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# Oil and Gas: Should the Cost of Transporting Oil Be Deducted in the Computation of Gross Value for Oklahoma's Gross Production Tax

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# Oil and Gas: Should the Cost of Transporting Oil Be Deducted in the Computation of Gross Value for Oklahoma's Gross Production Tax?

Producers of oil or gas in Oklahoma are required to pay a gross production tax of 7% on the gross value of the commodity produced.[1] They are also required to pay an excise tax on the same products.[2] Generally, the purchaser pays the tax and deducts the amount from the corresponding payments to the producer.[3]

These taxes have traditionally played an important role in Oklahoma's econmony.[4] In fiscal year 1987, over $372,882,960 in gross production and excise taxes were collected.[5] This amounted to over 15% of the state's tax revenue.[6]

This note will discuss elements of the definition of gross value for production tax purposes. The starting point for the computation of gross value is the posted field price for oil and the contract price for gas.[7] The posted field price is the price major purchasers are willing to pay for oil of a specified quality in that field.[8]

This note will address the problem that occurs when additional price reductions are made because there is no pipeline connection at the leasehold. In

1. 68 OKLA. STAT. § 1001 (1981).

2. 68 OKLA. STAT. § 1101 (1981).

3. 68 OKLA. STAT. § 1007 (1981). Usually, the producer owns a leasehold, and pays a 1/8 or 3/16 share of the proceeds to the owner of the mineral rights. The producer deducts the corresponding share of the taxes from the royalty payment to the owner.

4. In 1908, Oklahoma became the second state to pass a production tax on oil and gas. Collier, *State Taxation of Oil and Gas*, 11 INST. ON OIL & GAS L. & TAX'N 397 (1959). The current Gross Production Tax is derived from R.L. 1910, § 7464. This section levied a tax on the gross receipts of the production. The tax was changed to one on the gross value of the production and made in lieu of a property tax by Laws 1913, Ch. 240, Art. 2, subdiv. A, 1, p. 640. The producer was required to file a report showing the actual cash value at the time and place of production by Laws 1916, Ch. 39, 1, p.103. This was modified by Laws 1933, Ch. 103, 5, p. 202, which required the producer report the actual cash value, to include any premiums, at the time and place of production. This is essentially the version of the Gross Production Tax in use today. At the time the principal cases that are discussed in this note arose, the Gross Production Tax was codified at 68 OKLA. STAT. § 821 (1951) and 68 OKLA. STAT. § 821 (1961). The Gross Production Tax Code was renumbered in 1965 and now appears at 68 OKLA. STAT. §§ 1001-1024 (1981).

5. Annual Report of the Oklahoma Tax Commission 2 (1987).

6. *Id.* at 22.

7. Oil is usually sold to a purchaser after it is pumped out of the ground and stored. The oil is purchased one lot at a time. Gas has traditionally been sold to pipeline companies under longterm contracts. This practice has been changing under the pressure of changing market conditions. *See* Pearson & Dancy, *Negotiating and Renegotiating the Gas Contract: Producers' Duties to Third Parties*, 56 OKLA. B.J. 2181, 2189 (1985).

8. 8 H. WILLIAMS & C. MEYERS, OIL & GAS LAW 731 (1987).

this case the price paid for the oil may be adjusted downward to reflect the cost of trucking or hauling the oil to a pipeline, a receiving station or the use of other companies' pipelines.[9] The issue is whether the Oklahoma Tax Commission (the "Commission") may ignore the adjustment for transportation in computing the gross value if the price paid for the oil was the result of good faith, arm's length bargaining.

### *The Conflict Between Apache and Sun Oil.*

The Oklahoma Supreme Court has decided two cases that confront this problem. The issue was first addressed in *Atlantic Oil Refining Co. v. Oklahoma Tax Commission.*[10] The court held that the gross value of oil or gas would be the posted field price with no deduction for transportation charges.[11]

A different conclusion was reached in *Apache Gas Products Corp. v. Oklahoma Tax Commission.*[12] The court allowed a price adjustment for low gas pressure, and held that the proper measure of the gross value of gas was the actual sale price if it resulted from good faith, arm's length bargaining.[13] The court stated that the Commission could use the posted field price only if the circumstances showed a lack of good faith bargaining that indicated a purpose to avoid taxes.[14]

Clearly, the decisions conflict. While the cases can be reconciled, the result is an asymmetric judicial treatment of oil and gas producers within a statute that treats them symmetrically in all relevent respects. Additionally, the underlying principals used in the two cases conflict, and objections that appeared in the dissenting opinion in *Atlantic* later became the guiding principals of *Apache.*

This conflict is of more than mere academic interest. In *Sun Oil Exploration and Production Co. v. Oklahoma Tax Commission,*[15] the producer attempted to apply the gross production tax to the price it received for its oil. This price was the posted field price less deductions made by the purchaser as an adjustment for the costs of transporting the oil.

The Tax Commision, relying on *Atlantic,* assessed and confirmed an additional tax of over $500,000. The Oklahoma Court of Appeals affirmed in an unpublished memorandum opinion, and the Supreme Court of Oklahoma

9. Alternatively, the producer may haul the oil to a pipeline himself. He may also hire an independent hauler to do the job. Economically, the results are the same: the producer winds up with less for the oil.

10. 360 P.2d 826 (Okla. 1961).

11. *Id.* at 832. There is no posted field price for gas. However the court's symmetric treatment of oil and gas is easy to understand. See *infra* text accompanying notes 79-85.

12. 509 P.2d 109 (Okla. 1973). This case is, perhaps, better known for its impact on the calculation of gas royalty payments. *See, e.g.,* Harris, *Gas Royalties— Leading State and Federal Cases Reviewed: Alice's Adventures in Royalty Land,* 37 OKLA. L. REV. 699, 704 (1984).

13. *Apache Gas Prod. Corp.,* 509 P.2d at 116.

14. *Id.*

15. No. 66,943 (Okla. Ct. App. Dec. 29, 1987), *cert. denied,* (Okla. Apr. 12, 1988).

denied the resulting request for a writ of certiorari. In the absence of a precedent to resolve the problem, other litigation has begun.[16]

*Atlantic Refining Co. v. Oklahoma Tax Commission*

Between November 1, 1956, and May 31, 1957, Atlantic produced oil in certain counties of Oklahoma. The leaseholds in question had no pipeline connections. The oil had to be trucked or hauled to the pipeline or receiving station of the purchaser.[17]

During this period producers of oil and gas were requried to pay a 5% tax on the gross value of the commodity produced.[18] Atlantic computed the gross production tax by deducting the cost of transportation from the posted field price for the oil. The Commission computed the tax on the posted field price without the transportation deduction and assessed an additional tax on the difference.[19]

Atlantic paid the additional tax under protest and requested a hearing before the Commission. The Commission affirmed the additional assessment. The issue, as stated by the Oklahoma Supreme Court, was whether the cost of transporting oil was deductible when computing the gross production tax if pipeline connections to the leasehold were unavailable.[20]

Section 821 of the Gross Production Tax Code (the "Code") required a monthly report of the actual cash value paid for oil and gas at the time and place of production, and a payment of a tax of 5% of the gross value of the product.[21] The Commission argued that the tax should be assessed on the gross value which, it claimed, was the posted field price with no deductions for transportation.[22]

Atlantic contended that the tax should be computed on the actual cash value at the time and place of production or the gross value at the place of production. Because production occurred at the wellhead, both of these quantities were the actual amount received less the cost of transportation from the wellhead to pipeline.[23]

16. TXO Prod. Corp. v. Oklahoma Tax Comm'n, No. P-86-537 (Okla. Tax Comm'n 1988).
17. *Atlantic Ref. Co.*, 360 P.2d at 828.
18. 68 OKLA. STAT. § 821 (1951).
19. 360 P.2d at 828.
20. *Id.* at 829.
21. 68 OKLA. STAT. § 821 (1951) provided, in pertinent part:

> [Producers] of petroleum or other crude oil or other mineral oil, natural gas and/or casinghead gas shall, monthly, file with the Oklahoma Tax Commission, a statement . . . showing . . . the actual cash value thereof at the time and place of production . . . and shall at the same time pay . . . a tax equal to five percentum of the gross value of the production of petroleum or other crude or mineral oil . . . which is hereby levied based on 42 U.S. gallons of 231 Cubic inches per gallon, computed at a temperature of 60 degrees Fahrenheit for oil measurements and a tax equal to five percentum of the gross value of production of natural gas and/or casinghead gas.

22. 360 P.2d at 829.
23. *Id.* In this case, Atlantic apparently received the posted price for the oil but paid to have the oil hauled to a pipeline or hauled the oil itself. In *Sun Oil Exploration and Prod. Co.*,

The court agreed with Atlantic that oil was produced for gross production tax purposes at the wellhead when it was brought to the surface and confined for measurement.[24] However, the court disposed of the "actual cash value" branch of Atlantic's argument by holding the words "cash value" only referred to the reporting requirement of the statute.[25] The levying portion of the statute referred to the gross value of the production, and the issue was reduced to the determination of the meaning of gross value.[26]

The court held that "gross value" was not defined by the statute.[27] Atlantic argued that the meaning could be derived from a 1957 amendment to the Code.[28] The amendment levied a production tax on uranium and defined gross value as being the value of the ore immediately after mining or the value that could or should have been received.[29] The court held that this addition was not controlling because the legislation had the opportunity to similarly amend the oil and gas provisions but did not.[30]

The court then turned to the history of the oil industry to determine the legislature's intent. The court found the price paid for oil had historically been the posted field price, as modified for gravity, without regard to the need to transport the oil to a pipeline or other station. In addition, the court found the Commission had consistently construed gross value to refer to this method of pricing ever since assuming its enforcement duties in 1931.[31]

The court stated that a uniform and consistent construction of an ambiguous statute by an administrative agency charged with its enforcement should be given great weight and should not be overturned without a cogent reason.[32] Additionally, the court held the legislature had acquiesced to this interpretation because it had met many times during this period of administrative construction and had not objected.[33]

Atlantic argued that one cogent reason for changing the Commission's practice was that this interpretation of the statute violated the constructional requirement that taxes be uniform on the same class of subjects.[34] The uniformity requirement applies to property taxes, but not taxes such as licenses,

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the producer tried to distinguish the cases by arguing the purchaser of Sun's oil took possession at the wellhead. See *supra* note 3 and accompanying text. However, the value of the oil at the well head is the same no matter who has possession.

24. 360 P.2d at 829.
25. *Id.* at 830. See *supra* note 21.
26. *Id.*
27. *Id.*
28. 68 OKLA. STAT. § 848(5) (Supp. 1957).
29. 360 P.2d at 830.
30. *Id.*
31. *Id.* at 831.
32. *Id.*
33. *Id.* at 832.
34. OKLA. CONST. art. X, § 5 provides that "taxes shall be uniform upon the same class of subjects."

privilege taxes and excises.[35] The court stated that the gross production tax was, without question, a property tax in lieu of an ad valorem tax.[36]

The court held that nothing could be more uniform than the Commission's practice of requiring all producers of the same gravity of oil pay the tax on the same basis regardless of geographic location.[37] Further, when interpreting an ambiguous tax statute, the statute should be construed so it distributes the burden of the tax uniformly.[38] Therefore, the court affirmed the additional assessment and defined gross value "as the posted price for oil or gas of like kind, character and quantity produced in the same field or area without regard to transportation charges to pipelines."[39]

The court based its interpretation of an ambiguous term in the Gross Production Tax Code on long standing adminstrative practices. Because the court found no good reason to change the practice, it construed the statute accordingly. The dissent, however, argued there were two good reasons to change the Commission's practice.[40]

First, the gross production tax is in lieu of all ad valorem taxes.[41] The statute exempts production facilities from ad valorem taxes but not transportaion facilities.[42] Apparently, this indicates an intent by the legislature not to include transportation in the scheme of production for tax purposes. Therefore, the increased value of oil due to the use of transportation equipment should not be subject to the gross production tax.[43]

Second, the Code does not authorize the Commissioner to compute the tax on the prevailing price in the field[44] unless the sale price does not represent the actual cash value.[45] The majority, by equating gross value and posted field price, makes this part of the statute irrelevant because the tax is computed on the posted field price regardless of the sale price. The dissent stated that a good faith arm's length bargain is the best measure of the gross value of oil, and the majority holding allows the Commission to ignore this aspect of the transaction entirely.[46]

35. *See In re* Skelton Lead & Zinc Co.'s Gross Prod. Tax for 1919, 81 Okla. 134, 137-38, 197 P. 495, 498-99 (1921); Johnston v. Oklahoma Tax Comm'n, 497 P.2d 1295, 1297-98 (Okla. 1972). This point is not stated in the opinion and has created some confusion. See *infra* note 65.

36. 360 P.2d at 829.

37. *Id.* at 832.

38. *Id.*

39. *Id.* at 827.

40. *Id.* at 832 (Andrews, S.J., Davison, Haley and Jackson, J.J. in dissent).

41. 68 OKLA. STAT. § 821 (1951).

42. *Id.*

43. *Atlantic Ref. Co.*, 360 P.2d at 832.

44. "Prevailing price" and "field" are two among several terms that the legislature did not define in the Code. The Commission interpreted prevailing price as the price that the majority of the product sold for. If this definition is accepted, it is not the same as the posted field price because the posted field price is a base price to which adjustments may apply. 8 H.R. WILLIAMS & C. MEYERS, OIL & GAS LAW 731-33 (1987).

45. 68 Okla. Stat. § 833 (1951).

46. 360 P.2d at 832.

The dissent's position in *Atlantic* was later adopted in the *Apache* decision. Therefore, it is worth noting that the holding in *Atlantic* refers to both oil and gas even though the facts only concern the production of oil. The symmetric treatment of oil and gas by the Code is the reason for this feature of the holding.[47]

This symmetry was still in existence when *Apache* was decided, and it continues today.[48] This observation should be kept in mind when analyzing the effect of the court's treatment of gross value in *Apache* because the holding results in different treatment of oil and gas producers.

### *Apache Gas Products Corp. v. Oklahoma Tax Commission*

Apache Gas Products Corporation and Warren Petroleum Corporation purchased natural gas from R.H. Siegfried, Inc. and other producers in Lincoln County, Oklahoma, over a period of several years. For several years prior to April 1963, Apache and Warren reported and paid a gross production tax on this gas.[49]

The purchases were made pursuant to a long term, written contract. The contract prescribed a price of 11¢ per mcf (thousand cubic feet) for gas whose pressure was high enough to enter a high pressure line and 9¢ per mcf for gas that had to be delivered into a low pressure system. The gross production tax was paid on the value received for the gas.[50]

The Commission assessed an additional tax for the period August 1, 1960, to Febuary 28, 1963. The Commission claimed 12¢ per mcf was the prevailing price in the field during the period in question and applied the tax to this value. Apache and Warren paid under protest and filed suit for a return of the additional assessment.[51]

The trial court affirmed the additional assessment. The court found that the contract was negotiated at arm's length. The court also found the price represented the highest and best price obtainable for gas in that field under the circumstances. However, the court held that the Commission was not bound to use that price as the gross value but was authorized by law to use the prevailing price in the field.[52]

In addition, the court found that the Commission's price of 12¢ per mcf was supported by the evidence presented by the Commission. The evidence consisted of data showing the price of gas purchased in January of each of the years in question in Lincoln County. About 55% of the gas was sold at 12¢ per mcf, while only 2% was sold for 9¢ per mcf. Apache produced

47. See *infra* text accompanying notes 79-85.
48. *Id.*
49. *Apache Gas Prod. Corp.*, 509 P.2d at 110.
50. *Id.*
51. *Id.* at 110-11.
52. *Id.* at 111-12.

evidence which demonstrated several other factors, including pressure, affected the price of gas in a given field.[53]

The Oklahoma Supreme Court noted that the Commission's evidence did not reflect the prevailing price paid for gas of like kind, quality or character at the time the contracts for the gas were made.[54] Thus, the trial court adopted the Commission's view that the contract price could be ignored and the tax computed on the prevailing price in the field at the time of production.[55]

The Commission's practice had been to levy the gross production tax on the actual sale price determined by the contract. The contracts were long term, and the contract price might differ from the price being offered when the gas was finally produced. When the price of gas went up, the Commission wanted to collect the additional revenue.

Whatever the Commission's actual motive for changing this policy, the language of the Code and the decision in *Atlantic* strengthened the new policy. Section 833 of the Code permitted the Commission to levy the tax on the prevailing price in the field at the time of production if the sale price did not represent the prevailing price in the field.[56] However, the court's decision in *Atlantic* appeared to make the Commission's power to tax on the prevailing price in the field at the time of production absolute.[57]

The Oklahoma Supreme Court disagreed. First, the court noted the Code authorized the Commission to require the tax to be paid on the basis of the prevailing price in the field only when the prices paid did not represent the actual price.[58] Because the unique nature of the gas industry required long-term contracts, the court held that the comparison must take place when the contract is made, not when the gas is produced.[59] The court stated that the legislature could not have intended the purchaser to pay one price, deduct the tax at that price and then pay the tax as if the gas were purchased at another price.[60]

Having ruled on the long term nature of the agreements, the court turned to the pressure adjustment feature of the contract. The Commission argued, possibly with *Atlantic* in mind, that the uniformity requirement of the

53. *Id.* at 112.
54. *Id.* at 113.
55. *Id.*
56. 68 OKLA. STAT. § 833 (1961), now 68 OKLA. STAT. § 1109(f) (1981), provided:

> In case oil, gas, or casinghead gas is sold under circumstances where the sale price does not represent the cash price thereof prevailing for oil, gas, or casinghead 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 thereof in said field for oil, gas, or casinghead gas of like kind, quality and character.

57. See *supra* text accompanying notes 44-46.
58. *Apache Gas Prod. Corp.*, 509 P.2d at 113.
59. *Id.*
60. *Id.*

Oklahoma Constituition mandated that the tax be computed on a price that was the same for all producers in the field.[61] The court gave two reasons for rejecting this argument.

First, the Oklahoma Constitution provides that nothing within it shall be constructed as prohibiting the classification of property for the purposes of taxation.[62] One valid basis of classification would be the variety of circumstances affecting the price.[63] In this case, the pressure could have served as the basis for classification.[64]

Second, the court traced the history of the gross production tax to determine its true nature.[65] The court found its prior characterization as a property tax in lieu of an ad valorem tax was a judicial attempt to tax production on restricted Indian lands without running afoul of the prohibition of taxing a federal activity.[66] Because this taxation had been allowed by federal statute, the court overruled the cases that characterized the production tax as a property tax.[67] The court returned to the original view that the tax was on the privilege to engage in an occupation and not subject to the uniformity requirement of the Oklahoma Constitution.[68]

Finally, the court noted that although the gross production tax was in lieu of an ad valorem tax, exact conformity between the two taxes was not required.[69] Therefore, although the ad valorem tax on property would be subject to the uniformity requirement, the gross production tax was not subject to the requirement of uniformity.

Because no uniformity problem existed, and because great weight had to be given to the Commission's previous practices of taxing on the basis of market influenced contract prices, the court ordered the repayment of the additional assessment.[70] Finally, the court directed the Commission to compute the tax on the gross proceeds realized by the producer, unless the circumstances indicated the gross proceeds were the result of an attempt to avoid the tax.[71]

61. *Id.*
62. *Id.* (citing OKLA. CONST. art. X, § 22).
63. 509 P.2d at 113.
64. *Id.* The costs of pressurization affect the value of gas. Collier, *supra* note 4, at 471-72.
65. The authorities have expressed some puzzlement over the importance of the *Atlantic* court's characterization of the Gross Production Tax as a property tax in lieu of an ad valorem tax. Collier, *supra* note 4, at 469-71. As previously mentioned, only property taxes are subjects to the uniformity requirement. See *supra* text accompanying notes 34-36.
66. 509 P.2d at 113-15. See *supra* note 35.
67. *Id.* at 115.
68. *Id.*
69. *Id.* at 116.
70. *Id.*
71. The court stated:

> In future applications of the statute here involved, the Commission should apply the gross production tax to the 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

*Conflict, Reconciliation and Problems*

The holdings clearly conflict. *Atlantic* required that the Commission use the posted field price for oil and gas to compute the gross value of oil and gas for gross production tax purposes.[72] *Apache* instructed the Commission to compute the tax on the gross proceeds from the contract for gas and the decision gave no guidance on computing the tax for oil.[73]

In addition, *Atlantic* made section 1009(f) of the Code, which permitted taxation on the prevailing price in the field, irrelevant because the posted field price must be used to compute the tax independently of the sale price or the amount of money that changed hands.[74] On the other hand, *Apache* directed the Commission to use the gross proceeds of the sale to compute the tax.[75] The section 1009(f) provision should only be used if the sale was made without good faith, arm's length bargaining.[76]

The first question needing to be addressed is whether the cases can be reconciled. The holding in *Atlantic*, as far as the taxation of gas was concerned, was dicta because the facts of the case did not involve gas.[77] The holding in *Apache* referred only to gas.[78] Therefore, any mention of gas in *Atlantic* was not law, and the impact of *Apache* was to insure it would never become law.

Therefore, the cases result in one rule for oil producers and another rule for gas producers. The gross production tax is computed on the gross value for either product. The gross value of oil is the posted field price. The gross value of gas, however, is the actual sale or contract price, unless it appears the bargain was not the result of good faith, arm's length bargaining. In this instance the tax is computed on the prevailing price in the field at the time the gas is produced.

*Symmetry*

As noted previously, the *Atlantic* court defined gross value as the posted field price for oil and gas in spite of the fact that the gas industry does not use a posted field price.[79] This was natural because it reflected the legislature's

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> 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."

*Id.* It is interesting to note that this definition of gross value is a return to the form of the gross receipts tax of 1910. See *supra* note 4.

72. 360 P.2d at 827-28.
73. *Apache Gas Prod. Corp.*, 509 P.2d at 116.
74. 360 P.2d at 832.
75. 509 P.2d at 116.
76. *Id.*
77. 360 P.2d at 827-28.
78. 509 P.2d at 116.
79. See *supra* note 11.

symmetric treatment of oil and gas producers in the Code. The holding insured that the legislative intent would be preserved upon judicial construction of the statute.

With minor exceptions, the phrases "petroleum, or other crude oil or other mineral oil, natural gas and/or casinghead gas"[80] and "oil or gas" appeared uniformly throughout the Code.[81] The only deviations from this symmetric usage resulted from the different physical characteristics of liquids and gases.

For example, in section 821 of the Code, the 5% tax on the gross value of oil was levied in a different sentence than the same tax on gas. This was done because volume and temperature standards for the measurement of oil had to be specified.[82] Section 824 of the Code levied a 12½% tax on oil found in natural depressions if the source of the oil is unknown.[83] No corresponding provision for gas was created because gas does not collect on the surface when it seeps from the earth.

Although the law has been amended many times since 1951, the essential symmetry has never been changed. The current version of the gross production tax, article 10, title 68 of the Oklahoma Statutes, shows the same pattern.[84] For example, section 1001(d) of the Code refers to oil produced by enhanced recovery procedures, a method without counterpart in the gas industry.[85]

Therefore, the legislature clearly intended to treat oil and gas producers in the same manner. Furthermore, the rules derived from *Atlantic* and *Apache* clearly do not preserve this intent because oil is valued by its worth to major purchasers at their pipeline while gas is valued by the local market.

Although the legislature intended to treat oil and gas producers in the same way, differences between the industries could require a statutory construction that results in different treatment. Arguably, the *Apache* court supplied the necessary distinction. The court stated that because the gas industry had a unique nature, long term contracts were required.[86] The oil industry did not require long term contracts.[87]

However, this distinction is not germane to the issue discussed in this note. It is the use of the contract or sales price, as opposed to the posted field price, to determine gross value that is of interest here. If the contract in *Apache* had been for immediate purchase, the features of the *Apache* holding that conflict with *Atlantic* remain. Gross value is the sales price, as legitimately

80. Casinghead gas is gas that is produced along with oil at an oil well. 8 H. Williams & C. Meyers, Oil and Gas Law 120 (1987).

81. See *supra* notes 21 and 56.

82. See *supra* note 21.

83. 68 Okla. Stat. § 824 (1951).

84. Sections 1001 and 1009(f) have replaced sections 821 and 833. There has been no substantial change that is relevant to this argument. 68 Okla. Stat. §§ 1001-1024 (Supp. 1988).

85. 68 Okla. Stat. § 1001(d) (Supp. 1988).

86. *Apache Gas Prod. Corp.*, 509 P.2d at 113.

87. *Id.* at 113.

influenced by the pressure and other characteristics of the gas, unless the contract is not made at arm's length and results in the payment of less tax.[88]

Additionally, long term contracts are no longer essential to the gas industry. Long term contracts were used to attract investors, who wanted guaranteed sources of supply, to finance pipeline construction. The pipelines were for both transportation and storage.[89]

This need is no longer as great because gas can be stored in depleted fields and due to the existence of pipelines. Therefore, when the price of gas dropped two or three years ago, long term contracts were broken. The industry began to use contracts lasting as little as a month to be able to adjust to the changing market.[90]

In addition, there is now "open access" to the gas market. Producers can sell directly to the user instead of to the pipeline. The pipeline company becomes a transporter for a fee and plays a role similar to an independent hauler of oil.[91] Therefore, if it could be argued that the need for long term contracts is a relevent difference, that difference is disappearing.

The structure of the Code does not direct or imply different treatment of oil and gas producers. Nor does the nature of the industries require they be treated differently under the Code. Nonetheless, the decisions in *Atlantic* and *Apache* result in different rules for each industry. To solve this problem, one or both of the rules must be changed.

### *Construction and Internal Consistency*

When the *Atlantic* court held the legislature had not defined gross value in the statute, they immediatley looked outside the statute to the history of the oil industry for a definition.[92] In taking this approach, the court chose not to look at the entire Code to determine the meaning of the term. As demonstrated below, this approach resulted in inconsistencies in the structure of the Code.

One problem is that the *Atlantic* definition of gross value causes oil to be valued at a point beyond the place of production. The place of production is where the oil is brought to the surface and confined for measurement.[93]

88. *Id.* at 116.

89. Private Communication, Executive Director of the Oklahoma Independent Producer's Association ("OIPA") (Nov. 2, 1988).

90. *Id.* It appears the days of the long term contracts are over because gas is now traded on the New York Mercantile Exchange. This has resulted in a spot market for gas which tends to keep the price fluid. *See also* Pearson & Dancy, *supra* note 7, at 2189.

91. Executive Director of the OIPA, *supra* note 89. It should also be noted that a similar situation always existed in the gas industry anyway. Smaller pipelines, operated by "gatherers" are used to collect the gas from wells in an area and transport it to a central receiving point on the main pipeline. The purchaser, traditionally the major pipeline, pays the gatherer and deducts the amount from the payment to the producer. *Id.* Because this is done by contract, the tax is paid on the cash received by the producer. In contrast, although the hauler of oil plays the same role as the gatherer, the tax does not take into account his services.

92. *Atlantic Ref. Co.*, 360 P.2d at 830.

93. *Id.* at 829.

The posted field price for oil is the price purchasers are willing to pay for oil delivered into a pipeline. For the producer with a pipeline, these two points are the same and no problem is presented.

For the producer without a pipeline connection, these points are not the same. Taxing this producer at the posted field price values the product beyond the point of production. This result is inconsistent with case law.[94]

The dissent in *Atlantic* also noted that section 833 of the Code allowed the Commission to tax at the prevailing price in the field if the sale price did not represent the actual cash price.[95] The legislature intended to use the market to define gross value as long as there was no collusion to avoid taxes.[96] The holding in *Atlantic* repealed section 833, at least for the oil industry, and destroyed the intent of the legislature because gross value would be determined solely by the posted field price.

The dissent thought the better approach was to use the market to determine gross value.

> A sale under circumstances indicating the absence of armslength [sic] bargaining justifies the application of the prevailing field price. But when a bona fide sale of the production has occurred, the sale price should be accepted as the proper measure of value. The best means of determining value is a bona fide sale.[97]

This statement correctly recognizes the interaction of sections 821 and 833 in expressing the legislature's intent to let the market determine gross value unless there is evidence of collusion to avoid taxes. By using the four corners of the Code to define gross value, the dissent avoided the resulting internal problem of repealing section 833 for the oil industry. The dissent's construction of the statute was essentially the same that would be made in *Apache* twelve years later.[98]

The dissent also stated that the tax was on production, not production and transportation.[99] The legislature exempted production but not transportation facilities from ad valorem taxes.[100] Therefore, the use of transportation facilities should not be used to increase the value of oil for gross production tax purposes.[101]

94. *See, e.g.*, Oklahoma Tax Comm'n v. Sun Oil Co., 489 P.2d 1078 (Okla. 1971).
95. 360 P.2d at 832.
96. *Id.*
97. *Id.*
98. 509 P.2d at 116.
99. 360 P.2d at 832.
100. *Id.* 68 OKLA. STAT. § 821 (1951) has not changed in this respect. 68 OKLA. STAT. ANN. § 1001(i) (Supp. 1987). Property not directly involved in production, such as pipelines, gathering lines, compressors and collection tanks have always been subject to ad valorem taxation. *See* Going v. Shaffer, 89 Okla. 46, 213 P. 736 (1923). Although trucks used to haul oil are not subject to ad valorem taxation, it is not because of the gross production tax. Their exclusion is based on licensing and registration fees as motor vehicles. 47 OKLA. STAT. § 1103 (Supp. 1988).
101. 360 P.2d at 832.

This argument can be based on legislative intent or the constitutional prohibition against double taxation. The prohibition on double taxation makes it unconstitutional to require a member of a class to contribute twice to a tax burden when others in the same class are only required to contribute once.[102] Producers with and without pipeline connections are placed in the same class by the majority holding because the tax is applied to the same price for both producers. Therefore, the Commission's practice of taxing the transported oil at its value after transportation results in an unconstitutional double taxation on oil producers without a pipeline connection. The transportation means are subject to the gross production tax and an ad valorem tax.

The constitutional support for this argument was removed by the *Apache* decision holding that the gross production tax was not a property tax, but a tax on the occupation of the production of oil and gas.[103] Therefore, the gross production tax is not subject to the uniformity requirement that gives rise to the double taxation problem. The foundation of legislative intent, however, still remained.

The legislature set up a system of taxation where the gross production tax was in lieu of the ad valorem tax in the oil and gas production industry.[104] The "in lieu of" provision makes it clear the legislature did not intend these taxes to overlap. Taxing a producer who has no pipeline connection at the posted field price puts a production tax on transportation facilities which are already subject to an ad valorem tax. Therefore, the majority's holding is inconsistent with the "in lieu of" portion of the Code.

### *Equity*

Another concern is fairness to the oil producer without a pipeline connection. In *Apache*, the court stated "[c]ertainly this portion of the Act does not contemplate that the purchaser shall pay the producer one price, deduct the tax due the state at that price . . . and then pay the State a tax at another price."[105]

The same logic applies to the fact pattern in *Atlantic*. A producer cannot fairly be expected to be paid at one price and then be taxed on another when other producers are not treated this way. The legislature probably did not intend this strange result.

The *Atlantic* court stated that it was required to distribute the tax burden uniformly when interpreting an ambiguous tax statute.[106] While the court gave no authority for this statement, its source appears to be a judicial attempt

102. *See* Olson v. Oklahoma Tax Comm'n, 198 Okla. 607, 180 P.2d 622 (1947).

103. 509 P.2d at 115. It should be noted that the overruling of all cases in as much as they held the gross production tax to be a property tax does not overrule the holding of *Atlantic*. The need for uniformity is removed, but there is no reason why a uniform tax cannot be imposed.

104. 68 OKLA. STAT. § 1001 (1971).

105. 509 P.2d at 113 (quoting W.R. Davis Inc. v. State, 142 Tex. 637, 180 S.W.2d 429, 432 (Tex. 1944)).

106. 360 P.2d at 832.

at equity and it is independent of the nature of the tax.[107] The burden is not laid uniformly by a court decision that requires the same tax be lieved on producers whose products are not worth the same amount.

*Out of State Authority*

Oklahoma is not the only state to have a gross production tax on petroleum products.[108] While the laws of other states have no authority in Oklahoma, they may be used to examine the logical bases and policy justification of Oklahoma law.[109]

The nature of the tax varies considerably from state to state.[110] Most of these taxes are of four forms. Some are taxes on the value of the real property itself.[111] Others are ad valorem taxes on an interest in the product,[112] and some are property taxes on an interest in production.[113] Other states have chosen to impose a tax on the privilege or occupation of producing, severing, gathering or distributing oil and gas.[114]

Oklahoma's gross production tax has been characterized as a tax upon the privilege of producing oil and gas.[115] Several states have taxes that are similarly characterized, and either explicitly or judicially deal with the instant issue.

Florida taxes those persons engaged in the business of producing oil or gas.[116] The tax is computed on the value of the oil and gas as measured at the point of production.[117] Transportation deductions are expressly allowed by the statute.[118]

Texas levies an occupation tax on producers of oil and gas.[119] The tax is computed on the market value of the product.[120] The market value is the price the product is actually sold for, less the costs of transportation and processing, unless the contract was not made at arm's length or there is evidence of collusion or fraud.[121]

Wyoming taxes the privilege of severing oil and gas from the ground.[122]

107. *See* Magnolia Pipeline Co. v. Oklahoma Tax Comm'n, 196 Okla., 167 P.2d 884, 889 (1946).

108. *See* 4 W.L. Summers, Oil & Gas §. 781-815 (Supp. 1987).

109. 82 C.J.S. *Statutes* § 365 (Supp. 1988).

110. The variety is amply displayed by the summary of taxes in the mountain states contained in Kelly, *State Mineral Taxation: An Overview*, Mineral Tax'n Inst. 9-1 (Mar. 31, 1977).

111. 4 W.L. Summers, Oil and Gas § 374 (1962).

112. *Id.* § 785-96.

113. *Id.* § 797-98.

114. *Id.* § 801-14.

115. *Apache Gas Prod. Corp.*, 509 P.2d at 115.

116. Fla. Stat. Ann. §§ 211.01-211.21 (Supp. 1987).

117. *Id.* § 211.02(1).

118. *Id.* § 211.03.

119. Tex. Tax Code Ann. §§ 201.001-201.404, 202.001-202.353 (Vernon Supp. 1989).

120. *Id.* §§ 201.101, 201.102, 202.053.

121. Bullock v. Mid American Oil & Gas Inc., 680 S.W.2d 612 (Tex. Ct. App. 1984); Mobil Oil Corp. v. Calvert, 451 S.W.2d 889 (Tex. 1970); W.R. Davis Inc. v. State, 142 Tex. 637, 180 S.W.2d 429 (1944).

122. Wyo. Stat. §§ 39-6-301 to 39-6-307 (Supp. 1988).

The tax is levied on the value of the gross product[123] which is defined as the cash value of the product unless the transaction is not made at arm's length.[124] The courts have construed the statute to allow transportation deductions.[125]

North Dakota's gross production tax[126] has been characterized as a property tax,[127] but is of interest because it is based on Oklahoma's gross production tax.[128] While the courts have not addressed the issue of transportation deductions the Commission has stated that the tax should be computed on the price received at the pipeline less the cost of transportation.[129]

Generally, accounting for the need to transport the product before sale is common no matter how a state characterizes its tax.[130] The limitation on the state's power to set the value to situations where the sale indicates a purpose to avoid taxes also appears in these states.[131]

The scope of this note prohibits a state by state investigation of every tax scheme. Nonetheless, it is possible to conclude that Oklahoma taxes the gas production industry in much the same way as the majority of other states. However, Oklahoma's treatment of the oil industry, especially when contrasted with the way the gas industry is taxed in the state, puts Oklahoma in a minority, if not unique, position.

### *Conclusion*

The holdings of *Atlantic* and *Apache* are not contradictory. Taken together, however, the holdings result in a treatment of oil and gas producers that does not conform to the symmetric treatment of these industries by Oklahoma's statutory law. If the intent of the legislature as expressed by the structure of the Code is to be preserved, at least one of the holdings must be changed.

123. *Id.* § 39-6-302(a).

124. *Id.* § 39-2-202. The arm's length criteria used in Wyoming is broad enough to include the arm's length plus additional tax burden used by the Oklahoma Supreme Court. 509 P.2d at 116.

125. *In re* Monolith Portland Midwest Co., 574 P.2d 757 (Wyo. 1978); J. Ray McDermott v. Hudson, 370 P.2d 364 (Wyo. 1962).

126. N.D. CENT. CODE §§ 57-51-01 to 57-51-03 (Supp. 1987). There is also an oil extraction tax on the gross value of oil. *Id.* § 51.1-01 to 51.1-08.

127. Amerada Hess Corp. v. Conrad, 410 N.W.2d 124 (N.D. 1987).

128. Federal Land Bank of St. Paul v. State, 274 N.W.2d 580, 582 (N.D. 1979).

129. Private Communication, Chief Auditor, Oil and Gas Section, N.D. Tax Dep't. (Sept. 6, 1989). It should be noted that the North Dakota courts have rejected the portion of *Apache* that held the gross value of gas is determined at the time of contract not the time of production. 410 N.W.2d at 128-29. As discussed above, the view of the North Dakota court on this matter is still consistent with allowing the market to determine the gross value of the product. See *supra* text accompanying note 88.

130. New Mexico's ad valorem production tax levies a tax on the actual price received and expressly allows deductions for transportation. N.M. STAT. ANN. § 7-32-2(D) through 5(3) (Supp. 1986). Kansas taxes oil and gas through a real property tax that expressly instructs the assessor to take the need for transportation into account. KAN. STAT. ANN. § 79-331 (Supp. 1987). Kansas also has a severance tax on the gross value of oil and gas. *Id.* 79-4217, 79-4230.

131. *See, e.g.*, N.M. STAT. ANN. § 7-32-6 (Supp. 1986).

The holding in *Atlantic* is at odds with other provisions of the Code and distributes the tax burden rigidly and unfairly. These points, raised by the dissent in *Atlantic*, are supported by the decision in *Apache*.

The *Apache* holding is more equitable, provides flexibility for changing ways of doing business and conforms more closely to the intent of the legislature. Therefore, the holding of *Apache* should be applied uniformly to producers of both gas and oil, and transportation deductions should be allowed in computing the gross production tax on oil.

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