Opinion No. 67-122

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BY: OPINION OF BOSTON E. WITT, Attorney General

TO: Mrs. Pepita Jeffus Director Oil and Gas Accounting Commission Santa Fe, New Mexico

QUESTION

FACTS

In 1961 the Oil Conservation Commission issued a nonflare order for the Cha Cha Gallup and Simpson Gallup pools. This order forced operators to either shut in their Gallup oil production or provide facilities for marketing gas.

The pressure of the gas is not sufficient to meet the purchaser's pipeline pressure and therefore before the gas can be marketed it must be repressurized. Pan American Petroleum Corporation is the major operator in the area and El Paso Natural Gas Company is the major purchaser of the gas. A compressor manufacturer, Knight Engineering Company, operated a pipeline system in the area. Knight Engineering formed a company, Jalou Gas Company, to operate the pipeline system and Jalou has contracted with Pan American for the purchase of the gas and with El Paso Natural Gas for its sale. Under the terms of the contract with Pan American, Jalou was to pay Pan American 40-90%, depending on volume, of the price which Jalou receives from El Paso Natural for the gas. This amount was later renegotiated by letter agreement so that now Jalou pays Pan American only 10% of the price it receives from El Paso Natural Gas. All of the above facts were taken from the materials submitted with the opinion request.

QUESTIONS

1. Do the contracts establish a value from which the State of New Mexico can levy taxes under Sections 72-19-4, 72-20-4, 72-21-4 and 72-22-4, N.M.S.A., 1953 Compilation?

2. Does the letter agreement amend the contracts to establish a new value from which the State can levy its taxes?

CONCLUSIONS

1. See analysis.

2. See analysis.

OPINION

*{*186}* **ANALYSIS**

We understand the economic aspects of the problem as follows: The resources in the Cha Cha Gallup and Simpson Gallup pools will probably be depleted in a very few years. Pan American is faced with either constructing its own pipelines which can be used for two or three years or contracting with Jalou which already has pipelines and compressors in the area. Evidently Pan American has determined that it would be more costly to provide its own transportation than to subsidize Jalou in order to market the gas. The legal question is whether New Mexico must lose tax dollars because of this arrangement between Pan American and Jalou since taxes are usually levied on the value received for the products at the production unit. To determine this issue, we will look to the Oil and Gas Severance Tax Act.

*{*187}* Section 72-19-4, N.M.S.A., 1953 Compilation provides that the Oil and Gas Acocunting Commission shall collect a tax of 2 1/2% of the taxable value of all oil, natural gas or liquid hydrocarbon products which are severed and sold. Section 72-19-5, N.M.S.A., 1953 Compilation sets forth the method of determining taxable value as follows:

"To determine the taxable value there shall be deducted from the value of products:

A. Royalties paid or due the United States or the state of New Mexico;

B. Royalties paid or due any Indian tribe, Indian pueblo or Indian that is a ward of the United States of America;

C. The reasonable expense of trucking any product from the production unit to the first place of market."

Finally "value" is defined in Section 72-19-2 D, N.M.S.A., 1953 Compilation as follows:

"D. 'Value' means the actual price received for products at the production unit, except as otherwise provided herein;"

Thus we see that the contract price between Pan American and Jalou will be controlling in determining taxable value, unless there is an exception in the Oil and Gas Severance Tax Act. The exceptions are found in Section 72-19-6, N.M.S.A., 1953 Compilation which provides as follows:

"The commission may determine the value of products severed from a production unit when:

A. The operator and purchaser are affiliated persons; or when

B. The sale and purchase of products is not an arm's length transaction; or when

C. Products are severed and removed from a production unit and a value as defined in this act is not established for such products.

The value determined by the commission shall be commensurate with the actual price received for products of like quality, character and use which are severed in the same field or area."

The only question then is whether the Oil and Gas Accounting Commission can determine the value of the products severed under authority of Section 72-19-6, supra. To determine this, we must look to each instance when the commission is allowed to set value.

First of all the commission may determine the value of products severed if the operator and purchaser are "affiliated persons." Webster's New International Dictionary, Second Edition, Unabridged, states that to affiliate is to band together by stock ownership, lease or permanent agreement. In **Hernandez v. Charles Ilfeld Co.,** 66 F.2d 236,293 (10th Cir., 1933 it was held that in the ordinary case:

". . . [A]n affiliation commences with the acquisition of a corporation from owners outside the group [and] ends with a disposal of all its properties or its stock to those outside the group."

Finally in **Col-Tex Refining Co. v. Railroad Comm'n of Texas,** 240 S.W. .2d 747 (1951) it was held that a simple purchase contract between an oil producer and an oil refinery where neither the purchaser nor the seller had the right to nor exercised control over the other, did not make the purchaser and seller affiliated companies. We therefore must conclude that under the facts, as presented to this office, Pan American and Jalou cannot be considered by the commission *{*188}* as affiliated companies under Section 72-19-6, supra, for purposes of determining value of the products severed.

Subsection B of Section 72-19-6, supra, provides that the Oil and Gas Accounting Commission may determine value if the sale and purchase of products is not an arm's length transaction. "An arm's length transaction is one which compares favorably with the usual course of action taken in the conduct of business with trade generally." **Marcum v. Kentucky & Indiana Terminal Railroad,** 363 S.W. 2d 98, 100 (Ky., 1962). The phrase arm's length transaction has been equated with "fair market value" when used in the tax area. See **Inecto, Inc. v. Higgins,** 21 F. Supp. 418 (D.C.N.Y., 1937). "'Fair market value' is theoretically what a willing seller would take and a willing buyer offer." **Board of Com'rs of Dona Ana County v. Gardner,** 57 N.M. 478, 485, 260 P.2d 682 (1953). Sales are not made at fair market value when they are affected by an element which does not enter into similar transactions made in the ordinary course of business. It is our opinion from the facts submitted with the opinion request that the amended contract between Jalou and Pan American probably is not a contract between a willing seller and a willing buyer. The contract entered into was apparently forced upon the parties through a peculiar economic situation and the consideration paid to Pan American by Jalou does not necessarily reflect the value of the gas at the

production unit. If the Oil and Gas Accounting Commission finds that there is an element in the contract between Pan American and Jalou which does not ordinarily enter into similar transactions of this type in the ordinary course of business, we believe that it is proper for the commission to conclude that this contract is not an arm's length transaction. If the commission finds that the fair market value is not being charged for the gas by Pan American then the commission may determine a value commensurate with the actual price received for products of like quality, character and use severed from the same field or area.

Last of all the commission may determine value if there is no value established. See Section 72-19-6 C, supra. Since "value" is defined as the actual price received, it is clear that a value has been established in the present case and therefore the commission may not set a value for the severed products under subsection C of Section 72-19-6, supra.

Your second question asks if the letter agreement between Pan American Petroleum Corporation and Jalou Gas Company amends the earlier contracts between these companies and establishes a new value from which the State can levy its taxes? If the individuals signing this letter agreement had the power to bind the respective companies for which they signed, this agreement amends the earlier contracts of the parties. However, as pointed out above, the commission need not look at this amendment to the contract as setting "value" if the commission finds that the amendment was not entered into between a willing buyer and willing seller.

Since the statutory formula used in the determination of value is the same under the Oil and Gas Severance Tax Act, Oil and Gas Conservation Tax Act, Oil and Gas Emergency School Tax Act and the Oil and Gas Ad Valorem Production Tax Act, it will not be necessary to discuss these acts individually. The same reasons that lead us to the conclusion that the amended agreement between Pan American and Jalou may not be an arm's length transaction is applicable under these acts.

By: Gary O'Dowd

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