COLORADO – OIL & GAS

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-- REPORTER –

COURT OF APPEALS RULES THAT RETURN ON INVESTMENT MAY NOT BE DEDUCTED IN CALCULATING SEVERANCE TAXES

In *BP America Production Co. v. Colorado Department of Revenue*, 2013 COA 147, 2013 WL 5947018, the Colorado Court of Appeals ruled that return on investment (ROI) could not be treated as a cost and deducted in calculating total gross income for severance tax purposes. The Colorado severance tax statute defines gross income (on which severance tax is based) as the net amount realized by the taxpayer for the sale of natural gas, calculated on the basis of gross lease revenues minus deductions for "any transportation, manufacturing, and processing costs borne by the taxpayer." 2013 COA 147, ¶ 2 (quoting Colo. Rev. Stat. § 39-29-102(3)(a)).

BP America Production Company (BP) had amended its 2003 and 2004 severance tax returns and sought to deduct ROI costs associated with facilities used for transporting, manufacturing, and processing natural gas. *Id.* ¶ 3. BP's predecessors, Atlantic Richfield Company (ARCO) and Amoco Production Company (Amoco), had developed in the 1980s a method for producing natural gas from coal seams in Colorado. The method was unproven, and transportation and processing companies were unwilling to invest in the method. Thus, "ARCO and Amoco invested in and constructed facilities to transport and process the natural gas produced from the coal seam wells." *Id.* ¶ 4.

The Mineral Audit Section of the Colorado Department of Revenue (Department) "allowed deductions for BP's operating and depreciation costs for the transportation and processing facilities, but did not allow a deduction for ROI." *Id.* ¶ 5. BP requested a hearing and "[t]he hearing officer ruled that ROI is not a transportation or processing cost, but is an 'opportunity cost that reflects the cost of alternatives that were forfeited to pursue a certain action.'" *Id.* ¶ 6. The district court disagreed and granted summary judgment in favor of BP. *Id.* ¶ 8. The Department appealed. The court of appeals agreed with the Department and reversed and remanded the case for entry of judgment in the Department's favor.

The court's discussion of the statute includes a statement that "the term 'costs' is reasonably susceptible of different interpretations" and cites several prior Colorado cases where use of the word "cost" in different phrases had been found to be ambiguous. *Id.* ¶ 15. The court noted that in New Mexico and Wyoming, the regulatory or statutory language clearly allows deduction of a rate of return or ROI, but the Colorado statute does not explicitly provide for a deduction for ROI. *Id.* ¶ 21. The court also cited a publication of the Council of Petroleum Accountants Societies, Inc. (COPAS), the COPAS Severance Tax Guide, as "mak[ing] clear that severance taxes in Colorado should include deductions only for direct costs paid by a taxpayer." *Id.* ¶ 22. Finally, the court relied on rules of construction and found that because "transportation, manufacturing, and processing" precedes the general term "costs" in the statute, "the legislature intended the specific terms to control the general term." *Id.* ¶ 26. The court then found that "only costs incurred directly for the transportation or processing of oil or gas are allowable deductions under the statute." *Id.*

COURT OF APPEALS STATES AN OIL AND GAS LEASE CREATES AN INTEREST IN REAL PROPERTY

Maralex Resources, Inc. v. Chamberlain, 2014 COA 5, 2014 WL 43531, is primarily a case regarding a prescriptive easement. The first issue the court addressed, however, is whether Maralex Resources, Inc. (Maralex), as an oil and gas lessee under several federal oil and gas leases, had standing. The district court in Rio Blanco County had found that Maralex did not have standing to assert the prescriptive easement, based on landlord-tenant common law. 2014 COA 5, ¶ 4. The court of appeals disagreed and found that Maralex had standing. In this portion of the case, the court reviewed numerous authorities, including prior Colorado cases, supporting the conclusion that an oil and gas lessee has an interest in real property. The court concluded that an oil and gas lessee has a legally protected property interest in the mineral estate covered by the leases. *Id.* ¶ 18.

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-- GUEST REPORTERS --

NEW COGCC SPILL AND RELEASE REPORTING REQUIREMENTS UNDER RULES 337 AND 906

Effective February 1, 2014, operators are subject to new Colorado Oil and Gas Conservation Commission (COGCC) spill and release reporting requirements under COGCC Rules 337 and 906. The new Rules, which implement the newly enacted Colo. Rev. Stat. § 34-60-130, shorten the spill/release reporting deadlines, lower the reporting thresholds, and add additional notice requirements. On December 17, 2013, the COGCC voted to adopt the COGCC staff's draft amendments to Rules 337 and 906, with certain modifications, including the adoption of an industry recommendation to extend the Form 19 submission requirement from 48 hours to 72 hours, as described below. This report will refer to the newly adopted Rules as the "Amended Rule(s)."

Rule 337 Amended to Cover E&P Waste and Produced Fluids

Amended Rule 337 provides: "A spill or release of E&P waste or produced fluids shall be reported to the Director on a Spill/Release Report, Form 19 pursuant to the reporting requirements in Rule 906."

The prior version of Rule 337 provided: "All spills and releases of E&P waste exceeding five (5) barrels shall be reported on a Spill/Release Report, Form 19. Form 19 shall be filed with the Director pursuant to the reporting requirements in Rule 906."

While Amended Rule 337 removed the reference to a five barrel threshold to trigger the Form 19 reporting requirement, as discussed below, Amended Rule 906.b has lowered the Form 19 threshold to one barrel where the spill/release is outside the berms or other secondary containment.

Note that Amended Rule 337 applies to "E&P waste," which is a term defined by the Colorado legislature and adopted by the COGCC in its Rules, see Colo. Rev. Stat. § 34-60-103(4.5), and "produced fluids." The additional language "or produced fluids" is intended to cover any and all liquids produced from a well including releases of oil, condensate, or natural gas liquids under the theory that if a produced product is spilled, it becomes waste. *See* COGCC, "Statement of Basis, Specific Statutory Authority, and Purpose—New Rules and Amendments to Current Rules of the Colorado Oil and Gas Conservation Commission, 2 CCR 404-1," at 5 (Dec. 20, 2013).

Rule 906 Amended to Shorten Spill/Release Reporting Deadlines, Lower Reporting Thresholds, and Increase Notice Requirements

Reporting Deadlines. Amended Rule 906 requires that *all* spills/releases that meet the criteria set forth in Rule 906.b.(1)A–C be immediately reported, *verbally or in writing*, to the Director within 24 hours of discovery (the "Initial Report"). The previous Rule 906 required 24-hour verbal reporting to the Director only if the spill/release exceeded 20 barrels or impacted or threatened to impact any waters of the state, residences or occupied structures, livestock, or public byways. Amended Rule 906 lowers the volume threshold for 24-hour reporting, distinguishes between spills/releases within or outside secondary containment, and implements a 72-hour Form 19 reporting requirement. Note that the 24-hour reporting requirement for spills/releases of any size that impact or threaten to impact waters of the state, a residence or occupied structure, livestock, or public byway remains unchanged. *See* Rule 906.b.(1).

Reporting Thresholds. Amended Rule 906.b.(1) requires that a spill/release be reported, *verbally or in writing*, to the Director within 24 hours of discovery, if the spill/release:

(1) "[I]mpacts or threatens to impact any waters of the state, a residence or occupied structure, livestock, or public byway";

(2) Consists of one barrel or more of E&P waste or produced fluids *outside* of berms or other secondary containment; or

(3) Consists of five barrels or more of E&P waste or produced fluids regardless of whether the spill or release is completely contained within berms or other secondary containment.

Initial Report Requirements. If a spill/release meets the above criteria, the Initial Report to the Director, either *verbally or in writing*, must include, at minimum:

(1) The location of the spill/release; and

(2) Any information available to the operator about the type and volume of waste involved.

See Amended Rule 906.b.(1).

Submittal of Form 19 Not Later Than 72 Hours. An operator may elect to make its Initial Report to the Director on Form 19, which is being converted to an eForm that can be updated as additional information becomes available to an operator concerning the spill/release. *See* Amended Rule 906.b.(1). If, however, the Initial Report is verbal or not made on Form 19, "the Operator must submit a Form 19 with the Initial Report information as soon as practicable but not later than *72 hours* after discovery of the spill/release unless extended by the Director." Amended Rule 906.b.(1). COGCC staff proposed a 48-hour deadline to file a Form 19. However, the COGCC, after industry representatives expressed concerns over the 48-hour deadline, adopted the industry's proposed 72-hour reporting period.

Notification to Local Government Within 24 Hours. Amended Rule 906.b.(2) added an additional notice requirement to local government for spills/releases that fall under Amended Rule 906.b.(1)A or B, which are: (1) spills/releases of any size that impact or threaten to impact any waters of the state, residences or occupied structures, livestock, or public byways; or (2) spills/releases of one barrel or more that are outside of the berm or other secondary containment. Operators are now required to provide *verbal or written* notice of the spill/release within 24

hours after discovery to the entity with jurisdiction over emergency response. The notice must include, at minimum, the same information contained in the Initial Report to the Director. If the spill/release occurred within a municipality, the notice should be made to the appropriate municipal agency with emergency response jurisdiction. If the spill/release occurred outside of a municipality, the notice should be made to the respective county.

Notification to Surface Owner Within 24 Hours. Amended Rule 906.b.(3) modified the surface owner notice of spill/release requirement under the previous Rule 906.c. Like the local government notification requirement, the 24-hour surface owner notice requirement only applies to spills/releases that fall under Amended Rule 906.b.(1)A or B. *Verbal* notice to a surface owner or the surface owner's appointed tenant is sufficient. If the surface owner cannot be contacted within 24 hours, the operator is required to continue good faith efforts to reach the surface owner until notice has been provided. The notice must include, at minimum, the same information contained in the Initial Report to the Director.

Supplemental Report. The previous version of Rule 906.b.(5) required an operator to submit a Form 19 within 10 days after discovery of any reportable spill and required the inclusion of an 8.5" x 11" topographical map showing the governmental section and location of the spill. The operator was also required to include information related to initial mitigation, site investigation, and remediation. Amended Rule 906.b.(1) requires the operator to submit a *supplemental report* on Form 19 within 10 days after the spill/release is discovered. The supplemental report is to include the same information as required under the previous Rule; however, the operator may submit either a topographical map *or an aerial photograph* identifying the spill/release, and the operator is required to submit any pertinent information about the spill/release that was not previously reported.

Remediation Shall Not Be Unreasonably Delayed. Amended Rule 906.c.(2), which amends, in part, previous Rule 906.c., requires that an operator make good faith efforts to notify and consult with the surface owner, or the surface owner's appointed tenant, before commencing operations to remediate a spill/release in an area *not* being used for oil and gas operations. If, however, remediation has been approved by the Director, such efforts shall not unreasonably delay commencement of remediation.