and became the operator of Field on Date 3. Due to additional drilling and facilities construction, production from Field increased to y MBOPD by Year 2.

A miscible water-alternating-gas process (MWAG) was implemented on Field, and was in effect from Date 4 to Date 5. The MWAG process was certified on Date 6. Since Date 5, a process using water-alternating-gas in an under-saturated reservoir (US-WAG) has been used on Field. The US-WAG process was approved as a qualified tertiary recovery method in Private Letter Ruling.

At Field, there are several source water producing wells that produce a low salinity water, which contains approximately w parts per million total dissolved solids. Taxpayer intends to implement a project involving the injection of low salinity water (water containing fewer than x ppm total dissolved solids) into one of the three reservoirs in Field in lieu of conventional high salinity water injection. The project will be implemented in Year 3. Taxpayer represents that the injection of low salinity water will affect the reservoir fluid by increasing the pH of the reservoir fluids, and by reducing the interfacial tension between the oil, reservoir rock, and water. The water wettability of the reservoir will also be increased. As a result, the injection of low salinity water can result in a reduction in residual oil saturation by y% of total pore volume, leading to an incremental recovery of z% of the original oil in place.

While the injection of low salinity water will also provide energy and drive mechanisms similar to conventional waterflooding, the above-mentioned changes to the relative properties of the reservoir fluids do not occur with conventional waterflooding. Taxpayer represents that the injection of low salinity water achieves a result similar to alkaline or surfactant flooding projects. Taxpayer has also provided a substantial amount of literature, including laboratory study and simulation data, which has been written over several decades and describe the process in detail.

Taxpayer requests a ruling that the process of injecting low salinity water, as described, is a qualified tertiary recovery method not described in § 1.43-2(e)(2) or in a revenue ruling for purposes of the § 43 enhanced oil recovery credit.

Section 43(a) provides a credit in an amount equal to 15% of certain costs paid or incurred by a taxpayer in connection with a qualified enhanced oil recovery project.

Section 43(c)(2) defines the term "qualified enhanced oil recovery project" to mean any project that: (1) involves the application (in accordance with sound engineering principles) of one or more qualified tertiary recovery methods (as defined in section 193(b)(3)) that reasonably can be expected to result in a more than insignificant increase in the amount of crude oil that ultimately will be recovered; (2) is located within the United States (within the meaning of section 638(1); and (3) with respect to which the first injection of liquids, gases, or other matter commences after December 31, 1990.

Section 1.43-2(e)(1) of the regulations defines the term "qualified tertiary recovery method" to mean any one or combination of the tertiary recovery methods described in section 1.43-2(e)(2) or a method not described in section 1.43-2(e)(2), which has been determined by revenue ruling to be a "qualified tertiary recovery method." A taxpayer may request a private letter ruling that a method not described in section 1.43-2(e)(2) or in a revenue ruling is a qualified tertiary recovery method. Generally methods identified in revenue rulings or private letter rulings will be limited to those methods that involve the displacement of oil from the reservoir rock by modifying the properties of the fluids in the reservoir or providing the energy and drive mechanism to force the oil to a production well.

Section 1.43-2(e)(3)(i) states that waterflooding is not a qualified tertiary recovery method. Waterflooding is defined as the injection of water into an oil reservoir to displace oil from the reservoir rock and into the bore of the producing well.

Taxpayer represents that the recovery method under consideration changes the properties of the fluids in the reservoir by increasing the pH of the reservoir fluids, by reducing the interfacial tension between the oil, reservoir rock, and water, and by increasing the water wettability of the reservoir. The proposed recovery method also provides the energy and drive mechanism to force the oil to a production well. Section 1.43-2(e)(1) of the regulations states that a qualified method generally is limited to methods that involve the displacement of oil from the reservoir rock by modifying the properties of the fluids in the reservoir or that provide the energy and drive mechanism to force the oil to a production well. This project does both.

The injection of low salinity water resembles waterflooding, an excluded method under § 1.43-2(e)(3), in that in both cases water is injected into an oil reservoir to displace oil from the reservoir rock and into the bore of the producing well. However, the proposed method causes changes in the properties of the fluids in the reservoir which do not occur with conventional waterflooding. Further, as reflected in the literature provided, the proposed recovery method is not a conventional recovery method that was in use at the time § 43 was enacted, and is implemented following a previously applied enhanced oil recovery method.

Taxpayer has represented that the proposed project is within the United States and first injection will occur after December 31, 1990 as required under § 43(c)(2). Also, Taxpayer has represented that the project involves the application (in accordance with sound engineering principles) of a recovery method which can reasonably be expected to result in a more than insignificant increase in the amount of oil that will ultimately be recovered.

Based on these facts, as well as review by Service experts, we conclude that the recovery method Taxpayer will implement at Field, is a qualified tertiary recovery method not described in § 1.43-2(e)(2) or in a revenue ruling, and therefore, the project using the method is a qualified tertiary recovery project provided it otherwise meets the requirements of § 43 and the regulations thereunder.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion whether the project implemented by the Taxpayer otherwise meets the requirements of a qualified enhanced oil recovery project under § 43 and the regulations thereunder.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. A copy of this letter must be attached to any income tax return to which it is relevant.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Joseph H. Makurath  
Senior Technician Reviewer, Branch 7  
(Passthroughs & Special Industries)

cc: