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Person to Contact:

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Refer Reply To:
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Date:
March 26, 1999

Legend :

A = .
B =
C =
D =
E =
F =
G =
H =
i =
j =

Dear :

In a letter dated you requested a ruling under Section 613A of the Internal Revenue Code. We understand the facts to be as follows.

A is a diversified energy holding company. A files a consolidated federal income tax return for the affiliated group of which it is the common parent (the "A Group"); the members of the A Group include A, B, C, D, E and others.

D is a corporation wholly owned by C . C and B are wholly owned by A.

F is a limited partnership owned i percent by D and j percent by an unrelated corporation.

G is a limited partnership owned i percent by C and j percent by E, a corporation wholly owned by C .

A is a holding company engaged in, *inter alia*, (i) exploration for and production of oil and natural gas through B and its subsidiaries, (ii) natural gas and electricity marketing and services through C and its subsidiaries, and (iii) natural gas pipeline transmission through other subsidiaries. D is primarily engaged in the distribution and sale for resale of natural gas and related services.

Several years ago, B and D entered into a series of gas purchase and sale contracts and other contracts under which D acquired the sole and exclusive right and obligation to market 100% of the gas attributable to B's gross working interests and market group share from a substantial number of the wells owned or controlled by B, including after-acquired wells. The commitments of these contracts exclude B's wells which are subject to existing area or sales dedication, or which, in certain circumstances, are not operated by B, or which produce oil or liquids. The production which is not sold by D is sold to persons unrelated to B and B has no knowledge of or control over what happens after it is sold. D sells the gas purchased from B and others into the stream of commerce to multiple purchasers and has no knowledge of, or control over, what happens to the gas after it is sold.

D and a corporation unrelated to D or other members of the A Group, entered into a natural gas services and marketing partnership called F. D contributed a substantial part of its assets and liabilities, including its contracts with B, to F in return for a i percent partnership interest therein. F also provides risk management services to B in exchange for specified fees.

The primary business activity of F has, since its formation, been the making of bulk sales of natural gas to interruptible industrial and large commercial users in the K United States including the State of H . F has traditionally delivered gas to the user's facilities, or if the user is served by a local distribution company, to the facilities of such distribution company, using a combination of released firm capacity and interruptible capacity on interstate pipelines serving H . During periods when gas usage is at peak, interruptible transportation capacity is generally unavailable and F must depend on generally available released firm capacity.

Pursuant to recently enacted legislation providing for the deregulation of the sale of natural gas to "firm retail" gas customers in H , a local distribution company has filed an election to unbundle its services to retail customers and to exit the merchant function so that these customers may purchase their gas requirements from gas marketers. The distribution company's firm retail customers in H are comprised of residential users and small commercial users. As a result of this process, the distribution company will be required to transfer to marketers its activity of selling gas to residential and commercial users, and to allocate its intrastate and interstate transportation capacity to such marketers based upon peak requirements of the firm residential and firm commercial customers to be served by the marketers. Because F does not make sales of the type to be included in the capacity allocation calculus, it will be required to obtain transportation and storage capacity on the distribution company's system through the secondary market for "excess" capacity. This lack of a guaranteed transportation capacity puts F at a competitive disadvantage, because it is not clear that the "excess" capacity needed by F will be available through the secondary market.

In order to ensure that F has adequate transportation capacity to serve its customers, it is proposed that a newly formed, wholly owned affiliate of C ("Newco") would become a certificated marketer in H . In order to qualify as a certificated marketer in H , Newco would be required to meet certain credit requirements of the H Public Service Commission. Newco would meet these requirements by obtaining a corporate guarantee of its financial obligations from A.

Following certification, Newco would make sales to some of the firm retail customers currently served by the distribution company. As a result of undertaking such sales, Newco would receive a guaranteed allocation of transportation and storage capacity on the distribution company's system. Because such allotment would be based on peak demands, it is likely that Newco would have capacity allotments in excess of that actually needed at any one time. Newco would make available to F , at the secondary market rate for such capacity, this "excess" capacity.

Newco would not purchase gas from B, F , or any person related to either, and F would have no ownership interest in Newco. Newco may have, however, excess gas supply at one time or another and may sell this excess gas supply to F at an arms-length market price. Additionally, Newco may have to utilize certain systems and employees of B, F or E in order to begin its initial operations. Newco would pay the providing company an amount equal to the fair market value of these services.

The designed purpose of the Proposed Transactions would be to assure that F can obtain transportation capacity necessary to continue to serve its existing industrial and large commercial markets without having to become a retailer. It is not known whether a thriving secondary market for excess capacity will materialize, but in the event that it does, the obtaining of capacity from Newco may prove to have been unnecessary. Nevertheless, the proposed solution affords the certainty that, without regard to the development of such a market, F will have adequate transportation capacity available to it.

Ignoring any effects of the Proposed Transactions described above, (i) B qualifies as an "independent producer" for purposes of Section 613A(c) of the Code

and is not subject to treatment as an integrated oil company for purposes of Section 291(b)(1)(A) of the Code, and (ii) neither B, C , D or F are "retailers" described in Section 613A(d)(2) of the Code.

You have requested a ruling that the Proposed Transactions, as described above, will not cause B to fail to qualify as an "independent producer" for purposes of Section 613A(c) of the Code, or to be subject to treatment as an integrated oil company for purposes of Section 291(b)(1)(A) of the Code.

Section 291(b)(1)(A) of the Code provides that the amount allowable as a deduction for any taxable year under Section 263(c) in the case of an integrated oil company (relating to the allowance in certain circumstances of the deduction of certain intangible drilling and development costs) shall be reduced by 30 percent. Section 291(b)(4) provides that, for purposes of Section 291(b), the term "integrated oil company" means, with respect to any taxable year, any producer of crude oil to whom subsection (c) of Section 613A does not apply by reason of paragraph (2) or (4) of Section 613A(d).

Section 611(a) provides the general rule that there will be allowed as a deduction in computing taxable income a reasonable allowance for depletion in the case of mines, oil and gas wells, other natural deposits, and timber. Section 613(a) provides, in the case of specified mines, wells and other natural deposits, for a depletion allowance equal to a percentage of the gross income from the property (excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property).

Section 613A(a) provides that except as otherwise provided for in Section 613A, the allowance for depletion under Section 611 with respect to any oil or gas well is to be computed without regard to Section 613. Section 613A(c), as one exception to Section 613A(a), provides that percentage depletion will be allowed to independent producers with respect to limited quantities (depletable quantities) of domestic crude oil or natural gas production, except as provided in Section 613A(d).

Section 613A(d)(2) provides that Section 613A(c) is not to apply to any taxpayer who directly, or through a related person, sells oil or natural gas (excluding bulk sales of such items to commercial or industrial users), or any product derived from oil or natural gas (excluding bulk sales of aviation fuels to the Department of Defense),

> (A) through any retail outlet operated by the taxpayer or a related person; or
>
> (B) to any person (i) obligated under an agreement or contract with the taxpayer or a related person to use a trade mark, trade name, or service mark or name owned by such a taxpayer or related persons, in marketing or distributing oil or natural gas or any product derived from oil or natural gas, or (ii) given authority, pursuant to an agreement or contract with the taxpayer or a related person, to occupy any retail outlet owned, leased, or

in any way controlled by the taxpayer or a related person.

Section 613A(d)(2) further provides that the foregoing rule is inapplicable in any case where the combined gross receipts from the sales of such oil, natural gas or products derived therefrom for the taxable year, from all retail outlets taken into account for this purpose, do not exceed $5,000,000.

Section 613A(d)(3) provides that for purposes of Section 613A(d), a person is a related person with respect to the taxpayer if a significant ownership interest (in the case of a corporation, 5 percent or more in value of the outstanding stock) in either the taxpayer or such person is held by the other, or if a third person has a significant ownership interest in both the taxpayer and such person.

Section 613A(d)(4) provides that Section 613A(c) shall not apply to any taxpayer who directly, or through a related person, refines crude oil if on any day during the taxable year the refinery runs of the taxpayer and such person exceed 50,000 barrels.

Section 613A(c)(8)(A) provides that, for purposes of Section 613A(c), persons who are members of the same controlled group of corporations are to be treated as one taxpayer. Under Section 613A(c)(8), members of a controlled group of corporations are treated as a single taxpayer *only for purposes of Section 613A(c)*. Thus, members of a controlled group of corporations are *not* treated as a single taxpayer for purposes of the definition of “retailer” contained in Section 613A(d)(2).

Section 1.613A-7(r)(2)(ii) contains rules under which a taxpayer may be deemed to be selling oil, natural gas, or a product derived therefrom through a related person or through a related person’s retail outlets:

> “[A] taxpayer shall be deemed to be selling oil or natural gas (or a product derived therefrom) through a related person in any case in which any sale of oil or natural gas (or a derivative product) by the related person produces gross income from which the taxpayer may benefit by reason of the taxpayer’s direct or indirect ownership interest in the related person. . . . A taxpayer shall be deemed to be selling oil or natural gas (or a derivative product) through a retail outlet operated by a related person in any case in which a related person who operates a retail outlet acquires for resale oil or natural gas (or a derivative product) which the taxpayer produced or caused to be made available for acquisition by the related person pursuant to an arrangement whereby some or all of the taxpayer’s production is marketed. . . .”

In Revue Ruling 85-12, 1985-1 C.B. 181, a wholly owned subsidiary of a holding corporation produced oil and gas that it sold at or near the wellhead to unrelated parties. Another wholly-owned subsidiary of the same holding corporation was a retailer of petroleum or petroleum products it purchased from unrelated parties, selling more than $5,000,000 annually to end users. The holding corporation filed a consolidated return with its subsidiaries. The revenue ruling concludes that the producer subsidiary had no direct or indirect ownership interest in the retailer subsidiary, and, thus, did not benefit from the retail sales. Although the two subsidiaries were related persons for purposes of Section 613A(d), none of the producing subsidiary's production was, in form or substance, sold through the retailing subsidiary. Thus, the producer subsidiary was not precluded from taking the percentage depletion deduction as provided in Section 613A(c) or from being treated as an independent producer for purposes of the former windfall profit tax.

Under the foregoing rules, if F were to become a retailer, B would also become a retailer because of the sales of its production to F . However, as illustrated by Rev. Rul. 85-12, the fact that a related person to F is a retailer does not operate to taint F as a retailer provided that F does not sell any production to such person and is not the owner of any interest in such person.

Following the Proposed Transactions, Newco's activities will result in it being treated as a retailer. Also, Newco will be a related person both to B and to F . However, because neither B nor F will own, directly or indirectly, any interest in Newco, Newco's retailer status does not taint B as a retailer so long as neither B nor F sells oil, natural gas or derivative products to, or causes such items to be made available to, Newco.

Section 1.613A-7(r)(2)(ii) of the regulations deems production to be sold through a related person in certain cases where the taxpayer may benefit from the retail sales of the related person. In this case neither B nor D have any knowledge of or control of the their oil or gas after its sale. Newco will purchase natural gas from numerous suppliers and has no knowledge of or control of the source of the gas. Section 1.613A-7(r)(2) of the regulations circumscribes the type of benefits which may work a tainting of the recipient to those resulting from either (i) direct or indirect sales to, or (ii) direct or indirect ownership interest in, a related retailer. Neither of these criteria are present in this case.

For the foregoing reasons, the formation and operation of Newco, as described in the Proposed Transactions, will not cause B to fail to qualify as an "independent producer" for purposes of Section 613A(c) of the Code, or to be subject to treatment as an integrated oil company for purposes of Section 291(b)(1)(A) of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. A copy of this ruling should be attached to your tax return filed for the year in which the transaction covered by this ruling was consummated. A copy is enclosed for this purpose.

Sincerely yours,
Assistant Chief Counsel (Passthroughs
and Special Industries)

By ______________
Joseph H. Makurath
Senior Technician Reviewer
Branch 7