

THOMPSON & KNIGHT LLP
MEMORANDUM

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SUBJECT: NAESB Contract Modification / Texas Severance Tax

SUMMARY OF ISSUE

Texas severance tax is paid by producers on gross receipts (minus certain marketing costs) realized from the sale of natural gas.¹ The Texas severance tax rate is 7.5%.² Producers frequently agree with purchasers that proceeds received by the producer include both the value of the gas and an amount that represents reimbursement by the purchaser for Texas severance taxes payable by the producer. It is important for producers that proceeds attributable to tax reimbursements be excluded from the gross receipts tax base used to compute the amount of Texas severance tax due (otherwise Texas severance tax is artificially assessed as an “income tax” rather than a tax on gross receipts from production). Consider the following simplified example:

Example: \$100 of gross receipts for a gas sale at the Texas severance tax rate of 7.5% yields tax of \$7.50. Tax reimbursement to the producer would yield a total payment to producer of \$107.50. If the tax reimbursement is not ‘backed out’ of the total proceeds received by the producer, Texas severance tax would be artificially inflated at \$8.06 (\$107.50 x 0.075).

This example illustrates the importance that producers’ gas contracts satisfy certain requirements imposed by the Texas Tax Code so that amounts received from purchasers representing tax reimbursements can be excluded from the Texas severance tax base. The North American Energy Standards Board, Inc. (“NAESB”) contract currently being used by EnCana Oil & Gas (USA) Inc. (“EnCana”) does not meet the requirements imposed by the Texas Tax Code. Therefore, EnCana must pay Texas severance tax on a tax base that includes tax reimbursements, which leads to an artificially inflated severance tax liability.

¹ TEX. TAX CODE § 201.101.

² TEX. TAX CODE § 201.052.

OVERVIEW OF LAW

Section 201.102 of the Texas Tax Code provides:

If gas is sold for cash only, the tax shall be computed on the producer's gross cash receipts. Payments from a purchaser of gas to a producer for the purpose of reimbursing the producer for taxes due under this chapter are not part of the gross cash receipts.

Although the face of this statute provides that tax reimbursements are not part of a producer's gross receipts for purposes of computing the amount of severance taxes due, the administrative rules of the Texas Comptroller of Public Accounts ("Comptroller") impose certain contractual requirements that must be satisfied in order for tax reimbursements to be excluded from the severance tax base.³ Comptroller Rule 3.18(c) provides that one of the two following requirements must be satisfied for a producer to exclude a tax reimbursement from the severance tax base:

(1) The amount of the tax reimbursement must be separately stated in the contract, check stub, and/or purchaser statement. For example, the contract might specifically state a price per MCF or MMBTU to be paid to the producer by the purchaser for the gas and state an additional amount to be paid per MCF or MMBTU for severance tax reimbursement; or

(2) **A written contract between the parties must contain an express statement that the payment that the purchase made includes severance tax reimbursement to the producer for tax that is due on the gas.** Contracts or other documents that merely state that "all taxes" are included are not specific enough to establish that the purchaser has made a severance tax reimbursement. The total amount that is shown on such documents will be presumed to be the producer's gross receipts without tax reimbursement. Either party may overcome the presumption by using the purchaser's records to show that severance tax reimbursement was included in the total payment that was made to the producer. When the total price that the purchase paid to the producer includes severance tax reimbursement, the taxable value for that gas is computed by dividing the sum of one plus the tax rate into the sum of the total receipts minus marketing costs.

(Emphasis added.)

³ The Texas Supreme Court has held that valid rules and regulations promulgated by an administrative agency acting within its statutory authority have the force and effect of legislation. *See Lewis v. Jacksonville Building & Loan Assoc.*, 540 S.W.2d 307 (Tex. 1976).

**NAESB CONTRACT DOES NOT SATISFY REQUIREMENTS
OF COMPTROLLER RULE 3.18**

EnCana uses the NAESB Standard Contract 6.31 “Base Contract for Sale and Purchase of Natural Gas” (2002 version) for gas sales. Section 6 of the NAESB Base Contract provides for the allocation of certain taxes. However, neither Section 6 nor any other provision in the NAESB contract meets the requirements of Comptroller Rule 3.18(c). In order to meet the requirements of Comptroller Rule 3.18(c), the NAESB contract would need to be amended. This can be easily accomplished with the addition of very limited language, as discussed in our recommendations below.

RECOMMENDATIONS

1. Alternative 1: Add required language to EXHIBIT A (Transaction Confirmation For Immediate Delivery). For example, on the line setting forth the contract price, insert language stating that “payment made by Buyer includes reimbursement to Seller for Texas severance taxes due on gas sold by Seller to Buyer.”

2. Alternative 2: Build required language into Section 6 of the Base Contract. For example, a provision similar to the following could be added at the end of the current Section 6:

Reimbursement of Certain Severance Taxes. Notwithstanding the foregoing, all payments made by Buyer to Seller includes reimbursement to Seller for Texas severance taxes due on gas sold by Seller to Buyer.

Either of the above additions to the NAESB contract would satisfy the requirements of Comptroller Rule 3.18. Otherwise, the contract does not allow EnCana to exclude tax reimbursements from its tax base in computing the amount of Texas severance tax EnCana must pay. If tax reimbursements cannot be excluded from the tax base, EnCana must pay Texas severance tax on an artificially inflated base amount.

Please call us with any questions.