Oklahoma Law Review

Volume 59 | Number 4

2006

State ex rel. Oklahoma Tax Commission v. Texaco Exploration & Production, Inc.: Favoring the Drafting Party?

Jonathan D. Morris

State ex rel. Oklahoma Tax Commission v. Texaco Exploration & Production, Inc.: Favoring the Drafting Party?*

I. Introduction

The methods by which taxpayers and the Oklahoma Tax Commission calculate the gross production tax on severed gas is a major concern for Oklahoma, which had the second highest volume of marketed production of natural gas of all states in the United States in 2004,[1] and is thus heavily dependent upon gross production taxes as a source of revenue. Proceeds from the Oklahoma Gross Production Tax Code for severed gas are split among: (1) the General Revenue Fund, for general expense use by the state government as appropriated by the legislature; (2) the County Highway Fund, for disbursement to each county in proportionate share to the total value of production from each county; and (3) each county, in proportionate share to the total value of production from each county, for apportionment amongst the school districts in that county.[2] In the fiscal year ending in 2004, the Oklahoma Tax Commission collected $553,222,787.10 from the severance tax on gas and apportioned $443,689,240.47 to the General Revenue Fund — 10.0% of the total taxes apportioned to the General Revenue Fund; $36,956,849.93 to the County Highway Fund — 18.6% of the total taxes apportioned to the County Highway Fund; and $36,956,849.93 to the budgets of school districts — 13.0% of the total taxes apportioned to the budgets of school districts.[3]

Given the importance of this source of revenues, one might presume that the Oklahoma Gross Production Tax Code is sophisticated and clear. Unfortunately, individual circumstances indicate that this is not the case. Because of the prevalence of major companies acting as both gas producers and gas purchasers in the industry, the gas producer and initial purchaser may

---

* The author would like to thank Professor Owen L. Anderson and Johnathan L. Rogers for their guidance and comments on earlier drafts of this article. Any and all mistakes are mine alone. I am especially thankful to Alyssa B. Morris for her unwavering support.

1. *See* ENERGY INFO. ADMIN., U.S. DEP'T OF ENERGY, NATURAL GAS ANNUAL 2004, at 3 tbl.2 (2005), *available at* http://tonto.eia.doe.gov/FTPROOT/natgas/013104.pdf.

2. 68 OKLA. STAT. § 1004(2)-(4) (Supp. 2005), *amended by* Act of June 27, 2006, 2d Extra. Sess. ch. 43, § 1, 2006 Okla. Sess. Laws 2072, 2072-76.

3. *See* TAX POLICY DIV., OKLA. TAX COMM'N, ANNUAL REPORT OF THE OKLAHOMA TAX COMMISSION: FISCAL YEAR ENDED JUNE 30, 2004, at 17, 19, 29 (2005), *available at* http://www.oktax.state.ok.us/oktax/publicat/AR2004.pdf.

be related entities not dealing at arm's-length.[4] Alternatively, a producer may retain title to produced gas without making an arm's-length sale until the gas has been moved far downstream and after the gas is processed for the removal of valuable natural gas liquids.[5] In either circumstance, the provisions of the Oklahoma Gross Production Tax Code fail to adequately define the method by which the Oklahoma Tax Commission may curb potential abuse by a producer and purchaser who, through a loophole in the statutes, may work in concert to lower the basis on which gross production taxes are calculated on severed gas and fail to adequately provide guidance to taxpayers who try to comply with the gross production tax laws.[6]

Because the only portion of the statutes that contemplates these situations does not provide concrete guidance for enforcement by the Oklahoma Tax Commission or compliance by gas producers and purchasers,[7] and the definition of "gross value of the production" contained in the Oklahoma Tax Commission Rules does not assist in resolving this issue,[8] the Oklahoma Supreme Court must supply the proper interpretation. The court attempted to address these concerns in *State ex rel. Oklahoma Tax Commission v. Texaco Exploration & Production, Inc.* (*Texaco*).[9] This note argues that the *Texaco* court correctly determined available alternative valuation methods for tax purposes but incorrectly interpreted the application of the alternative valuation methods in favor of the state — the party who must take accountability for the language of the tax statutes as the drafting party.

Part II of this note discusses the pre-*Texaco* background of gross production taxation law and gas valuation law for both gross production tax and royalty purposes. Part III provides the factual and procedural background of *Texaco*, along with a summary of the opinion of the Oklahoma Supreme Court. Finally, Part IV details why the *Texaco* court correctly determined available

---

4. *See generally* HOWARD R. WILLIAMS & CHARLES J. MEYERS, MANUAL OF OIL AND GAS TERMS 602 (11th ed. 2000) (A major company is "[a] company integrated to a substantial degree, that is, engaged in production, refining, transportation, and marketing.").

5. *See* Owen L. Anderson, *Self or Affiliate Gas Processing:* Howell v. Texaco, Inc., 42 ROCKY MTN. MIN. L. FOUND. J. 331, 332 n.5, 355 (2005).

6. *See* 68 OKLA. STAT. §§ 1001(B)(4), 1009(F), *amended by* Act of May 10, 2006, ch. 134, §§ 2-3, 2006 Okla. Sess. Laws 545, 546-47, 557-58; *id.* § 1010(B)(5).

7. *See id.* § 1009(F), *amended by* Act of May 10, 2006, § 3, 2006 Okla. Sess. Laws at 557-58.

8. OKLA. ADMIN. CODE § 710:45-1-2 (1996) ("'Gross value of the production' means the gross proceeds realized from the first sale of such production, including the actual cash value and all premiums otherwise given to or reserved for the producer and all interest owners of such production, without any deduction for costs whatsoever.").

9. 2005 OK 52, 131 P.3d 705.

alternative valuation methods for tax purposes but incorrectly interpreted the application of the alternative valuation methods in favor of the state.

II. The Landscape of Gross Production Taxation and Gas Valuation Law Before Texaco

Overviews of three areas of Oklahoma law are important to an analysis of the Oklahoma Supreme Court's decision in *State ex rel. Oklahoma Tax Commission v. Texaco Exploration & Production, Inc.*: the law of gross production taxation, the law of gas valuation for gross production tax purposes, and the law of gas valuation for royalty purposes.

A. The Law of Gross Production Taxation

Oklahoma levies a severance tax based on the gross valuation of oil and gas production in lieu of an ad valorem property tax.[10] Thus, Oklahoma does not levy a property tax on oil and gas reserves not yet produced.[11] As the Oklahoma Supreme Court has stated, "[i]f there [has been] no production . . . no tax is authorized" under the Oklahoma gross production tax statutes.[12] For gross production tax purposes, Oklahoma courts have considered oil and gas "produced" when the minerals are brought to the surface and confined, allowing the measurement of its quantity and the testing of its quality and value.[13] The purpose of Oklahoma's gross production tax on minerals is to "provid[e] a more efficient and expeditious method of levying and collecting a property tax upon the minerals, the property used in connection with the production thereof, the leasehold estate, and all interests inherent in the right to said minerals."[14] Rather than being a tax on real property, the gross production tax is a tax levied on oil and gas after severance and thus as

---

10. *See* 68 OKLA. STAT. § 1001, *amended by* Act of May 10, 2006, § 2, 2006 Okla. Sess. Laws at 546-56; Apache Gas Prods. Corp. v. Okla. Tax Comm'n, 1973 OK 34, ¶ 18, 509 P.2d 109, 113-14; Noram Energy Corp. v. Okla. Tax Comm'n, 1995 OK CIV APP 149, ¶ 22, 935 P.2d 389, 395.

11. *See* 68 OKLA. STAT. § 1001(R), *amended by* Act of May 10, 2006, § 2, 2006 Okla. Sess. Laws at 556; Mitch Kunce & William E. Morgan, *Taxation of Oil and Gas in the United States 1970-1997*, 45 NAT. RESOURCES J. 77, 91 (2005).

12. *In re* Gross Prod. Tax of Wolverine Oil Co., 1915 OK 792, ¶ 7, 154 P. 362, 365, *overruled by In re* Skelton Lead & Zinc Co.'s Gross Prod. Tax for 1919, 1921 OK 121, ¶ 2, 197 P. 495, 498, *and* Bergin Oil & Gas Co. v. Howard, 1921 OK 240, ¶ 1, 199 P. 209, *overruled by Apache*, ¶¶ 18-23, 509 P.2d at 113-15.

13. Okla. Tax Comm'n v. Sun Oil Co., 1971 OK 100, ¶¶ 10-12, 489 P.2d 1078, 1081 (deciding what constituted "production" of natural gas); Sinclair Prairie Oil Co. v. State, 1935 OK 1210, ¶ 12, 53 P.2d 221, 223 (deciding what constituted "production" of oil).

14. State v. Indian Royalty Co., 1936 OK 366, ¶ 4, 58 P.2d 601, 602.

personal property.[15] When the producer sells oil and gas at the time of production, the purchaser pays the gross production tax by deducting the amount of the tax from the producer's first-sales proceeds.[16] This procedure differs from a sales tax, where the tax is collected and paid by the seller by adding the amount of the tax to the sales price.[17]

B. The Law of Gas Valuation for Gross Production Tax Purposes

Title 68, sections 1001(B)(4), 1009(f), and 1010(B)(5) of the Oklahoma Statutes address the valuation of the gross production of gas. Oklahoma assesses taxes levied upon natural gas production on the "gross value of the production of gas."[18] Oklahoma requires "every person responsible for paying or remitting the tax levied" by these statutes to report "[t]he total value of the mineral oil, gas, or casinghead gas, at the time and place of production, including any and all premiums paid for the sale thereof, at the price paid, if purchased at the time of production" to the Oklahoma Tax Commission.[19] Section 1009(F) permits the Oklahoma Tax Commission to "require the said tax to be paid upon the basis of the prevailing price then being paid at the time of production in said field for oil or gas of like kind, quality and character" if "oil or gas is sold under circumstances where the sale price does not represent the cash price prevailing for oil or gas of like kind, character or quality in the field from which such product is produced."[20]

The Oklahoma Supreme Court has interpreted the "gross value of the production of gas" for gross production tax purposes as:

> [T]he gross proceeds realized by each producer from his individual sales contracts, except where the conditions under which a particular contract was entered into were such as not to reflect arm's length bargaining or as not to be a reasonably prudent exercise of such bargaining, resulting in an improper burden upon the public revenue by a price not representing "gross value of the production of natural gas." Where the Commission finds such exceptions to exist, it should make a proper adjustment of the tax to conform to the "prevailing price in the field at the time of production." The "field" . . . . should be equated with "common

15. *See Apache*, ¶ 18, 509 P.2d at 113-14; *Noram*, ¶ 22, 935 P.2d at 395.

16. 68 OKLA. STAT. § 1009(D), *amended by* Act of May 10, 2006, § 3, 2006 Okla. Sess. Laws at 557.

17. Exxon Corp. v. Okla. Tax Comm'n, 1993 OK CIV APP 178, ¶ 7, 873 P.2d 306, 309.

18. 68 OKLA. STAT. § 1001(B)(4), *amended by* Act of May 10, 2006, § 2, 2006 Okla. Sess. Laws at 546-47.

19. *Id.* § 1010(B).

20. *Id.* § 1009(F), *amended by* Act of May 10, 2006, § 3, 2006 Okla. Sess. Law at 557-58.

> source of supply" as that term is used and understood in the oil and gas industry.[21]

The Oklahoma Tax Commission may invoke the "prevailing price in the field at the time of production" means of determining tax "ONLY in cases where the prices (already) paid are less than the prices that prevailed in the field at the time said sale prices were contracted for."[22]

C. The Law of Gas Valuation for Royalty Purposes

The terms of the oil and gas lease executed between the lessor and the lessee determine the valuation of gross production of gas for royalty purposes.[23] A common term used to describe the value of gas in a typical lease royalty clause is "market value at the well."[24] Oklahoma courts have generally held the term "market value" as synonymous with actual value.[25] Thus, market value represents the sales price negotiated between willing, nonobligated buyers and sellers in a free and open market.[26]

Three basic methods of determining the "market value at the well" exist: the actual arm's-length sale method, the prevailing market price method, and the work-back method.[27] The preferred method is the actual arm's-length sale method.[28] Explaining this preferred method, the Oklahoma Supreme Court stated:

> [W]hen a producer's lease calls for royalty on gas based on the market price at the well and the producer enters into an arm's-length, good faith gas purchase contract [including long-term contracts] with the best price and terms available to the producer at the time, that price is the "market price" and will discharge the producer's gas royalty obligation.[29]

Producer-lessees and royalty owner-lessors use the other two methods in the absence of an actual arm's-length sale at the well.[30]

---

21. Apache Gas Prods. Corp. v. Okla. Tax Comm'n, 1973 OK 34, ¶ 27, 509 P.2d 109, 116.
22. *Id.* ¶ 13, 509 P.2d at 113.
23. *See* 3 EUGENE O. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS §§ 38.1, 40.1-40.4 at 255-56, 311-48 (1989); JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL 44 (4th ed. 2003).
24. *See* LOWE, *supra* note 23, at 279.
25. Katschor v. Eason Oil Co., 1936 OK 705, ¶ 30, 63 P.2d 977, 981.
26. Johnson v. Jernigan, 1970 OK 180, ¶ 5, 475 P.2d 396, 398.
27. Howell v. Texaco, Inc., 2004 OK 92, ¶¶ 18-20, 112 P.3d 1154, 1159.
28. *Id.* ¶ 18, 112 P.3d at 1159.
29. Tara Petroleum Corp. v. Hughey, 1981 OK 65, ¶ 14, 630 P.2d 1269, 1273.
30. *See Howell*, ¶¶ 19-20, 112 P.3d at 1159.

Because of the economic impracitability of storing gas at the well,[31] establishing a hypothetical "market value at the well" often leads to disputes over proper gross production valuation for royalty computations when the producer must construct gathering lines and feeder lines to transport the gas to a major gas transmission line and perhaps even move the gas through the transmission line to the actual point of sale.[32] When the producer cannot prove "market value at the well" by an actual arm's-length sale, the producer may use evidence of the prevailing market price to establish the market value.[33] Evidence which may prove the prevailing market price can include any arm's-length wellhead sales or purchase offers from the same well or arm's-length wellhead sales from other wells in the vicinity which are close in time to the transaction not completed at arm's length.[34]

Absent an actual arm's-length sale at the well, producers often establish the market value by using the work-back method,[35] under which "the market value at the wellhead is calculated by subtracting allowable costs and expenses[, if any,] from the first downstream, arm's-length sale."[36] If the producer can show that the gas was marketable at the wellhead and reasonable post-production costs increased the actual royalty revenues proportionately, these costs constitute allowable deductions from the royalty payment calculations under the work-back method.[37] Allowable post-production costs for deduction include transportation, compression, dehydration and blending costs if those costs are reasonable, "the costs enhanced the value of an already marketable product," and "actual royalty revenues increased in proportion with the costs assessed."[38] Because royalty owners have a right to be paid based on the "highest possible market value,"[39] they are also "entitled to have their royalty payments based on the prevailing market price or the work-back method,

31. LOWE, *supra* note 23, at 280.

32. *See* Johnson v. Jernigan, 1970 OK 180, ¶ 9, 475 P.2d 396, 398 (acknowledging that lessees must often build a pipeline from their well or transport the gas through other lines to the pipeline of a gas purchaser to create any market for their gas); LOWE, *supra* note 23, at 281 (recognizing gas is not always sold to an unrelated third party at the well, but often sold "downstream" from the well).

33. *Howell*, ¶ 19, 112 P.3d at 1159 (citing Cimarron Utils. Co. v. Safranko, 1940 OK 181, ¶ 0, 101 P.2d 258, 259 (syllabus 1 by the court)).

34. *Id.* (citing *Johnson*, ¶ 5, 475 P.2d at 398).

35. *Id.* ¶ 20, 112 P.3d at 1159 (citing Wood v. TXO Prod. Corp., 1992 OK 100, ¶ 9 n.1, 854 P.2d 880, 882 n.1; Katschor v. Eason Oil Co., 1936 OK 705, ¶¶ 0, 32, 63 P.2d 977, 977 (syllabus 4 by the court), 981).

36. *Id.* (citing *Katschor*, ¶¶ 0, 32, 63 P.2d at 977 (syllabus 4 by the court), 981).

37. Mittelstaedt v. Santa Fe Minerals, Inc., 1998 OK 7, ¶ 2, 954 P.2d 1203, 1205.

38. *Id.*

39. *Johnson*, ¶ 14, 475 P.2d at 399.

whichever one results in the higher market value."[40] Additionally, producers cannot use contracts for intra-company gas sales as the basis for the valuation of gas for royalty purposes.[41]

Essentially, the valuation of gas for royalty purposes is derived from contract terms and their interpretation, whereas the valuation of gas for taxation purposes is derived from state statutes and their interpretation.[42] When the contract terms of the oil and gas lease or the language of the gross production tax statutes do not fully address gas valuation courts must decide how to interpret the problem within both arenas of the law. In *Oklahoma Tax Commission v. Texaco Exploration & Production, Inc.*, the Oklahoma Supreme Court interpreted the gas valuation problem that occurs in the absence of an arm's-length transaction at the wellhead, as contemplated by the provisions of the Oklahoma Gross Production Tax Code.

III. Statement of the Case: State ex rel. Oklahoma Tax Commission v. Texaco Exploration & Production, Inc.

In 2002, the Oklahoma Tax Commission (OTC) filed suit against Texaco Exploration & Production, Inc. and Texaco Inc. (collectively Texaco) in district court in Stephens County, alleging that Texaco had intentionally evaded taxes by devising and implementing "a scheme to calculate gross production and petroleum excise taxes on a price less than the fair market value."[43] The OTC sought damages for gross production and petroleum excise taxes, together with interest and penalties, totaling at least $20 million.[44] Texaco denied the allegations and set forth nineteen affirmative defenses.[45]

A. Statement of Facts Giving Rise to the Dispute

Texaco produced gas from wells in Stephens County.[46] Texaco gathered the gas it produced with its own gathering system, processed the gas at its own processing plant, and sold residue gas at the tailgate of the plant to third parties.[47] In addition, "Texaco . . . gathered and processed gas purchased from

40. *Howell*, ¶ 22, 112 P.3d at 1160.
41. *Id.*
42. *See* Oklahoma v. Texas, 266 U.S. 298 (1924) (acknowledging that gross production taxes are governed by statutes imposing the tax and must be computed in accordance with those statutes); *see also supra* Part II.B.
43. State *ex rel.* Okla. Tax Comm'n v. Texaco Exploration & Prod., Inc., 2005 OK 52, ¶ 2, 131 P.3d 705, 707.
44. *Id.*
45. *Id.*
46. *Id.* ¶ 3, 131 P.3d at 707.
47. *Id.*

other producers in the field under wellhead gas purchase contracts for a percentage of the proceeds received at the tailgate of the plant."[48] Based on the price of those percentage-of-proceeds gas purchase contracts, Texaco executed a written contract with itself for purchase of its own gas.[49] Texaco based its gross production of gas taxes contained in its reports to the OTC on a percentage of the proceeds it received at the tailgate of the plant under these contracts.[50]

B. The Holding of the Stephens County District Court

Both parties moved for partial summary judgment on the issue of the proper method for determining the value of the gas for purposes of calculating gross production tax absent an arm's-length wellhead sale.[51] The OTC took the position that the gross production tax statutes and applicable OTC rules "require[d] Texaco to pay taxes based on the gross proceeds realized from the first arm's length purchase of the gas."[52] In contrast, Texaco argued that it had complied with the gross production tax statutes and "correctly paid the taxes on the production based on the prevailing price established by the comparable sales prices paid under the percent of proceeds contracts for wellhead sale of gas of like kind, quality and character in the same field."[53]

Agreeing with Texaco's argument, the district court granted its motion for partial summary judgment.[54] The court "concluded that 'in the absence of individual sales contracts, negotiated under circumstances that reflect arm's length bargaining, . . . gross value of gas produced is best reflected by the prevailing price in the field for gas of similar kind, quality and character at the time of production.'"[55] The district court reserved judgment on determining the prevailing price because the facts necessary to resolve that issue remained in dispute.[56]

---

48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.* ¶ 4, 131 P.3d at 707 (urging the use of 68 OKLA. STAT. § 1001 (2001) and OKLA. ADMIN. CODE § 710:45-1-2 (1996)).
53. *Id.* (urging the use of 68 OKLA. STAT. §§ 1001, 1009).
54. *See id.* ¶ 5, 131 P.3d at 707.
55. *Id.*
56. *Id.*

C. The Opinion of the Oklahoma Supreme Court

The Oklahoma Supreme Court granted the OTC's petition for writ of certiorari to review the partial summary judgment of the district court.[57] As a threshold matter, the Oklahoma Supreme Court noted that "the basis for determining gross value of gas for taxation purposes must be found in the gross production tax statutes" because, as an exclusively legislative function, the authority for and proper implementation of taxation must come from statutory language.[58] Citing *Apache Gas Products Corp. v. Oklahoma Tax Commission*,[59] the court stated that the required standard for computation of gross production taxes is the price paid for gas at the wellhead in an actual arm's-length transaction between the producer and the purchaser.[60]

The court also acknowledged that the relevant portions of the gross production tax code levy severance taxes on the gross value of the gas production at the time and place of production.[61] The statutes, however, permit the OTC to adjust the basis for the tax to "the prevailing price then being paid at the time of production in said field for oil or gas of like kind, quality and character"[62] if the sales price is not an accurate representation of prevailing market prices.[63]

The court deduced that when the producer's individual sales contracts are the result of reasonably prudent arm's-length bargaining, the taxpayer and the OTC should calculate gross production tax on the gross proceeds realized by those contracts.[64] When the producer's sales contracts do not exhibit arm's-length bargaining, such as Texaco's contracts with itself in this case, the taxpayer and the OTC should calculate the gross production tax "on the prevailing price in the field at the time of production" in accordance with title 68, section 1009(F) of the Oklahoma Statutes.[65] In an effort to define the proper alternative methods of valuation, the court applied its holding in *Howell v. Texaco, Inc.*[66] to *Texaco*.[67]

---

57. *Id.* ¶ 6, 131 P.3d at 707.
58. *Id.* ¶ 7, 131 P.3d at 707.
59. 1973 OK 34, 509 P.2d 109.
60. *Texaco*, ¶ 18, 131 P.3d at 710.
61. *Id.* ¶ 20, 131 P.3d at 710 (citing 68 OKLA. STAT. §§ 1001(B)(4), 1010(B)(5) (2001)); *see also supra* Part II.B.
62. 68 OKLA. STAT. § 1009(F) (Supp. 2005), *amended by* Act of May 10, 2006, ch. 134, § 3, 2006 Okla. Sess. Laws 545, 557-58.
63. *Texaco*, ¶ 20, 131 P.3d at 710; *see also supra* Part II.B.
64. *Texaco*, ¶ 23, 131 P.3d at 711.
65. *Id.*
66. 2004 OK 92, 112 P.3d 1154.
67. *Texaco*, ¶ 24, 131 P.3d at 711.

The *Howell* court, in deciding the appropriate gas valuation method for purposes of royalty payments in the same absence of an arm's-length sale at the wellhead, recognized three suitable methods of establishing market value of gas at the wellhead:

> 1) the actual sale price paid through arm's length negotiation; and, in the absence of an arm's length wellhead purchase, 2) the prevailing market value method, and 3) the work-back method whereby the market value at the wellhead is calculated by subtracting allowable costs and expenses from the proceeds of the first downstream, arm's length sale.[68]

When choosing between the latter two methods because of the absence of an actual arm's-length wellhead purchase, the *Howell* court concluded that producers must use the higher of the two methods for calculations of royalty payments.[69]

In the instant case, the court determined that the *Howell* methods for establishing wellhead value of gas "fall within the comprehensive language used in the pertinent gross production tax statutes" and found that the OTC had already effectively used them in other administrative assessment processes.[70] The court also noted that "other provisions in these statutes contemplate that the purchaser will report and pay the gross production tax based on the price it paid to the producer and the royalty owners."[71]

Based on the reasoning of *Apache*, the court held that taxpayers and the OTC were to use the methods adopted by *Howell* in the royalty context for purposes of determining gross production tax.[72] Specifically, the court stated "that in the absence of an actual arm's length sale at the wellhead, gross value of gas for calculation of gross production taxes is to be determined by using the prevailing price method or the work-back method . . . whichever results in the higher value."[73] Furthermore, the court held that Texaco's contract with itself could not act as the source of gas valuation for calculating gross production taxes.[74]

68. *Id.* ¶¶ 24-25, 131 P.3d at 711.
69. *Id.* ¶ 25, 131 P.3d at 711.
70. *Id.* ¶ 26, 131 P.3d at 711.
71. *Id.* (citing 68 OKLA. STAT. §§ 1001(C), 1009(d) (2001)).
72. *Id.*
73. *Id.*
74. *Id.*

IV. Analysis: Favoring the Drafting Party?

Perhaps in an effort to achieve uniformity of gas valuation measures, the *Texaco* court too hastily applied the recent royalty decision in *Howell v. Texaco*[75] directly to the arena of gross production taxation. Even though the issue at the heart of the dispute in *Texaco* was the proper interpretation of the language of Oklahoma's gross production tax provisions, the *Texaco* court applied the holding of *Howell* — a case involving the interpretation of contract-based lease provisions.[76] In doing so, the *Texaco* court broke with prior precedent acknowledging a difference between determining the value of gas for gross production tax purposes and determining the value of gas for royalty purposes.[77]

In fact, the Oklahoma Supreme Court "has observed that a term used for the purpose of calculating a tax may have a different meaning in calculating a royalty."[78] Furthermore, "this Court . . . [has] explain[ed] that *the value of gas for the purpose of the gross production tax was not necessarily calculated in the same manner as its value for the purpose of paying royalties*."[79] While acknowledging that the facts of *Apache* are "distinguishable" from those in *Texaco*, the court's only explanation for this break with precedent was that the reasoning in *Apache* "supports application of *Howell* . . . in this case."[80] Because *Howell* was an interpretation of royalty obligations under oil and gas lease terms, whereas *Texaco* was an interpretation of gross production tax obligations under state statutes, the available precedent before the *Texaco* court would seemingly prescribe that the reasoning in *Apache* supports the ultimate determination of some, but not all, of the conclusions in *Howell*.[81] Although this distinction may appear trivial, its effects are nevertheless significant.

A. Adoption of the Howell *Methods for Taxation Purposes*

The Oklahoma Supreme Court's decision to adopt both alternative methods of valuation for royalty purposes embraced in *Howell* — the prevailing market value method and the work-back method — and to use them to establish gross value of gas for gross production tax purposes is justifiable. The court

75. Howell v. Texaco, Inc., 2004 OK 92, 112 P.3d 1154.

76. *Compare id.*, *with Texaco*, 2005 OK 52, 131 P.3d 705.

77. *See* Mittelstaedt v. Santa Fe Minerals, Inc., 1998 OK 7, ¶ 23, 954 P.2d 1203, 1209; Okla. Tax Comm'n v. Sun Oil Co., 1971 OK 100, ¶ 13, 489 P.2d 1078, 1081.

78. *Mittelstaedt*, ¶ 23, 954 P.2d at 1209.

79. *Id.* (emphasis added).

80. *Texaco*, ¶ 24, 131 P.3d at 711.

81. *See Mittelstaedt*, ¶ 23, 954 P.2d at 1209; *Sun Oil*, ¶ 13, 489 P.2d at 1081.

correctly observed that a basis for these alternative methods must exist within the gross production tax statutes because any method of taxation — exclusively a function of the legislature — must be prescribed by statute.[82] Tax statutes are subject to the fundamental rule of statutory construction that courts are to ascertain and, if possible, give effect to the statute's legislative intent and purpose.[83] To determine the intent of the legislature and allow the practical application of statutes courts must construe statutes that relate to the same subject matter together, giving full force and effect to each statute.[84] Courts must assign words in a statute "the same meaning as that attributed to them by ordinary and common definitions," absent a contrary definition provided by the statute itself.[85] A presumption exists that courts should give effect to every provision of a statute because the legislature intended some useful purpose for every provision.[86]

The Oklahoma Gross Production Tax Code provides that "there is hereby levied upon the production of gas a tax . . . on the gross value of the production of gas."[87] Because the Oklahoma legislature intended the gross production tax to replace real property taxes for minerals, the purchase price of gas upon production at the wellhead paid in an arm's-length transaction between the producer and the purchaser best represents the gross value of production.[88] Further interpretation of the Oklahoma Gross Production Tax Code provides that when a wellhead transaction does not exist, the OTC "should make a proper adjustment of the tax to conform to the 'prevailing price in the field at the time of production.'"[89]

At first reading of the language of section 1009(F), it appears that the legislature intended to allow taxpayers and the OTC to use one of the alternative valuation methods for royalty purposes affirmed in *Howell* — the prevailing market value method — to determine valuation for gross production

82. *Texaco*, ¶ 7, 131 P.3d at 707 (citing Gay v. Thomas, 1896 OK 67, 46 P. 578).

83. Samson Hydrocarbons Co. v. Okla. Tax Comm'n, 1998 OK 82, ¶ 7, 976 P.2d 532, 535 (citing Wal-Mart Stores, Inc. v. Switch, 1994 OK 59, ¶ 5, 878 P.2d 357, 359).

84. *Id.* ¶ 15, 976 P.2d at 537-38 (citing Ledbetter v. Okla. Alcoholic Beverage Laws Enforcement Comm'n, 1988 OK 117, ¶ 7, 764 P.2d 172, 179).

85. *Id.* ¶ 7, 976 P.2d at 535 (quoting Anson Corp. v. Hill, 1992 OK 138, ¶ 10, 841 P.2d 583, 585).

86. *Id.* (citing Hunt v. Washington Fire & Marine Ins. Co., 1963 OK 112, ¶ 11, 381 P.2d 844, 847).

87. 68 OKLA. STAT. § 1001(B)(4) (Supp. 2005), *amended by* Act of May 10, 2006, ch. 134, § 2, 2006 Okla. Sess. Laws 545, 546-47.

88. Apache Gas Prods. Corp. v. Okla. Tax Comm'n, 1973 OK 34, ¶¶ 16, 18, 27, 509 P.2d 109, 113-14, 116.

89. *Id.* ¶ 27, 509 P.2d at 116.

tax purposes.[90] In fact, language in both *Apache* and *Oklahoma Tax Commission v. Sun Oil Co.* indicates that this may be the only alternative valuation method available to taxpayers and the OTC in the absence of an actual arm's-length transaction.[91] When reading sections 1001(B)(4), 1009(F), and 1010(B)(5) together and giving full force and effect to each statute as one must, however, these provisions seem to express the legislature's intent to make available to taxpayers and the OTC all reasonable alternative valuation methods in the absence of an actual arm's-length transaction. A determination that only the prevailing market value method, and not the work-back method, would be available to taxpayers and the OTC in the absence of an actual

---

90. *See* 68 OKLA. STAT. § 1009(F) (Supp. 2005), *amended by* Act of May 10, 2006, § 3, 2006 Okla. Sess. Laws at 557-58.

91. *See Apache*, ¶ 27, 509 P.2d at 116 (finding that, where the OTC finds that the individual sales contracts do not reflect arm's-length bargaining, "it should make a proper adjustment of the tax to conform to the 'prevailing price in the field at the time of production,'" and remaining correspondingly silent towards the work-back method); Okla. Tax Comm'n v. Sun Oil Co., 1971 OK 100, ¶¶ 12-13, 489 P.2d 1078, 1081 (referring to the prevailing market value method as the litmus test for determining if the value of gas expressed in a gas sales contract was the appropriate value under the gross production tax statutes and rejecting the work-back method as a method "to be used in determining royalty to be paid, not . . . in determinging [sic] the amount of gross production tax due"). The *Texaco* court inappropriately dismissed the relevance of *Sun Oil* to its holding, finding that *Sun Oil* "turned on the statutory language imposing the tax at the time and place of production in § 1001" and "did not construe the statutory provisions applicable herein." State *ex rel.* Okla. Tax Comm'n v. Texaco Exploration & Prod., Inc., 2005 OK 52, ¶ 21, 131 P.3d 705, 710. The court's determination to dismiss the relevance of *Sun Oil* is contrary to the holding of *Texaco*, which finds this *same* "comprehensive" statutory language, codified in sections 1001(B)(4) and 1010(B)(5) of the Oklahoma Gross Production Tax Code, as reason to adopt the alternative valuation methods under the Tax Code. *Id.* ¶¶ 20, 26, 131 P.3d at 710-11. "In order to ascertain the intention of the Legislature in the enactment of [a statute], the court may look to each part of the statute [and] to other statutes upon the same or relative subjects." Blevins v. W. A. Graham Co., 1919 OK 147, ¶ 8, 182 P. 247, 248. "[W]hen two statutes covering in whole or in part the same matter are not absolutely irreconcilable, effect should be given, if possible, to both of them." Carpenter v. Russell, 1903 OK 66, ¶ 7, 73 P. 930, 932 (quoting United States v. Greathouse, 166 U.S. 601, 605 (1897)). "Different statutes on the same subject are generally to be viewed as *in pari materia* and must be construed as a harmonious whole." Taylor v. State Farm Fire and Cas. Co., 1999 OK 44, ¶ 19, 981 P.2d 1253, 1261 (citing State *ex rel.* Marland v. Phillips Petroleum Co., 1941 OK 66, ¶ 32, 118 P.2d 621, 625 ("The general rule is that statutes in pari materia are those which relate to the same person or thing or to the same classes of persons or things or which have a common purpose; that in the construction of a particular statute, or in the interpretation of its provisions, all statutes relating to the same subject or having the same general purpose should be read in connection with it as together constituting one law.")). Certainly, the precedent laid down by the decision in *Sun Oil* construing the *same* "comprehensive" language of the Oklahoma Gross Production Tax Code at the heart of the *Texaco* court's decision is applicable to the court's interpretation of the legislative intent of the Tax Code and highly instructive on the matter.

arm's-length transaction would render section 1009(F) null and void if no suitable arm's-length sales from the same or nearby wells close in time to the transaction at issue were available to use under the prevailing market value method. Therefore, the *Texaco* court justifiably determined that both alternative valuation methods were authorized by the Oklahoma Gross Production Tax Code.

B. Adoption of the Highest Alternative Method

1. The Oklahoma Supreme Court Favors the Drafting Party

Although the court correctly determined that the statutes authorized taxpayers and the OTC to use both alternative valuation methods to establish the prevailing price for purposes of gross production taxation, the express language of both section 1009(F) and the decisions in *Apache* and *Sun Oil* discussed above indicate a clear preference for the prevailing market value method,[92] which generally produces a lower valuation figure than the work-back method.[93] Therefore, the *Texaco* court's determination that taxpayers and the OTC should determine a taxpayer's obligation based on the alternative method producing the higher result, without express statutory language indicating as much, was not justifiable. A fundamental tenet of oil and gas law is that because oil and gas leases are essentially contracts as well as conveyances, contractual rules of construction apply.[94] Courts construe any doubt as to the contract's meaning against the party who supplied the language of the contract.[95] Likewise, because courts strictly construe tax statutes, such as the gross production tax statutes, against the state as the drafting party, "[a]ny ambiguity or doubt as to a tax statute's meaning must be resolved in favor of the taxpayer."[96]

The *Howell* court correctly deduced that when no arm's-length sale at the wellhead is at hand and the parties must use one of the alternative methods to determine the valuation of gas for royalty purposes, the parties should use the higher of the two methods because "[a] royalty owner has a right to be paid on the best price available."[97] Because oil and gas leases are contracts executed

---

92. *See supra* Part IV.A.

93. *See* Anderson, *supra* note 5, at 346.

94. *See* 2 KUNTZ, *supra* note 23, §§ 18.2, 19.10, at 4-6, 33-38.

95. RESTATEMENT (SECOND) OF CONTRACTS § 206 (1981).

96. Samson Hydrocarbons Co. v. Okla. Tax Comm'n, 1998 OK 82, ¶ 8, 976 P.2d 532, 536 (citing Globe Life & Accident Ins. Co. v. Okla. Tax Comm'n, 1996 OK 39, ¶ 10, 913 P.2d 1322, 1327; Strelecki v. Okla. Tax Comm'n, 1993 OK 122, ¶ 20, 872 P.2d 910, 920; Wilson v. State *ex rel.* Okla. Tax Comm'n, 1979 OK 62, ¶ 5, 594 P.2d 1210, 1212).

97. Howell v. Texaco, Inc., 2004 OK 92, ¶ 22, 112 P.3d 1154, 1160 (citing Johnson v. Jernigan, 1970 OK 180, ¶ 14, 475 P.2d 396, 399).

between lessors as royalty owners and lessees as gas producers, courts must enforce the leases according to the parties' intentions as expressed within the lease.[98] To ascertain the parties' intent, courts rely upon rules of construction of contracts to interpret oil and gas leases.[99] When interpreting oil and gas leases, courts apply the well-established rule that language in the leases should be construed strictly against the lessee and in favor of the lessor,[100] at least where the lessee provided the lease form — the common occurrence.[101] "Market value leases," such as the leases at issue in *Howell*, contain lease royalty clauses that require lessees to pay a royalty based upon the market value of gas at the wellhead.[102] Interpreting the phrase "market value" in the royalty clauses in accord with the preceding rule of construction, the *Howell* court correctly determined that the alternative method resulting in the highest "market value" is the proper method for ascertaining the value of gas for royalty purposes.[103]

Applying essentially the same statutory rule of construction to the gross production tax statutes, however, requires that courts construe the tax statutes in favor of the taxpayer as the nondrafting party.[104] Although both alternative valuation methods should be available to taxpayers and the OTC in the absence of an arm's-length transaction at the wellhead,[105] the value of the gas subject to the gross production tax statutes should not be the higher of the alternative valuation methods absent statutory language authorizing this result.[106] By interpreting the language of the Oklahoma Gross Production Tax Code to require taxpayers and the OTC to use higher of the two alternative valuation methods, the *Texaco* court violated this well-established rule by construing the statute in favor of the state — the drafting party.[107]

---

98. Probst v. Ingram, 1962 OK 97, ¶ 20, 373 P.2d 58, 62.

99. *Id.* ¶ 21, 373 P.2d at 62.

100. Wilson v. Wakefield, 72 P.2d 978, 980 (Kan. 1937); *Probst*, ¶ 23, 373 P.2d at 62; Masterson v. Amarillo Oil Co., 253 S.W. 908, 914 (Tex. App. 1923); Young v. Jones, 222 S.W. 691, 694 (Tex. App. 1920).

101. McMahon v. Christmann, 303 S.W.2d 341, 346 (Tex. 1957).

102. *Howell*, ¶ 3, 112 P.3d at 1157.

103. *See id.* ¶ 22, 112 P.3d at 1160.

104. *See* Samson Hydrocarbons Co. v. Okla. Tax Comm'n, 1998 OK 82, ¶ 8, 976 P.2d 532, 536 (citing Globe Life & Accident Ins. Co. v. Okla. Tax Comm'n, 1996 OK 39, ¶ 10, 913 P.2d 1322, 1327; Strelecki v. Okla. Tax Comm'n, 1993 OK 122, ¶ 20, 872 P.2d 910, 920; Wilson v. State *ex rel.* Okla. Tax Comm'n, 1979 OK 62, ¶ 5, 594 P.2d 1210, 1212); *see also supra* text accompanying note 96.

105. *See supra* Part IV.A.

106. *See Samson*, ¶ 8, 976 P.2d at 536 (citing *Globe Life*, ¶ 10, 913 P.2d at 1327; *Strelecki*, ¶ 20, 872 P.2d at 920; *Wilson*, ¶ 5, 594 P.2d at 1212).

107. State *ex rel.* Okla. Tax Comm'n v. Texaco Exploration & Prod., Inc., 2005 OK 52, ¶ 26, 131 P.3d 705, 711.

Because any method of taxation must be prescribed by statute, a basis for determining that courts should use the higher of the alternative methods must exist within the gross production tax statutes.[108] The *Texaco* court stated that "other provisions in [the gross production tax] statutes contemplate that the purchaser will report and pay the gross production tax based on the price it paid to the producer *and the royalty owners*."[109] The court's flawed reasoning for this statement ignores the realities of the gas market. In reality, purchasers do not actually make payments to royalty owners; purchasers pay producers who, in turn, pay royalty owners for their proportionate share of the production under their lease because the common gas royalty provision places title to all of the gas produced in the producer.[110]

In support of its flawed reasoning, the court stated that title 68, section 1009(D) of the *Oklahoma Statutes* "requires the purchaser of gas sold at the time of production to withhold the gross production taxes in making settlements with the producer and the royalty owner and report and pay the tax to the OTC," and that section 1001(C) "provides that the gross production tax attaches to and is a lien upon the royalty interest."[111] The actual language of sections 1001(C) and 1009(D), however, merely provides for the deduction of the gross production taxes from both the producer's portion and the royalty owner's portion of the production proceeds.[112] Expressed differently, the royalty owner's portion of the production proceeds is not free from the gross production taxes owed by the producer.[113] The purchaser pays gross production taxes by deducting from the producer's first sales proceeds of the minerals, rather than adding to the purchaser's price of the minerals like a sales tax.[114] Therefore, the Gross Production Tax Code authorizes a purchaser to deduct its gross production tax payments from its payments to producers and ultimately, royalty interest owners, as they are the parties responsible for payment of the gross production taxes.[115] To suggest that sections 1001(C) and 1009(D) "contemplate that the purchaser will report and pay the gross production tax based on the price it paid to . . . the royalty owners" is simply a misreading of those sections, which place the burden of gross production

108. *Id.* ¶ 7, 131 P.3d at 707 (citing Gay v. Thomas, 1896 OK 67, 46 P. 578).

109. *Id.* ¶ 26, 131 P.3d at 711 (emphasis added).

110. *See* 3 KUNTZ, *supra* note 23, § 40.4(a)-(b), at 322-27.

111. *Texaco*, ¶ 26 n.6, 131 P.3d at 711 n.6.

112. *See* 68 OKLA. STAT. §§ 1001(C), 1009(D) (Supp. 2005), *amended by* Act of May 10, 2006, ch. 134, §§ 2-3, 2006 Okla. Sess. Laws 545, 547, 557.

113. *See id.*

114. *Id.* § 1009(D), *amended by* Act of May 10, 2006, § 3, 2006 Okla. Sess. Laws at 557; Exxon Corp. v. Okla. Tax. Comm'n, 1993 OK CIV APP 178, ¶ 7, 873 P.2d 306, 309.

115. *See* 68 OKLA. STAT. §§ 1001(B)(4), (C), 1009(D) (Supp. 2005), *amended by* Act of May 10, 2006, §§ 2-3, 2006 Okla. Sess. Laws at 546-47, 557.

taxes on the producers and royalty interest owners.[116] Accordingly, the *Texaco* court erred when it determined that the taxpayers and the OTC must use the greater of the alternative valuation methods to determine the valuation of gas for tax purposes in the absence of an arm's-length transaction at the wellhead.

2. Better Interpretations in Alabama and Colorado

An analysis of interpretations of valuation language in the Alabama and Colorado gross production tax statutes supports this conclusion.[117] The Supreme Court of Alabama has determined that under the language of the Alabama gross production tax statutes, the Alabama Department of Revenue (Department) may assess the value of gas by either the prevailing market value method or the work-back method in the absence of an arm's length sale at the wellhead.[118] The court further noted the unfavorability of the work-back method, and stated that any alternative method of valuation may be attacked by the taxpayer as unrepresentative of "market value" through use of expert testimony or evidence of other sales of like-quality gas.[119]

Alabama's gross production tax statutes contain similar provisions to Oklahoma's gross production tax statutes. Both states' statutes impose a severance tax based on the gross value of production of gas.[120] In both states, value is preferably determined by an arm's-length sale at the wellhead.[121] Likewise, both statutes provide similar authority for the use of alternative methods of valuation in the absence of an arm's-length transaction at the wellhead.[122]

---

116. *Texaco*, ¶ 26, 131 P.3d at 711.

117. State v. Phillips Petroleum Co., 638 So. 2d 886 (Ala. 1992); Washington County Bd. of Equalization v. Petron Dev. Co., 109 P.3d 146 (Colo. 2005).

118. *Phillips*, 638 So. 2d at 889.

119. *Id.* at 889-90.

120. *Compare* ALA. CODE § 40-20-2(a)(1) (1975) ("There is hereby levied . . . annual privilege taxes upon every person . . . producing or severing . . . gas. . . . The amount of such tax shall be measured at the rate of eight percent of the gross value of said . . . gas at the point of production."), *with* 68 OKLA. STAT. § 1001(B)(4) (Supp. 2005) ("[T]here is hereby levied upon the production of gas a tax . . . on the gross value of the production of gas."), *amended by* Act of May 10, 2006, § 2, 2006 Okla. Sess. Laws at 546-47.

121. *Compare* ALA. CODE § 40-20-1(3) ("VALUE. The sale price or market value at the mouth of the well."), *with* Apache Gas Prods. Corp. v. Okla. Tax Comm'n, 1973 OK 34, ¶ 27, 509 P.2d 109, 116 (holding that the value of gross production tax should first be based on the sales price in arm's-length transactions at the wellhead).

122. *Compare* ALA. CODE § 40-20-1(3) ("VALUE. . . . [I]f there is no sale at the time of severance or if the relation between the buyer and the seller is such that the consideration paid, if any, is not indicative of the true value or market price, then the department shall determine the value of the . . . gas subject to the tax hereinafter provided for, considering the sale price for cash of . . . gas of like quality."), *with* 68 OKLA. STAT. § 1009(F) (Supp. 2005) ("In case . . . gas

In *State v. Phillips Petroleum Co.*, the Alabama Supreme Court reasoned that "the statute defines 'value' as 'sale price or market value.' Therefore, any method of assessing 'value,' other than actual sale at the wellhead, must be calculated to result in an amount *approximating* market value."[123] If an arm's-length sale at the wellhead does not exist, "'then the department shall determine the value' of the raw gas, '*considering* the sale price for cash of . . . gas of like quality.'"[124] Because of the use of the word "considering," the *Phillips* court determined that this provision of the Alabama gross production tax statute required the Department to "reasonably regard" the sale price of like-quality gas — essentially, a valuation determination using the prevailing market value method — but not to treat this evidence as dispositive.[125]

Therefore, the *Phillips* court concluded that Alabama's gross production tax statutes, which bear great similarities to Oklahoma's gross production tax statutes, permitted the Department to assess gross production taxes based on either of the alternative valuation methods — the prevailing market value method or the work-back method.[126] The decision of the *Phillips* court, however, differed from the decision of the *Texaco* court in two important aspects. First, the *Phillips* court allowed any taxpayer who believed the selected valuation method overestimated or underestimated the "value" or "market value" of the gross production of gas to challenge the assessment through "expert testimony or . . . evidence of other sales of like-quality gas,"[127] whereas the *Texaco* court was silent on this important point.[128] Thus, the question of whether a taxpayer may introduce expert testimony on the subject of value if the taxpayer disagrees with the OTC's valuation assessment remains open in Oklahoma. Second, the *Phillips* court identified the work-back method as the "disfavored method" of calculating gas value and allowed any taxpayer who believed that a value calculated by the Department using the work-back method did not result in a fair indication of value to challenge the assessment "by showing that the calculations improperly included or excluded

---

is sold under circumstances where the sale price does not represent the cash price prevailing for . . . gas of like kind, character or quality in the field from which such product is produced, the Tax Commission may require the said tax to be paid upon the basis of the prevailing price then being paid at the time of production in said field for . . . gas of like kind, quality and character."), *amended by* Act of May 10, 2006, § 3, 2006 Okla. Sess. Laws at 557-58.

123. *Phillips*, 638 So. 2d at 889.

124. *Id.* (quoting ALA. CODE § 40-20-1(3)).

125. *Id.*

126. *Id.* at 889-90.

127. *Id.* at 889.

128. *See* State *ex rel.* Okla. Tax Comm'n v. Texaco Exploration & Prod., Inc., 2005 OK 52, 131 P.3d 705.

items."[129] In contrast, the *Texaco* court gave the prevailing market value method and the work-back method equal footing in determining the appropriate value of gas under similar gross production tax statute language.[130] Given the language of the Oklahoma Gross Production Tax Code and the precedent before the *Texaco* court tending to show that the prevailing market value method was the preferred method for determining the value of gas subject to the Tax Code,[131] the *Texaco* court should have made a determination about the unfavorability of the work-back method more similar to that of the *Phillips* court.

The Supreme Court of Colorado recently acknowledged the distinction urged by this note in interpreting provisions in oil and gas leases for royalty purposes versus interpreting provisions in statutes for taxation purposes.[132] In *Washington County Board of Equalization v. Petron*, the court rejected the county tax assessor's argument attempting to analogize *Rogers v. Westerman Farm Co.*,[133] another recent decision by the Colorado Supreme Court that disallowed the deduction of certain costs while using the work-back method to determine valuation for royalty payments under oil and gas leases, to the issue in *Petron*, which dealt with the ability to deduct these costs while using the work-back method to determine valuation for state tax obligations under the state tax statutes.[134] The *Petron* court determined that although "oil and gas leases are strictly construed against the lessee in favor of the lessor" in the royalty context, the "benefit of the doubt goes to the taxpayer" in the taxation context.[135] Accordingly:

> The analogy between *Rogers* and this case is misplaced. Our decision in *Rogers* addresses royalty obligations under private gas leases. We applied common law principles of interpretation to contracts that were silent as to how the natural gas was to be valued for purposes of calculating royalties. . . .

---

129. *Phillips*, 638 So. 2d at 889-90.

130. *Texaco*, ¶ 26, 131 P.3d at 711.

131. *See supra* Parts IV intro., IV.B.

132. Washington County Bd. of Equalization v. Petron Dev. Co., 109 P.3d 146, 154 (Colo. 2005).

133. 29 P.3d 887 (Colo. 2001).

134. *Petron*, 109 P.3d at 154.

135. *Id.* (dictum) (quoting *Rogers*, 29 P.3d at 901). The *Petron* court principally based its holding — that the taxpayer properly deducted leasehold-site gathering and processing costs to make the oil marketable from the downstream point of sale to determine the value of the unprocessed material at the wellhead subject to taxation — on interpretations of language of article X, section 3(1)(b) of the Colorado Constitution and section 39-7-101(1)(d) of the *Colorado Revised Statutes*. *Id.* at 149-54.

> Our analysis of the contract relating to the allocation of costs incurred downstream of the physical wellhead between working and royalty interest owners under the gas leases in *Rogers* is not relevant in the context of the constitutional and statutory interpretation applicable here.[136]

The *Petron* court's determination that interpretations of royalty provisions regarding valuation of gas under oil and gas leases do not apply to interpretations of tax provisions regarding valuation of oil and gas under state tax statutes should have been adopted by the *Texaco* court. Instead, the *Texaco* court chose to ignore the relevant precedent establishing that methods of gas valuation for royalty purposes were not applicable to determining methods of gas valuation for taxation purposes when the court applied the royalty decision in *Howell* directly to the taxation issue in *Texaco*.[137] Based on the applicable rules of construction for contracts and statutes as explained by the *Petron* court and the precedent before the *Texaco* court,[138] the *Texaco* court erred by applying the *Howell* decision absolutely to its taxation and statutory interpretation decision. The *Texaco* court should have held that the prevailing market value method was the "favored" method for taxpayers and the OTC to determine the value of gas in the absence of an actual arm's-length transaction at the wellhead under the Oklahoma Gross Production Tax Code and reserving the availability of the work-back method to taxpayers and the OTC in circumstances where application of the prevailing market value method is not possible.

V. Conclusion

The Oklahoma Gross Production Tax Code and prior precedent do not contemplate that the value of gas for gross production tax purposes should be calculated in the same manner as the value of gas for royalty purposes, as the Oklahoma Supreme Court erroneously determined in *State ex rel. Oklahoma Tax Commission v. Texaco Exploration & Production, Inc.* Courts should treat taxpayers in the same manner as royalty interest owners with regard to the valuation of gas under the language of the gross production tax statutes and lease royalty clauses, respectively. The well-established rule of construction that courts should strictly construe the language against the drafting party works against the gas producer as lessee of an oil and gas lease; however, the rule should favor the gas producer as taxpayer under the gross production tax

136. *Id.* at 154.
137. *See supra* Parts IV intro., IV.B.
138. *See supra* Parts IV intro., IV.B.

statutes as dictated by precedent and reason. The holding of the *Texaco* court improperly ignores this rule and inappropriately gives equal force to the alternative valuation methods. Other gas producing jurisdictions have made similar determinations; Oklahoma, as a leading gas producing state, should have done the same.

VI. Addendum

On May 10, 2006, House Bill No. 2411 was approved and made substantial changes to title 68, section 1009(F) of the *Oklahoma Statutes* effective July 1, 2006.[139] This amendment prohibits the OTC from using the work-back method by prescribing the use of the prevailing price method and "no other basis" to value gas for the purpose of calculating gross production taxes.[140] The amended statute also defines "related entities" and specifies a procedure for valuation of gas for tax purposes when the sale is between related entities.[141] In its entirety, section 1009(F) now reads:

> F. *1.* In case oil or gas is sold under circumstances where the sale price does not represent the cash price prevailing for oil or gas of like kind, character or quality in the field from which such product is produced, the Tax Commission may require the said tax to be paid upon the basis of the prevailing price then being paid at the time of production *for sales* in said field for oil or gas of like kind, quality and character *and on no other basis.*
>
> *2. In the case where the sale of oil or gas is between related entities, the taxpayer shall have the burden of proving with evidence of arm's-length sales between unrelated parties that the sales price represents the cash price prevailing for oil or gas of like kind, character or quality for sales in the field from which such product is produced. In the absence of such proof, the prevailing price shall be presumed to be the average price of oil or gas produced for sales in the county from which the product is produced, as determinded by the Tax Commission from monthly tax reports filed pursuant to Section 1010 of this title. In determining the average price, the Tax Commission shall not include the sales of oil or gas under review and shall not include prices from other sales that have been previously adjusted by the Tax Commission pursuant to this subsection.*

---

139. *See* Act of May 10, 2006, ch. 134, §§ 3, 5, 2006 Okla. Sess. Laws 545, 557-58.

140. *Id.* sec. 3, § 1009(F), 2006 Okla. Sess. Laws at 557; Okla. Indep. Petroleum Assoc., *Bill Addresses OTC v. Texaco Decision*, WELLHEAD, May 2006, at 13, 13.

141. Act of May 10, 2006, ch. 134, § 3, 2006 Okla. Sess. Law Serv. 547, 559-60.

3. For the purposes of this subsection, an entity is related to another entity if:

a. the two entities have significant common purposes and substantial common membership,

b. the two entites have direct or indirect substantial common direction or control, or

c. either entity owns, directly or through one or more entities, a fifty percent (50%) or greater interest in the capital or profits of the other entity.[142]

Jonathan D. Morris

142. 68 OKLA. STAT. § 1009(F) (Supp. 2006) (emphasis added to show changes).