GUIDELINES FOR COMPRESSION AND GATHERING

The attached procedure is the Commission’s guideline for determining the cost incurred in the gathering, compressing and treating of natural gas and casinghead gas, with instructions covering the method of reporting the costs allowed to be deducted.

This procedure shall become effective as of July 1979 production and will remain in effect until such time as the Commission issues formal rules and regulations covering this subject. There will be no refunds allowed on production prior to July 1979 as a result of any such costs incurred prior to that date.

The Commission reserves the right to determine, through audit of your records, the validity of any costs deducted from your gross proceeds and to assess, where applicable, additional tax, penalties and interest.
Beginning with July 1979 production, producers of natural gas and casinghead gas who incur certain non-production related costs in effecting the delivery and sale of their gas may deduct those costs from their gross proceeds when computing the gross proceeds realized subject to gross production and petroleum excise taxes. Allowable gathering and compression expenses paid under the provisions of contracts between producers and purchasers may be deducted as the cost to the producer of gathering, compressing and treating the gas sold by him, subject to adjustment through Commission audit.

Deductions, to be allowed, must meet the following criteria:

1. They shall not include any cost incurred in the production of gas, oil or condensate or in the separation therefrom of any product subject to gross production taxes;
2. Taxes shall be computed on gross proceeds, including tax reimbursement, less the cost of gathering, compressing and treating the gas sold;
3. Costs deducted for computation of gross production and petroleum excise taxes must also be deducted for computation of conservation excise taxes.

Deductions allowed may include:

1. Depreciation of the cost of those facilities used in gathering, compressing and treating the gas that is sold;
   (a) Whenever the same facilities are used for gathering and compressing gas that is sold and gas that is recycled for pressure maintenance, gas lift or other purposes, the cost of those facilities shall be allocated to gas sales and production on the basis of the volume handled for each purpose.
   (b) Whenever the same facilities are used to gather, compress and treat both sales gas and other products subject to gross production tax, the cost of those facilities shall be allocated to gas sales and production on the basis of the value of the products handled;
2. Ad Valorem taxes paid on those facilities;
3. Direct costs incurred in the operation and maintenance of these facilities;
4. Rental of facilities used in gathering, compressing and treating the gas sold;
5. Fees paid to others for performance of the above services.

To facilitate reporting, it will be necessary that tax remitters claiming deductions to report on the OTC Form 300. Producers who intend to take these deductions must submit OTC Forms 320 for each lease affected. The OTC Form 320 shall show the
producer as the taxpayer and shall give the reason for the change. The OTC Forms 320 must be transmitted to the Commission by a letter from the producer which states his intention to begin deducting the costs of gathering, compressing and treating the gas sold and indicating the effective date and contain a list of the OTC Production Unit Numbers upon which such deductions will be claimed.

GROSS VALUE:
Section 1001(b) provides for a tax equal to seven percent (7%) of the gross value of the production of natural gas and/or casinghead gas. Section 1010(b)(5) requires that taxes be reported and paid on the total value at the time and place of production, including any and all premiums paid for the sale thereof. Therefore, tax remitters shall report the gross proceeds of the sale in Section 13 of their reports. Gathering allowances paid by the purchaser, whether separately stated or otherwise, are a part of the gross proceeds. The party remitting the taxes will enter the cost deduction taken for each lease, each month, as Code 9 exemption in Column 23 of his report.

The deduction must be computed on the basis of the cost per MCF of handling the gas sold. The total amount of annual depreciation, ad valorem taxes and other allowed costs for the year divided by the number of MCF handled through the system during that year equals the cost allowed per MCF sold.

Inasmuch as cost deductions are to be reported on a monthly basis during the year the costs are being incurred, estimates of costs should be made as accurately as possible. If the costs reported are within 25% of the actual costs incurred, the amounts reported for the succeeding year may be adjusted upward or downward to compensate for the error. Should the error be more than 25%, amended reports must be made and accompanied by either payment of additional tax, penalty and interest or a claim for refund. Cost deductions and adjustments reported shall never be allowed to result in a minus taxable value nor in a taxable value greater than the gross proceeds. Records of all expenditures must be maintained for examination by the Tax Commission.

Operators of gathering systems who purchase gas from outside producers or report as purchasers of their own production, or both, are reminded of the provisions of Section 1009(f), Title 68, O.S., 1971, “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, character or quality”. If there is no other sale in that field upon which to base the then prevailing price, the Tax Commission may base such price on the then prevailing price being paid in the next nearest field for oil, gas or casinghead gas of like kind, character or quality.

MARKETING COSTS - MARKET VALUE

MARKETING COSTS:

Marketing costs are those costs incurred by the producer to get the gas from the mouth of the well to the market and shall include:

- - Costs for compressing the gas sold.
- - Costs for dehydrating the gas sold.
- Costs for sweetening the gas sold.
- Costs for delivering the gas to the purchaser.

The marketing costs shall be determined by adding together the following:
- Depreciation - A reasonable charge for depreciation of the marketing facility being utilized. If the facility is rented, the actual rent fee shall be used; and
- Operating Expenses –
  (1) Direct or allocated labor associated with the marketing facility;
  (2) Materials, supplies, maintenance, repairs, and fuel associated with the marketing facility;
  (3) Ad Valorem taxes paid on the marketing facility.

ITEMS EXCLUDED:

Marketing costs shall not include:
- Costs incurred in producing the gas;
- Costs incurred in normal lease separation of the oil or condensate;
- Insurance premiums on the marketing facility.

MARKETING FACILITIES:

If the facility is used for purposes other than marketing the gas being sold, then the cost shall be allocated accordingly.

If the facility is handling gas for outside parties, then the average cost for handling all of the gas shall be applied against the facility owner's gas.

"Marketing facilities" includes but is not limited to:
- flow lines or the gathering system from the separator to the purchaser's transmission line;
- compressor stations;
- dehydration units;
- line heaters (after separator);
- sweetening facilities.

NOT INCLUDED IN MARKETING FACILITIES:

The following items are not included as marketing facilities:
- pumping units, tank batteries, lease separators;
- liquid bypass facilities (as used in full well stream);
- meters, unless producer is paid based on that meter, or unless gas is metered through a common meter but producer allocates more than one lease based upon his own meters;
- Christmas trees and down-hole equipment.

MAXIMUMS AND MINIMUMS:

Marketing cost deductions may only be claimed when gas is actually sold, and deductions should only be taken on a lease if sales are made from that lease. Marketing costs claimed cannot exceed gross value received. If costs do exceed the sales value, there is no credit; it should simply be netted out to zero.

MARKETING COSTS - DEPRECIATION

DEFINITION OF DEPRECIATION ACCOUNTING:

Depreciation accounting is a system of accounting which aims to distribute the cost of other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.

SALVAGE VALUE:
A salvage value can be determined based upon the life expectancy of equipment, the type of equipment and the anticipated final disposition of the equipment. Once the life expectancy and salvage value of a system have been determined, depreciation is a relatively simple procedure.

STRAIGHT-LINE DEPRECIATION:

The use of straight-line depreciation is the preferred method. We are not required to accept depreciation procedures approved by IRS audits.

DETERMINING AMOUNT OF DEPRECIATION:

There are two problems in determining the amount of depreciation to allow for marketing cost deductions.

- Establishing the life expectancy, and
- What adjustment should be made to the established life expectancy when material revisions are made to the system.

LIFE OF SYSTEM:

The original estimate of the life of a system should be based upon two factors:

- A reasonable estimate of the actual life of the system should be established, and
- The anticipated life of the field should be ascertained.

DEPRECIATION PERIOD:

The depreciation period should be the shorter of the two factors stated above.

Example: A compressor with an expected life of fifteen years should not be depreciated over the life of the field which might be forty years. On the other hand, should the life of the field be only ten years, it would be best to use a ten-year depreciation period with higher than normal salvage value.

RENTALS:
If the facility is rented, we will allow the actual rental fee in lieu of a depreciation charge.

MARKETING COSTS - OPERATING EXPENSES

OPERATING EXPENSES:

Operating expenses are the direct monthly expenses incurred in marketing the gas. They include such items as:

- Direct or allocation labor associated with the marketing facility, i.e.:
  - portion of pumper's salary
  - workers utilized to hook up compressor, thaw line, do repairs, etc.
  - direct supervision of compressor or gathering line work.
- Materials, supplies, maintenance, repairs, and fuel associated with the marketing facility, i.e.:
  - lubricants
  - repair parts
  - compressor fuel (if reported also as lease use fuel)
  - glycol for dehydrator
- Ad valorem taxes paid on the marketing facility
A reasonable overhead allocation to the marketing facility.

The Audit Division will only allow a deduction of overhead based on the actual direct labor incurred on the exempt facility compared to the total direct labor incurred by the company as a whole. Also remember that for any expense to be deductible, it must be incurred by the producer.