Agency # 006.05

RULE 2008-4: NATURAL GAS SEVERANCE TAX RULES

Pursuant to the authority granted by Ark. Code Ann. §§ 26-18-301 and 26-58-129, the Director of the Arkansas Department of Finance and Administration promulgates the following rules for the purpose of facilitating compliance with the Act 4 of the First Extraordinary Session of 2008 (the Act to Increase the Severance Tax Rate on Natural Gas) and to facilitate the administration, enforcement, and collection of the tax.

NG-1. EFFECTIVE DATE:

These rules shall be effective from and after January 1, 2009.

NG-2. PURPOSE OF RULES:

The following rules are promulgated to implement and clarify Title 26, Chapter 58 of the Arkansas Code as it relates to severance tax levied upon natural gas production. All persons affected by or relying upon these rules are advised to read them in their entirety because the meaning of the provisions of one rule may depend upon the provisions contained in another rule.

NG-3. DEFINITIONS:

For purposes of these rules, unless otherwise required by their context, the following definitions apply:

A. The term “Director” means the Director of the Department of Finance and Administration or any of his or her duly appointed deputies or agents.

B. The terms “Completion” or “Completed” means the act of making a well capable of producing gas.

C. “Date of First Production”, when used in reference to a particular gas well, means the first day in the month that the gas well produces natural gas for sale.

D. “High-cost Gas Well” means any gas well that is completed as a well capable of producing high-cost gas.

E. “Marginal Gas Well” means any gas well that produces or is capable of producing marginal gas, as determined by the Director of the Oil and Gas Commission using the current wellhead deliverability rate methodology utilized by the Oil and Gas Commission.

F. “Market Value” means the producer’s actual cash receipts from the sale of natural gas to the first purchaser less the actual costs to the producer of dehydrating, treating, compressing, and delivering the gas to the first purchaser.

G. “New Discovery Gas Well” means any conventional gas well that is completed as a well capable of producing gas.

H. 1. The term “Payout” means the date the cumulative working interest revenues from a high-cost gas well equal the sum of:

a. All reasonable and necessary drilling and completion costs incurred in connection with the high-cost gas well; and

b. All reasonable and necessary operating costs incurred or accrued in connection with the operation of the high-cost gas well during the period of cost recovery.

2. In calculating allowable “Payout”, the following definitions shall apply:

a. “Drilling and Completion Costs” shall mean all reasonable and necessary drilling and completion costs incurred and paid by the cumulative working interests in connection with the high-cost gas well.

b. “Operating Costs” shall mean all reasonable and necessary operating costs incurred or accrued by the cumulative working interests during the period of cost recovery.

3. In calculating allowable “Payout”, drilling, completion, and operating costs shall not include lease acquisition costs, tank batteries, meters, pipelines, or other external equipment.

I. The term “Producer” means any person, firm, receiver, or other fiduciary, corporation, or association, who or which engages in the business of severing natural gas.

J. The term “Purchaser” means any person, firm, receiver, or other fiduciary, corporation, or association, consignor, agent, or other dealer, by whatever name called, who or which acquires title outright or conditionally to any interest in severed natural gas.

K. The terms “Sever”, “Severed”, or “Severing” mean natural gas taken or removed for commercial purposes from the soil or water. However, “Sever”, “Severed”, or “Severing” as defined in this rule do not apply to any natural gas returned to any formation, in recycling, repressuring, pressure maintenance operation, or other operation, for the production of oil or any other liquid hydrocarbon. Further, "Sever", "Severed", or "Severing" as defined in this rule do not apply to any hydrocarbons in gaseous or liquid form which are burned, used, consumed, or otherwise employed in oil and gas operations including but not limited to, secondary recovery operations and fuel for engines in the same leasehold, drilling, or production unit, or unit area of a unitized reservoir from which such hydrocarbons are produced.

L. The term "Transporter" means any person, firm, receiver, or other fiduciary, corporation, or association, who or which transports severed natural gas to any point within, across, or out of the State of Arkansas.

M. "Tight Gas Formation" means any natural gas bearing formation that:

1. Has previously been determined by Oil and Gas Commission orders or field rules to be a low permeability formation, including:

   a. Booneville and Chismville-OR# 84-2003-07;

   b. Gragg-OR# 89-2004-07;

   c. Waveland-OR# 86-2007-07;

   d. Rich Mountain-OR# 304-2006-09;

   e. Mansfield-OR# 28-2003-03; and

   f. Witcherville and Excelsior-OR# 103-2005-07; or

2. Is determined by the Director of the Oil and Gas Commission to have an estimated in situ permeability of one-tenth milliDarcy (0.1 mD) or less; or

3. Is determined to be a tight gas formation by field rules, general rules, or orders issued by the Director of the Oil and Gas Commission.

N. The term "Well" means a hole or shaft dug or drilled to obtain natural gas and includes production from all zones and multilateral branches without regard to whether the production is separately metered.

Source: Ark. Code Ann. § 26-58-101.

NG-4. DETERMINATION OF MARKET VALUE AND MARKETING COSTS:

A. Producers of natural gas who incur marketing costs of the gas produced may deduct such costs from the actual cash receipts when computing the market value subject to the severance tax.

B. Marketing costs are reasonable and necessary non-production costs incurred by the producer to enable the transport of gas from the well to the first purchaser, including:

1. Costs for compressing the gas sold to the first purchaser;
2. Costs for dehydrating the gas sold to the first purchaser;
3. Costs for treating the gas sold to the first purchaser;
4. Costs for delivering the gas sold to the first purchaser.

Marketing costs do not include:

1. Costs incurred in producing the gas;
2. Costs incurred in normal lease separation of the oil, gas, or condensate; or
3. Insurance premiums on the marketing facility.

C. Marketing facilities include but are not limited to flow lines or gathering systems from the separator to the purchaser's transmission line, compressor stations, dehydration units, line heaters (after the separator) and treating facilities.

D. Marketing costs are determined by adding:

1. Charges for depreciation of the marketing facility being used, provided that, if the facility is rented, the actual rental fee is added.

2. Costs of direct or allocated labor associated with the marketing facility.

3. Costs of materials, supplies, maintenance, repairs, and fuel associated with the marketing facility.

4. Ad valorem taxes paid on the marketing facility.

E. Marketing cost deductions from actual cash receipts from production may only be claimed when gas is actually sold. Marketing costs claimed cannot exceed actual cash receipts from production received. If marketing costs do exceed the actual cash receipts from production received, there is no credit or carryover and the market value should be reported as zero for that month.

F. Whether a cost is deductible or not will often depend upon exactly how the item is used. If the cost is deductible, it must then be determined whether the item should be expensed or depreciated.

1. Depreciation shall be determined by subtracting the salvage value from the purchase price and dividing the difference by the number of years of useful life.

   Example of calculation:

Purchase price	$	100,000
Minus salvage value	$	10,000
Equals	$	90,000
Divided by useful life		÷ 10
Equals depreciation per year	$	9,000

2. Ten years useful life and a depreciation rate of 10% per year are normally used. However, a different term can be used if the situation warrants, based upon documentation in the taxpayer's records. Useful life must be the lesser of the expected life of the equipment, or the life of the field. Straight line depreciation is the preferred and recommended depreciation method. If another method is used, the taxpayer should be ready to support why that particular method is appropriate for the situation.

NG-5. CATEGORIES OF NATURAL GAS AND CLASSIFICATION OF NATURAL GAS WELLS:

A. Conventional Gas: The term "Conventional Gas Well" means any gas well that is not classified by the Director of the Arkansas Oil and Gas Commission as a high-cost gas well, new discovery, or marginal gas well.

B. "High-cost gas" means natural gas that is:

1. Produced from any gas well completed within a shale formation, including, but not limited to, the Fayetteville Shale, the Woodford Shale, the Moorefield Shale and the Chattanooga Shale Formations, or their stratigraphic equivalents, as described in published stratigraphic nomenclature recognized by the Arkansas Geological Survey;

2. Produced from any gas well in which the production is from a completion that is located at a depth of more than 12,500 feet below the surface of the earth, where the term "depth" means the length of the maximum continuous drilling string of drill pipe used between the drill bit face and the drilling rig's kelly bushing.

3. Produced from a tight gas formation;

4. Produced from geopressured brine; or

5. Occluded natural gas produced from coal seams.

C. Types of Marginal Gas:

1. "Marginal Conventional Well Gas" means all natural gas produced from a conventional gas well beginning on the date the conventional gas well is

incapable of producing more than 250 Mcf per day, as determined by the Director of the Arkansas Oil and Gas Commission using the current wellhead deliverability rate methodology utilized by the Oil and Gas Commission, during the calendar month for which the severance tax report is filed.

2. "Marginal High-Cost Well Gas" means all natural gas produced from a high-cost gas well beginning on the date the high-cost gas well is incapable of producing more than 100 Mcf per day, as determined by the Director of the Oil and Gas Commission using the current wellhead deliverability rate methodology utilized by the Oil and Gas Commission, during the calendar month for which the severance tax report is filed.

3. The term "Marginal Gas" shall include production from all zones and multilateral branches at a single well without regard to whether the production is separately metered.

4. "Marginal Gas" shall not include gas produced from:

   i. A high-cost gas well during the thirty-six (36) month period provided in NG-7.C.1;

   ii. A high-cost gas well during any allowed extension provided in NG-7.C.2; or

   iii. A new discovery gas well during the twenty four (24) month period provided in NG-7.B.

D. "New Discovery Gas" means natural gas that is produced from a new discovery gas well and is eligible for the twenty-four (24) month reduced severance tax rate of NG-7.B.

Source: Ark. Code Ann. § 26-58-101.

NG-6. AMOUNT AND NATURE OF TAX:

A. On and after January 1, 2009, the severance tax rate levied on natural gas production is the following percent of market value of the natural gas severed within the State of Arkansas:

1. One and one-half percent (1.5%) on new discovery gas for the time period provided in NG-7.B;

2. One and one-half percent (1.5%) on high-cost gas for the time periods provided in NG-7.C;

3. One and one-quarter percent (1.25%) on marginal gas; and

4. Five percent (5%) on all natural gas which is not defined as new discovery gas or marginal gas.

5. Five percent (5%) on high-cost gas following the cost recovery period(s) of NG-7.C., as applicable.

NG-7. COST RECOVERY PERIODS:

A. Election of Cost Recovery Periods for New Discovery Gas and High-Cost Gas:

For each natural gas well, a producer may only once obtain certification from the Director of the Oil and Gas Commission to pay the reduced severance tax rates for new discovery gas or high-cost gas. Following the conclusion of the cost recovery periods of NG-7.B.1. or NG-7.C.1., a producer may request certification to pay the reduced severance tax rate for marginal gas.

Example i. A producer completes a well in a shale formation and the well is certified by the Director of the Oil and Gas Commission as a high-cost well. The producer is permitted to pay the reduced severance tax rate of NG-6.A.2. for high-cost gas. The producer's high-cost gas reduced severance tax period expires, and the producer is able to obtain natural gas production in the same well but in a new formation. The producer may not request certification to pay at the reduced severance tax rates for new discovery gas or high-cost gas. The producer may request certification to pay at the reduced severance tax rate for marginal gas.

Example ii. A producer completes a well that is certified by the Director of the Oil and Gas Commission as a new discovery gas well and is permitted to pay the reduced severance tax rate of NG-6.A.1. The producer's new discovery gas reduced severance tax period expires, and the producer is able to obtain natural gas production in the same well but in a shale formation. The producer may not request certification to pay at the reduced severance tax rates for new discovery gas or high-cost gas. The producer may request certification to pay at the reduced severance tax rate for marginal gas.

B. New Discovery Gas:

1. The one and one-half percent (1.5%) severance tax rate on new discovery gas shall apply to the first twenty-four (24) consecutive calendar months beginning on the date of first production from the new discovery gas well, regardless of whether production commenced prior to January 1, 2009; provided, however, that all production attributable to the period prior to January 1, 2009 shall be taxed at the rate in effect prior to January 1, 2009.

2. At the end of the twenty-four (24) month period, the severance tax rate under NG-6.A.3. or NG-6.A.4., as applicable, shall apply.

C. High-Cost Gas:

1. The one and one-half percent (1.5%) severance tax rate on high-cost gas shall apply to the first thirty-six (36) consecutive calendar months beginning on the date of first production from the high-cost gas well, regardless of whether production commenced prior to January 1, 2009; provided, however, that all production attributable to the period prior to January 1, 2009 shall be taxed at the rate in effect prior to January 1, 2009.

2. If a high-cost gas well has not achieved payout by the end of the thirty-six (36) month period, the one and one-half percent (1.5%) severance tax rate of NG-6.B.2. may be extended until the earlier to occur of:

   a. Payout of the high-cost well; or

   b. Twelve (12) months following the expiration of the original thirty-six (36) month period.

3. In order to request an extension of the thirty-six (36) month high-cost gas cost recovery period, a producer of a high-cost well shall furnish the Director an initial payout statement, in a form to be prescribed by the Director, setting forth the following:

   i. The producer’s cumulative costs of drilling and completing the high-cost well.

   ii. The producer’s cumulative costs of operating the high-cost well through the end of the last month of the payout period reflected on the initial payout statement.

   iii. The total volume of gas production from the high-cost well through the end of the last month of the payout period reflected on the initial payout statement.

   iv. The total actual cash receipts received from the production of natural gas from the high-cost well through the end of the last month of the payout period reflected on the initial payout statement.

4. a. For each high-cost well a producer has requested an extension of the thirty-six (36) month high-cost gas recovery period, the producer shall furnish a monthly payout statement to the Director within twenty-five (25) days after the end of the month in which

the producer filed his or her request for extension as well as in each successive months until the earlier of either of the following occurs:

i. Payout of the high-cost well; or

ii. Twelve (12) months following the expiration of the original thirty-six (36) month period.

b. The producer's monthly payout statement shall be in a form to be prescribed by the Director and set forth the following:

i. The producer's operating costs incurred for the high-cost well during the month.

ii. The producer's cumulative cost of operating the high-cost well through the end of the last month reflected on the monthly payout statement.

iii. The volume of gas production from the high-cost well during the month.

iv. The actual cash receipts received from production from the high-cost well during the month.

v. The remaining dollar amount needed to achieve payout for the high-cost well.

5. At the later of the expiration of the thirty-six (36) month period of NG-7.B.1. or any allowed extension of NG-7.B.2, the severance tax rate of NG-6.A.3. or NG-6.A.4., as applicable, shall apply to high-cost gas.

Source: Ark. Code Ann. § 26-58-127.

NG-8. DETERMINATION OF NEW DISCOVERY GAS, HIGH-COST GAS OR MARGINAL GAS:

A. The producer of a proposed or existing gas well may apply, at any time, to the Director of the Oil and Gas Commission for determination that the well qualifies as a new discovery gas well, a high-cost gas well, or a marginal gas well.

B. The Director of the Oil and Gas Commission may require an applicant to provide any information required to administer this rule.

C. The Director of the Oil and Gas Commission shall make the determination within fifteen (15) calendar days of the application by the producer and the producer shall attach the determination to its severance tax form next due.

Source: Ark. Code Ann. § 26-58-128.

NG-9. APPORTIONMENT OF SEVERANCE TAX BETWEEN ROYALTY OWNER AND PRODUCER:

The portion of the severance tax that is required to be deducted from the royalty owner or other interest shall be calculated in the same manner as the portion of the severance tax borne by the producer.

Source: Ark. Code Ann. § 26-58-129.

NG-10. MONTHLY REPORTS AND PAYMENT OF TAX:

A. Each producer of natural gas within twenty-five (25) days after the end of each month, whether or not he or she shall have actually severed natural gas during the preceding month, shall file with the Director a report setting forth, in a form to be prescribed by the Director, the natural gas, if any, severed by such producer or processed or acquired for processing by such primary processor during the next preceding month, the point of severance thereof, the gross quantity so severed and the market value thereof, the amount of severance tax due, and such other information as the director may reasonably require for the proper enforcement of the provisions of this subchapter.

B. The report shall be verified by the producer or primary processor himself in the instance of an individual producer or primary processor and by a member or officer or the manager of the producer or primary processor in all other instances.

C. The payment of the full amount of the severance tax appearing to be due from the report shall accompany the report.

D. Within ten (10) days after any producer or primary processor shall have ceased operation with the intention of no longer engaging in the business of severing or processing natural gas, the permit theretofore issued shall be returned by him to the Director for cancellation; but any such producer or processor whose permit shall have been so canceled may engage in such business upon the filing of a new application with and the issuance of a new permit by the Director.

E. Any producer or primary processor who shall fail to comply with the provisions of this section shall be guilty of a misdemeanor and upon conviction shall be fined not less than one hundred dollars ($100) nor more than five hundred dollars ($500) for each such offense; and the willful false swearing as to the contents of any such report shall constitute perjury and shall be punishable as such.

F. Except as otherwise provided in these rules, the monthly report shall be filed and the payment of the severance tax shall be made by the producer actually severing the natural resources whether as owner, lessee, concessionaire, or contractor.

G. The reporting taxpayer shall collect or withhold out of the proceeds of the sale of the natural gas severed the proportionate parts of the total severance tax due by the respective owners of the natural gas at the time of severance.

H. Every producer actually operating any natural gas well is authorized, empowered, and required to deduct the amount of the severance tax in respect thereto from any such royalty or other interest before making the direct payment.

I. Notwithstanding the sale or delivery, all severed natural gas sold or delivered to any pipeline company for transportation by it through pipes connected with the natural gas well of the owner is subject to the severance tax on the severed natural gas.

Source: Ark. Code Ann. §§ 26-58-114 and 26-58-115.

Issue Date: ______________________________

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